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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/73

10:00 a.m., May 11, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	C. Enoch
Dai Q.	
	E. L. Walker, Temporary
	A. Rieffel, Temporary
	J. Prader
	E. V. Feldman
	M. Hepp, Temporary
M. Finaish	
	B. Goos
J. E. Ismael	J. Reddy
	J. R. N. Almeida, Temporary
M. Massé	
	D. Saha, Temporary
	I. A. Al-Assaf
	L. Filardo
J. Ovi	
H. Ploix	G. Pineau, Temporary
G. A. Posthumus	
	C.-Y. Lim
	I. Sliper, Temporary
	O. Kabbaj
	A. A. Agah, Temporary
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	S. Yoshikuni
	S. Rebecchini, Temporary
	S. Appetiti, Temporary

L. Van Houtven, Secretary and Counsellor
R. Gaster, Assistant

Also Present

Asian Department: P. R. Narvekar, Director; K. A. Al-Eyd. S. P. O. Itam, R. J. Hides, S. N'guiamba, W. M. Tilakaratna. Exchange and Trade Relations Department: H. B. Junz, Deputy Director; L. M. Valdivieso. External Relations Department: B. J. Mauprivez. Fiscal Affairs Department: P. S. Heller. Legal Department: F. P. Gianviti, General Counsel; R. H. Munzberg, Deputy General Counsel; H. Elizalde, P. L. Francotte, A. O. Liuksila. Treasurer's Department: F. G. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; D. Berthet, J. E. Blalock, D. H. Brown, W. L. Coats, Jr., M. L. Peery, G. Wittich. Advisors to Executive Directors: M. B. Chatah, W. N. Engert, P. Kapetanović, K.-H. Kleine, M. Pétursson. Assistants to Executive Directors: N. Adachi, F. E. R. Alfiler, H. S. Binay, R. Comotto, Di W., B. Fuleihan, J. Gold, A. Iljas, S. King, K. Kpetigo, M. A. Kyhlberg, V. K. Malhotra, T. Morita, J. A. K. Munthali, D. V. Nhien, W. K. Parmena, G. Seyler, C. C. A. van den Berg, R. Wenzel.

1. VALUATION OF LATE PAYMENTS - REVIEW OF PROCEDURES

The Executive Directors considered a staff paper on the review of procedures applied to the valuation of late payments to the Fund (EBS/88/16, 1/29/88).

The Deputy Treasurer said that late payments had begun in 1981 with delays of only a few days. Since then the extent of late payments had increased very sharply. The staff had developed two operational guidelines in handling late payments, which had been explained to the Executive Board in 1984. If changes in the exchange rate in terms of the SDR caused shortfalls or overpayments relative to the payments to be made on the due date that were less than SDR 5,000, the difference was waived, unless the member requested reimbursement, in keeping with an old Fund tradition of not picking up small administrative shortfalls or overpayments. The second procedure involved keeping the exchange rate constant for up to 10 days to account for late payments that were due to technical delays, many of which occurred because members were using the commercial banking system to effect payments to the Fund, and that system was often inexperienced in dealing with the Fund. In order to avoid any incentive to delay a payment, if there was a shortfall in excess of SDR 5,000, the member concerned would be asked to pay for the shortfall; if, however, there was an overpayment as a result of changes in the exchange rate, that would normally not be returned.

In late 1986, an issue had arisen from a late payment which had resulted in an overpayment of some considerable size--SDR 250,000--resulting from an exchange rate appreciation, the Deputy Treasurer continued. The Executive Director concerned had asked that the overpayment be returned, and that the calculation be made on the basis of the exchange rate three business days before the payment was made, not the date on which the payment was due. As the payment was late by seven or eight days, the staff had not, in accordance with the guidelines, changed the exchange rate, and there was technically no overpayment to the Fund resulting from the windfall appreciation of the exchange rate since the rate had been fixed on its due date and not subsequently changed.

A number of Executive Directors, including those from the United States, Germany, and the United Kingdom, had then asked for a review of the late payment procedures, the Deputy Treasurer recalled.

The guidelines for handling late payments had in practice worked very satisfactorily, the Deputy Treasurer concluded. He also noted that the number of late payments that were essentially administrative had now risen to many hundreds. Keeping the exchange rates steady for up to ten days had worked satisfactorily, particularly in avoiding any incentive for late payments.

Mr. Kabbaj said that he thanked the staff for the concise paper, although he failed to understand why its preparation had taken more than a year. The question of the evaluation of late payments had arisen on the occasion of late payments by Morocco during a brief period in 1986. The Moroccan authorities had drawn attention to the asymmetry resulting from the Fund's treatment of such payments. The asymmetry involved imposing adjustments in cases where that would favor the Fund, and of not compensating for adjustments when they favored the member country. The Moroccan authorities had further remarked that such an accounting practice had no legal basis, as the Executive Board had never taken a formal decision to the effect.

The Board had had a long discussion on the subject on December 16, 1986, Mr. Kabbaj observed. The staff had explained that the policy had been included in a staff paper on overdue obligations and had been implicitly endorsed by the Executive Board, the rationale being to penalize member countries paying late. The Moroccan authorities had submitted that since the time that Morocco had joined the Fund, there had been no instances of financial matters having been decided without formal decisions by the Executive Board. Moreover, the Chairman's summing up of the Board meeting at which the staff paper on overdue obligations had been taken up did not explicitly endorse the staff's particular suggestion on the valuation of late payments.

The Board had taken an interim decision regarding Morocco's case, and had asked the staff to prepare a paper dealing with the general case, Mr. Kabbaj noted. The paper currently before the Board did not, in the view of the Moroccan authorities, satisfactorily address the legal issue raised, and still retained the original weak rationale for the policy being implemented. The problem faced by Morocco should not be repeated, and he urged Executive Directors to reaffirm the principle that no financial matter should be decided without a proper decision by the Board. The Fund was, after all, a cooperative institution, and member countries should be able to retain full confidence in its financial policies. Those policies should not be changed by indirect means of which the Board could not be aware.

He agreed with the staff, Mr. Kabbaj continued, "that there should be no exceptions from the valuation procedures when payments are made later than their due date," and "that valuation on the basis of exchange rates in effect three business days before the actual value date of the transaction should apply to all operations and transactions, including those that are made after the scheduled valued dates." That was the normal procedure consistent with the Articles, relevant decisions, and rules and regulations of the Fund. Regarding implementation, he added that he could go along with the staff proposal contained in paragraph 9 of EBS/88/16, including the proposal on retroactivity.

Mr. Massé said that his authorities believed the present valuation approach to be, in practice, appropriate, for the reasons advanced by the staff. Indeed, given those arguments, his authorities were somewhat surprised by the staff's proposed changes.

There was certainly an asymmetry involved in the present approach since exchange rate gains on late payments were retained by the Fund while late paying members were required to cover exchange rate losses, Mr. Massé noted. Nevertheless, in addition to the desirability of ensuring that a member using SDRs receive the expected amount, and the desirability of avoiding shortfalls in the Fund's investment program, the present valuation approach presented the appropriate incentive structure to avoid delayed payments. Consequently, his authorities preferred to retain the existing approach.

Mr. Ismael stated that he supported the staff recommendation that the three-business-day rule be applied to the valuation of all payments, including those that were delayed. While the proposed uniform procedure would expose the Fund to some exchange risk, which the present exceptions to the general rule had averted, he was satisfied with the staff assurance that the risk would be minimized by careful evaluation of maturing obligations, so that prior investment of the proceeds of payments falling due would be made only when there appeared to be no doubt about such payments being received on time. Under the new rule, the manner of distributing the cost of late payments relating to SDR transactions would be left to the mutual agreement of the parties involved, or would be decided by customary market practices. He supported the staff argument that that development would enhance the general acceptance of the SDR as a reserve asset. Although the staff suggestion that the new rule be made retroactive to October 1986 would involve more work for the Fund and for the relevant member countries, he nevertheless supported, in principle, that recommendation.

Mr. Enoch noted that the existing system was designed so that countries would be unable to benefit from any windfall gains that might accrue as a result of exchange rate fluctuations during delays in completing a transaction. If exchange rates moved against countries in such situations, they were asked to provide appropriate compensation. There was, therefore, no incentive to accumulate short-term arrears. Those arrangements were eminently sensible, and were consistent with Fund policies concerning arrears. They ensured that the Fund was compensated for the cost of countries' running arrears, and the Fund system of special charges was also based on that principle. The modifications now being proposed would create a situation in which countries would have an incentive to delay payments by a few days beyond the due date, if they expected the relative exchange rates to move in their favor during that period. He found no very convincing reasons in the staff paper to justify that change, as the proposal was made essentially by assertion, rather than as a result of any clear criticisms of the existing practices. It seemed strange to make such a modification at a time when the arrears problem was having a serious effect on the Fund's finances. Moreover, insofar as a member making a late payment might gain from that delay, there would, of course, be a counterpart loss, which would have to be made up from the accounts of the Fund. He did not see why that potential additional burden should be imposed on the Fund's accounts.

The SDR 5,000 criterion below which adjustments would not be made was rather high, Mr. Enoch continued. The staff had recognized that problem by proposing to reduce the cutoff to SDR 500. He endorsed that reduction, but would otherwise wish to retain the existing practices.

Mr. Almeida said that transactions between the Fund and the member should take place on the scheduled value dates on the basis of well-established applications of the procedural rules, including the three-business-day valuation rule. While he appreciated the rationale for exceptional procedures relating to the application of those rules especially in cases of small underpayments, the asymmetry in the application of the procedures needed to be resolved. While an exchange rate advantage was disallowed, the same member was expected to make up any exchange losses resulting from a depreciation of its currency. He therefore supported the staff proposal to introduce a procedure under which the three-business-day rule would be applied to all payments, including delayed payments, that would settle all overdue obligations of the member, subject to the adjustment being not less than SDR 500.

His authorities could go along with the other proposals in paragraph 9 of the staff paper, but they saw no rationale for making those changes retroactive to October 1986, Mr. Almeida concluded.

Mr. Saha observed that current procedures did not permit refunds to members when payments were made later than the due date, and when the currencies used in the transactions had appreciated in the meantime. However, when the currencies depreciated adjustments were made and the member was called upon to make up the shortfall. As the staff had explained, the reason was to discourage member countries from trying to take advantage of expected currency appreciations by delaying payments.

As far as countries in his constituency were concerned, payment delays might occur not as a result of speculative intentions but mainly because of communication and administration difficulties, Mr. Saha continued. He supported the staff proposal that payments should be refunded when currencies used in the transactions appreciated, and he went along with the staff proposal that the change should be made retroactive to October 1986. However, since the Fund had comprehensive records of such past transactions, the burden of identifying transactions for claims should not be shifted to member countries. He also preferred that the Fund take the initiative in advising member countries of such possible refunds.

Mr. Pineau remarked that like some other speakers, he had some difficulties with the staff's basic proposal. By applying the three-business-day rule to all late payments, the Fund would follow a simple evaluation procedure in line with past practices. That method would also allow excess and shortfall adjustment payments to be made symmetrically. Nevertheless, that approach could give rise to expectations of windfall gains, thereby affecting the timing of payments. To avoid such disincentives to timely payments, he preferred to adhere to the principle that adjustments should not be made when they resulted in a windfall profit for the member.

The limit of SDR 500 seemed too low as a new floor under which adjustments would not be made, Mr. Pineau commented. That level could imply considerable additional work for the staff, and significantly higher administrative costs. He saw no compelling reason why the present de minimis limit of SDR 5,000 could not be retained, but suggested that a compromise could perhaps be found between the two.

Mr. Appetiti said that he could not support the proposed decision. His authorities believed that being in arrears, whether for several months or a few days, should in no circumstance benefit the country concerned. Nor should any incentive be given to countries to delay payments. Discontinuing the exception to the three-business-day rule that currently disallowed exchange rate windfalls would actually introduce such an incentive. Also, in adopting the proposed alternative procedures, the Fund could also face some inappropriate exchange rate risk.

His authorities had additional reasons for opposing the proposal to make the change retroactive to October 1986, as that would be costly to the Fund and could give rise to unfair practices, Mr. Appetiti concluded.

Mr. Abdallah said that his authorities supported the staff proposal, but considered that the three-business-day rule should be applied to all payments to the Fund, including delayed payments. There was considerable merit in the transparency of rules governing valuation of payments, and transparency could have helped to avoid the confusion that had occurred with respect to the late payments by Morocco. The Moroccan authorities were correct to question the asymmetry in the procedure. The exception to the three-business-day rule, which was designed to remove incentives for members to take advantage of exchange rate appreciations, created a measure of uncertainty in the application of procedures for the valuation of payments. In any event, since almost all transactions, particularly those involving payment to the Fund, were governed by agreements, the exception to the rule appeared to have been inappropriate. The staff had indicated that in adopting the proposed amendment to the rules governing the valuation of late payments, the Fund could bear some risk relating to currency exposure with respect to investments. That risk appeared small and rather remote. However, the staff paper also indicated that if such cost were incurred, the rate of charge could be adjusted taking into account all relevant factors, including the overall financial position of the Fund. He hoped that that possibility never became a reality.

