MASTER FILES

ROOM C-130 04

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/159

10:00 a.m., September 19, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	D. C. Templeman, Temporary
	H. G. Schneider
	T. Alhaimus
H. Fujino	M. Sugita
	B. Goos
	Wang X., Temporary
J. E. Ismael	
	J. R. N. Almeida, Temporary
	M. Foot
	S. King, Temporary
H. Lundstrom	
	L. Leonard
	A. Abdallah
	J. J. Dreizzen, Temporary
	J. E. Suraisry
	J. de la Herrán, Temporary
	G. Nguyen, Temporary
J. J. Polak	
C. R. Rye	
	H. Alaoui-Abdallaoui, Temporary
	A. Vasudevan, Temporary
	N. Kyriazidis

L. Van Houtven, Secretary
A. Akanda, Assistant

Also Present

African Department: S. M. Nsouli. Asian Department: P. R. Narvekar, Director; U. Baumgartner, A. Ariyoshi, J. R. Márquez-Ruarte, H. L. Mendis, D. J. Robinson, R. C. Williams. Exchange and Trade Relations Department: E. H. Brau, N. Floros, K. M. Huh, R. P. Kronenberg, S. Kanesa-Thasan. Fiscal Affairs Department: P. Alonso-Gamo, G. Blöndal, T. Catsambas. Legal Department: J. K. Oh. Research Department: N. M. Kaibni. Bureau of Statistics: R. V. Kennedy. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, L. P. Ebrill, G. D. Hodgson, H.-S. Lee, K. Murakami, P. Péterfalvy, I. Puro, M. Z. M. Qureshi. Assistants to Executive Directors: A. Bertuch-Samuels, O. S.-M. Bethel, G. K. Hodges, Z. b. Ismail, J. A. K. Munthali, M. Rasyid, J. E. Rodríguez, V. Rousset, D. Saha, S. Simonsen, G. Schurr, G. Seyler, B. Tamami.

1. SOLOMON ISLANDS - 1986 ARTICLE IV CONSULTATION, AND PURCHASE TRANSACTION - EMERGENCY ASSISTANCE

The Executive Directors considered the staff report for the 1986 Article IV consultation with the Solomon Islands, together with a request for SDR 1.2 million in emergency assistance (EBS/86/177, 8/6/86; and Sup. 1, 9/18/86). They also had before them a report on recent economic developments in the Solomon Islands (SM/86/204, 8/20/86).

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

> The latest monetary data indicated that the greater degree of monetary restraint observed in the second quarter of 1986 continued in July-August 1986. During this period, credit to the private sector showed little growth and credit to the public sector stagnated following some increase in early July. As a result, the sharply lower growth of total domestic credit in the second quarter of 1986 (about 15 percent at an annual rate), compared with over 50 percent in the first quarter, was broadly maintained in July-August. By contrast, inflation has accelerated in the aftermath of the cyclone, reflecting shortages of locally grown foodstuffs. The Honiara retail price index jumped by 4 percent in June, raising the year-on-year inflation rate to 16.5 percent.
>
> Gross international reserves continued to decline in July-August, falling by about SDR 2 million, about the same rate of decline as in the first half of 1986. The Solomon Islands dollar depreciated by about 4 percent vis-à-vis the U.S. dollar in July-August 1986, resulting in a nominal effective depreciation of close to 5 percent during this period. Thus, the authorities have continued with their policy of gradual depreciation of the Solomon Islands dollar that has been in effect since mid-1985. The pace of adjustment in July-August was broadly unchanged from that of the preceding months.

Mr. Rye made the following statement:

> My authorities have asked me to record their appreciation for the frank and extremely valuable discussions with the mission staff. They are in broad agreement with the staff's analysis, although some differences of views do arise in the details of the policy prescription.
>
> Solomon Islands exemplifies many of the problems of low-income, small island economies. About 80 percent of the population maintains a traditional subsistence lifestyle. There is a chronic shortage of investment to underpin growth in the economy sufficient to improve the living standards of a population

growing at 3 1/2 percent per annum. Although the export base is more diversified than in many comparable economies, export returns are still subject to substantial swings. And in this very open economy, excess demand tends to be reflected quickly in rapidly rising imports.

Events of the past few years illustrate these difficulties. Solomon Islands is now at a crossroads in economic performance, a fact well recognized by my authorities. After boom years in 1983-84, export returns have fallen sharply in response to a severe weakening in the terms of trade, leading to a significant deterioration in the balance of payments and a contraction in GDP and contributing to a widening in the budget deficit and excessive monetary growth. In mid-May 1986, Cyclone Namu--the worst in living memory and even in oral tradition--severely impaired the economy's export potential and placed major additional pressures on imports and public finances. The heaviest damage occurred in the most populous regions of the country, and reconstruction and rehabilitation will take several years.

This disaster aside, the Solomons have been faced with a long-run downward trend in the terms of trade and real income, from which the 1983-84 upswing was a short-lived and misleading departure. The adjustments now being made will need to be more or less permanent, transmitting to the growing population a steady decline in overall levels of consumption with as much equity and stability as the nature of the process, and society, will allow. It will be necessary to avoid a sense of hopelessness and frustration, resisting any urge to destroy what has been built, while taking every opportunity to slow down the decline and wherever possible, by developing new and improved sources of income, producing some offsetting upward movement. The motto will be "adjust for survival, invest for growth."

Accordingly, the authorities have very large investments under way or planned in fisheries and forestry and are looking to identify and implement new investments in agriculture, processing and manufacturing. A comprehensive reform of the tuna industry is in hand to restore viability in the face of continued low prices and to enable increased investments to take place on a sound commercial footing. Tourism and industrial and mineral development are also being encouraged. All this will assist in strengthening (and broadening) the recovery in the external accounts.

My authorities' acceptance of the need for continued flexibility in exchange rate management is reflected in the depreciation of the Solomon Islands dollar by 26 percent against the U.S. dollar and by 40 percent against the SDR in the last 20 months. However, they do not share the certainty with which the staff recommends an immediate and large devaluation of the currency to restore export profitability. The devaluation needed to restore profitability to copra and palm oil industries would administer such a shock to the price structure of the economy that the authorities could not, with confidence, predict the outcome. They prefer, therefore, to maintain the flexible exchange rate management that has operated during the last three years, but with greater discretionary freedom week by week.

As the staff report notes, the authorities adopted a wide range of fiscal and monetary measures earlier this year. The jury is still out on the effectiveness of these measures. Although the monetary aggregates were stable at end-August, credit to the private sector is expected to rise, and deposits and reserves are expected to decline during the next four months as the full impact of the worsened external position comes home. What is uncertain is the speed and magnitude of these effects. The authorities wish to assess the effectiveness of recent measures before moving in a more severely contractionary direction.

My authorities believe that the last quarter of 1986 should see the economy bottom out in respect of all the main economic indicators. By then, the full effects of Cyclone Namu on export production will have worked through; copra producers will have responded to the sharply reduced market prices; and it will be clearer how much imports have been compressed by reduced incomes, higher interest rates, currency depreciation, and higher import duties. Parliament will have dealt with the 1987 budget, including general austerity measures, encompassing the proposed public service pay and employment freeze, reductions in subsidies, increases in taxes, charges and fees, a strengthening of the tax system, and finance to encourage new export-oriented investment. The authorities will also have a better idea about the Namu rehabilitation financing and other large components of the 1987 capital account.

By early 1987 the authorities expect to be able to forecast the economic outlook for 1987 and the size of the gap to be closed by a combination of adjustment and financing. They propose to adopt an adjustment program for 1987 (embracing domestic credit, credit to the Government, exchange rate and external financing) which would meet the Fund's criteria for a stand-by arrangement and a drawing under the compensatory financing facility.

Mr. King, noting the concern of his authorities for the difficulties facing the Solomon Islands as a result of the cyclone earlier in the year, said that he could warmly support the authorities' request for emergency assistance, which appeared eminently justified. The Solomon Islands would clearly face a difficult external position over the medium term as a result of the sharp fall in the value of copra and palm oil exports. While he could perhaps share the staff's view that the extent of the adjustment required of the authorities would have been reduced if the export proceeds from the "boom years" had been used to augment reserves, it was clear that that observation was of little help at present. The authorities would need to take firm action on a number of fronts if the external position was to be strengthened and the conditions that would allow for a rapid recovery from the effects of the cyclone were to be created. If Mr. Rye's opening statement was any indication, the authorities were well aware of the problems they faced.

The bleak outlook for the balance of payments shown in the staff's medium-term scenario underlined the importance of strengthening the external position, Mr. King continued. Although the scenario showed some rise in reserves from the current low level, it was clear that the reserves increase would leave large residual financing gaps of a magnitude that could be filled only by an unsustainable rise in foreign borrowing. Furthermore, the staff was projecting a strengthening in the terms of trade in the later years, due presumably to a recovery in copra prices to more normal historical levels. While such a recovery was not impossible, the current uncertainties underlined the need for caution in relying upon such forecast. In that connection, he would be interested in any additional details the staff might provide on longer-term assumptions about copra prices.

Recognizing that the external position was likely to remain difficult over the medium term, he could support the staff's view that the authorities would need to keep exchange rate policy under close review, Mr. King commented. While he could understand the authorities' concern that too rapid a depreciation might result in a rise in inflation, the evidence that the profitability in the export sector had reached alarming levels would seem to suggest that there was little room for doubt that further action on the exchange rate front would be required. In any case, the exchange rate was perhaps an inappropriate tool for the control of inflation in the face of major imbalances, control which could perhaps better be achieved through appropriate fiscal and monetary policies. It was encouraging to note that the authorities apparently recognized the need to increase the flexibility of exchange rate policy.

Fiscal policy would have a role to play in supporting the authorities' domestic price objectives; the authorities would also need to take into account the importance of strengthening the external position and creating the necessary resources to finance the much needed capital investment to restore and then augment the capital stock, Mr. King remarked. In that connection, it was clear that expansionary fiscal policies in 1985 had contributed to the pressures on the external account. The priorities he had mentioned would seem to imply that it was important to impose firm control over current expenditure in addition to seeking measures to strengthen revenue. He was thus glad to see that the authorities were considering various measures to reduce current expenditure in the 1987 budget, including a freeze on public sector wages and employment and reduction in subsidies. A significant reduction in the budget deficit would seem to be a prerequisite for the substantial improvement in the external position that was needed over the medium term.

Efforts would also need to be made in the monetary policy area if the external position was to be improved and inflation was to be kept under control, Mr. King considered. In that connection, the measures taken in 1985 to restrain credit growth had been a move in the right direction, and the increases in interest rates to positive levels in real terms had been particularly helpful. Nonetheless, those measures seemed to have produced slightly disappointing results. The additional measures taken in early 1986 had been helpful, therefore, and he could join the staff in welcoming the intention of the Central Bank officials to limit credit growth to 10 percent in the second half of 1986. Also encouraging was the news in the staff's opening statement that credit growth had slowed sharply in the second quarter of 1986.

Welcoming the authorities' intention to request a use of resources under the structural adjustment facility, Mr. King wondered how preparations toward that end were proceeding. Potentially, there were a number of areas to be covered under a structural adjustment facility program. As the staff had noted, the effectiveness of public investment had suffered from administrative shortcomings; in addition, the tax and tariff systems both seemed in need of review and, where necessary, reform. The staff had also pointed to the system of customary land tenure, which might be inhibiting the rapid growth of agricultural production. It was thus encouraging to see that the authorities were taking measures to regularize the system of land registration.

Finally, Mr. King considered it important to give appropriate encouragement to direct investment. He had noted that the staff's medium-term scenario anticipated a modest rise in the flows of such investments in the years ahead, which presumably reflected the response to the revision of the Foreign Investment Act that the Government was currently preparing. He would be interested in any further details the staff might have on the status of that revision. In conclusion, the authorities in the Solomon Islands were currently facing a major challenge to repair the damage caused to the economy by the cyclone and to deal with the results of the sharp worsening of the terms of trade and the effects of relaxed fiscal policies. It was appropriate that the Fund should be able to offer not only its advice but also financial assistance in dealing with all those problems. He could therefore support the proposed decision and looked forward to the opportunity to discuss in the near future a comprehensive adjustment program that could be supported by the use of Fund resources.

Mr. Templeman made the following statement:

> It is clear that the authorities of the Solomon Islands face some very difficult problems, and I would agree with Mr. Rye's conclusion that the economy is at a crossroads. A rather steady worsening in the terms of trade in recent years and the tragic effects of the May cyclone clearly are important factors behind present problems and the rather unpromising outlook over the medium term. That being said, it is regrettable that the

benefits of the vegetable oil price boom of 1984 were not managed in a more cautious way, so that the extent of adjustment now required could have been less.

