NOT FOR PUBLIC USE

MASTER FILES

ROOM C-120 04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/28

3:00 p.m., February 14, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	A. R. Ismael, Temporary
	D. C. Templeman, Temporary
J. de Groote	G. Ercel, Temporary
	S. de Forges
	G. Nguyen, Temporary
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
	Jiang H.
J. E. Ismael	
	J. Hospedales, Temporary
T. P. Lankester	
	H. Fugmann
M. Massé	L. Leonard
E. I. M. Mtei	
	B. Jensen
	M. A. Weitz, Temporary
Y. A. Nimatallah	
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuâldez
G. Salehkhou	
A. K. Sengupta	A. S. Jayawardena
	A. Vasudevan, Temporary
	L. Tornetta, Temporary

J. W. Lang, Jr., Acting Secretary
L. Collier, Assistant
J. K. Bungay, Assistant

Also Present

IBRD: A. O. Hamilton, East Asia and Pacific Regional Office. Asian Department: A. K. McGuirk, R. J. Niebuhr, D. M. Ripley, S. Tiwari. European Department: O. J. Evans, N. L. Happe. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; E. H. Brau, G. Hacche, A. B. Petersen. Fiscal Affairs Department: S. Richupan. Legal Department: F. P. Gianviti, Director; P. L. Francotte, J. K. Oh. Research Department: P. R. Masson. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; K. B. Bercuson, P. B. Clark, R. J. Corker, L. E. DeMilner, E. Hernández-Catá. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, G. W. K. Pickering. Assistants to Executive Directors: J. R. N. Almeida, A. Bertuch-Samuels, B. Bogdanovic, J. de la Herrán, J. J. Dreizzen, S. Geadah, V. Govindarajan, G. D. Hodgson, O. Isleifsson J. M. Jones, S. King, H. Kobayashi, R. Msadek, K. Murakami, J. Reddy, J. E. Rodríguez, S. Simonsen, B. Tamami, A. J. Tregilgas, H. van der Burg, B. D. White.

1. CANADA - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/86/27, 2/14/86) their consideration of the staff report for the 1985 Article IV consultation with Canada (SM/86/1, 1/3/86; and Sup. 1, 2/13/86). They also had before them a report on recent economic developments in Canada (SM/86/16, 1/31/86).

Mr. Sengupta said that the Canadian authorities should be commended for their excellent management of the economy, which had exhibited several positive features during the past year. Real GNP had increased by 5 percent in the third year of the recovery, investment had picked up thereby laying a solid foundation for growth in the medium term, inflation had continued to be moderate at about 4 percent, and the unemployment rate had declined somewhat. However, exports had slowed down--although from the extremely high levels of the previous two years--the rate of unemployment had continued to be high, the balance of payments had shown a deficit after three successive years of surplus, and the federal fiscal deficit and consequently the national debt had remained large.

The staff and the Canadian authorities recognized that reduction of the fiscal deficit and the rate of unemployment required urgent attention, Mr. Sengupta continued. The comprehensive strategy outlined in the November 1984 Economic Statement aimed at tackling those two problems. However, under present assumptions, the reduction in the level of the deficit in the period until 1990/91 would be small and the federal debt would continue to rise in relation to GNP during that period. It was not clear from Mr. Massé's statement whether the authorities continued to be committed to the goal of stabilizing the federal debt in relation to GNP by 1990/91 and if so, how the authorities intended to achieve that objective. It was also not clear whether the authorities agreed with the staff that "a more heavily front-loaded fiscal plan would achieve an earlier and more pronounced deceleration of the federal debt, would yield greater savings in the form of interest payments, and therefore would result in a larger reduction in the deficit over the medium term." If the authorities agreed, he asked Mr. Massé or the staff to explain what steps the authorities were planning to take.

The deficit reduction process was necessarily time-consuming if orderly adjustment were to take place, Mr. Sengupta commented. In the case of developing countries, the argument had been put forward that drastic reductions in fiscal deficits not only caused disorderly conditions in the economy but also led to social and political tensions. But in the case of Canada it was not clear what the outcome would be in terms of inflation and balance of payments viability if the medium-term fiscal goal of deficit reduction of about 1 percent of GNP as indicated by the staff were not achieved.

The recent weakness in the Canadian dollar was puzzling, Mr. Sengupta remarked. The Canadian authorities had had to intervene in the markets in recent weeks to check the further depreciation of the Canadian dollar.

The balance of payments figures did not suggest any large-scale capital movement out of Canada, and there did not appear to be any developments in the economy that could have generated major problems with respect to expectations. The staff had not been able to explain fully the recent movements of the Canadian dollar and had cited the effective appreciation of the U.S. dollar from mid-1980 to early 1985, which could not be fully explained on the basis of changes in real interest rates and balance of payments variables. Even if the behavior of the Canadian dollar could not be explained, measures should be taken to revise the declining trend in order to, first, manage Canada's monetary policy appropriately, as the freedom to maneuver interest rates was limited by exchange rate movements; and second, achieve a fall in the effective exchange rate of the U.S. dollar, in which the role of the Canadian dollar was important. Estimates indicated that if the Canadian dollar continued at the rate of US$0.70, the Japanese yen might have to fall to ¥ 140 = US$1 and the mark to about DM 2 = US$1 to attain the U.S. dollar base in 1984.

The commitment of the Canadian authorities to multilateralism and free trade was welcome, Mr. Sengupta noted. However, the recent bilateral negotiations with the United States with the aim of liberalizing trade between the two countries was a matter of grave concern. The McDonald Commission had expressed the view that the bilateral arrangement with the United States would have to be compatible with Canada's obligations under the GATT, and it was not clear how that conflict between multilateral responsibility and bilateralism would be resolved. Although the staff had presented the Canadian authorities' views on the subject, it had not presented its own. Clearly, a bilateral arrangement of that nature might undercut the foundations of multilateralism; such an arrangement could mark the beginning of a trend, which could, if allowed to continue, return international trade to pre-World War II conditions. The issue was a serious one that merited attention. The staff must go beyond "taking note of these developments" and examine the implications of the different proposals at the initial stage of their discussion and report to the Board for consideration, therefore acting in keeping with the principles of symmetry and effective multilateral surveillance.

Since most of the Canadian-U.S. trade was subject to negligible duty, the bilateral arrangement would obviously concentrate on nontariff barriers, existing or potential, Mr. Sengupta observed. The possibility of trade diversion in such arrangements might be substantial, and while the effect might be more severe on other developed and EC countries, trade diversion was also a matter of concern to developing countries, especially if it set a trend. Furthermore, such arrangements could cause protectionist pressures in some sectors of one country to spread to the policies of another, as had happened to some extent in the case of automobiles when the 1981 U.S.-Japanese agreement had been followed quickly by the Canadian-Japanese understanding; the argument given had been the threat of entry through Canada of Japanese cars into U.S. markets.

It was unfortunate that actions had been taken by the Canadian authorities in 1985 to tighten controls on textiles as well as on imports from small, low-income developing countries such as Bangladesh, Indonesia, Malaysia, Sri Lanka, and Thailand, Mr. Sengupta continued. He hoped that the authorities would reconsider their actions in view of the severe hardship that those measures had caused, especially to the smaller countries. While he welcomed the recent decision not to renew quotas on footwear imports, he was concerned that there might be a tendency to replace formal barriers with less transparent and nuisance barriers. In light of the fact that Canada had been posting impressive growth rates and that the competitiveness of the products had been substantially restored, he strongly urged the authorities not only to resist protectionist pressures but also to further liberalize imports. Such action would help the developing countries not only earn needed foreign exchange but also achieve the general objective of a more efficient allocation of resources.

The decision to raise the ratio of official development assistance to GNP was commendable, Mr. Sengupta noted. The commitment of Canada to maintain a large concessionary element in its aid to developing countries was appreciated. While he welcomed the authorities' intention to raise the ODA target to 0.7 percent of GNP by 1995/96, he urged them to consider favorably the recommendations of the Group of Seventy-Seven and the Group of Twenty-Four that that target should be reached as early as possible and at any rate not later than the end of the decade.

Mr. Salehkhou commented that the economic recovery in Canada, which had started in early 1983, had continued to be strong throughout 1985. Unit labor costs had remained stable as productivity gains had matched wage increases. At the same time, sizable progress had been made in controlling the rate of inflation, which had been brought down from its two-digit level of 1981 to 5.5 percent in 1984 and 4 percent in 1985. However, in spite of the slight improvement of 1 percentage point in 1985, unemployment had remained high at 10 percent. That rate was incompatible with the present stage of recovery, and an elaboration by Mr. Massé or the staff on the structural characteristics of the Canadian unemployment level and on the inherent causes would shed some light on the problem.

The proximity of the U.S. market had been a major influence on Canadian trade, which, helped by an upturn of economic activity and a favorable exchange rate, had quickly led to a higher current account surplus in 1984, Mr. Salehkhou continued. With the slowdown in U.S. demand, exports had fallen in 1985, but total domestic demand had continued to provide the impetus for GNP growth, which was estimated to have reached 5 percent. As the economy continued to expand at a fairly rapid rate, a number of policy issues needed to be addressed promptly. They pertained to the federal budget deficit, the level of unemployment, the slow rate of recovery of fixed investment, and high real interest rates.

The May 1985 budget outlined a number of measures aimed at improving the fiscal position, but difficulties of implementation seemed to stand in the way, presaging a continuation of large deficits in the medium term, Mr. Salehkhou observed. The deficit would probably rise to 8 percent of GNP by 1990 because of lower expected growth rates unless strong corrective measures were implemented. The failure of two banks, which had raised budgetary expenditures by US$1 billion in 1985/86, and the withdrawal of the controversial partial deindexation of old age security payments were also behind that deterioration. The authorities had tried to offset those expenditures by increased gasoline and corporate taxes. A substantial shortfall remained, however, and the authorities hoped to clear it through further corrective measures. An improvement in the fiscal position would have positive effects on the level of unemployment, as the deficit tended to crowd out the capital formation necessary for an increase in productive capacity.

Other incentives for the improvement of the rate of employment could come from a well-tailored monetary policy that could stimulate the growth of fixed investment through appropriate interest rates, Mr. Salehkhou added. The margin of maneuver was, however, understandably narrow as the monetary authorities tried to maintain low inflation and a stable exchange rate through an improved economic performance rather than an adjustment in the level of interest rates. The opposite strategy would lead to a depreciation of the Canadian dollar and a rise in inflation.

The major shift in the Government's energy policy contained in the provisions of the Western Accord should further stimulate economic activity, Mr. Salehkhou considered. The deregulation of the National Energy Program, which had resulted in the removal of price controls on crude oil and substantial tax incentives in the energy sector, would lead to the exploitation of oil and gas resources that had been previously uneconomical. However, the decline in the international price of oil had changed the picture, and he wondered whether the staff could elaborate on the cost-price relationship of oil production in some of the Canadian provinces.

Some budgetary improvement could be gained by a thorough examination of the state enterprises, Mr. Salehkhou stated. For several years the Crown corporations had suffered losses and had required, in one form or another, large government subsidies. The announced measures to liquidate or sell some of those companies should alleviate the Government's fiscal position. The reform of public enterprises in Canada represented a large-scale shift in corporate strategy that was especially significant for Canada at a time when it was liberalizing its trade and investment. The decline in relative importance of the mining and forestry sectors in total exports stemmed from inefficiency and a lack of competitiveness in the face of lower-cost mining in some developing countries. The drive to dissolve or streamline the public enterprises and to restore their financial viability was commendable, particularly in light of the high level of unemployment.

With respect to public enterprises and the general role of government in the economy, he shared Mr. Lundstrom's view on the staff appraisal of the Canadian economy and reiterated that the reduced role of government in the economy would not necessarily lead to efficiency, Mr. Salehkhou said. Privatization and efficiency were not one and the same thing.

The external current account was estimated to have recorded a deficit in 1985 that would widen further in 1986, largely because of the slower growth of the U.S. economy, Mr. Salehkhou observed. Canada's external performance could therefore only benefit from the restructuring of its industries and an improvement in its competitive position. The services and transfer balances also showed a growing deficit, owing to increased payments on foreign investment incomes and travel. The frequent interventions of the authorities to defend the Canadian dollar had put a severe strain on the country's international reserves, which had declined substantially in 1984 and 1985.

Canada had traditionally been attached to the provisions of GATT, Mr. Salehkhou noted. The move toward greater liberalization of trade was welcome after the protectionist tendencies which had led to restrictions on textile imports. At the same time, he welcomed the decision to abolish the quota on footwear. The perspectives of a new trade agreement with the United States should not hinder the prospects for cooperation with developing countries in conformity with Canada's commitment to the principle of free multilateral trade. The cooperation between Canada and the developing countries was exemplary, as Canada maintained its level of official development assistance near its U.N. commitment. Furthermore, he welcomed the positive role played by the Canadian International Development Agency in many developing countries.

Mr. A. R. Ismael commented that a number of positive developments had taken place in the Canadian economy; yet there continued to exist some major financial imbalances. Since the end of 1982, the economy had maintained a high rate of real economic growth, and the unemployment rate had been reduced from about 12 percent in 1983 to about 10.5 percent in 1985. The rate of increase in the unit labor costs had been reduced considerably from about 12 percent in 1981 to 4 percent in 1985; during that same period, the rate of inflation, measured in terms of the consumer price index, had been reduced from 12.5 percent to less than 4 percent. Those achievements were commendable for an economy whose performance was influenced to a large extent by developments in the U.S. economy.

He agreed with the staff's identification of the large fiscal imbalance as one of the major problems facing the Canadian authorities, Mr. Ismael said. It was a matter of some concern that the ratio of federal government expenditure to GNP had increased sharply from 21 percent in 1981 to about 26 percent in 1985. During the same period, the ratio of federal revenue to GNP had actually declined, and the budget deficit had increased from about 2 percent of GNP in 1981 to over 7 percent in 1985. In spite of the measures taken by the authorities, the reduction in the level of the budget deficit between now and 1991 would be very small, and it was worrisome that the federal debt would continue to rise in relation to GNP.

The question arose of how to deal with the current and prospective large fiscal deficit, Mr. Ismael continued. The staff stressed the importance of expenditure cuts; it was reluctant to advocate additional revenue measures because it seemed to be concerned about the negative effect of tax increases on incentives. In the Fund's dealings with member countries, there had frequently arisen cases of fiscal imbalances of the magnitude faced by Canada; invariably, particularly in the case of developing countries, the staff and the Board had advocated new revenue measures, together with expenditure control, as a means of correcting fiscal imbalances. He therefore would have liked to see greater consistency in staff recommendations. In particular, he would have liked to see the staff more forthcoming in the present case in advocating additional revenue measures, especially in view of the difficulties of reducing expenditures.

He had some trouble assessing the appropriateness of Canada's monetary policy, Mr. Ismael commented. He agreed with the Canadian authorities that innovations in financial markets had made monetary targeting difficult. In that situation, supplementary indicators should be used to reach a judgment on the stance of monetary policy. Available data suggested that monetary growth in recent times had been high. Over an 11-month period to November 1985, M1 had risen by 9.5 percent and M1A by 40 percent. He wondered whether it would be possible for the staff to make even a tentative judgment, after taking into account any supplementary indicators that might be helpful, on the rate of monetary growth.

On the one hand, the staff had given credit to "restrained monetary policy" for the low inflation and low wage increases, which suggested that the staff favored a restrained monetary policy, Mr. Ismael continued. On the other hand, the staff seemed to say that because inflation and wage increases were moderate at present, the high rate of monetary growth might not be inappropriate in the present circumstances. Those two positions seemed contradictory, and perhaps the staff could state whether it supported a restrained or expansionary monetary policy.

Recent attempts to reverse trade restrictions had been inadequate, Mr. Ismael noted. For example, the elimination of import quotas for footwear would apply only to certain categories. Similarly, the restrictions on imports of textiles and clothing were to be continued. In addition, the formal voluntary restraint on automobile imports from Japan was being replaced by an informal voluntary restraint, which meant in essence no change. At a time when many developing countries were facing severe external difficulties, their access to the markets of industrial countries was crucial. He hoped that in the coming year Canada would be able to show real progress in rolling back protectionism.

Canada's good record of providing official development assistance was laudable, Mr. Ismael commented. At 0.5 percent of GNP, Canada's aid record was better than that of most industrial countries, and he welcomed Canada's intention to achieve an ODA target of 0.6 percent of GNP by 1991 in spite of efforts at fiscal retrenchment. Apart from the volume of assistance, there was also much to be said for the quality of Canadian aid: it was concessional in nature, intended for nonmilitary purposes, and above all, directed to the most needy countries.

There had been a strong economic recovery in both Canada and the United States since 1982, Mr. Ismael noted. In the United States, that recovery had led to substantial job creation and a major reduction in the unemployment rate. Canada had not had the same success in tackling its unemployment problem. He asked the staff to explain the reasons for the difference in the performance of the two economies in dealing with their unemployment problems and to indicate whether the U.S. experience could provide some lessons for the Canadian authorities.