The staff had also noted the cost that could be incurred through uniform application of the three-business-day rule with respect to voluntary transfers, Mr. Abdallah continued. In such situations, the distribution of costs arising out of late payments should be left to the parties concerned. A further review would, however, be appropriate if a solution was sought that promoted the quality of the SDR as a reserve asset.

Making the changes retroactive to October 1986 seemed reasonable, Mr. Abdallah concluded. The implied payments that might be due to members could be quite high, and could involve new budgetary allocations. It would also be an enormous task to trace all transactions to the time when the rule became operational.

Mr. Prader remarked that although his authorities had no particularly strong view on the different methods of valuation of late payments to the Fund, they favored the present procedure, which seemed to have worked satisfactorily. One of the basic proposed changes was that the new rule would no longer, under certain circumstances, offer an incentive for prompt payment. As many members were often a few days late in their payments, the application of a strict three-business-day rule would increase administrative work considerably. Nevertheless, his authorities could support a change in the rule if a majority of Executive Directors favored such a change. His authorities could not, however, support a reduction in the de minimis limit for collecting shortfall or overpayments. Nor could they support making the change retroactive. Such steps involved a risk of unnecessarily increasing the already high administrative cost to the Fund. It might also be difficult to explain to his authorities that they would have to recalculate transactions with the Fund for the past several years.

Mr. Goos said that he endorsed Mr. Prader's views. He also preferred to maintain the existing procedure, and having listened to the Deputy Treasurer, he was reassured that the procedure had worked satisfactorily so far. Thus, he saw no need for a change.

Mrs. Hepp commented that her authorities could generally go along with the proposals presented in paragraph 9 of the staff paper. The more general application of the three-business-day rule to all payments, including delayed payments, was a positive step. In addition, the reduction in the de minimis limit for collecting shortfalls from SDR 5,000 to SDR 500 seemed appropriate.

Her authorities also supported making the adjustment retroactive to October 1986, the date on which the issue had first been raised, Mrs. Hepp remarked. However, the retroactive revision should be based on claims by the member country identifying in each case the transaction and the amount involved. The new de minimis limit of SDR 500 should also be applied to those retroactive transactions.

Mr. Al-Assaf stated that the present method of valuation should be maintained. He did not believe that the Fund should treat the member that paid on time the same as a member that delayed payment in the expectation of a more favorable exchange rate.

Given the existing arrears situation in the Fund, no incentive should be given to a member to delay payment, Mr. Al-Assaf continued. It was also inequitable for a member using SDRs to receive a smaller amount of currency than it was entitled to and at a later date. Like Mr. Abdallah, he would be interested to see a staff paper dealing with voluntary transfers of SDRs among participants and prescribed holders. That paper could deal with the effect of those transfers on the SDR as a reserve asset. In addition, he did not wish to see an increase in the prospects of a capital loss in the Special Disbursement Account, a reduction in the assets available to eligible members, or an increase in the cost to the Borrowed Resources Suspense Account.

Given those points, the present practice of not refunding amounts to a late paying member, when the currency value had appreciated against the SDR, was appropriate, Mr. Al-Assaf concluded. However, he had an open mind on the amount that was judged not to be cost effective for adjustments of small underpayments that arose because of delays.

Mr. Posthumus said that he wondered why the staff had produced its proposal, when the Deputy Treasurer had stated that the existing procedures were working well. While one or two Directors had complained about existing procedures, he did not recall that the whole Board had done so.

The staff paper raised more questions than it answered, Mr. Posthumus remarked. Perhaps the Board should look again at the three-business-day rule, which might now be archaic. He also did not understand why members that used the SDR apparently now had to carry the risk that another member would not pay on time. That might not be a good way to make the SDR more widely acceptable as a reserve asset. Nor did he understand how members that delayed their payments could know the direction of future exchange rate movements. If late payments were so attractive, why did the Fund use the asymmetrical rule to discourage members from making late payments rather than simply increasing the charge? The reason why October 1986 had been chosen as the date against which to make payments retroactive remained unclear. The staff proposal seemed likely to incur considerable costs for the Fund and was not really necessary. Thus, he had many reasons for not agreeing to the proposal.

Mr. Sliper observed that he had some difficulty in understanding the rationale for changing the current procedures. Given the cost of creating the wrong incentives and also the question of image at a time of growing arrears, it would be unwise to change those procedures. His authorities therefore considered that the existing procedures should be maintained.

Mr. Ovi remarked that he saw no good case for changing the existing practices, which seemed to be working satisfactorily.

The staff paper discussed the possible implications of valuations of late payments in three areas: Fund investments, incentives, and SDR transactions, Mr. Ovi noted. With respect to investment, while he saw the point of a change in procedures, that area was certainly not a decisively important one. On incentives, there should certainly be an incentive for members to pay on time. If the existing asymmetry was discontinued, another incentive would have to be created--perhaps a fee of some sort. On SDR transactions, he failed to understand why--and indeed found unacceptable that--delays in payment by a member of the SDR counterpart should imply that the user of SDRs was taking on some exchange risks, a point that applied whether the transaction was under designation or voluntary.

Like several other speakers, he had difficulties in understanding parts of the paper, in particular paragraph 7, Mr. Ovi commented. While the staff had observed that the absence of rules might lead to more use of customary market practices, and that that might contribute to the quality of the SDR, he thought that the arguments rather ran the other way. In addition, the burden on the staff was quite sufficient. Thus, no new paper on those aspects of the SDR was warranted. In conclusion, he saw no case for changing the existing practices.

Mrs. Walker said that she sympathized with the problem as it related to members that made late payments owing to technical difficulties beyond their control. However, on balance, her authorities believed that it was important not to provide any incentive for late payments to the Fund, and it did appear that the proposed changes tended to go in the direction of providing some possible incentive for late payments. In addition, the proposed retroactive character of the change appeared exceedingly complex. Thus, her authorities preferred to maintain the present procedures.

Mr. Adachi noted that his authorities shared the view expressed, inter alia, by Mr. Massé and Mr. Enoch, and preferred to maintain the present practice. They were, however, prepared to go along with the majority of Executive Directors. In any event, his authorities did not support a retroactive adjustment which would require time and resources on the part of both the Fund and member countries.

Mr. Fernando said that the issue was whether the Fund should continue its existing practice, based on the need to eliminate the potential tendency for members to derive windfall gains, or whether the Fund should recognize the complexities arising from floating exchange rates and the delays caused by agents who had to respond to foreign exchange transactions with the Fund initiated by Fund members. Delays in many instances could also be ascribed to administrative and legal problems in member countries; for instance, appropriations sometimes required prior legislative action. He therefore supported the proposed changes, including the symmetrical treatment of depreciation and appreciation set out in paragraph 9 of the staff paper, although he did not favor any retroactive adjustment.

Mr. Chatah noted that his authorities would have been prepared to support the staff proposal, but the majority of the Board clearly favored maintaining the present practice. He had thought that the main reason for the staff proposal was that the current practice was unusual for financial transactions, and also for legal reasons. Neither explanation seemed completely apparent from the staff paper, and he wondered whether the staff could explain why the proposals had been made, and whether the current practice involved any legal difficulties.

The Deputy Treasurer stated that the staff did not intend to come forward with a further paper on SDRs. If, however, the Board went along with the suggestions in paragraph 9 of the staff paper, the staff would apply the same procedure, and would make it a requirement, for members entering into a voluntary transaction in SDRs. That could be done administratively and would provide a consistent and coherent system of valuation for all late payments in SDRs.

The staff had come forward with a paper because it had been pressed to do so by the Board, the Deputy Treasurer continued. The staff had done so somewhat reluctantly, because present procedures were working well, but those procedures had undoubtedly raised questions in the minds of some Executive Directors. The particular proposal under discussion had been presented because the staff was anxious that any system adopted should be applicable to all types of late payments, and there were a considerable number of different types of late payments with which the staff had to contend. Rather than tailoring some transactions to some rules rather than to others, the only acceptable uniform system would be a post hoc system, in which the exchange rate was determined three business days after the transaction had been made. That system would at least ensure that the proper amount of the currency would be determined in terms of the SDR on the date that the payment itself was made. Any other proposal could lead to a considerable number of types of adjustments. The proposal before the Executive Board could at least be administered uniformly, and would achieve its main aim of maintaining the currency amount exactly in terms of the SDR, despite the fact that the payment would be late.

The staff was examining the three-business-day rule, the Deputy Treasurer noted. The rule was archaic in the sense that the speed of transactions in the market was increasing. On the other hand, central banks had some attachment to the three-business-day rule as they often needed time to manage their investments and to disinvest so as to make conversions when their currency was sold by the Fund. Historically, the Fund had begun with a two-business-day rule, and had moved to three business days under pressure from various central banks, partly because two days in the United States amounted to only one day working in Europe. The staff did plan to come to the Board on that matter, and expected to shorten the current three-business-day rule in some SDR transactions.

Members could not know when the exchange rate would move in their favor, as Mr. Posthumus had noted, and the staff had not put its proposals forward in the expectation that members would try to use the exchange rate to their benefit, the Deputy Treasurer remarked. The problem was that under current rules, if the exchange rate did move against a member, that member had to pick up the cost. If the Fund moved to the post hoc system, that incentive to make early payments would be removed.

Mr. Goos said that he too saw little need for an additional staff paper on the matter of late payments in the context of voluntary SDR transactions.

Mr. Kabbaj recalled that he had raised a general point concerning the legality of applying rules in financial matters without an explicit decision of the Board. While the Board seemed to favor maintaining the existing procedure, that decision would be taken today, and would be a formal decision, which would not refute the validity of his original point.

As the rules had not been applied in a proper and legal manner, the countries that had been subjected to the procedure without rules should not be penalized, Mr. Kabbaj continued. Morocco had incurred those late payments exceptionally for a very short period, and because at the same time in 1986 it had incurred net repurchases of 100 percent of quota, the amount involved had been small in comparison. It was, however, a question of principle, one that seriously affected the cooperative character of the Fund. Even commercial banks adjusted for exchange rate changes when there were mistakes, or delays. It appeared as though the Fund was constantly seeking a tighter and tighter regime, as for instance during the recent discussion of burden sharing. Sharp differences had now emerged between creditors and debtors. And while everyone understood the varied interests of those groups, a succession of decisions that placed the entire burden on debtor countries would be counterproductive, and would constitute no incentive for those countries which sought to discharge their obligations to the Fund and to other creditors. They could even be discouraged from continuing to do so.

The Deputy Treasurer said that it was the staff's uniform experience that commercial banks did not provide compensation for exchange rate changes. They only compensated for interest losses, and that loss was often a small proportion of the effect of exchange rate changes incurred during delays in the transmission of payments.

The General Counsel said that Mr. Kabbaj had raised the question of whether the decision taken that day would affect past transactions and operations, or would only apply in the future. There were two elements to that problem. First, there had been an ongoing practice in the Fund, one that had been in place for several years and that had been discussed by the Board at EBM/84/54, although he agreed with Mr. Kabbaj that there had been no clear decision or explicit answer when the practice described in the staff paper under discussion had been mentioned at that Board meeting. At the end of 1986, the question had been raised in connection with late payments by Morocco. It had been decided that the problem would be taken up later by the Board, and it would, in fact, be resolved at the present meeting. Therefore, the Board was in the same situation as a court deciding on a case that had been pending for years or months. And the general rule in such cases was that the decision was declaratory, that it applied retroactively to the facts that had given rise to the dispute. He therefore concluded that the Board's decision would apply to those past payments which were the subject matter of the controversy, and that the decision would therefore have a retroactive effect.

Mr. Kabbaj said that despite the General Counsel's clarifications, it was still clear that no proper decision had been taken in 1984. In addition, the Fund was not a court; the decision could not automatically apply retroactively.

The central banks that were making payments to the Fund also had auditors and supervisory authorities, and the Fund would have to take that into account when imposing decisions, Mr. Kabbaj continued. He did not see how the Central Bank of Morocco could justify paying US$200,000 to the Fund without any decision to show the basis on which that payment was made. While the rule was mentioned in a staff paper, a large number of staff papers came before the Board, and the rule in question had not been explicitly approved by the Board. In his summing up of EBM/84/54, the Chairman had drawn attention to the points raised by all Executive Directors, but had not mentioned that point at all.

Mr. Al-Assaf asked if the staff could explain how receptive prescribed holders were to the idea of voluntary settlement of late payments among themselves, how large an incidence of late payments existed, and the effects of late payments on the acceptability of SDRs.

The staff representative from the Treasurer's Department observed that with regard to transactions with designation, cases of late payments were very rare indeed.

With regard to voluntary transactions for which late payments were relatively few, the market practice was to hold the exchange rate constant so that if there was a delay of a few days, compensation would occur through an interest rate adjustment and not through adjustment of the exchange rate, the staff representative added. The Fund's existing practice--under which the exchange rate was held constant--was in accordance with market practice, and therefore worked well for voluntary transactions. Should the Board decide to change the valuation practice so that all transactions, including SDR transactions, would be valued on a three-business-day basis, the staff would have to work out arrangements between the transferers of SDRs that would effectively compensate for the exchange rate differences, because under Fund rules the exchange rate would shift whereas the market practice was to hold the exchange rate constant. Determination of the compensation system would be left to the staff for an administrative solution.

