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Minutes of Executive Board Meeting 85/187

10:00 a.m., December 27, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
	D. C. Templeman, Temporary
	M. Lundsager, Temporary
	G. Ercel, Temporary
	S. de Forges
M. Finaish	
H. Fujino	M. Sugita
	B. Goos
Huang F.	
J. E. Ismael	
	H. A. Arias
	M. Foot
	O. Isleifsson, Temporary
	G. D. Hodgson, Temporary
	A. Abdallah
	P. E. Archibong, Temporary
	C. A. Salinas, Temporary
	J. E. Suraisry
	E. M. Taha, Temporary
	G. Ortiz
	J. de la Herrán, Temporary
	J. de Beaufort Wijnholds
	A. V. Romuáldez
	A. A. Agah, Temporary
	A. Vasudevan, Temporary
	N. Coumbis

A. Wright, Acting Secretary
S. L. Yeager, Assistant

Also Present

IBRD: F. Jaspersen, Latin America and Caribbean Regional Office. African Department: G. E. Gondwe, Deputy Director; J. Artus, J. M. Jiménez, J. D. Simpson. Exchange and Trade Relations Department: M. Guitián, Deputy Director. Fiscal Affairs Department: J. R. Modi. Legal Department: S. A. Silard. Treasurer's Department: J. E. Blalock, B. Von Numers. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; C. M. de Rosa, R. A. Elson, S. Umana. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: G. R. Castellanos, M. Chatah. Assistants to Executive Directors: J. R. N. Almeida, R. Fox, N. Haque, Z. b. Ismail, H. Kobayashi, A. Mustafa, W. K. Parmena, V. Rousset, M. Sarenac, L. Tornetta.

1. KOREA - STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION OF PERFORMANCE CRITERIA

The Executive Directors considered a staff report for the first review under the stand-by arrangement with Korea together with a request for modification of performance criteria (EBS/85/271, 12/9/85; and Cor. 1, 12/23/85).

Mr. Romuâldez made the following statement:

> In spite of unfavorable external developments, much more severe than anticipated at the time when the adjustment program was first presented to the Board (EBM/85/105, 7/12/85), the Korean economy has performed relatively well in 1985. Real GNP is expected to grow by 5 percent, with output in the latter half of the year picking up, though well below the 7.5 percent projected at the beginning of 1985. Consumer prices are being contained at a 3 percent rate of increase. The external current account deficit is being reduced further.
>
> As the staff has affirmed, my Korean authorities have been able to maintain the fundamental policy commitments made in connection with the stand-by program. The fiscal deficit is expected to be within the program target. Exchange rate policy continues to be pursued flexibly. The maturity profile of external debt has been improved. Trade liberalization and financial deregulation have been implemented.
>
> Adverse external developments, however, particularly the greater than anticipated slowdown in the U.S. economy, increased protectionist pressures, and severe cutbacks in construction activity in the Middle East, have enormously hurt Korea's exports. Some sluggishness in economic growth has resulted, and current account receipts have suffered an aggregate shortfall amounting to about $3.5 billion, equivalent to more than 4 percent of GNP. Unexpected repayments of the external debt of foreign subsidiaries of Korean companies have moreover complicated the management of the balance of payments and external debt; inevitably both domestic credit needs and foreign borrowing requirements have had to be expanded. In the light of these developments, a modification of performance criteria for end-December net domestic assets of the banking system and overall external debt is being requested.
>
> Furthermore, on the domestic front, the financial reform of April 1985 has induced a marked acceleration in the growth of broad money and other bank liabilities much to the detriment of nonbank financial intermediaries. Even while recognizing the desirability of this development, my authorities stress that it was a major factor in the increase of the domestic assets of the banking system beyond the program ceiling.

In responding to these adverse developments in their international economic environment and to the unfavorable, mixed in with the favorable, results of their efforts toward financial system reform, my Korean authorities adopted a series of policy measures, including a supplementary budget, to stimulate exports and investment. They felt that a sharp tightening of credit in the short term could put at serious risk the prospects for economic recovery while bringing about only a limited favorable impact on the balance of payments in the short run. They believed that, had credit to the private sector been reduced to fall under the net domestic assets (NDA) ceiling, a substantial shortage of domestic liquidity would have occurred, and more and greater difficulties would have been added to the reorganization process of the financially troubled industries. They do recognize, nevertheless, that the rate of domestic credit expansion should be slowed down significantly if the deterioration of the net foreign asset position is to be arrested and price stability preserved. Indeed, they would assure Directors that structural adjustment will not be sacrificed for shorter-term gains.

My Korean authorities would like to stress that external debt management has also been hampered by the unexpected repayment of the foreign debt of overseas subsidiaries. These transactions, necessary to safeguard Korea's creditworthiness in the international financial markets, were made by Korean parent companies through domestic bank credit extension and foreign borrowing.

Preliminary data for October 1985 indicate that the recovery in economic activity continued during the third quarter. Seasonally adjusted manufacturing rose by 5.2 percent over figures for figures for the same month a year previously. If trade trends continue throught the remainder of the year, my authorities are convinced that a 5 percent growth in real GNP for 1985 is within reach. Some acceleration in consumer price increases to 3.2 percent in November from 2.6 percent in October--over the same month last year--partly reflects upward adjustments in public utility and transportation charges and, partly, the depreciation of the won. With domestic demand remaining soft and public and private wage increases limited to an average of 6 percent, a 3 percent rate of inflation remains a probability. Preliminary data for November show a current account deficit of $59 million, a figure substantially smaller than that registered in October, $203 million, and, for the first 11 months of 1985, a current account deficit of $1 billion, constituted a trade deficit of $0.3 billion and combined services and transfers deficit of $0.7 billion, with a net services deficit of $1.2 billion. In view of past trade records for December, it appears likely that the current account deficit for 1985 as a whole will be within the program target. With a surplus of $300 million in the overall balance of payments for November, the banking system was able to reduce its reserve-related external liabilities and to increase external reserves by a modest $46 million to $8.4 billion at end-November--3.8 months of merchandise imports--$200 million higher than at end-1984. The overall balance of payments deficit for the first 11 months of the year, however, widened to $2.1 billion.

The consolidated public sector position showed a surplus of W 679 billion during the first three quarters of 1985, compared with the W 203 billion surplus experienced during the comparable period in 1984. The fiscal surplus enabled the public sector to reduce its net liabilities to the banking system by W 661 billion, equivalent to 2.6 percent of broad money at the end of 1984.

Domestic bank credit, as measured by NDA, in October, on constant exchange rate basis, was W 382 billion below the September NDA. During the year ended November, the NDA growth rate was stable at 21 percent. The private sector credit growth slowed slightly to 18.5 percent from 18.9 percent during the year ended October. The stable credit expansion during November was associated with an acceleration of broad money growth at an annual rate of 15.5 percent, from 14.2 percent in October, and with an improvement of $210 million in net foreign assets of the banking system between October and November.

Since March 1985, the won has been depreciated by 14 percent in real effective terms by end-November.

My Korean authorities announced on December 13, 1985 that the number of items subject to the interim system of emergency and adjustment tariffs are being reduced to 28 from the present 33, effective January 1, 1986 through June 30, 1986. From January through November 1985, foreign direct investment, on approval basis, amounted to $497 million, ahead of the 1985 target of $450 million. On a balance of payments basis, inflows of foreign direct investment for the first 11 months amounted to $203 million, compared with $150 million during the same period of 1984.

On December 14, 1985, my Korean authorities announced their economic management plan for 1986. The Table below summarizes the projections for the major macroeconomic indicators.

	1984	1985 (provisional)	1986 (projected)
		(In percent)	
GNP growth	7.5	5	7
GNP deflator	4.1	3.5	3.5
Wholesale price index	1.6	1	2-3
Consumer price index	2.4	3	3
		(In billions of U.S. dollars)	
Current account deficit	1.37	0.7-0.8	0

My authorities have stated that reducing the unemployment rate and improving the balance of payments would receive top policy emphasis in 1986. They have been quick to reaffirm nevertheless that the somewhat higher economic growth target does not imply a sacrifice of price stability. In order to rely less on foreign financing, my authorities have targeted a rise in the ratio of domestic savings to GNP from the 28 percent estimated for this year to 29 percent.

My Korean authorities remain committed to achieving program targets during the first half of 1986. They will continue to place the highest priority on the attainment of the external objectives, accompanied by a continuing low rate of inflation and a sustainable economic growth rate over the medium term. My authorities will continue to pursue the fiscal restraint policy they have followed in recent years. They will formulate monetary policies consistent with the guidelines pertaining to the net domestic assets of the banking system by further proceeding with the liberalization of the financial sector. Commercial banks should be able then to attract domestic savings and reduce the rate of expansion of bank credit to a level commensurate with resource flows. The authorities are determined to maintain a flexible exchange rate policy to ensure that the competitiveness of the export sector remains consistent with external objectives.

My Korean authorities will continue to improve the maturity structure of their external debt through cautious management of short-term debt. They hope to reduce the rate of growth of external debt by decreasing the external current account deficit. Because the repayment of the foreign debt of overseas subsidiaries constituted an important factor in the growth of external debt in 1985, my authorities will closely monitor further developments in this regard within the context of their broad policy objectives.

Finally, I should say that my Korean authorities are grateful to the management and staff for the flexibility and constructiveness with which they have appraised and discussed the difficulties which the Korean economy is facing. During the Annual Meetings in Seoul, the Korean authorities and the Fund management closely reviewed the economic situation. It was agreed then to send a Fund mission well in advance of originally planned schedules in order to minimize deviation from the stand-by arrangement program. My Korean authorities are in broad agreement with the thrust of the staff report.

Mr. Fujino recalled that during the Board discussion of the 1985 Article IV consultation with Korea and the request for a stand-by arrangement in July (EBM/85/105, 7/12/85), he had expressed his deep appreciation of the authorities' efforts to implement successfully their far-reaching adjustment policy. In his summing up, the Chairman had also noted that the Executive Directors "commended the Korean authorities for their decisive economic management, which had yielded impressive results in the economy...." Later, on the occasion of the Annual Meetings in Seoul, he had been impressed not only by the authorities' warm hospitality, but also by visible signs of their economic achievements, particularly the rising standard of living and an active and developing economy.

He generally supported the staff's view that under increasingly difficult circumstances, the Korean authorities had maintained the fundamental policy orientation of the program underlying the stand-by arrangement, and performance had been generally favorable, Mr. Fujino added. Fiscal policy had been kept tight in spite of the considerable weakening of domestic demand and economic activity, the exchange rate had been managed flexibly, and financial sector reform and the liberalization of imports and direct foreign investment had proceeded as scheduled.

Although further progress had been made in the adjustment effort, the external environment had proven even more unfavorable to Korea than had been foreseen at the beginning of the program, Mr. Fujino remarked. The adverse impact of the slowdown of the U.S. economy and the cutback of the construction programs in the Middle East had been severer than expected. As a result, export growth--an important element in Korea's overall economic growth--had slowed and was expected to fall to less than 2 percent in 1985, far below the program target of 12 percent. As a result, domestic demand and economic activity would weaken considerably. The staff had projected that real GNP would grow at a rate of 4.5 percent in 1985, the lowest rate since 1981; however, he took note of Mr. Romuáldez's statement that the authorities considered that a rate of 5 percent was attainable. Nonetheless, the external current account was expected to improve further owing to a reduction in import growth, and inflation had been kept well under control in spite of the depreciation of the won. The authorities' general adherence to the program guidelines and good performance on the external and inflation fronts under unfavorable circumstances were commendable.

Slippages had occurred with respect to the net domestic assets of the banking system and the overall external debt, Mr. Fujino observed. Those slippages were apparently related to and triggered by the assumption and repayment by resident Korean firms of the obligations of their overseas subsidiaries in an effort to maintain Korea's creditworthiness in international capital markets. To the extent that those operations led to a reduction in the overall external debt--including that of Korean overseas subsidiaries--the slippage with respect to the external debt of domestic entities was inevitable. Thus, the modification of the ceilings would not affect the basic thrust of the program. However, exceeding the target for net domestic assets of the banking system was more difficult to justify, as the excess credit expansion could have easily been absorbed by reducing credit to other sectors. In that regard, he noted that the annual rate of expansion of domestic credit for the financial system as a whole had been more moderate, increasing to 23 percent in October 1985.

The complexity of the financial reform might also have influenced the expansion of credit, and he was also aware of the authorities' concern about the sustainability of the economic recovery and the need to support it from the financial side, Mr. Fujino continued. Nevertheless, the rate of credit expansion was excessive, and he agreed with the staff that a prompt tightening of credit was warranted. He therefore welcomed the measures taken recently to slow the pace of bank credit expansion.

The relationship between the interest rate and credit expansion in monetary policy was intriguing, Mr. Fujino remarked. Real interest rates in Korea seemed to be sufficiently high, with an interest rate of 12 percent for a one-year saving deposits, a maximum rate of 13.5 percent for term lending, and an inflation rate of about 2-3 percent. Considering the high cost of money, he wondered how the expansion of domestic credit on the order of 18 percent had been sustained. Did that rate of expansion indicate the existence of still high inflationary expectations or a low effective lending rate compared with the announced rate?

The program for 1986 was formulated to continue the adjustment effort, Mr. Fujino observed. He broadly supported the main elements of the program, including a tight demand management policy, a flexible exchange rate policy, and further liberalization of the financial system and of imports and foreign investment. As he had stressed during the July discussion of the stand-by arrangement, the high level of Korea's external indebtedness was a source of concern. It was therefore appropriate that the authorities place the highest priority on external adjustment and on the management of the growth and maturity of external debt as well as on reducing unemployment.

In spite of the unfavorable external conditions, revised medium-term projections endorsed the attainment of a sustainable balance of payments position with reasonable GNP growth of 6-7 percent a year, Mr. Fujino continued. That achievement would, however, depend on the continuation of present policy efforts.