The expansionary financial policies and the projected external deficit tended to suggest that the value of the Canadian dollar should be depreciated, Mr. Ismael said. However, the authorities were determined to maintain a relatively strong Canadian dollar because they would like to control inflation while creating confidence in the dollar. He asked the staff to give its opinion on whether it considered the value of the Canadian dollar appropriate, in the light of the prospects for Canada's external balances and the rate of growth in the gross external indebtedness.

Mr. Romuáldez stated that there were several commendable features of Canadian economic policy and practice during the past year. For example, monetary policy, in spite of difficulties with targeting and interpreting monetary aggregates' behavior, had been successful in keeping inflation under control. At the same time, interest rates had been brought steadily down to a level sufficient to encourage nonresidential fixed business investment and residential construction, although present real levels continued to be high. Consequently, the employment picture had improved, although relatively slightly.

Furthermore, price controls on crude oil had been removed in June 1985, Mr. Romuáldez continued, and in November 1985 action had been taken to reduce government controls over natural gas prices and export volumes. Significant progress had been achieved toward privatization or dissolution of Crown corporations: six had been closed, two were about to be dissolved, and four were on the verge of being sold. The authorities seemed to be successful in resisting protectionist pressures, deciding, for example, not to renew import quotas on footwear, subject to a few exceptions. Furthermore, the Government's decision to raise the ratio of official development assistance to GNP at the present time, when other governments were curtailing their ODA ratio, was particularly noteworthy.

In 1985, overall competitiveness had improved significantly vis-à-vis countries other than the United States, Mr. Romuáldez added. He hoped that the trend in merchandise trade balances of Canada, particularly with other OECD countries, would be reversed as it had deteriorated steadily since 1980, becoming negative in 1984 and worsening further in the first three quarters of 1985.

A major problem, however, persisted and could cause serious difficulties in the medium term, Mr. Romuáldez noted. Despite serious efforts on the part of the authorities to exercise firmer control on the budget and thereby reduce the federal deficit significantly in the medium term, the outlook in the staff appraisal was pessimistic. The main reason was that developments in 1985/86 had not brought about the decline of about \$3.3 billion targeted by the authorities for the deficit. Indeed, expectations were for a 1985/86 federal deficit of \$34.8 billion as opposed to the \$33.5 billion target. The authorities' inability to gain political acceptance of some measures--for example, the partial deindexation of old age security payments--meant that projections of a greatly reduced federal deficit by 1991 were unrealistic; the deficit projection of \$30.0 billion for that year had been changed to \$33.5 billion. The federal debt/GNP ratio, already high in 1985 at 49.8 percent of GNP, was projected to rise to about 62.8 percent in 1990/91.

Given the present momentum of fiscal performance, the Canadian authorities were faced with either the threat of government deficits crowding out capital formation, which could set back efforts to encourage employment creation, or, because of the possible use of foreign savings, the threat of foreign debt service ballooning, Mr. Romuáldez observed. Consequently, more needed to be done not only in terms of revenue measures but also, and more important, in terms of expenditure cuts. The staff was right in alerting authorities to the probable adverse effects of additional tax financing on incentives to work and invest.

Since taking office in 1984, the new Government had made major attempts--at least twice--with updated comprehensive plans to achieve fiscal balance, Mr. Romuáldez noted. In both instances, later developments had hindered the realization of meaningful progress. The Government was again in the midst of trying to reach a solution to that problem, and he wished them the success that they had achieved in other sectors of the economy.

Mr. Weitz observed that the economic situation of Canada had improved over the past year. There had been a balanced expansion of the economy, with a welcome increase in business fixed investment, and inflation had declined. The rate of unemployment, in spite of a recent decline, was still close to 10 percent. Considering that the economy had been growing at a reasonable rate during the past years, structural rigidities might have had an important effect in slowing the reduction in unemployment. While wage policy had been pursued in a prudent way, unit labor costs had risen moderately during the past year, reflecting a cyclical slowdown in productivity growth. The declared policy of promoting investment and job creation in the private sector should help to increase employment.

The new trends and recent depreciation of the Canadian currency, beyond what appeared to be a pure restoration of competitiveness, were noteworthy, Mr. Weitz said. A number of factors had played a role in those developments, but knowledge of the process was still incomplete, and variables singled out as explanations had fallen short of expectations. One important factor was that the fiscal deficit, as a percentage of GNP, was large and a perception existed that some time might be needed to control it. Similarly, the recent fall in energy prices must have increased anxiety in financial markets regarding the repercussions on the economy, and it could have eroded confidence in the Canadian economy. In the same vein, the actions of the Federal Government to cover huge losses after the failures of two important banks had increased expectations that the authorities might do the same if the financial institutions ran into trouble in the future, thus endangering the achievement of a more balanced fiscal position.

He would like the staff to state whether it believed that the recent intervention of the Canadian monetary authorities might help in the coming weeks or in the medium term to keep the currency stable, Mr. Weitz remarked. He also asked the staff to comment on the additional measures that the authorities should implement in order to stabilize the Canadian dollar, and in that context whether it was feasible and convenient to permit further increases in domestic short-term interest rates.

He agreed with the staff that there was no room for maneuver on the fiscal side, Mr. Weitz continued. Considering the magnitude of the problem, a less gradual approach was appropriate, with both significant cuts in expenditures and increases in revenues. Strong action in the fiscal area would make Canada less vulnerable to external developments and would increase investors' confidence in the economy.

The authorities had, in general, been successful with regard to monetary policy, despite the difficulty of using monetary aggregates as policy targets, Mr. Weitz commented. The Bank of Canada conducted monetary policy taking into account a set of economic and financial indicators, including some monetary and credit indicators, the exchange rate, and trends in total spending in the economy. The policy of restraint pursued in the past years should be continued while monetary policy should be oriented to avoid an acceleration of inflation in the medium term.

As to Canada's trade policy, Mr. Weitz continued, the level of protection was a cause for concern. There was a need for better access for developing countries' exports. Canada's system of restrictions seriously affected goods in which many developing countries enjoyed a comparative advantage, and it thereby jeopardized the continued implementation of adjustment efforts by those countries.

The authorities were to be commended for their continued generous official development assistance, Mr. Weitz concluded. In particular, he welcomed the intention of the authorities to raise the ratio of official development assistance to GNP in the coming years.

Mr. Jiang said that he was impressed with Canada's economic performance since the previous Article IV consultation discussion (EBM/85/31, 2/27/85). Real GNP in Canada had increased by about 4.7 percent during 1985, which was higher than the average in the OECD countries. Particularly noteworthy, the Canadian economy seemed to be expanding at a steady and continuing pace. Along with the sustained economic expansion, prices had been stable for some time and, at present, the danger of an acceleration in inflation appeared to be remote. The foreign payments position was strong, although the current account balance had weakened somewhat in 1985.

Two major issues needed careful and skillful handling, Mr. Jiang commented: the long-standing problems of unemployment and the fiscal deficit. There were promising signs that the high level of unemployment might be easing, with the January 1986 unemployment rate in Canada dropping to 9.8 percent compared with 10.2 percent for the fourth quarter of 1985, indicating considerable progress. The most challenging task confronting the Canadian authorities at present was to lower the federal deficit. Indeed, developments in the federal deficit in recent years gave cause for concern, considering that expansion had occurred not only in absolute amounts but also as a percentage of GNP. Particularly worrisome was the fact that the cumulative federal debt, in terms of GNP, had increased from 34.3 percent in 1982/83 to 49.7 percent in 1985/86 and, as a result, interest payments on public debt had increased dramatically and accounted for the largest portion of the increase in total expenditures.

He was impressed by the fact that Canada's official development assistance to developing countries--both bilateral and multilateral--had increased continuously, with the total amount of official development assistance increasing from $1.2 billion in 1982 to $1.62 billion in 1984, Mr. Jiang concluded. In terms of GNP, the figure was 0.5 percent; by 1995/96, it was hoped that a target of 0.7 percent of GNP would be met. That policy was far-reaching and highly commendable.

Mr. Tornetta said that Canada's economic performance in the past year had been characterized by many positive developments. GNP had grown at a buoyant rate of about 4.5 percent; that growth had been sustained by rises in all components of domestic demand and, in particular, by the increase in consumer spending and a pickup in investments. That latter development was encouraging as it had been preceded by three years of sluggish or negative growth in business fixed investment, and it had probably been favored by the prolonged economic recovery and by decreases in nominal and real interest rates. Other positive developments included further decreases in the rate of inflation as well as a reduction in the rate of unemployment, which, however, remained at a relatively high level.

The possibility of consolidating gains in employment through continued economic growth, sustained by adequate levels of domestic investment, would depend crucially on the progress that would be made on the fiscal front, Mr. Tornetta commented. The authorities had correctly adopted a medium-term strategy aimed at progressively reducing budget deficits and at stabilizing the government debt/GNP ratio. The authorities should avoid excessively abrupt corrections that would withdraw stimulus from the economy and would negatively affect employment and investment. It appeared, however, that in light of the medium-term fiscal outlook and of unexpected developments that had increased expenditures, timely measures should be taken on the revenue and expenditure sides to reach the Government's objectives for the current fiscal year.

The role that could be played by monetary policy in fostering economic growth appeared limited, as durable decreases in real interest rates would have to yield to reductions in government deficits, thus creating more room for sustaining the expansion of the real capital base of the economy, Mr. Tornetta observed. Furthermore, owing to the close interrelationship between the Canadian and U.S. economies, interest rate developments in Canada would be strongly influenced by developments in the United States; Canada would therefore benefit from a possible reduction of interest rates in the United States.

Financial innovations had affected the relationships between monetary aggregates and the main macroeconomic variables, making it difficult to interpret the likely consequences of recent developments in monetary aggregates, Mr. Tornetta continued. Shifts in portfolio preferences stemming from financial innovations could, in general, be expected to accelerate the rate of increase of some monetary aggregates while reducing the rate of increase of others. However, the breakdown of monetary aggregates on page 52 of the report on recent economic developments indicated that in 1985 the rate of growth of all monetary aggregates from M1 to M3 had increased in 1984, although to a different extent. In that connection, he asked for a clarification of the impact of the float mentioned on page 15 of the staff report. That problem was apparently related to double counting, and changes in the size or sign of the float could affect gross measures of M1 and their comparability to previous measures. However, he was unsure about the extent to which the subtraction of a negative float had inflated the net measure of M1 and what economic significance should be attached to the change in that net measure.

The Canadian dollar had depreciated rapidly in 1985, reversing in part the appreciation that had taken place in 1980-83, Mr. Tornetta noted. The depreciation of the Canadian dollar in the past year had been more marked than that of the U.S. dollar, and that tendency had recently been accentuated. Those movements did not appear fully justified by underlying economic developments or by Canada's current account position, which was estimated to show a relatively small deficit in 1985. He agreed that a further depreciation appeared undesirable at present. He wondered whether the staff could shed more light on the underlying causes of recent movements in the exchange rate. Also, with the existing strong integration of the Canadian and U.S. economies, the likely negotiations for a free trade arrangement between the two countries, and the similar price performances, he wondered whether the Canadian authorities had considered linking their currency to the U.S. dollar.

The authorities' commitment to liberalizing trade was welcome, Mr. Tornetta said. However, in some areas, such as footwear and automobile imports, quotas and voluntary restraints might be replaced by other limitations.

The staff representative from the Western Hemisphere Department recalled that on the crucial issue of the deficit reduction effort, a speaker had commented that while in the case of many countries the staff had pushed for tax increases, in the case of Canada it appeared to endorse cuts in expenditures rather than revenue increases. He explained that the staff had not opposed increases in revenue but rather had emphasized the strategy of expenditure restraint, which the Canadian authorities had indicated from the outset was essential and should be maintained. The staff had not adopted an extreme supply-side position; it had clearly stated that tax financing was preferable to deficit financing. In view of the size of the fiscal deficit in Canada, however, and of the great difficulty in achieving expenditure reductions, tax increases would probably be unavoidable. As to the possibility of further deficit reduction measures, the staff had not ruled out additional revenue measures but had warned that such measures should be carefully designed to avoid adverse effects on incentives to work and to invest. In that respect, the staff had expressed a preference for eliminating some of the existing tax preferences, which distorted the allocation of resources, rather than increased tax rates for persons or for corporations. Although there was scope for additional revenue measures, care must be exercised so as not to proceed too far in that direction. The burden of taxation in Canada was not low by international standards, particularly when provincial taxation was taken into account.

While the staff had observed that emphasis on expenditure cuts was justified in reducing the deficit on the grounds that it would achieve a reduction in the size of government, Mr. Lundstrom had noted in that regard that the staff's evaluation of the role of government must be based strictly on economic considerations, the staff representative recalled. First, it was not always easy to achieve a rigid separation between economic considerations and political or ethical considerations. Second, it was the explicit objective not only of the staff but also of the Canadian authorities--as repeatedly indicated by the Minister of Finance--to reduce the role of government as a way of improving the functioning of markets and the efficiency of the Canadian economy. Third, he agreed with Mr. Lundstrom that it was difficult to determine the optimal size of government. The question of the appropriate provision of public goods and social services was a delicate one that must reflect a nation's collective value judgments.

In some cases, however, there was no contradiction between considerations of efficiency and ethics, the staff representative continued. With regard to the Canadian principle of universality, there was no moral justification for the granting of subsidies to the upper middle class and to the rich; that was an area where deficit reduction through reduced subsidies would fulfill both ethical and economic criteria. The question was not only one of social equity at a particular point in time but also one of intergenerational equity and justice, and it was clear that deficit financing through the issuance of government bonds represented borrowing at the expense of future generations.

It had been asked whether a more rapid reduction in the federal deficit could be achieved in an economy with such a high rate of unemployment, the staff representative recalled. It was precisely out of concern for the long-term prospects for capital formation, growth, and employment that the Canadian authorities had decided to implement a large deficit-reduction package. The staff's preference for a more heavily front-loaded effort than the one envisioned by the authorities reflected the view that short-term adverse effects of the withdrawal of fiscal stimulus would be cushioned if the fiscal effort was credible. There was no doubt that credibility would be enhanced with an early and more visible attack on the fiscal problem.

Several Directors had commented on the appropriate guides for monetary policy and had suggested that a greater role should be attached to monetary aggregates, the staff representative noted. The difficulties in interpreting the monetary aggregates in Canada should not be underestimated; those difficulties were related to a number of far-reaching technological developments. For example, the development and rapid growth of interest-bearing checking accounts had not only distorted the growth of M1 and M1A in particular but also the growth of broader monetary aggregates.

The emergence of a negative float in 1985, which contrasted with the historical situation in which the float had been positive in Canada, apparently reflected the increasing use by corporations of large cash management facilities, the staff representative explained. One of the elements of those facilities was the direct payment by the banks of salaries to the employees of those corporations. Apparently, the banks knew when they must make a payment to the workers of the enterprise, and the banks immediately debited the corporation's cash management account on the workers' payday although the workers did not immediately cash their checks. In that transitional period, a negative flow developed. Apparently that trend had been increasing in Canada recently. The extent to which it had impinged upon the growth of M1 during 1985 was not clear, although apparently it had boosted the actual growth of M1, which was computed on a net basis by the Bank of Canada by subtracting the float from the gross amount of demand deposits.

In view of the difficulties with M1 and M1A, it had been suggested that broader monetary aggregates, such as M2 and M3, might be used, the staff representative added. The Bank of Canada had in fact placed more emphasis on the broader aggregates since the recent problems with M1; nevertheless, those broader aggregates were not immune from problems of interpretation related to technological developments, and those assets were less subject to direct control by the Bank of Canada than the narrower monetary aggregates such as M1.

The staff saw no contradiction in its evaluation of monetary policy when it credited monetary restraint for reducing inflation while commenting that the rate of monetary expansion had been adequate in face of the moderation in wages and prices, the staff representative commented. The policy of monetary restraint in Canada had been the predominant factor in bringing down inflation from the high rates it had reached in the late 1970s and early 1980s. Inflation had dropped considerably, and at present, the authorities were understandably less exclusively concerned with the aim of reducing inflation. However, the staff had emphasized that monetary policy must continue to be aimed primarily at the longer-term objective of bringing down inflation and had stated clearly that achievement "of further progress in the direction of price stability will require a monetary policy aimed at a steady reduction in the trend rate of expansion of nominal demand toward the long-run rate of growth of potential output." As the growth of potential output in Canada was generally estimated at about 2 3/4 percent, that statement had to be interpreted as an endorsement of a restrained monetary policy.