The Acting Chairman then made the following concluding remarks:

The Executive Directors have reviewed and endorsed the procedures that are currently applied for the valuation of currencies paid to the Fund later than the due date of the obligation involved. These procedures are outlined in the text below (based on paragraphs 2 and 3 from EBS/88/16 (1/29/88)).

The valuation of currencies in terms of the SDR in the Fund, including the valuation of the Fund's holdings of members's currencies for the purpose of maintenance-of-value obligations by members, is governed by Article V, Section 10(b) and Section 11 and Article XIX, Section 7(a). The general rule of valuation is that members should receive the same value in terms of SDRs on a particular day whatever currencies might be provided by any particular member. For the implementation of this general system of valuation, the Executive Board in 1977 adopted Decision No. 5590, and the O and P Rules. Decision No. 5590 prescribes that the exchange rate used in operations and transactions between the Fund's General Resources Account and members shall be the rate as of three business days before the value date of the operation or transaction. If that rate cannot be used, the rate of the closest preceding day that is practical is used. The O and P Rules apply to other operations and transactions, and generally provide for the valuation of currencies in terms of SDRs based on the three-business-day rule. In voluntary transactions involving transfers of currencies against SDRs, members may agree to use the applicable exchange rate two business days before the value date (rather than the normal three business days).

The system of valuation is based on the assumption that payments to the Fund are made when due. It is presumed that operations and transactions will take place on the intended or scheduled value dates, and the Fund normally issues its instructions three business days before that date. "Business days" mean business days of the Fund. However, business days in the country whose currency is being used in the transaction and the country that is a party to the transaction are also taken into account, e.g., to avoid a value date falling on a holiday of a member that is party to the transaction or to ensure that adequate notice is given. (In valuations after the fact, because of late payments, three business days always mean business days of the Fund.) The procedures for valuing currencies in the General Resources Account are also used when payments to the various accounts in the Fund (including the Trust Fund and the Administered Accounts) are made later than the scheduled or advised value dates. The responsibility for completing payments to the Fund rests with the member, and any losses arising from negligence or delays by agents for a member would need to be resolved between the member and its agent. The Fund has assisted in resolving difficulties arising from late payments by commercial banks although instructions had been given on a timely basis by the member concerned, but on the understanding that responsibility to ensure timely payment rests with the member. In such cases, the amounts of currencies necessary to discharge given SDR obligations are adjusted on the basis of exchange rates three business days before the date of receipt. However, in the practice followed by the staff there have been two exceptions to this general rule, which were described in "Overdue Payments to the Fund - Experience and Procedures" (EBS/84/46, 3/9/84). 1/ The reasons for these exceptions are twofold and relate (i) to administrative costs and (ii) to the distribution of exchange risks.

(i) First, in order to avoid administrative costs both for member countries and for the Fund, no adjustments (for shortfalls) are collected for small underpayments that arise because of delays unless a member that issues the currency being used indicates that the adjustment should be made irrespective of costs. The size of adjustments that might be considered not to be cost effective is a matter of judgment; in the past, it had been set at SDR 5,000.

(ii) Second, payment instructions are not revoked if a late payment is expected to be completed within a short period of time (ten business days in practice). If no payment is received within ten business days, instructions are considered revoked, and new instructions are issued when a new payment date is indicated by the member then in arrears. If payment is made by a member without seeking the Fund's instructions, the procedure is to value on the basis of the three-business-day rule. In these circumstances, an adjustment is made and new or supplementary instructions are issued when the currency used in the transaction has depreciated, but no adjustment is made if the currency used in the transaction appreciates in terms of the SDR. There are a number of reasons for this exception to the application of the three-day valuation rule. One is the intent to avoid any possible incentive to delay a payment for a few days in order to benefit from exchange rate developments, regardless of whether the resources involved are from the General

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1/ No adjustment would be called for in the case of a delay by the issuing member in the exchange of a currency the Fund has sold into a freely usable currency. If such a delay arises, it is considered that the domestic currency was provided on the due date by the member whose currency is being sold in accordance with the Fund's instructions, and that there was a delay in the exchange. (In contrast, the transfer of domestic currency in a repurchase cannot take place until the corresponding foreign asset is paid to the Fund.) The member that is responsible for exchanging to a freely usable currency under Rule 0-4 is asked to compensate the purchasing member for loss of interest on the amount involved. Cases of delays in exchange of currency are rare and it is proposed to continue the current practice in such cases.

Resources Account or from other accounts of the Fund. 1/ Second, in case of an SDR transaction, it would appear inequitable if the member using SDRs not only did not receive currency on the date it was entitled to receive it, but in addition received a lesser amount. Third, investments of proceeds of payments to the Special Disbursement Account and the Borrowed Resources Suspense Account are generally initiated prior to the receipt of funds, in order to assure that the receipts of currency and their investment have the same currency value. The currency amount of the investment denominated in SDRs is thus fixed, and a refund to the member that settles an obligation only after the due date would reduce the amount of currency available for investment. 2/

2. INDONESIA - ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII, SECTIONS 2, 3, AND 4; AND 1988 ARTICLE IV CONSULTATION

The Executive Directors considered a staff paper on Indonesia's acceptance of the obligations of Article VIII, Sections 2, 3, and 4 (EBS/88/128, 5/10/88), and the staff report for the 1988 Article IV consultation with Indonesia (SM/88/85, 4/15/88). They also had before them a background paper on recent economic developments in Indonesia (SM/88/89, 4/27/88).

Mr. Ismael made the following statement:

Indonesia entered 1987 with a significantly weakened balance of payments and a sharp reduction in government revenues due to the steep decline in oil prices. At the same time, it was saddled with a substantial increase in its external debt and in debt service obligations due to the sharp depreciation of the U.S. dollar. A series of further deregulation measures were introduced in 1987 to preserve the competitive advantage provided by the September 1986 devaluation, thereby improving the balance of

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1/ The exchange risk in terms of currencies would be borne by the member issuing the currency which is used in the operation or transaction, which would receive a smaller or larger amount of currency units for a given amount of SDRs than would be the case had the transaction been completed as scheduled. Thus, for example, in cases of surpluses arising from late payments to the General Resources Account in an appreciated currency, the benefit accrues to the member whose currency is used in the transaction.

2/ Accordingly, the currency amount of the investment would also be less and would be lower than the value of the obligation settled. As a consequence, the Special Disbursement Account would incur a capital loss and the assets available for disbursement to eligible members would be reduced, or the cost of the Borrowed Resources Suspense Account, and hence charges on the use of the Fund's borrowed resources, would increase.

payments and the general economic climate for trade, production, and investment, an improvement which would further facilitate growth and employment.

In January 1987, import duties were lowered on an additional 55 items, supplementing an earlier decision introduced in October 1986 in which tariffs were reduced on over 150 items. At the same time, nontariff barriers to imports were removed on more than 100 items, while quota restrictions were abolished on approximately 140 categories of textile and steel products. The measures also amended industrial regulations to permit the use of excess capacity to diversify product lines.

In May 1987, a new investment priority list was announced, expanding the areas open to foreign and domestic private investment.

In June 1987, the licensing system governing manufactured goods was simplified. Product-by-product permits were replaced with a system of "broad banding," thus enabling companies operating within the new categories to engage in production of any additional product within the overall category without requiring a new permit. Output ceilings for various products have been relaxed so that production can be increased by 30 percent without a new authorization. These measures also ended the need for a company to apply for a new license every five years. On the foreign investment front, the areas of business open to foreign investors have been further increased, reclassified, and broadened according to process rather than by commodity with the intent of enabling existing investors to expand their operations to other products within the same broad classification without needing to obtain new licenses.

In December 1987, 58 separate decrees were issued, relaxing further rules on foreign investment through more favorable ownership transferal requirements, the removal of restrictions prohibiting joint venture companies from marketing Indonesian exports, allowing foreign firms to purchase domestic inputs without restrictions, eliminating and reducing many other tariffs and nontariffs barriers, easing restrictions on the hiring of expatriate personnel, simplifying approval procedures for investment in tourist hotels, and revitalizing the stock market.

In response to these measures, improvement in competitiveness, and strong external demand, non-oil export earnings have risen sharply and are currently averaging over $800 million per month. A number of Indonesia's industrial products, such as plywood, textiles and garments, chemical products, basic metals, motor vehicles, dry batteries, televisions, and refrigerators, have achieved a breakthrough in penetrating world markets. As a result, out of a total export earnings of $16.7 billion in 1987,

$8.5 billion comprised non-oil export earnings, which is not only 30 percent higher than that attained in 1986 but has simultaneously surpassed oil export earnings for the first time since the early 1970s.

This export surge has played a major role in reducing the current account deficit from $4.1 billion in 1986 (or 5.4 percent of GDP) to $1.8 billion in 1987 (or 2.4 percent of GDP). As inflow of resources from direct foreign investment has sharply increased, and a sufficiently large amount of fast-disbursing official assistance became available as well, the overall balance of payments turned from a deficit of $0.5 billion in 1986 to a surplus of $1.2 billion in 1987.

To cope with the second major problem--namely, a severely constrained resource situation--the Government has implemented another austere budget for FY 1987/88, with no increases in civil service salaries for the second year in succession and sharp reductions in the real levels of capital spending. In addition, special efforts were made to mobilize foreign assistance to finance the local cost of a number of projects. Intensified efforts to increase non-oil and gas revenues netted an increase from Rp 7.9 trillion in FY 1986/87 to Rp 9.1 trillion in FY 1987/88. Likewise, oil and gas tax revenue increased from Rp 6.3 trillion in FY 1986/87 to Rp 9.7 trillion in FY 1987/88 due to improvement in oil prices in 1987, thereby recovering most of the loss that was realized in the previous fiscal year. As a result of expenditure restraint and substantial improvement in revenues, the Government was able to have the overall budget deficit reduced from 5.0 percent of GDP in FY 1986/87 to 2.2 percent in FY 1987/88.

In addition to these deregulation measures and the prudent fiscal policy pursued, the effective conduct of monetary policy and the reversal of private capital outflow have contributed significantly to the improved performance of the overall economy in 1987. However, the Government is fully aware that Indonesia continues to face a severely constrained resource situation. At the same time, the Government recognizes that with the presently high debt service burden, future external borrowing should be limited and should as far as possible be on concessional terms. In the short term, however, some additional program borrowing may be unavoidable.

A continuation of the trends pursued so far is, therefore, projected in the 1988/89 budget. To contain current expenditures, consideration is being given to reducing subsidies through increases in the prices of fertilizer, pesticides, and petroleum products. In addition, adjustment in wages and salaries will only be in terms of a once-and-for-all bonus, conditional on better oil and gas revenue performance. On the revenue side, consideration is being given to extend the coverage of VAT to include selected services; adjustment of selected tax rates; and taxing interest earning on bank deposits. By containing both current and capital expenditures and increasing non-oil and gas tax revenue, it is expected that the fiscal deficit can be further reduced to 0.6 percent of GDP in FY 1988/89.

In addition, the Government is fully aware that large important sectors of the economy remain constrained; and therefore, trade and industrial policies should be geared toward further deregulation. In this regard, Indonesia's record since 1983 is more than ample proof of its commitment to such an adjustment. However, the Government believes that further deregulation should continue to be implemented, as in the past, on a stage-by-stage basis after careful consideration of the feasibility and impact.

On the other hand, it should be realized that the cost of adjustment in terms of economic growth has been high. Real GDP growth has fallen from 7 percent to 8 percent annually in the 1970s to an average of only 4 percent during the past five years. Furthermore, there seems to be little prospect of a significant improvement in the external environment facing Indonesia in the near future. Oil prices continue to be low and uncertain, and the depreciation of the U.S. dollar vis-à-vis other major currencies would continue to burden the economy.

Under these circumstances, international financial assistance will still be needed to ease the transition in the balance of payments and to support the recovery of the Indonesian economy over the medium term. Of equal importance is the effective implementation of international policy coordination to ensure maintenance of stable exchange rates, thereby preventing successful ongoing adjustment programs from being destabilized.

In conclusion, I join my Indonesian authorities in expressing deep appreciation to the staff for their thorough analysis of the problems and prospects of the Indonesian economy and for a fair and balanced appraisal with which my authorities broadly agree.

Mr. Ismael said that after maintaining an exchange system free of restrictions on payments and transfers for current international transactions for many years, his authorities had decided that Indonesia was prepared to accept the obligations of Article VIII, Sections 2, 3, and 4. In the context of the general progress being made in the country's economy, it was only fitting for Indonesia to make that transition. In particular, his authorities regarded the transition as underpinning the ongoing structural adjustment efforts to open the economy and to move toward a higher path of economic growth.

Mr. Yamazaki made the following statement:

I am in broad agreement with the views expressed in the staff report as well as in Mr. Ismael's statement.

I welcome the Indonesian authorities' unrelenting efforts to adapt their economy to the changing international economic environment. Given Indonesia's dependence on the petroleum sector, volatility in the price of oil and oil products has made it all the more difficult for the authorities to manage economic policy efficiently during the period of oil glut that followed the worldwide economic downturn after the second oil crisis. Viewed in that light, recent economic performance is encouraging, if not satisfactory, as the negative impact of the decline in the oil prices has to a large extent been absorbed. Furthermore, the recovery in the oil price last year, together with the favorable effects of the structural and financing reforms already implemented, enabled the authorities to maintain economic growth at 4 percent, while containing the rate of inflation to 9 percent despite the adverse effects of serious droughts. In sum, the authorities should be commended for their prudent and efficient management of economic policy. In addition, the flexible application of the contingency financing facility by the Fund has also aided a rapid response to the decline in non-oil exports. Notwithstanding these favorable achievements, there are still some areas that warrant further strenuous efforts.

