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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/105

10:00 a.m., July 12, 1985

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	L. K. Doe
C. H. Dallara	
	G. Ercel, Temporary
	S. de Forges, Temporary
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	Jaafar A.
	L. Leonard
A. Kafka	H. A. Arias
H. Lundstrom	H. Fugmann
	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
	G. Ortiz
J. J. Polak	
C. R. Rye	
	O. Kabbaj
	A. S. Jayawardena
	T. A. Clark
S. Zecchini	N. Coumbis
	Chen J., Temporary

L. Van Houtven, Secretary
J. M. Oppenheim, Assistant

Also Present

IBRD: R. V. Key, East Asia and Pacific Regional Office. African Department: R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy Director; Y. Fassassi, C. A. François, E. Sacerdoti. Asian Department: Tun Thin, Director; C. M. Browne, R. G. Di Calogero, R. J. Hides, J. R. Márquez-Ruarte, C. Sassanpour, D. A. Scott. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; S. J. Anjaria, K. B. Dillon, J. Hicklin, C. Puckahtikom. Legal Department: J. M. Ogoola, J. V. Surr. Middle Eastern Department: P. S. Chabrier, Deputy Director; S. M. Thakur. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; R. S. Franklin. Treasurer's Department: D. Williams, Deputy Treasurer; O. Roncesvalles. Western Hemisphere Department: C. Cha. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: G. R. Castellanos, D. Hammann, K. A. Hansen, J. Hospedales, H.-S. Lee, G. Nguyen, G. W. K. Pickering, T. Sirivedhin, N. Toé, M. A. Weitz. Assistants to Executive Directors: W.-R. Bengs, M. B. Chatah, J. de la Herrán, R. Fox, Z. b. Ismail, J. M. Jones, H. Kobayashi, M. Lundsager, J. A. K. Munthali, K. Murakami, J. K. Orleans-Lindsay, M. Rasyid, C. A. Salinas, A. A. Scholten, E. L. Walker, B. D. White.

1. REPORT BY MANAGING DIRECTOR

The Managing Director said that he had participated in the meeting of the UN Economic and Social Council (ECOSOC) in Geneva on July 5, 1985. He had hosted a working luncheon for a number of ambassadors at which Fund and world monetary matters had been discussed. His formal statement had been circulated to the plenary meeting, during which the Chairman had taken the initiative of holding an innovative question-and-answer session. In addition to the Fund, representatives of the World Bank, GATT, UNCTAD, and UNICEF, as well as the Director-General of Development and International Cooperation of the United Nations, had responded to questions from delegates in an attempt to indicate that constructive solutions were being sought to the world's economic problems. Subsequently, he had attended a meeting in Basle of the central bank governors of the Bank for International Settlements (BIS), at which he was invited to make an informal presentation on the international debt situation. A discussion of the world economic outlook had also taken place. It was clear to him that there was considerable support among central bankers for what the Fund was trying to do.

2. MOROCCO - 1985 ARTICLE IV CONSULTATION - POSTPONEMENT

The Chairman noted that the staff report for the 1985 Article IV consultation with Morocco, together with Morocco's requests for a stand-by arrangement and use of Fund resources under the decision on the compensatory financing of fluctuations in the cost of cereal imports, had been taken off the agenda of the present meeting in order to enable the staff to obtain more comprehensive data through the end of July. The Moroccan authorities had indicated that data would be available at the beginning of August 1985 to verify whether or not the criteria in the program supported by the stand-by arrangement relating to the Treasury deficit and credit to the Government for end-July had been met. An updated report would be issued by the staff as soon as possible, and he proposed that the discussion should be postponed until August 9, immediately before the Executive Board recess.

Mr. Kabbaj confirmed that his authorities were confident that the performance criteria for end-July would be met and that the relevant data would be available in time for the Executive Board to discuss the staff reports for the 1985 Article IV consultation with Morocco and Morocco's requests for use of Fund resources before the recess.

The Executive Board then took the following decision:

> Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted

April 29, 1977, the Executive Board agrees to extend the period for completing the 1985 Article IV consultation with Morocco to not later than August 9, 1985.

Decision No. 8025-(85/105), adopted
July 12, 1985

3. KOREA - 1985 ARTICLE IV CONSULTATION AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1985 Article IV consultation with Korea and a request for a stand-by arrangement in an amount equivalent to SDR 280 million for the period from July 12, 1985 to March 10, 1986 (EBS/85/151, 6/14/85; and Cor. 1, 7/9/85). They also had before them a report on recent economic developments in Korea (SM/85/176, 6/27/85).

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

> External developments in the second quarter were less favorable than expected. Although export performance began to improve in March, the value of exports in the first half year was only marginally higher than in the corresponding period of 1984. Reflecting in part sluggish exports, together with declining import prices, the value of imports declined so that the external trade deficit was broadly in line with projections during the first half year. However, the deficit on the services account has continued higher than expected, mainly reflecting low receipts from overseas construction activity. The external current account recorded a deficit of about $1 billion in January-May but is estimated to have shown a moderate surplus in June. The won continued to drift down vis-à-vis the U.S. dollar in recent weeks and in real effective terms depreciated by about 5 percent during the first half year. Given the prospective level of import demand and the impact on exports of the exchange rate depreciation and taking into account the lower interest payments in the second half year, the programmed target for the external current account deficit in 1985 remains feasible.
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> The growth of real GNP is estimated to have been around 5 percent on an annual basis during the first half year. The index of wholesale prices rose by 1.4 percent and for consumer prices by 2.8 percent in the year to June. Industrial wage settlements averaged 6.7 percent in the first half year.
>
> The consolidated public sector recorded a modest overall surplus in the first quarter--in contrast to a deficit in the first quarter of 1984--aided by strong central government revenue performance, particularly for corporate and individual income taxes. Bank credit to the consolidated public sector declined

during the first half year by an amount equivalent to about 2 1/2 percent of the stock of broad money. The Grain Management Fund's purchase and selling prices of barley are being raised by 5.5 percent, but the projected deficit on these operations is expected to be much lower in 1985 because of the smaller crop.

The rate of increase of the net domestic assets of the banking system accelerated to 15.4 percent in the year to June reflecting in large part higher lending to shipping and construction companies. The rate of expansion of broad money reached 13.6 percent, with particularly strong growth in bank deposits in the second quarter following the introduction of more attractive savings instruments. In contrast, the growth of deposits at nonbank financial institutions slowed markedly, as did the rate of expansion of their lending. Effective July 1, the Bank of Korea introduced long-term loans at 3 percent interest to commercial banks facing difficulties because of nonperforming assets, which are concentrated in the shipping and construction sectors.

Gross international reserves were $7.3 billion at the end of June, about $900 million below the level at the end of 1984. External short-term debt was $11,007 million at the end of May, a decline of $418 million in January-May. Total external debt of all maturities (including bank liabilities and all nonbank private debt, but excluding credit from the Fund) increased by about $2 billion in January-May. The authorities announced in June that the proportion of industries in which foreign direct investment is permitted would be expanded from 66 percent presently to 79 percent later this year and to 90 percent by 1988.

Continuing his remarks, the staff representative added that the penultimate sentence of paragraph 26 of the memorandum of the Government of the Republic of Korea, reproduced in Attachment II of EBS/85/151, should be corrected to read: "Accordingly, the reserve target might be scaled downward to the extent that short-term external debt is reduced by more than programmed."

Mr. Rye made the following statement:

I should like to convey the thanks of my Korean authorities to the staff for the very constructive discussions with the mission and for the comprehensive staff report. My authorities agree with the thrust of the report.

A recapitulation of Korea's achievements in structural adjustment since the early 1980s, when the economy was faced with severe difficulties internally and externally, demonstrates the efforts the Korean authorities have made to overcome those difficulties and the key role which Fund support has played in that regard.

After two decades of rapid economic growth, averaging 9 percent annually, the Korean economy encountered serious difficulties in 1980 because of a disastrous harvest, steep rises in international oil prices and interest rates, and domestic political disturbances. Real GNP declined by more than 5 percent--the first decline in Korea's modern history--inflation soared to 35 percent; and the deficit on current account of the balance of payments rose to a record $5.3 billion, 9 percent of GNP.

The response of the authorities to these adverse developments was to embark upon adjustment programs supported by stand-by arrangements with the Fund. During the period 1981-82 substantial adjustment took place, as economic growth resumed at an annual rate of 6 percent, the rate of inflation declined to 5 percent, and the current account deficit more than halved to 4 percent of GNP.

Notwithstanding these improvements, the high level of Korea's external debt and its relatively short maturity structure became an increasing source of concern, particularly against the background of weakening export growth and the emerging international debt crisis. The Government therefore adopted an intensified and more far-reaching stabilization program which was also supported by a stand-by arrangement with the Fund running from July 1983 to March 1985.

In the fiscal sector, containment of public sector spending along with increased revenues resulted in a further reduction in the ratio of the public sector deficit to GNP to 1.4 percent in 1984, enabling the ceiling on credit to the public sector to be readily observed.

In the financial sector, the Government has pursued a long-term program of liberalization, an essential element of which is the gradual relaxation of interest rate ceilings. Other important institutional reforms have been implemented to enhance competition within the financial sector and to reduce the role of the authorities in credit allocation. Restrictions on foreign investment have been greatly eased.

Early in 1984, the Government announced its intention to follow a five-year plan of import liberalization. The plan is being implemented on schedule, including measures applying from July 1, 1985 detailed in the staff paper. The Government also announced a five-year program of tariff reform that aims at eliminating excessive protection, reducing the dispersion in tariff rates, and lowering the cost of imported raw materials.

While the stock of total external debt was contained to a level well below the agreed ceiling, the debt structure was improved by reducing the ratio of short-term debt to total debt from 30 percent in 1983 to 26.4 percent in 1984. The gross international reserve target was also achieved.

In short, the program proved to be highly successful--output rose by an annual average of over 8 percent during 1983 and 1984, inflation was contained to 2 percent, and the current account deficit fell below 2 percent of GNP.