Exchange rate policy in Canada, aside from foreign exchange market intervention aimed at smoothing short-run fluctuations, was essentially an aspect of monetary policy, which had been discussed extensively in various parts of the report, the staff representative noted. With regard to the role of the exchange rate in monetary policy over a number of years, the Canadian authorities had not had a rigid exchange rate target and had recognized the need for flexibility. However, at the same time the Bank of Canada had been concerned about the possibility of excessively sharp downward movements in the exchange rate between the Canadian and the U.S. dollars, particularly in view of the great sensitivity that existed in Canadian labor markets regarding movements in that exchange rate. That concern went back to the experience of the late 1970s when the Canadian dollar had depreciated sharply against the U.S. dollar, giving rise to serious pressures on wages and, later, on prices at a time when the monetary aggregates in Canada did not seem to give indications of a dramatic acceleration. That experience had not been forgotten, and during the past several years attention had been focused on the exchange rate between the Canadian and U.S. dollars to ensure progress in the direction of price stability at a time when the U.S. Federal Reserve was perceived to be engaged on a decisive anti-inflationary course.

The exchange rate was not the only indicator used by the Bank of Canada in conducting monetary policy, the staff representative pointed out. The Bank of Canada also looked at wage and price developments, nominal GNP developments--although those were available only with a certain lag--interest rates, and all the monetary aggregates. The Bank had constantly been searching for aggregates that would do a better job than M1 in indicating some stable relationship with nominal GNP and interest rates. So far, however, that search had not been fully successful.

As indicated in Chart 15 of the report on recent economic developments, Canada had recently reversed to a large extent the loss of international competitiveness that it had experienced from mid-1980 to late 1983, the staff representative remarked. The recent improvement in competitiveness had been particularly strong relative to the U.S. dollar, but not as strong vis-à-vis other trading partners, although there had been some improvement relative to overseas countries. But competitiveness must be assessed in effective terms rather than in bilateral terms. He therefore considered it inappropriate for Canada to deliberately seek a depreciation of the Canadian dollar in relation to the U.S. dollar simply to improve its competitive position relative to other countries, particularly in view of the predominance of U.S.-Canadian trade and of the sensitivity of Canadian labor markets to downward movements in the exchange rate vis-à-vis the U.S. dollar. He shared the view of officials at the Bank of Canada that monetary policy in the long run could not influence the real exchange rate. Concerns about competitiveness were not ill-founded, but the response to that concern should not be an expansionary monetary policy but rather a reduction in the absorption of savings by the Federal Government.

In referring to exchange rate movements that were not explained by historical relationships, the staff had wished to make a technical point, the staff representative explained. Econometric equations relating to the exchange rate, interest rate differentials, inflation differentials, or current account balances that had accurately tracked the data up to the end of 1983 had since then overpredicted the value of the Canadian dollar by a significant margin. The depreciation of the Canadian dollar over the past two years could not be adequately explained by those fundamental developments; other factors must have been at play. One of the reasons mentioned in public commentary as an explanation for the recent selling pressure against the Canadian dollar was the drop in the world price of oil. That drop had had an adverse impact on expectations because of its detrimental effect on the Canadian current account balance, but he did not believe that the impact could have been large enough to explain the depreciation that had occurred during the past year, of about 10 percent in real terms. As Canada's net energy exports at present were about $10 billion, the highest estimate of that effect would amount to a 30 percent--or $3 billion--decline in net energy exports. Canada's nonenergy exports amounted to $120 billion at present; with an elasticity of approximately 1, the Canadian dollar would have to depreciate about 2 1/2 percent in real terms to offset such a decline. Therefore, although the effect was significant, it could not explain the full extent of the drop in the value of the Canadian dollar. In addition, to focus on a $10 billion net energy balance was not entirely appropriate; the net petroleum balance was in Canada's favor by only $3 billion. The remainder consisted of net exports of coal, natural gas, and hydroelectricity--some of which were still subject to some residual regulations. Most exports of hydroelectricity and some of the exports of natural gas were subject to long-term contracts that could not be easily renegotiated.

There was concern in Canada about the rapidly rising federal and foreign debt, the staff representative continued. But it was difficult to see how those factors could explain the recent depreciation of the Canadian dollar relative to the U.S. dollar. A decisive fiscal program had been announced in Canada, although the staff was concerned that it might be eroded by slippages over time. In addition, the fiscal effort had been increasingly tilted from expenditure cuts toward tax increases, a perception that had created some degree of uneasiness in Canadian business circles.

Furthermore, recorded short-term capital outflows had not been large in Canada, and there had been net inflows in recent years, the staff representative said. However, Canada had been a net borrower of long-term capital in the form of long-term issues by the provincial governments, the Crown corporations, and private corporations. The short-term capital account frequently had been weak or in deficit while the long-term capital account had been strong. Moreover, the residual errors and omissions item in the Canadian balance of payments in recent years had been negative and very large, probably as a result of unrecorded capital outflows and perhaps because of unreported transactions in some areas of the current account, particularly services.

Speculators might have been betting against the Bank of Canada, the staff representative added. They did not expect the Bank of Canada to raise interest rates to resist the downward pressure on the Canadian dollar. On February 12, the spread between three-month commercial paper rates in Canada and in the United States had been raised to 4.18 percentage points, and it appeared that speculators had lost their bet.

There had been a strong economic recovery in both Canada and the United States since late 1982, the staff representative remarked. That recovery had led to substantial job creation and a sharp drop in the level of unemployment in the United States, but Canada had not experienced the same degree of success. It was important to remember that the 1981-82 recession had been considerably deeper in Canada than in the United States and therefore the peak of unemployment in Canada had been higher. Since the recovery of economic activity had proceeded at approximately the same pace in both countries, there was a higher degree of labor market slack in Canada and therefore there was more room in Canada for a cyclical reduction in unemployment without necessarily triggering an acceleration of inflation. In addition, the growth of employment in Canada during the recent recovery had not been small by historical standards. Rather, the rate of job creation in the United States, particularly in the first two years of the recovery, had been extraordinarily strong by historical standards, notably in the area of services. The recent report of the McDonald Commission had put forth some conclusions about the scope for reducing the natural rate of unemployment in Canada as summarized in Appendix IV of the report on recent economic developments. The Commission had recommended a number of changes in the unemployment insurance system aimed at removing inappropriate incentives and lowering frictional unemployment. In particular, the Commission had recommended a reduction in the benefit rate from 60 percent to 50 percent of insurable earnings in the previous year.

On the question of the natural rate of unemployment and market rigidities, Canada was a large and diverse country with a number of geographic barriers to mobility, only some of which could be remedied; others were inherent in the geographical and linguistic structure of the country, the staff representative commented. For example, the maritime provinces and the oil producing provinces such as Alberta and Saskatchewan had been affected, the former by the decline in the fisheries industries, and the latter by the National Energy Program and by recent developments in international oil prices. In addition, Canada was a bilingual country, and not everyone was fluent in both languages; there were therefore limitations to geographical mobility which translated into wide disparities in rates of unemployment, ranging from relatively low in Ontario to very high in the maritime provinces and British Columbia. Some of those problems might be alleviated by certain measures. For example, at present there were obstacles to the portability of pensions from one province to another or from one employer to another. In addition, certain features of the unemployment insurance system discouraged interprovincial mobility of workers by making some benefits contingent upon the provincial rate of unemployment. One of the proposals of the McDonald Commission was to eliminate those restrictions.

The higher savings rate in Canada than in the United States reflected a number of cyclical factors, the staff representative observed; for example, the higher unemployment rate in Canada would account for higher savings for precautionary reasons. But there were also more permanent factors: for example, there was no income tax deduction for interest on mortgages in Canada. Moreover, mortgage interest rates in Canada had been adjustable for a long period, a development which had started only recently in the United States; hence, Canadian consumers who had experienced large increases in adjustable mortgage rates in the early 1980s had attempted to pay down mortgage debt rapidly and to maintain provisions in the event of future rises in interest rates. In addition, there were institutional differences, including a number of programs to promote savings in Canada, that did not have exact parallels in the United States.

Recently Canada had concluded an agreement with the European Communities that involved the relaxation of some of the residual restrictions that had been retained on women's and girls' footwear, the staff representative reported. A monitoring system had been implemented, but the action of discontinuing the quotas on the majority of footwear imports should not be underestimated in view of the intense pressure placed on the Canadian Government by the domestic footwear industry.

On another key trade policy area, the staff representative continued, the staff would monitor carefully the progress of the bilateral negotiations between Canada and the United States and their significance for multilateral trade negotiations. Meanwhile, the staff had emphasized to the Canadian authorities its concern about possible contradictions between those approaches in two main areas: first, compatibility with the GATT--and the Canadian authorities had given assurances that any bilateral agreement between Canada and the United States would be fully consistent with the GATT--and second, voluntary restraints and other grey area measures, where there might be a tendency for harmonization at a more restrictive level of trade. The staff had emphasized its concern that a bilateral agreement might mean a greater likelihood that such grey-area measures would be homogenized between the two countries and would give rise to a more restrictive overall trade policy in North America. The Canadian authorities had stated that they did not intend to emphasize the role of voluntary restraints or other grey area restrictions on trade.

Certain foreign investment restrictions had been maintained in the case of large foreign takeovers, although those restrictions had been eased with the new investment law, the staff representative stated. Restrictions had also been maintained in the case of culturally sensitive industries--such as the film and publishing industries--which was a political decision taken by the Canadian Government.

With regard to the conduct of monetary policy in relation to the exchange rate, recently the authorities had intervened on a fairly large scale to resist sharp changes in the exchange rate, the staff representative noted. The authorities had decided that speculative pressures were out of line with fundamental realities and that there was justification for decisive action on the part of monetary policy. That decision had been reflected in the sharp increase in interest rate differentials, as well as in the borrowing of considerable amounts from stand-by credit lines with Canadian and international banks and from the Eurobond and Euro-yen market in order to finance intervention. Recent events had not been characteristic of the history of intervention in Canada. Historically, purchases and sales of currency by the Bank of Canada and the Department of Finance had been correlated with short-run changes in the value of the Canadian dollar, confirming that intervention had not been conducted to peg the exchange rate at a given level but rather to smooth out erratic fluctuations.

The failure of two Alberta banks had been related to loan problems in institutions that had heavily concentrated their lending in two areas: real estate in Alberta and energy inside and outside Canada, the staff representative said. Asset values in energy had declined and, as a consequence, the real estate market in Alberta had not done very well. The problem was compounded by the fact that those banks had not relied on a wide variety of small depositors--which were adequately covered by federal deposit insurance--but on large wholesale deposits. The withdrawal of deposits had become rapid and substantial with a spillover effect on other small Canadian banks. The asset structure of those other banks was sound, however, and any problems had been solved through mergers of those small banks with larger Canadian banks.

The slowdown in productivity in the manufacturing sector in 1985 was to a large extent a normal cyclical development at that stage of recovery, the staff representative commented. The behavior of trend productivity growth had been poor in Canada in the 1970s, compared with previous decades, as had also been the case in the United States. However, there were reasons to believe that the trend behavior would improve in the next several years owing partly to demographic developments. It was too early to interpret the slowdown in 1985 as foreshadowing a mediocre performance in the long run.

Replying to a question about the difference in the forecasts of the staff and the Canadian authorities on the current account deficit in the next two years, the staff representative from the Western Hemisphere Department explained that in the context of the World Economic Outlook, the staff's current account and trade forecasts for each country were based on specific oil price and exchange rate assumptions that were agreed collectively among the area departments and the Research Department. At the time that the staff had made its projections, the assumption was that the effective value of the Canadian dollar would remain constant at the November 1985 level. Since then, in the light of events, the assumptions were in the process of being changed with respect to the trade balance and the current account, using, in the case of both the United States and Canada, a lower effective exchange rate and taking into account recent developments in international oil prices. On the exchange rate side there would therefore be a better trade performance in Canada, although perhaps not in 1986 because the price effect initially would tend to predominate over the volume effect, but certainly in 1987. However, those results would be offset to some extent by a 15 percent decline in the oil price, from $23.50 to $20 a barrel.

The Director of the Exchange and Trade Relations Department commented that issues involving the exchange rate would be discussed more explicitly in forthcoming staff reports.

Mr. Massé observed that his Canadian authorities considered developments in 1985 positive in terms of the growth rate, reduced inflation, and decreased unemployment. However, there remained a number of problems, notably the size of the fiscal deficit and the continuing difficulties it would represent over the next few years. That question was under review by the Canadian Government, and the Minister of Finance had indicated that the budget of February 26 would include a further reduction in the deficit. Nevertheless, the authorities were concerned that a considerable reduction of the fiscal stimulus--probably through a combination of expenditure reductions and additional tax revenue options--might cause a negative effect on the rate of unemployment, at least in the short term. Until about a month and a half previously, the authorities' strategy had been to reduce interest rates so that private investment could produce the economic growth that would compensate for the reduction in the stimulus provided by the public sector.

Because of developments in the exchange rate and the subsequent rise in interest rates, the Canadian authorities faced a more difficult choice of options at present, Mr. Massé continued. The authorities would, however, still move toward a faster reduction of the fiscal deficit. He would circulate to the Board a statement summarizing the main measures of the Canadian federal budget following its presentation on February 26, 1986.

The Canadian authorities believed that they had had considerable success in reducing unemployment, which in January had been 9.6 percent, a significant reduction over the past three years, Mr. Massé noted. Other problems affected the structure of the labor force in Canada. There had been a notable increase in the participation rate, especially for women, which had increased the labor force at the same time that employment had been created. In addition, labor markets in Canada--as opposed to those in the United States--had been less flexible in many respects because of the dispersion of the labor force over a wide territory. Furthermore, regional and provincial differences, cultural and linguistic factors, and climatic variability had also affected the mobility of the labor force and the flexibility of the labor markets.

For those reasons, the unemployment problem continued to affect the Government politically, Mr. Massé remarked. The authorities would endeavor to lower the level, but success would depend on reducing the fiscal deficit and improving the conditions for private investment, with the hope that increased private investment would create more growth than the reduction in the size of the public sector would eliminate.

His authorities had moved away from monetary targeting because they had concluded that it was not an appropriate guide for monetary policy, Mr. Massé commented. However, at present they were noting a better correlation between the aggregates of M2 and M3 and changes in national income; if that correlation was seen to continue and to be an appropriate guide to policy, the authorities could move closer to a policy of monetary targeting.

Several speakers had mentioned the proposed free trade arrangement with the United States, Mr. Massé recalled. His authorities referred to it as an appropriate trade arrangement with the United States, within an environment of multilateral trade negotiations. He reaffirmed the commitment of his authorities that their actions relative to trade arrangements with the United States would respect the GATT. The Canadian Government considered that there was no alternative but to move closer to a free trade area with the United States, but it would endeavor to reduce any negative aspect. First, a political decision must be made that free trade was wanted by the Government and the Canadian people. Subsequently, difficult arrangements would have to be negotiated with the United States, during which the Canadian Government would take fully into account its international and multilateral obligations.

The question of restrictions on foreign investment in culturally sensitive areas was especially difficult because of Canada's cultural heritage, Mr. Massé explained. That question had been debated among the various ministries for some time, but the preliminary position of the Canadian Government was that those areas would have to be protected.

On the size of the government sector, traditionally in Canada the public sector was considered a guardian of national values, because of regional differences and of the influence of Canada's southern neighbor, Mr. Massé said. Therefore, the government sector and Canadians in general continued to believe that the public sector in Canada had special functions and should be larger than that in the United States. In addition, the size of the federal sector relative to the provincial public sector determined the relative spending power of both areas--historically a significant bone of contention in Canada. It was likely that federal-provincial transfers would come under increased pressure, not only because the Federal Government wanted to reduce its total expenditures, of which those transfers were sizable, but also because the Federal Government was aware of the size of the provincial sectors. The previous budget had announced that there would be a $2 billion reduction in transfers by the Federal Government to the provinces; that issue had not been solved during the Halifax meeting of the Federal Government and provinces, and it would continue to be the subject of delicate negotiations.

He had noted several speakers' commendations of Canada's official development assistance, Mr. Massé remarked. In the present circumstances, the level of official development assistance was coming under pressure, as were all areas of expenditure, and would be considered by the financial authorities. He hoped that the commitment of the Government would be fully kept in the budget to be announced on February 26.

Mr. Sengupta said that the Canadian authorities had stated recently that they were committed to reversing the trend of the falling dollar by intervention financed by borrowing. It had also been suggested by Mr. Massé and the staff that in conducting domestic policy there was a move toward monetary targeting and the reduction of interest rates. Those policies might be conflicting, especially if the intervention would be nonsterilized. He recognized the pressure on the Canadian authorities to reverse the trend of the Canadian dollar and, given the effective rate for the U.S. dollar vis-à-vis the Canadian dollar at present, the need for a significant change, with subsequent implications for the Japanese yen and the deutsche mark. That movement did not mean that the Canadian authorities should change their domestic monetary and economic objectives, considering the effects on wage rates and other variables. The inflationary impact of the depreciation had been contained by the authorities;

consumer price differentials had not widened and the impact on wage rates had not been substantial. In those circumstances, he wondered whether the Canadian authorities should actually try to move the dollar upward or whether growth and a balanced economy should be given first priority. The present case was one where domestic objectives might come into conflict with international considerations.