First, uncertainty regarding the price of oil continues to be a source of concern, although from the viewpoint of oil-importing countries, the lower oil price should be a blessing. In this connection, efforts should be continued to reduce the dependence of the Indonesian economy on the petroleum sector. In particular, the recent increase in the share of the non-oil/liquified natural gas manufacturing sector should be further encouraged. In this connection, I welcome the fact that the exports of that sector time surpassed that of oil/liquified natural gas for the first time in 1987. Much remains to be done, however, to sustain that favorable trend. Structural measures such as the liberalization of trade, production, and investment, as well as the authorities' more open attitude toward foreign investment, have helped to enhance private sector activity, and should be further strengthened.

Second, despite remarkable adjustment in the last fiscal year, the fiscal consolidation process is far from complete. In particular, most of the reduction in the overall government deficit/GDP ratio stems from the favorable swing in the oil price. This, coupled with the continuing uncertainty about the price of oil, indicates the need to broaden the fiscal revenue base and to streamline expenditures on various subsidies.

Third, I welcome the recent conduct of monetary policy aimed mainly at protecting the external reserve position. Reversing the capital outflow by tightening liquidity has alleviated the burden of external debt management, and will eventually provide the authorities with room for more flexible policy management. In the long run, that will result in interest rates lower than those produced by early relaxation of monetary policy. In this regard, I agree with the staff that real interest rates may need to remain high for some time, despite the authorities' concern over investment. In the area of financial reform, I strongly welcome Bank Indonesia's initiative in introducing a new auction system, thereby enhancing the effectiveness of the open market operation.

Finally, I commend the authorities for their strenuous efforts toward opening the market. As a result, Indonesia maintains no restrictions on payments and transfers for current international transactions. In this regard, I commend the authorities for their well-timed decision to accept the obligations of Article VIII, and I am pleased to welcome Indonesia as a new Article VIII country.

Mr. Posthumus made the following statement:

Indonesia has successfully adjusted to an adverse external environment by implementing well-chosen policies. Fiscal restraint, together with a large devaluation against the dollar at the end of 1986, have prevented the development of uncontrollable imbalances. I agree with the staff that further reduction of the fiscal deficit and the elimination of still widespread quantitative restrictions in the economy are important. But I do not have anything to add to the staff report in that respect.

Monetary policy was reoriented in the middle of 1987 to support the international reserves position; through higher interest rates, monetary policy approximately protects the present rate between the rupiah and the dollar. And this, it seems, is what has happened since September 1986: the rate between the rupiah and the dollar has been more or less maintained.

The staff notes that an essential component of policy toward "the maintenance of adequate external competitiveness is an appropriate management of the exchange rate, and the authorities are to be commended for having safeguarded the gains from the September 1986 devaluation." In my view, however, the authorities have safeguarded the gains from the 1986 devaluation mainly by keeping price developments sufficiently under control.

I tend therefore to disagree with the staff view that continuation of flexible exchange rate management over the medium term will be essential to underpin structural reforms and to maintain market confidence. Market confidence will be better maintained by a policy to control wage and price developments, and by a monetary policy which is supportive as much as possible, and which also helps to maintain a stable nominal exchange rate, whether in terms of one currency or of a basket of currencies. However, as in 1986, devaluations to restore competitiveness should not in the end be ruled out. Perhaps Mr. Ismael can shed some more light on this issue.

Mr. Ismael has observed that the cost of adjustment in terms of economic growth has been high. While I agree that adjustment in the short term can have negative effects on real growth, I am convinced that this is not the case in the long term. On the contrary. In fact, Indonesia is one of the countries which have repeatedly and consistently adjusted in the face of external contingencies with excellent results. The staff scenarios also indicate that there is, in the medium term, no trade-off between adjustment and growth. However, the tasks in Indonesia are large, with its fast growing population and widespread poverty. Strong adjustment policies may not be sufficient, and continuing external assistance will be required to bring the debt burden under control. In this respect, the depreciation of the dollar in terms of other currencies which are important for Indonesia's capacity to repay its debts has been a big problem, one which I hope will not increase further in the near future.

Finally, I support the draft decision welcoming Indonesia's acceptance of the obligations of Article VIII, Sections 2, 3, and 4, which I find very satisfactory indeed.

Mrs. Filardo made the following statement:

In general, we agree with the staff that the Indonesian economy has performed remarkably well in recent years. The authorities were able to implement sound macroeconomic and structural policies that kept the economy growing at a satisfactory rate--faster than the population growth rate--together with price stability. In addition, the balance of payments turned into surplus, notwithstanding the deficit on the current account. This was the result of a strong increase in the non-oil sector and the reversal of capital flows. Thus, economic policies created sufficient confidence to attract varied financial resources for some of the required investment and development. Furthermore, these achievements were possible despite various external shocks, namely, the deterioration in the terms of trade, and the effect on the external debt of the dollar depreciation vis-à-vis the major currencies.

One of the most striking accomplishments has been the increase in non-oil exports, which, as Mr. Ismael notes, were 30 percent higher than in 1986, and for the first time surpassed oil export earnings.

The authorities deserve to be strongly commended for their courage in implementing policies that have created the basis for maintaining sustained economic growth. After so many years of adjustment, no doubt they will continue to make all efforts necessary to keep the economy on track. Nevertheless, the external sector remains fragile given the uncertainties surrounding the world economy.

Indonesia is a poor country, densely populated, with very high rates of population and labor force growth. Thus, one of the main challenges to the authorities is to generate development to mitigate poverty while maintaining an efficient pace of economic expansion, so as to generate employment at the same rate. For this to be possible, adequate financial resources are necessary, which implies enhancing the utilization of existing resources and increasing international concessional assistance. In this regard, although the authorities and the staff have agreed on short- and medium-term projections, and both have recognized the downside risk, three factors could weaken the short- and medium-term outlook.

First, oil prices were calculated at $16.35 per barrel in the staff report, although that assumption in the end depends on the composition of export products and on Fund staff calculations. These are usually based on the information provided by the authorities and the world economic outlook forecast of oil prices. When we discussed the world economic outlook, the projected price was in line with the original staff estimate. At this stage, given recent market developments, the estimate seems optimistic.

Second, exchange risk on the external debt seems extremely high as reflected by the large increase that resulted from the dollar depreciation against major currencies.

Third, there is the possibility that an increase in interest rates of just 1 percentage point would have a serious impact on the fiscal and current account deficit. Perhaps Mr. Ismael or the staff could comment on this matter and on alternative scenarios, if any.

Turning now to fiscal policy, the Government has certainly made great efforts to streamline the budget by reducing expenditures and increasing revenues. Nevertheless, one of the external shocks just mentioned has a dramatic impact on increasing the deficit, namely, the depreciation of the dollar. That resulted in an increase in interest payments of 75 percent and 32 percent in 1985-86 and 1986-87, respectively. In spite of these shocks, the authorities have reduced expenditures on development projects--so important for a poor country like Indonesia--on infrastructure maintenance, and on salaries. This expenditure reduction has seriously impaired the standard of living of the population, and has affected the competitiveness and efficiency of the public versus the private sector. Indonesia's external debt is relatively high, given the still manageable fiscal deficit in relation to GDP. But the question is first to determine the sensitivity of the external projections, and if the financial gap is larger than expected, to find ways to streamline the utilization of financial resources, taking into account the areas just mentioned, and stimulating the mobilization of domestic and foreign savings.

To this end, according to the background paper, there still seems to be some room for maneuver through enhancing provincial sources of finance, the management of public enterprises, and possibly reducing part of the subsidies--weighing the impact of subsidies on inflation and on the agricultural sector, as employment is highly concentrated in that sector of the economy.

Given the constraint imposed by financial resource limitations, the authorities will have to continue to protect the external sector by maintaining adequate real exchange and interest rates and by continuing the deregulation process with a view to improving competitiveness and enhancing the growth potential of the economy.

Finally, I strongly endorse Mr. Ismael's comment on the importance of the effective implementation of international policy coordination to ensure a stable exchange rate. This is crucial to avoid jeopardizing a successful economic program, such as Indonesia's, through indiscipline on the part of some industrial countries.

Mr. Lim made the following statement:

I commend the Indonesian authorities for a very creditable performance of the Indonesian economy in fiscal year 1987. This achievement is more significant in view of the accompanying substantial improvement in Indonesia's external position and reduction in the fiscal deficit.

These achievements were made possible by the authorities' determined efforts to implement structural and financial policy changes to ensure more efficient domestic resource utilization and external competitiveness. While the favorable oil price situation no doubt contributed to an easier implementation of adjustment measures, it was still significant that the authorities chose to continue with their policy of fiscal restraint and exchange rate adjustment as well as the liberalization of trade, production, and investment during the year.

I therefore welcome the authorities' general agreement to continue the economic management strategy pursued in recent years and the fiscal consolidation process--particularly through expenditure controls in the form of reduction in subsidies for fertilizer, pesticides, and petroleum products; and through revenue measures including expansion of the coverage of the VAT and adjustments in selected tax rates.

I encourage the authorities to continue with their policy of exchange rate flexibility, but I also share Mr. Ismael's view that the currency realignment of the U.S. dollar vis-à-vis other major currencies caused an increase in the debt-servicing burden on Indonesia's economy, in view of the currency composition of its debt stock which is heavily weighted toward the yen. I can therefore join him in calling for greater exchange rate stability.

I can also join the Indonesian authorities' call for external financing on concessional terms, as Indonesia's external debt remains high and its balance of payments situation, although improving, is still precarious.

I agree on the need to maintain monetary discipline and the continued emphasis on protecting the external reserve position. I also endorse the view that more needs to be done in the liberalization of trade, production, and investment, especially since signs of greater private sector enthusiasm to support high levels of growth appear to be emerging. I note particularly that removal of domestic monopolies can go a long way in minimizing production bottlenecks.

Given the remarkable performance by the economy in 1987 and the good record of performance by the authorities in recent years, I am confident that the needed international financial assistance for Indonesia will be easy to secure.

Finally, I strongly welcome Indonesia's acceptance of the obligations of Article VIII, Sections 2, 3, and 4.

Mr. Massé made the following statement:

I congratulate the authorities on the good performance of the economy in the past year. While this can be attributed in part to some favorable external developments, including the moderate recovery in oil prices, clearly an essential element has been the strength of the adjustment effort pursued by the authorities. The improvement of the fiscal position, the effective implementation of monetary policy, and the maintenance of an appropriate exchange rate regime were important factors in maintaining the momentum of economic growth, in holding inflation to a relatively moderate rate, and in registering significant improvements in the balance of payments position. I also welcome the authorities' acceptance of the obligations of Article VIII, Sections 2, 3, and 4.

Overall, my authorities agree with the thrust of the staff analysis of Indonesia's economy. In particular, we commend the authorities' prudent management of monetary policy. The authorities' willingness since mid-1987 to orient monetary policy to support the external reserve position has helped to improve confidence in the rupiah and to reverse private capital outflows. Understandably, authorities are concerned that a high real interest rate structure may be hampering a more rapid recovery of investment. Nevertheless, in view of the uncertainties related to the outlook for the price of oil and Indonesia's debt burden, it would be prudent to link interest rate reductions to the implementation of the adjustment program and to the strengthening of Indonesia's external position. Indeed, maintaining market confidence is crucial, given Indonesia's open payments system. We welcome the further progress achieved in reforming the financial sector and the steps taken to promote development of a domestic capital market.

My authorities have some concern about the fiscal strategy. The staff presents some convincing analysis for its projection that there will be no further reduction in the central government deficit this year. We note that the authorities have now revised their expectations for the reduction in the fiscal deficit from that indicated in the budget to something more along the lines of the staff's projection. In light of this, we encourage the authorities to introduce the revenue measures described in the paper promptly--particularly the extension of the tax base for the VAT, and the increase in VAT and property tax rates. Such measures would help to diversify revenue away from the heavy reliance on the petroleum sector and would be an important complement to the current program of improving the tax administration.

On the expenditure side, we share the staff's skepticism that the 60 percent decline in subsidy payments included in the budget can be achieved through the improved efficiency of operations of public sector enterprises. I wonder if Mr. Ismael could provide us with some further explanation on how the authorities plan to pursue this objective. In light of the high risk that the interest expense on foreign borrowing will exceed the amount budgeted, we urge the authorities to seek other deficit reduction measures, including a review of pricing policies, particularly for domestic petroleum products. A cautious fiscal stance is the key ingredient in the continued success of Indonesia's adjustment process.

The authorities have had enviable success in significantly reducing the current account deficit in the past year, and we note the marked decline in the reliance on oil exports to less than 50 percent of the total. However, the projection for non-oil export growth of 24 percent and 18 percent in the next two years appears somewhat ambitious. We would welcome comments from Mr. Ismael and the staff on the realism of this projection, in light of the constraints on capacity utilization and the amount of investment in this sector. On the other hand, the increase in 1987-88 of non-oil exports of that type has been approximately 37 percent.