Nevertheless, Korea remains one of the largest debtor countries--third among developing countries listed by debt to banks--with a high level of short-term debt which makes it highly vulnerable to any adverse developments in international financial markets. The proposed 20-month stand-by arrangement, through March 1987, is intended to put the remaining task of adjustment on a solid footing. It would also secure additional long-term resources needed for reduction in short-term debt, which is a matter of prime concern to the authorities. The amount of the requested stand-by, SDR 280 million, is 36 percent of Korea's quota on an annual access basis. Korea's repurchases during the period of stand-by will be SDR 450.1 million, so that even under full drawdown Korea would be a net supplier of resources to the Fund during the stand-by period.

Program for 1985/86

The major policy goals are as follows:

- first, to achieve 7.5 percent GNP growth while expanding employment by stabilizing private consumption and accelerating investment;

- second, to maintain price stability and eliminate inflationary expectations, keeping increases of wholesale prices at 1-2 percent and of consumer prices at 2-3 percent;

- third, to reduce the current account deficit to $500-700 million by promoting sustained growth in exports and by increasing the efficiency of imports; and

- fourth, to promote balanced regional development and to enhance the efficiency of the economy through structural adjustment.

In line with these targets, money and credit will be managed so as to reinforce price stability without unduly constraining economic growth. Interest rate policy will be directed toward gradual enhancement of the role of the market and additional measures will be taken to improve the efficiency of the financial sector.

In the public sector a policy of stabilization will be pursued with the aim of reducing the consolidated fiscal deficit and thus lessening inflationary pressures.

Improvement in the balance of payments is one of the prime objectives of economic policy in 1985. This is seen as central to the alleviation of problems arising from the high level of external debt. Notwithstanding that the external economic environment is expected to be less favorable than in 1984, the Government firmly believes that the current account deficit should be reduced. The management of aggregate demand will be directed to this objective. Increased financial support will be provided for investment in export industry and for technological development. The exchange rate will continue to be floated to reflect price levels of trading partners and fluctuations in major currencies.

To cope with uncertainties in the international capital market and volatility in exchange rates, Korea will continue to diversify borrowing strategies and to seek improved terms and conditions of external borrowing. The growth rate of total external debt will be slowed and the debt structure will be improved by further reducing the proportion of short-term debt.

Structural adjustment of the economy is progressing. Trade liberalization will be continued, despite intensifying protectionism in Korea's overseas markets. The five-year tariff reform will also be steadily implemented, and the financial sector will be further exposed to foreign competition.

Recent developments

According to a preliminary estimate by the Bank of Korea, the nation's real GNP expanded at the much slower annual rate of 4.1 percent in the first quarter of 1985.

A major reason for this was sluggish export performance, notably in construction, iron and steel, shipbuilding and light industrial products. On recent indications, growth of GNP for the first half of 1985 was about 5 percent annually.

The current account deficit for January-May 1985 of $1 billion reflected lower overseas construction receipts and higher interest payments. Preliminary indications are for some improvement in June and, given the historical pattern of balance or surplus in the second half of the year, the current account target for 1985 as a whole--a $900 million deficit--is still achievable.

The broad development of the economy so far in 1985, then, is of slower growth from a more subdued export performance, with the effects of this on the balance of payments being largely offset by slower growth in imports. The Government has not thought it appropriate to attempt any offset by a countercyclical approach to fiscal policy; on the contrary, the net budget position is running ahead of expectations--and accordingly the net extension of credit by the banks to the public sector as a whole is running lower than expected. It is accepted that with the balance of payments constraint, the Government's goals for economic growth in 1985 will not be attained.

Recent credit developments also require mention. As the staff supplementary paper indicates, net domestic assets of the banking system have been growing at a rate in excess of the path to the September ceiling. This reflects two factors. The first is the effects of more market-oriented bank interest rates and the consequent reflows from nonbank financial intermediaries--the growth of which has decelerated considerably into the banking system. This in itself should not, it seems to me, be a cause for concern. Second, however, the authorities have found it necessary to provide substantial financial support to the key but financially troubled sectors of construction and shipping.

To achieve program targets in the second half of 1985, the authorities are committed to using the full range of instruments of monetary control, including higher reserve requirements, increased issuance of monetary stabilization bonds and activation of monetary stabilization accounts.

Finally, my Korean authorities would like to assure the Board that they appreciate the need for effective management of the Fund's scarce resources, and will of course cooperate fully with the Fund in this regard. They have asked me to say that, if balance of payments developments should turn out to be significantly better than now expected--which is their earnest hope--they would refrain from making drawings under the proposed stand-by arrangement.

Extending his remarks, Mr. Rye explained that Korea, particularly in the light of its external debt, still had some adjustment to carry out--a process in which the Fund could play a valuable role. The question that might be raised, however, was whether it was appropriate for a country in Korea's position to use the Fund's scarce and revolving resources. Certainly, effective management of the Fund's limited resources was crucial to the future of the organization.

There were two alternatives to the proposal that Korea should benefit from a further stand-by arrangement, in an amount equivalent to SDR 280 million, with the Fund, Mr. Rye continued. The first was an enhanced surveillance arrangement, which, it had generally been agreed, should be contemplated only when the member country viewed it as an appropriate procedure. The second alternative was a classical stand-by arrangement under which the member country undertook not to make drawings unless its circumstances changed unexpectedly for the worse. Korea was a high-debt country, subject to the uncertainties of international financial markets. The Korean authorities believed that a program supported by drawings that would actually be made would give more assurance to the market than a program not necessarily involving drawings. Moreover, a classical stand-by arrangement would contain some underlying element of risk in that any need to activate the stand-by arrangement could send a signal to the international banks that things were going wrong. International bankers occasionally failed to discriminate sufficiently between those high-debt countries that were coping well with their problems--as Korea undoubtedly was--and those that were not. There was a strong desire on the part of the international banking community to reduce its exposure in Korea, particularly short-term exposure, and any indication that Korea's program was going off track would render the country quite vulnerable. By contrast, no such problem arose with the normal stand-by arrangement under which drawings could be made as a matter of course. If developments were better than expected and drawings were not needed, that in itself would be a substantial confidence builder.

The amount involved in supporting the program was not large, whether from the standpoint of Korea or from that of the Fund, Mr. Rye noted. Six larger arrangements were currently in effect. Moreover, the drawings would be substantially exceeded by Korea's repurchases during the period of the stand-by arrangement. Although the annual access under the proposal would be 36 percent of Korea's quota, that proportion would have been much smaller, if the size of Korea's quota had kept pace with development of its economy. The relationship of Korea's quota to GDP was certainly among the lowest of Fund members.

It was possible to argue that Korea did not really need to make such relatively small use of Fund resources, Mr. Rye commented. The Korean authorities did not see the matter in that light, but rather believed that the drawings would be a useful element in their economic management plans, particularly in helping them to reduce short-term borrowing. The Fund should not be regarded as an institution whose resources should be available only to those in despair.

There was finally the question of prolonged use of Fund resources, Mr. Rye concluded. During the 1980s, Korea had made extensive use of Fund resources in an exceptionally beneficial way. As Mr. de Vries had said in the previous Board discussion on Korea, "the real question was not so much...prolonged use of Fund resources but proper use. Korea had clearly used Fund resources properly. Furthermore, the Executive Board should not place itself in the position of implying that if a country performed well it did not need credit, while if it performed poorly it did not deserve it."

Mr. Ismael commented that the Korean case demonstrated how well a country could cope with the problem of heavy indebtedness without jeopardizing its economic growth and stability, provided that its policies were well conceived and were implemented with firmness and consistency. Strict financial discipline, flexible exchange rate management, and market-oriented structural measures--the basic policy elements of a Fund-supported program--could work well together with the sort of export-oriented development strategy that Korea had relied upon for many years.

Not only had all performance criteria been met under the previous program period, but the rates of economic growth and inflation had remained impressive, Mr. Ismael continued. The improvement in Korea's external position was reflected in a lower current account deficit, slower growth of external debt, reduced share of short-term debts, and a higher level of international reserves than in 1983. Progress had also been made in reducing the fiscal deficit, containing liquidity growth, and increasing the national savings rate, all important achievements given that the performance of the external sector in the second quarter of 1985 had been less buoyant than expected.

Nevertheless, the medium-term outlook still pointed to the need for a further improvement in the external position, Mr. Ismael added. Even under the staff's most optimistic scenario, Korea would show some degree of dependency on international capital markets for the next few years. Given its large external debt, of which short-term debt still constituted a large share, Korea would remain vulnerable to any major shifts in the markets' perception of its credibility. The Korean authorities therefore needed to continue with their present policies under a Fund-supported program.

The emphasis of the proposed program, Mr. Ismael noted, was to improve the balance of payments position without jeopardizing economic growth and price stability. It was not altogether clear, on the one hand, whether the objective of generating a current account surplus was in Korea's best interest in the long run. On the other hand, the objective of a reduction in the current account deficit, slower growth in external debt, a decrease in the proportion of short-term debts in total debt, and an increase in international reserves were quite appropriate in the short run. The authorities were correct to subordinate short-term growth to the achievement of external objectives and to refrain from providing a fiscal stimulus if external conditions proved less favorable than foreseen.

Within the context of the Fund-supported adjustment program, Mr. Ismael expressed support for the authorities' continued commitment to increasing savings in the consolidated public sector, especially in conjunction with the investment strategy already endorsed by the World Bank. It was good to see that the authorities had decided to strengthen the finances of the public funds, particularly of the Grain Management Fund (GMF), which was accounting for about 40 percent of the public sector deficit. The authorities should accelerate progress toward eliminating the GMF's buying and selling price differential and turn over a large part of its operations to the private sector.

The authorities' continued restraint in expanding liquidity, by containing the increase in M-2 below the growth rate of nominal GDP, was appropriate, Mr. Ismael considered, despite the decline in the velocity of broad money aggregates. The authorities' cautious stance remained critical to restrain inflationary pressures, which were likely to increase as a result of the recent accelerated depreciation of the won. There had been some recent increases in maximum lending rates and an introduction of a wider band on bank lending rates--both important steps toward the eventual elimination of the official administration of interest. However, more substantial progress was needed to rationalize investment decisions. Moreover, the liberalization of interest rates allowed businesses to establish appropriate debt/equity ratios in a more efficient and rational way than had occurred under the restrictions recently imposed on the bank borrowings of many business conglomerates.

