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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/5

10:00 a.m., January 13, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
	M. Teijeiro
R. D. Erb	M. K. Bush
	T. Alhaimus
	T. Yamashita
	Jaafar A.
R. K. Joyce	L. Leonard
	C. Robalino
	G. Grosche
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
	S. El-Khouri, Temporary
J. J. Polak	T. de Vries
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
F. Sangare	E. I. M. Mtei
M. A. Senior	
J. Tvedt	
N. Wicks	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

I. Szalkai, Assistant General Manager, National Bank of Hungary. European Department: B. Rose, Deputy Director; E. O. C. Brehmer, P. B. de Fontenay, P. C. Hole, H. B. Junz, J. K. Salop, J. Somogyi, P. W. Stanyer. Exchange and Trade Relations Department: A. Abisourour, M. Allen, G. Belanger, S. Kanesa-Thasan, C. Puckahtikom. External Relations Department: G. P. Newman. Fiscal Affairs Department: M. J. Fetherston, B. J. Nivollet. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder. Middle Eastern Department: K. Nashashibi. Treasurer's Department: D. Gupta. Western Hemisphere Department: G. Oliveros. Personal Assistant to the Managing Director. S. P. Collins. Advisors to Executive Directors: S. R. Abiad, S. E. Conrado, L. Ionescu, G. E. L. Nguyen, Y. Okubo, P. Péterfalvy, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, L. E. J. M. Coene, R. J. J. Costa, G. Ercel, I. Fridriksson, V. Govindarajan, D. Hammann, C. M. Hull, J. M. Jones, H. Kobayashi, M. J. Kooymans, M. Rasyid, Shao Z., N. Toé, Wang C. Y.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Ms. Mary K. Bush as the new Alternate Executive Director for the United States.

2. HUNGARIAN PEOPLE'S REPUBLIC - 1983 ARTICLE IV CONSULTATION AND REQUEST FOR STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1983 Article IV consultation with Hungary and its request for a one-year stand-by arrangement equivalent to SDR 425 million (EBS/83/268, 12/16/83; and Cor. 1, 1/12/84). They also had before them a report on recent economic developments in Hungary (SM/83/261, 12/28/83).

Mr. de Groote made the following statement:

> The staff has realistically assessed both the policies pursued by the Hungarian authorities and the circumstances that dictated their formulation. These policies amply justify renewed IMF support and show that the Fund's advice has been taken seriously in Hungary: the Hungarian authorities consider their dialogue with the Fund to be important in clarifying the issues they face as they outline the medium-term adjustment path that must be followed to improve the efficiency of the economy.
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> The Fund's contribution so far has not been limited to an exchange of views on economic issues. Its assistance under a first stand-by arrangement last year has strengthened Hungary's standing in the international financial markets. There are now good signs that the international community understands both the global significance of the reform process in Hungary and the role of the Fund in that process. The involvement of the Fund through the present stand-by arrangement will accordingly be interpreted as a clear signal that this institution continues to stand behind the reform process with all the expertise and skill at its command.
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> Some particular present aspects of the Hungarian economy deserve special attention.
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> First, it is obvious that the first stand-by arrangement for Hungary approved 13 months ago was successful, as the performance criteria were basically fulfilled and Hungary's solvency was preserved. Hungary improved its current account balance in convertible currencies by $664 million in 1982 and by $368 million in 1983, attaining in the latter year a current account surplus of $305 million. The international financial community has recognized the significance of this improvement, and its restored confidence in the Hungarian economy is reflected in an improved capital account and an increase in reserves for 1983.

These desired improvements resulted from the curtailment of domestic absorption, from renewed efforts to increase Hungary's exports, and from the effects of the temporary import restrictions introduced in September 1982, although the effectiveness of these measures was weakened by adverse developments in the terms of trade. In this connection, it should be noted that even though Hungary's exports in convertible currencies increased in volume terms by 7.2 percent in 1982 and by 4.4 percent in 1983, adverse price developments caused export receipts in convertible currencies to decline by 0.7 percent in 1982 and to decline again by 6.2 percent in 1983. At the same time, the import restriction measures mentioned above caused the volume of imports to decline by 5.5 percent in 1982 and by 1.8 percent in 1983, while import expenditures decreased even more significantly.