While the major responsibility for economic adjustment and structural reform of course rests with the authorities, it is clear that the Fund, bilateral donors, and the multilateral banks--as well as private capital--can help. Improvements in the economic data base and in various aspects of public administration can also play an important role, with the help of technical assistance from abroad. In that connection, we note that the Fund is currently supplying two experts to the Central Bank and one budget advisor and that Fund missions in 1985 made some recommendations concerning improvements in statistics on the national accounts, production, prices, foreign trade, and government finance. We hope that the authorities will make good use of this advice.

The current account of the balance of payments was in deficit in 1985 to the extent of more than 22 percent of GDP, and a deficit equal to more than 33 percent of GDP is expected in 1986. Apparently, the Solomon Islands has been able to finance fairly large current account deficits in the past without the buildup of a large debt burden due to substantial official aid from abroad. However, prospective deficits of the size expected through 1990 raised questions about their financeability. It is unfortunate that it was not possible to make firm estimates of foreign assistance for reconstruction and rehabilitation for inclusion in the staff's medium-term balance of payments scenario. We wonder if it is any clearer now how much of the financing gaps in 1987-90 might be filled from this source. The staff's cautionary note with regard to the risks to the debt service burden of filling such gaps on a large scale with commercial credit is well taken, given the large and rapid rise in the debt and debt service ratios that could result.

We are somewhat uncertain about the appropriate exchange rate policy to be followed in the near term. Clearly, over the longer term, diversification of exports and maintenance of profitability of existing exports will require a flexible policy. The currently very low, or negative, rate of export profitability does call attention to the possible need for some downward adjustment now. However, we also recognize the dilemma presented, due to the already evident danger of accelerating inflation, and we are aware of the fact that the immediate impact of a further depreciation on the trade balance may be small, partly because of the need to import to permit reconstruction to proceed. On balance, we would conclude that, in light of the rather substantial exchange rate decline that has already occurred, some time might be allowed to see the results before a major additional depreciation is effected.

We also feel uncertain about the adequacy of the pricing policy. A large-scale pass-through of the 1984 world copra price increase and the high copra support prices in 1985 evidently cannot be continued for much longer, in light of the decline in the reserves of the Commodity Export Marketing Agency. However, we wonder whether the new formula for setting copra support prices on the basis of a seven-year average and a 50 percent pass-through is reasonable. We also wonder about the plans for new price support schemes for palm oil and cocoa and what they imply for the fiscal accounts and other parts of the economy.

Concerning the fiscal accounts more generally, the decline in revenues due to the weakness of exports is only one factor behind the very large deficit ratios. The problems appear to be in large part structural, reflecting weakness in the tax system, tax administration, and expenditure control, although the rise in current expenditures averaging 18.5 percent in the three years 1983-85 may reflect some other factors. For 1987, we support the authorities' plan for a reduction in the deficit ratio below the 12.7 percent of GDP expected for 1986, based on reductions in subsidies, a freeze on wages and employment in the public sector, and increases in taxes, charges, and fees. Over the longer run, the review of the tariff and tax system may be even more important. As I mentioned earlier, technical assistance from abroad should be helpful. I noticed, for example, that the National Development Plan for 1985-89 does not seem to have been reviewed by the World Bank, although the Bank has been involved in agricultural investment planning. If the authorities are seriously contemplating a request to the Fund for financial assistance under the structural adjustment facility, we would expect that the World Bank's involvement in the Solomon Islands might expand somewhat.

My only comment on monetary policy is to endorse the staff's recommendation that credit expansion be kept under careful restraint, not just for the rest of 1986 but for 1987 as well. Credit growth of 36 percent and 61 percent in 1984 and 1985, respectively, and a still high rate of credit growth in early 1986, are clearly not consistent with the need to reduce pressure on prices and the balance of payments.

Finally, I can support the request for emergency assistance from the Fund, since the request seems to conform adequately to the guidelines that the Board considered in 1982. First, it does appear that the country cannot meet its immediate financing needs arising from the natural disaster without a serious depletion of its reserves, although it would be clearer if we had a better idea about the amount and promptness of official aid which may be forthcoming. Second, the 25 percent of quota amount for the assistance is acceptable. Third, we expect that the amount of emergency assistance being extended will be taken into account if a compensatory financing facility or stand-by request is received, so as to avoid any double compensation. Fourth, we believe that the initial measures taken by the authorities sufficiently ensure that inappropriate policies are not compounding the problems created by the disaster. Finally, we believe that the authorities have adequately described their general policies and have clearly indicated their intent to cooperate with the Fund to take the necessary adjustment measures. Of course, this will be clearer when a comprehensive program for 1987 in support of the expected stand-by request is submitted to the Board.

Mr. Goos observed that the Solomon Islands had apparently fallen, like so many countries before it, into the trap posed by external windfall gains by having allowed the bulk of those gains to feed through the economy and the budget. The failure to stabilize those gains to a greater extent than had been done in order to strengthen the fiscal position and bolster external reserves had, as the staff had rightly observed, considerably complicated the authorities' task of economic management, a task that had been exacerbated significantly by the damage caused by the cyclone. Based on developments thus far, it was clear that a successful resolution of the problem would undoubtedly require determination and perseverence by the authorities.

He was in full agreement with the staff analysis and appraisal of the specific policy areas requiring attention, Mr. Goos continued. In particular, he agreed that exchange rate policy must play a crucial role in securing adequate profitability in the export sector in order to protect the export base against further unfavorable external developments. In the circumstances, he welcomed the fact that the exchange rate had been allowed to depreciate further in recent months beyond the real effective depreciation of 24 percent that had occurred in the 12-month period through April 1986. Nevertheless, it was clear from the staff report and Mr. Rye's opening statement that the adjustment of the exchange rate had failed to restore export profitability. While he appreciated the authorities' concern about domestic price inflation, he was inclined to agree with the staff and Mr. King that gradualism in exchange rate policy might unduly delay the necessary expansion of the export base.

It was of course clear that a more active exchange rate policy must be supplemented by tight financial policies in order to contain the inflationary pressures resulting from devaluation, Mr. Goos remarked. Such policies would also help to mobilize additional domestic savings that were badly needed to support reconstruction and the ambitious development objectives without threatening overall financial stability. Against that background, the recent slippages that had occurred in fiscal and monetary policy were clearly a matter for concern. He hoped that the authorities would make every effort to achieve a substantial reduction in the fiscal deficit and in domestic credit expansion. The need for such reductions was clearly reinforced by a number of developments or projections. First, there was evidence that export profitability had been eroded not only by external price developments but also by continued high domestic inflation rates, which, except for 1983, had fluctuated within the range of 10-16 percent. In that connection, he noted that the medium-term development plan was based on an inflation rate that was not to exceed 10 percent a year. He felt strongly that a more ambitious ceiling for that rate would be more appropriate in the circumstances of the Solomon Islands.

Second, Mr. Goos continued, although the existing external indebtedness of the country did not give rise to immediate concern, recent and prospective trends were worrying. Between 1982 and 1985, external debt had doubled in relation to GDP, while the debt service ratio had risen almost tenfold. Moreover, according to the staff's projections, those ratios were expected to roughly double again within the next one to two years. Third, he agreed with the staff and Mr. Templeman that the medium-term outlook for the balance of payments revealed that the present policy stance was probably not sustainable, even with higher financial support on concessionary terms.

In sum, Mr. Goos said, there was little doubt that the financial policies needed to be tightened significantly and supplemented by appropriate supply-side policies including an appropriate exchange rate policy. In the circumstances, he welcomed the authorities' intention to formulate an adjustment program along those lines. If properly designed, the program would certainly deserve the support of the Fund. Given that the two previous arrangements with the Fund had had to be terminated prematurely, and in view of recent policy slippages, any such program should place considerable emphasis on the effectiveness of budgetary and monetary planning and control procedures.

Finally, Mr. Goos considered that the guidelines for emergency assistance had been followed and that in particular the requirement of a serious depletion of external reserves had been met. He could therefore support the proposed decision in the expectation that the authorities' intention to stabilize the economy would soon be effected through the adoption of firm and convincing measures.

Mr. Sugita observed that the Solomon Islands economy suffered from fluctuations in world prices of export commodities and from fluctuations in weather conditions. While the economy had benefited from a substantial improvement in the terms of trade in 1984, the subsequent fall in the prices of copra and palm oil had led to a significant deterioration in economic performance, particularly in the balance of payments and the fiscal balance. And the outlook was for continued difficulties for the next four years. In addition, the Solomon Islands economy had suffered from extensive damage caused by a cyclone in May 1986.

In his opening statement, Mr. Rye had emphasized the need to avoid a sense of hopelessness and frustration and had referred to the motto "adjust for survival, invest for growth" as good advice for bringing the Solomon Islands out of its present difficulties. He himself found the advice to be appropriate, as the need for strong and comprehensive adjustment measures was clear. But that strategy must be complemented by the adoption of structural measures aimed at increasing the efficiency of investment and at rationalizing foreign aid. Another important consideration at the present juncture was the need to avoid excessive accumulation of foreign commercial debt, which could have a serious adverse impact on debt management in the longer run.

The early implementation of adjustment measures would reduce the need for further commercial borrowing, Mr. Sugita commented. He therefore strongly urged the authorities to formulate an adjustment program to be supported by a stand-by arrangement as soon as possible following the approval of the emergency assistance.

On exchange rate policy in the Solomon Islands, Mr. Sugita noted that the authorities were concerned about the possible adverse impact that a further large devaluation might have on the price structure in the Solomon Islands. While he had some sympathy for their concerns, he doubted whether the authorities could realistically avoid a further devaluation in the face of the severe balance of payments difficulties. There was an urgent need for enhancing the profitability of export commodity producers and, in that connection, he noted that copra production by small holders had been price responsive. Those considerations led him to favor an early and substantial devaluation of the currency in order to avoid further deterioration in the balance of payments and to avoid further recourse to foreign financing.

The deterioration in the fiscal situation arising from a sharp fall in export prices had been compounded by poor expenditure control and weak tax administration in the Solomon Islands, Mr. Sugita remarked. The authorities had indicated that a number of measures would be taken to achieve a reduction in the fiscal deficit in the 1987 budget. He welcomed those indications and hoped that any measures taken would be sustained. At the same time, expenditure control and tax administration must be strengthened, and the tax and tariff systems should be reviewed.

While appreciating the measures that had been introduced to contain the growth of domestic credit, Mr. Sugita said that he agreed with the staff that domestic credit should be under tighter control and should be closely monitored. On structural matters, he had taken note of the adoption in August 1985 of the National Development Plan for 1985-89. However, in view of the drastic change in the economic environment that had taken place since that time, he would appreciate any comment the staff might have on the status of the Plan and its assessment. There were major weaknesses in project planning and implementation; and in order to enhance the efficiency of investment, it was important to address those weaknesses. It was to be hoped that the structural problems would be dealt with as part of an adjustment program to be supported by the stand-by arrangement and by the use of structural adjustment facility resources aimed at enhancing the economy's growth potential over the longer term. Finally, he could support the proposed decision.

Mr. Suraisry, noting that he too felt that the authorities' request for emergency assistance was fully justified, said that he could support the proposed decision.

The staff representative from the Asian Department, responding to questions about staff assumptions for the longer-term trend of copra prices, observed that commodity price projections were difficult to make. At present, the situation in the vegetable oil markets was characterized by an oversupply, which put downward pressure on prices. The oversupply problem was undoubtedly due to a number of factors, including good weather conditions in most producing countries. Over time, with adequate growth in the industrial countries and some adjustment on the supply side, prices were expected to recover somewhat, although they would not return to anywhere near the boom levels of 1983-84 or of the years prior to 1980. With some recovery in prices, one could hope for a significant improvement in the terms of trade by the end of the 1980s, although such an outcome was highly uncertain and should not be counted upon in the formulation of policies.

Progress in developing a comprehensive program of structural adjustment had not been as rapid as hoped, and the authorities did not envisage that a full program could be put in place in the near future; indeed, they were in only the initial stage of formulating structural adjustment policies. However, adjustment should not be delayed, and the authorities should therefore concentrate on a program that could be supported by a stand-by arrangement. Use of resources under the compensatory financing facility could also be considered in connection with the adoption of appropriate measures to correct existing imbalances.

He had little to add to the information already provided on the status of the revision of the Foreign Private Investment Act, the staff representative remarked. The authorities had told the staff that it was their intention to improve incentives for private foreign investment and to reduce administrative barriers. Since that time, the Solomon Islands had been devastated by a cyclone, and it was unclear whether the natural disaster had caused any delays in implementing the changes in the Foreign Private Investment Act. On a related matter, Mr. Templeman had asked whether the staff had any additional information on the financial assistance that would be provided by bilateral donors and multilateral agencies in the aftermath of the cyclone. Bilateral donors and multilateral agencies had met in mid-July and, according to the Solomon Islands authorities, pledges made at that time had been substantial. However, the staff had no firm quantitative indications beyond what had been outlined in the report. Given the weak administrative capacity in the Solomon Islands, it would take some time to identify reconstruction projects and to line up necessary financing for them.