Mr. Massé replied that undoubtedly a conflict between the exchange rate objective of the Government and the investment growth rate had arisen in recent months. The authorities had used interest rates to firm up the exchange rate as a short-term maneuver because they believed that a level above $0.70 was appropriate at present for the Canadian dollar. The wage rate impact had been contained in the past few years because rates were determined not only by the exchange rate but by the slack in the labor market, which had been very high. As unemployment was reduced, the relative effect of the exchange rate on inflation and on pressure in labor markets would increase. At present, his authorities were in the difficult position of trying to maximize two conflicting objectives, but they believed--correctly, in terms of relative competitiveness--that a rate below $0.70 was clearly not in line with the basic fundamentals of the Canadian economy and that the dollar must be maintained above that level.

The Chairman then made the following summing up:

> Executive Directors welcomed the continued strength of economic activity in Canada and noted that the recovery had not been associated with any significant upward pressure on prices and costs. They felt it was encouraging that the economic expansion had become more balanced, as business fixed investment had picked up following several years of sluggishness and had been accompanied by a high personal saving rate.
>
> Directors observed that Canada's unemployment rate had declined but that it remained high by historical standards. They considered that the major challenge faced by economic policy was to achieve a lasting reduction of unemployment while extending the progress made toward the goal of price stability. In their view, a strategy to achieve these objectives must involve a substantial improvement in the federal fiscal position and a monetary policy aimed at consolidating the gains made in reducing inflation. They added that these macroeconomic policies must be coupled with continued efforts to improve the efficiency of resource allocation by increasing the role of market mechanisms, removing distortions, and encouraging innovation.
>
> On fiscal policy, Directors noted with concern the sharp increase in the fiscal deficit over past years, from 3 1/2 percent of GNP in 1980 to 7 percent in 1985. They stressed that strong action to cut the federal deficit would make room for

private investment, improve confidence in economic policies in general, and thus contribute to the stabilization of the exchange market situation. While noting the fiscal measures announced in the Government's May 1985 budget, most Directors were concerned that the reduction in the federal deficit over the medium term would nevertheless be very small. By 1991, under the present strategy, the ratio of federal debt to GNP would rise to 63 percent, a level perceived by a number of Directors as being far too high. They noted that by 1991 interest paid on the public debt would exceed borrowing by the Government. They expressed, therefore, the view that a larger and more front-loaded fiscal correction would be needed to achieve the macroeconomic objectives pursued by the Canadian authorities.

Indeed, several Directors shared the staff's view that a more rapid implementation of corrective fiscal measures would achieve an earlier and more pronounced deceleration of federal debt and was more likely to lead to a significant improvement in economic performance. The improvement in confidence that would result from such policies should encourage the private sector to take advantage of the reduced absorption of resources by the Government and would thus help cushion the near-term effects on economic activity resulting from the withdrawal of fiscal stimulus. However, some Directors pointed out that in view of the high level of unemployment and the rapid growth of the labor force in Canada, a gradual approach to deficit reduction was appropriate.

Directors generally agreed with the staff that while emphasis should be placed on expenditure restraint in reducing the fiscal deficit, measures on the revenue side might well be unavoidable in view of the magnitude of the fiscal imbalance, but they should be structured in a way that does not hamper incentives to work, save, and invest.

With regard to monetary policy, Directors agreed that the policy pursued by the Bank of Canada in the past several years had succeeded in bringing about a large reduction in inflation and in keeping wage and price increases at relatively low levels during the economic recovery. They noted, however, that pressure on costs and prices might well develop in the period ahead should aggregate demand continue to expand rapidly.

Most Directors shared the view of the Canadian authorities that difficulties in interpreting the behavior of the monetary aggregates, particularly M1 and M1A, precluded a return to monetary targeting in the near future. However, a number of Directors felt that movements of the monetary aggregates--interpreted in the light of broader economic and financial indicators--might well have been downplayed too much. They were still worthy of attention, as they could provide an early warning of incipient inflationary pressures. In this regard, the acceleration of the aggregates during the latter half of 1985 was noted by several Directors. Although it was generally recognized that this development reflected in part the effects of financial innovations, some Directors considered that the growth of the aggregates might have to be restrained in the period ahead to prevent a resurgence of inflationary pressures.

Directors observed that Canada's balance of payments had been strong during the early stages of the recovery but that it had recently shown a deficit, which was expected to widen over the next two years. Directors noted that Canada's competitive position had improved in 1984-85, owing largely to the effective depreciation of the Canadian dollar. They pointed out that the recent depreciation had reversed a considerable part of the appreciation that had taken place from mid-1980 to early 1984. They asked whether the recent depreciation of the Canadian dollar--which is difficult to explain and a subject that a number of Directors felt should have been dealt with somewhat more extensively in the staff report--did not reflect some lack of confidence related to the rise in monetary aggregates and to developments on the fiscal side.

Over the medium term, Directors believed that the outlook for the current account would depend crucially on the progress made in improving the federal fiscal position. Several Directors commented that failure to reduce the absorption of savings by the Federal Government could lead to a further widening in the current account deficit and to problems that might be associated with a buildup in Canada's already high external indebtedness.

Directors commended the Canadian authorities for the steps taken in the past year to foster economic efficiency and to remove impediments to the working of market forces. They welcomed measures taken in the energy area to ease the regulatory burden imposed under the National Energy Program and the introduction of a tax regime that should encourage investment and growth in this sector in the long run. They also welcomed the streamlining of the review process in the area of foreign direct investment--although reservations were expressed by some on the actual degree of liberalization in that field--and the steps taken to improve the operations of federal Crown corporations, as well as the ongoing efforts aimed at selling to the private sector a number of corporations for which public ownership was not justified in the view of the authorities.

In the area of trade policy, Directors were encouraged by the reaffirmation of Canada's commitment to free trade and Canada's support for an early round of multilateral trade negotiations. Directors also noted Canada's intention to enter into bilateral negotiations with the United States with the view of liberalizing trade between these two countries. However, several Directors expressed concern about potential conflicts between such bilateral negotiations and a multilateral approach to trade liberalization.

On specific trade issues, Directors welcomed Canada's decision not to renew import quotas on footwear, subject to certain exceptions. However, some Directors were concerned that there might be a tendency to replace formal restrictions on imports of footwear with less clearly defined and less transparent barriers. A similar concern was expressed with regard to imports of automobiles from Japan. In addition, several Directors urged the Canadian authorities to refrain from imposing quotas on textile imports and, indeed, to take action to liberalize trade in these products.

Directors warmly commended the Canadian Government for its intention to increase the ratio of official development assistance to GNP at a time when other government programs were often being curtailed. Directors welcomed Canada's continued efforts to extend a substantial proportion of its bilateral aid to the poorest developing countries and to maintain a large concessionary element in its exemplary development assistance program.

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

2. INDONESIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Indonesia (SM/86/11, 1/14/86). They also had before them a report on recent economic developments in Indonesia (SM/86/13, 1/27/86; and Sup. 1, 2/6/86) and an information notice on the real effective exchange rate of the Indonesian rupiah (EBS/86/31, 2/7/86).

The staff representative from the Asian Department made the following statement:

Detailed information on the budget for 1986/87--fiscal year ending March 31--has become available to the staff subsequent to the issuance of the staff report for the 1985 Article IV consultation with Indonesia (SM/86/11, January 14, 1986). The new information on the budget was provided in Supplement 1 to the report on recent economic developments (SM/86/13, 1/6/86). An illustrative simulation for balance of payments developments and growth that takes into account this additional information, and also reflects changes in the external environment, is outlined below. In light of recent oil market developments, the simulation incorporates an oil price of $20 per barrel. The uncertainty surrounding these projections is large.

The budget for 1986/87, announced on January 7, was the first to foresee a fall in expenditures and receipts. Budgeted expenditures were to fall by about 9 percent, and receipts by 5 percent. Oil/liquefied natural gas (LNG) revenues were formulated on the basis of an oil price of $25 per barrel for crude, and production of 1.3 million barrels per day. Expenditures were based on projections of government revenues and use of foreign finance for project expenditure. The revised assumptions indicate an average price of $20 per barrel in 1986 and 1987, some 18 percent below the price for 1986 used in the alternative baseline scenario of the staff report. A strengthening in the U.S. dollar prices of Indonesia's primary commodity export above that foreseen in the earlier scenario is not projected for 1986. The revision for commodity prices reflects primarily a change in exchange rate assumptions but also the firming of coffee prices. Also, market growth in industrial countries is projected to be marginally higher. For purposes of the scenario presented below, government revenues were adjusted to reflect an oil price of $20 per barrel, but expenditures were left at the budgeted level. Thus, oil revenues are projected to be Rp 1.9 trillion less than in 1986/87 budget, and the overall deficit is increased by 2 percentage points to 3.5 percent of GDP. In addition, the base values for 1985/86 were adjusted to reflect the expected weakening in export receipts from the oil/liquefied natural gas (LNG) sector in the first quarter of 1986 and a lower level of project implementation, and associated imports than foreseen at the time of the consultation discussions in Jakarta.

The estimated current account deficit for 1985/86 is reduced to $2.7 billion, from the $3.1 billion foreseen earlier. The deficits for 1986/87 and 1987/88 are projected to be only marginally larger than those presented in the alternative scenario of the staff report, at $4.1 billion and $4.2 billion, respectively. Unless otherwise indicated, the assumptions underlying the projections presented here are identical to those described for the alternative scenario in Annex V of the staff report. The fall in net oil/liquefied natural gas export receipts is largely offset by the further marked decline in project imports resulting from the reduction in budgeted development expenditures, by higher non-oil/liquefied natural gas export receipts on account of higher commodity prices, and to a lesser extent, by a decline in general imports on account of lower growth. A reduction in the rate of growth of real GDP of 1/2 to 1 percentage point below the rate foreseen earlier would appear probable. Because of lower levels of nominal GDP and export receipts, the ratio of debt to GDP and the debt service ratio are about 2 percentage points higher by 1987/88 in the revised projections, reaching 35 percentage points higher by 1987/88 in the revised projections, reaching 35 percent and 25 percent, respectively, for the debt of the public sector, and 45 percent and 28 percent, respectively, for total debt.

Mr. Ismael made the following statement:

In response to a weakening in its resource position in the previous few years, Indonesia has launched a bold and comprehensive adjustment effort, which has involved important measures in demand management, exchange rate, and structural policies. As a result, the economy has been able to retain its resiliency, as evidenced by the maintenance of price stability, a strong international reserves position, and the resumption of growth in 1983 and 1984, even as world economic developments have proved adverse. In addition, the achievement of rice self-sufficiency in 1984, which followed sugar self-sufficiency in 1983, has been of great importance for internal and external balance: imports of these two commodities were valued at some $900 million in 1981/82. The further weakening in the world oil markets in 1985 and early 1986, depressed commodity prices, protectionist barriers in industrial nations, and sluggish domestic demand continued to pose serious challenges to the authorities' adjustment efforts.

Economic activity in 1985 has been depressed due to weak domestic and foreign demand. The impact of the sluggish demand on output has been compounded by the lack of substantial increases in agricultural and liquefied natural gas production, which in the previous year were the main contributors to economic growth. The rate of real GDP growth is thus expected to be substantially lower than the 5.8 percent obtained in 1984, with most estimates clustering around 2.5 to 3 percent. Offsetting this setback, however, were the success in reducing the rate of inflation from 8.8 percent in 1984 to 4.3 percent; a continued comfortable reserves position; and some decline in nominal interest rates. Despite a 25 percent drop in the value of oil export, the current account deficit is expected to remain at its previous level of about $2 billion, with the trade surplus only slightly lower than $5.8 billion obtained in 1984, which has been made possible by a further compression of imports and a 5 percent growth of non-oil exports. On the capital account, however, there were further substantial declines in both official and private inflows, reflecting a more restrained borrowing policy as well as slower project aid disbursements. As a result, the overall balance of payments showed a modest surplus of $95 million, compared with $943 million in 1984, contributing to a slight increase in the official reserve position from $5.7 billion in 1984 to $5.8 billion in 1985. Foreign exchange holdings of commercial banks went up by $0.6 billion to $4.9 billion.

The slump in economic activity, together with the sharp drop in imports and exports in 1985, have hampered the achievement of some policy targets. Nonetheless, the momentum of adjustment has generally been preserved, with overall demand management continuing to be prudent, exchange rate policy remaining flexible, and more reform measures undertaken in key economic sectors.

As in the previous budget, the budget for 1985/86 maintains the traditional policy of restraining expenditures consistent with the expected level of revenues and project aid receipts. On the basis of revenue projection at the time the budget was formulated, a 20 percent increase was budgeted in recurrent expenditure. This was required partially to offset the loss in the real value of civil service salaries during the previous three years and to provide some stimulus to the consumer demand, whose demand had contributed to substantial underutilized capacity in industry. Development expenditures were kept at the same level as in the previous budget, although still higher than the budget's actual outturn.

In the event, however, the 1985/86 revenue performance is expected to be considerably weaker than envisaged in the budget, particularly with regard to oil/liquefied natural gas revenues. As a result of the continued weakening in the world oil market, this revenue category has been estimated to decline by about 25 percent from the previous year and about 10 percent below the budgeted amount. A shortfall is also expected in the non-oil/liquefied natural gas category owing to a slump in economic activity, as well as a drop in imports and an unanticipated reduction in duty rates. Since recurrent expenditures are expected to be close to the budgeted level, the overall budget deficit is likely to substantially exceed the budget's target of 2.5 percent of GDP and to represent quite a turnaround from the small surplus recorded in 1984/85.

Since the liberalization of banking in 1983, monetary conditions in Indonesia have been characterized by very high real interest rates. As a result, rupiah time and savings deposits with the banking system rose substantially by 90 percent, 35 percent, and 50 percent in 1983, 1984, and 1985, respectively. At the same time, however, such high interest rates only aggravated the weakness in investment and economic activity in the country. Such a situation is of particular concern to my authorities, as they feel that an adequate supply of credits is not needed to help the business setor ride out the current economic recession and to facilitate industrial restructuring in order to achieve a higher level of efficiency. But in recent months, following the trend in the international market, there has been some decline in nominal interest rates. However, with the larger decline in domestic inflation, real rates of interest still remain at a high level of 12-13 percent. Although total domestic bank credits expanded by about 31 percent, total bank credits to the private sector and public enterprises increased by 16.9 percent for the year ending September 1985.

My authorities are confident, and are actively seeking to ensure, that the consequent increase in broad money of about 23.2 percent in 1985, as compared with 22.3 percent in 1984, will not endanger domestic price stability or exacerbate the balance of payments situation. The continued satisfactory increase in the value of Bank Indonesia Certificate (SBI) and the money market certificate (SBPU)--amounts outstanding rose to Rp 993 billion and Rp 573 billion, respectively, at the end of 1985--clearly shows the greater flexibility with which the authorities can make use of the readily accepted monetary instruments in managing liquidity. Furthermore, such confidence seems justified by the continued drop in inflation and the recently increase demand for real money balance. Moreover, my authorities do not think that the current rate of money and credit expansion is a cause for great concern by Indonesia historical standards.

Flexibility in exchange rate management has been maintained, and in fact, enhanced in 1985. This is in line with the authorities' expressed commitment to increase the competitiveness of Indonesian non-oil/liquefied natural gas products. Since the last Article IV discussion on Indonesia (EBM/85/20, 2/8/85), the real effective exchange rate of the rupiah depreciated by about 12 percent to a level even below its level after the March 1983 devaluation.

The increased emphasis accorded to structural adjustment and the need to step up the overall efficiency of the economy are perhaps the most important features of policy development in 1985. As a result, fiscal reform has been continued with the introduction of a value-added tax (VAT) in April 1985 to replace the previous sales tax; this follows the enactment in January 1984 of the new income tax law. Another new tax law, replacing the present ineffective property tax and land tax with a single Land and Development tax, is due to take effect in April 1986. In an effort to tackle the problems of high transport and marketing costs, red tape, and delays in shipments, the authorities have recently undertaken a particularly significant reform in the areas of customs, port, and shipping administration. Under the new regulation, the responsibility for customs inspections was given to a private Swiss-based firm; port charges and procedures were rationalized; and many restrictions on shipping and cargo handling were abolished or relaxed. Another key area where improvements have been sought is in investment licensing and regulation. These include the simplification of approval procedures for granting investment licenses as well as the streamlining of these procedures to facilitate project disbursements. The recent extension of access to preferential export credits to joint ventures and relaxation in geographical limitation on foreign banks' operation are among the more concrete stops taken to improve the foreign investment climate.

My authorities are fully aware of the uncertainties and serious challenges they have to meet in the face of the continued weakening in the world oil market, depressed commodity prices, and protectionism in industrial nations. They are aware of the consequences of thes developments for the country's resource position in the coming years. In 1986, as a result of a decline in exports, the current account deficit is expected to widen; and the debt service ratio is expected to increase further. Indeed, with the prospect of substantially lower oil earning and a fall in government revenues, never before has the need for the authorities to develop a dynamic and competitive private sector been given such a great emphasis in official policy as at present.