Although Hungary's improvement of its current account exceeded the target by $90 million in 1982, it was not possible to duplicate this success in 1983, mainly as a result of adverse circumstances beyond Hungary's control. The current account improvement for 1983 was above $200 million less than expected. About $100 million of this shortfall may be attributed to the severe drought that affected the export-oriented agricultural sector, and a further $70 million to the unforeseen deterioration in the terms of trade with the nonruble area. The demand management policy has thus achieved its basic aims in the external sector and succeeded in maintaining a satisfactory level of domestic absorption.

Second, the experience with the past Hungarian program and with programs in several other countries has raised questions about both the strengths and the weaknesses of the Fund's approach of relying primarily on a traditional set of performance criteria. As some Board discussions have shown, in countries that can be roughly described as having nonmarket economies, the Fund's traditional recourse to these performance criteria has in certain cases proved inadequate. Indeed, in some countries, adherence to the Fund's performance criteria has gone hand in hand with a further deterioration of the underlying imbalances. An alternative approach--in which the Fund would involve itself in the setting of quantitative planning targets in order to control the economic development of such economies--is, on the other hand, undesirable.

A more realistic approach to the Fund's role in these countries might be to seek, in addition to the usual demand management measures, the introduction of market instruments, and then to monitor their implementation: to consider, in a word, the introduction of such instruments as additional performance criteria. The adoption of such an approach requires the establishment of a good understanding between the Fund and the country involved concerning the real objectives of the program, and the devising of appropriate measures for achieving them in an atmosphere free of preconceptions about the policies needed. The implementation of the program and, of course, its success would depend very much on the skill with which the authorities are able to adopt appropriate adjustment measures as circumstances may warrant. The progressive implementation of market mechanisms in these economies would in time allow a more efficient monitoring of economic developments by the use of the traditional performance criteria.

Actually, Hungary's present economic and political endeavors, characterized by an adjustment effort not accompanied by shortages, disruptions in production and supply, or political unrest, proves that an economic reform based on the gradual integration of market instruments into all economic activities--planning, investment, production, marketing--could be taken into consideration as a blueprint for adjustment policy.

Third, the Hungarian authorities consider the economic reforms that they will continue to implement in 1984 to be a precondition of further adjustment. They will integrate an increased reliance on market instruments into their basic socialist objectives, in order to achieve a better resource allocation and to attain, within the constraints of available resources, a higher level of economic activity. As outlined in the letter of intent, these economic reforms will be concentrated in the following basic fields:

- a price reform: price formation will be freed, except for certain sensitive consumer goods or for the products of domestic producers' monopolies. Price liberalization requires the maintenance of an adequate degree of competition;

- a wage reform: wages will be freely determined on the basis of a social consensus to be attained by harmonizing the interests of different social forces;

- a tax reform: a new comprehensive system, based on the taxation of value added and personal income, will be introduced;

- a reform of the financial intermediation system: capital flows will be channeled through an independent banking system on the basis of market principles and profit motivation, using new financial instruments;

- a reform of the decision-making process: decision making by enterprises will become more autonomous and will rely on market-oriented managerial initiatives.

These reforms embody he basic principles that underlay the structural measures adopted by the Hungarian authorities in FY 1982/83 and that will continue to serve as the underlying framework for the 1984 program.

Fourth, the 1984 program for Hungary is predicated on the assumption that further assistance from the Fund will be needed to ease its balance of payments situation. The Hungarian authorities consider that to ensure an adequate level of competition it will be essential in 1984 to eliminate the import restrictions introduced in 1982 for balance of payments reasons. Easing the balance of payments situation through the availability of adequate financing would permit faster progress in implementing the country's economic reform program. The present program, although it concentrates on demand management, also provides several specific measures that will contribute, even in the first half of 1984, to the basic aims of the reform program. The elimination of a large number of price subsidies, the loosening of limitations on wage differentiation, and increasing labor costs by augmenting the social security contributions of the enterprises, are all intended to contribute to the freeing of the price and wage formation processes. The streamlining of the turnover taxes and unification of some of the existing income taxes will prepare for the introduction of a new tax system. New bond issues will be launched, and commercial paper will be introduced for the enterprises, as preliminary steps in the direction of a more effective system of financial intermediation. Simultaneously, the existing financial institutions other than the National Bank of Hungary will be granted a wider scope of activities.