As mentioned by Directors, exchange rate policy in the Solomon Islands was a matter of concern, the staff representative commented. The current situation was characterized by low export profitability and strong pressure on the balance of payments, which had resulted in a steep fall in reserves. More than one half of total exports were facing record low profitability or even making losses; and there was a danger of a substantial decline in export volume in the short run as small farmers switched to production of nontradables. There was also a danger that plantations would fall into disrepair and that the planned expansion of the export sector would not take place because of a lack of profitability. Furthermore, as many Directors had emphasized, the medium-term balance of payments outlook was unfavorable, indicating prospective large financing gaps with adverse implications for external debt. It was true that the low export profitability was largely due to steep declines in world prices for vegetable oils and to depressed world markets for fish. Domestic policy in those circumstances could not fully protect the export sector. However, with copra, palm oil and fish constituting a large share of the Solomon Islands' resources, the financial viability of the fish and vegetable oil industries needed to be assured.

Copra production was subject to a price stabilization scheme, and producer prices at present were well above the world market price, although that was justified to some extent, given that the world market price was depressed, the staff representative remarked. But at the present rate of subsidization, the stabilization fund would soon run out of reserves, because it had already provided support in 1984-85, when world prices had been high. The solution was not simply to lower the producer price even further with a view to stopping the unsustainable drain on reserves; nor would it be appropriate for the stabilization fund to borrow, because that would tend to exacerbate the already strong pressure on the balance of payments. The circumstances suggested the use of the exchange rate, a suggestion reinforced by the situation in other industries and, more fundamentally, by the current and prospective balance of payments situation. Exchange rate action to redress the situation did not necessarily have to fall outside the framework of flexible management of the exchange rate that was currently in place, although it would entail a different pace of adjustment for a short time. The authorities had managed the exchange rate flexibly; the challenge was to adapt their policy to the requirements of the present situation. And, in his view, the balance of payments problems were sufficiently acute to warrant immediate action. Export volume was declining, reserves would fall to the equivalent of two months of imports by year-end, and large financing gaps were envisaged in the years ahead.

A question had been raised by Mr. Templeman about the formula for establishing the producer price for copra, and whether that formula was more appropriate than the one used in the past, the staff representative recalled. It should perhaps be noted that no one formula could serve all situations, and judgment must be exercised in each case. Even at present, the authorities were not relying on a formula to automatically establish a producer price; they were exercising judgment. As for price support for cocoa and palm oil, the authorities were aware of the pitfalls and dangers of price stabilization, particularly the dangers of yielding to political pressures and providing support at times when prices were high. But there were plans to go ahead with the price stabilization scheme for cocoa where there were small producers. In the area of palm oil, the one large company was unlikely to want to participate in a stabilization scheme. Finally, responding to a question posed by Mr. Templeman on the development plan, he noted that the economic situation in the Solomon Islands had changed since the development plan had been adopted, and revisions would certainly be needed.

Mr. Rye, recalling the indication by Mr. Goos that the Solomon Islands should perhaps take advantage of windfall gains, reminded his colleagues that the Solomon Islands had a weak administrative capacity, and the failure to follow Mr. Goos's advice must be attributed in no small measure to the shortage of skilled administrators.

On exchange rate policy, it should be made clear what was at issue between the staff and the authorities, Mr. Rye continued. The Solomon Islands authorities would have no difficulty agreeing with Mr. King's proposition that the exchange rate must be kept flexible and under close review and that it should not be a tool for controlling inflation. However, the Solomon Islands was suffering from a sharp increase in inflation; indeed, the figures in the supplementary paper showed that the retail price index had jumped by 4 percent in June 1986, raising the year-on-year inflation rate to 16.5 percent. Obviously, the rate of price increase at the moment expressed in annual terms would be far sharper. The authorities were thus fearful that a further rapid exchange rate adjustment of any significant size could greatly exacerbate the inflation problem. Moreover, the situation was complicated by the fact that, at present, the economy was unusually dependent on imported food because the cyclone had destroyed many local crops. And there were pressures resulting from a very sharp rise in imported food prices. In the circumstances, the authorities felt that the time was not right for a very quick movement in the exchange rate, although they fully appreciated that they must maintain a very flexible policy and move as fast as possible without causing social pressures to become excessive.

Recalling the indication by the staff that in establishing policy the authorities should not count on the improvement in vegetable oil prices that the staff had predicted, Mr. Rye agreed that no one could be certain about future developments. Indeed, far from counting on any improvement in vegetable oil prices, his authorities were rather skeptical about the extent of the improvement that had been built into the staff's forecast.

Responding to questions on possible use of resources under the structural adjustment facility, Mr. Rye noted that the World Bank had been only minimally involved until recently in small Pacific countries, including the Solomon Islands. In fact, his counterpart on the World Bank Executive Board had been pressing the Bank to pay greater attention to small island economies in the Pacific. Work on the structural adjustment facility would require greater collaboration between the Fund and the World Bank and would of course make it necessary for the Bank to become more actively involved in such countries.

The Chairman made the following summing up:

Executive Directors were in full agreement with the staff appraisal. They noted that Solomon Islands was faced with a very difficult situation: a steep decline in export prices had led to the emergence of substantial pressure on the balance of payments, which had been reinforced by the effects of the recent cyclone. However, it was also observed that a deteriorating fiscal situation and rapid growth of credit had contributed to the worsening of the external position. The immediate outlook was for a sharp decline in reserves, and medium-term projections indicated sizable external financing gaps. Against this background, Directors emphasized the need for the adoption of tight financial policies in the framework of a strong and comprehensive adjustment program and they urged the authorities to formulate as soon as possible an adjustment program that could be supported by the use of Fund resources. Concern was expressed as to whether the large external financing gaps projected in the period 1987-90 could be financed and, in that context, they noted the need for larger financing at concessionary terms, in particular to help with reconstruction following the cyclone.

Directors expressed concern about the sharp deterioration in export profitability and the need for a substantial improvement was stressed. While the poor profitability of exports was mainly due to external factors, economic policy needed to ensure the continued viability and growth of the export sector. The profit situation, the pressure on reserves in 1986, and the prospective large external financing gaps all pointed to the need for action and flexibility in the field of the exchange rate. Furthermore, Directors observed with concern the very rapid increase in recent years in the external debt burden and urged the authorities to exercise great caution and to limit external borrowing, particularly at commercial terms. Directors also noted that support price policy for copra should be reviewed and directed more firmly at ensuring the financial viability of the price stabilization fund.

Directors expressed concern about the deterioration in the fiscal situation and urged a sizable reduction in the fiscal deficit that, at 12-13 percent of GDP, was very large. In that context, they noted the large rise in current expenditure and weaknesses in expenditure control, the tax system, and tax administration. Directors welcomed the authorities' intention to consider for the 1987 budget a freeze of public service wages and employment, a sharp reduction of subsidies, and increases in taxes, fees, and charges. The authorities were encouraged to intensify their efforts at improving tax administration, expenditure control, and budget planning; they were also encouraged to go ahead with the review of the tax and tariff systems.

Directors observed that domestic credit had risen very rapidly in 1985 and that there was a need to strengthen monetary control. The recent slowing of credit growth was encouraging and Directors welcomed the intention to limit that growth to 10 percent in the second half of 1986. In the present situation, the emphasis should remain on exercising tight control over credit developments, both to reduce the external imbalance and contain inflationary pressures.

Directors noted that a number of structural problems had impeded growth and the attainment of a stronger external position. Foremost among those problems were constraints on developments arising from the traditional land tenure system, resource management issues in the timber sector, and administrative barriers to foreign investment. The authorities were encouraged to develop policies to address those structural problems. The view was also expressed that a strong and active collaboration between the Fund and the World Bank in tackling those structural problems was called for. Finally, the authorities were encouraged to improve the economic data base; to that effect, the recommendations of technical assistance missions should be considered for early implementation.

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

The Executive Board then took the following decision:

1. The Government of Solomon Islands has requested a purchase equivalent to SDR 1.25 million.

2. The Fund notes the intentions of the Government of Solomon Islands as stated in its letter dated July 30, 1986, and approves the purchase in accordance with the request.

Decision No. 8402-(86/159), adopted
September 19, 1986

2. KOREA - 1986 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1986 Article IV consultation with Korea and a review under the stand-by arrangement with Korea (EBS/86/194, 8/19/86; Cor. 1, 9/16/86; and Sup. 1, 9/18/86). They also had before them a report on recent economic developments in Korea (SM/86/230, 9/5/86).

Mr. Rye made the following statement:

My Korean authorities would like to thank the staff for its timely and appropriate analysis of the Korean economy, with which they have no significant disagreement.

In the period since 1980, a year when the economy was facing great difficulties both internally and externally, Korea's continued adjustment programs have aimed at securing a viable external position with price stability in the context of sustained economic growth. With the support of the four stand-by arrangements with the Fund, these programs have been steadily implemented without major interruption.

The results have been impressive. In the three years 1981 to 1984, real output grew at an average 8 percent a year, inflation fell from nearly 30 percent to 2 percent, and the current account deficit declined from 9 percent of GNP to less than 2 percent.

Korea also made substantial progress in coping with heavy external debts. Growth in external debt slowed from a yearly average of 36 percent in 1979-80 to 6 percent by 1984, and short-term external debt fell from 34 percent of the total to 27 percent.

In 1985, progress was maintained in the face of an unfavorable external environment. Korea's exports were in the doldrums, reflecting mainly slower growth of the industrial economies and ever-increasing protection in world markets. Business investment at home was also stagnant. Reflecting these weaknesses in domestic and foreign demand, manufacturing output, the engine of Korean growth, rose by only 3.5 percent, about a quarter of the previous year's figure. But the forces of recovery gathered pace in the second half of the year as exports and business investment picked up.

Prices remained stable in 1985 for the fourth successive year, reflecting falls in import prices and the relative weakness of aggregate demand. Consumer prices increased at the same rate (about 3 percent) as in 1984.

Despite the improvement in the current account (the deficit fell from $1.4 billion in 1984 to $0.9 billion), the balance of payments deficit increased by $1.1 billion to $2.5 billion reflecting a decline in autonomous capital inflows, a sharp increase in exports on credit, and large repayments of foreign debt of overseas subsidiaries of Korean companies. While external debt continued to rise, the maturity structure improved, the share of short-term debt in the total falling from 27 percent in 1984 to about 23 percent.

According to preliminary data for the second quarter of 1986, real GNP grew by 12.1 percent over the same quarter of the previous year, following growth of 9.7 percent for the first quarter, thus bringing average growth in the first half of 1986 to 10.9 percent. The main impetus to acceleration of growth continued to be exports of goods and services (including receipts from tourism) and gross fixed investment; final consumption continued to rise at a moderate rate. A noteworthy impetus to the economy has been provided by the revival of construction, which has also contributed to the absorption of returning construction workers.

The rate of inflation remains stable, the consumer price index having risen at a moderate 2.4 percent over the year to August.

With the help of a sharp fall in international oil prices and of declining international interest rates, Korea's balance of payments has turned substantially for the better. The current account recorded surpluses totaling $638 million for the first half of 1986, compared with a deficit of $1,033 million for the same period of last year. This is the first surplus in Korea's current account since 1977. However, my Korean authorities regard it as a temporary phenomenon; in their view, the present favourable conjuncture is unlikely to prove lasting.

As noted in the staff report, the authorities have undertaken to refrain from further drawings under the current stand-by arrangement. In so doing, they have noted that this does not reflect an elimination of the country's balance of payments need but rather the need to keep faith with the assurance given to the Board last year, and their wish to maintain a cooperative approach in their relations with the Fund.

In response to tighter monetary policy, the growth of domestic credit in both the banking system and the financial system as a whole has been declining. Monetary and financial developments are as follows:

	Growth one year earlier (in percent)			
	May	June	July	August (P)
M2 and CD	19.8	18.6	18.1	17.9
Domestic credit	17.0	15.8	14.1	13.2
of which, private	17.0	16.2	15.2	13.6
M3	23.8	24.1	24.6	24.9

Deceleration of the growth of M2 plus CDs with accelerating M3 growth indicate shifts at the margin in portfolio preferences toward nonbank deposits, particularly security investment trust funds and deposits in mutual savings and finance companies.

In the fiscal sector, the authorities maintain a firm intention to contain the public sector deficit, in particular the deficit of the Grain Management Fund which the Government intends to reduce gradually by narrowing and eventually closing the price gap between sales and purchase prices. The authorities will also review the possibility of transferring most of the operations of the GMF to the private sector.