Despite substantial progress on the external sector, Indonesia continues to be faced with a heavy debt service burden over the medium term, which will only be exacerbated by further devaluations of the U.S. dollar. The authorities' ability to meet the debt-servicing obligations without resorting to debt rescheduling is further evidence of their prudent economic management. We welcome their intention to continue to meet debt-servicing obligations without debt rescheduling. This will require a determined effort to promote domestic resource utilization, to minimize reliance on foreign financing, and to maintain market confidence.

A key aspect of the success of Indonesia's adjustment effort has been the emphasis on structural reform. As Mr. Ismael has indicated, the authorities, in recent years, have significantly reduced the extensive network of regulations governing trade, production, and investment. Continued commitment by the authorities to eliminate structural impediments will be needed in order to achieve longer-term development objectives. These include a more efficient economy, the creation of a business environment conducive to stronger growth and employment, an enhanced role for the private sector, and the transition from an oil-dependent economy to one that is more diversified and industrialized.

Despite advances in structural reform, large sectors of the economy remain subject to inefficient regulatory constraints. Remaining monopolies should be further reduced and administrative systems streamlined; this would minimize the bureaucratic delays which have arisen in the implementation of deregulation measures. We commend the authorities for the recent efforts to reduce non-tariff barriers to trade and for their policies aimed at rationalizing import tariffs. The staff's alternative medium-term scenario for a slowdown in policy actions by the Government clearly shows the resulting adverse affects on the economic outlook. We urge the authorities to maintain their commitment to structural reforms despite the short-term pain. As the staff projection illustrates, the long-term benefits of the full implementation of such a program far outweigh the short-term costs.

Mr. Sengupta made the following statement:

We welcome the request of the Indonesian authorities to move to Article VIII status. The authorities should be commended for adopting a pragmatic and consistent set of policies so as to strengthen the economy in the face of many adverse exogenous developments. Mr. Ismael has highlighted in particular the enormous external and fiscal adjustments that took place in 1987.

The authorities have attached high priority to maintaining external current and capital transactions free of restrictions, and the interest rate acquires a special significance in this connection. Interest rates have been high in real terms, and those levels include a disincentive premium against outward capital flows. At the same time, the development strategy is oriented toward the private sector. While deregulation and liberalization will provide one set of incentives for the private sector, interest rate policy, and through it the capital market, should also encourage private investment. There are severe budgetary constraints on direct public sector investment, and there is a need for a high level of private sector investment, where new investment is required as existing capacities have been stretched, while deregulation and liberalization are constantly opening new areas for investment. The high interest rate may then prove discouraging.

On the other hand, a decline in interest rates, might be an inducement for capital flight. The authorities are aware that destabilizing capital flight occurs when policy orientation is uncertain, when policies are inconsistent with underlying trends, and when contrary expectations are formed on the exchange front. So long as basic policies are on track, however, capital flight would be speculative and short term. Indeed, this phenomenon was observed twice in 1987, and the authorities acted swiftly: in both instances, short-term interest rates rose sharply. The problem is to protect the long-term rate from the effect of speculative impulses, so as to preserve private sector confidence. Is it possible to limit the influence of policies to the short-term rates alone, as against the long-term rates? Considering the thinness of the money and capital markets, the Indonesian monetary authorities may have to rely on direct measures to curb liquidity in times of stress; otherwise the use of monetary policy may have to be swift and quickly reversible, provided of course that the underlying trends and policies are correct and stable. Perhaps the staff could react to this issue. There is clearly a need for a broadening and deepening of the money and capital markets as an aid to effective monetary policy, and for promoting financial intermediation. In this context, we welcome the removal of the tax exemption on interest earned on bank deposits, as that will reduce the disparity in yields between bank and nonbank securities. We concur with the authorities' ongoing actions to remove impediments to business expansion as well as to review the laws governing asset ownership.

The positive encouragement given to foreign direct investment both through incentives and nondiscriminatory treatment of domestic and foreign capital testifies to the consistency of the Indonesian strategy of development led by the private sector. The availability of labor and the size of the domestic market are indeed powerful magnets for foreign investment. The staff report notes that more recently, along with improved competitiveness and liberalization, the focus has shifted toward export-oriented industries. The dismantling of import licensing and other restrictions and the reduction of tariffs have also facilitated production by making inputs such as materials and components and other intermediate goods easily available.

There are, of course, limits to the export orientation of foreign enterprises in markets whose currencies have strengthened against the U.S. dollar, given that the exchange rate is pegged to the U.S. dollar. But the possibility of exporting back to the markets of the parent country of foreign investors faces limits imposed on the subsidiary by the parent companies. Export franchise restrictions are a common feature associated with foreign direct investment. This is not to deny the positive role that foreign investment can play, but only to provide a reminder that its role in export promotion should not be exaggerated.

Turning now to the medium-term prospects for the Indonesian economy, we share the importance attached by the staff to the continuity of policy both in form and content. In fact, the baseline scenario assumes an overall budget deficit of 2.2 percent of GDP, and it appears that the authorities have conceded that the budget projections for 1988/89 may be too optimistic. Considering the downside risks in terms of oil prices and international interest rates, we wonder whether the contingency plans mentioned in the staff report have been developed in concrete terms. We welcome the alternative scenario developed by the staff, premised on a slowdown in policy action by the Government, setting out the implications for growth, the budget, and the balance of payments. We encourage the staff to develop these exercises, with a view to showing the implications of both a slowdown and an acceleration in policy action.

The authorities have attached crucial importance to maintaining market access and normal relations with creditors. We can also see the rationale on which they seek to maintain a comparatively high level of reserves. However, as Mr. Ismael has noted, this policy implies the risk of large exchange losses. International financial intermediation can play a more positive role in promoting economic activity in an environment of exchange rate stability. We agree with Mr. Ismael that effective implementation of international policy coordination is a necessary precondition for a stable environment. So too is increased market access for the products of structural reform.

Mr. Prader made the following statement:

The staff has provided us with a precise and constructive report identifying areas and opportunities for improvement in one of the most dynamic economies of Southeast Asia. Indonesia's economy is one whose structural adjustment toward a sounder economic basis can be accelerated with minimal social costs. I agree with the general direction of economic policy, and fully agree with the staff appraisal.

In 1987-88, Indonesia's non-oil/liquid natural gas exports grew by 34 percent, and much of this growth came from a 77 percent increase in manufactured exports. This good performance alone is sufficient to justify optimism, even though 34 percent of domestic production was still affected by import licensing at the end of 1987. The speed of the economy's response in the desired direction, the great diversification of the new manufactured exports, and the need for export-led growth should encourage the Indonesian authorities to end import licensing practices.

The abandonment of import licensing is not the only condition for continuing the rapid expansion of manufactured exports. In light of the social costs and undesirability of further reductions in domestic demand, and with capacity utilization approaching technical limits in many industries, further expansion of manufactured exports will also require increased investments in this sector. The complex thicket of regulations surrounding investment and bureaucratic delays in the deregulation process are threatening to waste the unique opportunity provided by the present restoration of business confidence and the heightened interest of foreign investors in Indonesia. The authorities are well aware of this situation: Mr. Ismael mentions that in December 1987 alone, 58 separate decrees on deregulation were issued. We urge the authorities to abandon such a piecemeal approach and to proceed more rapidly, with broader, simpler deregulatory actions. Not only would simpler rules and regulations be easier and less costly to administer; the promotion of private initiative is better served by simplifying and generalizing the rules. If there is a rationale for maintaining the present investment licensing practices, which obviously hamper private investment, we would be interested to hear it.

Liberalization of investment procedures would readily offer another positive externality. It would redirect some of the floating private capital, estimated in January 1987 at about $1.8 billion, away from speculative uses and back into productive ones. Given the clear signs of the domestic economy's absorptive capacity, encouragement of investment will also help the monetary authorities to monitor their policies and to stabilize the structure of interest rates at a more sustainable level.

We welcome the authorities' intentions with respect to the public enterprises and their continuing study of privatization. There are commendable benefits to offering shares to the public, which would stimulate a major breakthrough in the development of Indonesia's lagging capital markets. The sale of stock in the profitable public enterprises would increase the volume of shares traded on the Jakarta Stock Exchange. It would also broaden share ownership, increase public revenues, and offer yet another opportunity to the floating speculative capital mentioned above. Injection of private entrepreneurship by the divestiture of public enterprises would also impose the kind of financial discipline needed for more efficient operation.

In the sphere of fiscal policy, we have two areas of concern. These are the subsidies paid on fertilizers, pesticides, and petroleum products; and the taxation structure of the fiscal system. According to the preliminary estimates in the 1987/88 budget, subsidies amount to as much as one third of VAT revenues. A careful selection of items to be exempted from the VAT or a rational rate reduction that would be budget neutral would assist in mobilizing public approval of subsidy elimination. There is also the possibility of cost savings in the area of subsidy administration.

The share of VAT and excise taxes in total tax revenues in the 1987/88 budget substantially exceeds revenues from non-oil income and profits, by a margin of 55 percent. Most striking of all, nearly half of the corporate income tax will be paid by the public enterprises, which have been criticized for their inefficiency. A recent study by the Fiscal Affairs Department compared the different ways that direct taxation and taxes levied on goods and services affect poverty groups, and showed that any tilt introduced into the system which increases taxes on goods and services will reduce the living standards of the poor. Excessive dependence on indirect taxes limits the ability of a government to implement appropriate measures during hard times without causing social disturbances. In addition, tolerance of tax evasion or incompetence in tax administration is one of the major factors driving capital into speculative, highly liquid assets. Improving the tax yield of direct taxation is thus most welcome.

In conclusion, we expect that the Indonesian authorities will proceed in all areas of adjustment with the same determination and vigor that they displayed in their approach to the exchange and payments system. We also welcome their decision to accept the obligations of Article VIII, Sections 2, 3, and 4.

Mrs. Ploix made the following statement:

In the face of adverse external conditions, the Indonesian authorities reacted promptly at the end of 1986 by adopting a comprehensive set of measures. This policy package, which included significant structural reforms, proved decisive in restoring a more balanced growth process.

At the beginning of 1988, the progress made in adjusting the economy to a more difficult environment looks impressive. Healthy expansion has been maintained at a rate higher than population growth; fiscal developments have been kept under firm control; and an upsurge in non-oil exports has made a major contribution to strengthening the external position.

Despite all these remarkable achievements, the situation remains difficult, and additional efforts lie ahead for Indonesia. My authorities share most of the staff's views on fiscal policy, structural reforms, and external prospects.

Public finances are the first area in which some results look fragile and call for further consolidation. Development expenses bore the brunt of fiscal adjustment at an early stage in the process. It is therefore encouraging to see that current expenditures are to shoulder a larger share of the burden in the future. However, the authorities may be confronted with some difficulties in implementing this shift from capital to current spending. The public sector wage policy has been tight until now. At the same time, this strict stance seems difficult to maintain under growing pressures.

The authorities have created certain expectations by granting a bonus payment for the end of this year, conditional upon favorable oil price developments. These expectations may prove difficult to resist in the event of unfavorable oil market developments. Furthermore, given the latest trends in world oil prices, perhaps Mr. Ismael or the staff know whether the authorities contemplate some sort of contingency plan to offset the possible impact of unexpected oil price developments on the fiscal position.

Like Mr. Massé, we think that the intended sharp reduction in subsidy payments raises some doubts. It seems unrealistic to consider that drastic cuts in production and distribution costs would allow a 60 percent decrease in subsidies paid on agricultural input and oil prices.

While the expenditure side must be kept under close scrutiny in order to react in a timely fashion to unforeseen circumstances, the authorities should move more resolutely on revenue-enhancing measures. Two areas seem to be of particular relevance: first, the broadening of the VAT base, which should not be unduly delayed in the present context of moderate inflation; second, the deepening of the tax administration reform which is already yielding some noticeable results.

In the area of structural reform, indisputable progress has been made in trade liberalization, which, together with an active exchange rate policy, stimulated non-oil exports. The main task for the authorities now lies in deregulation of the productive sector. As the economy gradually opens, the authorities should alleviate the numerous restrictive practices which still hamper the broadening of the production base. A more liberal foreign investment regime would undoubtedly facilitate progress in this direction.

These efforts aimed at diversifying the range of tradable goods appear all the more important as the external position remains vulnerable. The debt service burden, which will be significantly alleviated in the medium term, is a major cause for uncertainty. Although the room for maneuver left by this tight external constraint seems limited, I note that Indonesia does not intend to seek debt rescheduling. The authorities should be commended for their sustained efforts to implement their own adjustment policy, but I would be interested in knowing whether they are ready to implement additional adjustment measures in the context of a Fund program if the economic situation were to deteriorate unexpectedly. Perhaps Mr. Ismael or the staff could offer some clarification on this point.

Finally, we welcome Indonesia's acceptance of obligations of Article VIII. It reflects the decisive progress made by the country in liberalizing its payment system.

Mr. Almeida said that he welcomed the authorities' perseverance in their adjustment strategy initiated in 1986. The central government deficit had been reduced to only 2.25 percent in fiscal year 1987, and monetary policy had been sharply tightened. The exchange rate policy had been maintained, as was necessary to protect the gains in competitiveness that followed the 1986 depreciation.