The problem of the overseas subsidiaries of Korean construction firms might be seen as a symptom of the vulnerability of Korea's external position, Mr. Fujino observed. While the overall level of external debt remained well within Korea's debt-servicing capacity, prudence called for a cautious debt management policy under the present circumstances. He therefore welcomed the reduction in the share of short-term debt and the general improvement in the debt profile. Further liberalization of foreign direct and portfolio investment would also contribute to easing the burden of external debt in the longer run. As for the increase in external debt for 1986, he tended to share the staff's view that it would be appropriate to aim at limiting the increase to below the authorities' preliminary estimate of about 6 percent. He therefore endorsed the ceiling set on external debt for the first half of 1986, which was consistent with the annual increase of 5 percent or less, and hoped that the ceiling for the second half of the year, which was to be set at the time of the second review, would not deviate from that trend.

He was uncertain about the appropriateness of the growth rate of net domestic assets in the banking system, Mr. Fujino commented. Even after taking into account the change in relative competitiveness between the banking sector and the nonbank financial institutions and also the downward trend in the velocity of money, the growth of net domestic assets by 14 percent in 1986 after an expansion of 23 percent in 1985 seemed to be on the high side. Indeed, the combined growth rate of net domestic assets in those two years would amount to some 40 percent, while that of nominal GNP over the same period was expected to be about 16 percent. In view of the importance of avoiding the resurgence of inflationary expectations, credit conditions should be monitored closely and further steps should be taken if necessary.

In concluding, he supported the proposed decision, Mr. Fujino remarked.

Mr. Suraisry stated that the performance of the Korean economy in 1985 had been mixed; inflation had been contained, the current account deficit had been reduced sharply, and the thrust of the program had been adhered to. However, the growth of real GNP had been revised downward from a projected 7 percent to 4 1/2 percent, a much lower growth rate than that achieved in 1984. While the revised rate could be considered high by the standard of many countries, in the case of Korea it was not. Because Korea was a heavily indebted country, a higher growth rate was needed to service the debt and further develop the economy's industrial base.

The primary reason for that downward revision in the output growth rate was export performance, Mr. Suraisry remarked. Exports were at present estimated to increase by only 1 1/2 percent in 1985 compared with the program estimate of 12.2 percent. While recognizing that projections were subject to many uncertainties, he wondered whether the factors that had led to a large deviation in such a short period could not have been envisaged when the program had been proposed less than six months earlier.

In 1986 exports were projected to grow by about 11 percent, Mr. Suraisry continued. However, recent forecasts, including those of the OECD and the GATT, foresaw slower growth in the industrial countries and smaller world trade expansion in 1986; he wondered whether the projected rate of export growth was still attainable. Accelerating the pace of the exchange rate depreciation as intended might not be sufficient to realize that projection, particularly if Korea's competitors followed the same course. He invited staff comment on those points.

The overall implementation of the program had been mixed, Mr. Suraisry observed. While fiscal and exchange rate policies, as well as import liberalization, had been in conformity with the program, there had been deviations from the targets for domestic bank credit expansion and net foreign borrowing. That outcome could be partly related to the program design, which had not taken sufficient account of the impact of the higher interest rates introduced in April 1985 on the banks' liquidity and on credit expansion. He therefore sympathized with Mr. Romuáldez's comments on the impact of financial reform on the increase in the net domestic assets of the banking system in excess of the program ceiling. However, the outturn was also partly related to the repayment of debt of overseas subsidiaries and to the authorities' desire to expand credit to the private sector in order to limit the slowdown in economic activity. Taking all those factors together, he could agree with the modifications requested by the authorities.

As to the 1986 economic program, he supported the authorities' objective of continuing to implement firm demand management and structural adjustment policies, Mr. Suraisry remarked. The fiscal policy for 1986 appeared to support that objective. While increases were planned in expenditures to support certain sectors and in transfers to local governments, the offsetting measures that the authorities intended to take were satisfactory. Implementing those measures and the tax plan in a timely manner should be essential for avoiding slippages in the fiscal area. In that context, he was concerned about the intention to continue the policy of assisting some soft sectors through off-the-budget lending. Such lending might more appropriately be kept within the budget and thus subject to budgetary control.

The circumstances that had led to slippages in monetary policy in 1985 were considered unlikely to recur in 1986, Mr. Suraisry noted. Nonetheless, it would be important to monitor monetary developments closely so as to take appropriate offsetting measures if those factors reappeared. In that context, Mr. Romuâldez's statement that structural adjustment would not be sacrificed for short-term gains was reassuring.

The pursuit of a flexible exchange rate policy and the liberalization of the exchange and payments system was particularly important for Korea, as economic growth depended heavily on external demand, Mr. Suraisry observed. Managing the exchange rate flexibly and removing all the structural rigidities in the external sector were essential to preserve the country's competitiveness and maintain strong demand for Korea's exports. The authorities were aware of that fact and were following the right course of action. It was equally important that Korea's trading partners keep their markets open.

The external debt was perhaps the most pressing problem in the external sector, and its management had been complicated by the foreign debt of overseas subsidiaries, Mr. Suraisry commented. The efforts made by the authorities to facilitate the repayment of the subsidiaries' debt were appropriate, since the accumulation of arrears in any area was likely to affect adversely the country's creditworthiness. Every effort should be made to reduce further the debt of those subsidiaries.

Reducing the growth of external debt and at the same time mobilizing enough domestic resources to maintain economic growth at the levels attained in recent years would be a difficult task, Mr. Suraisry noted. Korea's success so far in optimizing the use of foreign borrowing was one of the main reasons for Korea's impressive achievements in economic development and was also manifested by Korea's debt servicing record. However, if the world economy slowed down further, or Korea's real output growth remained low, the country could encounter difficult problems. Consequently, the staff's caution concerning debt management appeared to be appropriate. In that connection, he asked the staff or Mr. Romuáldez for a clarification of the statement that: "They [the authorities] also believed that the rapid swing to sizable external surpluses could intensify protectionist pressures against Korea in foreign markets." In his view, it was essential for Korea to aim for a surplus in its external current account so as to service its debt.

In concluding, he supported the proposed decision, Mr. Suraisry remarked. He also wished to congratulate the authorities for their remarkable success in organizing the 1985 Annual Meetings of the Fund and the World Bank and to express his deep appreciation for their warm hospitality during those meetings.

Mr. Goos said that he generally agreed with the staff that Korea's performance under the program in 1985 had been satisfactory, particularly considering the progress that had been made in further reducing the current account deficit under a much less favorable external environment than had originally been foreseen. Of course, that progress could not detract from the relatively weak performance in terms of overall economic growth and the considerable slippages in the balance of payments and monetary targets. That the authorities had resisted the temptation to counter the impact of adverse external developments by taking recourse to stimulatory measures was commendable, and it was also reassuring to note that import liberalization had remained on track.

More specifically, he agreed with the staff's analysis regarding the slippages in the performance criteria and the target for the overall balance of payments, Mr. Goos continued. In that regard, he appreciated the authorities' concern about the country's international credit rating, which had given rise to the unprogrammed repayment of debts incurred by the foreign subsidiaries of Korean firms. He also appreciated their concern that tightening monetary policies to offset the expansionary effect of that rescue operation could have threatened the emerging economic recovery. However, considering that the resulting deterioration in the balance of payments and the accompanying decline in net foreign assets were also powerful factors determining the country's credit standing, the policy stance chosen was not without risk. In fact, it could easily have turned out to be counterproductive.

Against that background, the staff's advice to promptly tighten credit policy and limit the increase in external debt to a rate of growth below 6 percent was certainly well taken, the more so considering the prospect that such rescue operation in support of overseas subsidiaries might have to be repeated in 1986, Mr. Goos added. Furthermore, he agreed with the staff that in present circumstances a close monitoring of the external debt situation, as well as appropriate banking supervision, deserved particular attention.

The thrust of the economic program for 1986 was broadly appropriate, Mr. Goos considered. He was however somewhat concerned about the sharp increase in the fiscal deficit in 1986, which was projected to be higher in terms of GNP than in each of the previous three years. Although two fifths of the increase could be attributed to temporary factors, he wondered whether the projected outcome would be consistent with the continued need for financial restraint. Inasmuch as the higher deficit did not reflect discretionary tax deductions aimed at stimulating investment, particularly savings, recent experience in other countries had demonstrated the difficulty of predicting with any degree of precision the behavior of savings in response to tax reductions. In that light, he recommended a more cautious fiscal policy approach than that envisaged under the 1986 program.

The medium-term projections for exports had been revised downward to take account of the recent deterioration in the external environment, Mr. Goos noted. Nevertheless, with annual growth rates of over 10 percent, those projections appeared quite ambitious even considering the authorities' flexible exchange rate policies. Although those policies were welcomed as an important instrument to maintain the country's external competitiveness, they were of little avail in a recessionary or protectionist external environment. Those policies could even become counterproductive by provoking additional protectionist measures if they were perceived by trading partners as aiming at an unfair competitive advantage. In that regard, Chart 3 showed a steep decline in both the nominal and real effective exchange rates for the past nine months or so, and particularly for the end of that period. On that basis, it would be difficult to justify recent exchange rate developments with a possible need to correct those rates toward a lower equilibrium level that might have existed in previous years, and there also seemed to be little justification in view of domestic price and cost developments, which were certain to suffer from an undervalued exchange rate. Against that background, he urged the authorities to closely monitor exchange rate developments in order to forestall the potential risks that he had mentioned. He invited the staff to comment on that point.

In concluding, he endorsed the staff appraisal and the proposed decision, Mr. Goos stated.

Mr. de Forges remarked that Korea's performance so far had been satisfactory in terms of the external current account, inflation, and economic growth. Some deviations from the original program had occurred with regard to the ceilings on net domestic assets of the banking system and the overall balance of payments deficit. Nevertheless, the effects of unforeseen circumstances, such as softer external demand and developments in the debt of overseas subsidiaries, would have been even more damaging if countermeasures had not been rapidly taken to tighten fiscal policy and manage exchange rate policy flexibly. The Korean authorities were to be commended not only for the economy's performance but also for their capacity to react to unexpected developments.

The macroeconomic targets in the 1986 program represented challenging policy objectives, Mr. de Forges observed. Considering the underlying assumptions, the policy design and quantitative guidelines, if fully implemented, would be consistent with the attainment of those objectives. In order to realize the medium-term scenario, all efforts should be directed toward meeting those targets. However, in light of the most recent developments in the world economy and world trade, the projected rates of growth for output and exports appeared to be overly optimistic. There was a danger that, as designed, the scenario was an optimum one. Although in the past Korean economic performance had often been outstanding in terms of growth and exports, it had also been adversely affected by protectionism, which was perhaps increasing. Therefore, he would have preferred that the staff would provide a set of medium-term scenarios under different assumptions concerning the external environment--such as decline in world oil prices and its effects on the Korean economy, or a more sluggish rate of growth for world trade--or a different growth pattern with less reliance on export-led growth.

He welcomed the initiatives set out in paragraph 11 of the Government's letter of intent, which would benefit the Korean people whose efforts in diverting domestic goods and consumption to exports had contributed importantly to growth in past years, Mr. de Forges remarked. During the Annual Meetings held in Seoul in October, he had been favorably impressed by Korea's economic development, its people, and their skills and eagerness to work. He supported the proposed decisions, including the modification of performance criteria.

Mr. Hodgson said that the past year had clearly been more difficult for Korea than had been expected, with the external environment in particular turning less favorable. Nevertheless, the authorities had persisted with their broad economic strategy. As a result, performance in a number of important areas, most notably prices and the current account, had been in line with planned targets, although growth had been weaker than expected. In view of those still favorable trends and the authorities' strong record of economic management, he supported the proposed modifications to the performance criteria, which resulted largely from special factors of a temporary nature and were not cause for undue concern.

Part of the rapid growth of domestic credit stemmed from a shift away from nonbank financial intermediaries as a result of the liberalization of the banking system earlier in the year, Mr. Hodgson observed. As the staff had noted, insufficient allowance had probably been made for that factor in setting the program targets for 1985. Also understandable was the authorities' decision to encourage the repayment of the external obligations of Korean offshore firms experiencing financial difficulties so as to maintain the country's creditworthiness, even though that decision had led to an increase in externally funded bank credit to parent companies, thereby contributing to the need to modify performance criteria. As Mr. Romuâldez had indicated, to the extent that those special factors continued, the task of setting and meeting the program's financial targets was clearly difficult.

Nonetheless, he agreed with the staff that continued domestic credit expansion at the recent rapid pace was not advisable, Mr. Hodgson continued. The growth rate of M2 had not yet slowed significantly, and a tightening of credit policy therefore appeared warranted if strong price performance was to be maintained. In setting monetary policy, a course needed to be steered between undue tightening that might threaten the stronger pace of economic growth that was desired and an overly expansionary policy. The authorities should exercise caution and closely monitor developments to ensure an appropriate slowing of credit expansion as the impact of recent special factors lessened.

Further liberalization of the financial system, particularly elimination of the remaining preferential interest rates, would be appropriate, Mr. Hodgson considered. He welcomed the steps that had already been taken to allow greater interest rate flexibility and noted that with the prevailing low rate of inflation, interest rates tended to be highly positive.

The continuing policy of fiscal restraint, coupled with some shifts in expenditures and changes in taxation to encourage saving and investment, appeared appropriate, Mr. Hodgson commented. However, as the public sector deficit as a percentage of GNP was projected to increase moderately in 1986, particularly as a result of a one-time transfer to local governments, steps might be considered to reduce the deficit of the Grain Management Fund (GMF) by even a larger amount than was planned at present. While the scaling down of the GMF's operations was welcomed, the gap between purchase and sales prices was not being narrowed, and he therefore considered that sale prices of rice and cereal grains could be increased. With the current low inflation rate and continuing growth in real incomes, such price increases should not have a major impact on inflation or on income distribution.