Since the recent decline in oil prices is likely to be transitory, and having regard to the scarce resource endowments of Korea and the country's high vulnerability to any unfavorable turn in the external environment, the authorities have not allowed domestic oil prices to be reduced by the full extent of the world price decline. They expect to sterilize a substantial amount of the incremental proceeds of the Petroleum Business Fund in 1986 as savings for the purpose of improving the industrial structure and supporting the energy sector in subsequent years.

With the substantial improvement in the balance of payments and faster economic growth, the growth of broad money has been accelerating in recent months. Having regard to the possible adverse effects of this development on inflation, the authorities have taken a number of measures to tighten external commercial borrowings and to intensify restraint on domestic credit. These include raising the Bank of Korea's rediscount rate (from 5 percent to 7 percent), reducing available export credit amounts, and tightening external commercial borrowing.

The authorities have continued to pursue a long-term program of financial liberalization aimed at promoting a better allocation of resources through measured steps to enhance competitiveness and efficiency. An essential element of this program is a gradual deregulation of interest rates (these measures have been set out in detail in the staff paper). Deposit rates are being kept high in real terms to increase domestic savings further.

With regard to external policy, Korea's objectives are to keep down the growth rate of external debt and to improve its structure--objectives which require the maintenance of a viable balance of payments. In this context, the Korean authorities strongly hope that the recent turnaround of the external accounts will provide the momentum to achieve the external objectives envisaged in the staff's medium-term projections. Notwithstanding the recent improvement, Korea's external debt is still at a high level and its relatively short maturity structure is vulnerable to adverse external developments. Since the latter part of 1985, the management of the exchange rate has been complicated by the sharp depreciation of the U.S. dollar vis-à-vis other major currencies (but not against those of the Asian NICs). To maintain Korea's competitiveness against other major competitors and in the U.S. market, the authorities have maintained a close relationship between the won and the U.S. dollar. As the staff has indicated, the Government believes that Korea's present level of external competitiveness is consistent with its external objectives, and intends not to depreciate the won for the remainder of 1986--and, indeed, the won has appreciated by nearly 1 percent against the U.S. dollar in nominal terms since end June.

Notwithstanding intensifying protectionism in Korea's overseas markets, the trade liberalization program that was announced in early 1984 has been implemented as scheduled and will be continued.

Finally, I should like to recall a comment made by the staff two years ago--a comment which is still applicable today: "the Korean success story...should not obscure the fact that Korea is still a developing country with a relatively low level of income." It might be added that Korea's external debt burden is still heavy; Korea is third on the list of developing countries ranked by debt to banks.

Mr. Fujino made the following statement:

Since the Board discussion of the first review under the stand-by arrangement, which took place last December, the performance of the Korean economy has, as Mr. Rye has stressed, turned out to be very impressive. On the occasion of the first review, the external environment seemed to become increasingly unfavorable. The slower growth of the world economy and trade and the reduction in construction programs in the Middle East weakened export performance, leading to a considerable slowdown of economic activities. The slippages of the program occurred with respect to net domestic assets and overall external debt. They were primarily of a technical nature and, with continued confidence in the authorities' firm policy stance, we had no difficulty in approving the modification. Since then, there have emerged three declines, which are generally thought to have a beneficial impact on the Korean economy. The lower value of the dollar, lower oil prices, and lower interest rates have worked to improve the climate in which the Korean economy has been placed.

Helped by a steady and firm policy stance on financial management, the Korean economy has been able to take full advantage of these favorable developments. Exports expanded sharply. The volume increase was 23 percent in the first seven months and, in dollar terms, it is expected to grow by about 17 percent during the year. The growth of GNP in the first half of the year stands at 10.9 percent, and growth for the year as a whole is estimated to be close to 10 percent. I would like to commend the authorities for their successful implementation of adjustment policies. Indeed, their achievements over the past several years had enabled the Korean economy to respond quickly to, and take full advantage of, the recent improvements in its external environment.

The very high level of the Korean economy's external indebtedness continues to be a source of concern. It is imperative that the authorities avail themselves of every opportunity to improve the debt profile of the country. A favorable turn in the external account would certainly provide room for restructuring the external debt in a more viable way. The slower than projected growth of external debt and the larger reduction of short-term debt would certainly contribute to alleviating the problem of high external debt, which has to be dealt with cautiously. The revised medium-term projection provides a brighter prospect for external debt in the years to come. The absolute amount of outstanding external debt will remain at almost the same level, at $48 billion. However, a look at the ratio of debt to GNP suggests a considerable improvement in the years to 1991. In the December scenario, the improvement was more moderate. The outstanding external debt was expected to decline to 44.7 percent of GNP in 1990. In the revised projection, this ratio is expected to decline to 32 percent in 1991. While the burden of debt remains heavy, the prospects seem to be promising. Naturally, the projections are subject to many uncertainties, and the staff's sensitivity analysis indicates a degree of vulnerability. I would appreciate comments from Mr. Rye on the staff's medium-term projections and their possible vulnerability.

The staff has produced a detailed and balanced paper, the main conclusions of which I can endorse. I would like, however, to make a few brief comments on specific issues. First, on fiscal policy, I believe that in order to consolidate the gains attained so far and to achieve the authorities' targets, continued fiscal restraint is called for. While I understand the need for the authorities to avail themselves of the opportunity to improve social welfare and other areas where demand is still great, I tend to share the staff's view that the present cyclical position of the economy does not warrant the stimulus to domestic demand from the fiscal side to the extent of 3-4 percent of GNP.

The narrowing of the gap between the purchase and sale price of rice is always a politically difficult task, and I welcome the clear intention of the authorities to reduce and eventually close the gap. The buoyancy of the economy at present may provide a good opportunity to make one substantial step forward, as the staff suggested, in reducing the Grain Management Fund deficits. Any comments on that possibility would be appreciated.

There seems to be a likelihood that actual revenue will overshoot the forecast. Any additional revenues should be used to reduce the fiscal deficit.

As to the use of savings from the terms of trade improvement from oil imports, in the present economic circumstances of the Korean economy, I would have no difficulty with the measure now contemplated by the authorities. The savings would be efficiently utilized to supplement investment and strengthen the structure of industry, which are essential conditions for sustained growth.

On monetary policy, I welcome the authorities' commitment to the continuation of credit restraint. The authorities' monetary program for the rest of 1986 is consistent not only with price stability but also with the projection for further improvement in the balance of payments. As to the interpretation of the monetary indicators, like the staff, I would caution against an excessive reliance on the growth of broad money.

On capital flows, it would not be a wise approach to exercise restraint on the inflow from domestic economic considerations. In view of the high external indebtedness of the economy to which I have referred, the issue of capital inflows should be approached from the angle of having to improve the structure of outstanding debt.

Interest rate deregulation is an important element of the economic program supported by the present stand-by arrangement, and, thus, should be steadily implemented. It is essential to the creation of an environment for a more efficient and effective financial system, and it is a vital prerequisite for better performance of private savings. The lending rate is an area where it is easier and important to liberalize for the competitive allocation of funds. The narrowing of the lending rate band puzzles me, however, and I would appreciate some elaboration on that development.

Remarking on external policies, I note that the won depreciated by about 17 percent in real effective terms in the year ended June 1986, reflecting the decline in the value of the U.S. dollar. Thus, Korea's external competitiveness has improved substantially. According to its report, the staff considers the present level of competitiveness to be adequate and supports the authorities' intention to avoid a further real effective depreciation of the won in the remainder of 1986. While accepting this line of argument, I believe that it would be appropriate for the authorities to pursue a practical approach to exchange rate policy, particularly paying due regard to future developments in the balance of payments, inflationary pressures, and the profit margins of enterprises.

On trade and exchange restrictions, the environment in Korea at present offers the right opportunity for the authorities to make further and substantial progress in the liberalization of the exchange and trade system.

I note with appreciation the intention of the authorities to refrain from further drawings under the stand-by arrangement. The program guidelines for the remainder of the year appear to be reasonable, although there may be room for further consolidation of successful achievements. In conclusion, I warmly endorse the continuation of the Fund's close collaboration with the authorities through the current stand-by arrangement, which may be precautionary in nature, but which is certainly successful. I can also support the proposed decision.

Mr. Ismael made the following statement:

I am extremely pleased with this report. Impressive progress has been made overall in the Korean economy. Strong economic growth, accompanied by low inflation and substantial improvement in the external sector, despite the difficult world economic situation, has provided the Government with the opportunity to strengthen its internal reserves position and to improve the maturity profile of its external debt. Under such circumstances, I am appreciative of the authorities' decision to refrain from further purchases under the current stand-by arrangement.

While impressive achievement had been made possible by the generally sound and consistent policies pursued by the Korean authorities during the past few years, the external environment--particularly the fall in world oil prices as well as interest rate and exchange rate developments--has facilitated the process. Further consolidation of the progress achieved in economic adjustment is, therefore, essential to ensure a continued strengthening in growth, price, and external performance. Prudent demand management should continue to receive strong emphasis in view of the need to avoid any overheating of the economy. On the supply side, the opportunity provided by the favorable external environment to accelerate removal of the remaining market rigidities and distortions, which are essential for increasing overall economic efficiency, should be utilized.

The progress made in reducing the fiscal deficit permitted by the better prospects for the economy will make a significant contribution to both demand restraint and improvement in the savings/investment balance. The authorities' new target for the consolidated public sector deficit, which is well below the original program target, represents remarkable progress indeed. But I share the staff's concern on the stimulus it would still impart to domestic demand, which may not be warranted at the present cyclical position of the economy. The new target should, therefore, be viewed as the minimum to be achieved. A lower deficit should be realized if the actual revenue performance turns out better, as the staff expects, than what the authorities have projected. In addition, as the bulk of the consolidated public sector deficit is created by the Grain Management Fund, a more decisive action to improve the financial position of that institution will contribute significantly to the strengthening of the fiscal position.

On monetary policy, I note that the staff is less concerned than the authorities over the rapid growth of broad money caused by improvements in the balance of payments. The staff holds that the increase in broad money, which reached 18.5 percent in the first half of 1986, is consistent with the increase in demand for money associated with the growth of real income and the decrease in velocity. Despite this observation, however, I believe that a cautious attitude on the part of the authorities continues to be appropriate, particularly because the change in velocity that was observed in 1985 involves some uncertainty. This approach is also justified in the face of the shifts of the portfolio preferences toward nonbank deposits pointed out in Mr. Rye's opening statement. In containing an excessive monetary expansion, the control of domestic credit expansion is more appropriate than restraining capital inflows. As the paper has stressed, the question of capital inflows should be considered on its own merits in Korea's present circumstances. On interest rate management, I endorse the staff's suggestion for more progress in interest deregulation and in allowing more flexibility for the interest rates to adjust to demand and risk conditions.

With regard to external policy, I note that the staff concurs with the authorities on the adequacies on the present level of competitiveness for achieving the current account objectives of the program. The level of competitiveness has indeed improved substantially as a result of a marked depreciation of the currency and increases in Korea's export prices. I believe, however, that the real competitiveness of the economy ought to be established against a more liberal trade and exchange system than the one currently in place. Any competitiveness largely supported by protectionist practices would impair the overall efficiency of the economy and, therefore, would be unsustainable in the long run. The authorities' five-year program to liberalize up to 95 percent of imports by end-1988, and the policy to announce the items to be liberalized three years in advance, are therefore commendable. The use of temporary adjustment tariffs so ensure a smooth transition for the liberalized items is also justified, provided the temporary character of this system can be assured. However, I do not see the use of the import surveillance list as significantly different from the present restrictions. More decisive actions along the lines proposed in the draft act regulating foreign trade transactions are, therefore, necessary.

Turning to the staff's medium-term projections, I am happy to note that the picture of the economy is brighter than it was in late 1985. Higher trade and current account surpluses have been projected, and these would permit a decline in external debt beginning in 1990 in a steady fall in the debt service ratio to only 13 percent by 1991. The improved external position will also permit a continued high rate of economic growth of 7-8 percent annually, without significantly impairing price stability. It is heartening to know that Korea will cease to be a user of Fund credit by 1990. I think it is implicit in this scenario that no further financial assistance from the Fund will be needed in the medium-term period. While this projection is subject to certain assumptions about the authorities' policy stance and external developments, I believe the scenario is clearly attainable. Nevertheless, the need for continuing the present stance of policies and for appropriate responses to unexpected developments cannot be overemphasized, particularly after the current stand-by arrangement expires. In conclusion, I can support the proposed decisions.