The results of the intensive adjustment effort implemented over the past three years--including, $10.7 billion in total reserves, $2.5 billion in undrawn credit lines, domestic price stability, and a stronger base for the non-oil/liquefied natural gas revenues--will provide the authorities with a cushion to ride out this difficult situation. Nevertheless, even more stringent austerity measures have already been anticipated.

In early January, the authorities presented to Parliament the 1986/87 budget which, for the first time in 20 years, featured a 7 percent cut in total expenditures and 22 percent cut in development expenditure, compared with the 1985/86 budget. This is consistent with the expected 13 percent decline in oil revenue which is to be only partly offset by almost 8 percent larger non-oil/liquefied natural gas revenue than the previous budget. The increase in the latter is expected to materialize for the newly introduced VAT and the first year's operation of the Land and Development tax. Except for wholly rupiah-funded projects, no new projects will be started during FY 1986/87; and the completion of some ongoing projects will be stretched out. In an effort to have better control over expenditure and improve project implementation, the authorities have also ended the practice of carrying over undisbursed appropriations of development funds from one year to the next. At the same time, allocation of investment expenditure and improve project implementation, the authorities have also ended the practice of carrying over undisbursed appropriations of development funds from one year to the next. At the same time, allocation of investment expenditure have been further rationalized, with social and economic infrastructures and regional development receiving increased emphasis. While the fuel subsidy would be further reduced by 73 percent, following a decrease of 53 percent in the current fiscal year, no increase is envisaged in public sector salaries. In addition, the authorities have called upon public enterprises to improve their efficiency and financial position so as to increase their role as an important source of budgetary resources.

In the area of monetary policy, my authorities will encourage a further reduction in deposit and lending rates. But this will be done only to the extent permitted by developments in the balance of payments and the domestic price situation. In order to promote growth and adjustment, banks are being directed to give high priority in their lending to industries faced with primarily cyclical problems and those engaged in restructuring efforts. In the meantime, the authorities will continue to manage the exchange rate flexibly, taking into account the need to preserve public confidence in rupiah as well as to promote external competitiveness.

In addition to the continued prudence in financial and exchange rate policies, my authorities will intensify efforts to encourage private sector savings and investment. Deregulation will be continued further; and some new policy measures affecting foreign and domestic investments, banking business, and public enterprises are now under serious consideration. In the area of private investments, some major policy initiatives are expected to be announced in June 1986. This would include custom duty exemptions for imports of machinery to be used in industrial restructuring, as well as reopening of sectors and industries now reserved for domestic investments or totally closed to foreign investments.

In conclusion, I would like to stress to members of the Executive Board that the present adjustment efforts, as evidenced by the recent drastic budgetary measures, not only clearly show my authorities' firm determination and full commitment to adapt to an adverse external economic environment, but also reflect the ongoing resolve of my authorities to create a stable and sustainable, outward-looking economy with greater reliance on the private flexibility and resourcefulness of my authorities in adapting to the changing circumstances of the external economy. With this in mind, my authorities are fully confident that the present adjustment efforts will not only be fully implemented but will constitute another important step toward the attainment of its goals.

Mr. Polak observed that in terms of broad policy measures, Indonesia's performance in recent years had given much reason for commendation: the sharp adjustment of the investment program in 1983 in response to the deterioration in the oil outlook; the liberalization of the banking system; the flexible management of the exchange rate; the severe adjustment in the budget for 1986/87; and two important tax initiatives in 1984 and 1985. The flexibility of policies followed in Indonesia had yielded important dividends--the attainment of a low rate of inflation, reasonable growth in 1983 and 1984, and overall balance of payments surpluses and a strong reserve position--that had been achieved in the face of unfavorable external circumstances. The authorities were focusing their attention on medium-term structural issues while promptly making the needed adjustments to changes in the conditions of the world economy. All those measures suggested that the Indonesian economy was run by a highly experienced team at the top that was able and prepared to take drastic measures as required by the situation.

Unfortunately, the same competence and efficiency that prevailed at the top of the administration were not evident at the lower levels, Mr. Polak continued. The staff had hinted at that problem in its appraisal, stating that it understood, but was apparently unable to say that it endorsed, the freezing of public sector salaries, even though it had made a strong plea for a greater control of the public sector employment. Reference had also been made to the lack of efficiency in the public enterprise sector and to continued delays in project disbursements. Indeed, the staff had devoted a full paragraph in the section related to World Bank activity to Indonesia's weakness in project implementation, which had led to an unusually slow rate of disbursement on World Bank loans. Also, the compliance rates on the new taxes remained low, and the transference of customs inspections to a Swiss private firm seemed to provide evidence of the intractable slowness and red tape of the Indonesian customs administration and the willingness of the authorities to overcome problems with imaginative solutions.

As far as he could tell, the staff and the Indonesian authorities disagreed with respect to only one major Fund issue, Mr. Polak said. The growth of the monetary aggregates in excess of the growth of GDP was viewed by the staff as a potential source of inflation but apparently was not a matter of concern to the authorities. There was much to be said for both positions. Indonesia had a private national savings rate of about 10 percent of GDP. There was no capital market to speak of, largely because of the preferential tax treatment for interest income from bank deposits. Moreover, given the high real interest rates prevailing in Indonesia--about 15 percent per year--the demand for savings in the form of money or near money was high. As long as those demand conditions persisted, the large increase in monetary variables would probably not pose any current inflationary risk. If the monetary authorities refused to meet the large demand, interest rates would be even higher. However, if the authorities succeeded in bringing down interest rates, a tendency to transfer rupiah assets into goods or foreign assets might arise, and Bank Indonesia would need all its potential to absorb what might then have become excess liquidity. In the meantime, the authorities should prevent the likely drawdown of government balances from adding to liquidity growth by the sale of more Bank Indonesia certificates.

The authorities had expressed concern about the possible adverse consequences for activity and investment resulting from high interest rates in Indonesia, Mr. Polak commented. The use of interest rate subsidies from the budget to support productive investment was not an attractive policy choice, however. It was true that preferential interest rates had a distorting effect, but in relative terms the distortion was only moderate. The 12 percent preferential rate still implied a real rate of 7-8 percent, and it was not all that much lower than the nominal prime rate of 17-18 percent. If preferential credits at those interest rates were directed toward socially and economically attractive investment opportunities that might otherwise not arise, there was no strong reason for objecting to them. It was interesting to note that joint venture enterprises were among the projects eligible for those credits. Finally, he would welcome comment on whether Indonesia would derive any net benefit from bilateral trade agreements in their various forms. Moreover, given the crucial importance to Indonesia's medium-term payments position of a strong rise in non-oil/liquefied natural gas exports, the authorities should make every effort to strengthen the country's export trade.

Mr. Templeman said that the Article IV consultation with Indonesia was particularly timely in view of the recent decline in world oil prices. That development was an obvious cause for concern to the authorities, but their past record of prudence in dealing with the oil bonanza after the 1973 and 1979 price rises and in subsequently adjusting policies to less favorable oil-market developments gave cause for confidence. Although Indonesia had made good progress since 1983 in areas such as the fiscal balance, the rate of inflation, the current account balance, and economic growth, developments in 1985 had been generally unfavorable. All the problems that had been mentioned at the previous consultation remained--uncertain future oil prospects, declining investment, an inadequate nonenergy tax base, the need for current expenditure constraint, a tendency toward more trade restrictions, and the undesirable use of preferential credit--and some had become more serious.

The worsening of the oil outlook needed to be seen in a medium-term perspective, Mr. Templeman continued. Some of the weakness in that outlook included uncertain nonenergy export prospects, a rather heavy and still rising foreign debt burden, and continued impediments to greater economic efficiency in the form of restrictions on trade and foreign investment.

According to the World Bank, a real growth rate in the range of 4-5 percent was needed in the coming years to provide jobs for a growing labor force, Mr. Templeman commented. However, the medium-term projection in the staff report, based on World Economic Outlook estimates prepared late in 1985 and on an assumption of strengthened adjustment policies, was for a real growth rate in the next five years of only 3 1/4 percent. The most recent projections, based on an oil price of $20 per barrel, had reduced the average growth prospects by 1/2 to 1 percent. Given the probable drag on overall growth from the oil/liquefied natural gas sector, diversification in the sources of economic growth and exports was particularly important, yet gross fixed investment had fallen by more than 7 percent in 1984 and by about 10 percent in 1985. Furthermore, both the ratio of investment to GDP and that of domestic savings to GDP had been falling. While the decline in the public savings ratio was partly to blame, there had also been a perceptible drop in the private savings ratio.

The authorities seemed to have followed prudent fiscal policies in recent years, Mr. Templeman observed but he would feel more comfortable with that observation if more comprehensive data were available for the entire public sector. Since 1983, the authorities had attempted to broaden the revenue base by streamlining the income tax in 1984 and implementing a value-added tax in 1985; those measures, as well as a general restraint on expenditures, revealed the authorities' serious attitude toward the dangers of excessive fiscal deficits. In fact the 1984/85 outcome had been more restrictive than contemplated. However, he was disappointed to note that the deliberate move toward a fiscal stimulus in FY 1985/86 seemed to be going well beyond the original aim of a central government deficit limited to 2.7 percent of GDP and was threatening to reach 5 percent. Contributing to the deficit were a larger than expected decline in revenue from oil and liquefied natural gas operations; a shortfall in the growth of revenues from other sources, owing partly to inadequate tax compliance; and an overshooting of current expenditures, caused mainly by fertilizer subsidies and the cost of export certificates. Each of those developments was also symptomatic of underlying longer-term fiscal problems.

The authorities had made a prompt response to those imbalances in the 1986/87 budget, Mr. Templeman noted. Unfortunately, the latest staff scenario, based on oil prices of $20 per barrel, suggested a decline in the budget deficit ratio to only 3.5 percent of GDP, compared with a target of only 1.4 percent. However, other features of the new budget merited commendation: some of the rice subsidy costs had been included directly in the budget for the sake of fiscal transparency, and an end had been brought to the carry-over to the subsequent year of undisbursed development appropriations. It was also noteworthy that consolidation and simplification of the wealth and land taxes were to take effect in April 1986 and that customs reform was under way, including the transfer of major responsibility for customs inspections to a private Swiss firm. Further comments on the new customs arrangement and on the broader question of the adequacy of the overall tax structure in Indonesia would be welcome.

The authorities had refrained from financing fiscal deficits from domestic sources and had built up central government deposits in recent years, which had had a contractionary effect on monetary aggregates, Mr. Templeman considered. However, the more recent turnaround in the fiscal position had put an end to that pattern, and he was concerned about the rapid rise in the monetary aggregates. It was true that economic activity had been sluggish, excess capacity existed in some sectors, and inflationary pressures had been considerably reduced; nonetheless, he was uneasy about the danger of a lagged effect on inflation and a potentially adverse effect on the external position. While the authorities had indicated their firm intention to absorb excess liquidity if necessary, that might not be an easy task. In addition to the rapid rise in the overall expansion of credit, the continued use of preferential credit not only added to total liquidity but might lead to less than optimal resource allocation. Some of the factors causing the high real interest rates in Indonesia presumably included the substantial and rather recent drop in the rate of inflation, some lag in inflationary expectations, the use of subsidized credit that forced higher lending rates for other types of credit and, perhaps, inefficiency in bank operations. Any other explanations for high real interest rates would be welcome. The staff report contained a brief reference to the need for capital market reforms; he wondered whether the authorities were concerned about the matter and whether they had any specific reform plans in mind.

The staff's medium-term outlook and the latest drop in oil prices underscored the importance of the growth and diversification of competitively produced exports, Mr. Templeman noted. Continued pursuit of a flexible exchange rate policy could contribute to that goal, as could strong control over domestic prices and costs; and accumulated reserves could provide some cushion during the transitional period. However, the restrictive trade regime and continued practical impediments to foreign investment might hinder export growth prospects. Even on rather favorable assumptions, the current account deficit was expected to remain in the range of 4 percent to 4 1/2 percent of GDP for the next three years. The ratio of total external debt to GDP, under the $20 per barrel projection, would peak at about 45 percent and the total debt service ratio would reach 28 percent in 1987/88. Those high prospective figures would not help Indonesia maintain access to international credit markets.

The apparent increase in the restrictiveness of the trade regime, and the use of countertrade and bilateral arrangements with state trading countries despite expressions of the Government's intent to move toward liberalization, were worrying, Mr. Templeman went on. Furthermore, despite the authorities' stated desire to encourage foreign direct investment in joint ventures in Indonesia, a number of serious disincentives remained: domestic content requirements; limits on some joint ventures to partnerships with disadvantaged groups; transfer of majority ownership over time; prohibition of foreign ownership of land; limits on leasing of property; and restrictions on access to domestic credit in local currency. Those impediments should be carefully reviewed and a comparison should be made of Indonesia's current investment regime with the foreign investment arrangements in countries that had had success in attracting foreign investment. The possible new deregulation measures referred to by Mr. Ismael were of interest in that regard.

The uncertain outlook for oil prices had added substantially to the challenge of economic management in Indonesia for the future, Mr. Templeman observed. Although the authorities' past record offered considerable reason for confidence, there were some fundamental structural weaknesses, restrictions, and disincentives ingrained in the Indonesian economy. Prompt and determined action would be needed to overcome them.

Mr. Pérez indicated that unfavorable external factors had contributed to making 1985 a difficult year for the Indonesian economy. However, the authorities had continued a cautious and persistent approach that had permitted the consolidation of some adjustment measures and the achievement of a remarkable performance in some areas. Their success in reducing the consumer price index to 4.4 percent from its 17 percent level five years earlier deserved special attention because it would provide wider room for maneuver in policy management during a difficult period.

Oil price behavior had a strong influence on budgetary policy in Indonesia, as in other oil producing countries, Mr. Pérez observed. Oil revenues amounted to two thirds of Indonesia's total fiscal receipts, and the authorities were having understandable difficulties in projecting tax revenues from petroleum related activity, given the turmoil currently characterizing the international oil market. Nevertheless, the wide deviations from the 1985/86 budget targets could not be attributed entirely to the sudden drop in oil prices. Shortfalls had occurred in all categories of fiscal revenues, but mainly those associated with the lower than expected level of economic activity and the import decline. Updated information on the 1986/87 budget (SM/86/13, Sup. 1, 2/6/86) indicated that the authorities had appropriately decided to increase their reliance on non-oil/liquefied natural gas revenue. Because budget projections had been made under the assumption--no longer valid--that oil prices would be fixed at $25 per barrel, he wondered whether the authorities had made any provisions to offset the impact of the lower oil prices on the budget.

He welcomed the additional reforms that had been carried out, particularly the new tax law and the introduction of the value-added tax, Mr. Pérez said. Although expenditures had not deviated from the targets as sharply as revenues, they still posed a great burden on the budget, mainly through the system of subsidies. He was glad to learn from Mr. Ismael that the fuel subsidy was being reduced, but he noted that other areas of the economy remained heavily subsidized. Further reductions in the fertilizer subsidies appeared to be warranted--especially as the amount budgeted for 1986/87 was higher than that budgeted in 1985/86--not only to reduce fiscal outlays but also to rationalize agricultural production patterns.

The sluggishness of domestic demand had not been offset by a more active external impulse, Mr. Pérez remarked. The increased protectionism of Indonesia's major trading partners, as well as sharp drops in oil prices, were the two main factors behind the weakened external sector. The authorities were trying to counterbalance the adverse external impact through a program designed to promote non-oil exports, which, linked with the provision of incentives for foreign investment, could render positive results by rapidly increasing export receipts and reducing the excessive reliance on oil exports. The various joint ventures currently in progress, as well as future projects, could make a particularly important contribution to the authorities' effort. The projects themselves should generate increased investment demand while fostering positive externalities as a by-product of foreign investment activity. The authorities had correctly implemented a trade policy that rationalized the tariff system and provided for the orderly substitution of quotas by tariffs. He hoped that Indonesia's trade liberalization effort would be matched by its trading partners.

The external debt figures prepared by the staff showed a rather bleak medium-term outlook, Mr. Pérez commented. In view of the latest development in the oil market, that outlook seemed likely or perhaps even somewhat optimistic. Given the strong dependence of Indonesia on petroleum markets, the authorities should reinforce and accelerate actions to diversify the utilization of resources and to promote non-oil activities. Those actions would necessarily have to be framed in a medium-term context; at the same time, further adjustment efforts would be required. The years ahead would be difficult, but he was quite impressed by how quickly the authorities had reacted to the new situation, and by the appropriateness of the measures already adopted early in 1986.