Korea had maintained its creditworthiness on international financial markets and had improved its external debt profile by consistently following sensible economic policies--including a flexible exchange rate policy--over a number of years, Mr. Hodgson noted. The slowdown in export growth in 1985 illustrated Korea's vulnerability to unfavorable external developments. The broad stance of macroeconomic policies planned for the balance of the stand-by arrangement, as well as further liberalization of imports and the financial sector, should promote increased efficiency in resource allocation, encourage domestic saving and investment, and generally help to sustain the competitive strength of the Korean economy. Those measures should also be consistent with the slowing in the rate of growth of the external debt, an objective that appeared appropriate in the current global environment.

Mr. Ercel remarked that although exogenous factors had led to departures from two quantitative performance criteria, Korea's program appeared to be on the right track. Corrective measures and timely actions taken by the authorities had helped to achieve the program's major objectives in 1985, particularly in the areas of the current account deficit, inflation, and growth. Moreover, the liberalization of import and foreign investment as well as the deregulation of the financial sector were encouraging. The Korean authorities had shown their commitment and determination to carry out the broad objectives of the program in order to attain the goals of a sustainable position for the external account as well as sustained growth. He therefore supported the proposed decision.

A shortfall in projected current account receipts of about $3.5 billion had put a heavy burden on the implementation of economic policies that had not been foreseen in the initial stage of the program, Mr. Ercel noted. In addition, the intensification of protectionist pressures worldwide had adversely affected the Korean economy in 1985. That development was even more worrisome since the medium-term scenarios for the Korean economy clearly indicated the need for increasing annual export earnings to about 12 percent in 1990 in order to maintain a debt service ratio of about 20 percent. Otherwise, achieving the envisaged growth rate targets and the desired external debt management could become difficult. The unexpected developments in the foreign debt obligations of the Korean firms' overseas subsidiaries could also put an additional burden on the external accounts. He agreed with the staff that the Korean authorities should closely monitor the borrowing abroad by Korean firms operating offshore.

The main problem in the monetary area was the excess in the rate of domestic bank credit expansion resulting from both an acceleration of broad money growth and the decline in the net foreign assets of the banking system, Mr. Ercel observed. The important initiatives adopted by the authorities in the area of financial deregulation had contributed significantly to the marked acceleration of broad money growth. Obviously, measures such as the gradual elimination of officially administered interest rates, together with the implementation of institutional changes, would help to ameliorate the efficiency of the financial market and resource allocation. However, those changes would have an impact on the demand for money and money supply. A policy of continuing to limit the growth of monetary aggregates would probably cause a slowdown in nominal and real GNP growth. The staff had explained that that factor had been insufficiently provided for in the present program. Bearing in mind that most of the Fund programs had included financial deregulation and changes in financial regulations, he considered that the effects of those measures on the demand for money and monetary aggregates should also be considered in program design. In that regard, he welcomed the new quantitative guidelines for net domestic assets and net bank credit to the public sector for March and June 1986, which took into account the lagged effect of financial deregulations. He invited the staff to provide more information about the assumptions regarding the impact of financial innovation on the formulation of the new quantitative guidelines.

In concluding, he considered that the policies and measures to achieve the objectives of the program had been appropriate, and he supported the proposed decision, Mr. Ercel remarked.

Mr. Wijnholds said that he agreed with the staff's assessment that Korea's performance under the stand-by arrangement program had been generally favorable. The way in which the authorities had reacted to external conditions that were less favorable than earlier foreseen was commendable. Despite a disappointing export performance owing to causes beyond the authorities' control, the external current account deficit had fallen to 1 percent of GNP. Prospects existed for a further reduction in the current account deficit, thereby reducing Korea's external borrowing needs to relatively modest and manageable levels.

Although economic growth was considerably lower in 1985 than in previous years, growth performance was still satisfactory in that the slowdown could be attributed to the externally induced weak export performance, and it had been accompanied by low inflation, modest unemployment, and further trade liberalization, Mr. Wijnholds commented. That performance, together with the high, rising investment and savings ratio and a prudent fiscal stance, gave the overall picture of a country whose economy continued to be run in a exemplary fashion. The recent data provided by Mr. Romuâldez showed that the economy was again moving to a high growth path.

The performance of monetary policy had been less satisfactory, Mr. Wijnholds remarked. Although several factors were involved, the increase in net domestic assets of the banking system was well in excess of the September ceiling under the program. Moreover, a significant part of the strong credit expansion had been financed from external sources. However, in view of Korea's excellent performance in the past and the recent tightening of credit policy, he could accept the proposed modification of the performance criteria relating to the net domestic assets and overall external debt for December 1985. Although domestic bank credit and the broad money supply were projected to decelerate significantly in 1986, the rate of increase would still be substantial--for instance, it would considerably exceed the increase in nominal GNP. Those developments were, however, related to the reform of the financial system and a shift of activity from the nonbank financial institutions and the curb market to the banking system, which in itself was a desirable development. It was therefore difficult to judge at present what rate of monetary expansion would be appropriate for Korea. Nevertheless, a vigilant attitude by the authorities with respect to monetary and credit developments was called for, particularly as the budget deficit would increase somewhat in 1986, the depreciation of the won and rising import prices might refuel inflation, and the prices of imported commodities might strengthen in the coming year. Moreover, the ample liquid position of the private sector could possibly, with a lag, result in accelerated spending.

The improvement in the maturity structure of Korea's external debt was welcome, Mr. Wijnholds commented. The revised medium-term projections indicated that the debt service ratio would be somewhat less favorable in coming years but would continue to show a downward trend. Among the major borrowers, Korea exemplified good debt management.

In concluding, he supported the proposed decision, Mr. Wijnholds remarked.

Mr. Coumbis remarked that economic developments in Korea in 1985 had not been as favorable as had been anticipated during the previous consultation discussion. External conditions had deteriorated markedly and as a result exports had been almost stagnant and service receipts had been falling. The overall deficit of the balance of payments was expected to increase to $2.7 billion in 1985 compared with $1.5 billion in 1984 and $0.7 billion originally forecast for 1985. Outstanding external debt had exceeded the original program ceiling by about $0.4 billion, and net foreign assets had declined considerably more than had been projected. Moreover, as the result of slippages in credit policy, net domestic assets of the central bank had increased by 21 percent during the year ending in October, compared with the program target of 13 percent; and the corresponding ceiling for end-September had been exceeded by about 5 percent.

Although two performance criteria had not been met and GDP was not expected to increase by more than 4.5 percent in 1985 compared with 7 percent originally targeted, he agreed with the staff that the adjustment program was basically on track, Mr. Coumbis continued. Moreover, with the exception of credit policy, the policies followed had been consistent with the guidelines of the stand-by arrangement program, which aimed to strengthen the external position through continued demand restraint and exchange rate flexibility. In fact, the rate of inflation was not expected to exceed the program target, while the current account deficit of the balance of payments and the consolidated deficit of the public sector were expected to be slightly less than originally forecast.

For 1986 the major policy objectives with respect to the rate of inflation, external equilibrium, and the rate of growth would be the same as in 1985, Mr. Coumbis observed. The authorities intended to continue to maintain a restrained fiscal stance, a flexible exchange rate policy, and a constrained credit program. The rate of growth of foreign borrowing was expected to be reduced significantly in 1986, while the rate of increase of net domestic assets would be reduced below 14 percent. Moreover, the authorities were continuing their vigorous efforts to correct structural weaknesses in the areas of import controls, tariffs, and direct investment.

Nevertheless, he was not as confident about the medium-term prospects of the balance of payments as he had been at the time of the previous Board discussion on Korea, Mr. Coumbis commented. Recent developments clearly indicated that increased protectionist pressures, increased competition from other producers, the slowdown of economic activity in the United States, and the severity of the crisis in construction activity in the Middle East had seriously affected both merchandise exports and invisible receipts. He questioned whether that crisis was temporary. In that regard, it was notable that the staff had revised the medium-term projections for Korea's balance of payments presented in the staff report for the 1985 Article IV consultation (EBS/85/151, 6/14/85) and that the present medium-term scenario assumed that the problems were temporary in nature and that for 1986 and subsequent years external conditions would change substantially. According to the staff's revised projections, a sustainable medium-term balance of payments path was compatible with annual rates of GNP growth of 6 percent to 7 percent up to 1990. He invited the staff to provide supportive evidence for those hypotheses. For the next review, he requested that the staff prepare alternative balance of payments scenarios that assumed less favorable developments for exports of goods and services up to 1990.

Korea's credit policy in 1985 raised several questions, Mr. Coumbis noted. According to the authorities and the staff, the program targets had been exceeded owing mainly to three factors. First, there had been a shift of assets and liabilities away from nonfinancial institutions to banks. Second, to repay the foreign debt obligations of overseas subsidiaries that expected to encounter financial difficulties, the commercial banks had increased domestic credit to the parent companies by increasing their borrowing from abroad. And third, in view of the unanticipated weakness of export performance, there was a need to promote export diversification in important industries including shipping and shipbuilding. He wondered why the performance criteria on net domestic assets had not included the assets of nonbank financial intermediaries. Was the repayment of foreign debt obligation of overseas subsidiaries with financial difficulties a once-for-all operation or were similar situations expected to occur? While it was quite necessary for Korea to diversify its exports, diversification was a long-term process and therefore excesses in financing in one year or another were not justified. Was it possible that the increased credit allocation to important industries, including shipping and shipbuilding, was merely the financing of problematic industries? In that respect, he recalled that during their previous discussion on Korea, Executive Directors had expressed concern about extending substantial financial support to the troubled construction and shipping sectors. Finally, according to the authorities, developments in the external current account and in domestic prices indicated that domestic credit developments in 1985 had not provided any significant stimulus to domestic demand. He questioned that interpretation and agreed with the staff that credit developments had affected the evolution of foreign assets, which were substantially weaker than programmed.

In concluding, he supported the proposed decision, Mr. Coumbis remarked.

Mr. Finaish said that he was in broad agreement with the staff appraisal. Korea's performance to date under the stand-by arrangement had been generally good, with macroeconomic developments and the pace of structural adjustment broadly in line with most program targets. In view of that assessment and the understandings that had been reached with respect to the program for 1986, he could support the proposed modification of performance criteria.

More specifically, the stand-by arrangement assigned a high priority to external adjustment, Mr. Finaish noted. In view of the country's existing debt burden, the growth and structure of external debt was therefore a major policy concern. Consequently, particular importance attached to the observance of the program's balance of payments and external debt targets. As far as feasible, the 1986 program should attempt to correct the overshooting of the overall balance of payments and external debt targets in 1985, and in that regard he was pleased to note that the understandings reached with the authorities with respect to the 1986 program were broadly in line with that objective.

The unplanned large decline in net foreign assets and the overshooting of the external debt ceiling in 1985 had been attributed largely to the repayment by some resident Korean firms of the foreign debt obligations of their offshore subsidiaries, Mr. Finaish observed. Though, in accordance with statistical convention, foreign debt owed by offshore subsidiaries was not included in Korea's debt statistics, developments in 1985 showed that because of the perceived link between the foreign debt obligations of those subsidiaries and Korea's own creditworthiness, the servicing of those obligations could have significant implications for the parent country in its management of external debt. Adequate monitoring and supervision by the Korean authorities of developments in the foreign debt of offshore subsidiaries and of the guaranteeing of such debt by Korean banks would thus be in order. Although the debt repayment obligations of offshore subsidiaries that were assumed by resident Korean firms in 1985 were as large as $0.9 billion, that development apparently had not been foreseen at the time of the last Article IV consultation (EBM/85/105, 7/12/85) and program discussions held earlier in March-April 1985. In view of the significant implications of such transactions for the attainment of the monetary and external financial targets of the stand-by arrangement, it would be helpful if adequate and timely information were available to permit some projection of the likely magnitude of those transactions during the program period. The staff had reported that those transactions were expected to decline in 1986, although no broad estimate had been mentioned. He noted, however, that developments regarding the foreign debt obligations of offshore subsidiaries were to be examined in detail at the time of the second review.

The staff paper reported that several discretionary tax changes had been introduced in mid-1985, Mr. Finaish continued, and broad mention had been made of changes in the corporate tax system to encourage enterprises to improve their financial structure. Some indication by the staff of the actual changes made in corporate taxation would be helpful. According to a recent article by Mr. Sundararajan entitled, "Debt-Equity Ratios of Firms and Interest Rate Policy: Macroeconomic Effects of High Leverage in Developing Countries,"1/ the average corporate debt-equity ratio in

1/ Staff Papers, International Monetary Fund (Washington) Vol. 32 (September 1985), pp. 430-74.

Korea was unusually high and was estimated to have risen from about 100 percent in the early 1960s to about 500 percent at the beginning of the 1980s. That large, rapid increase in the debt-equity ratio had been explained in terms of, among other factors, the institutional framework of the country's financial system, the relative ease of access to and the relative cost of debt finance, the large use of foreign borrowing, and biases in the tax system that favored debt finance. The article contained an interesting general discussion of how an overleveraged financial structure could complicate the conduct of stabilization policies, particularly interest rate policies, could act as a factor accentuating macroeconomic instability, and in certain cases lead to perverse effects of real interest rate changes on saving and investment. He invited staff comment on the significance of those potential implications of high leverage in the Korean context. Furthermore, he noted that the World Bank had made two industrial finance loans to Korea between 1983 and 1985 which, inter alia, had emphasized measures to bring about a better balance in firms' debt-equity management. Did available information point to any significant tendency for the average debt-equity ratio's decline in recent years as a result of such measures?

Mr. Templeman observed that the Board was considering the completion of the first review of Korea's stand-by arrangement nearly two and a half months ahead of schedule. Although the promptness of the Korean authorities in dealing with some emerging problems under the program was admirable, some aspects of the procedural arrangements that the Board was being asked to approve gave rise to concern.