Mr. Leonard made the following statement:

The Korean economy, under the firm economic management of the authorities, has made substantial progress since 1980. The year 1985 was more difficult than expected, but it has been followed by a year of vigorous growth, with real GNP now expected to increase by 9-10 percent in 1986. The earlier aim of achieving balance in the external account will clearly be exceeded, with an estimated surplus of $0.5-1.0 billion now in prospect. The performance criteria for March under the Fund stand-by arrangement program were observed, and those for the remainder of 1986 appear well within reach. In these circumstances, the decision of the Korean authorities to refrain from further drawing under the stand-by arrangement was well judged, and they are to be commended for it.

The prospects for Korea consolidating its impressive gains in economic growth, external balance, and debt management are good. What will be achieved mainly depends upon the authorities continuing their careful approach to macroeconomic management and increasing further the efficiency of resource allocation.

In the fiscal area, the reduction in the original fiscal stimulus that the authorities will now undertake is in the right direction. Nevertheless, the revised target for the consolidated public sector (CPS) deficit would still provide a stimulus to domestic demand of the order of 0.75 percent of GNP. I would agree with the staff that, in view of the strength of the economy, the stimulus is more than required and should be scaled down. In this connection, the authorities have argued that the room for further expenditure restraint is limited by social and economic objectives. However, like the staff, I believe that there is scope for further restraint through the operations of the Grain Management Fund (GMF). The authorities' intention is not to allow the gap between the GMF's purchase and sales prices to increase any further than it has already and so to contain the deficit, which has to be financed through the budget. This chair would go further and urge earlier action that would lead to the narrowing and eventual elimination of the price differential and a consequent improvement in the CPS finances.

The decision of the authorities not to pass through fully recent declines in oil prices to consumers is consistent with their goals of conservation of oil, greater reliance on other forms of power, and avoidance of faulty investment decisions based on what could be a transitory decline in oil prices. The authorities' approach itself is not without risks, as the long-run real equilibrium price is essentially unknowable, and whatever price is assumed--or estimated--may itself lead to incorrect investment decisions, including those relating to the Government's ambitious oil substitution program. Higher domestic fuel prices also reduce the competitiveness of Korean industry.

Monetary policy in Korea has been influenced by perceived weaknesses in certain sectors of the economy. In order to stimulate investment, the upper end of the band of maximum interest rates on bank loans was lowered in March. At the same time, interest rates on bank deposits were not reduced, so as not to discourage saving and to promote competitiveness vis-à-vis nonbank institutions. I also understand that direction of credit through administrative guidance has increased in the first four months of 1986 compared with the same period in 1985. Furthermore, regulations requiring 35 percent of lending to go to small and medium-sized industries have this year been extended to foreign banks. These actions run counter to the authorities' goals of financial liberalization and improving the allocation of resources through market-determined interest rates.

The authorities, for their part, have suggested that the poor financial condition of the commercial bank sector has hindered progress in financial deregulation. It appears, however, that the banks' poor financial shape partly resulted from their role of channeling funds under government supervision to enterprises that have subsequently become distressed. The staff report notes that the effective reduction of the spread between lending and deposit rates is likely to depress bank profitability further and restrict scope for differential risk premiums in bank lending. I urge the authorities, therefore, to push ahead with measures designed to open up credit allocation to market forces. Given the recent strength of the economy, the authorities should not be concerned about any modest reduction in credit demand that may occur if, as a result, interest rates were to rise somewhat.

During the past year, the authorities have maintained a close relationship between the won and the U.S. dollar, so that the won underwent a real effective depreciation of about 17 percent. I agree with the staff that the present value of the won is consistent with the preservation of Korea's competitiveness and with achieving the desired improvement in the external current account. For the future, the authorities should continue to manage the exchange rate in a way that is flexible and responsive to market forces. In this connection, I would welcome hearing from the staff whether, in its view, the Korean foreign exchange market, in which government policy has traditionally been important in determining the value of the won, is such that the exchange value of the won could be largely determined by market forces under a more flexible exchange rate policy.

Further on the external side, this chair commends the continued progress in import liberalization and is pleased to note the decline in the number of items to which temporary adjustment tariffs apply. We also welcome the draft act on Foreign Trade Transactions for its proposals on phasing out the import surveillance system and relaxing rules on companies engaging in foreign trade. We would encourage the authorities to implement this measure.

The sharp improvement in Korea's external performance has contributed to what is likely to be a substantial deceleration in the rate of growth of external debt. The country's standing in foreign financial markets has risen accordingly. Continuation of the responsible economic policies that the Government has pursued in recent years will improve that standing further. In my remarks, I have attempted to draw attention to policy directions that I believe will be helpful in achieving that end.

Mr. Kyriazidis observed that Korea's success story was indeed impressive. Rarely could one see growth rates in excess of 10 percent, sustainable medium-term growth rates of 7-8 percent combined with a rate of inflation of 2 percent, strong savings and investment performance, a current account surplus that would appear to be sustainable over the medium term, and a substantial reduction in both the GDP/debt ratio and the debt service ratio, even under the various assumptions used in the sensitivity analysis.

Despite the liberalization measures taken by the authorities, Korea maintained a substantial range of tariff and nontariff protective measures, the full extent and effect of which were not easily visible, Mr. Kyriazidis noted. As was well known from the European experience, the use of percentage figures to talk about liberalization could be misleading. Nevertheless, it must be asked whether the degree of restriction applied in Korea was excessive on the basis of available evidence. It would be interesting in that connection to hear staff comment on the figures in the table on page 73 of SM/86/230 relating to imports of consumer goods for domestic consumption. At an average level of just over $900 million, or less than 3 percent of total imports in the past two years, the numbers appeared to be surprisingly low, and he wondered whether they reflected the effect of protective measures. If so, the implication was for a very high degree of restriction, the appropriateness of which, even for a developing country like Korea, was questionable.

Against the background of vigorous export growth a high level of competitiveness achieved through exchange rate management, vigorous productivity growth and modest wage increases, a more rapid liberalization program would seem to be in order, even if it had some adverse effects in the short run, Mr. Kyriazidis said. In the medium term, it would certainly enhance growth through more efficient allocation of resources. In passing, he wondered whether the staff could provide an indication of the competitiveness of the Korean economy on the basis of relative unit labor costs, particularly in view of the staff's implicit recommendation that no further improvement in competitiveness should be sought through exchange rate adjustment. It would also be interesting to hear staff comment on prospects for the establishment of an open foreign exchange market.

He agreed with the staff that more rapid decontrol of the credit and financial markets was in order and that interest rates should be deregulated, Mr. Kyriazidis continued. However, as noted by Mr. Leonard, the call for deregulation presented only half the picture. As indicated in Annex III of SM/86/230, there was extensive direct government intervention in the allocation of credit, with emphasis on priority sectors. In the first quarter of 1985, in response to a decline in the volume of exports, a growing share of domestic credit had been channeled to the export sector. It would appear, in the circumstances, that the mechanism in place had been far more pervasive than the staff's comments implied. A more detailed description of the mechanism and its scope would be helpful, particularly since direct or indirect subsidies might be involved. Also, since the intervention mechanism tended to neutralize the effects of interest rate liberalization, it would be interesting to hear whether the authorities had any intention of abolishing the system in the near future in order to ensure effective allocation of credit on the basis of market criteria.

Questioning the significance of the consolidated public sector accounts, Mr. Kyriazidis observed from Annex III that the consolidated public sector accounts excluded, in addition to the local government account, the operations of public enterprises except for their financial transactions with the Central Government. If so, he wondered about the significance of the calculation of the fiscal stimulus applied to the economy and the ceilings for the CPS in the stand-by arrangement.

The Korean success story was one to be envied, Mr. Kyriazidis remarked. In the circumstances, however, and given current developments and medium-term prospects, the maintenance of a stand-by arrangement that had been concluded in different circumstances seemed rather odd. While not opposed to the maintenance of the arrangement, particularly given the intention of the Korean authorities not to make any further drawings, he wondered whether Korea might not stand to gain more by terminating the arrangement.

Korea had made extensive use of Fund resources over a number of years; and at the end of June 1986, Korea's outstanding debt to the Fund had amounted to SDR 1.4 billion, Mr. Kyriazidis commented. Medium-term balance of payments prospects were favorable, despite the qualifications mentioned by Mr. Rye. The external debt situation was manageable at present and could improve, particularly in view of Korea's credit rating in international capital markets. Perhaps the authorities should consider within their debt management operations the possibility of contributing to the resources of the Fund through an acceleration of repurchases. Such a move would contribute to the revolving character of the Fund's resources; it would also give substance to the principle embodied in Article IV, Section 7(b) of the Articles of Agreement and could pave the way for closer cooperation with the Fund through the eventual assumption by Korea of the obligations of Article VIII. Such a call for early repurchase might appear to be a penalty for success. However, given the magnitude of the success, the penalty was by no means exorbitant.

Mr. Suraisry made the following statement:

> The economic strategy pursued by the authorities over the past few years has met with remarkable success. The economy adapted to the changing circumstances; and, consequently, Korea has been able to benefit from favorable world economic conditions. In many areas, particularly growth, price stability, and exports, performance has been outstanding. The authorities, indeed, have succeeded in mobilizing domestic and foreign financial resources to achieve high growth rates with low inflation, and, at the same time, have reduced growth of external debt. How to accomplish these goals simultaneously is a dilemma that is facing all highly indebted countries. Unlike those countries, Korea, so far, is winning the race; the success achieved by Korea lies, in my view, in its ability to optimize the use of foreign borrowing. I commend the authorities for their achievements.

The authorities' decision not to make further drawings under the present stand-by arrangement is commendable. This, of course, is consistent with the spirit of stand-by arrangements, and is compatible with the authorities' strategy of reducing the overall external debt. The success of the authorities in managing the economy, and the enviable results they have achieved, leave little to be added. Obviously, the process of putting the economy on a sustainable growth path is not complete. The economy is not shock proof. Therefore, there is a need for continuing with the adjustment efforts. The authorities' decision to refrain from further drawings under the present stand-by arrangement should not lead--and there is no reason to suspect that it will lead--to a relaxation of those efforts.

In this context, while the fiscal stance is broadly appropriate, the upward revision of the consolidated public sector deficit target provides a stimulus to domestic demand that might not be needed in view of the high growth rate being achieved. Like the staff, I believe that there is room for reducing the CPS deficit by reducing the deficit of the Grain Management Fund, which will, in turn, reduce the need for borrowing. Mr. Rye's comments on this point are welcome.

The authorities' concern about the acceleration of broad money is a manifestation of their determination to preserve the right environment for sustained growth. However, I agree with the staff that rapid growth in this indicator, by itself, should not constitute a cause for concern, since such growth is a logical outcome of the recent improvement in the economy. The risk that this acceleration in broad money will lead to inflation at this time is minimal, in view of the low rate of inflation and the significant level of unused capacity in the industrial sector. Nonetheless, the worry is warranted, and this area should be monitored carefully. Although restraining the inflow of capital in this case, where the external position is favorable and the stock of foreign debt is large, is good in its own right, it might not be the most appropriate means of checking the rapid growth in broad money; this goal may best be achieved by tightening credit conditions, as the staff argues.

On the external side, the authorities should be commended for their prudent approach to debt management. Their decision to slow down their external borrowing, in spite of their spontaneous access to international capital markets, under the circumstances, is prudent. It is gratifying to see a highly indebted country--Korea--achieve high growth rates with low rates of inflation. This, indeed, is a bright spot in the clouds of the debt problem. I agree, however, with Mr. Rye that Korea's external debt is still high, and, therefore, there is no room for complacency. I share Mr. Fujino's point that the present favorable developments in the Korean economy provide a good opportunity to reduce further the external debt burden. This will certainly increase the flexibility available to the authorities in managing the economy in the future.

Finally, I take note of the on-schedule implementation of the program of import liberalization. Clearly the economic achievements that have been made provide the authorities with a good opportunity to proceed vigorously in the implementation of this policy. Furthermore, in view of the outward-looking strategy which the authorities are undertaking, Korea has a stake in preserving an open trading system; what Korea does to its trade system has, of course, a bearing on the international trading system. I support the proposed decisions.

Mr. Schneider considered that the Korean authorities should be commended for their impressive economic achievements in 1985 and the first half of 1986. As pointed out by the staff, all the performance criteria under the arrangement had easily been met. Moreover, favorable developments had enabled the authorities to decide not to draw further on the stand-by arrangement. It should perhaps be mentioned that, while the successes of the authorities had been achieved mainly during a period when the external environment had been favorable, the authorities had also been successful at economic management through expenditure control even during a less favorable climate in 1985.

Fiscal policy in particular had been more successful than expected, partly reflecting the postponement of the one-time transfer to local governments in 1985, Mr. Schneider continued. In that respect, he would welcome some additional clarifications on the one-time transfer. As to the consolidated public sector (CPS) deficit, he agreed that the targeted reduction would not be easy to effect, in view of the present cyclical position of the economy. It was clear that the Grain Management Fund was responsible for a major part of the CPS deficit. The gap between purchases and sales prices must be prevented from widening if the stated objective of reducing the deficit of the Grain Management Fund was to be achieved. The authorities' decision to absorb part of the oil price decline in order to maintain the energy investment and consumption habits of the past should also contribute to the reduction of the deficit.