The adjustments made in the exchange rate during March and April 1985 to correct the previous appreciation of the won were commendable, Mr. Ismael continued. Also welcome was the authorities' commitment to maintaining a flexible exchange rate after that point. Those developments were critical for the maintenance of competitiveness and to facilitate the implementation of five-year plans for import liberalization and tariff reform. In an effort to reduce the rate of increase in external debt, Korea needed to make additional efforts to attract direct foreign investments, especially in view of the high productivity of capital. The recent initiatives to simplify administrative guidelines and the approval process and to open up previously restricted industries to foreign investment had significantly improved the prospect of an increased flow of direct foreign investment.

Mr. Fujino said that he commended the Korean authorities for their successful implementation of far-reaching adjustment policies, under a series of stand-by arrangements, since 1980. During 1980-84, there had been a remarkable reduction in the external current account deficit and in the fiscal deficit as a proportion of GDP. The most notable achievement had been a lowering of the inflation rate from more than 30 percent to about 2 percent. Few countries had ever succeeded in rectifying domestic and external imbalances to such an extent in a relatively short period. The heavy reliance on an export-oriented development strategy, combined with prudence in domestic demand management, had proved instrumental in maintaining traditionally high growth rates. Vigorous investment had raised labor productivity by more than 10 percent per annum and had allowed a steady increase in the real wage rate.

However, Mr. Fujino suggested, it was important not to underestimate the vulnerability of Korea's external position, an inevitable reflection of its high external indebtedness. Although the domestic savings rate, after dropping sharply at the beginning of the 1980s, had returned to the level prevailing in the 1970s, there was still a need to strengthen domestic resource mobilization. It was important to maintain investment activities without relying on financing from foreign sources. In that respect, the size of the banking sector seemed to be rather small in proportion to total economic activity, and the recent increase in domestic credit had been concentrated in the nonbank financial institutions. It was questionable whether the increase in credit from investment institutions was a desirable financial development. The recent rise in the savings rate might be due both to the resumption of high economic growth after the difficulties at the beginning of the 1980s and to the recent introduction of new financial instruments and an increase in deposit rates. It was an open question whether such high real interest rates could be sustained. It might be inevitable, as a transitional measure, to pay high deposit rates in order to attract funds from the curb market to the banking sector. However, the high nominal interest rates would result in high real rates if inflation were to stay at the 2-3 percent level and would not be compatible with sustainable growth, even though the productivity increase in the economy was very high at the moment. Despite a number of steps taken to enhance the profitability and competitiveness of the banking sector, there was need for additional steps. Further comment from Mr. Rye on the way in which the authorities planned to improve the institutional framework of the financial sector to include private savings would be helpful.

Although the authorities were still hoping to maintain a growth rate of about 7-8 percent over the medium term, Mr. Fujino continued, overall performance in the first quarter of 1985 had been significantly below the authorities' targets, mainly owing to lower growth rates in some industrial countries. It would be premature to argue whether that was just a temporary phenomenon or whether it represented a change in the medium-term trend, but significant uncertainties were involved in estimating future growth potential. The authorities should maintain their present prudent policy stance and refrain from taking additional stimulative measures, even if the growth rate turned out to be lower than expected.

The authorities should continue their efforts to reduce the deficit of the Grain Management Fund by narrowing the differential between its buying and selling price, Mr. Fujino stated. The recent 5 percent rise in the selling price was a welcome step, and the authorities should limit the increase in purchase prices during the second half of 1985. In general, the management of nonfinancial public enterprises appeared to be efficient, as evidenced by the significant operating surplus that had been recorded each year. Nevertheless, the net financing requirement of those enterprises would increase in 1985 because of a 20 percent rise in investment spending. Accordingly, more flexible pricing policies might be warranted, particularly in electricity and telecommunications.

High priority should be given to the maintenance of price stability through adequate control of monetary expansion, Mr. Fujino added. It was gratifying to note that the growth of net domestic assets in the banking system had decelerated further in 1984 to a rate slightly above the rise in nominal GDP. Monetary policy had been complicated by the growing importance of nonbank financial institutions. The authorities, therefore, should monitor closely the development of total liquidity--M-3--which had expanded at the relatively higher rate of 20 percent in 1984.

The flexible adjustment of the exchange rate in recent months would help to overcome weaknesses in export performance, Mr. Fujino noted. The authorities were to be commended for their continued efforts to liberalize imports and reform tariffs, despite the adverse external environment. As the Korean economy matured and labor costs increased, it would be important to open up markets in order to maintain international competitiveness. The rate of return on real investment was still high in Korea and could provide a strong incentive for foreign direct investment. The recent movement from a positive to a negative list system of foreign direct investment, and further liberalization measures envisaged in the near future, would make a valuable contribution toward achieving the rather ambitious growth targets, at the same time helping to reduce dependence on external debt financing.

The movement of overall balance of payments deficits depended heavily on the size of negative errors and omissions, which were almost equivalent to the reduced size of the current account deficit, Mr. Fujino pointed out. Since capital transactions were still under the control of the authorities in Korea, it was rather strange to see such a large unidentified flow.

It could be argued that Korea's balance of payments need had been lessened because of the recent dramatic decline in the current account deficit, Mr. Fujino said. However, Korea must still improve its external debt structure. The authorities were committed to maintaining their present prudent course of action. The stand-by arrangement was for a modest amount, in terms of Korea's quota and the size of its economy, but it could be instrumental in strengthening the external position. The authorities had indicated their intention not to use the Fund's resources if the course of future events were favorable, in keeping with the original character of stand-by arrangements. Therefore, he supported the request and the proposed decisions.

Mr. Polak emphasized that despite a formidable economic performance in 1984--helped by the recovery in the industrial world and particularly in the United States--Korea remained vulnerable as a result of its high external debt. It was of the utmost importance that the authorities remain highly attentive to developments in the external environment, as in fact they had done when export performance had become less favorable toward the end of 1984 and early in 1985.

The main goals of the program were to reduce Korea's reliance on external savings and to increase domestic savings, Mr. Polak commented. The large financing requirements of the Grain Management Fund remained a concern; they were caused by a policy under which prices were set below costs, a problem that was compounded in years of good harvest. However, to the extent that the system stabilized producer incentives, the financial costs might be justifiable. Although a shift to cost-based pricing might be preferable, the savings that could be achieved would be small in relation to the financing requirements of the Fund, as shown by the 1984 figures. The ongoing reform in the financial system as well as the program of import liberalization was also welcome.

It was understandable that Korea, which with Indonesia was the only debtor that had not had to reschedule its debts, had again opted for a stand-by arrangement to enhance its status in the financial markets, Mr. Polak continued. It was debatable, however, whether the proposed stand-by arrangement was a good idea for Korea, a country exposed to substantial risks that might well need to make substantial use of the Fund's resources in future. Korea should ensure that it was in a position to make the optimal use of Fund resources in case of such need. Accordingly, Korea should make the maximum net repurchases in good times--1985 and 1986 looked likely to be good years--and should not use the stand-by arrangement unless market conditions made it necessary. If Korea had followed a contingency approach in its request to the Fund, it could have asked for a stand-by arrangement for a somewhat larger amount than SDR 250 million. If, however, the proposed stand-by arrangement was essentially symbolic, then the amount should have been set considerably below 61 percent of quota. It was not enough that the authorities had acknowledged an awareness of the need for economy in the use of Fund resources and did not plan to draw the full amount under the stand-by arrangement independent of the balance of payments position. Korea should make fewer or smaller drawings than permitted under the arrangement.

Mr. Grosche said that the Korean authorities were to be commended for the remarkable success that they had achieved in recent years following the adoption of Fund-supported stabilization measures. However, he had a number of reservations with regard to the new stand-by arrangement. First, it was not clear whether the economic program for 1985-86 was mainly an adjustment program, deserving continued Fund support, or whether it was primarily an ambitious economic development program that, at the same time, envisaged a further reduction in external imbalances. The high real growth rates expected and the renewed increase in the consolidated public sector deficit were both evidence of the latter. The nonfinancial public enterprises also had large investment programs, which were budgeted to increase by 19 percent in 1985. It was debatable whether such a strategy was fully compatible with the need for continued adjustment. A less ambitious growth strategy would be advisable in view of the uncertainties regarding the future development of the world economy and Korea's high external indebtedness and would also reduce the need to finance current account deficits.

It appeared that the main reason for the new stand-by arrangement was to provide sufficient assurances to the international banking community that Korea remained creditworthy, Mr. Grosche continued. In light of the impressive adjustment progress made in Korea, it was questionable whether the catalytic role of the Fund was really needed. Korea had succeeded in maintaining its credit standing and had enjoyed uninterrupted access to credit markets even at a time when the country's economic imbalances had been much higher and when access for some other highly indebted countries had been severely curtailed. Only recently, Korea had had no difficulty at all in obtaining new foreign credits totaling $650 million, more than it had requested.

Nor was it clear, Mr. Grosche commented, that the amount of credit being requested was moderate, as stated in the staff appraisal. Korea already had relatively large outstanding purchases that would be reduced only slightly over the program period. A country in a relatively favorable economic position should reduce its indebtedness to the Fund more rapidly. Korea's foreign reserves had risen in 1984 by $0.7 billion, and a further increase was expected in 1985. With such comfortable reserves, the authorities could easily substitute for the amount of Fund credit requested by making a slight reduction in the country's international reserves.

However, he could support the request for a stand-by arrangement, provided that the authorities appreciated the need for an effective management of the Fund's scarce resources and would refrain from making drawings under the proposed arrangement if the balance of payments should turn out to be significantly better than expected, Mr. Grosche said. It would have been preferable if the authorities had made a commitment not to use the full amount of the arrangement even if external account developments were in line with projections.

Mr. Leonard noted that the adjustment measures undertaken by Korea since 1980 had greatly strengthened the economy. Although developments in the latter part of 1984 and in the first half of 1985 had not been as encouraging as had been originally expected, economic performance had nevertheless been good and provided ample grounds for confidence that external balance would be restored.