He agreed with the staff's assessment that the fundamental policy stance had not changed since the Board approved the stand-by arrangement in July and that performance had been generally favorable, Mr. Templeman continued. Despite export shortfalls, the current account deficit and its ratio to GNP had been as good as or better than expected. Inflation remained modest. The authorities' exchange rate policy had helped to restore Korea's international competitiveness; the public sector deficit ratio should be less than anticipated; the maturity structure of foreign debt had improved; and progress continued in structural reforms involving the liberalization of imports, foreign investment, tariffs, and financial markets. Nonetheless, developments had been disappointing in a few areas: the lower rate of growth of GNP--although a recovery appeared to be underway in the latter half of the year; excessive expansion of net domestic assets beyond the performance ceiling at end-September; a larger rise in foreign debt than anticipated; and a larger than expected overall deficit in the balance of payments.

The principal problem that had arisen under the program was the rate of domestic credit expansion, which had exceeded the end-September ceiling and had led to a request for modification of the end-December ceiling, Mr. Templeman noted. A main cause of the problem seemed to have been the unexpected extension of credit to parent firms of foreign subsidiaries to finance the repayment of the subsidiaries' foreign debt. The larger than expected shift from nonbanks to the banking system of both deposit and lending activity as a result of financial market liberalization also seemed to have contributed to breaching the ceiling on net credit of the banking system. However, the overall credit expansion level had also risen beyond expectations. In any case, there had clearly been a deliberate attempt to restimulate domestic demand through greater monetary ease in the face of disappointing growth early in the year. The relaxation of monetary policy had contributed to the worsened net foreign asset position of the banking system but had not yet had a detectable adverse effect on inflation. The authorities now recognized the dangers of continued excessive credit expansion, and he could therefore go along with the somewhat higher December ceiling for net domestic assets and the new ceilings for the first half of 1986. However, he would appreciate more information on the specific policy changes to be implemented in order for Korea to remain within the new ceilings.

He continued to support financial market liberalization, which had resulted in raising deposit and lending interest rates early in 1985, along with the introduction of new savings schemes with attractive interest rates and the promise of further financial market deregulation in 1986, Mr. Templeman added. He invited the staff or Mr. Romuâldez to explain what further action was expected in that area.

Two external account developments--the shortfall in exports and the weak capital account--were disappointing, Mr. Templeman observed. While the current account deficit would still be somewhat lower than originally envisaged, the overall deficit might be $2 billion higher than expected owing to the deterioration both in medium-term flows and in the short term and errors and omissions accounts. While the repayment of the foreign debt of Korean subsidiaries had contributed to capital outflows, that factor did not seem to explain fully the magnitude of the deterioration in the capital accounts. He invited staff comment on that point.

The continuing progress in liberalizing imports, foreign investment, and tariffs was encouraging, Mr. Templeman remarked. Two hundred and three import items had been removed from the restricted import list in 1985, and 302 more items were to be removed in 1986. He commended the Government for publicly announcing its liberalization plan well in advance so that economic sectors could make timely adjustments in anticipation of its impact. Clearly, tariff reform aimed at eliminating excess protection, reducing rate dispersion, and lowering the average tariff rate could play an important supporting role in import liberalization. In that connection, the slight reduction in the unweighted average tariff rate in 1985 was a positive sign. Also, the liberalization of foreign direct investment by gradually removing sectors from the negative list could contribute importantly to economic growth, modernization, and efficiency. The rise in the share of economic sectors that had been liberalized from 60 percent in 1983 to 76 percent in 1985 represented a move in the right direction, although substantial parts of the economy would still remain excluded. The parallel liberalization of foreign portfolio investment would also contribute to developing the capital market and creating incentives to capital inflows. He would be interested to hear more details about the authorities' plan to ease foreign investment restrictions further in 1986.

The medium-term balance of payments projections had been revised, Mr. Templeman noted. Despite an assumption that export growth would be somewhat lower than had been projected earlier, the outlook appeared promising for achieving small but growing current account surpluses beginning in 1987 in the context of real economic growth of 6.5-7 percent, a sustainable overall balance in the external accounts, and a reduction in the debt service ratio to about 20 percent in 1990. Nevertheless, like other Executive Directors, he would be interested to see alternative scenarios.

Recent developments in foreign debt and debt management policy were cause for concern, Mr. Templeman commented. Unexpected large-scale repayments in 1985 on the foreign debt of subsidiaries abroad of Korean firms had clearly had a serious impact on both monetary and balance of payments developments. The authorities' concern that the financial difficulties of Korea's foreign subsidiaries could damage the country's overall foreign credit rating was understandable in view of the continued dependence on substantial voluntary lending by its foreign creditors. However, financing those repayments through foreign borrowing by Korean banks had increased the recorded level of debt, apparently without a correspondingly large decline in the subsidiaries' foreign debt. He invited the staff to provide an update on the level of, and outlook for, the foreign debt of subsidiaries. He agreed with the staff that the authorities should exercise caution in extending guarantees of such debt. While agreeing to the proposed increase of $411 million in the ceiling on external debt for end-December, he also supported the staff's proposal that the authorities seek to limit the growth of debt in 1986 to no more than 5 percent rather than 6 percent as presently contemplated. At the time of the second review in mid-1986, foreign debt developments should be examined carefully both with regard to total debt and the expected continuation of repayment of foreign debts of Korean subsidiaries.

The most notable fiscal development in 1985 was a modest response to disappointing economic growth, Mr. Templeman remarked. Although there undoubtedly had been pressures for fiscal stimulus, the authorities had resisted that temptation fairly successfully and had instead adopted some selective tax cuts, mainly favoring saving and investment, and had reallocated expenditures somewhat. Similarly, both the ratios to GNP of public sector revenues and spending had remained stable and at moderate levels, and the public sector deficit was expected to be somewhat smaller in 1985 than had been expected. However, room existed in the area of public enterprises and the operations of the Grain Management Fund (GMF) for reducing deficits and possibly privatizing the GMF.

He was generally satisfied with Korea's economic performance and policies, in view of the adjustments that were being made to correct some of the problems that had arisen earlier in 1985, Mr. Templeman continued.

Nevertheless, the review raised some procedural questions concerning the absence of a formal waiver of noncompliance with the end-September net domestic asset ceiling, accelerated completion of the first review, and the prolonged use of Fund resources. Board approval of the modified net domestic asset target for end-December would eventually allow Korea to receive both the end-September and end-December disbursements, assuming that all end-December performance criteria were met. While he recalled that a member had been allowed to receive an earlier disbursement upon returning to the original adjustment path, in the present case, the original ceiling would have been raised. He invited staff comment on that procedure.

Accelerating the completion of the review raised the possibility that Korea could make the third purchase sooner than originally expected, provided that the modified end-December performance criteria were met, Mr. Templeman added. In his view, when program reviews were completed too far in advance of the original schedule, the Board would not have the opportunity to observe performance over a sufficiently long period of time before the succeeding disbursement. Nevertheless, he understood Korea's wish to act promptly to move back into compliance with the program and the importance of compliance to Korea's foreign creditworthiness. But, use of the accelerated review procedure could be subject to abuse.

Finally, as had been indicated in July when the stand-by arrangement with Korea had been approved, his chair was concerned about the prolonged use of Fund resources by a number of countries, including Korea, Mr. Templeman concluded. He recognized that the capital account and overall external balance in 1985 would be weaker than expected, which offered some justification for stand-by arrangement purchases. But the current account was on track in 1985, the current account deficit was expected to fall substantially in the coming year, and the capital account in 1986 should be stronger. Furthermore, good performance under the Fund program was more important in terms of Korea's international creditworthiness than was the actual use of Fund resources. He therefore urged the authorities to minimize actual purchases under the stand-by arrangement over the remainder of the program period.

Mr. Foot recalled that during the previous discussion of the stand-by arrangement with Korea, his chair had questioned whether a classical stand-by arrangement might not have been more appropriate. The authorities' pledge at that time to refrain from making purchases if balance of payments developments turned out to be significantly better than expected had been welcome. While recognizing that the overall balance of payments had been weaker than expected, he continued to hope that if the external position improved the authorities would avoid further purchases.

He accepted the need for a waiver owing to the unprogrammed repayment of the debts of foreign subsidiaries of Korean companies, Mr. Foot continued. The authorities' desire to encourage those repayments in order to preserve the country's creditworthiness was wholly understandable. However, he would be interested to know whether there were other vulnerable areas where similar problems might occur. For example, the construction sector's difficulties were at present fairly clear. The debt problem of foreign subsidiaries also had implications for bank supervision and should be covered at the time of the next review.

The continuation of reasonably firm fiscal policies was welcome, Mr. Foot remarked. The public sector deficit in 1985 had been lower than previously expected even after allowing for delays in the one-time transfer to local governments, which was at present expected to take place in 1986. However, like Mr. Goos, he noted that the public sector deficit was expected to rise somewhat in 1986, a development which could be only partly explained by that transfer. The increase was particularly disappointing in the light of the projected rise in GNP, which would normally be associated with an improvement in the fiscal position. The extent of the increase in the fiscal deficit was possibly not a major source of concern, but the authorities should resist pressures to adopt significantly more expansionary policies.

The authorities' efforts to improve their control over the public enterprises were also welcome, Mr. Foot added. He looked forward to an analysis of those changes together with a more general discussion of public enterprise performance at the time of the next review, but he would be interested in any preliminary details that the staff might have on the progress of those reforms. In concluding, he could support the proposed decision.

Mr. Vasudevan said that he supported the proposed decision.

Regarding monetary policy, the staff had argued that domestic credit to the private sector was high and that broad money had risen strongly because of high interest rates, and the introduction of foreign bank certificates of deposit and savings deposits in 1985, Mr. Vasudevan added. For the financial system as a whole, the annual rate of credit expansion was only marginally higher. The stand-by arrangement program obviously had not taken into account the changes that might be expected to result from the deregulation of the financial sector that had taken place in 1985. To what extent had deregulation been taken into account in determining the modified performance criteria? If the effects of the April deregulation had been completely exhausted and if the real rate of interest had played such an important role in the overshooting of the program's targets, what should the real rate of interest be in the future? Could interest rates be used as policy instruments to ensure that the modified credit targets would be met? He also wondered whether the credit targets could be achieved through further deregulation of bank lending and deposit rates. If the 1986 program met expectations, what impact would further deregulation have in terms of the overall interest rates?

The staff representative from the Asian Department noted that the expansion of net domestic assets had slowed down significantly in November to a seasonally adjusted annual rate of about 11 percent. The coincidence of high real interest rates and the rapid expansion of credit to the private sector resulted in part from the way that special facilities had been made available to some soft sectors--for example, through waiving amortization payments falling due to the banks. Although market rates in Korea remained significantly below informal rates, a backlog of credit demand might still exist.

In 1982/83 the authorities, concerned about the high debt-equity ratios of a number of larger Korean corporations, had significantly restrained the access of those corporations to the banking system, the staff representative continued. For the 66 largest conglomerates, credit outstanding to the banking system at the end of any month could not exceed the level outstanding at end-December 1983. Various provisions affecting some large corporations had been eased in 1985, resulting in borrowing in the informal market at rates exceeding market rates. Compared with the cost of borrowing abroad, domestic market rates in Korea did not seem unusually high. For example, the rate on bonds in the secondary market, which had been about 14 1/2 percent, had declined by more than half a percentage point, or 70 basis points, over the previous 2-3 months. In any event, the pace of credit demand seemed brisk.

Two concerns expressed by Executive Directors regarding the growth of net domestic assets projected for 1986--namely, that a growth rate of 14 percent might be on the high side and that the impact of financial deregulation on the banking system might not have been exhausted by late 1985, were interrelated, the staff representative observed. M2 had been projected to expand by about 15 percent, of which 5 percentage points reflected the continuing impact of the deregulation measures already taken in 1985 and 10 percentage points reflected the growth of real GNP, given the underlying rate of inflation projected for the period, with no strong change in velocity other than that attributable to the deregulation. As some Executive Directors had pointed out, the staff's forecast of the demand for money in 1985 had been too low. The program had been based on a projected expansion of broad money by 13.9 percent in 1985, compared with an expansion rate of about 10 1/2 percent in 1984. The difference between those two figures represented the expected impact of the financial deregulation, which had not been fully appraised quantitatively at the time the program was discussed. Broad money growth could reach 18 percent by the end of 1985, as the Korean authorities were projecting, but at end-November it was about 15 1/2 percent. The underestimation of the demand for money accounted for about half of the adjustment proposed in the modification in the credit ceilings.

The staff had not completed its discussion with the authorities on further financial deregulation, but hoped that deregulation would go beyond deposit liberalization and begin to focus on lending rates as well, the staff representative added. The matter would be pursued further in the context of the second review, discussions for which would take place in June 1986.

The overestimation of exports for 1985 had resulted mainly from an erroneous assumption concerning the price of exports, the staff representative explained. Also, the value of ship exports had been considerably lower than projected, although their volume had been closely in line with staff forecasts. That outturn could be explained by a number of factors, such as the greater than expected fall in prices and the fact that some of the ships produced in 1985 were not acquired by the importers as scheduled. The export target for 1986 reflected an expected turnaround of export unit values, which, after declining by 2.6 percent in 1985, were forecast to increase by 3 1/2 percent in 1986. Indeed, prices had started to increase both on the import and the export side. The projected increase in export volume was more modest, moving from 4.1 percent in 1985 to 7.1 percent in 1986; that increase seemed feasible if the forecast growth in world trade volume by about 5 percent a year was realized. The staff would test the sensitivity of the various assumptions underlying the medium-term scenarios and present some alternative scenarios for the medium term in its report on the second review.

The reference in the staff paper to "a rapid swing to sizable external surpluses" had raised the question of an appropriate current account objective for Korea, the staff representative recalled. During the July 1985 discussion on the stand-by arrangement with Korea, Executive Directors had broadly agreed that an appropriate set of external objectives would aim at eliminating the current account deficit in the near term and achieving a modest current account surplus. The Korean authorities shared that view.