Mr. Fujino indicated that the Indonesian authorities' adjustment efforts--including prudent financial policies and a far-reaching structural adjustment program--had successfully brought more resiliency into the structure of the economy since early 1983. Despite the increasing difficulties associated with declining oil prices in 1985, the Indonesian economy had retained its basic strength, with the consumer price index having averaged 4.7 percent in 1985, the lowest rate registered since 1978; the current account deficit had widened slightly in 1985/86 to $2.7 billion, compared with $2 billion in 1984/85. However, these developments had been accompanied by a slower real growth in the economy and larger than budgeted deficits in public finance. He was encouraged to note that the prudent demand-management policy and the momentum of adjustment had been maintained and strengthened. Initiatives in the tax area had been accompanied by significant administrative reforms in customs, port, and shipping procedures, and in other areas of investment promotion.

The authorities' continued adjustment efforts had brought about tangible achievements, but they still needed to tackle a number of structural imbalances, especially given the aggravating external circumstances, Mr. Fujino continued. First, in order to achieve strong and sustainable growth based on the non-oil sector, the authorities should strengthen the relatively weak infrastructure and remove the basic impediments to that goal. They would also need to devise an effective solution to the problems of the so-called high-cost economy. As the World Bank paper on policies for growth and employment had rightly stressed, Indonesia's success depended crucially upon its skill to manage the transition from oil dependency to a more diversified, semi-industrialized economy. Excess capacity and financial stresses seemed to be the most significant contributors to high-cost industry, with the cost and quality of the infrastructure, including administrative processes, apparently affecting efficiency adversely. Despite the encouraging steps planned or already taken, more needed to be done to make them effective. While non-oil exports should be vigorously promoted through adequate incentives and a flexible exchange rate policy, the authorities should gradually reduce the high level of protection in the trade system, with a view to strengthening the efficiency of domestic production.

The medium-term scenario depicted a balance of payments position that was serious but still sustainable, Mr. Fujino considered. With the decline in oil prices, however, more active adjustment policies were needed, and the authorities would have to work harder to capture a larger share of export markets while adopting a more cautious approach to imports. Although the overall structure of the external debt was not a matter of immediate concern, the recent rapid increase in the outstanding amount and the prospects for a continuation of that trend, together with a rising debt service ratio merited some caution. The medium-term scenario had been based on an annual growth rate of 3 1/2 percent. According to the World Bank, in order to absorb a 2.3 percent annual growth in the labor force in the coming years, the economy needed to grow annually at 4.5 percent, and the non-oil sector GDP needed to grow at a rate of 5 percent. Thus, more initiatives and efforts would be needed to achieve the labor absorption.

Attaining self-sufficiency in rice in 1984 was an important achievement for Indonesia, Mr. Fujino noted. He hoped that adequate incentives would be supplied to maintain that self-sufficiency and encourage a further increase in productivity.

The large increase in time deposits since 1983 might partly reflect the portfolio adjustment of depositors, but the depositors might also be attracted by profitable real effective yields, Mr. Fujino remarked. In any event, the increase was evidence that in Indonesia, effective policy measures could mobilize domestic resources. However, as Mr. Ismael had pointed out, the high level of real interest rates--at 12-13 percent--was exerting a dampening effect on investment that should not be overlooked. How to balance the positive and negative impacts of high interest rates was a problem, and any further comments from the staff or Mr. Ismael on that matter and domestic resource mobilization would be helpful.

To provide support for domestic activity, the 1985/86 budget had included a projected deficit of 2 1/2 percent of GDP, which had not been considered inappropriate at the Board discussion on the occasion of the 1984 Article IV consultation with Indonesia (EBM/85/20, 2/8/85), Mr. Fujino recalled. However, the outturn in the first half of 1985/86 had caused some concern, given the overshooting of expenditures for the fertilizer subsidy and substantial shortfalls in income tax receipts. It was therefore encouraging that those problems had been identified and had been dealt with in part in the proposed 1986/87 budget. The substantial reduction in the petroleum subsidy was another welcome element in the proposed budget. However, the authorities still needed to pick up the pace of project implementation.

The World Bank report to the Inter-Governmental Group on Indonesia had pointed out in 1984, that complexities in Indonesia's administrative procedures had been causing delays in disbursements of official aid in recent years, Mr. Fujino indicated. Because his authorities were troubled by the delays, they had been meeting periodically with the Indonesian authorities to expedite the disbursement process, and meetings were expected to bring about positive results.

Recent monetary developments in Indonesia had been characterized by a modest decline in interest rates and continued rapid growth of monetary aggregates, Mr. Fujino remarked. The decline in interest rates had been modest compared with the deep decline in the rate of inflation. While a further reduction in interest rates would help provide support for economic activity--particularly stagnated investment--the authorities had rightly realized that a rapid reduction would not be warranted because of its possible adverse effects on capital flows. However, the rapid growth of broad money was a cause for concern not only because of its effect on prices but also because of its potential impact on the balance of payments. He was not a monetarist and did not necessarily believe in a direct, causal link between an increase of the money supply and the rate of inflation; institutional changes or other factors might be responsible. Nonetheless, the authorities should carefully monitor the rapid growth of the money supply and respond with appropriate and timely measures.

The maintenance of a flexible exchange rate policy had resulted in some real depreciation of the rupiah in 1985, owing mainly to the depreciation in the value of the U.S. dollar, Mr. Fujino mentioned. While fully recognizing the importance of preserving public confidence in the rupiah, he urged the authorities to maintain their flexible exchange rate policy so that the price competitiveness of non-oil exports would continue. He welcomed the flexible and positive attitude of the authorities toward the creation of a more favorable and less complex climate for foreign investments. Effective utilization of foreign investments could enhance the growth potential of the Indonesian economy.

Mr. Nimatallah remarked that Indonesia had adjusted successfully to the increase in external constraints in the past few years. Although oil export revenues had declined, Indonesia had been able to increase the growth rate of output, accumulate external reserves, and moderate its domestic price pressures--impressive results for which the authorities merited commendation.

More recently, however, with the sharp decline in oil revenues, the authorities had been facing increasingly difficult challenges, Mr. Nimatallah continued. Economic activity had been sluggish and the rate of urban unemployment had been rising and thus the authorities had been using credit liquidity to alleviate those problems. Since the sharp decline in oil revenues might not be a temporary phenomenon, the authorities' use of credit liquidity could jeopardize several areas--domestic price stability; the current structural adjustment measures, which needed the support of tighter financial policies; and the external debt position, which was already suffering from a large and rapidly rising debt and might lead to unsustainable fiscal and balance of payments positions. The key question was whether the sharp decline in oil revenues was temporary or lasting. If lasting, the non-oil sectors would require several years to compensate for the decline in income generated by the oil sector and the consequent drop in revenue for the Government. Thus, it might be helpful for the authorities to consider implementing measures that would permit a gradual adjustment to lower economic activity and income. They should also take long-ranging measures to strengthen the non-oil sectors.

The authorities, aware of the magnitude of the challenges, had already started taking the necessary steps, Mr. Nimatallah added. They had targeted a reduction in total expenditure by 7 percent in the new budget for 1986/87, a reduction that was consistent with the 13 percent decline in oil revenue and 8 percent increase in non-oil revenue. The authorities' intention to reduce current expenditures was welcome, but more should be done to cut subsidies.

The important structural reform efforts of the authorities were welcome and should continue, Mr. Nimatallah considered. Setbacks should be avoided, because those reforms were essential to improve the productive capacity of the other sectors to offset the decline in income and revenue to the Government from the oil and gas sectors. The authorities should take further measures, such as reducing costs and improving administration, to enhance the efficiency of the economy. Measures to promote the private sector, in particular, were needed to help reverse the sharp drop in 1985 in private investment. The recent simplification of investment measures to reduce the cost of transport was a step in the right direction; however, more was needed--particularly additional incentives in the tax and regulatory areas--to give the private sector a convincing profit margin. He was aware of the efforts of the Government to reform the tax system, including tax collection, to improve revenue, but he would caution against the introduction of any taxes that might discourage private sector investment initiatives.

With respect to Indonesia's external position, the authorities' commendably flexible management of the exchange rate helped maintain competitiveness in the non-oil sector, Mr. Nimatallah stated. He also welcomed the intention to move toward a liberal trade system; reliance on tariffs instead of quantitative restrictions should strengthen the efficiency of domestic production. External debt had grown substantially in recent years and was projected to be 42 percent of GDP in 1986. The debt service ratio had also grown rapidly, in part because of the increase in debt but also because concessional aid continued to decline as a share of total credit. He was therefore pleased that the authorities had strengthened the maturity profile of public sector debt and had continued to maintain a conservative borrowing policy.

Mr. Leonard remarked that after a good recovery from the difficulties of 1982 and early 1983, economic performance in Indonesia was showing signs of incipient weakness. The growth of GDP over the past year had slowed considerably; the overall balance of the Government's revenues and expenditures had moved from a small surplus in 1984/85 to a prospective deficit exceeding 5 percent of GDP in 1985/86; and the budgetary variable of net domestic expenditure had shown a similar deterioration. In the external account, the outlook for 1985/86 suggested a less favorable outturn than in 1984/85, with an increase in the current account deficit to about $2.7 billion, or about 3.1 percent of GDP compared with 2.2 percent in 1984/85. He assumed that the different amounts of the deficit cited by Mr. Ismael and the staff had arisen from the use of calendar years versus fiscal years.

Thanks largely to prudent management by the authorities, Indonesia's economy had a number of strengths that provided a useful foundation for the conduct of future policy, Mr. Leonard noted. The rate of inflation had been halved since 1984/85 and, as measured by the consumer price index, was currently less than 4 1/2 percent a year. The taxation system had been reformed and the Government's position vis-à-vis the commercial banking system was comfortable. Gross official reserves were the equivalent of nearly 7 months of non-oil/liquefied natural gas imports. In making use of those favorable factors and in determining the direction and pace of future economic management, the authorities should not lose sight of the medium-term outlook and the pressing need to raise the growth rate and provide more employment for a rapidly expanding labor force. The staff recommendations seemed to have been carefully designed with those considerations in mind; the urgent need for action had been reinforced by the less favorable economic outlook, especially for oil prices, that had arisen since the staff had drawn up the medium-term scenarios.

The general design of the 1986/87 budget was reassuring, Mr. Leonard said. With less buoyant revenues, total expenditure would be cut back, in line with the Administration's practice of seeking budgetary balance in the customary Indonesian sense, and the negative balance of net domestic expenditure as a share of GDP would fall. Only a small increase in personnel expenditure was envisaged, and increased efficiency in the provision of government services was being sought. Furthermore, the authorities were not intending to have recourse to domestic bank or nonbank financing. In the past, however, budgetary intentions had not always been realized, and in 1985/86, the amount of the deficit was likely to diverge considerably from the budget. There was reason to believe that the actual evolution of the budget in the next fiscal year might also differ from the plan. For example, non-oil/liquefied natural gas revenue was expected to rise by nearly 22 percent, mainly on the basis of increased compliance with tax requirements already in place and a strengthening in tax administration. No new revenue measures had been included in the budget. On the expenditure side, increases in efficiency in providing services might, by their nature, be slower in coming about than hoped, and it might be difficult to hold the line on recruitment. To some degree, therefore, the budgetary figures were less firmly based than they might be, and there was a danger that the actual outturn would run contrary to the current needs of economic management. Thus, the authorities should design both revenue and expenditure measures that could be implemented if the deficit showed signs of widening unacceptably.

The provision in the 1986/87 budget of a 20 percent increase in the fertilizer subsidy seemed peculiarly out of place, Mr. Leonard went on. Not only was there a need to constrain expenditure, but an increase in the consumer price of fertilizer would encourage growers to diversify from rice to other agricultural products. The 1986/87 budget would contain expenditure by cutting development spending by one quarter while increasing current spending, which did not seem to be the right order of priorities in a country where growth should be given pre-eminence. Investment expenditure allocations were being rationalized, with social and economic infrastructures and regional development receiving increased emphasis. While he welcomed those actions and hoped that they would increase the efficiency of investment, he doubted that the increase in efficiency would be sufficiently large to counterbalance the reduction in the overall development allocation. The authorities should re-evaluate their budgetary allocations to ensure that they were enhancing growth and employment.

The staff was concerned about the degree of liquidity prevailing in the Indonesian economy, fearing in particular the danger of accelerating price rises and consequent additional imports, Mr. Leonard observed. However, the staff had indicated recently (SM/86/13, Sup. 1, 2/6/86), and Mr. Ismael had confirmed, that the authorities had effectively used the monetary instruments at their disposal to prevent the degree of liquidity from getting out of hand. Nevertheless, the staff had rightly pointed out that a potential danger existed; although an excess of liquidity might bring idle capacity into use, it was unlikely to foster the cost consciousness and efficiency that competitive commercial activity required.

Effective demand management was important to Indonesia; equally important was the expansion of the non-oil/liquefied natural gas productive base, Mr. Leonard considered. However, there seemed to be an indecisiveness on the part of the authorities toward industrial development that confounded their aspirations for expansion, as evidenced by the degree of regulation and procedural delays that conflicted with incentives to bring in industry from outside, as well as high costs deriving from protection, and the explicit and implicit costs of port and shipping services. The authorities' efforts to step up the overall efficiency of the economy notwithstanding, he hoped to see them build on their previous accomplishments and bring together the various separate efforts into a well-defined, simplified industrial strategy.

Finally, the staff's caveats on the shortcomings of data had put him on notice that things might not be what they seemed in Indonesia and that views must be tempered accordingly, Mr. Leonard indicated. He supported the staff's call for a strengthening of the data base in Indonesia.

Mr. Grosche agreed that the policies that had been pursued by the Indonesian authorities in recent years had been successful. However, the recent fall in oil prices had clouded the outlook, so that the continuation and strengthening of the adjustment efforts seemed to be imperative in order to preserve the gains made in recent years. The assumptions underlying the budget for 1986/87 had become shaky, as the sharp drop in oil prices was bound to lead to a further significant reduction in exports and fiscal revenues. It was, however, encouraging to hear Mr. Ismael underscore his authorities' continued adherence to the principle of restraining expenditures and keeping them consistent with the expected level of revenues and aid receipts. He was thus confident that the authorities would adapt flexibly to an emerging difficult budgetary situation.

A further tightening of fiscal policy would limit the scope for offsetting some of the oil price effects on economic growth, but the authorities should resist the temptation to finance the projected losses in export revenues by increased recourse to international credit markets, Mr. Grosche advised. Although Indonesia enjoyed a comfortable reserve position and sufficient creditworthiness, it would be prudent for the authorities to remain cautious about additional external borrowing. In view of the uncertainties surrounding the medium-term outlook, the authorities would be well advised to follow the staff's recommendations and place even greater emphasis on structural adjustment and on the strengthening of market forces, thereby providing new impetus to the export-oriented non-oil sector.

He welcomed the simplification of the procedures for granting investment licenses and the efforts undertaken to facilitate project disbursements, Mr. Grosche commented. However, a wide range of regulations and bureaucratic obstacles continued to discourage the inflow of foreign investment. Actual measures that provided clear signals to investors were preferable to the mere offer of flexibility in the application of existing rules and regulations. Moreover, it was disappointing that there were no substantial plans for the restructuring of sectors with chronic excess capacity. The World Bank could play an important role in assisting the authorities in working out a comprehensive program to respond to the problem.

He shared the authorities' concern about the extraordinarily high level of real interest rates, and he would have appreciated a more in-depth analysis in the staff report of the causes for those high rates, Mr. Grosche indicated. It would be of particular interest to learn more about the share of nonperforming loans in the portfolio of the banks, the the extent to which high interest rates reflected high-risk premiums, the level of competition among banks, and the gross margins between the banks' deposit and lending rates. It was difficult to understand why there was no taxation of interest paid on deposits. The very attractive yield on relatively low-risk financial assets would tend to have an adverse effect on enterprises working with a high share of borrowed capital. Moreover, he wondered whether there were any mechanisms to ensure that subsidized investment loans or liquidity credits were actually being used for the intended purpose and not for investments in high-interest-yielding time deposits.

His authorities welcomed the reduction in the maximum tariff rate and the simplification of the tariff system, but they regretted that the Indonesian trade system had recently become more restrictive, Mr. Grosche pointed out. A more restrictive system entailed important risks: it might lead to a loss of competitiveness and reduced growth prospects, and it could obstruct the ongoing efforts to reduce Indonesia's dependency on oil. It was doubtful whether any net benefits could be derived from bilateral or countertrade arrangements. Efforts to resist protectionist pressures in the industrial countries needed to be supported by similar efforts in developing countries.