The authorities deserved to be commended for their successful and extensive efforts to reduce the complex system of regulations, Mr. Almeida continued. Much work remained to be done, but he supported the authorities' firm attention to continue the deregulation process, so as to enhance the growth potential of the economy.

In 1987, despite the severe drought and some problems in the structure of the economy, there had been a healthy growth in output and a very low rate of inflation, Mr. Almeida commented. Non-oil exports had also increased considerably in 1987, largely as a consequence of the appropriate policy stance adopted by the authorities. He was confident that the authorities would be able to maintain a flexible approach in the future, particularly in terms of structural measures needed to increase investments. Finally, he welcomed the authorities' decision to accept the obligations of Article VIII, Sections 2, 3, and 4.

Mr. Enoch made the following statement:

> I broadly agree with the staff's analysis, and will make only a few points. First, the Indonesian authorities lived up to their reputation for prudent economic management by maintaining policy firmly on course in 1987. At the time of the last Article IV discussion on Indonesia, particular concerns were expressed about the adequacy of monetary policy in the face of capital outflows. The speed and effectiveness of the authorities' response in tightening monetary policy was impressive, and is no doubt a major reason why the background to our discussion today seems rather less gloomy.
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> Second, the Indonesian economy responded vigorously to the structural reforms implemented within the authorities' sound macroeconomic framework. The surge in manufacturing for export and in private investment are especially encouraging. These particular responses are vital to the longer-term goal of diversifying Indonesia's economy away from its current dependence on energy exports and in absorbing the projected rapid growth in the labor force. Manufacturing provided the main impetus for growth in 1987. And non-oil exports for the first time accounted for more than half of the total: a significant shift from the one fifth share in 1982, and a sign of the success of the 1986 devaluation. It will, of course, be imperative to maintain the pace of this expansion and, indeed, there remains considerable scope to extend the liberalization which has so clearly unlocked the potential of the Indonesian economy. Nontariff barriers still restrict some 25 percent of imports by value and some 35 percent of manufacturing production. And beyond these external structural reforms, domestic reforms are still needed. Private monopolies remain a serious problem, and I concur with the staff in regarding the present scale of restrictive and monopolistic practices as an impediment to Indonesia's future development.

Third, some attention will be needed to be devoted to the financial sector. The soundness and efficiency of the financial sector are vital to the process of economic restructuring. There is a need to improve the cost and availability of credit, particularly long-term investment funds and financing for newer export-oriented and smaller firms. However, the fallback in activity following the collapse in the oil price, devaluations of the rupiah, and higher interest rates have resulted in financial difficulties in the corporate sector which may have fed through to creditors in the financial sector. It will be important to ensure that financial institutions can support appropriate restructuring in the corporate sector, and to limit the impact on new borrowers, particularly in sectors such as export manufacturing, from the costs arising from underperforming or nonperforming loans. I also urge the authorities to build on the recent welcome steps taken to strengthen the domestic money and capital markets, which remain among the most rudimentary in the region, in order to underpin the efficient allocation of resources. I was disappointed at the absence of any reference in the staff paper to domestic bond markets. A modest amount of domestic borrowing by the authorities could be preferable to foreign borrowing at commercial rates.

Fourth, in view of the vulnerability of the Indonesian economy to external developments--as clearly demonstrated in the staff's medium-term scenarios--there is a clear need to maintain the pace of macroeconomic adjustment. And here I have some concern for the future. The likely overshooting of the official budget deficit---by more than 1.5 percentage points of GDP--is worrying. The authorities need to close this deficit with some urgency; interest payments are already constraining their room for maneuver, and there is a danger that additional and largely foreign borrowing to finance the deficit will further narrow the authorities ability to deal with any renewed external weakness. Fiscal weakness is starting to distort the composition of government expenditures, with an enforced contraction in the development budget and, in particular, in operations and maintenance expenditures. Further action therefore seems necessary to ensure that the original budget projections for this fiscal year are indeed achieved. Some action should be focused on reducing subsidies--which represent a disruptive and open-ended element in the budget--and on improving the low rate of return from the parastatal sector, for which it will be important to have a clear program of reform in place. But perhaps the most promising target for further action is in enhancing revenues. The tax base remains narrow--some estimates put it as low as 2 million people--and both income tax and VAT remain rather inelastic. The broadening of the VAT base and the imposition of a withholding tax are welcome steps, but I also urge the authorities to consider the various suggestions offered by the staff, particularly a general increase in non-oil tax rates.

Fifth, the quality of the Indonesian adjustment effort has been notably successful in catalyzing external support. Indonesia provides a clear demonstration of how external finance and committed adjustment can reinforce each other, thereby enhancing the country's prospects for growth in the medium term.

Sixth, I strongly commend the resolution of the Indonesian authorities in continuing to meet their financial obligations without recourse to rescheduling. This reflects to some extent the relatively cautious debt policy pursued in the past, but it would be wrong to underestimate the current burden. Nevertheless, Indonesia's avoidance of debt relief has been crucial in maintaining the confidence of the international financial community and of domestic investors. The authorities are entirely correct in not risking their creditworthiness in order to secure temporary relief. In view of the weight of debt service, I especially welcome Indonesia's adoption of Article VIII status. This is a highly commendable confirmation of Indonesia's achievements in maintaining a system of payments and transfers free of restrictions on current international transactions, and in continuing to honor fully its debt service obligations, and its commitment to continued pursuit of this strategy.

Finally, I have a general question to the staff on the implications of dollar depreciation on the debt burden. It has been stated that Indonesia has suffered over the past year from dollar depreciation because a high proportion of its debt is denominated in non-dollar currencies. An indebted country will suffer from the depreciation of an external currency, at least in terms of debt/export ratios, if the proportion of its debt denominated in that currency is less than the proportion of its exports that are so denominated. Presumably, this is the case for Indonesia, at least because its oil and natural gas exports are dollar denominated. However, if the dollar is effectively just a numerator, in the sense that any move in the dollar is effectively offset by price movements so as to maintain the real value, then perhaps the picture is not so clear.

I would also be interested in any staff comments on the relative importance of the dollar in Indonesia's debt burden and its non-oil exports. In the more general case, I am interested in any general views that the staff might have on the impact of dollar depreciation on foreign debt burdens for those countries where a high proportion of debt is denominated either in Japanese yen or in European currencies.

Mr. Rieffel made the following statement:

Looking back at developments in the Indonesian economy since our last review one year ago, we must commend the authorities for their effective implementation of a broad range of policy measures that have contributed to a substantial strengthening of the country's balance of payments position, and a significant consolidation of the Government's fiscal position.

Looking forward, through the eyes of the Fund staff, we see a gradual improvement in the policy foundation for long-term economic growth, but less eagerness than we would expect in tackling the structural obstacles to more rapid growth. Here we are concerned about Indonesia's future growth prospects not only because it is the world's fifth most populous country, but also because it stands out among the largest developing-country members of the Fund as having a remarkably liberal external payments regime.

In this connection, we join other Directors in congratulating the Indonesian authorities on their recent decision to accept Article VIII status, and heartily support the proposed decision. We hope that Indonesia's success in liberalizing its exchange regime will inspire other countries to follow its example. To this end, I urge the staff of the External Relations Department to consider including an item in an upcoming issue of the IMF Survey describing Indonesia's decision to relinquish the protection of Article XIV and highlighting the advantages to Indonesia and to other Fund members that should result from this step.

Now I would like to comment on Indonesia's economic policies and performance in areas that will have a critical bearing on the country's future growth prospects.

I will begin with fiscal policies not because this is the traditional order but rather because we share the view of the staff that fiscal management is critical to Indonesia's performance both in the short term and in the long term. Perhaps it is also worth noting that improvements in fiscal policy will be felt not only through their direct macroeconomic impact, but also through their effect on the confidence of creditors and donors in Indonesia's future.

From this perspective, we must commend the authorities for the extent of the fiscal adjustment achieved in the 1987/88 fiscal year. At the same time, we must express our deep concern over the pace of fiscal adjustment implied in the budget for the current fiscal year. The objective of a 1988/89 deficit equal to 0.5 percent of GDP is unquestionably an ambitious one, and we would say the right one. But the staff presents some convincing arguments that the deficit ratio is more likely to end up close to last year's 2.2 percent.

On the revenue side, we are pleased that the authorities have under consideration a number of measures, such as broadening the coverage of the VAT and increasing the property tax rate. To reach the deficit objective, we believe that it will be necessary to implement a number of these measures early in the current fiscal year.

On the expenditure side, I was struck by the fact that subsidies paid in the 1987/88 fiscal year were five times the budgeted amount, and that the staff is projecting another 50 percent increase in the amount of subsidies that will actually be paid out in 1988/89. It is hard to imagine that the deficit objective of the authorities will be met unless action is taken at an early stage to limit subsidies. Judging by last year's results, a greater effort will also need to be made to limit expenditures for personnel and transfers to regions to the amounts in the budget.

In short, as the staff has pointed out, Indonesia has become rather heavily dependent upon external financing and must rely more on domestic resource mobilization in the future to finance its growth. At the same time, we believe that rapid economic growth can only be achieved in Indonesia if the role of the public sector declines relative to the private sector. More rapid fiscal adjustment is the best route to both these objectives.

Turning now to monetary policy, I have very little to say. We welcome, of course, the shift in monetary policy that occurred last year, and we trust that the authorities will be less reluctant to use monetary policy in the future to bolster confidence in the face of adverse balance of payments developments.

We also share the view of the staff that the authorities should not be too anxious to reduce interest rates. It would appear much more preferable to encourage investment through structural reforms.

Among the various areas where structural reforms offer the prospect of large, long-term benefits, we would single out the public enterprise sector, the financial sector, and the deregulation of internal and external commerce.

In the case of the public enterprise sector, the staff report does not focus sufficient attention on the shortcomings in this area. For example, if I am not mistaken, the Indonesian authorities initiated efforts to rationalize the public enterprise sector more than 15 years ago. Consequently, I was astonished to read in the background paper that data on the financial operations of the public enterprises are so limited that it is difficult to assess their performance. How can a country which has transformed its economy in this period of time have made so little progress in this vital area of public finance? I find this deficiency especially puzzling since Indonesia is the recipient of World Bank lending at a rate approaching $1 billion a year which--according to Annex IV of the staff paper--has emphasized industrial restructuring and improved cost recovery.

I am also concerned by the statement in the background paper that "public sector enterprises play a large and growing role in the economy". How do the authorities reconcile this with their long-term objectives? This paper also notes that there are 158 nonfinancial enterprises fully owned by the Government, and yet we see very little in the way of a program to privatize sound enterprises and to liquidate marginal ones. I would like to have the staff's assessment of how much of a fiscal contribution--in terms of percent of GDP--could be made by this sector in the current fiscal year and the next if a major effort were made to sell off nonessential enterprises, and to improve the financial performance and accountability of those that remain.

Turning to financial sector reform, we welcome the measures announced last December to develop the domestic capital market. This market should be playing an important role in mobilizing domestic capital, and the December measures constitute important steps in the right direction. We see a bright future for Indonesia's capital market assuming that the authorities move vigorously to subject the public enterprise sector to the discipline of this market, and that they accelerate the process of deregulation that began in 1985.

As we note in the Board with some regularity, adjustment efforts tend to be more successful when they are pursued through comprehensive, mutually reinforcing efforts. The deregulation of economic activity in Indonesia is especially important in this regard. Obviously, we were encouraged by the three packages of measures relating to trade, production, and investment that were adopted in 1987. We were disappointed, however, that tariff increases accompanied the removal of import controls on many items so that the level of overall protection remained unchanged. We urge the authorities to move deliberately and quickly to reduce the level of protection, and we would hope that the World Bank, in the process of supporting trade liberalization in Indonesia, would not be satisfied with a slower pace of liberalization than the Fund staff would consider appropriate. Furthermore, we place particular importance on the elimination of monopolistic practices involving both domestic and international commerce.

In concluding, I would like to make several points in reaction to the medium-term scenarios presented by the staff. First, Indonesia is a heavily indebted country. I do not see how the Indonesian authorities can be satisfied with any medium-term scenario in which the level of debt--even in nominal terms--is higher in five years than it is today.

Second, Indonesia currently receives a large amount of official capital, and the amounts are projected to increase slightly over the medium term. I would think that it would be more prudent for Indonesia to follow a strategy that places somewhat less reliance on official capital.

Third, following from the first two points, the current account adjustment projected for 1988/89 appears modest compared to the medium-term objective. The outcome appears to be determined by a level of imports that strikes me as unnecessarily high. I would be interested in the staff's views on policies that might be adopted that could bring the 1988/89 deficit down to the $1.2-1.5 billion range, and whether this could be done without adversely affecting Indonesia's medium-term growth prospects.

Finally, my authorities would like to acknowledge the extraordinary skill with which the Indonesian authorities have steered their economy toward the objectives of sustainable growth and balance of payments viability. Despite adverse winds and unexpected currents, the Indonesian economy remains on course. Having successfully passed numerous shoals, the authorities should be increasingly confident of the ability of their economy to respond positively to additional policy reforms that will bring them to their destination more quickly.