The current monetary and fiscal strategy would help to keep inflation low and should reduce the current account deficit further, Mr. Leonard continued. The Grain Management Fund was a major source of fiscal weakness that had to be remedied if public sector savings were to increase; narrowing the gap between the agency's purchase and selling prices would be in line with the authorities' longer-term goal of increasing the role of the private sector in grain marketing. In the monetary field, the expanded role of market forces in determining interest rates was particularly encouraging. The rise in interest rates on personal savings and household deposit accounts should significantly improve the rate of private savings. In addition, increased flexibility in lending rates would help maintain a nonaccommodating monetary stance and ensure a better allocation of financial resources.

Although Korea's creditworthiness was enviable in comparison to that of many other countries, Mr. Leonard stated, the authorities were wise to pursue a more conservative borrowing policy abroad. The reduction of regulatory barriers on direct investment inflows would complement the efforts to increase domestic savings and help to ensure adequate access to finance. An important element of recent adjustment efforts had been an improvement in the maturity structure of external debt. Further lengthening of the average maturity of external debt would help to increase financial stability in the future.

The continuing efforts of the authorities to reduce trade barriers were also welcome, Mr. Leonard noted. Although there had been growing protectionist pressures directed against Korea, it was nevertheless in the authorities' interest to continue the medium-term strategy of more thoroughly integrating the domestic economy with international markets. The deceleration, early in 1985, in export growth was partly due to the appreciation of the real effective exchange rate. Maintenance of strong growth in exports was a key element in achieving Korea's medium-term financial goals. It was essential, therefore, that a competitive exchange rate be maintained. The advantages of such a strategy had been demonstrated by the positive impact on exports of the recent exchange rate adjustments. The authorities deserved support for their determination to maintain a flexible exchange rate policy.

He could support the request for a stand-by arrangement, with some reservations, Mr. Leonard said in concluding. If developments were favorable, the authorities should consider the desirability of drawing less than the full amount available under the stand-by arrangement. It might even be in their interest to make some early repurchases on their outstanding obligations to the Fund.

Mr. Dallara remarked that the Korean authorities were to be commended for their impressive adjustment efforts in recent years. Between 1980 and 1984, a number of the key macroeconomic indicators had improved significantly. GNP growth in 1984 had been 7.6 percent as opposed to negative 5.2 percent in 1980, the national savings rate had increased from 22 percent to 27 percent over the same period, inflation had fallen from 35 percent to 2 percent, and the current account deficit as a proportion of GNP had declined from 8.7 percent to 1 percent. Those indicators were evidence of both soundness of design and firmness of implementation in Korea's recent economic policies. The Fund and the Korean authorities had worked successfully and collaboratively in the effort, which was to continue during the 20 months of the requested stand-by arrangement.

The macroeconomic policies, targets, and objectives set forth for 1985-86 were consistent with achieving a sustainable balance of payments position, while maintaining real economic growth with low inflation, Mr. Dallara continued. Important structural changes, including reform of import tariffs, liberalization of import licensing and of foreign direct investment controls, financial sector reforms and a more flexible pricing policy in the 19 nonfinancial public enterprises, would complement the macroeconomic efforts and support the achievement of the fundamental objectives of the program.

In view of Korea's large outstanding foreign borrowing and continued significant gross borrowing requirements in the medium term, Mr. Dallara reiterated, high priority had to be given to strengthening the external account. The cautious approach to balance of payments in the proposed program was appropriate. It was good to see emphasis placed on the continued improvement in the maturity of Korea's debt structure. Although there had been a slight weakening in the balance of payments in the first five months of 1985, it appeared that the targeted reduction in the 1985 current account deficit, to about $900 million, was still within reach. A reduction in the current account deficit from 1.7 percent in 1984 to 1.1 percent in 1985 remained a possibility.

The fiscal stance proposed in the program continued the cautious approach adopted in the past few years, Mr. Dallara noted. However, there was a significant burden of transfer payments from the Central Government to local governments, largely in the form of revenue sharing. The Korean authorities wanted to reduce the dependence of local governments on the Central Government--a development that might facilitate the extension of fiscal incentives to the private business sector. It would be interesting to know how that process might take place. The financial imbalances of the Grain Management Fund were a further source for concern, particularly in view of the recent increase in the purchase price of barley. Fortunately, the smaller barley crop in 1985 would reduce the impact of that change on the deficit, compared to 1984. The authorities should forgo or minimize the increase in the purchase price of rice proposed for later in 1985. The deficits of public enterprises should be reduced through the adoption of more flexible pricing policies and continued wage restraint.

The plan for a moderate rate of expansion in domestic credit and in the broad money supply was appropriate, Mr. Dallara observed. There had been, however, an acceleration in the rate of increase of net domestic assets in the banking system to 15.4 percent in the first half of 1985. Such an acceleration reflected, in part, the need to provide for the financially troubled sectors of construction and shipping. Such subsidies were not in the long-term interest of economic efficiency in Korea. The introduction of new financial instruments to facilitate the growth of private savings, the widening of the interest rate bands on term lending by the banks, the permission for the commercial banks to engage in trust activities, and the easing of some restrictions on the operations of branches of foreign banks in Korea all were moves in the right direction. However, the liberalization of interest rates and the reduction in the use of direct credit were occurring at too modest a pace. The important steps taken in recent years to create a modern, open financial structure in Korea and to reduce interest rate controls and the use of directed credit should continue.

It was gratyfing to note the recent measures designed to increase foreign direct investment in Korea, Mr. Dallara remarked. Approvals of foreign investment proposals had risen from $188 million in 1982 to $419 million in 1984. With luck, the inflows might reach $1 billion by 1988. An increased inflow of direct foreign investment was an important element in the overall strategy of Korean economic management. The ongoing five-year plans, import tariff reform, and import liberalization should be continued. If the plans were to succeed, it would be necessary for the balance of payments position to be strengthened and for a realistic exchange rate to be maintained. Exchange rate developments in early 1985 had not been helpful although the authorities had been prompt in their corrective actions. They should continue to be vigilant in ensuring competitiveness in the export sector.

Despite his support for the policies pursued by Korea, the request for a new 20-month stand-by arrangement, involving the possible use of SDR 280 million, posed potentially significant risks for the Fund, Mr. Dallara continued. Both in 1983 and 1984, the U.S. authorities had expressed concern about Korea's prolonged use of Fund resources and had encouraged the authorities to develop other modalities of cooperation with the Fund. While it was true that of those countries that had relied on Fund financing for prolonged periods, few had been more successful than Korea in their adjustment efforts, not many countries had larger outstanding use of Fund credit as a percentage of quota than Korea. The concern of his authorities in all those cases was rooted in the need to preserve the revolving character of the Fund's resources and the temporary nature of its balance of payments support. Since the beginning of 1974, Korea had benefited from approximately six years of Fund-supported programs, and its current obligations to the Fund under the tranche policies amounted to 239 percent of quota. If the new stand-by arrangement were approved, there would be an additional period of nearly two years of Fund financial and policy support. Currently, only three countries had had more years of Fund-supported programs than Korea during the past decade, and only ten had a higher outstanding use of Fund credit relative to quota. While it was true that net use of Fund credit would be reduced by SDR 36.8 million during the course of the stand-by arrangement, most of that reduction would occur under the special facilities. Outstanding Fund credit to Korea under the tranche policies would decline only marginally, from 239 percent of quota to 227 percent of quota, assuming full use of resources that could become available under the program.

While the authorities had an impressive adjustment record, Korea's foreign debt was substantial, Mr. Dallara stated. Although he agreed with the staff that "Korea needs to ensure that financial markets perceive clearly the quality of its policies for maintaining creditworthiness," it was not at all clear that a stand-by arrangement would be the most appropriate vehicle to accomplish that objective. Some form of enhanced surveillance could have provided the framework for a relationship with the Fund, in a way both more consistent with the temporary character of Fund resources and complementary with the authorities' economic objectives. It was not necessarily true that enhanced surveillance should be contemplated only when a country saw that as the most appropriate course of action. Any decision in that regard would depend on whether other possible courses of action were fully consistent with Fund policies. Since the authorities preferred a stand-by arrangement to support the formulation and implementation of a sound economic program and provide clear and objective signals to the international financial markets about Korea's continued creditworthiness, their position had to be respected.

Yet the proposed use of Fund resources under the stand-by arrangement was at the very heart of the U.S. concern, Mr. Dallara observed. Korea clearly had a balance of payments need in a technical sense. Korea also had a legal right to draw under current access policies. However, there were two significant question marks about the present course of action. The first was whether Korea needed to draw from the Fund in order to send appropriate signals to the marketplace. It was not actual drawings from the Fund, but rather the existence of a set of policies that the Fund could support, and adherence to those policies over a period of time, that were the key to maintaining external creditworthiness. According to the staff report the authorities took the position that "The proposed access under the arrangement would convey to the international financial markets a clear and objective signal that policies are on track." The emphasis on policies and performance seemed to be somewhat at odds with the planned drawings under the arrangement.

His second question was whether further use of Fund resources by Korea was consistent with one of the guiding principles of the Fund--that its resources were to be provided temporarily to assist members in dealing with their balance of payments problems, Mr. Dallara continued. In recent years, a number of Fund members had experienced serious payments problems, reflecting a number of factors, including deep-seated structural difficulties. Those difficulties had not always been corrected without a sustained effort over a number of years and, in certain cases, with the exceptional support of the international donor community. Prolonged use of Fund resources was of no less concern in those cases. It was the impressive success of Korea's adjustment effort that made the further use of Fund resources so difficult to understand. Such a stand-by arrangement would raise the question: under what circumstances could and should the Fund expect a member not to reduce but to cease, at least for a period of time, reliance on Fund resources? In light of Korea's broad-based economic progress and its very high outstanding use of Fund resources, an opportunity existed for the Fund to continue to support Korea's adjustment efforts while the authorities, for their part, refrained from actual further use of Fund resources. It was a shame that that opportunity had not been seized by the authorities. The possibility that they would not draw the full amount of the stand-by arrangement, if the balance of payments position improved, was welcome. However, it would have been preferable for Korea to provide assurances that it did not intend to draw under the program unless the payments situation deteriorated. In the circumstances, he supported the request for a stand-by arrangement only with considerable reluctance.