Mr. Nguyen recalled that at the discussion of the previous Article IV consultation with Indonesia, the Executive Board had commended the authorities for their firm adjustment effort and had expressed understanding for fiscal stimulus they had given to domestic activity. The Board had also noted that developments in the world oil market would pose a continuing challenge, an assessment that was even more relevant in the present context. During the past year, the authorities had made every effort to meet their objectives, in line with the Fund's recommendations; a strict budget had been implemented, and, thanks to a firm demand-management policy, the rate of inflation had been halved. Despite those efforts, weaker revenue performance had led to an eventual outturn for the budget deficit that was 5.2 percent of GDP, exceeding the target by 2.5 percentage points; the current account was expected to show a deficit of $3 billion. The growth rate, expected to be between 2.5 percent and 3 percent, would be barely positive, whereas the World Bank had estimated that a rate of growth of at least 5 percent was needed to provide jobs for a growing labor force. Two exogenous factors had combined to bring about the unfavorable outcome: a collapse in non-oil primary commodity prices, which had dropped an average of 12 percent during 1985; and a progressive slide in crude oil prices, together with a reduction in market shares. Those events had seriously jeopardized the budget objectives and the targets of the Five-Year Development Plan, as well as the external account equilibrium.

Given the rapid changes in oil prices, the updated data provided by the staff had been useful, Mr. Nguyen commented. It had not been easy to distinguish between the staff assumptions and the government estimates, and he also had some difficulties in reconciling the staff's figures and comments. At one point it had been stated: "oil revenues are projected to be Rp 1.9 trillion less than in the 1986/87 budget and the overall deficit is increased by 2 percentage points to 3.5 percent of GDP"; elsewhere it had been noted that "the fall in net oil/liquefied natural gas export receipts is largely offset by a decline in project imports, by higher non-oil/liquefied natural gas export receipts and to a lesser extent, by a decline in general imports." He found it difficult to understand why the targeted budget deficit did not show the effects of revenue increases or expenditure cuts and why it was not lower than the 3.5 percent.

The authorities' official projections for the 1986/87 budget exercise--which showed a deficit for the current account of $2.2 billion--on the assumption of an oil price of $25 per barrel and production of 1.2 million barrels per day--had led him to estimate that with the oil price at $20 per barrel the deficit would amount to $4.2 billion; with a barrel price of $15, it would be $6.6 billion, Mr. Nguyen said. The staff, having barely taken into account the oil drop, had forecast a higher deficit, about $4 billion, or 4.7 percent of GDP. Theoretically, one could foresee a deficit of the order of $6 billion in the very conservative hypothesis of a barrel price of $20. Since the staff had maintained its previous estimates even in the updated information, more elaboration on the data would be useful. In any case, the effect of such an estimated deficit was alarming, given the current level of the external debt at $35 billion. Although the level of foreign reserves--$11.8 billion--was still sizable, it did not seem sufficient in the short term to counterbalance the recent changes.

As Mr. Ismael had indicated, the authorities were fully aware of the uncertainties, but their margin for maneuver seemed to have been further narrowed in the short term, Mr. Nguyen continued. It was thus crucial for the authorities to readjust their budgetary policy and reduce certain public investments to compensate, if only partially, for the oil receipts' decline; he welcomed the decisions already taken toward that end. Greater selectivity also appeared necessary in credit policy in the area of preferential loans; for example, the authorities should insist upon diversification factors of production and exports.

Indonesia would need external financial inflows to lessen the effects of developments in the oil markets, Mr. Nguyen indicated. In that context, the World Bank seemed destined to play a greater role, owing to its long relationship with Indonesia, its means to facilitate structural adjustment, and its capacity to encourage desirable diversification through individualized operations. Finally, he wondered whether a change in the exchange value--which would be harmful to the control of inflation and to the cost of imports but favorable to non-oil exports and the budgetary oil revenues--was being contemplated by the Indonesian authorities.

Mr. Ercel congratulated the Indonesian authorities on their impressive adjustment efforts launched in 1983, after a period of severe imbalances owing mainly to exogenous factors. Their bold and timely reactions over the past few years had been instrumental in establishing momentum for a more balanced approach to the country's long-term growth prospects. However, further weakening of the world oil markets in 1985 and early 1986 had placed an additional obstacle in Indonesia's adjustment path. In view of the medium-term projections for the economy, a marked intensification of adjustment policies was clearly needed, and the development of a dynamic and competitive private sector--already emphasized by official policy--had become imperative in the light of the substantial reduction of oil earnings and government revenues.

The 1986/87 budget proposal contained a number of significant expenditure reductions, which reflected the unavoidable decline in oil revenues and the authorities' continued pursuit of the "balanced budget" policy, Mr. Ercel remarked. The balanced budget approach was correct for maintaining appropriate adjustment in the face of the weakening oil markets. However, the resultant cut of over 20 percent in development expenditures, even though they were designed to be consistent with available resources, would limit the growth in non-oil revenues that might be expected in future. Despite the newly introduced taxes the authorities still had room to raise the level of non-oil/liquefied natural gas revenue, which accounted for only 8 percent of the total share of non-energy GDP. The realization of the authorities' intention to improve project implementation, as a means of partially offsetting the effects of reduced development expenditures, was a vital issue for the Indonesian economy.

The main monetary problem in Indonesia was the continued rapid growth of broad money, Mr. Ercel considered, and the Executive Board should give full attention to the divergence of views between the authorities and the staff concerning the effect of that growth on prices and the balance of payments. Broad money growth had received a substantial impetus from the authorities' 1983 change in the structure of the monetary system. Banking liberalization, high real interest rates, shifts in the demand for assets, and a reflow of funds from abroad had not only improved the efficiency of the financial market; it had also affected the money supply and demand for money. The lagged effect of those financial deregulation measures should therefore be taken into account in judging movements of monetary aggregates. Discussions had focused on the lagged impact of financial deregulation in other countries, notably Korea (EBM/85/187, 12/27/85), and staff comments on the possibility of measuring the impact of such deregulation on the economy of Indonesia would be helpful.

The authorities were correctly pursuing a flexible exchange rate policy, Mr. Ercel stated. The reallocation of resources toward the non-oil/liquefied natural gas sectors had been favored by the effective depreciation of the rupiah, an effect that had continued into 1985. Uncertainties in the world oil market would affect the medium-term balance of payments projections and would thus necessitate the maintenance of a flexible exchange rate policy and structural adjustment policies for years to come. He therefore welcomed the authorities' determined commitment to adjust their economy to the external environment.

It would be difficult in the short term to eliminate the structural weaknesses of the Indonesian economy, Mr. Ercel noted. Reallocation of domestic resources and the pursuit of sound economic policies would eventually ensure a better balance of development among the various productive sectors and lead to a viable balance of payments situation. In general, the policies chosen by the authorities were aimed in the right direction, but more action was needed in the light of recent developments in the oil markets.

Mr. Salehkhou commended the Indonesian authorities for their continued efforts to implement the adjustment program in spite of a weakening of export receipts over the past three years. Prudent financial policies during the period of the rise in oil prices in 1979 and 1980 had enabled the economy to respond properly to the deterioration in the world environment in the early 1980s. Implementation of supportive measures for food production to reduce the country's reliance on food imports had led to self-sufficiency in rice and sugar. Moreover, appropriate monetary and fiscal policies had contributed to a strengthening and growth of the non-oil/liquefied natural gas sector and to price stability. However, a substantial level of external debt and increasing urban unemployment continued to be a matter of concern.

Economic performance in Indonesia depended largely on developments in the oil market, Mr. Salehkhou continued. Weaknesses in oil prices during the past three years had intensified the need to implement adjustment measures and resulted in sluggish economic activity and a considerable deceleration of the GDP growth rate from 6 percent in 1983 to an estimated 1 1/2 percent in 1985. Weak domestic demand resulting from restrictive monetary and fiscal policies, compounded by sluggish foreign demand, had been the major causes of the slow performance of the economy.

Investment expenditures had registered a sharp decline in the first half of 1985/86, owing to the authorities' cautious public investment policy, Mr. Salehkhou noted. The authorities wisely intended to keep development outlays in line with budget projections for the full year through an ample increase in foreign-financed project disbursements. However, given the most recent developments in oil/liquefied natural gas revenues, the budget deficit might rise above the projected level and necessitate a sharper than anticipated drawdown in government deposits.

The initiatives taken thus far to enhance the efficiency of resource allocation appeared promising, Mr. Salehkhou considered. However, additional monetary measures in parallel with fiscal policy were also needed to remove the existing investment disincentives and to curb increasing unemployment in the industrial sector. The authorities should take further steps to reduce the high interest lending rates--particularly after inflationary pressures had abated--not only to enhance the competitiveness of enterprises but also to help eliminate some of the existing impediments to GDP growth, which was needed to absorb new entrants into the labor force.

The external performance of Indonesia had continued to weaken during the first half of 1985/86, reflecting a sharp decline in oil/liquefied natural gas exports, Mr. Salehkhou observed. While non-oil imports had contracted significantly in the first half of the year, only a modest decline in imports was expected for the entire year, in line with the projected pickup in foreign-financed project expenditures. The country's external debt was expected to rise to 42 percent of GDP. In addition, the increase in the debt service ratio reflected a continuing reduction in the share of concessional credit and a fall in export earnings. However, the authorities were well aware of the importance of incentives to expand export shares and had implemented policies to ease the limitation of producers' exports, to provide concessional export credits, and to diversify the markets and products. However, sluggish growth in most of Indonesia's trading partners, compounded by increasing protectionist tendencies abroad, remained major obstacles to the authorities' efforts.

More adjustment efforts would be needed in the short and medium term, and projections for growth and the balance of payments would have to be revised, Mr. Salehkhou remarked. More support to the private sector to enhance its efficiency and competitiveness would enable the economy to respond comprehensively to the changing external environment. He hoped that the successful results of the authorities' intensive efforts in implementing the adjustment program over the past few years would help them overcome the current difficult situation.

Finally, given the recent developments in the world oil market, Mr. Salehkhou asked the staff to assess whether Indonesia might use Fund resources under the compensatory financing facility.

Mr. Alfidja noted that 1985 had been a fairly difficult year for the Indonesian economy. Positive results had been achieved during the past few years as a result of the authorities' intensive adjustment efforts. However, their emphasis on prudent demand management, a flexible exchange rate, and structural policies had been threatened by adverse external factors, especially the continued weakness and uncertainties in the world oil markets, as reflected in a substantial decline in oil exports, and lower prices for Indonesia's non-oil export commodities. Despite the vulnerability of the Indonesian economy to oil market developments, the balance of payments position had registered a slight surplus, largely as a result of a cutback in imports and the improved competitiveness of some non-oil exports. Inflationary pressures had been kept under control. The authorities deserved commendation for having maintained the thrust of their adjustment efforts and having achieved such encouraging results. Nonetheless, he was concerned about developments in the real and fiscal sectors of the economy.

Indonesia's real GDP growth, which had peaked at 5.8 percent in 1984, had slowed to about half that level in 1985 and was projected to remain at an annual average of 3 percent over the next few years, Mr. Alfidja continued. The slowdown reflected the continuing weakening of oil and commodity prices. It was worrisome that the nonenergy sector--dominated by agriculture and manufacturing--with all its productive potential was not growing sufficiently to generate the necessary employment opportunities for absorbing the rapidly growing labor force. Hence, he was pleased that the authorities were placing increased emphasis on further structural adjustment, including the elmination of some of the cumbersome regulations and other excessive rigidities that had discouraged both domestic and foreign private investment. The simplification of licensing approval procedures, and the reforms in customs, port, and shipping administration should go a long way toward promoting economic efficiency and improving resource allocation for enhancing the economy's growth. He was concerned about the slack output in the agricultural sector; it would be regrettable to see a reversal of the significant progress made recently toward the attainment of self-sufficiency in food, especially rice. An encouraging sign was that the authorities were reviewing the general structure of incentives to the agricultural sector, and the acceleration of the programs for tree crop support was also welcome. Those steps should go a long way toward reviving confidence, diversifying agricultural production, and strengthening the non-oil sector of the economy.

In the fiscal sector, the uncertainties surrounding the 1986/87 revenue estimates--particularly those from oil--were a cause for concern, given the continued weakening in the world oil market, Mr. Alfidja considered. The need for the authorities to continue pursuing cautious financial policies consistent with a viable external payments position could not be overemphasized. It was reassuring to learn from Mr. Ismael and the staff that government revenues had been revised recently to reflect the drop in oil prices. Measures being taken to strengthen non-oil revenue through the introduction of a value-added tax and the land and development tax were steps in the right direction, as was the call to the public enterprises to improve their financial performance in order to increase their contribution to the budgetary resources. The authorities had taken an appropriately cautious stance in limiting their expenditures to the available financial resources. They were also making efforts to improve project implementation by not rolling over undisbursed appropriations of development funds from one year to the next. In sum, the authorities were to be commended for implementing actions to minimize the adverse effects of the oil market developments on their economy and for promoting diversification.

Mr. Alhaimus considered that the prudent financial policies followed by the authorities in the past few years had made it easier for Indonesia to withstand the impact of depressed commodity prices and the weakening of the oil market. Cautious demand management, especially since 1983, had been accompanied by structural adjustment designed to improve the performance of the non-oil sector. As a result, the authorities had achieved considerable progress in reducing fiscal and external deficits, controlling inflation, and stimulating economic activity. Particularly noteworthy had been the sharp cut in the current account deficit in 1984/85, despite much lower oil prices; the realization of a small fiscal surplus in 1984/85 period, compared with a deficit reaching 5 percent of GDP in the previous year; and the fall of the inflation rate in 1985 to less than a third of its 1983 level. The pickup of real growth from its zero level in 1982 to nearly 6 percent in 1984 was also significant.

The continued weakness of the oil market and foreign demand, however, had led to a sharp reversal in economic activity during 1985 and to a much larger fiscal deficit than the 1985/86 budget had estimated, Mr. Alhaimus added. That turnaround, together with the worsening external prospects, had made the outlook for the economy much more difficult and would require an even more active policy in the period ahead to cope with the severe situation, especially if it persisted.

The authorities' most recent policy response was the 1986/87 budget, which had been formulated against a background of falling oil prices, depressed commodity markets, and continued protectionist barriers in industrial countries, Mr. Alhaimus remarked. According to the budget estimates, the sharp 11.3 percent cut in expenditures from the expected outturn of expenditures in 1985/86, would go a long way to offset the large fall in expected revenues, thus limiting the 1986/87 deficit to some 1.5 percent of GDP. A deficit of that magnitude, which was expected to be financed entirely by foreign borrowing, seemed to be manageable. However, the deficit estimate depended crucially on oil price assumptions. The staff expected a much higher deficit--3.5 percent of GDP--on the basis of an average oil price of $20 per barrel, which was more in line with current trends than the authorities' budget assumption of $25 per barrel. Unless revenue performance improved considerably, a higher deficit would demand a further cut in expenditures.

There might be scope for some reduction in current expenditures--such as fertilizer subsidies--that had been projected to increase, Mr. Alhaimus noted. Nevertheless, it was difficult to see how development expenditures could be cut further than the 25 percent already included in the new budget. The impact of further cuts on output growth should be carefully assessed; the staff already expected a further deceleration of GDP growth to even less than 1 percent in the light of the new assumptions on oil prices. Of significance were the social consequences expected from the aggravation of unemployment. The World Bank had estimated that an annual GDP growth of 4-5 percent would have to be maintained to absorb new entrants to the labor market, and thus a GDP growth rate of less than 1 percent would lead to increasing problems.

To minimize the damage that might befall the economy, especially if the present weakening of the oil market persisted, the authorities faced a particularly difficult task, Mr. Alhaimus remarked. In the short term, the financial situation seemed to be manageable, given adjustments already made and the availability of a reasonable level of reserves and undrawn credit lines. In the years ahead, however, the authorities would face increasing difficulties as the external imbalances widened and the debt rose and they would need to explore the possibilities for action beyond that already incorporated in the 1986/87 budget. Given the urgent need to encourage non-oil exports, the review of incentives for that sector should be expedited. The authorities had already considered the possible contribution of foreign investment and had pursued an active promotional policy. In devising measures to encourage domestic investment, the authorities should pay more attention to the appropriate interest rate level most conducive to such investment. Improvement of public sector efficiency, especially in project implementation, should be on the priority list of policy objectives. A stable price level was also of significant importance, especially as the growth of liquidity might increase pressure on prices in the period ahead.

On a global scale, Indonesia could undoubtedly be helped if the barriers against its exports to industrial countries were reduced, Mr. Alhaimus considered. Of more crucial importance for Indonesia, and indeed the world economy, was the need for concerted international cooperation to control the volatility of oil prices, with a view to the long-term impact of the present uncertainties.

Mr. Vasudevan observed that although Indonesia had a large debt to GDP ratio of about 40 percent, it had retained considerable creditworthiness in the international financial markets. Given that the same proportion of debt burden was expected to continue in the medium term, Indonesia's creditworthiness could be attributed to the adjustment policies pursued flexibly since 1983 by the authorities, and to the financial world's favorable perception of the authorities' commitment to adjustment. In view of the basic assumptions for Indonesia's medium-term prospects, the authorities would need to continue their adjustment policies, although that did not necessarily mean austerity measures were needed or that short-term adjustments in the mix of policies were precluded. There was considerable merit in the authorities' intention to see that monetary and fiscal policies did not allow the current sluggish economic activity to continue and intensify. The staff also understood the importance attached to supporting activity through the extension of credit. Not only monetary policy but also fiscal policy seemed to have provided such support, since the overall central government deficit was expected to be 5.2 percent of GDP in 1985/86, compared with the budget estimate of 2.7 percent.