The behavior of monetary aggregates in Korea suggested that the economy was buoyant, although such buoyancy was in line with the growth of nominal income due to productivity increases and changes in bank deposits, Mr. Schneider remarked. However, broad money indicators could not be examined in a vacuum. Comparisons of broad money curves with the behavior of domestic prices of the balance of payments and unemployment rates should certainly be included, especially since there appeared to be a close relationship between credit expansion and balance of payments results. To further improve the overall balance of payments, it would be advisable to tighten domestic credit, especially consumer credit, to some extent. Interest rate deregulation through movement toward market determination of rates would accelerate the tightening and would simultaneously introduce more differentiated interest rate margins, reflecting the different direction of bank portfolios. Such deregulation would also improve prospects for the long-term viability of the banking system, which had suffered from low profitability. By raising the Bank of Korea's discount rate to a more realistic level, the authorities could send an important signal of their readiness to deregulate interest rates. He agreed with the staff that the level of interest rates was too low in light of the inflationary expectations in the economy, and a higher rate was called for to support a strong savings performance to ensure an adequate allocation of resources.

On the external side, the authorities had been pursuing a flexible exchange rate policy for some time, Mr. Schneider noted. Korea's competitive position seemed to offer ample room for further liberalization. Also, he noted with satisfaction that the growth rate of external debt was expected to decline sharply. Nevertheless, the overall level of debt was rather high and called for careful debt management, especially in view of the susceptibility of the balance of payments to adverse external developments. In conclusion, he noted that except for some problems of the sort he had mentioned, the most recent economic developments showed Korea poised to take full advantage of the external environment of declining oil prices and international interest rates. The Korean authorities had succeeded in building a strong macroeconomic basis for completing the phase of adjustment that had begun in the early 1980s. He had no problem in agreeing to the proposed decisions.

Mr. Foot commented that as he was in broad agreement with the staff report, he would limit his remarks to a few questions not fully covered in the papers. As all speakers had noted, the performance of the Korean economy had been impressive. There had been hints in the staff appraisal--and elsewhere even before the news of faster than expected growth in the first half of 1986--of the dangers of overheating. Capacity utilization in Korea was at its highest level in seven years, although that fact had not been specifically mentioned by the staff. He would welcome comment on how the staff at present rated the risk of overheating and the implications such overheating might have.

In the area of monetary policy, Mr. Foot supported the staff's view on the appropriateness of looking at a wide range of indicators in formulating monetary policy and on the need to press ahead with interest rate liberalization. At the same time, he would welcome further thoughts on the stability of the Korean banking system and financial markets more generally, since such questions had been given too little consideration in recent Article IV discussions.

On the external front, Mr. Foot indicated that he could join those who welcomed Korea's progress and the decision of the authorities to refrain from further drawings under the stand-by arrangement in present circumstances. Encouraging progress had been made on import liberalization, but Korea's current position provided an opportunity for the authorities to press ahead. He could therefore join previous speakers in hoping the measures proposed in the draft for regulating foreign trade transactions, mentioned on pages 24 and 31 of the staff report, could therefore be implemented soon. He would also be interested in clarification from the staff of the percentages relating to the import liberalization schedule outlined in Table 30 of SM/86/230. Finally, he agreed with those who felt that the time was ripe to address the issue of when Korea could move to Article VIII status. His authorities regretted the absence of any discussion of that issue in the staff papers. Korea was in a position to act and lead others; none of the developing countries classified in the world economic outlook papers as exporters of manufactures had Article VIII status, and of those countries, Korea was as well placed as any to take up the obligations of Article VIII. Finally, he could accept the proposed decisions.

Mr. de la Herrán made the following statement:

I would like to begin by commending the Korean authorities for their impressive economic performance. Over the past few years, they have been able to introduce corrective actions in almost every area of the economy. All macromagnitudes seem under control: real GDP increased by about 11 percent in the first half of 1986; the public sector deficit was equivalent to just 1 percent of GNP in 1985; and the inflation rate is expected to remain close to 2 percent in 1986. On the external front, although the situation does not appear as robust as on the domestic side, it has still registered substantial improvement, which is reflected in the shift in the current account balance from a deficit in 1985 to a surplus expected in 1986, which, according to the most recent available data, could well be about $2 billion. Korea's external competitiveness also improved remarkably during 1985 and has continued to do so over the first part of 1986. The apparently problematic external debt situation has also improved, as shown by the external debt indicators used in the report. Overall external debt is expected to rise 4 percent this year, compared with an increase of 8 percent over last year; short-term debt declined, reserves are expected to rise; and the ratio of debt service to exports remains at a very comfortable level.

If we turn our attention to the medium term, the situation also appears comfortable and without any major obstacles that could endanger the improving trend initiated a few years ago. Thus, I have not much more to add on the recent evolution of Korea's economy, except to congratulate the authorities for all their achievements.

I would like to raise an additional point, already mentioned in our previous statement on Korea at the time of the approval of the present stand-by arrangement. I am referring to the question of Fund involvement in a case like that of Korea. Let me say from the start that we welcome the intention made public by the authorities of refraining from further drawings under the present stand-by arrangement. Korea's creditworthiness cannot be seriously questioned; the country is at present enjoying a most favorable position in banks' ratings. Actually, it would be difficult to find among developing countries many not wishing to switch places with Korea in their relationship with creditors. We must ask ourselves how the problem of a lack of creditworthiness that is affecting so many indebted members nowadays is to be perceived when a country in such good financial shape as Korea needs to be backed by a Fund program in order to keep open relationships with creditors. In my view, neither the volume of external reserves nor the balance of payments situation of Korea suggest the need for an enhanced relationship with the Fund.

In addition, I have some difficulty regarding the recent improvements in the balance of payments as a temporary phenomenon. Based on the latest medium-term projections, the external situation of Korea was likely to be stronger in 1991 than at present. It thus appears obvious that there is no need for further Fund financial support. Furthermore, I cannot see the need for a Fund program under present circumstances; the close relationship that the authorities want to have with the Fund, which we also see as a positive factor, could, in our view, be maintained through other more suitable channels.

Mr. Goos said that there was no doubt that Korea was enjoying excellent economic performance, which could be traced to a great extent to external factors, but also reflected in large measure the adjustment efforts of the authorities over the past five years and several supporting Fund arrangements. He therefore shared the staff's positive assessment of Korea's economic policies, which held the promise of further substantial improvement in the medium term, particularly with respect to the balance of payments and critical external debt ratios. At the same time, he observed that the staff's sensitivity analysis in the framework of the medium-term scenario, together with the still high external debt, clearly signaled a note of caution that begged for the continuation of sound economic policies. The authorities would be well advised to use the present favorable environment for accelerating the planned reduction of domestic and external imbalances, increasing international reserves, and strengthening the structural reform effort.

He was therefore pleased to note from the supplementary paper that the authorities had lowered the deficit target for the consolidated public sector and that external indebtedness--both long and short term--was apparently declining, Mr. Goos continued. However, he joined those who were concerned that the ongoing strong expansion of domestic and external demand entailed the risk of overheating of the economy, and the staff's advice to contain the deficit even more tightly than envisaged under the revised fiscal plan appeared to be well taken.

On the external side, Mr. Goos reiterated his view that the authorities should accelerate progress in the area of structural reform, including liberalization of the exchange and trade system. At the same time, they should aim as a matter of priority at reducing the strong concentration of Korean exports and imports in two of Korea's trading partners. In that context, he understood that the Government had recently adopted a multiyear program to strengthen import substitution and restructure the industrial sector. The final objective of the program seemed to be a much stronger vertical integration of production with a view to maximizing value added in the domestic industry. Those efforts, as he understood it, would be supplemented by the development of new export markets. He would welcome comment by the staff or Mr. Rye on that strategy, which in his view could make an important contribution toward reducing Korea's dependence on only a few export and import markets and, hence, could contribute toward the goal of securing Korea's medium-term growth potential. Achievement of that latter objective should be greatly facilitated by the substantial gains in external competitiveness resulting from the pronounced devaluation of the Korean currency in the recent past. In that context, however, the authorities' intention to prevent further depreciation of the real effective exchange rate was highly appropriate, particularly given concerns--including his own--that the exchange rate might have been devalued too far.

He could join previous speakers in commending the authorities for their decision to refrain from further drawings under the stand-by arrangement in the existing favorable external circumstances, Mr. Goos said. In that regard, he had found most interesting Mr. Kyriazidis's observation that the Korean authorities might consider accelerated repurchases of outstanding Fund credit. Finally, he could support the staff appraisal and the proposed decisions.

Mr. Nguyen remarked that the Korean program was clearly on track; all the performance criteria had been met, and he could fully support the proposed decision on the review under the stand-by arrangement. During the previous discussion on Korea, his chair had expressed its positive views on the 1985-86 economic program and on the aims of strengthening the foundation for sustained noninflationary growth through the achievement of the external objectives. In many respects, 1985 had been a year of transition and consolidation, owing mainly to the sluggishness in exports and somewhat less than impressive growth by Korean standards. GNP had grown by more than 3 percentage points, and the overall balance of payments had widened from $1.4 billion to $2.5 billion. However, price stability had persisted, while the public sector deficit had been kept low, despite some stimulatory expenditures. On the whole, the authorities had been able to derive the full benefits of the improved external environment due to the drop in the price of oil, the fall in interest rates, and more buoyant export markets. He had little to add to what had already been said by previous speakers about the current state of the Korean economy, which was growing at a rate of 11 percent for 1986. It was that rate on which no doubt rested the concerns of some of his colleagues for possible overheating of the Korean economy. In the circumstances, he shared the staff's recommendations that the authorities must adopt policies to prevent overheating.

Like others he would be interested in staff answers to questions raised by Mr. Kyriazidis regarding the competitiveness of the Korean economy, Mr. Nguyen continued. The authorities' decision not to pass through to consumers the full extent of the world oil price declines--on the grounds that those declines were likely to be transitory and that such a decision might weaken conservation efforts--deserved support. However, the staff's medium-term projections were sensitive to external developments, and he urged the authorities to take advantage of the present propitious circumstances to make further progress in the implementation of structural reforms, along the lines proposed by the staff. In conclusion, he warmly commended the authorities for their management of the economy and could support the proposed decisions.

Mr. Templeman made the following statement:

> The current staff report for the Article IV consultation and stand-by review concludes that economic performance in 1985 was generally satisfactory and that the outlook for 1986 is more favorable than had previously been thought. More important is the conclusion that the economic adjustment phase begun in 1981 has been successfully completed. It is on this longer-term aspect of Korea's economic situation that I would like to focus my remarks. While there have been a few ups and downs along the way, the performance between 1981 and 1986 has been impressive. It is especially worth noting that economic growth has not suffered; on the contrary, real growth has ranged between 5 percent and 12 percent and has averaged 7.5 percent in the five years 1981-85. Inflation fell from 21 percent to less than 3 percent during the same period, and the consolidated public sector deficit fell from about 4.5 percent to about 1.5 percent of GNP. The current account balance of the balance of payments reversed from a deficit equalling nearly 7 percent of GNP to a surplus of 1 percent or more for 1986, reflecting a real effective depreciation of the won of nearly 28 percent between 1981 and the first quarter of 1986. And Korea's debt and debt service ratios have been kept stable and rather moderate throughout the international debt crisis.
>
> Progress has also been made in some areas of structural reform. Recently, the focus has been on import liberalization and tariff reform, interest rate deregulation, and liberalization of foreign direct and portfolio investment. However, progress has been rather uneven, and it seems that a faster pace of reform should now be possible in some areas as a result of the improved external outlook.

The current account of the balance of payments has staged a remarkable recovery, particularly in 1986, with the staff now foreseeing a surplus of about $2 billion. Although import volume in 1985 grew by less than 1 percent, import compression has not been an important part of Korea's adjustment programs. Rather, real export growth has been sufficient to accommodate substantial import growth, helped along somewhat by slightly improved terms of trade. In fact, export volume has risen on an average by more than 10 percent a year over the past five years and an increase of 18 percent is foreseen by the staff for 1986.