Mr. Ortiz said that Korea's success story had become a paradigm of stable growth. The way in which the economy had adjusted to the difficulties encountered in the late 1970s and the early 1980s had been remarkable. GNP had recuperated rapidly, the rate of inflation was among the lowest in the world, and both the internal and external deficits had fallen substantially since 1980. Few countries could claim an economic performance equal to that of Korea. Given the clearly manageable nature of the remaining imbalances, it was surprising that the country required any Fund-supported program. The reason provided by the authorities was the need to ensure that financial markets perceived clearly the quality of their policies for maintaining Korea's creditworthiness, given the country's large external debt.

At least one aspect of the request involving the relationship between the Fund and commercial banks gave rise to concern, Mr. Ortiz noted. Korea was one of the few developing countries that still enjoyed normal access to international capital markets. If the Fund had to stamp a seal of good housekeeping on Korea's well-managed economy in order to reassure commercial banks, it was disturbing to consider the implications for the market rating of those countries whose debt situation or economic performance was less satisfactory than that of Korea. It remained unclear whether commercial banks would require the adoption of a Fund program before committing any resources on a "voluntary" basis to a developing country. It was far from obvious whether it would be appropriate for the Fund to perform such a function.

During the Board's discussion in March 1985 on developing countries' indebtedness to commercial banks, there had been a consensus that the Fund should not provide on/off signals about the appropriateness of further bank lending, Mr. Ortiz added. The Fund should avoid assuming the role of loan evaluator for commercial banks. At one level, it was important to question whether the Fund should be in the game of providing signals at all, even in the form of a Fund-supported program. At another level, if some sort of Fund involvement were deemed absolutely essential, there was a strong case for the Fund to provide some type of enhanced surveillance rather than committing further resources. An additional reason for requesting a stand-by arrangement appeared to be that the authorities were seeking a partial rescheduling of Korea's debt to the Fund, which did not, however, seem to be excessive. Nonuse of Fund resources would have had only a marginal effect on the accumulation of gross reserves.

The adjustment envisaged in the program implied that approximate external balance would be achieved by late 1986, Mr. Ortiz added, at which point the balance of payments situation would be sustainable. It would be wrong, however, to draw the inference that the current balance of payments position was not sustainable. The current account deficit had been significantly reduced as a percentage of GDP, with the result that accumulation of debt service charges would not seem to be a serious cause for concern. It was certainly appropriate that the authorities take a prudent view of future external indebtedness. Total external debt as a proportion of GDP was about 30 percent, a relatively high figure compared with other developing countries that had formerly had access to market borrowing. However, Korea's debt service ratio was only 22 percent, a much smaller fraction than that in other indebted countries in the Western Hemisphere or even in Asia. Even under the worst case scenario envisaged by the staff, both the ratio of external debt to GDP and the debt service ratio would decline in 1990, resulting in an external situation that appeared quite manageable. That scenario assumed, of course, that protectionist pressures would not hinder the growth of Korea's exports. Protectionism was one of the greatest dangers to Korea's future economic prosperity.

It was true that conditions in financial markets made external credit an uncertain source of future finance, Mr. Ortiz said in concluding, but Korea's current economic situation did not appear to be endangered. It was difficult to see why a Fund program should be needed on those grounds.

Mr. Suraisry observed that for the fifth consecutive year the Korean economy had enjoyed high growth, low inflation, and substantially lower fiscal and external deficits. The authorities were to be commended for their prudent financial policies and successful export-led growth strategy. Their policies for 1985 and 1986 were appropriate to maintain noninflationary growth and to strengthen external adjustment.

In the program itself, the continued emphasis on financial restraint was appropriate, Mr. Suraisry said. The authorities were right to keep the consolidated public sector deficit below 2 percent of GDP in 1985 and 1986, and in fact there was room for further reducing the deficit. The implementation of tax measures and the reduction of budgetary transfers would be a move in that direction. A strong fiscal performance, including that of the public funds, was essential to raise domestic savings and reduce reliance on foreign borrowing. It was also essential to increase the operational autonomy of the public enterprises, thereby helping to raise the share of their investment that was internally financed.

The authorities had successfully struck a balance in monetary policy between controlling inflation and accommodating private sector demand for credit, Mr. Suraisry added. Their efforts to enhance the efficiency of the financial sector were a key element to Korea's continued growth.

The authorities had made good progress toward a sustainable balance of payments position, Mr. Suraisry continued. Moreover, the maturity of the debt structure had improved. More still needed to be done, particularly in light of the size of Korea's debt and the less favorable external prospects for 1985. It was important to reduce further the current account deficit. A flexible exchange rate policy was particularly important to support Korea's export-led growth strategy. Ultimately, the success of the strategy would depend on the removal of trade restrictions by other countries. While Korea was taking commendable steps to liberalize its own trade system, other countries were becoming more protectionist. Korea's major trading partners should remove restrictions as soon as possible.

The favorable projections for the medium term were encouraging, Mr. Suraisry noted. Nevertheless, a cautious approach toward foreign borrowing was appropriate. The authorities should intensify their efforts to mobilize domestic savings and thereby reduce dependence on foreign borrowing over time.

Korea had been a prolonged user of Fund resources, but its track record and prospects were good, Mr. Suraisry said in concluding. The authorities understood that Fund resources were scarce and intended to refrain from making purchases, if the balance of payments position improved. That approach was sensible and allowed Korea to call on Fund resources in the future, if the economy were to worsen. While it might be argued that a truly classical stand-by arrangement would have been more appropriate, the Korean authorities deserved the benefit of the doubt.

Mr. Zecchini remarked that Korea's successful adjustment process demonstrated that adjustment and growth were not incompatible, provided that domestic demand policies were geared toward controlling the growth and composition of domestic absorption. All the main macroeconomic indicators were on line and the targets of the 1985-86 program marked further progress toward a long-run sustainable economic position. The main problem of the country was the size of its foreign debt, which placed a heavy constraint on the pattern of financial flows in the immediate future. Accordingly, it was appropriate that the authorities had adopted a cautious attitude toward the net use of foreign savings.

The fiscal adjustment had been substantial, Mr. Zecchini continued. The amount of current public debt did not appear to be unsustainable over the medium term, and, with the growth of GDP and a high household savings ratio, domestic financing should be feasible without any need to constrain monetary policy. It was not clear, however, why central government transfers--equivalent to about 0.2 percent of GNP--to local authorities for the purpose of reducing their indebtedness with commercial banks should affect the consolidated public sector deficit.

The gradual decline in the velocity of broad money aggregates was a sign of more constrained inflationary expectations, Mr. Zecchini said. It was good to hear that the Korean authorities were liberalizing their financial markets. However, there appeared to be an inconsistency between the deregulation of interest rates and the introduction of selective credit ceilings. Such a move suggested that the authorities believed that, in a fully liberalized system, large business firms would still show a tendency to borrow beyond what could be considered optimal levels.

The authorities' decision to abandon the dollar as a peg for the won and to pursue a policy of stable real exchange rates had been a favorable shift, Mr. Zecchini noted. There was still a problem in the short-term capital component of the balance of payments and also--probably related--in the errors and omissions item. There appeared to be some inconsistency between a persistent outflow of short-term capital and the decline in the velocity of circulation, an indication that confidence in the currency was stronger. If the reason was an unfavorable interest rate differential, it should provide a further incentive to proceed toward deregulation.

Korea's margin for further access to Fund resources was relatively low and would become lower after the authorities had drawn under the proposed stand-by arrangement, Mr. Zecchini said in concluding. It was debatable whether there was a compelling need for Korea to resort to the Fund's financial assistance. The concept of balance of payments need was very flexible, and it was, of course, important to give the clearest signal to the financial community. The question was how best to give that signal. To use a medical analogy, with the recovery in Korea's economic health clearly discernible, if the Fund were to continue in its role as physician, that might be interpreted as a negative rather than a positive sign.

Mr. Clark remarked that his chair had also been stressing for several years the continuous use by Korea of Fund resources. The case for a new Fund-supported program would therefore have to be examined with care. The Korean authorities had achieved impressive adjustments over the past few years. There were certain concerns in fiscal policy, particularly the deficit of the Grain Management Fund. Specific plans should be adopted to bring buying and selling prices into better balance and to reduce the deficit. The overall deficit of the other public enterprises largely reflected capital spending. There might well be a case for generating a larger proportion of that investment spending from internal funds. The authorities should maintain their commitment to pricing policies that would increase the current surplus of those public enterprises.

The liberalization of the financial sector was a welcome step, Mr. Clark commented. The development of Korea's financial sector had lagged behind that of the industrial sector. In terms of liabilities, the banking system was only about the same size as the nonbank sector. The authorities should allow for greater differentiation in bank lending rates in order to improve credit allocation and profitability. In that regard, the recent move to allow foreign branches access to the Bank of Korea's rediscount facility for export finance was a welcome move. Generally, foreign and local banks should be allowed to compete on more equal terms.

The authorities were relying on diversification within the heavy industrial, chemical, and electronics sectors as a means of increasing their share of world markets, Mr. Clark observed. It would be interesting to know whether they were considering plans to diversify into higher-technology industries. The increased policy emphasis on direct foreign investment would have beneficial consequences. Such structural shifts within the industrial sector might be particularly important in the light of the relatively poor export performance in the early part of 1985. It would be interesting to know whether that performance was attributable to slower growth in the United States or to some earlier erosion of competitiveness.

Korea's short-term debt was relatively high, with about three fourths of it related to trade financing, Mr. Clark remarked. It remained unclear whether that component of the short-term debt was a relatively stabilizing feature or not.

One could not help being concerned about Korea's continued use of Fund resources at a time when the external position and indeed the economy as a whole were well set on a viable path, Mr. Clark went on. Of course, the extent of Korea's demand on the international capital markets left the country exposed to shifts in confidence, and, if the Fund were to withdraw its support, there could be a risk of adverse reaction. Nevertheless, perhaps Fund support could be equally well provided by other means, through either a classical stand-by arrangement or enhanced surveillance. The present case approximated a model of the circumstances in which enhanced surveillance might be appropriate--namely, a country that had pursued Fund programs for a number of years and had substantially adjusted its economy but that would benefit from further support in order to assure access to the international capital markets. There was little way of knowing from the staff report to what extent the Korean authorities had been encouraged to consider those alternatives. That Korea had used Fund resources to its benefit was only a necessary but not a sufficient condition for further access to them.