Mr. Rye observed that the development of the Indonesian economy had been quite satisfactory. Most of the major indicators--output, investment, inflation, exports, and the external payments position--had turned in encouraging performances in 1987 and showed every sign of maintaining their momentum into 1988. Evidently, the appropriate conduct of macroeconomic policies had been a major factor underlining the marked improvement in economic performance. While uncertainty about oil prices might still impose a restraining influence on the economy, that impact had been significantly reduced by the authorities' impressive efforts of structural adjustment. Those efforts had led to rapid growth in non-oil sectors, and were gradually weaning the economy away from excessive government control, and excessive dependence on public expenditure. In short, the authorities were to be commended for their success in reviving the economy.

Notwithstanding the continued improvement, however, the fiscal sector was still a cause of concern, Mr. Rye continued. While uncertainty currently prevailing in the international oil markets might thwart the achievement of revenue targets, the increase in debt service payments and continued subsidy payments could be major impediments to further reductions in government expenditures. Under those circumstances, additional external borrowing appeared unavoidable. It was, however, clearly necessary to limit the borrowing so far as possible, even borrowing on concessional terms, in light of the heavy debt burden currently carried by the economy. Therefore, he supported the authorities' intention to put greater emphasis on domestic resource mobilization, and to curtail subsidies and to improve the efficiency of the public sector.

Indonesia's debt service burden had been exacerbated by the sharp depreciation of the U.S. dollar, as a large proportion of its foreign debt was denominated in nondollar currencies, Mr. Rye remarked. As a result, the debt service ratio was forecast to rise to 37 percent in 1988/89, with only a slow decline expected in later years. The authorities had opted for a restructuring of the economy to achieve external liability, rather than a rescheduling of debt. He endorsed both their choice and their determination to continue the wide-ranging structural adjustment with a view to improving the competitiveness of the economy, reversing speculative capital outflows, and attracting direct foreign investment. As the economic adjustment and reforms strengthened further, with the support of international financial assistance, Indonesia would be able to regain its economic growth momentum. Finally, he joined other Directors in welcoming the Indonesian authorities' intention to accept the obligations of Article VIII, and he supported the proposed decision.

Mrs. Hepp said that she was pleased to note that Indonesia maintained an exchange system free of restrictions on payments and transfers, and had accepted the obligations of Article VIII. Her authorities supported the proposed decision.

The Indonesian authorities were to be commended for the improvements in economic performance achieved during 1987, Mrs. Hepp continued. As Mr. Ismael had noted, the main features characterizing economic policy in 1987, and which had contributed to those accomplishments, had been the further deregulation of the economy, and adequate fiscal, monetary, and exchange rate policies. Since her authorities were in broad agreement with the staff appraisal, she wished to make only a few comments on specific policy areas.

The authorities recognized the adjustment realized in fiscal policy by the significant reduction in the deficit to 2.25 percent of GDP, Mrs. Hepp remarked. For the 1988/89 budget, the authorities envisaged a further reduction of fiscal deficit to about 0.5 percent of GDP. Expenditures were expected to remain unchanged in normal terms, including a freeze on wages and salaries for a third consecutive year. Nevertheless, interest payments on the external debt could be underestimated, partly as a result of depreciation of the U.S. dollar. In addition, some further adjustment in the price of several subsidized products would be needed, so as to permit the reduction in subsidies to the level contemplated in the budget. On the revenue side, the staff had indicated that additional measures would also be necessary to achieve the expected increases in non-oil revenues. In that regard, she encouraged the authorities to pay close attention to the control of expenditures and to the enhancement of revenue, and to adopt the measures needed to achieve the expected improvement in the fiscal position.

The risk of a slowdown in the implementation of structural or adjustment measures--such as a less restricted fiscal stance--were described in the alternative medium-term scenario in the staff paper, Mrs. Hepp observed. Those scenarios clearly showed the difficulties facing the authorities as they sought to achieve external viability and the required sustained growth in the medium-term, if policy actions were relaxed. On the other hand, it was encouraging to learn from the baseline scenario that if the restrictive stance of domestic financial policies was maintained, and under the same set of general assumptions, a 5 percent of real growth of GDP--sufficient to absorb the projected increase in the labor force--together with low inflation and a balanced external current account could be expected for the coming years.

Her authorities welcomed the shift in monetary policy that had occurred by mid-1987, Mrs. Hepp commented. The objective of stabilizing interest rates had been reoriented toward supporting the exchange rate and protecting the international reserve position. The opportune response of the Bank of Indonesia to speculative activities in the foreign exchange market, a response that had helped to enhance confidence in the rupiah, had also led to increases in interest rates. Although she understood the authorities' concern about the effects of high interest rates on investment, she agreed with the staff that, given the high debt burden and the uncertainties prevailing in the oil market, the high exchange premium included in the structure of interest rates was needed.

In the area of structural reforms, the Indonesian authorities had in recent years introduced extensive deregulatory measures, Mrs. Hepp went on. Her authorities encouraged them to continue the deregulatory process, with the objective of improving the efficiency and competitiveness of the economy. Given the high debt burden and the rapid growth of population and the labor force, it was necessary to resolve the prevailing imbalances, and to achieve the high and sustained growth that was necessary in the medium term. The efforts undertaken by Indonesia merited support from the international community.

Mr. El Kogali made the following statement:

> The Indonesian authorities should be commended for their skill in economic management over the last two years. As the oil sector accounted for 75 percent of GDP, 66 percent of government revenue, and 80 percent of export earnings, the Government had to undertake major adjustments following the sharp decline in the oil prices. I was pleased to see the achievements recorded in 1987/88 and projected into 1988/89. In particular, the GDP growth rate has accelerated, especially in the manufacturing sector, to an annual rate exceeding 4 percent, while the rate of inflation is now expected to be reduced to 5 percent in 1988/89

from over 9 percent two years ago. The greatest achievement has been made in correcting financial imbalances in the fiscal and external fields, sectors which relied heavily on oil revenues. The authorities' adjustment measures succeeded in reducing the budgetary deficit and the external current account deficit by more than half in 1987/88 to 2.2 percent of GDP and 2.7 percent of GDP, respectively.

Let me now turn to the interplay of the structural, external, and financial policies that worked so well in Indonesia. As Mr. Ismael explained, the wide-ranging measures of deregulation enacted in 1987 made a major contribution to growth in investment and production, especially in the manufacturing sector. Deregulation removed impediments to investment and production, thus broadening the scope for foreign and domestic investment in the production, service, and trading sectors. In the course of 1987, the result was a 76 percent increase in foreign investment approvals and a 132 percent increase in domestic investment approvals. Since these structural policies have been so successful, and there are still numerous restrictions and monopolies, the authorities are proceeding with the deregulation program in collaboration with the World Bank.

The deregulation measures were complemented by an appropriate exchange rate policy, as the rupiah was devalued by 31 percent in September 1986. The real effective exchange rate depreciation during 1986/87 reached 34 percent, considerably boosting the competitiveness of Indonesian exports. The resulting large increase in the volume of non-oil exports and the 11 percent improvement in terms of trade led to the turnaround in the balance of payments in 1987/88 to an overall surplus. We expect the authorities to maintain a similar exchange rate policy in 1988/89. In addition, the flexible management of interest rates played a crucial role in reversing capital outflows in mid-1987, underscoring the need for complementary exchange and interest rate policies to underpin Indonesia's medium-term balance of payments. This is particularly important since Indonesia has limited room for external borrowing for balance of payments support, as the debt service ratio has reached a high level estimated at 37 percent for 1988/89.

The dramatic improvement in fiscal performance in 1987/88 was due both to additional revenue measures and to expenditure restraint, and the authorities wish to maintain the same policy stance in 1988/89. In that case, the staff forecasts the same level of budget deficit, but Mr. Ismael projects a virtual balance. With regard to 1988/89, however, I would agree with the staff recommendation to lean more on revenue measures, as there is little room for further expenditure restraint. In particular, the best option appears to lie in broadening the VAT tax base, increases in some tax rates, further improvements in tax collection, and the rationalization of public enterprises. On the expenditure side, capital expenditure has fallen in real terms and the development budget now contains only essential domestic programs and ongoing projects. The authorities should therefore be cautious in making further cuts, and should seek external donor financing more actively. As Mr. Ismael explained, the cost of adjustment in terms of growth has been high, with real GDP growth falling from 7 percent to 8 percent annually in the 1970s to an average of 4 percent during the past five years.

We also congratulate Indonesia for accepting obligations of Article VIII, Sections 2, 3, and 4, and support the proposed decision.

Mr. Al-Assaf made the following statement:

I would like to join other speakers in commending the Indonesian authorities for the extent of the adjustment they have been able to achieve over the last few years. Clearly, this adjustment was made necessary by an excessive degree of dependence on oil and gas, especially for a country of Indonesia's size and resources.

The results of the authorities' actions can best be seen in the areas of previous weaknesses. On the external side, the vigorous expansion of non-oil exports has substantially reversed the dependence on oil. Today, non-oil exports are again the largest source of foreign exchange. On the fiscal side, the ratio of revenues derived from the energy sector has declined in relation to other revenues, and is expected to decline further. In sum, the authorities have been successful in correcting financial imbalances, and have achieved a firm basis on which to sustain a satisfactory growth momentum, while continuing to open up the economy. The thrust of future efforts planned by the authorities seems well tailored to allow them to capitalize on what has been achieved so far.

First, it will be essential that future efforts continue to give the highest priority to facilitating the promotion of non-oil exports. The capacity of the Indonesian economy to respond to domestic and external incentives has been impressive in recent years, especially in 1987. Building on those recent successes will require further simplifications in the existing system of regulations on trade, production, and investment. Deregulation is obviously a matter to which the Government is giving high priority, as evidenced by the list of measures adopted in 1987 and mentioned in Mr. Ismael's statement. More will need to be done in order to enable the private sector to further enhance its contribution to growth and total exports.

Second, a gradual and steady opening up of the economy should also be viewed as a key to the process of modernizing the economy. In this respect, attracting foreign investment will play a key role. The sharp increase in foreign investment in 1987 indicates that the level of incentives presently offered to investors is probably correct. From a longer-term perspective, however, a further opening up of certain areas of business to foreign investment might also become necessary.

Finally, I tend to share the disappointment expressed about the low rate of return on capital invested in public enterprises. In view of the present budget constraints and the need to minimize recourse to borrowing, improving the financial position of those enterprises as a group would seem essential. I would be interested to know whether the authorities have further plans in this area, and whether the World Bank could be of assistance. Perhaps Mr. Ismael could elaborate on this point.

In conclusion, the Indonesian authorities have weathered a period that has been particularly difficult for many developing countries, in a commendable manner. The quality of their performance has been recognized by international financial markets, and it is noteworthy that Indonesia has been able to maintain its access to such markets. This should be interpreted as an additional vote of confidence in the prospects of the economy and the policies being implemented by the authorities. I would like to add my own vote in support of this view, and to join other Directors in welcoming Indonesia's important decision to accept the obligations of Article VIII, Sections 2, 3, and 4.

Mr. Rebecchini made the following statement:

Positive developments have characterized the Indonesian economy in the past year, owing to favorable external developments and to a series of courageous adjustment measures pertaining to demand management policies and structural reforms. Among several positive results, non-oil production and exports expanded remarkably. This indicates that the country has entered a promising path that should help to reduce its heavy dependence on oil. Notwithstanding these favorable results, diversifying the productive and the export base of the economy will continue to be a high priority, in order to establish the most appropriate framework for sustained and stable growth.

We share the staff's emphasis on the need for further reductions in the budget deficit. At the same time, the strategy for fiscal consolidation must provide sufficient support for diversification. The authorities should, therefore, strictly adhere to their commitments to cut current expenditures, particularly the subsidized items, and to reduce their capital outlays. We approve the maintenance of development expenditure and net lending at more or less constant levels in terms of GDP in the coming fiscal year, following the sizable reduction in past years. At the same time, public investment programs should be concentrated on projects aimed in particular at production diversification and export enhancement.

On the revenue side, we welcome recent measures to broaden the VAT base and the decision to remove tax exemptions from time deposits. Those measures should help to foster the development of capital market instruments. In general, further strengthening of the tax administration and improvement in the collection of non-oil taxes should be sought.

In the area of monetary policies, we welcome the recent shift in policy objectives to the support of international reserves. This change prompts two considerations. First, it will possibly induce a higher level of real interest rates, which in turn will affect investment. In order to offset these negative effects, structural and fiscal measures supportive of growth should be stepped up. Second, the shift in objectives, if anything, reduces the degree of freedom of fiscal policy, because it reduces the scope for deficit monetization and makes the need for further budget consolidation all the more urgent. The authorities will have to continue to aim exchange rate policy toward fostering the expansion of the productive base of the economy by maintaining an adequate level of competitiveness. Since the 1986 devaluation, the rupiah exchange rate has been remarkably stable vis-à-vis the dollar, as evidenced by Chart 9 of the background paper. While this practice might be consistent with the objective of maintaining external competitiveness at a time of a declining dollar, it is bound to induce a loss of competitiveness if the dollar appreciates. Some clarification on the part of the staff or Mr. Ismael on the reason for and the scope of this apparent dollar pegging would be welcome. The responsiveness of the Indonesian economy to exchange rate changes is underlined by the strong performance of manufacturing exports, and by the tourism receipts that resulted from the 1986 devaluation. As in other economies largely dependent on one single commodity, the success of an expenditure-switching strategy will require the continued support of structural measures aimed at enhancing the role of price signals and at removing supply distortions and bottlenecks.