The small increase in the fiscal deficit to 1 1/2 to 2 percent of GNP did not represent a shift in policy stance, but rather a nonrecurring one-time transfer to local governments in 1985, the staff representative remarked. The fiscal deficit in relation to GNP in both 1985 and 1986 would be below 2 percent. At the time when the authorities had discussed the program for 1986 with the staff, their economic management plan had not been fully formulated; thus the 2 percent figure was an indicative target. Fiscal targets would be discussed further at the time of the second review when credit ceilings would be set for the rest of the year.

Some Executive Directors had questioned the attainability of the export targets for 1986 and, in that connection, the impact of exchange rates on Korea's competitiveness, the staff representative recalled. The staff had attempted to assess the degree of protection that might be brought against major commodity items such as automobiles, VCRs and other electronics, footwear, and textiles, as well as the impact of antidumping challenges, and had concluded that an increase in export volume of 7 percent was feasible. Export performance had been buoyant in November and was expected to be good for December. At present the staff did not consider its 1986 export forecasts, which were consistent with those of the Korean authorities, to be overly optimistic.

Within the context of those export projections, the exchange rate level seemed appropriate to maintain Korean competitiveness, the staff representative indicated. At the time of the Board discussion in July 1985, the exchange rate had depreciated by about 6 percent in real effective terms; that development, as well as continued flexible exchange rate management in the context of balance of payments objectives, had been viewed quite favorably by Directors. From November to October 1985, the Korean authorities had approximately maintained their competitive position vis-à-vis the United States, their major trading partner, the won appreciating marginally against the U.S. dollar. Following the concerted exchange rate action by major industrial countries in September 1985, the won had depreciated sharply vis-à-vis major European currencies and the Japanese yen. Consequently, about 45 percent of the depreciation in the real effective rate during 1985 had occurred in the November-December period. The policy response had been appropriate so far as it continued to maintain competitiveness in the U.S. market and also took into account Korea's unexpectedly weak export performance as well as the difficult situation facing Korean exports in markets abroad other than the United States. To have maintained the real effective rate would have required a fairly sharp appreciation of the won vis-à-vis the U.S. dollar and a potentially significant loss in exports to the United States that could not be rapidly offset by increased exports to other markets. Thus, the staff considered Korea's response to international exchange rate developments to have been prudent.

Some Executive Directors had questioned whether the external conditions facing Korea were temporary, the staff representative recalled. In the staff's medium-term scenario, the expectation was that overall world trade growth would pick up. The duration and impact of the intensification of protection against Korean exports was more difficult to surmise. A favorable factor, also difficult to quantify at present, was the extent to which world oil prices would fall in the next several months and the medium-term level of real oil prices was also uncertain. In the latest forecasting exercise, the staff had utilized the most recent World Economic Outlook assumptions for world petroleum prices.

While the overshooting of the target for overall external debt had implications for external debt management, the staff representative noted, the proposed modification of performance criteria, assuming that additional margins were fully utilized, would raise the overall debt level by only nine tenths of one percent above the original ceiling for 1985. Nonetheless, a number of Directors had supported the staff's view that a somewhat more cautious debt management would be appropriate for 1986 in view of the overshooting in 1985. It should be pointed out, however, that Korea had an excellent track record in external debt management within the framework of a program supported by the Fund, having undershot the ceiling in 1984 by $800 million.

Further repayments on behalf of the overseas subsidiaries, particularly construction subsidiaries, in 1986 were expected to be significantly less than those made in 1985, the staff representative observed. Early discussions with the Korean authorities indicated that repayments in 1986 would probably amount to no more than one third those made in 1985, or about $300 million.

Efforts had been made to reduce the debt-equity ratio of Korean firms, inter alia, by severely constraining the access of the largest corporations to the domestic banking system, the staff representative commented. Also, administrative guidelines had provided that the largest corporations would have to finance an increasing share of new investments by selling off other assets, such as real estate, rather than relying on the credit markets, particularly the bond markets. That policy was still in effect, although it had been eased temporarily in the light of a softening of economic conditions during the summer when the annual rate of growth of real GNP had fallen to about 3 percent. Also, debt-equity ratios might be significantly overstated because accounting practices in Korea valued assets at historical costs rather than current market values. The staff did not have information on recent developments regarding debt-equity ratios, but that subject would be taken up with the authorities during the next midterm review discussions.

With regard to external policy, further import liberalization measures were expected, the staff representative noted. The Korean authorities had always identified items subject to liberalization well in advance to enable firms time to make any necessary adjustments. Additional measures had already been scheduled and were described in the staff paper. Also, the Korean authorities had announced major new liberalization measures for all those sectors that had been opened to direct foreign investment, but as yet the staff had no information regarding precise policy intentions. That subject also would be an element of the next review.

The latest data on the external debt of the overseas subsidiaries of Korean firms was as of September 1985, the staff representative continued. Total debt was approximately what it had been at the beginning of the year, although the total amount for construction firms had been somewhat reduced. The debts being repaid were those of companies that were being repatriated; other overseas operations were expected to continue to borrow in order to complete ongoing projects. If the repayment of $900 million had been cleared by the end of the year, as the Korean authorities had indicated, outstanding debt for the construction sector overseas would decline; a decline in the overall stock of overseas outstanding debt could also be expected in such circumstances.

A considerable lag existed between developments in economic activity in Korea and their impact on fiscal receipts because of the structure of income taxes and other factors, the staff representative from the Asian Department commented. Tax revenues had been buoyant in 1985 despite the downturn in economic activity and were expected to be less buoyant in the coming year. The discretionary tax measures taken in 1985 had had little impact quantitatively, affecting perhaps less than 1 percent of revenue.

The corporate tax system had been changed so as to tax dividends and thereby encourage equity financing; that change represented one approach the authorities had in mind to improve debt-equity ratios.

The Deputy Director of the Exchange and Trade Relations Department noted that the procedural questions concerning the absence of a waiver, the accelerated completion of the review, and prolonged use of Fund resources were interrelated. During the Board's discussion of the stand-by arrangement in July, some Directors had attached importance to Korea's restraint in using Fund resources. The staff considered that if the arrangement was being observed, Korea would be entitled to use Fund resources, but it also took into account the views expressed by some Executive Directors. Because of the substantial departure from the performance criteria for September on net domestic assets, understandings had to be reached on further policy adjustments. In this context, the authorities had decided not to request a waiver but had sought instead to accelerate the completion of the first review. Typically, it was more frequent to see a review delayed rather than accelerated.

In Korea's case, there had been no relaxation of the conditions attached to purchases, the Deputy Director continued. The timing of the review had originally provided that the December drawing would be subject to meeting the performance criteria for December and completion of the review; that drawing was still subject to both those conditions. Given the deviations in September and the need to discuss with the Korean authorities policies for the last quarter of 1985, it seemed logical also to discuss the modification of the December ceilings and the 1986 program. In fact, a proposal to modify the December ceiling could not be presented to the Board for approval without setting it in the context of the policies for 1986. Thus, the review and the request for a modification had been brought to the Board together. In the future the staff would explain the reasoning behind the timing of the reviews, the Deputy Director of the Exchange and Trade Relations Department remarked. In that regard, he noted that there was some merit in keeping the review process fairly flexible. The review date set forth in arrangements served the purpose of indicating the latest period by which understandings should be reached, without which further drawings would not be affected; the staff had been fairly flexible in dealing with delays in the timing of reviews, which were inevitable when the authorities were not in a position to formulate policies. In the present case, the staff had operated within that same flexible understanding of the review process.

Mr. Suraisry remarked that he supported the approach taken by the staff, but in future it would be important and an explanation be provided in the staff paper to help alleviate some of the concerns that might arise concerning procedural issues.

Mr. Romuâldez said that he would convey the views of Executive Directors to his authorities as faithfully as possible. He had also taken note of the concerns that some Executive Directors had expressed concerning prolonged use, which he would also communicate to his authorities. However, he wished to stress that at the previous discussion of the arrangement in July 1985, the issue of prolonged use had received considerable attention and that his chair had put forward a number of points which he believed were still relevant, perhaps even more so in view of subsequent developments.

The Acting Chairman noted that Directors had been in broad agreement with the thrust of the staff report for the first review of the stand-by arrangement with Korea and had broadly commended the authorities for their policy performance in 1985. With respect to policies for 1986, Directors had endorsed the authorities' intention to maintain a restrained financial policy stance, which was reflected in the quantitative guidelines established for the first half of the year. But several speakers had urged that the situation would need to be closely monitored and had cautioned that further tightening of policies might prove necessary.

With respect to fiscal policy, Directors had noted that the deficit of the consolidated public sector was relatively small, but it was pointed out that the deficit as a percentage of GDP would be higher in 1986 than it had been in recent years, the Acting Chairman continued. Thus, the authorities were encouraged to keep public finances on track by implementing strict control over spending and also resisting prospective expansionary pressures. In that regard, some Directors had taken note of the substantial improvement envisaged in the operations of the Grain Management Fund and had urged the authorities to supplement the planned reduction in rice purchases with a narrowing of the gap between purchase and sale prices.

Noting the relatively high growth in domestic credit and money expansion, and while recognizing that the implications of financial institutional reforms needed to be taken into account, Directors had emphasized the need to closely monitor credit expansion in 1986 in order to mitigate the pressures on the balance of payments and prevent a resurgence of inflation, the Acting Chairman added. Directors had encouraged the authorities to continue to make progress in the area of financial liberalization, including taking action to deregulate interest rates and bring rediscount rates closer in line with market rates.

Directors had noted that the growth of external debt in 1985 would exceed the authorities' original plans and emphasized the need to reduce the rate of growth of debt in 1986, the Acting Chairman remarked. Transactions connected with a repayment of the foreign debt of overseas subsidiaries, it was noted, had added substantially to the external borrowing requirement by Korean entities in 1985. A number of Directors considered that that development had introduced an additional element of uncertainty in Korea's external environment and had made it necessary for even greater caution in the management of external debt. In that connection, it was suggested that the debt of foreign subsidiaries needed to be monitored more closely and that the authorities should be cautious in providing guarantees. Directors commented that the substantial reduction in borrowing requirements currently projected for 1986 would compensate for the unprogrammed borrowing in 1985, thereby permitting a considerable deceleration in the growth of external debt. It was also noted that the maturity structure of the external debt had been improved in 1985 and that the authorities intended to make further progress in that direction in 1986. A number of Directors had suggested that the staff and the authorities should review the medium-term prospects in the light of different assumptions about key underlying external factors, including the potential growth prospects for exports in the coming years, and taking into account perhaps more positive developments, such as changes in the price of oil.

Directors had commended the authorities for the progress made on import liberalization and tariff reform, particularly in the face of increased protectionism abroad, the Acting Chairman noted. Directors had also welcomed the recent measures to expand the scope for foreign direct and portfolio investment in Korea, which would facilitate the management of external debt.

The Executive Directors then took the following decision:

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

2. The letter dated December 6, 1985 from the Minister of Finance of Korea shall be annexed to the stand-by arrangement for Korea; and the letter dated May 17, 1985, with annexed memoranda, shall be read as supplemented and modified by the letter of December 6, 1985.

3. Accordingly, paragraphs 4(a) through (d) of the stand-by arrangement for Korea shall be amended to read:

(a) during any period until September 1986, in which the data for the preceding performance testing date indicate that:

(i) the ceiling on net credit to the public sector from the banking system, described in paragraph 1 and Table 1 of the Technical Memorandum annexed to the attached letter, as modified by the letter of December 6, 1985, has been exceeded; or

(ii) the ceiling on net domestic assets of the banking system, described in paragraph 2 and Table 2 of the Technical Memorandum annexed to the attached letter, as modified by the letter of December 6, 1985, has been exceeded; or

(b) during any period until September 10, 1986, if Korea fails to observe the limits on outstanding disbursed external debt described in paragraph 4 and Table 4 of the Technical Memorandum annexed to the attached letter, as modified by the letter of December 6, 1985; or

(c) after March 10, 1986 until understandings have been reached between Korea and the Fund on appropriate policies and suitable performance criteria have been established in consultation with the Fund pursuant to the first review as contemplated by paragraph 3 of the attached letter, as modified by the letter of December 6, 1985 or, after such performance criteria have been established, while they are not being observed; or

(d) after September 10, 1986, until understandings have been reached between Korea and the Fund on appropriate policies and suitable performance criteria have been established in consultation with the Fund pursuant to the second review contemplated in paragraph 3 of the attached letter, as modified by the letter of December 6, 1985 or, after such performance criteria have been established, while they are not being observed; or

4. The Fund decides that the first review provided for in paragraph 4(c) of the stand-by arrangement for Korea is completed and that Korea may proceed to make purchases under the stand-by arrangement upon observance of the performance criteria for December 1985.

Decision No. 8161-(85/187), adopted
December 27, 1985

2. EQUATORIAL GUINEA - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the first review under the one-year stand-by arrangement for Equatorial Guinea (EBS/85/280, 12/13/85; see also EBS/85/218, 9/11/85; and Cor. 1, 9/16/85).

Mr. Doe made the following statement:

The stabilization program launched by the Government of Equatorial Guinea early in 1985 is evolving satisfactorily on the whole. All the policy measures envisaged have been or are being implemented. In particular, the producer prices of several crops have been raised and the marketing and taxation arrangements for timber products have been clarified. More discipline is being introduced in the management of government finances. Apart from a deviation from the target of the ceiling on net total domestic credit, the quantified macroeconomic objectives of the revised program--as at end-July to beginning August 1985--are expected to be reached.

In the production sector, as a result of improved incentives arising from increases in producer prices in 1985 and efforts to rehabilitate the productive apparatus of the country under a program jointly financed by the Government, the World Bank, and other institutions, the output of coffee and cocoa is projected to rise to levels permitting export volume of the former to nearly quadruple in 1985 relative to 1984 and of the latter to rise by 8 percent. The harvest of food crops could also be sizable. These improvements also reflect the generally stronger confidence in the economy stemming from the switch from the former currency, the ekwele, to the CFA franc. On the whole, production activity has picked up and is improving.