Korea's GNP had grown rapidly over the past few years, Mr. Clark said in concluding, not surprisingly, such high growth had been associated with current account deficits and a need for external finance. The current account deficit had arisen not so much from a short-term imbalance but rather as a reflection of longer-term development need for capital. If it were seen in that light, there would be further reason to question the Fund's continued support.

Mr. Lundstrom remarked that the authorities were to be commended for their remarkable achievement with respect to developments in all major economic areas. GNP growth was running at high rates, inflation was low, there were modest current account and public sector deficits: overall economic performance was favorable, compared with most other economies. Moreover, the prospects were for further improvements in the economic position. Despite a relatively large external debt, Korea accordingly enjoyed a high credit standing in the international financial markets and had had uninterrupted access to them.

Like other Directors, he fully understood the potential threat posed by the large external debt of Korea, Mr. Lundstrom said. However, the maturity structure of Korea's debt had improved significantly. Short-term debt stood at only 25 percent of total debt; gross reserves were equal to about 74 percent of total short-term debt. Thus, given Korea's high credit rating and comfortable balance of payments position, it would seem to have little need for short-term balance of payments support from the Fund.

The staff report contained a proposal for a stand-by arrangement in an amount equivalent to 61 percent of quota, on the ground that "Korea needs to ensure that financial markets perceive clearly the quality of its policy for maintaining creditworthiness," Mr. Lundstrom continued. In previous stand-by arrangements, the catalytic argument had been put forward as a justification for relatively low access to Fund resources, but 61 percent of quota did not appear relatively modest. In several countries, in which the Fund's role had been primarily catalytic, access had been significantly lower despite severe economic difficulties and a compelling need for external financing. Some reassurance on the even-handedness of the Fund's treatment in the present case would be helpful. He was prepared to go along with the proposed decision if it gained overall support.

Mr. Ercel stated that he supported the request of the Korean authorities for a new stand-by arrangement. Through their policies, the Korean authorities had achieved a higher growth rate, a lower unemployment rate, and an exceptionally better price structure and export performance than other developing countries. The performance of the public sector; the growth of aggregate demand due to an increase, in almost equal proportions, of consumption, exports, and investments; a slower rise in unit labor costs; and gains in productivity in the manufacturing sector had all been important factors in the achievement of the positive outcome.

The area of concern in the medium term was the magnitude and composition of the external debt, Mr. Ercel remarked. Although Korea's debt obligations were consistent with its ability to pay, there was a need to accelerate the reallocation of resources from the domestic economy to the external sector in order to reduce the projected requirement of new external borrowings of about $6-9 billion per annum through 1990. The authorities could meet that need through a reduction in the growth rate and greater emphasis on direct foreign investment. With that strategy, they could achieve the transfer of resources to the balance of payments within a shorter period than currently predicted.

Important steps had been taken toward liberalizing the financial sector, Mr. Ercel continued. Measures such as the gradual elimination of officially administered interest rates and the implementation of institutional changes would help to increase the efficiency of financial markets and improve the management of the economy. The resources necessary to meet the credit needs of the small and medium-size enterprises could be provided by interest rate adjustments and reform of the financial sector. Those steps would also help to reduce the share of the informal financial sector. Further steps to enhance the role of market forces in interest rate determination and to reduce the role of Government in credit allocation would be appropriate. However, the problem of corporate indebtedness, which had emerged during the 1980-82 recession, would be difficult to resolve through liberalization. In that regard, equity market development might be an extremely powerful palliative.

In concluding, Mr. Ercel said that he agreed with the views of Mr. Zecchini and Mr. Clark on the issue of future relations between Korea and the Fund.

Mr. Alhaimus stated that the authorities were to be commended for the maintenance of high growth and moderate inflation, coupled with further improvements in the fiscal balance and money aggregates. Difficulties had been encountered, however, in the external sector. The loss of competitiveness due to exchange rate developments, lower exports and remittances from construction activities in Middle Eastern countries due to weaker oil prices and lower oil revenues, together with continued protectionist measures in industrial countries against Korea's exports, had contributed to the weakness of the external balance. In the circumstances, it was appropriate that the authorities focus on the prospects of further external adjustment, while sustaining high rates of output growth with price stability. Korea's external debt situation, though still manageable, allowed no room for complacency and called for particular emphases on the mobilization of domestic resources. Overall, the program appeared to include policies that reflected those priorities.

Restraint should be maintained in fiscal policy, Mr. Alhaimus continued. The 1985 budget provided only for a slight increase in the consolidated public sector deficit, due to understandable measures on the revenue side to support the export sector and restore the profit margins of oil refineries. Some scope for central government savings still existed through a reduction of the burden on the budget of the Grain Management Fund. However, although it had to be acknowledged that the nonfinancial public enterprises had a large current surplus, they had scope to reduce their foreign borrowing.

The recent deterioration in the external current account balance should provide the authorities with an added impetus to take measures to restore competitiveness, Mr. Alhaimus remarked. The shift in the exchange rate had made a positive contribution. However, Korean efforts to improve the external position would remain constrained by protectionist measures adopted in industrialized countries. In the medium term, given the persistence of large borrowing requirements in the period ahead, economic strategy should stress a prompter attainment of the external balance. Otherwise, Korea would remain vulnerable to the hazards of international capital markets.

He supported Korea's request for a stand-by arrangement, Mr. Alhaimus said, and he welcomed the authorities' intention to refrain from drawing under the arrangement if the balance of payments performance were better than expected.

The staff representative from the Asian Department said that the statement in the staff report that Korea's policies were not overly cautious was meant as a positive assessment that justified the Korean authorities' attempt to approach approximate external balance within the program period. It was not therefore the staff view that the present external position was unsustainable. The existing external gap would certainly be financeable in the period ahead. However, some major international banks did not seem to want to increase their exposure at a rapid rate, not because of the country's creditworthiness but because of the weight of Korea's debt in their portfolios. The Korean authorities intended to prevent their annual net borrowing requirements from rising, but, even if some increase came about, Executive Directors should not conclude that it could not be financed.

Errors and omissions did not appear large on the scale of total current transactions in Korea's balance of payments that were projected to be about $76 billion in 1985, the staff representative observed. However, errors and omissions had remained negative for some time, and the Korean authorities had set up a special commission which had studied to what extent the errors and omissions reflected current or capital account transactions; the issue had not yet been resolved. The reduction of short-term debt accounted for a fairly large part of short-term capital outflows in 1984, although precise information was unavailable, as the decline in debt above the line was of a commercial character and below the line of a monetary character.

With respect to the Central Government's funding of local governments, it should be noted that the latter's revenue bases were relatively weak in Korea, the staff representative stated. They had depended both directly and indirectly on funds from the Central Government. The issue of how to reduce that dependence, and the linkage it might have with private sector activities, would be dealt by the authorities within a medium-term context; in that respect, the Korean authorities had sought the technical assistance of the Fund. A recent staff mission to Korea had suggested ways in which grants from the Central Government to local governments could be reduced. The authorities were also exploring various ways of raising new revenues at the local government level. Local governments were not included in the definition of the consolidated public sector. Therefore, a net intergovernmental transfer would still show up as an increase in the consolidated deficit. At the same time, access by the private sector to credit, consistent with the monetary program, would not be reduced.

The ratio of bank deposits to other economic variables, such as GNP, indicated that perhaps the commercial banking sector in Korea was fairly small by international standards, the staff representative noted. It was much smaller than it had been in Japan, for example, when that country was at a stage of development with a per capita income similar to that of Korea. A major issue was how to strengthen the framework of the financial sector to improve resource mobilization. The initial approach to deregulation of the financial sector might have been a bit unbalanced, in that the instruments of nonbanking financial intermediaries had been permitted to become relatively more attractive than those of the commercial banking system. In 1984, rapid growth had occurred in the assets and liabilities of the nonbank financial intermediaries, while the commercial banking system had grown more slowly. That imbalance had been partially redressed and the commercial banks were allowed to offer new instruments, such as trust accounts, to the public. A significant increase in the rate of interest on household savings accounts also had been permitted. There had also been an increase in the interest that could be paid on commercial bank certificates of deposit. Accordingly, the monetary liabilities of the commercial banking system recently had been growing at a more rapid rate, whereas the growth rate of the nonbanking financial intermediaries had slowed somewhat.

Korean firms had recently started to use bond issues as a way to raise funds, the staff representative from the Asian Department commented. Commercial paper had been an important financing vehicle in recent years, except in areas where the authorities had taken prudential measures that limited issues in relation to a bank's capital. By contrast, the securities market had lagged behind. Until recently, the possibility of foreign participation in that market had been limited, but the Koreans had permitted up to $200 million of portfolio investment funds to be invested from abroad in 1985. The authorities were moving ahead steadily with plans to modernize the financial sector in Korea.

The Deputy Director of the Exchange and Trade Relations Department explained that, in general, the combination of a deficit in the current account and a relatively high external debt in a setting of uncertain access to capital markets indicated the existence of a balance of payments need. While technically there was no question that Korea had such a balance of payments need, a measure of judgment always had to be exercised because various definitions were possible for the concept of balance of payments need. In the specific case of Korea, its high foreign indebtedness had been an important factor in the staff's assessment of its need to use Fund resources. The commitment of Fund resources was nevertheless smaller for Korea than for other countries. With few exceptions, all arrangements approved since January 1984 had been for more than 40 percent of quota on an annual basis. Korea's annual access had been equivalent to under 40 percent, as the total amount of the arrangement was for the equivalent of 61 percent of quota over a period of about 20 months.