This brings us to the issue of structural reforms. Since 1985, the authorities have been implementing a wide-ranging policy of trade and industrial deregulation. The pace of these efforts should be maintained and, if possible, stepped up in the coming years. In this respect, we are reassured by Mr. Ismael's indication that the authorities are aware of the need for further liberalization and are committed to its implementation. At this stage, we support the authorities' intention to reform the trade system by attaching higher priority to the elimination of non-tariff barriers. However, it is also important that this first step be followed by the rationalization and the reduction of tariff rates. Moreover, further efforts seem to be required in the area of industrial deregulation, particularly investment licensing, where the recent reform measures seem to have achieved only in part the original goals of improving administrative efficiency. Development of a broad capital market, which has already received significant momentum from recent government initiatives, will also be necessary, so as to foster the mobilization of financial and entrepreneurial resources in support of the diversification process.

Finally, we commend the authorities for their acceptance of the Article VIII obligations, which highlights their commitment to maintaining an open and liberal payment system.

Mr. Goos said that he too commended the authorities on the impressive performance in 1987. The past year's outturn clearly demonstrated the virtues of financial restraint and of economic liberalization in the circumstances facing Indonesia. Thus, like others, he welcomed the authorities' intention to maintain their course of adjustment. That appeared highly appropriate, given that the external position remained vulnerable, and because there was some deterioration in the external debt ratios.

He agreed with much that had been said on fiscal policy, and emphasized that further fiscal adjustment was absolutely essential for the success of the stabilization effort, Mr. Goos continued. He was, therefore, somewhat concerned to see a virtual halt in the adjustment projected by the staff for 1988. Also, in view of the comparatively low ratio of revenue to GDP, he encouraged the authorities to adopt the revenue increasing measures currently under consideration, and also perhaps a general increase in the VAT. The objective of generating adequate fiscal savings could assume additional importance in the current fiscal year, given the likelihood of a strong pickup in private sector investment activity, which could overstrain domestic resources.

In the present circumstances, one should not look back with nostalgia to the growth rate of the 1970s, Mr. Goos observed. After all, those rates had not turned out to be sustainable and the projected growth rate of 5 percent was not exactly modest. Moreover, there was certainly no trade-off between adjustment and growth, at least in the long run.

He was impressed by the swift response of the monetary authorities to the capital outflows in 1987, and by the shift to a more flexible interest rate policy, Mr. Goos commented. But he was somewhat concerned about the continued strong expansion of monetary and credit aggregates in recent years. The staff had explained that expansion was a reflection of changes in portfolio preferences. While there were good reasons to believe that argument, the authorities should be alert to the fact that once those changes had run their course, monetary expansion would need to be curtailed in order to avoid a buildup of inflationary potential.

He was somewhat concerned that the withholding tax on interest earnings could spur renewed capital outflows, Mr. Goos remarked. There had already been some reaction in the market when the first rumors had appeared that such a tax might be introduced. The taxation of interest payments had been abolished only in 1984 or thereabout, and at that time the intention was to improve the attractiveness of domestic financial investment. Perhaps the staff could comment on that issue.

Mr. Sengupta had offered an interesting comment on the double function of interest rates with regard to external stabilization and the possible stimulation of domestic investment activity, Mr. Goos recalled. He agreed with Mr. Sengupta, and also with the staff, that for the time being there was little alternative but to emphasize the external function of interest rate policy. In the longer run, however, deepening of domestic capital markets could create some scope to differentiate the interest rate instrument by using short-term rates for external stabilization and the longer-term rates to stimulate investment activity.

In assessing the numerous and commendable initiatives taken in the area of structural and deregulation policies in 1987, it was fair to say that the deregulation process still took place within a context of numerous remaining restrictions and regulations, Mr. Goos observed. Thus, as previous speakers had stressed, much remained to be done in order to improve efficiency in the supply capacity of the economy. In that context, the series of measures introduced in 1987 suggested that the authorities should aim to formulate a more comprehensive and systematic approach to structural reform. More specifically, he feared that the effectiveness of liberalization in the area of trade and foreign direct investment might have suffered from the piecemeal fashion in which it had been implemented in 1987, although he admitted that the immediate results did not support that view. However, three of the four packages adopted in 1987 had brought changes to the foreign direct investment regime in close succession, and thus might have exposed potential foreign investors to a substantial degree of uncertainty. To put it differently, that type of uncertainty could perhaps have been reduced if the authorities had embarked on a more predictable and comprehensive approach to structural reform.

In reference to the outstanding statistical issues noted in Annex 3 to the staff paper, he hoped that those issues would be settled before long with the assistance of the Fund, so as to allow a more accurate and perhaps more detailed assessment of the economic situation, Mr. Goos said. Finally, he commended the authorities on their acceptance of the obligations of Article VIII, and supported the proposed decision.

Mr. Othman made the following statement:

After facing the difficult external environment which adversely affected economic performance in 1986, the Indonesian economy performed remarkably well in 1987. Output growth was sustained at over 4 percent, the fiscal deficit dropped from 5 percent to 2.2 percent of GDP, the external current account deficit was cut in half, and the overall balance of payments turned to a surplus from a large deficit in 1986.

This favorable economic outturn can undoubtedly be attributed largely to the broad range of macroeconomic and structural adjustment measures undertaken by the authorities. The thrust of the fiscal policy adopted by the authorities since 1986 has been instrumental in the remarkable fiscal adjustment achieved in 1987/88. The authorities' intention to further reduce the deficit in coming years is welcome, notwithstanding the current expectation that the budgeted reduction in the fiscal deficit in 1988/89 may not be realized. The substantial decline in expenditure during the past two years has undoubtedly had a positive effect on the budget performance. As this has been largely accomplished through a substantial cutback in development expenditure, it is crucial that the authorities continue the process of structural reform aimed at enhancing private sector investment in order to mitigate the potential impact on future growth of the cuts in public sector investment. In this context, it is encouraging to note from Table 6 of the background paper that total investment expenditure relative to GDP has actually increased in 1987, with private investment more than compensating for the decrease in public sector investment.

The firm implementation of the program for assessing the operations of the public enterprises with a view to improving their efficiency and productivity is particularly important for improving the fiscal position.

On wages, I noted that the 1988/89 budget assumed a continuation of the freeze on wages and salaries for a third consecutive year despite the increase in the rate of inflation from 3.7 percent in 1985 to 9.1 percent in 1987 and an estimated rate of 8.5 percent in 1988. The authorities' intention to adjust wages and salaries in terms of a one-time bonus, conditional on better oil and gas revenue performance, appears reasonable given the decline in real public sector wages and the need to contain fiscal spendings. In this connection, we share the staff's view that the additional revenue measures are necessary to achieve further reductions in the deficit. This would also help to avoid a concentration of the adjustment burden on public sector employees.

The authorities are to be commended for their effective monetary management. The large devaluation of the rupiah in September 1986 and the authorities' continued commitment to pursuit of a flexible exchange rate policy, together with the other deregulations measures, have effectively ensured the external competitiveness of the non-oil exports--which increased by one third in 1987/88 over 1986, surpassing oil export earnings for the first time since the early 1970s. This has, at the same time, been accompanied by an inflation performance which--given the large devaluation--is quite moderate. The recent shift in monetary policy toward supporting the international reserve position has also proved effective. The sharp increase in interest rates can be justified as a means of reversing the outflow of private capital. However, one would expect that a sustained improvement in the external position and in the general confidence in the economy will allow a reduction in the high real rates of interest prevailing since mid-1987.

While it is encouraging to note from the staff's medium-term scenarios that a steady and lasting decline in the burden of debt service is expected during the next few years, caution is called for, particularly given the Indonesian economy's vulnerability to changes in the external environment. In this connection, and given the adverse effect of the dollar's depreciation on Indonesia's debt position, we fully agree with Mr. Ismael that effective implementation of international policy coordination is very important to ensure maintenance of stable exchange rates, which will prevent successful ongoing adjustment programs from being destabilized. However, it would be interesting to know from the staff or Mr. Ismael whether consideration has been given to utilizing some of the hedging mechanisms available in the market. It would seem that Indonesia is well placed to make use of such instruments, given the structure of its balance of payments and its relatively well-developed debt management system. Finally, we welcome Indonesia's acceptance of the obligations of Article VIII, Sections 2, 3, and 4 and support the proposed decision.

Mr. Ovi remarked that he had a few general observations. First, in May 1987 the Board had approved a sizable drawing under the compensatory financing facility for Indonesia. Developments since then had confirmed that Indonesia's was a most appropriate case for a lower tranche compensatory financing. Second, the Indonesian case demonstrated that economic policies did make an important difference to economic development. Through consistent long-term adjustment efforts, Indonesia had been quite successful in restraining adverse external developments. Third, although major uncertainties remained, the staff's medium-term projections were encouraging. In particular, economic growth could generate sufficient employment opportunities to absorb the increase in the labor force, and could do so under conditions of low inflation and the attainment of the balance of payments equilibrium. That was a substantial achievement for a major developing country such as Indonesia, with a large and rapidly growing population.

Thus, he encouraged the authorities to continue their adjustment efforts, Mr. Ovi continued. In that respect, he was concerned that the staff seemed to be making a valid case for the lack of improvement in the fiscal position in 1988. Finally, he saw the authorities' decision to accept Article VIII status as a sign of confidence in their own achievements, and he welcomed their decision.

Mr. Agah made the following statement:

I fully support the staff appraisal, so I shall be brief. Given the negative impacts of the sharp fall in oil prices in 1986 and the weak prices in other commodity markets, and given the sizable depreciation of the U.S. dollar vis-à-vis other major currencies--which dramatically increased the dollar value of Indonesia's external debt burden--the authorities should be commended for their resolve to implement timely macroeconomic adjustment measures during 1986/87-1987/88. These adjustment measures, together with increased support from aid donors, maintained moderate domestic growth, after the impressive growth in 1986/87, and maintained balance of payments viability. Trade and industrial reforms, reduction in government expenditure, improved administration of the tax system, and a 31 percent devaluation of the rupiah in September 1986 were among the major adjustment measures that, despite a severe drought, provided the main impetus for the economy to perform so well in 1987. The manufacturing sector--which contributed to an impressive recovery in GDP in 1986 and its further increase in 1987--reflected the favorable impact of the deregulation measures that relaxed the trade, investment, and industrial licensing system. Together with the 1986 devaluation, that greatly improved competitiveness. Non-oil export earnings exceeded the 1986 level by 30 percent, and surpassed oil export earnings for the first time since the early 1970s.

Mainly as a result of a strong increase in non-oil exports and partial recovery of oil prices, the external current account deficit was reduced by half. A surplus in the overall balance of payments was achieved by a tightening of monetary policy which brought about a favorable reversal of private capital flows. Nonetheless, as in the case of other oil-producing countries, the negative effects of the depreciation of the U.S. dollar has been substantial; it accounts for about 75 percent of the increase in the dollar value of Indonesia's external debt in 1987/88. Thus, while the debt service ratio declined somewhat in the same period, it continued to impose a heavy burden on the economy.

Fiscal policy was generally restrained in 1987/88. Severely constrained expenditures, higher oil prices, and improved tax administration contributed to an appreciable increase in revenues, which in turn substantially reduced the overall budget deficit.

The appropriateness of the monetary policy stance, as well as the effectiveness of prompt and resolute action by the authorities through the introduction of several reform packages--especially the extensive package introduced in December 1987--have greatly reduced import licensing and simplified procedures for exports and investments. These reforms, together with the improved competitiveness, have restored public confidence in the rupiah and have helped diversification of investment, in favor of non-oil/liquified natural gas exports. Accordingly, the dependence of Indonesia's economy on the oil/liquified natural gas sector has significantly diminished.

While the medium-term adjustment strategy is supported by the staff, I am heartened to note that both the staff and the authorities recognize that in light of the country's severe resource constraints and the demand created by a growing population, little room is left for complacency. Indonesia's performance in recent years and achievements as a result of faithful implementation of Fund-recommended policies provides an opportune occasion to evaluate the real effectiveness of these recommendations. Mr. Ismael has correctly called our attention to the high cost of adjustment in terms of economic growth by considering that real GDP growth has fallen from 7 percent to 8 percent annually in the 1970s to an average of only 4 percent during the past five years. What is worrisome are the rather gloomy prospects in the external environment facing the country in the near future. Uncertainties surrounding the future of oil prices and the fate of the dollar vis-à-vis other major currencies continue to place heavy burdens on Indonesia, and more generally on many other developing countries. As this chair stated during our latest world economic outlook discussion, I wonder for how long and to what extent developing countries can be expected to carry the burden not only of their own needed adjustments, but also those of the industrial countries. Hence, the need for further borrowing and international financial assistance for these countries appears indispensable for the foreseeable future. The Indonesian authorities, however, deserve commendation for their ongoing and strenuous adjustment efforts and persistence.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/72 (5/6/88) and EBM/88/73 (5/11/88).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 87/142 and 87/143 are approved. (EBD/88/124, 5/4/88)

Adopted May 10, 1988

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/88/113 (5/5/88) and by an Assistant to Executive Director as set forth in EBAP/88/116 (5/6/88) is approved.

APPROVED: December 16, 1988

JOSEPH W. LANG, JR.
Acting Secretary