The fiscal outlook for 1985 is now expected to be somewhat brighter than at the time of the initial review. Indeed, the budgetary surplus now envisaged, though smaller than the level forecast at the inception of the program, nevertheless represents a significant improvement over the near-equilibium situation projected in August 1985. This marked amelioration of the fiscal outturn is to reflect the combined effect of lower total expenditure and slightly higher revenue--principally from timber exports. Total expenditure has been revised downward on account of prospective lower contributions to international organizations and interest payments. It must be mentioned, however, that the projected outturn of spending reflects also the impact of measures taken earlier in the program to strengthen the operations of the treasury and to monitor closely expenditure developments. As envisaged under the program, following the timely conclusion of the census of the civil service, the number of government workers has been reduced considerably. The remaining employees have been reclassified and a new wage schedule introduced. The curtailment of the government work force will undoubtedly contribute to restraining the growth of the wage bill. However, its social repercussions should not be ignored or understated. Satisfactory progress is being made toward reorganizing the public enterprises. In this connection, the authorities have decided to allow private sector participation in some of them, hence, changing their status from public to mixed enterprises pending the completion of the study under way. As regards payments arrears, considerable progress has been achieved toward establishing their inventory. In effect, their orderly elimination is evolving satisfactorily. All in all, the endeavors of the Equatorial Guinean authorities to strengthen budgetary discipline, in particular expenditure control, are progressing in the right direction.

The available information indicates that monetary developments were characterized thus far in 1985 by a more rapid expansion of total domestic credit than earlier anticipated. As reported by the staff, the sharp growth in private sector credit, which is at the origin of the aforementioned evolution, arose from credit demands associated with the upturn of economic activity, the financing of inventories of consumer and durable goods and the effects of delays in the repatriation of export earnings. In addition, the renewed confidence in the economy following the implementation of the new monetary arrangements has spurred credit expansion beyond earlier expectations in 1985. Consequently, the ceilings on total domestic credit had to be revised upward. It must be noted, however, that net credit to the Government evolved within the targets.

In the external sector, the 1985 overall balance of payments is now forecast to show a smaller deficit than estimated earlier, owing mainly to lower than scheduled debt service payments and to better than anticipated trade credits for imports. Export earnings are projected to be lower than previously expected. Subsequent to the replenishment of depleted stocks, import inflows are forecast to decrease. These developments, together with lower interest payments, are expected to contribute toward reaching the current account target as originally foreseen under the program.

In sum, the reordering of policies undertaken by the authorities of Equatorial Guinea under the present adjustment program is yielding satisfactory results. Economic activity has resumed in the agricultural sector and is gradually picking up in other sectors. Discipline is being progressively restored in government finances, and the parastatal sector is being restructured with a view to improving its efficiency. Looking ahead, the authorities are determined to pursue their efforts to redress the economic and financial imbalances of their country, thereby paving the way for sustained economic growth. In view of these satisfactory achievements and of the resolve of the Government to make further progress, I would like to reiterate its request for the completion of the review of the stand-by arrangement by the Executive Board. I should also like to add that, on the basis of the same considerations, the Equatorial Guinean authorities would have preferred a consent to make a purchase amounting to SDR 4.6 million subsequent to the completion of the first review instead of the SDR 3.1 million proposed.

Mr. de la Herrán said that his chair supported the proposed decision. He commended the authorities for the great effort they had made to initiate in a thorough manner the reforms that were necessary to cope with Equatorial Guinea's difficult economic situation. The results so far were encouraging, and the prospects were also optimistic. Nevertheless, there was no room for complacency, considering that the economy was still weak and that the implementation of adjustment policies must continue for some time.

The projected budgetary surplus for 1985 reflected the important adjustments already made in the fiscal area, Mr. de la Herrán continued. In particular, the decrease in transfers and the lower than expected interest payments had contributed to improvements on the expenditure side. The measures being implemented in the tax system were certainly positive steps toward the more general tax reform that was needed.

During the discussion of the stand-by arrangement in June (EBM/85/105, 6/28/85), he had pointed out his concern about excessive civil service salary increases, Mr. de la Herrán recalled. The most recent projections showed that expenditures on wages and salaries had exceeded the amount originally programmed by CFAF 72 million. Projections for 1986 showed a continuation of that trend, as well as the impact of several changes introduced into the wage system with regard to the payment of civil servants' home utilities. He wondered whether including such payments in the budget would prove to be useful and if such changes were justified on the grounds of simplifying the system of civil service remunerations.

He shared the staff's concern about the developments that had led to the overshooting of the credit ceilings, particularly credit to the private sector, Mr. de la Herrán remarked. He agreed that measures should be implemented as soon as possible to decelerate the present unsustainable rate of monetary expansion. Excessive credit growth could pose a threat to the program as a whole and have serious consequences even in the very short run.

As had been demonstrated, the level of exports projected in the program was a difficult goal to achieve, Mr. de la Herrán observed. Nevetheless, despite the weaker than expected export performance, the balance of payments strategy was perfectly in line with the program targets, and there were no prospects of a worsening situation. Given that fact, together with the successful rescheduling that had taken place in July under the auspices of the Paris Club and a broadly appropriate debt management, the overall external situation appeared to be stable. Moreover, there had been no further accumulation of external arrears, and the financing gap of $7.7 million originally projected for 1986 was at present expected to be completely filled.

The active assistance of the World Bank in the adjustment process was welcome, Mr. de la Herrán concluded. He invited the staff to describe World Bank involvement in the investment projects under study and in compiling an inventory of external debt obligations.

Mr. de Forges stated that he supported the proposed decision.

The authorities were clearly committed to the strong adjustment program agreed the previous June, Mr. de Forges observed. The 15 percent reduction in the government work force reflected the serious difficulties faced by the authorities. Among the more effective measures taken to stimulate the economy--apart from the dominant role played by the country's entry into the Bank of Central African States (BEAC)--were the rise of producer prices for several crops and changes in the marketing and taxation of timber products. Together with those reforms, firm implementation of fiscal policy and a restructuring of the public sector were essential to economic recovery. The staff paper had highlighted the considerable progress made in the supply and trade sectors during 1985 and had indicated the path to be followed in the future. However, Equatorial Guinea remained heavily dependent on its earnings from cocoa and timber exports, and in that regard, it was disappointing that previous staff forecasts of export earnings in those sectors had been revised downward for both 1985 and 1986. Clearly, the recovery process was only beginning.

In those circumstances, the staff was understandably prudent in emphasizing the monetary and credit aspects of the program, Mr. de Forges continued. While waiting for exports to recover, any credit expansion not justified by actual economic need should be avoided. In that respect, increased central bank assistance and strengthened commercial bank management could greatly help the authorities in their task.

He welcomed the forthcoming appraisal by the World Bank of a rehabilitation credit to finance imports in fundamental sectors, particularly agriculture and transportation, Mr. de Forges remarked. He hoped that a large part of that credit would be channeled toward the private sector to promote the policy of privatization now under way and to diminish the risk of the public investment program exceeding a level consistent with the country's means and objectives.

Mr. Taha said that Equatorial Guinea was implementing its program in a satisfactory manner. After joining the Central African Monetary Area--a move that had entailed a major exchange rate adjustment--the authorities had introduced far-reaching measures to stimulate agricultural output and strengthen the fiscal and balance of payments positions. The response to the consequent improvement in price incentives had been encouraging. Output of major export commodities and domestic food crops had expanded, resulting in a revival in economic activity. Mr. Doe's statement that the authorities remained committed to implementing the program fully was reassuring.

The deviation from the program target for total domestic credit was largely on account of higher than expected demand for credit from the private sector, Mr. Taha observed. That demand had, in turn, resulted from higher real output: the growth in domestic credit had been important for the growth of the economy.

The staff had set a new credit ceiling for December 1985 and an indicative target for the first quarter of 1986, Mr. Taha noted. The staff had also recommended rephasing the third purchase so that 65 percent of the purchase would be available after the December credit ceiling had been met. In view of the uncertainties regarding the evolution of the growth in private credit and as long as credit expansion was in line with real output growth--and therefore noninflationary--he considered that it would have been more appropriate to set the performance criterion in terms of credit to the Government, as had been done under a previous program, and avoid rephasing the third purchase. He invited staff comment on that point. In concluding, he had no problem with the other elements of the proposed decision.

Mr. Ercel said that he agreed with Mr. Doe and the staff that Equatorial Guinea's performance under the stand-by arrangement had been satisfactory, especially in the areas of economic activity, balance of payments, and fiscal performance. Moreover, Equatorial Guinea's entry into the Central African Monetary Union should obtain important benefits for the country.

One area of concern was the substantial increase in monetary and credit aggregates, Mr. Ercel continued. However, despite a sharp increase in the monetary stock and an 82 percent devaluation of the ekwele and the elimination of several administrative price controls in 1985, domestic prices had remained stable. He would appreciate more information from the staff about the reasons for that favorable price behavior.

Despite excessive monetary expansion in 1985--144 percent compared with an original projection of 9 percent--the ratio of the broad money stock to GDP appeared to be normal compared with ratios in similar African countries, Mr. Ercel observed. Based on that observation, the assumptions on monetary credit and the ceilings for domestic credit used in the initial stages of the program's design might not have been realistic. He wondered whether it would be possible during the process of designing a program to incorporate a factor that projected higher or lower monetary expansion based on the ratios of broad money stock to GDP in similar countries.

In concluding, he supported the proposed decision, Mr. Ercel remarked.

Mr. Goos noted that Equatorial Guinea was making good progress under the present stand-by arrangement and commended the authorities for being largely on track in their implementation of the agreed adjustment measures. The emerging positive response of the economy to those measures, as well as the exceptionally favorable response of the country's Paris Club creditors, should provide strong incentives for further compliance with the adjustment program.

Nevertheless, some concerns needed to be emphasized, not only in light of the economy's continued fragility but also because of the disappointing experience following the expiration of the previous stand-by arrangement, Mr. Goos continued. Budgetary performance was projected to fall considerably short of expectations even though expenditures would probably be lower than forecast, reflecting lower interest rate expenditures as a result of the downward revision in the estimated stock of debt. Considering the critical importance of fiscal surpluses for the country's ability to meet its debt service obligations, he agreed with the staff that revenue-raising efforts had to be strengthened and tight expenditure controls had to be maintained. In that context, the authorities' view that the current limit on the wage bill was too restrictive was worrisome. Wages and salaries had been increased by nearly 70 percent since 1984, while consumer prices had been stable since the beginning of 1985. While the authorities' intention to seek the World Bank's advice on that subject was welcome, there was a clear case for continued wage restraint.

The large discrepancies between the latest staff projections for monetary and credit expansion and the estimates in the original stand-by arrangement paper were disturbing, Mr. Goos considered. The expansion of monetary aggregates at rates of over 50 percent, and even 144 percent as in the present case, could not but give rise to concern. He appreciated the staff's explanation that the actual expansion had resulted largely from the country's entry into the Central African Monetary Area. Also, the staff had been reassured by the fact that the projected ratio of the broad money stock to GDP would compare favorably with the relevant ratios in other African countries, that prices had remained stable since the beginning of the year, and that external developments would compare favorably with the original projections. Despite the apparent plausibility of that explanation, he would caution that only one year's experience might be too short a pericd to make a final judgment on the inflationary and balance of payments impact of monetary expansion, particularly in the specific circumstances of Equatorial Guinea. Furthermore, it would be surprising if there were a close and stable correlation among countries between actual inflation rates and broad money stock/GDP ratios. Therefore, he welcomed the pronounced deceleration in the rate of money and credit expansion envisaged for the remainder of the program period and was reassured by the precautionary steps recommended by the staff that aimed at avoiding slippages in meeting the monetary target.

Another disturbing feature of recent monetary developments was the delay in the first program review owing to the large deviations from the program targets, Mr. Goos remarked. Moreover, the staff had recommended postponing part of the third purchase until after February 1986 to take into account the remaining uncertainty regarding the evolution of private sector credit. However, the slippages identified in the program targets as well as the remaining uncertainty were mainly, if not exclusively, due to the staff's inability to forecast the implications of the country's entry into the monetary zone with a sufficient degree of precision. He therefore concluded that the respective delays and postponements implied that the country was being punished for something it could hardly be blamed for--a conclusion that was all the more worrying in view of the satisfactory implementation of all the remaining measures under the program. He invited staff comment.

Apart from the points mentioned, he had no difficulties with the staff's analysis and recommendations, Mr. Goos concluded. He was, however, concerned about the expected large increase in the current account deficit under the most recent balance of payments projections for 1986 and about the considerable reversal of the improvement in the overall balance of payments achieved in 1985 that was being projected for the coming year. He wondered whether there would not be scope for aiming at a more favorable outcome in the external accounts that would be more commensurate with the country's difficult overall economic position. He invited staff comment on that point.

Ms. Lundsager recalled that at the time when the Board approved the stand-by arrangement program for Equatorial Guinea, her chair had emphasized the supply-side aspects of the adjustment effort, and she was pleased to see the continued implementation of those measures. Unfortunately, completion of the first review had been delayed for several months by unforeseen developments--notably, significant deviations in monetary policy that gave rise to some concerns regarding the still fragile balance of payments position and the low level of official reserves. Of course, Equatorial Guinea's recent entry into the BEAC had reduced the need for foreign exchange reserves while increasing the importance of an appropriate budgetary policy that generated the overall fiscal surplus required to finance debt service payments.

Fiscal developments had fallen somewhat short of expectations, although the smaller surplus did not present a problem because amortization payments were at present lower and external assistance was higher than originally projected, Ms. Lundsager continued. Fiscal adjustment in several areas had been appropriate, including the reduction in the size of the civil service and tax simplification. However, continued wage restraint would be required. Also, as her chair had noted previously, tax simplification should include a plan to reduce and eventually eliminate the export taxes that had been imposed earlier in the year. She remained concerned about the detrimental impact of export taxes on production and hoped that in the new fiscal year an effort could be made to reduce reliance on them.