The question remained, however, as to how far the expansionary stance could go, Mr. Vasudevan went on. In most developing economies, a quick answer could be found in the way commodity prices moved. Other answers could be seen in the movements in industrial production and the demand for bank credit by the private sector. The highly underutilized productive capacity in Indonesia's manufacturing sector and the moderate inflation rate of less than 5 percent suggested that the expansionary stance had not had adverse effects. Moreover, total domestic consumption had been growing at a much lower rate of 5 percent a year in the period 1982-85, compared with 10 percent in 1979-81, and had grown at the rate of about 3 percent in 1985. Finally, private consumption in the rural areas had been dampened by weak commodity prices and lower levels of production, as well as by a lower effective support price for substandard rice. Private consumption had been weakened in the urban areas by a slackening in economic activity and a rise in unemployment.

The weakness in domestic demand, supplemented by that in foreign demand--reflected in the decline in the value and volume of exports in 1985/86--had given rise to a large underutilized capacity, Mr. Vasudevan added. The entrepreneurial intent to invest had also been low. Even the reduced corporate tax rates and the granting of generous depreciation allowances in the 1984 tax reform had not fostered any buoyancy in investment. Although interest rates had declined somewhat, given the banks' freedom to fix interest rates, it was not clear how the authorities could lower those rates to levels that could help generate new investment. He asked the staff to comment on the relationship between interest rates and investment and to discuss whether there was any perception that investments would go up, irrespective of consumption trends.

How much the authorities could stimulate consumption demand was not easy to define, Mr. Vasudevan stated. In the current circumstances, however, that did not seem to pose much of a problem. The authorities were apparently satisfied with the current trends in the increase in liquidity, as evidenced by Mr. Ismael's remark that it was not a cause for great concern by Indonesian historical standards. It seemed that the authorities were confident of their ability to wield the necessary monetary instruments if a large monetary expansion occurred.

The budget for 1986/87, formulated against the backdrop of weakening oil and commodity markets, would reduce the budget deficit to 1.4 percent of GDP, from 5.2 percent in 1985/86, Mr. Vasudevan pointed out. The budget, which reflected the policymakers' view of the medium-term prospects, had called for increased reliance on non-oil/liquefied natural gas revenue, and cuts in total expenditures. While reliance on non-oil revenue was a welcome feature, the cuts in budgeted development expenditure--especially in the rupiah-financed expenditure--were large and had long-term implications. Given the limited infrastructure, it was necessary to prevent that sector from suffering from the reductions in expenditures.

A question needing detailed examination was whether the budgetary policy would be adequate to stimulate demand if the slack in economic activity continued, Mr. Vasudevan indicated. The slack would apparently continue for some time, given the weakness in oil demand and the adequacy of rice availability. He wondered how far the Central Government could go to increase consumption demand and ensure a pickup in investment activity, or whether the task should be left largely to monetary policy through the creation of domestic credits. Reactions from the staff or Mr. Ismael on those questions would be welcome.

The authorities had followed a laudable flexible exchange rate policy, Mr. Vasudevan mentioned. Given the need to develop the non-oil sector and non-oil exports, the authorities should develop a strategy that took into account industrial, trade, and exchange rate policies in an integrated way. Such an integrated strategy would be useful in many developing countries to diversify their economic structures, but it could not be pursued fruitfully unless it was accompanied by suitable organizational and institutional reforms, especially on the financial side. In that context, he was happy to note that the authorities recognized that fact, as reflected in their intention to develop a private capital market.

Mr. Romuâldez indicated that Indonesia's overall economic management stance during the past few years had been commendable; poised as it had been toward adjustment, the economy had been able to cope--with some degree of success--with the challenges that had emerged. In spite of sluggish foreign demand and continuing uncertainty in the oil and liquefied natural gas markets, the authorities had eked out a modicum of economic growth in 1985, maintained price stability, and retained a strong international reserves position. Mr. Ismael had rightly stressed that the efforts of the past few years had paid off to the extent that the authorities had a "cushion" to help them through the difficulties of their present predicament. Nevertheless, Indonesia must adhere to its adjustment stance for a while longer. Given the medium-term prospects--for economic growth and the rate of increase in the labor force, for oil/liquefied natural gas and commodity prices, and for external debt and debt service pressures--the authorities would have to exercise greater caution in debt management and intensify efforts to develop more fully and systematically their non-oil/liquefied natural gas capabilities through structural adjustment and sectoral development and rationalization, as well as through further trade liberalization.

He was concerned that Indonesia's fiscal performance in the past two years had diverged considerably from budget, Mr. Romuâldez said. A modest surplus had been registered for 1984/85 when a deficit equivalent to about 3 percent of GDP had been projected; and, for 1985/86 the deficit was threatening to balloon to 5 percent of GDP, as against the budgeted 2.5 percent. The apparent weakness of financial planning was worrying, and some tightening was needed. He wondered whether the authorities, who had previously shown a readiness to adjust to shifts in circumstances, were putting forward some contingency measures with which to counteract substantial revenue shortfalls and expenditure overshooting in the second half of 1985/86. Indeed, the authorities should be considering contingency measures as a normal feature of their financial planning, at least in such times of great uncertainty.

The authorities had recently begun to implement significant fiscal reforms, Mr. Romuâldez remarked. While hoping for successful implementation of those reforms in 1986 and the years ahead, he wondered whether the authorities could have achieved even more by rigorously examining the net impact on the economy of continued fuel and fertilizer subsidies. The authorities' approach might be too gradualist to make a meaningful improvement in the efficiency of resource allocation.

He shared some of the staff's concern over the current levels of liquidity, but he could not fault the authorities for having argued that, given the relatively high level of unutilized capacity, the situation remained manageable and inflationary pressures could still be kept in check, Mr. Romuâldez commented. However, the authorities should be particularly cautious--not only about increased liquidity per se but also about the distorted effects that preferential liquidity credits had on the allocation of capital resources. Data for the first half of 1985/86 suggested that the rapid growth of liquidity credits had continued.

Although no data for liquidity credits in nonpriority sectors had been given for 1985, those credits had not been much less in 1984 than credits in priority areas.

The staff representative from the Asian Department recalled that most Directors had commented on monetary developments, including the rapid growth of the monetary aggregates as well as the very high level of real interest rates. The spread between rates on time deposits and lending rates to the nonpriority sector was about 4 percent. That rather high spread could be partially explained by a lack of competition among banks. The costs of the transactions also seemed high, but the fairly large provision for loan losses was another important factor as well. Given the number of nonperforming loans, or loans in arrears, it was thought that the allocation for possible losses had put a constraint on reducing the spread.

The high level of real interest rates stemmed in part from the deflation of the nominal rate by the current rate of inflation; other more forward-looking deflators would modify the results, the staff representative continued. It was possible for the nonbank private sector, and certainly for foreign firms, to borrow abroad and convert the funds into rupiah, and that possibility, coupled with expectations, would constrain the level of nominal rates. The authorities were very concerned about the high rates and pointed to them as a reason for weak investment, but there were other reasons for investment weakness, including large amounts of excess capacity, difficulties in marketing products abroad, and sluggishness of demand both abroad and at home.

Although it was difficult to assess the impact of the high real interest rates on investment, it could be said that high rates were among the factors giving rise to the rapid growth of the monetary aggregates, the staff representative added. It was also difficult to determine the effects of rapid growth of the monetary aggregates; no pressure on prices had emerged to date, nor had pressure on the balance of payments occurred. There had been no monetary reforms during the past two years to give rise to a marked change in velocity. The effects of the 1983 reforms ought to have worn off already, but rapid growth was still continuing. However, the staff was pleased that the authorities had been able to use monetary instruments, such as Bank Indonesia certificates (SBI) and the rediscount facility based on newly established money market instruments (SBPU), to manage liquidity growth.

The staff was concerned about the rapid growth of the monetary aggregates in the context of the weakness of investment demand, the staff representative stated. As Mr. Polak and a number of other speakers had pointed out, the growth of time deposits suggested a potential for resource mobilization for investment. However, the demand for credit for productive investment was weak. The staff had explored whether liquidity credits, made available at attractive rates, were being redeposited. Although that possibility existed, it did not serve as a major explanation for the rapid growth of time deposits. Another factor possible explaining rapid liquidity growth, as Mr. Vasudevan had pointed out, was the active support for domestic activity stemming from monetary policy at a time fiscal support was restrained.

The recent and rapid drop in world oil prices had necessitated additional staff calculations in connection with the 1986/87 budget, the staff representative noted. The staff had made a mechanical adjustment to the oil revenue estimates, based on a new price of $20 per barrel instead of the original estimate of $25; that change led to a significant increase in the projected fiscal deficit, which in turn, gave rise to a significant increase in the domestic financing needs and a drawdown in the Government's balances to finance the shortfall in revenue. That drawdown would have consequences for the growth in liquidity, so that any future proliferation of liquidity credits and other sources of liquidity growth would need to take into account any prospective drawdown in the Government balances. Some Directors had commented that perhaps fertilizer subsidies could be cut further; that was an attractive idea, although the authorities would need to be careful in making any reductions not to impair the agricultural sector's confidence in rice or other foodcrop production. It was difficult to cut current expenditures, and the authorities had reviewed the situation very carefully before suggesting cuts; that review had been extended to development expenditures as well, as the authorities had identified potential cuts that would have the least impact on current and prospective growth. However, given the magnitude of the needed reduction in expenditures overall, it was not easy to see how the authorities could achieve their goal without making significant cuts in development expenditures.

All the reports evaluating a private Swiss firm's handling of Indonesian customs inspections had been very favorable, the staff representative indicated. The staff understood, however, that some adverse reports had been circulated by individuals who had not benefited from the transfer of responsibility. Revenues seemed to have strengthened somewhat since the Swiss firm had assumed the responsibility for customs inspections, and the delays in clearing customs had been reduced significantly. It was estimated that there could be a significant increase in export competitiveness because of a reduction in transportation costs, and the same pertained to costs of imports.

The latest staff calculations showed an increase in the budget deficit in 1986/87 because the estimated oil revenues had been revised downward without any other adjustments, the staff representative explained. There had been no change in the current account because, although the staff had revised oil revenue projections downward, it had revised import receipts dramatically downward as well.

The exchange rate in Indonesia would have an impact on the competitiveness of non-oil exports, but it was necessary also to implement an integrated strategy, including changes in industrial policy and in the trade system, to promote efficiency in the domestic economy, the staff representative from the Asian Department stated. The exchange rate by itself would have only a limited impact over the next three or four years; changes in the regulatory environment were of primary importance for growth over the long term. Finally, Indonesia might indeed be eligible under the compensatory financing facility. Calculations of the current and prospective growth of Indonesia's exports, based on the latest medium-term scenario, showed that 1986/87 was likely to be a shortfall year.

Mr. Ismael indicated that the Indonesian authorities, anticipating substantial cuts in the price of oil in 1986, had already prepared their most painful budget in well over a decade. Still, Directors had asked whether the price assumptions used in the draft budget had been realistic. The authorities' oil price assumption of $25 per barrel had been the market price prevailing when the budget had been drafted. The price of oil had since dropped below $20 per barrel, after the budget had been presented to Parliament. It would have been difficult for the authorities to have used a lower price assumption in drafting the budget, because it might have been interpreted as a willingness on their part to accept a lower price, thereby helping to trigger a real fall in oil prices in an already uncertain, unstable oil market. Besides, the attainment of the budgeted oil revenues depended not only on the price of oil but on net oil exports, the oil export tax, and the average rupiah exchange rate against the dollar. Although the President had ruled out any possibility of devaluing the rupiah, it might depreciate again by around 10-12 percent during the year and would thus assist in attaining the oil revenue target. Another avenue open to Indonesia was to increase production, but a more sophisticated observation of market information and aggressive marketing techniques would be needed in that connection. Still another possibility was to institute an innovative pricing policy, such as "net back" or a market basket index. In general, the authorities were prepared to enter into a new era in the crude oil market, which had changed from a buyers market to a sellers market.

The authorities were fully aware that the efficiency of the public and private sectors must be increased if Indonesia was not to remain a high-cost economy and, as such, was not to be pushed out of the competitive international markets, Mr. Ismael pointed out. They had already introduced some reforms and were in the process of implementing many more to help make the Indonesian economy more resilient in facing future adverse world economic developments.

The Chairman made the following summing up:

> Executive Directors were in broad agreement with the staff appraisal. They commented favorably on the implementation of wide-ranging and prudent adjustment measures by the Indonesian authorities since 1983, which had led to a significant moderation of inflation and to strong creditworthiness. Particular importance was attached to the maintenance of a flexible exchange rate policy, which had permitted the gains in competitiveness following the 1983 devaluation of the rupiah to be secured.

However, as illustrated by the staff statement, the effects of the additional budgetary restraint on imports, foreseen in the 1986-87 budget, were likely to be offset by the continued weakness in the oil market. Thus, there was no scope for a relaxation of the adjustment effort. A marked strengthening in the non-oil/liquefied natural gas sector was seen to be necessary by most Directors if Indonesia's growth and employment objectives were to be safeguarded. In that connection, Directors welcomed the statement of Mr. Ismael, affirming continued adherence of the authorities to prudence in financial and exchange rate policies, and signaling initiatives to further encourage private sector savings and investment.

Several Directors expressed concern, however, about the current rate of expansion of liquidity. They feared that it could lead to pressures on prices and the balance of payments, although at present there was substantial unutilized capacity and the rate of inflation was moderate. The assurances of the authorities that excess liquidity could be quickly absorbed were welcome, but a few Directors stressed the importance and the difficulties of timely action and urged the authorities to be cautious.

The renewed expansion of preferential credits, albeit in relatively modest proportions, was seen by several speakers to be somewhat inconsistent with the principles of the monetary reform. Directors agreed with the authorities that the present high real interest rates were burdensome for the economy and asked about the scope for reducing rates, for example, through increased competitiveness in the financial system.

Executive Directors noted the budgetary outturn for the first half of 1985-86, contrasting it with the deficit projected in the budget document, and the very much larger deficit estimated at the time of the consultation. Several Directors expressed concern about the overshooting of outlays, particularly in fertilizer subsidies, and the weakness in revenues from income tax receipts, if only because of the medium-term implications. Efforts to increase tax compliance and the success experienced thus far with the value-added tax were welcomed.

Directors commended the authorities for the cautious approach underlying the 1986/87 budget. They believed that expenditure restraint, especially in respect of subsidies, and a strengthening in non-oil/liquefied natural gas revenues were necessary. However, given the oil price situation, several Directors wondered whether the projected level of government revenues would be realized and suggested that policy adaptations might well prove necessary. The authorities were cautioned by several Directors to avoid coping with budgetary problems by an excessive recourse to external indebtedness.

A number of Directors noted that adjustment based on cautious financial policies alone was not optimal. Rather, an integrated strategy based also on a flexible exchange rate policy, and supported by industrial and trade policy measures, would be consistent with adjustment at higher real rates of growth. The role of the World Bank was stressed in that respect. Concern was expressed by several Directors on the delays in project implementation and some Directors wondered whether the authorities should not consider some reallocation of budgetary outlays so as to minimize reductions of productive investment projects. Adequate financial incentives for the private sector were important if that sector was to play a catalytic role. Several Directors commended the authorities for their intention to strengthen the role of the private sector in the development process and to create a favorable climate for foreign investment.

Although major changes in customs and port procedures were welcomed, some speakers noted with regret that the trade system had become more restrictive as a result of increased reliance on quantitative restrictions. Countertrade practices were considered by several Directors as a negative trend that the authorities should avoid. Accordingly, the intention of the Indonesian Government to place greater emphasis on tariffs was commended. Improvement in the performance of non-oil/liquefied natural gas exports was seen to be necessary in the coming years to keep the level of debt service manageable and to preserve Indonesia's excellent credit standing and high level of foreign exchange reserves. Several Directors also pointed to the responsibility of industrial countries to contain protectionist pressures and provide support for Indonesia's further development efforts.

It was agreed that Indonesia should remain on a 12-month consultation cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Indonesia in the light of the 1985 Article IV consultation with Indonesia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Indonesia maintains an exchange system which is free of restrictions on payments and transfers for current international transactions.

Decision No. 8202-(86/28), adopted
February 14, 1986

3. COOK ISLANDS - MEMBERSHIP - EXPRESSION OF INTEREST

The Chairman informed the Executive Directors that an inquiry about membership had been received from Cook Islands. Owing to the small size of Cook Islands and its constitutional relationship with New Zealand, the inquiry would require study. Accordingly, the matter would not be processed as if it involved a typical application for membership.

APPROVED: October 16, 1986

LEO VAN HOUTVEN
Secretary