On the question of prolonged use of Fund resources, only three countries had had a greater number of annual programs over the past decade, the Deputy Director said. Of the countries for which arrangements had been approved since January 1984, 14 members had had five or more annual programs during the previous ten years; Korea and another country had had six; three countries had had seven; and nine countries had had five programs. Excluding special facilities, the highest outstanding use of Fund resources as of May 1985 had amounted to 374 percent of quota. Korea's use of 239 percent of quota had been at the median, and it had also been close to the average use of those countries. If access to special facilities was included, Korea's use, at 324 percent of quota, would be above both the median and the average of the 14-country group. At end-May 1985, the highest total use of Fund credit in the group had been 445 percent of quota, with the median at 297 percent of quota and average use at 288 percent of quota.

The relative smallness of Korea's quota also should be taken into consideration, the Deputy Director noted. The member with the largest outstanding use of resources--including special facilities--owed the Fund the equivalent of 90 percent of its export receipts. Korea's outstanding use of Fund resources was the lowest by that measure, amounting to only 6 percent of exports, a proportion that provided a good indication of the relative smallness of its quota.

Not all countries that used Fund resources for a long time should be considered similar to those characterized as prolonged users of Fund resources, the Deputy Director added. The concept of prolonged use was related mainly to those countries experiencing adjustment problems, rather than to those countries in which it was generally agreed that the adjustment process was proceeding smoothly and conformed to the conditions that characterized a series of successful Fund-supported programs. Korea had had arrangements of the so-called classical type under which it had made no drawings. Thus, it would seem improper to place Korea in the category of prolonged users of Fund resources. During the discussion in the Executive Board on prolonged use, the Chairman had mentioned in his concluding remarks that "Directors generally agreed that it would not be appropriate at the present time to introduce strict rules limiting access based on the number of consecutive programs for which a member had received support from the Fund or on the period of its outstanding liabilities to the institution." The idea was to consider the issue of prolonged use on a case-by-case basis and on the merits of a particular country's policies.

There was only one type of stand-by arrangement, the Deputy Director stated; a stand-by arrangement was an instrument that defined the terms and conditions under which a country would be entitled to use Fund resources. When a member met those terms and conditions, it was free to use or not to use the Fund resources to which it was thus entitled. When in those circumstances a member chose not to draw on the Fund, its arrangement was termed classical as opposed to a so-called regular stand-by arrangement under which drawings were made. It would be disturbing, however, if that distinction were interpreted as implying that attached to some arrangements there was an additional condition that would prevent drawings from being made even when the terms of the arrangement were observed. Viewed in a symmetrical fashion, such an interpretation could be construed as allowing a country to make drawings only when its balance of payments turned out to be worse than expected in the arrangement. It was to the credit of the country when it did not draw on the Fund because its economic performance had improved; the obverse was not true.

Several Executive Directors had raised the question whether enhanced surveillance would have been a better instrument than a stand-by arrangement as a vehicle for Korea's current relationship with the Fund, the Deputy Director stated. Enhanced surveillance should be specifically requested by the debtor. Korea, however, had requested a stand-by arrangement and it was normal to accept the request given that there was a balance of payments need, since the country was undertaking an adjustment program with a set of policies of which the Fund approved. The stronger degree of Fund involvement in a member with an arrangement was appropriate for Korea.

In many respects, the issue for Korea was one of international reserve management, the Deputy Director of the Exchange and Trade Relations Department said in concluding. Korea's international reserve position in the Fund was a relevant factor in this context. To the extent that Korea repurchased on a net basis as envisaged in the period of the stand-by arrangement, it would be improving its reserve position in general and more particularly its reserve position in the Fund. The authorities had had those considerations in mind when they had indicated that they would not draw under the stand-by arrangement if their balance of payments position improved.

Mr. Rye noted that the Korean authorities regarded the higher savings ratios achieved recently as being more suitable to the country's circumstances than the low 20 percent ratio recorded at the beginning of the 1980s.

One reason for the rise in net domestic assets of the banking system had been the provision of substantial financial support to the troubled sectors of construction and shipping, Mr. Rye continued, support that had been directed at restructuring those industries. Such financing would be a cause for concern only if it had unwanted macroeffects, which the authorities were committed to preventing by using a wide range of instruments.

Korea was going through a period in which it was proving extremely difficult to export, despite its strong export tradition, Mr. Rye observed. He would not repeat his views on the authorities' decision to use the Fund's resources at such a difficult juncture.

As to enhanced surveillance, it would be altogether wrong for the Fund to impose a solution on countries that they did not consider appropriate in their circumstances, Mr. Rye stated. If the international banking community were able to differentiate more objectively the economic performance of high-debt countries, a stronger case in general could be made for enhanced surveillance arrangements rather than stand-by arrangements. In the absence of such rational behavior, Korea deserved the benefit of the doubt.

Mr. Dallara remarked that even though the Fund's quota system was imperfect, with quotas not always fully reflecting the realities of a member's economic situation in the periods between quota reviews, it was the basis on which the institution operated.

The interpretation of prolonged use as applying to countries that had made extensive use of Fund resources but had failed to adjust, suggested that consistently good performance over a period of time, supported by the Fund, would not require the country to give up reliance on Fund resources at some point in time, Mr. Dallara said. The fundamental issue was whether it was possible to reconcile continuous use of Fund resources with the temporary character of Fund financing.

The Deputy Director of the Exchange and Trade Relations Department noted that the proximate determinant of Fund access would always be balance of payments need, combined with the appropriateness of the policies that the authorities were prepared to pursue. If the adjustment process continued on track, the balance of payments should improve to the extent that there would no longer be a balance of payments need. Thereafter, the member would be making repurchases on schedule, and the temporary nature of the use of Fund resources would be assured, as would ultimately the restoration of a country's position vis-à-vis the Fund to some extent during the period of the arrangement. If the balance of payments position continued to improve, Korea would continue to repurchase and the question of its access would no longer arise.

The general experience was that members were reluctant to enter into stand-by arrangements because of the conditionality attached to them in the form of adjustment measures, the Deputy Director of the Exchange and Trade Relations Department said in concluding. It was unlikely that many countries would come voluntarily to the Fund and not only be prepared to subject themselves to stringent conditionality but also be reluctant to relinquish such conditionality.

The Chairman remarked that the vulnerability of Korea's external position should not be underestimated. It would be recalled that not many years before, the financial community had had serious fears that the deterioration in the external accounts of the Philippines and of Korea might have a domino effect in Southeast Asia. Together with events in other parts of the world, the consequences for the system might have been grave. Korea's external debt in relation to GDP--at 53 percent--was very high, even compared with that of Latin American countries. Korea therefore needed to ensure that it retained access to commercial markets, which was why the authorities had requested a stand-by arrangement.

The need for a serious adjustment program in Korea was incontrovertible, the Chairman stated. Korea had based its economic growth on the export sector, a difficult policy to maintain at a time when protectionism was looming everywhere and when the U.S. economy would no longer be providing an expansionary boost to the world economy. The first few months of 1985 had shown that life would not be easy for Korean exporters. Korea would have to make a serious effort to increase domestic resource mobilization, perhaps at the expense of slower domestic growth.

It was legitimate to ask whether Korea could dispense with the continued use of Fund resources, the Chairman said. The answer was largely a matter of judgment. The incontestable existence of a technical balance of payments need, the exemplary quality of the country's track record, and the importance to Korea of persevering with the adjustment effort would make it difficult to deny the member access to Fund resources.

There were inherent risks in the mechanistic application of rules on access to Fund resources, the Chairman continued. First, the Fund should be very careful not to give the signal that it was limiting its financial intervention to countries that no longer had access to capital markets. It would be unfortunate if the Fund were perceived as a source of financing only for countries in extremis, especially for an institution with a broad geographic base. He noted, in that connection, the often mentioned regret that countries needing to adjust but having access to international capital markets did not resort to the Fund. The Fund had to be in a position to provide services to countries that had performed well in the past and that were in a position to restore balance to their external accounts in a rather short time. There were few members like Korea that had the prospect of regaining balance of payments equilibrium by 1986, even after a period of prolonged use of Fund resources.

The opposite danger, which staff and management assiduously avoided, was that a country might be given a continuous right to use Fund resources provided that it had a balance of payments need and a satisfactory track record, the Chairman commented. The quality of the adjustment carried out in the past, supported by use of Fund resources, was an important criterion but not the only one; nor was it a sufficient reason to provide those resources indefinitely. Therefore, he welcomed the Korean authorities' statement that they would exercise self-restraint in drawing under the stand-by arrangement, which would be important for Korea's credit standing. Without in any way wishing to impose restrictions on the use of Fund resources under the proposed stand-by arrangement, contingent on the performance of the external accounts, the clear view of the Executive Board was that restraint should color the authorities' actions. It would thus be helpful if Korea did not make full use of the resources being made available under the stand-by arrangement. That would avoid the difficulty underlined by Mr. Rye that a country should not be placed in such a position that its use of Fund resources was interpreted as an automatic indication of unsatisfactory developments.

The Chairman then made the following summing up:

Executive Directors were generally in agreement with the thrust of the views expressed in the staff report for the 1985 Article IV consultation with Korea and supported its request for a stand-by arrangement. They commended the Korean authorities for their decisive economic management, which had yielded impressive results in the economy again in 1984. Korea's strong adjustment measures included a further reduction in the public sector deficit, upward adjustments in domestic interest rates along with other measures to liberalize the operations of the financial sector, deceleration of domestic credit expansion, and flexible management of the exchange rate. Those policies, together with growing export markets, had helped to yield a marked increase in the domestic savings ratio, continued rapid growth, substantial increases in household incomes, the virtual absence of inflation, and a further reduction in the external deficit. Directors noted that external conditions were less favorable to Korea in recent months than a year ago, as reflected in a slowing of export growth and less buoyant domestic economic conditions.

Directors observed that the policy stance--continued demand restraint combined with a real effective depreciation of the exchange rate--was appropriate in Korea's circumstances and reflected the priority given to attainment of external objectives. They endorsed the Government's decision not to use a countercyclical fiscal policy to offset the recent slower pace of expansion in GNP and exports. Directors considered that the policies, embodied in the Government's adjustment program for 1985, were well designed to achieve a further strengthening of the external accounts, while keeping Korea along a noninflationary growth path, and therefore warranted the Fund's support. Directors emphasized the need for strict fiscal discipline and monetary restraint in the period ahead, especially given that the challenge in achieving the program's external objectives was greater than might have been assumed earlier in the year. They welcomed the commitment to more flexible pricing policies for public services. They encouraged the authorities to limit the deficit of the Grain Management Fund by resisting pressures to raise the purchase price of rice, to enlarge the role of the private sector in grain marketing, and to consider additional measures to strengthen the savings of the nonfinancial public enterprises. Concern was expressed regarding the recent extension of substantial financial support to the troubled sectors of construction and shipping.