The transformation of an economy that has till now relied in many areas on nonmarket instruments into a system where the market must exert a leading influence on the planned economic processes is, however, a difficult transformation that cannot be implemented overnight. A smooth transition requires every step taken under the aegis of the reform to have a positive impact on overall economic performance. The different elements of the reform must indeed be supportive of one another, besides being well aligned with the balance of payments situation. Therefore, at the present stage of negotiations, the Hungarian authorities have submitted a shorter and less ambitious program, which they intend to transform into a more comprehensive program later in the year. Their present need is for more time, and in certain areas for advice and expertise from the international community, to elaborate and specify the reform measures, which will then be considered an appropriate basis for requesting further assistance from the Fund.

> The present program is intended to prepare for this reform and should be judged on that basis. Further administrative cuts in investments, the confiscation of reserve funds of the enterprises, further increases in total budget revenues and expenditures, all these are methods which, though they still have a strong flavor of the former system of administrative intervention, are considered to be necessary until the new system, based on comprehensive market mechanisms, is in place and functioning.

Extending his remarks, Mr. de Groote said that his Hungarian authorities attached great importance to the frankness of their relations with the Fund: they had asked him to communicate to the Executive Board a number of decisions taken at the political level but not yet announced to the public. He requested his colleagues to treat the information in the strictest confidence.

Within the framework of the 1984 price policy, a number of administrative prices would be raised in January, resulting in an overall increase of 2.8 percent in the consumer price index on an annual basis, Mr. de Groote went on. Some of the increases were: 20-22 percent on meat, meat products, and canned food; 20-30 percent on construction materials; 20 percent on household oil, an important consumer item; 50 percent on household electricity (night price); 15 percent on beer; 6 percent on cars; and 60 percent on sewage fees. In addition, serious consideration was being given to a 3 percent adjustment of the exchange rate by the end of January or early February. Furthermore, noninterest-bearing deposits by importers would probably soon be liberalized for export-oriented and creditworthy enterprises through a decision of the Board of the National Bank of Hungary. Importers would be able to substitute for the deposits a guarantee issued by the Credit Department of the National Bank. Those three major decisions represented the implementation of an important part of the program envisaged for the first half of 1984. He invited the staff to comment on their relevance within the program agreed with the Fund.

A number of other measures had already been announced in four important areas, Mr. de Groote added. First, at the end of December 1983, a resolution of the Council of Ministers had been published according to which the banks were no longer authorized to grant interest rebates on credits or state loans. Second, a decree had been published on price formation in manufacturing industry, according to which the obligation to link domestic profit margins to those obtainable on exports to the convertible-currency area had been abolished for 68 engineering enterprises, most of the textile industry, and part of the chemical industry. That measure represented a decisive step because it meant that, for a number of commodities in which the demand and supply relationships were in balance, prices would be freely determined instead of being determined through reference to external conditions, as occurred at present. The measure therefore represented a step in the direction that the Fund had been advocating. Enterprises operating in a sufficiently competitive domestic market could apply for exemption from the link between domestic profit margins and export profit margins. Import prices would continue to apply in all cases as the upper ceiling for domestic prices. Third, new wage rates had been announced, representing, on average, increases of about 10 percent in the lowest wages and about 25 percent in the highest wages, reflecting the Fund's encouragement of greater diversification in wage formation. Fourth, depreciation allowances had been changed: the number of depreciation rates had been significantly reduced, with the new rates applying only as general upper limits; enterprises could take lower depreciation allowances and would be free to allocate them among the different types of fixed assets as they wished.

From the information available since the time of the staff mission to Hungary, it appeared that some of the performance criteria for the end of December 1983 would be marginally breached, Mr. de Groote observed. The net domestic assets of the National Bank of Hungary would probably be above the ceiling, and the net foreign liabilities would probably be under the ceiling. The explanation for those developments, which lay in the improvement in the current account, was clearly described in the papers before Directors. The relatively small slippage affecting the accounts of the National Bank should be viewed in light of the fact that the overall balance of payments deficit in 1983 had been about $1 billion below the 1982 level and that the transfer of resources to the balance of payments in the past two years had been equivalent to about 5 percent of GDP.

Mr. Zhang commented that the Hungarian authorities should be congratulated for their success in having met the performance criteria so that the final purchase under the current stand-by arrangement could be made. In assessing Hungary's economic development in 1983, Directors should consider two important facts. On the external side, even though the improvement in the current account in convertible currencies in 1983 had been lower than expected as a result of a drought and a deterioration of the terms of trade, the actual transfer of resources to the external sector in 1983 had amounted to the equivalent of almost 2 percent of GDP, bringing the cumulative improvement since 1981 to close to 5 percent of GDP, by no means a small achievement.