The chart on page 22a of the staff report, which shows a rather steady real effective depreciation of the won over the entire period 1981 to the present, shows some revealing evidence of the steady improvement in Korea's price competitiveness compared with its trading partners. The acceleration of the depreciation from early 1985 onward was especially sharp, as the won followed the dollar down against many currencies. In contrast, there had been no such symmetrical appreciation earlier, when the dollar had been rising. This de facto linkage between the won and the dollar has clearly had an important impact on trade relations between Korea and my own country during this period and, no doubt, on Korea's trade relations with other countries. For example, the share of Korea's exports going to the United States rose by 9.5 percentage points between 1981 and 1985, while the U.S. share as a source of Korea's imports fell by 1.5 percentage points. This year alone, the United States expects to have a trade deficit with Korea of about $6 billion. I would conclude from recent trade and current account performance, and from the favorable outlook over the medium term, that Korea's competitive position has been very much strengthened, and I would agree with the Korean authorities, the staff, and other Directors that Korea's current competitive position, is, at a minimum, "adequate." Indeed, some additional staff analysis would have been welcomed as to whether the exchange rate depreeciation may have somewhat overshot the mark. While we are quite accustomed to hearing from the Fund and the Bank staffs' recommendations on the need for exchange rate depreciation, we should not overlook the need for assessing the appropriateness of movements in the opposite direction. This is not just a consideration in the case of Korea but may be a useful reminder more generally.

Certainly, we welcome the indication that the Korean authorities do not intend to reduce the real effective exchange rate of the won below the April/May level through the rest of 1986. It is not clear, however, what exchange rate policy will be followed beyond that point and, in particular, what the authorities' intentions are with regard to the past practice of maintaining a link between the won and the dollar. I am well aware that Korea still has a substantial debt service burden, that there are some normal capital exports which contribute to the foreign financing requirement, and that Korea must be concerned about staying competitive with other newly industrial countries, the currencies of some of which have also depreciated against the dollar, despite its recent decline. That being said, Korea plays an important role in international trade and, we would hope, will cooperate fully in contributing to reductions in world payments imbalances.

Turning to the liberalization of trade, we welcome the achievement of nearly 92 percent liberalization of import restrictions this year, against the goal of 95 percent for 1988. We also hope that the draft Foreign Trade Transactions Act, currently being considered for implementation in mid-1987, will promptly be approved, so that the automatic prior licensing of unrestricted imports and exports can be phased out, the import surveillance system can also be phased out, and the rules for registration of companies that wish to engage in foreign trade can be relaxed. That being said, we noticed that 80 percent of agricultural imports would be liberalized by 1988; and it seems strange that a country with Korea's deep involvement in foreign trade should be exercising any controls on the entry of new firms into the business.

Some progress has also been made in the liberalization of foreign direct and portfolio investment. Foreign direct investment has been liberalized to the extent of 76 percent of industrial sectors. A few open and closed-end mutual funds have been created for indirect investment by foreigners in Korean shares, and some Korean borrowers have been allowed to issue convertible bonds and depository receipts abroad. However, both for direct and portfolio investment, there does not appear to be any timetable for further liberalization, despite the fact that the improved external situation would now permit some acceleration of such liberalization efforts. We would be interested in any light that the staff or Mr. Rye could shed on this matter.

The improvement in Korea's current account and the overall balance of payments position extends to its foreign debt situation. This year, there would be deceleration in the growth of foreign debt, and short-term debt would decline in absolute terms. Over the period through 1991, the revised staff estimates suggest steady improvement, so that total debt would actually begin to decline in absolute terms in 1990. In addition, the ratio of debt to GNP would fall by 20 percentage points between 1986 and 1991, and the debt service ratio would be a modest 13 percent in that final year. Even considering the sensitivity of the balance of payments to higher oil prices, higher interest rates, lower export volume growth, or some loss in price competitiveness from currency appreciation, the debt and debt service ratios would not appear to rise very much in the presence of moderately worsened conditions in one or more of these areas. Of course, continued careful debt management will be required for the foreseeable future.

It is rather unusual these days not to have to place great stress on the fiscal situation of countries being reviewed by the Board. In fact, a fiscal deficit ratio of 1 percent of GNP last year and perhaps 1.5 percent in the staff's estimation this year is quite encouraging. However, there is clearly room for improvement in the position of the Grain Management Fund, where we find the assurances about not increasing the current sales/ purchases price gap and the reference to partial privatization of the GMF to be rather vague.

In the area of monetary policy, continued credit restraint, accompanied by strong demand for money, would be consistent with the expected substantial improvement in the overall balance of payments. We also believe that a variety of economic indicators need to be monitored by the monetary authorities, since direct controls on bank credit were terminated in 1982 as a major monetary tool. And we share the staff's disappointment at recent actions with regard to interest rate deregulation, involving a narrowing of the band of lending rates and of the spread between deposit and lending rates, because of possibly adverse effects on differential risk premia and on bank profitability. On the other hand, we wonder what is being done by the banks in the way of internal cost control and whether larger scale investments in some Korean banks by foreign banks might help to strengthen the banking system.

In conclusion, I continue to be greatly impressed by the comprehensive growth-oriented program of adjustment with structural reform, which the Korean authorities have been following for some years with considerable success. On several previous occasions, we have pointed out that Korea has been a prolonged user of Fund resources, albeit a successful user of those resources. Nonetheless, the time has come when dependence on such financing is no longer necessary. In fact, Korea has already begun to make net repayments to the Fund. This is entirely in keeping with the Fund's financial character. In that connection, we very much welcome the authorities' intention to refrain from further drawings under the current stand-by arrangement in present circumstances. And we can congratulate the authorities as they continue a cooperative relationship with the Fund which should no longer require Fund financial assistance for the foreseeable future.

Mr. Polak, commending the Korean authorities for their successful implementation of economic policies, joined others in welcoming the decision of the authorities not to draw further on the stand-by arrangement. Like Mr. Kyriazidis, he encouraged the authorities to consider contributing to the resources of the Fund through an acceleration of repurchases. He also agreed with the staff that a more rapid decontrol of the credit and financial markets was in order. The staff's medium-term projections pointed to an important improvement in the external position, as the current account was expected to approach 2 percent of GNP in the outer years and the debt service ratio was expected to moderate, Mr. Polak continued. In light of those projections, it would seem feasible for Korea to speed up the process of import liberalization beyond the pace currently envisaged. Korea would also do well to avoid the mistakes of other countries that had maintained for a long time heavy protection for primary products such as food and beverages.

On exchange rate policy Mr. Polak said that his views were very similar to those put forward by Mr. Templeman. Given the strong and continuous improvement in the trade and current accounts, the Board should focus on the real effective depreciation of the won by 17 percent over the past 12 months following a substantial earlier depreciation in the first half of 1985. The latest depreciation had been achieved by keeping pace with the fall in the U.S. dollar. In the process, the won had also declined in relation to the currencies of some of its main Asian competitors. He agreed with Mr. Rye that given Korea's large debt servicing burden, the maintenance of an adequate competitive position was crucial. However, appropriate competitiveness might well have been attained with somewhat less depreciation. The staff's comments on the major currency action had been limited to the observation that Korea's present level of competitiveness was adequate to achieve the program's external current account objectives, and the Korean authorities were apparently in agreement with that view, at least for the balance of the year.

He wondered whether the staff had considered whether the won's depreciation had perhaps been excessive and whether it might not have constituted a "competitive depreciation," Mr. Polak said. Very little thought had been given to such a notion in recent years, but only a few years previously the Fund had become so concerned about the possibility about competitive devaluations that it had called for a special consultation on a devaluation by Sweden of approximately the same size as the Korean devaluation, although not carried out as smoothly. The Fund's current policy was to preach flexibility; however, when note was taken of the extreme use that was being made of the exchange rate instrument in some cases, the Board would do well to resume the practice of appraising each case carefully on its merits, not only from the point of view of the depreciating country but also from the perspective of competitors and of the system as a whole.

The staff representative from the Asian Department, remarking first on the system of financial regulations in Korea, recalled that Mr. Leonard had pointed to the fact that Korean banks and branches of foreign banks would, under a new policy, be obliged to put 35 percent of their loan portfolios into smaller and medium-sized firms; and other Directors had noted that in the earlier part of 1986, the credit allocation through the system had increased proportionally. The 35 percent rule had been intended to ameliorate the efforts of the credit allocation policies that had operated in the past. The concern had been that so much emphasis had been given to large corporations in Korea in the 1960s and 1970s that the economy had been left with overcapacity in some sectors and less dynamism than might have been desirable. In the circumstances, and as a matter of national policy, it had been decided to stimulate the development of small and medium-sized firms. While the authorities had continued to use the credit allocation mechanism for that broad purpose, they were making progress toward deregulation, beginning primarily on the deposit interest rate side.

On exchange rate policy, the question had been asked whether the rates could be determined flexibly in the Korean market, the staff representative noted. The answer was that they could, but not without some prior actions, including financial sector liberalization of the sort that would improve the prospects for a freer operation of the exchange market. The issue of flexibility in exchange rate management had come up at the time of the discussions of the stand-by arrangement in March and April of 1985. At that time, the staff had been concerned about Korea's loss of competitiveness and of market shares, particularly in Western Europe. When the Board had reviewed the stand-by arrangement in December 1985, the staff had noted that the balance of payments prospects and objectives for 1986 had seemed to be attainable with the degree of competitiveness that Korea had achieved by that time. The extent of the subsequent depreciation of the dollar vis-à-vis other major currencies, which had led to a further depreciation of the won in real effective terms, had not been expected. He himself seriously doubted whether, had there been greater stability in the international currency markets at the time, the Koreans would have depreciated their currency vis-à-vis the U.S. dollar in order to further enhance their competitiveness.

At the same time, the staff representative continued, when oil prices had begun to decline significantly, Korea had been among those countries that, recognizing the temporary nature of the decline, had chosen quite wisely not to pass on all the benefits to the industrial sector as some of its competitors had done. The data on Korea's competitiveness vis-à-vis certain competitors in the region did show an improvement in Korea's position, but it was rather modest, and several of the competitors had large overall balance of payments surpluses, very sizable reserves, and little or no external debt.

It should perhaps be remembered that Korea had had a cumulative balance of payments deficit of nearly $12 billion in the five-year period through 1985, the staff representative commented. It had only been in May of 1986 that, for the first time, a modest surplus in the overall balance of payments had been registered. Even with the expected marked improvement in the current account in 1986, the staff was anticipating that, even if the authorities took advantage of the situation and did not increase medium-term external debt in 1986 while reducing the high short-term debts, there would be only a relatively modest increase in reserves. Korea's reserve position would not be at all large in relation to its trade transactions.

On the question of overshooting, the staff representative considered that it was in the interest of Korea and the international community for the authorities to maintain external competitiveness. Unfortunately, it was not possible to measure competitiveness in ways other than had been done in the staff paper; the staff simply had no data on unit labor costs, for example. At the same time, if changes in international currency relationships had been somewhat different and the real effective depreciation of the Korean won had been somewhat less in the first part of 1986, there was no doubt that the outcome still would have been quite comfortable for Korea.

On the matter of import liberalization, the staff representative agreed with Mr. Foot that the percentages in the report referred to the number of items liberalized. In response to those who had queried the pace of liberalization with respect to consumer goods imports, he noted that major efforts on that side would occur later in the liberalization. Korea produced a wide range of consumer goods itself, and the totals in the paper did not include a number of foodstuffs that might ordinarily be included in the consumption goods category. A number of speakers, including Mr. Polak, had mentioned that in light of the new and favorable external circumstances, it would seem appropriate for Korea to consolidate its position and perhaps to speed up the process of liberalization on the import side. He noted that the Korean authorities, like managers of economies around the world, faced certain political constraints domestically, particularly with respect to agricultural imports. The agricultural sector, it should be observed, tended to bring the liberalization ratio down; in many other sectors it was 100 percent. In any event, the authorities believed their approach was the appropriate one and should not be changed in light of a set of circumstances that might well be temporary.

Responding to those who had suggested that Korea make early repurchases, the staff representative remarked that Korea was scheduled to repurchase at a rate on average of about SDR 50 million per quarter, or almost SDR 160 million between end-June 1986 and the end of the stand-by arrangement. The question of early repurchase would no doubt be taken up with the authorities by the staff because of the size of, and recent increase in, reserves. However, under the formula for early repurchase--which allowed at least two full quarters following the most recent purchase--the amount of an early repurchase might be even less than the amounts already scheduled for repurchase.

Some Directors had wondered whether the Korean economy might not be close to overheating, the staff representative recalled. A broad look at the manufacturing and industrial sectors suggested that the degree of capacity utilization had risen from about 75 percent in 1985 to about 82 percent at present. Of course, within that framework there would be more slack in some sectors than in others; and it was difficult to see precisely where bottlenecks would develop. In any event, the sorts of increases projected for 1986, given the significant increases in investment that had taken place since September 1985, should not lead to cost pressures at the present juncture.

In response to a question by Mr. Kyriazidis, the staff representative observed that, among the nonfinancial public sector enterprises, the so-called government-invested enterprises did not enter into the definition of the consolidated public sector; rather, they were treated by the Korean authorities as purely private sector enterprises. Mr. Kyriazidis had rightly asked what sense it made to talk about the fiscal impulse of the public sector accounts in those circumstances. The staff's intention had been to show that a large part of the public sector operations, which included the Central Government and special financial funds, should not be allowed to give the kind of fiscal impulse that the authorities had projected for 1986.