Public enterprise reforms were progressing, Ms. Lundsager noted. The conversion of the state commercial distribution firm into two mixed enterprises with foreign capital participation was welcome. Additional restructuring was also being studied, and she urged the authorities to complete those studies quickly and implement their findings. The authorities had also pursued wide-ranging price adjustment and deregulation. Producer price increases implemented earlier in the year had restored incentives to farmers, while the policy of price liberalization should permit a more appropriate allocation of domestic resources.

As credit to the Government was within its subceiling, the deviation from the monetary target was entirely due to excessive credit to the private sector, Ms. Lundsager observed. The staff had put forward several explanations for the wide deviation. Since no pressures had yet emerged on the payments position or prices, money demand might also have increased, implying that there was no excess liquidity in the system. That possibility should be evaluated when data were available. Also, it was reassuring that the money supply/GDP ratio was within the range found in other members of the monetary union. The staff had also expressed some confidence that end-December ceilings would be adhered to. Nonetheless, in view of the difficult balance of payments position, the rephasing of purchases and the continuous monitoring of monetary developments appeared to be appropriate.

Careful management of both credit and fiscal policies were called for in 1986 in view of the financing gap projected in the budget, Ms. Lundsager remarked. Donor assistance was projected to fill that gap, and since the donors' meeting and the next review of the stand-by arrangement would take place in the near future, she expected that an appropriate mix between financing and adjustment would be formulated to permit attainment of the program's 1986 targets. Finally, she could support the proposed decision.

Mr. Archibong stated that although Equatorial Guinea had encountered problems in meeting some of the quantitative performance criteria, the underlying economic performance had been satisfactory in terms of growth, domestic prices, the budget, and the balance of payments. Mr. Doe had stressed the authorities' commitment to the path of discipline and adjustment, and the progress achieved thus far in implementing the adjustment program was encouraging. Table 2 of the staff paper clearly showed that the implementation of the program was broadly in line with its original objectives. The current account balance of payments target, for example, was expected to be attained through certain changes in economic conditions.

The satisfactory progress being made toward fiscal discipline was perhaps the most significant achievement under the program, not only because the target was expected to be met but also because such progress was being made in an area that was often a source of difficulty in Fund-supported programs, Mr. Archibong observed. In particular, net domestic credit to the Government had been contained within the prescribed ceiling, while the excess supply of credit to the private sector did not appear to have jeopardized economic performance but might even have contributed to revive economic activity. Moreover, the credit expansion apparently had not jeopardized price stability. The balance of payments target was also being met.

In view of the progress noted, he would have preferred that emphasis should be placed solely on controlling credit to the Government rather than on overall credit, Mr. Archibong remarked. The staff seemed unduly worried about credit flows to the private sector, which could easily be restrained. Also, he strongly supported the position taken by the authorities that they be allowed to purchase the full amount scheduled under the first and second drawings instead of rephasing purchases as proposed by the staff. The rephasing proposal raised some policy issues. For example, what was the legal basis for modifying the schedule of purchases when the September ceilings were only intended to be indicative? The strength of the case for allowing the authorities to draw the full amount rested with the performance of the budget, and that requirement had been met.

The staff representative from the African Department noted that the size of the wage bill had been one of the most difficult issues to resolve in discussions with the authorities. The wage bill was at present projected to be CFAF 1,072 million in 1985, and a target of CFAF 1,000 million had been set for 1986. The authorities continued to regard those figures as being on the low side, and the staff was therefore somewhat gratified that the authorities had been able to keep their expenditures close to the agreed level. The staff considered that it was important to keep the wage bill at the present level to prevent labor from shifting from the productive sectors to the Government and because prices had been stable during 1985. The proposal to include rent and utility allowances in the budget reflected the authorities' desire to demonstrate to civil servants that their actual consumption was higher than indicated by the basic wage bill. That presentational change could be useful: once the additional stipends were incorporated into the basic wage bill, it would be possible to move toward a more realistic market pricing for those services, thereby laying a better base for an appropriate wage policy in the future.

The World Bank had been active in Equatorial Guinea, especially in the productive sector where it had undertaken a cocoa rehabilitation project and was at present considering an import rehabilitation loan, the staff representative noted. The Bank was also involved in evaluating the investment program for 1986, particularly with regard to the rehabilitation of import credits. Fund-Bank cooperation was envisaged with respect to work on the national accounts as well as increased efforts to rehabilitate certain sectors, particularly the timber and coffee sectors. The staff of the two institutions had been cooperating closely, and a Fund mission was expected to visit Equatorial Guinea in January at which time a World Bank team would also be present, which should facilitate the coordination of discussions on policies for 1986.

Cocoa production for 1985 had been lower than originally projected, and the projection for 1986 was also lower owing to unfavorable weather patterns as well as rodent activity, the staff representative explained. Production in the crop year 1985/86 was expected to be about 6,000 tons, or about 1,000-2,000 tons below normal. For the crop year 1986/87, production was expected to recover to about 8,000 tons. But that production level was still much below the previous maximum output of about 40,000 tons in the 1970s. The rehabilitation of the cocoa sector presented a considerable challenge for the authorities and for those institutions assisting them.

The favorable price developments had resulted from the adoption of the CFA franc and the other institutional arrangements that had been introduced, upon the country's entry into the BEAC in 1985, the staff representative remarked. Consequently, the movement of goods from neighboring countries had been freer than in the past, and the country had also been able to attract foreign investment. The increase in imported goods had improved the supply situation markedly, thereby contributing to price stability.

It had been difficult to forecast the growth of credit at the beginning of 1985 owing to institutional changes resulting from Equatorial Guinea's entry into the BEAC monetary area, the staff representative noted. In fact, when Executive Directors first discussed the stand-by arrangement earlier in the year, the credit ceiling had been set only for June 1985. The difficulties arose owing to a major devaluation at the beginning of the program, resulting in a significant decline in the value of the money stock and currency holdings of transactors whose activity tended to be denominated in foreign exchange. To overcome that initial liquidity problem, transactors had been allowed to bring their initial money stock to a level that was consistent with their transaction values. The problem was not unique to Equatorial Guinea but had been observed in several other countries where devaluations of similar magnitude had occurred.

An Executive Director had suggested that the staff examine the broad money stock/GDP ratios in other similar African countries to see whether they yielded any insight on how to deal with the liquidity problems arising from such devaluations, the staff representative recalled. In that regard, the staff had considered that rates of growth had to be brought back to more normal levels in 1986. Thus the rate of monetary expansion proposed for 1986 was 12 percent, compared with 144 percent in 1985, while the proposed rate of growth for domestic credit in 1986 was only 9 percent, compared with 6 percent in 1985. The staff considered those decelerations to be reasonable, assuming that the prevailing levels were appropriate and that future rates of growth should be consistent with the rate of growth of nominal economic activity.

Taking into account an SDR 4.5 million credit from the World Bank, the current account deficit in 1986 would be lower than that in 1985, the staff representative from the African Department remarked. Therefore, the balance of payments situation was expected to improve somewhat in 1986. However, the underlying economic situation in Equatorial Guinea, with regard to both budgetary and external performance, remained relatively fragile and should continue to be monitored closely.

The Deputy Director of the Exchange and Trade Relations Department noted that an Executive Director had questioned whether Equatorial Guinea was being penalized because of its failure to meet a target that had been based on faulty staff forecasting. In his view, that was not the case. As the staff report noted, it had been difficult to forecast the monetary variable in part because of the uncertainty in estimating the path of demand for money, given the country's entry into the currency union. As a result, it had been difficult to agree on enough policy elements to enable the staff to recommend to the Board that the review be completed on schedule and hence, it had been delayed. Since then, it appeared that the demand for money had been proceeding at a higher rate than originally expected, and the targets now proposed in the context of the review did allow for some further credit expansion.

The proposal with regard to the rephasing of purchases conformed to the general practice of maintaining an appropriate relationship between purchases, and performance tests and reviews, the Deputy Director continued. In the present arrangement, in view of the generally good performance in terms of output, inflation, and perhaps the balance of payments, it had seemed reasonable to allow the member to make the purchase it had missed plus some portion of the September purchase.

Credit ceilings were generally formulated on a broad basis because it was overall credit expansion--not just credit to the Government--that had an impact on the balance of payments, the Deputy Director of the Exchange and Trade Relations Department observed. Moreover, once a country joined a currency union, an additional constraint was imposed on its ability to conduct an independent credit policy, a circumstance that made it even more important to keep overall credit expansion under control.

Mr. Doe stated that Equatorial Guinea's authorities considered the present ceiling on the wage bill to be fairly restrictive. At the program's inception, a devaluation of the currency by 82 percent had occurred upon Equatorial Guinea's entry into the CFA franc monetary area. Moreover, a number of price-raising measures had been taken. For example, electricity rates had been increased by nearly 180 percent. The authorities' policy of deregulating the prices of several commodities, consumer goods, and services clearly had an effect on the price level that could not be ignored when defining the wage bill. Also, following the completion of the census of the civil service, the government labor force had been cut by a sizable number with a view to reducing the overall wage bill. Moreover, a reasonable level of compensation was needed to maintain morale and improve productivity. Taking all those factors into consideration, the authorities strongly believed that a more restrictive wage policy could be counterproductive.

The Executive Directors then took the following decision:

1. Equatorial Guinea has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Equatorial Guinea (EBS/85/150, Sup. 1, 7/2/85) in order to reach understandings on the circumstances in which purchases can be resumed under that arrangement.

2. The letter from the Minister of Finance dated November 19, 1985 and the table attached thereto shall be annexed to the stand-by arrangement for Equatorial Guinea and the letter of June 6, 1985 and the table attached thereto shall be read as modified and supplemented by the letter of November 19, 1985 and the table attached thereto.

3. The references in paragraph 4(a)(i), (ii), and (iii) of the arrangement, respectively, to the limits on domestic credit and net bank credit to the Central Government, and the targets for the reduction in domestic and external payments arrears shall, accordingly, refer to those limits and targets set forth in paragraphs 13 and 14 of the letter dated November 19, 1985 and in the table attached thereto.

4. Paragraph 2(a) of the stand-by arrangement for Equatorial Guinea shall be amended to read as follows:

> Purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 2.3 million until August 30, 1985, the equivalent of SDR 5.4 million until February 28, 1986, and the equivalent of SDR 8.1 million until April 30, 1986.

5. The Fund decides, after this consultation pursuant to paragraph 4 of the stand-by arrangement for Equatorial Guinea, that on the basis of the understandings set forth in paragraphs 2 and 3 above, Equatorial Guinea may resume making purchases in accordance with the phasing in amended paragraph 2(a) of the arrangement as set forth in paragraph 4 above.

Decision No. 8162-(85/187), adopted
December 27, 1985

3. EL SALVADOR - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with El Salvador (SM/85/315, 11/26/85). They also had before them a report on recent economic developments in El Salvador (SM/85/329, 12/16/85).

Mr. Pérez made the following statement:

> My Salvadoran authorities consider that the staff report for the 1985 Article IV consultation fairly sets out the current economic situation of El Salvador. Nevertheless, my authorities consider that the report could have placed more emphasis on both the constraints the country is facing, and the efforts made not only to prevent a further deterioration of the economic situation but also to realize some concrete economic gains.
>
> It is difficult to obtain a fair impression of the economic situation in El Salvador through a conventional analysis of economic developments. Like the economies of most Latin American countries, the Salvadoran economy was severely affected by the decline in economic activity experienced by industrial countries

during the early 1980s and by the sharp deterioration in the terms of trade. In addition, the shrinkage of the Central American Common Market--a consequence of the world economic recession aggravated by political uncertainties in the region--as well as the difficulties encountered in maintaining a system of trade payments within the region, have been important factors that further aggravated the economic decline. Finally, the protracted armed conflict affecting El Salvador has compounded the above problems by increasing pressure on public expenditures, generating additional uncertainties, and posing limits to the decision-making process on economic matters.

The consequences of these factors on economic activity, as measured by the most relevant macroeconomic indicators, are evident. During the period 1979-82 real GDP dropped by 22 percent, the rate of unemployment increased from 4 percent to an estimated 30 percent, and both private and public investment fell by a cumulative 58 percent.

In this context, the economic strategy followed by my authorities aims at strengthening the productive sector within the limits imposed by external and internal economic conditions, allowing the country to reach positive real growth. This, in turn, should contribute somewhat to alleviating the unemployment situation. My authorities consider that even moderate success of the economic strategy, together with a certain degree of political stability, might facilitate an early solution to the armed conflict.

The one-year stand-by arrangement with the Fund approved in July 1982 facilitated the adoption of a set of policies aimed at arresting the economic and financial difficulties the country was experiencing. In spite of the difficult circumstances facing the country, the stabilization program yielded positive results. After four years of continued economic deterioration, real output began to recover in 1983, and a modest, positive growth rate was sustained through 1984 and 1985. Nevertheless, this broadly based but still insufficient recovery has not allowed for the improvement of the employment situation and has not arrested the decline in per capita income.

Regarding the public sector, the authorities have succeeded in gradually and continuously reducing the overall public sector deficit. The latest available estimates for 1985 point to an overall deficit of 5.5 percent of GDP, which represents a reduction of one percentage point with respect to 1984, and only one half of the deficit registered in 1981. Despite the limitations imposed by the present political and economic circumstances, the Government implemented measures directed toward increasing revenues and curbing both current and capital expenditures. However, the constraints imposed by defense-related expenditures in the context of a policy of an overall outlay compression have resulted in a significant reduction of capital expenditures, which may represent an obstacle to maintaining the economic recovery. This is especially worrisome as the guerrilla activity has caused significant destruction of the existing infrastructure, thereby damaging the country's productive capacity.