Directors commended the Korean authorities for the sustained implementation of their import liberalization and tariff reform program at a time when Korea's export growth had slowed, in part due to an intensification of protectionism abroad. In that context, they welcomed the authorities' intention to pursue an exchange rate policy that would support the balance of payments objective and allow for continued import liberalization. Directors also welcomed the steps in 1984-85 toward financial sector liberalization, in particular measures to deregulate interest rates and make them more subject to market forces. They urged the authorities to proceed further in that direction--possibly at an accelerated pace--and to ensure that appropriate, complementary adjustments were made in the Central Bank's lending and rediscount rates, as well as to reduce Central Bank rediscounting of subsidized bank credit.

Directors observed that Korea's overall level of external debt was high, but remained within the country's debt-servicing capacity. They welcomed the authorities' intention to further slow the rate of debt accumulation in 1985-86. They commended the authorities for the marked reduction in short-term debt which had both lengthened the maturity profile and, together with an increase in international reserves, had reduced Korea's vulnerability to possible shifts in market sentiment. They welcomed the authorities' aim to improve further the maturity profile of debt in the period ahead. In order to maintain effective creditworthiness, Korea needed to ensure that financial markets clearly perceived the quality of its policies.

The recent measures to expand the scope for foreign direct investment in Korea, and the intention to proceed further in that area were welcomed by a number of Directors. Such capital could usefully play a larger role in the Korean economy, and ease the burden of external debt management.

Given the size of Korea's external debt, the apparent limitation on the availability of longer-term market finance, the need to maintain a prudent international reserve position, and the medium-term balance of payments outlook, Directors endorsed the cautious strategy of the Korean authorities to achieve approximate external current account balance by the latter part of 1986. They therefore welcomed the continuing emphasis given to enhancing the domestic savings effort through financial sector reform, restraint on current public expenditure, and review of the investment plans and pricing policies of public enterprises.

A number of Directors expressed the view that, in the light of the marked degree of external adjustment already achieved with the Fund's support and Korea's access to international financial markets, and given the prolonged use by Korea of Fund resources in the past years, the present stand-by arrangement should be viewed as essentially precautionary in character. Many Directors welcomed the indication on the part of the Korean authorities to refrain from making use of Fund resources if balance of payments developments should turn out to be significantly better than expected.

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

The Executive Board took the following decision:

Decision Concluding 1985 Article XIV Consultation

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

2. The existing restrictions on payments and transfers for current international transactions are maintained by Korea in accordance with Article XIV. The Fund welcomes the progressive liberalizations by Korea of restrictions on payments for current international transactions and encourages the authorities in their determination to remove remaining restrictions as Korea's external position improves.

Decision No. 8026-(85/105), adopted
July 12, 1985

Stand-By Arrangement

1. The Government of the Republic of Korea has requested a stand-by arrangement for the period July 12, 1985 to March 10, 1987 for an amount equivalent to SDR 280 million.

2. The Fund approves the stand-by arrangement set forth in EBS/85/151, Supplement 2.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 8027-(85/105), adopted
July 12, 1985

4. TONGA - MEMBERSHIP - REPORT OF COMMITTEE

The Executive Directors considered a report by the Chairman of the Committee on Membership for Kiribati and Tonga and a proposed decision recommending the submission of a draft resolution to admit Tonga as a member to the Board of Governors for vote by mail. (EBD/85/166, 7/5/85)

Mr. Leonard, Acting Chairman of the Committee, noted that in the final paragraph of its report, the Committee had drawn attention to inconsistencies in the structure of the quotas of small countries and had asked the staff to re-examine in due course the position of small-quota countries in the Fund.

The Executive Board then approved the following decision:

1. The Board of Governors is requested to vote without meeting pursuant to Section 13 of the By-Laws of the Fund upon the attached draft Resolution.

2. The Secretary is directed to send the attached report and draft Resolution on Membership for the Kingdom of Tonga to each member of the Fund by rapid means of communication on or before July 15, 1985.

3. To be valid, votes must be cast by Governors or Alternate Governors and must be received at the seat of the Fund before 6:00 p.m., August 12, 1985. Votes received after that time will not be counted.

4. The effective date of the Resolution of the Board of Governors shall be the last day allowed for voting.

5. All votes cast pursuant to this decision shall be held in the custody of the Secretary until counted, and all proceedings with respect thereto shall be confidential until the Executive Board determines the result of the vote.

6. The Secretary is authorized to take such further action as he shall deem appropriate in order to carry out the purpose of this decision.

Decision No. 8028-(85/105), adopted
July 12, 1985

REPORT BY THE EXECUTIVE BOARD

MEMBERSHIP FOR TONGA

The Government of the Kingdom of Tonga applied on January 16, 1985 for admission to membership in the International Monetary Fund in accordance with Section 2 of Article II of the Articles of Agreement of the Fund; and, pursuant to Section 21 of the By-Laws, the Executive Board has consulted with the representative of that Government and has agreed upon the terms and conditions which, in the opinion of the Executive Board, the Board of Governors may wish to prescribe for admitting Tonga to membership in the Fund.

The Executive Board has therefore approved the attached Resolution for submission to the Board of Governors for a vote without meeting pursuant to Section 13 of the By-Laws.

DRAFT RESOLUTION

MEMBERSHIP FOR TONGA

WHEREAS, the Kingdom of Tonga on January 16, 1985 requested admission to membership in the International Monetary Fund in accordance with Section 2 of Article II of the Articles of Agreement of the Fund;

WHEREAS, pursuant to Section 21 of the By-Laws of the Fund, the Executive Board has consulted with the representative of Tonga and has agreed upon the terms and conditions which, in the opinion of the Executive Board, the Board of Governors may wish to prescribe for admitting Tonga to membership in the Fund;

NOW, THEREFORE, the Board of Governors, having considered the recommendations of the Executive Board, hereby resolves that the terms and conditions upon which Tonga shall be admitted to membership in the Fund shall be as follows:

1. Definitions: As used in this Resolution:

(a) The term "Fund" means the International Monetary Fund;

(b) The term "Articles" means the Articles of Agreement of the International Monetary Fund, as amended;

(c) The term "SDR" means the special drawing right.

2. Quota: The quota of Tonga shall be SDR 3.25 million.

3. Payment of Subscription: The subscription of Tonga shall be equal to its quota. Tonga shall pay 22.7 percent of its subscription in SDRs or in the currencies of other members selected by the Managing Director from those currencies that the Fund would receive in accordance with the operational budget in effect at the time of payment. The balance of the subscription shall be paid in the currency of Tonga.

4. Timing of Payment of Subscription: Tonga shall pay its subscription within six months after accepting membership in the Fund.

5. Exchange Transactions with the Fund and Remuneration: Tonga may not engage in transactions under Article V, Section 3, or receive remuneration under Article V, Section 9, until its subscription has been paid in full.

6. Exchange Arrangements: Within 30 days after accepting membership in the Fund, Tonga shall notify the Fund of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1 of the Articles.

7. Representation and Information: Before accepting membership in the Fund, Tonga shall represent to the Fund that it has taken all action necessary to sign and deposit the Instrument of Acceptance and sign the Articles as contemplated by paragraph 8(a) and 8(b) of this Resolution, and Tonga shall furnish to the Fund such information in respect of such action as the Fund may request.

8. Effective Date of Membership: After the Fund shall have informed the Government of the United States of America that Tonga has complied with the conditions set forth in paragraph 7 of this Resolution, Tonga shall become a member of the Fund on the date when Tonga shall have complied with the following requirements:

(a) Tonga shall deposit with the Government of the United States of America an instrument stating that it accepts in accordance with its law the Articles and all the terms and conditions prescribed in this Resolution, and that it has taken all steps necessary to enable it to carry out all its obligations under the Articles and this Resolution; and

(b) Tonga shall sign the original copy of the Articles held in the Archives of the Government of the United States of America.

9. Period for Acceptance of Membership: Tonga may accept membership in the Fund pursuant to this Resolution not later than six months after the effective date of this Resolution, which date shall be the date of its adoption by the Board of Governors; provided, however, that, if the circumstances of Tonga are deemed by the Executive Board to warrant an extension of the period during which Tonga may accept membership pursuant to this Resolution, the Executive Board may extend such period until such later date as it may determine.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/104 (7/8/85) and EBM/85/105 (7/12/85).

5. SPECIAL DISBURSEMENT ACCOUNT - TRANSITIONAL INVESTMENT OF BALANCES WITH FEDERAL RESERVE BANK OF NEW YORK

Pending placement in SDR-denominated investments with the Bank for International Settlements in accordance with Executive Board Decision No. 7990-(85/81), adopted May 28, 1985, the Managing Director is hereby authorized to invest with the Federal Reserve Bank of New York the U.S. dollars held by the Special Disbursement Account. (EBS/85/164, 7/3/85)

Decision No. 8029-(85/105), adopted
July 11, 1985

6. EXECUTIVE DIRECTORS - BENEFITS POLICIES - EXTENSION OF ADJUSTMENTS

The Executive Board approves the recommendation to extend to Executive Directors the adjustments in the education allowance policy and in the benefits travel policy and procedures as set forth in EBAP/85/178 (7/8/85).

Adopted July 10, 1985

7. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 84/143 through 84/146 are approved. (EBD/85/164, 7/3/85)

Adopted July 10, 1985

b. The minutes of Executive Board Meeting 85/147 are approved. (EBD/85/165, 7/5/85)

Adopted July 11, 1985

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/175 (7/5/85) and EBAP/85/180 (7/10/85) and by Assistants to Executive Directors as set forth in EBAP/85/176 (7/5/85) and EBAP/85/179 (7/9/85) is approved.

APPROVED: April 9, 1986

LEO VAN HOUTVEN
Secretary