The question had been raised by Mr. Templeman of the possibility of strengthening the banking system through foreign investment, the staff representative recalled. At present, foreign investment would not be permitted in the banking system. The authorities had been working intensively under the leadership of the current Deputy Prime Minister to sort out the problems of the banks that had invested in some ailing enterprises, not so much by working on the banks' side as by working on the enterprises' side. The hope was that, through consolidation of some of the weaker firms with the strong firms, the value of the debt in the banks' portfolios could be enhanced. The staff had urged the authorities to prevent the conditions from arising that would allow such problems to emerge again in the future. That was why the staff was concerned about measures that would tend to reduce the profitability of the banks and to reduce their scope for pricing risks adequately. For the same reason, the staff would support the view of those Directors who had called for greater flexibility in interest rates on the lending side. The banks must be allowed to make appropriate decisions on their own under a more liberal system. Finally, those who had questioned the possible subsidy element in export credits, should be aware that the Koreans had been borrowing and financing on market terms so that there was no implicit subsidy element involved.

The staff representative from the Exchange and Trade Relations Department, responding to Mr. de la Herrân's query about whether Korea had need for a Fund program, said that he would be reluctant to make a judgment about the vulnerability of the Korean economy and the authorities' need for an arrangement. The staff would rather view sympathetically a request by a member for assistance in the tradition of a precautionary arrangement under which, perhaps, no drawing was envisaged. Such an approach by the Fund to assisting members that had successfully completed the bulk of the needed adjustment, as well as those that were still at an early stage in their adjustment effort, was consistent with the guidelines and made it easier, if problems should emerge, for members to approach the Fund at an early stage of their difficulties.

Mr. Kyriazidis remarked that in referring to Article V, Section 7(b) he had meant to suggest only that the Korean authorities should perhaps give practical application to the principle embedded in the Article by picking up the pace of repurchasing. As he understood it, the Article had not been applied in the past, perhaps because there had been no success story of such a magnitude that the Fund could on the basis of Article V, Section 7(b) have asked the member to repurchase.

On the restrictions on consumer goods, he agreed that food was not included in the list of consumer goods; but food was already a restricted sector, Mr. Kyriazidis continued. He would appreciate hearing an answer to Mr. Foot's question about the values of imports under the liberalization procedure. Finally, noting that an increasing proportion of domestic credit had been channeled to exports, he was curious about the current credit allocation system in Korea and its relationship to the liberalization and effectiveness of interest rate arrangements.

The staff representative from the Exchange and Trade Relations Department recalled that there were two operative provisions of Article V, Section 7(b). One indicated that, as the balance of payments and reserve position of a member improved, the member would normally be expected to make a repurchase. The second indicated that the member "shall" repurchase if, in accordance with the Fund's policies on repurchases and after consultation with the member, the Fund represents that the member should repurchase. It was certainly clear that in a number of cases in the past, the expectation that members would repurchase as their position improved had indeed been applied.

Mr. Templeman reiterated his earlier question about whether a timetable had been established for direct and portfolio investment liberalization.

The staff representative from the Asian Department replied that the Korean authorities had provided no specific timetable except to say that steady progress would be made. It might be worth noting, however, that convertible bonds could be converted into shares approximately 18 months from the date of their issuance. The staff's expectation was that, within the next 18 months, regulations would be adapted in a way that would allow nonresidents to require portfolio investments in that fashion. Of course, that was not to say that, in 18 months, the portfolio investment would be purely free and open; but at least the bonds could be converted within that time frame.

Mr. Rye said he took it from the decision of his Korean authorities not to provide him with comments on the staff report that they were broadly happy with the report and could accept the implicit criticisms and explicit suggestions for change included in it. The fall in the value of the dollar, the price of oil, and interest rates had certainly given a substantial boost to the Korean economy, although he presumed it would not be a permanent one, Mr. Rye continued. The authorities also were not assuming that the growth rates in the first half of 1986 were likely to continue; indeed, for the second half of 1986 and through 1987 a rate of growth of 8 percent was being projected. While that rate would still be remarkable by world standards, it was more in keeping with the demonstrated capacity of the Korean economy to grow at its present stage of development.

Korean policymaking could be characterized as cautious, careful, and predictable, Mr. Rye continued. While the virtues of a cautious approach were clear, the authorities were occasionally slow to respond to rapid changes in the economy, a fact which underlay more than anything else the sort of exchanges in the exchange rate that had been witnessed over the past 12 months. In one sense, the exchange rate movement had outrun the authorities' capacity to respond to it. It must not be supposed that what had happened on the exchange rate front had been part of some scheme to grab a greater share of the export markets of other countries.

The cautious approach applied as well to the authorities' forward projections, for example, in the fiscal area, Mr. Rye commented. There was some question about whether the projected effects of the stimulus embodied in the figures would actually materialize; in fact, Korea had a history of bettering its conservative targets, and it was quite possible that the deficit would turn out to be lower than that projected by the authorities and possibly even lower than that projected by the staff.

The authorities might well have been overcautious on the monetary front, and he joined those who would like to see greater progress and liberalization in some areas, Mr. Rye remarked. As in other countries, of course, the Korean authorities had to balance a variety of considerations, not all of them economic. He doubted that the credit allocation system would be abolished right away, but it was certainly possible to hope for liberalization if present favorable developments continued.

On the exchange rate, Mr. Rye said he had little to add to the staff's remarks. It must be borne in mind that Korea remained a heavy debtor and was vulnerable to a renewal of the debt crisis. The authorities' objectives required a stabilization of the external debt and perhaps some reduction in it for a period of time. That approach would be fully consistent with the calls that Directors had understandably made for Korea to wean itself off Fund support. Of course, the policies that would enable the Korean authorities to achieve that objective would also involve a strengthening of the balance of payments, which some felt had already gone a bit too far. Certainly Korea should play its part in eliminating imbalances in the world trading system, but it could hardly be argued that, overall, Korea was experiencing a trade imbalance, although there well might be problems bilaterally with some countries.

While agreeing with Mr. Templeman and others that Korea might not need Fund financial support in the foreseeable future, Mr. Rye noted that the foreseeable future did not extend that far ahead in present circumstances. Still, the Korean authorities had been giving thought to their relations with the Fund, and they were in their cautious way anxious to maintain some support relationship, even if not of a directly financial sort.

The Chairman said that he had sensed some element of irony in the remarks of Executive Directors at the present meeting. Only a year previously, Korea had been perceived as a problem case, and many had asked him what the Fund had been doing to avoid a crisis in Asia. In the circumstances, a program had been worked out with the Fund. Since then, Korea had been doing well, and it would be repurchasing accordingly. However, he agreed with Mr. Rye that the collaboration between the Fund and Korea had been a responsible reaction by the authorities to the shocks affecting the Korean economy. If the authorities wanted to continue that collaboration in an appropriate form, their desires should be respected. It should not be that a good relationship was maintained only when serious problems occurred.

The Chairman then made the following summing up:

Executive Directors generally agreed with the thrust of the views expressed in the staff report for the Article IV consultation and review under the stand-by arrangement. They warmly commended the Korean authorities for the exceptional progress made in the past few years in reducing the external imbalances, while maintaining price stability and a high rate of income growth. To a large extent, such performance was attributable to the strong adjustment efforts of the authorities, which had been based on financial restraint, exchange rate flexibility, and measures to liberalize the financial, trade, and foreign investment systems.

Directors noted that Korea's economic prospects had improved significantly in recent months, partly because of the sizable declines in world oil prices, recent gains in external competitiveness, and lower interest rates. The external current account and output growth were expected to strengthen considerably in 1986, and prices were expected to remain stable. Although such an outcome appeared well within reach, Directors generally observed that cautious demand management would be needed to consolidate the progress of recent years and to prevent overheating the economy, as the authorities were well aware.

Directors observed that fiscal restraint had been one of the main elements of Korea's economic management in recent years. In 1985, in spite of the economic slowdown which had given rise to pressures on the Government to shift to fiscal stimulus, the deficit of the consolidated public sector had been reduced to 1 percent of GNP. Directors endorsed such a fiscal stance because it had made a substantial contribution to financial stability. However, the fiscal program for 1986 might result in the application of some stimulus to domestic demand which did not appear warranted in light of the strength of domestic economic activity. Therefore, the authorities were encouraged to limit the fiscal deficit in 1986 to below the program target. In particular, any possible excess in budget revenue above the forecast should be used to reduce the overall deficit, Directors advised. They also urged the authorities to make a strong effort to reduce the deficit of the Grain Management Fund. Furthermore, the decision to sterilize a substantial share of the incremental revenue of the Petroleum Business Fund that had resulted from the decline in oil prices was welcome.

Directors noted that domestic credit expansion had decelerated markedly in late 1985 and in 1986, thereby contributing to price stability and to an overall balance of payments outcome that was better than programmed. Directors encouraged the authorities to make further progress in interest rate deregulation by introducing substantial room for bank interest rates to move upward, which would limit credit demand, stimulate domestic savings, and permit an adequate pricing of risk.

Directors observed that Korea's overall external competitiveness had improved substantially. They noted that the present level of competitiveness was more than adequate to achieve the authorities' external current account target and encouraged the authorities to avoid a further real effective depreciation of the won. Indeed, some Directors raised the question whether the depreciation of the won had not gone further than necessary. Directors commended the authorities for moving ahead with their import liberalization program and noted that the ongoing improvement of the external accounts provided an opportunity to accelerate progress in that direction to improve the efficiency and structure of the economy and to contribute to a strengthening of the world free trade system.

Directors noted that the improvement in the external accounts would permit a substantial strengthening of Korea's external debt and asset position. In that connection, they encouraged the authorities to provide for a larger increase in growth in international reserves and a greater decline in short-term debt than programmed. The high level of Korea's external indebtedness was commented upon by many Directors, and the view was expressed by several that Korea should now firmly aim at reducing that level and further liberalizing foreign investment. They also viewed with satisfaction the intention of the authorities to refrain from making further drawings under the stand-by arrangement; it was even observed that Korea might consider accelerating its repurchases to the Fund. Finally, several Directors encouraged Korea to move to Article VIII status in the Fund.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1986 Article XIV consultation with Korea, in the light of the 1986 Article IV consultation with Korea conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Korea maintains restrictions on payments and transfers for current international transactions as described in EBS/86/194 and SM/86/230 in accordance with Article XIV. The Fund welcomes the progressive liberalization by Korea of these restrictions and encourages the authorities in their determination to remove them as Korea's external position improves.

Decision No. 8403-(86/159), adopted
September 19, 1986

Review Under Stand-By Arrangement

1. Korea has consulted with the Fund in accordance with paragraph 4(d) of the stand-by arrangement for Korea (EBS/85/151, Sup. 2, 7/15/85), and paragraph 3 of the letter dated May 17, 1985 from the Minister of Finance of Korea, as modified by paragraph 19 of the letter dated December 6, 1985 from the Minister of Finance of Korea in order to review the progress made by Korea in implementing the program supported by the stand-by arrangement and to reach understandings on suitable performance criteria for the remaining period of the arrangement.

2. The letter dated July 25, 1986 from the Minister of Finance of Korea shall be attached to the stand-by arrangement, and the letter dated May 17, 1985, with annexed memoranda, as heretofore modified shall be read as supplemented and modified by the letter of July 25, 1986.

3. Accordingly,

(a) the ceiling on net credit to the public sector from the banking system referred to in paragraph 4(a)(i) of the stand-by arrangement shall be as set out in the table attached to the letter of July 25, 1986;

(b) the ceiling on the net domestic assets of the banking system referred to in paragraph 4(a)(ii) of the stand-by arrangement shall be as set out in the table attached to the letter of July 25, 1986; and

(c) the limits on outstanding disbursed external debt referred to in paragraph 4(b) of the stand-by arrangement shall be as set out in the table attached to the letter of July 25, 1986.

Decision No. 8404-(86/159), adopted
September 19, 1986

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/158 (9/17/86) and EBM/86/159 (9/19/86).

3. BOLIVIA - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERION

The Fund decides that Bolivia may proceed to make purchases under the stand-by arrangement (EBS/86/120, Sup. 1, 6/27/86) notwithstanding that the ceiling on external payments arrears as of June 30, 1986, specified in paragraph 4(b)(iii) of the arrangement, was not observed. (EBS/86/215, 9/12/86)

Decision No. 8405-(86/159), adopted
September 17, 1986

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/222 (9/16/86) and EBAP/86/224 (9/17/86) is approved.

APPROVED: June 2, 1987

LEO VAN HOUTVEN
Secretary