The balance of payments situation remains difficult. For the second consecutive year export receipts will fall in 1985, reflecting the adverse external conditions for El Salvador's major export commodities as well as the financial difficulties faced by other Central American countries. Nonetheless, as a result of the recovery under way in El Salvador, imports are growing at a rate of 8 percent in dollar terms in 1985. The resulting large trade deficit will be offset by grants from friendly countries.

In the area of exchange rate policy, the authorities have maintained the trend toward unification. To this end, they have been gradually transferring transactions from the official market to the parallel market. While these shifts have offset part of the appreciation of the colón, the effects on prices have been significant. According to the latest available indicators, the rate of inflation--as measured by the consumer price index--may reach 22 percent during the 12-month period ending December 1985, compared with 12 percent in December 1984.

My authorities are aware that monetary developments were quite unsatisfactory during the first part of the year and had helped to facilitate the transfer of inflationary effects inherent in the shift of exchange operations from the official market to the parallel market. Accordingly, since June 1985 the Central Bank has adopted a tighter monetary stance by fixing ceilings for the public sector financing and instructing commercial banks to limit new credit exclusively for the financing of essential imports and productive activities.

In the vital area of wage policy, results have been encouraging. As mentioned by the staff, real wages fell by 20 percent in the public sector and 13 percent in the private sector over the period 1981-84. A further decrease in real wages will take place in 1985. In assessing the intentions of my authorities in this field, account should be taken of the Salvadoran context in which social unrest may exacerbate guerrilla activity.

With a view to strengthening current policies in order to sustain the incipient economic recovery, the Government is preparing a set of measures aimed at further correcting the economic disequilibria in the public and external sectors as well as curbing inflation. This package of economic measures to be implemented during 1986 would include: a further reduction in the overall public sector deficit; a significant lowering of the Central Bank's credit to the public sector; an increase of interest rates; a further reduction of wages in real terms; and unification of the exchange rate.

The package of measures is at present being negotiated with the social partners in order to gather the necessary consensus.

In the fiscal area the Government is targeting an overall public sector deficit of 4 percent of GDP for 1986. Due to the already highly compressed expenditure level, the adjustment will necessarily rest on the revenue side. In this regard, my authorities plan to introduce a series of tax measures, namely a strong increase in selective consumption taxes, the adoption of a temporary tax on net wealth that would be in force for one or two years, and a tax on windfall profits from coffee exports that would result from the exchange rate adjustment. This package would allow for the reduction of the public sector deficit while maintaining a moderate increase in capital and defense expenditures.

In the monetary field, the Government, in addition to reducing the financing of the public sector deficit through the banking system, will increase the legal reserve requirements and will proceed to a gradual adjustment of interest rates. Regarding the latter, my authorities have no doubts about the long-term effects of interest rates in fostering saving habits and rationalizing the use of scarce credit resources; nevertheless, they feel a certain degree of skepticism as to the impact of higher interest rates on the decision to retain savings in the country. In the case of El Salvador, it is quite clear that sociological and political factors, perhaps even more than purely economic factors, have an important bearing on the decision to save. Nonetheless, after weighing these and other considerations, the Government has decided to move ahead through a gradual increase in interest rates.

Regarding the exchange rate system, after accelerating the process of shifting products from the official market to the parallel market during the last 12 months, the Government is seriously considering unifying the exchange system at an appropriate rate as the next step. While my authorities are aware that this measure will facilitate the implementation of economic policy and will help to restrain imports, they have some doubts about its effects on exports in the short run. Traditional exports, over which this adjustment will have scant influence, still represent about 70 percent of total receipts, and Central America, which continues to be the main market for manufactured products, is experiencing serious financial difficulties.

Finally, all these measures are to be complemented by a further decrease of real wages. In the particular circumstances of El Salvador, and after the sharp fall in real wages over the past five years, a wage freeze in nominal terms at a time when inflation is running at 22 percent would not be advisable. Nevertheless, in order to be consistent with the plan's main targets, my authorities intend to limit any increase in wages to a level below the increase in prices. Furthermore, only those enterprises that are deemed to be financially able to absorb such increases will be allowed to grant them.

Given the unsettled conditions in El Salvador, the financial situation faced by neighboring countries, and the unfavorable world economic environment, the task of restoring the confidence needed to allow the maintenance of positive growth rates is most challenging. The Salvadoran authorities have followed thus far a gradual and realistic approach to correcting the severe economic imbalances the country is experiencing, and they are now considering the convenience of embarking on a major adjustment program to aid their strategy. The measures and targets included in this plan should merit the support of the Fund.

Mr. Arias said that the economic situation in El Salvador continued to be difficult. However, despite the political and economic constraints, the gradual reduction of the overall public sector deficit, the maintenance of the trend toward exchange rate unification, and the efforts to reduce wages in real terms were encouraging.

He agreed with the staff that the overall fiscal deficit should be kept at levels that were financeable and avoided recourse to domestic credit, Mr. Arias continued. That approach would lead to better resource allocation and lessen the pressure on domestic prices. Moreover, undertaking efforts to improve the financial position of the public enterprises would not only help reduce the flows of government transfers to those enterprises but would also help correct structural imbalances.

He was not convinced that an increase in interest rates would promote saving under the present circumstances, Mr. Arias remarked. He invited Mr. Pérez or the staff to comment on that point. He would also like to hear the staff's views on medium-term trends for private sector investment, taking into account the strength of union labor in El Salvador.

The further widening of the gap between official market transactions and parallel market transactions for the colón was welcome, and he encouraged the authorities to continue their efforts toward unifying the exchange rate system, Mr. Arias added.

The economic program for 1986 described by Mr. Pérez indicated the authorities' willingness to address the economic imbalances facing El Salvador, Mr. Arias concluded. He hoped that the adjustment program could be initiated as soon as possible and that the Fund would be in a position to support it.

Ms. Lundsager remarked that while facing a difficult situation, the Salvadoran authorities had made significant efforts to maintain a growing economy and a stable financial environment. Throughout 1984 inflation had been restrained, and positive economic growth had been restored and maintained in 1985. The overall budget deficit before grants had declined in each year, falling to 5.8 percent of GDP in 1985. That favorable development was however somewhat clouded by the large increase in domestic financing of the deficit in both 1984 and 1985. Furthermore, overall monetary policy had been expansionary in 1984 and earlier in 1985, which might have eroded the impact of earlier favorable trends by reinforcing the inflationary impact of the currency depreciation. The doubling of the inflation rate to some 22 percent in 1985 could undermine business confidence in the economy and lead to balance of payments difficulties. It was notable that in 1985, unrecorded outflows had risen again, and they could increase further if a more stable financial environment was not restored.

High priority should be given to firmly restricting monetary expansion, Ms. Lundsager continued. She wondered whether the staff had any information on the size of working capital balances held by the private sector. While she supported the overall emphasis placed on providing adequate credit to the private sector, such credit should not lead to excess liquidity and pressure on the payments position. She wondered if the "gradual approach" toward additional monetary measures, as described by Mr. Pérez, would be sufficient to contain inflationary and balance of payments pressures in 1986. The erosion of real returns on financial savings was especially worrisome. Real interest rates were at present significantly negative, with obvious implications for both the external position and domestic incentives to save.

A cautious fiscal policy could ease the pressures on the banking system, Ms. Lundsager observed. Also, although the authorities had managed to contain budgetary pressures through 1985, it might be difficult to contain current expenditures in 1986. In that respect, she noted that the staff paper pointed out that the National Assembly could not increase the level of total expenditures, but the paper also indicated that the budget included no wage increase and no allocation for some expected transfers. That feature could raise some concerns, but Mr. Pérez had reported that the authorities were committed to reducing the overall deficit to 4 percent of GDP, which represented a significant adjustment. She hoped that that target could be attained, but she had some reservations about the windfall profits tax on coffee exports. Although the rationale for that measure was understandable, the authorities should consider alternative measures that would not adversely affect exports. Also, budgetary developments might necessitate raising various public enterprise tariffs in addition to that for electricity. She welcomed the steps that had been taken to decontrol administrative prices, including the provision for reasonable profit margins for basic commodities.

Developments in the external sector were less favorable than had been expected, with exports actually declining in 1985 and imports still increasing, Ms. Lundsager remarked. The authorities were apparently aware of the need for additional action on the exchange rate, and Mr. Pérez had indicated they were seriously considering the unification of the exchange system, a step she could fully endorse. Although an additional depreciation might not increase exports in the short run, in the longer run the price effects would send the needed signals to domestic producers and lead to expanded production of traded goods, with concomitant effects on growth, employment, and the balance of payments. That point was especially important because it was becoming unlikely that the financing gaps projected for the medium term would be covered by foreign grants. In particular, given budgetary developments in the United States, foreign grants would probably not be sufficient to cover the expected financing gap for 1986. Thus, it was even more important to implement a comprehensive adjustment program to contain the situation while avoiding any further increase in arrears. Full implementation of the package of measures described by Mr. Pérez could lead to the needed reduction in the payments deficit and eliminate the gap projected for the coming year. Besides improving the trade account, a stable financial environment could also reduce capital outflows. She invited the staff to comment on those possibilities.

Over several years the Salvadoran authorities had managed to contain the financial problems that could have emerged, given the political situation, Ms. Lundsager concluded. The slippages that had occurred in 1985 could, however, lead to an accelerating deterioration with serious consequences. Mr. Pérez had outlined an economic strategy that was being considered at present by the authorities. She strongly urged them to implement the measures needed to attain the desired goals.

Mr. Hodgson said that political events and armed conflict in El Salvador in recent years had had an adverse effect on economic performance, despite the implementation of a Fund-supported adjustment program in 1983. While growth had recovered somewhat in the past two years, the external balances had continued to weaken and inflation had accelerated.

According to Mr. Pérez, the authorities believed that even modest economic success could help in finding the solution to the armed conflict in El Salvador, Mr. Hodgson recalled. He completely agreed with that viewpoint. The question was therefore not whether measures were necessary but rather which course of economic policy would help reinforce political stability. In his view, it was in the authorities own best interest to implement comprehensive macroeconomic measures that would help rebuild domestic and international confidence in the economy, encourage domestic saving, and stimulate public and private investment. He was encouraged to hear from Mr. Pérez that the authorities were at present considering such a set of measures to accompany the improved fiscal balance. However, as the staff had emphasized, the most pressing need was to adopt immediately a more restrictive credit policy to dampen the strong inflationary pressures evident at present. To be fully effective, monetary restraint also needed to be accompanied by measures such as those outlined in the staff paper. He therefore endorsed the policy views expressed in the staff appraisal. However, wage restraint in the public sector would be made much easier if the authorities could quickly bring inflation under control. Conversely, if credit growth was not restrained, pressure for wage increases would make the fiscal deficit that much more difficult to contain. That possibility reinforced the need for an immediate shift to a less expansionary monetary policy.

Mr. Salinas said that El Salvador's economic situation had been difficult in recent years because of several factors, including the armed conflict in the country, the world recession, and the disruption of the Central American Common Market. In particular, the internal armed conflict had adversely affected all aspects of economic activity. In the circumstances, the progress that had been made in the economic field, particularly in the public sector and in the exchange rate system, was encouraging.

Inflation had increased during 1985, reflecting both price adjustments associated with the shift of exchange transactions from the official market to the parallel market and an expansionary credit policy, Mr. Salinas noted. In 1986, prudent fiscal and monetary policies would be needed if the authorities were to avoid further increases in inflation and a deterioration in the balance of payments.

The authorities should be commended for the progress made in reducing fiscal imbalances in recent years as a result of a decline in nondefense expenditures and improvements in the tax system, Mr. Salinas continued. The staff had recommended that the rate of taxation should be raised above its current level of 12 percent of GDP. In particular, the staff had suggested the implementation of a contingency tax package and the imposition of an income tax surcharge. Considering the need to take further steps to improve the fiscal situation, he supported the implementation of those additional measures.

On expenditures, prudent policies should be pursued, Mr. Salinas added. However, he was concerned about the continuous reduction in capital expenditures and its negative impact on future growth. Additional efforts would be required to reduce current expenditures.

Considering the increase in inflation, he agreed with the staff that a more restrictive credit policy should be pursued, Mr. Salinas remarked. Some increase in interest rates would help to provide a stronger incentive to savings and improve the allocation of credit.

He welcomed the recent enlargement of the parallel exchange market as a further step toward exchange rate unification, Mr. Salinas commented. He endorsed the intention of the authorities to improve the system gradually. Any country facing internal problems, such as those in El Salvador, had no choice but to introduce some exchange restrictions. The gradual depreciation of the currency in the official market would be a helpful development.

The medium-term projections indicated that El Salvador's balance of payments would remain under pressure through 1990, even on the assumption that U.S. grants and aid would continue at $320 million a year, Mr. Salinas noted. Given the present uncertainties, the authorities' efforts to keep economic management on reasonably sure grounds should be concentrated on fiscal policy, the interest rate structure, and the exchange system. The authorities were making important efforts to improve the economic situation, and he encouraged them to take some additional measures to restore confidence in the economy.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/186 (12/23/85) and EBM/85/187 (12/27/85).

4. HAITI - TECHNICAL ASSISTANCE

In response to a request from the Haitian authorities for technical assistance in reviewing the budgetary process, the procedures for reinforcing expenditure controls, and the organization of the budget office, the Executive Board approves the proposal set forth in EBD/85/318 (12/19/85).

Adopted December 26, 1985

5. STAFF RETIREMENT PLAN - AMENDMENT TO PENSION PARITY ADJUSTMENT SYSTEM

The Executive Board approves the report from the Pension Committee recommending an amendment of the pension parity adjustment system (EBAP/73/102, 5/10/73) in respect of pensions denominated in local currency, as set forth in EBAP/85/315 (12/18/85).

Decision No. 8163-(85/187), adopted
December 23, 1985

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/318 (12/20/85) and EBAP/85/319 (12/23/85) and by an Advisor to Executive Director as set forth in EBAP/85/319 (12/23/85) is approved.

APPROVED: AUGUST 15, 1986

JOSEPH W. LANG, JR.
Acting Secretary