With regard to domestic demand management, Mr. Zhang continued, the Hungarian authorities had introduced additional timely and appropriate measures in the monetary, fiscal, wage, and price fields during the year. In conjunction with other supply measures, those actions had proved effective in dealing with the difficulties in "moving from a centralized system of microcontrols to a decentralized system of macrocontrols," in the phrase used by the staff on page 19 of EBS/83/268. In 1983, as in the previous few years, the internal policy objectives had generally been realized successfully. However, in the external sector, the authorities' adjustment efforts had been severely circumscribed by tight external constraints and had been adversely affected by developments in the world economy.

In EBS/83/268, the staff provided an interesting account of the current stabilization program, the reform policies, and the process of implementation, Mr. Zhang observed. However, the achievements of the Hungarian economy in the recent past had been made possible by the fact that the expansion of market mechanisms, the increased autonomy of the individual enterprises, and the liberalization of trade had taken place within the framework of the social ownership of the predominant part of the means of production, and with the retention of central planning.

The negotiations for a new one-year stand-by arrangement for 1984 had been successfully concluded, Mr. Zhang noted. Furthermore, the authorities' hope that the new arrangement could be replaced by an 18-month arrangement by the middle of 1984 had been implicitly accepted by the staff on the understanding that certain conditions were met.

There appeared to be certain inconsistencies in the staff appraisal, Mr. Zhang considered. On the one hand, the staff indicated that significant adjustments had taken place in 1983 and that the maintenance of import restrictions had prevented the pressure of demand from being reflected in a larger current account deficit in convertible currencies. It also stated that, to a large extent, the demand overruns associated with the authorities' attempt to free the economy illustrated the difficulties in moving from a centralized system of microeconomic controls to a decentralized system of macroeconomic controls. It further stated that there were limits to which wages and prices could be freed from regulation and that the supporting institutional changes ought not to be fashioned in haste. Therefore, the staff clearly recognized that the authorities had been seeking to move as fast as possible under the circumstances. On the other hand, on page 22 of EBS/83/268, the staff "urge[d] the authorities to move with considered speed and not to lose the momentum by deliberating too long." He invited the staff to comment on such inconsistencies. Furthermore, the quoted caution and the wording in some other passages might create the unintentional impression of a somewhat paternalistic attitude of the staff toward member countries.

Because the new program, like the previous one, would be implemented in conjunction with basic reforms, Mr. Zhang went on, some of the demand restraining measures might be too restrictive, thereby adversely affecting the future growth of the Hungarian economy. The large curtailment of investment expenditure was a case in point. Because the economic reforms being implemented in Hungary were in harmony with the objectives of the Fund, and because the authorities had clearly demonstrated their determination and capability to carry out the liberalization reform, it would be appropriate to leave to the authorities greater room for maneuver in the course of the year in implementing the policies already agreed with the Fund.

While urging the Hungarian authorities to take early steps to eliminate the higher import licensing and import quotas and the bilateral trade agreement, Mr. Zhang remarked, the Fund should be aware that such measures could not be removed in haste irrespective of internal and external conditions, in view of the risk of endangering the process of economic reform. In appraising the significance of various policies, Directors should bear in mind the importance of their social objectives, objectives that might, in some cases, pose constraints on the timing of the introduction of some measures considered desirable from a purely economic point of view. An example was the policy on the distribution of income. If the authorities could not take a decision to free wages and prices at present in the manner that the staff would prefer, such a decision should not be described as "diffident," as the staff had done on page 21 of EBS/83/268.

He agreed in general with the thrust of Mr. de Groote's analysis and his conclusions in his statement, Mr. Zhang went on. However, he had difficulty in accepting the suggestion for considering the introduction of market instruments as additional performance criteria for the Fund's stand-by arrangements with members having centrally planned economies. While the adoption of such instruments might be justified in Hungary under present circumstances, and on grounds of expediency, it would clearly have long-term implications for the Fund's lending policies, particularly those relating to centrally planned economies, for which the Executive Board did not yet have an overall policy. It was doubtful, therefore, whether such a procedure should be generalized and applied to other centrally planned economies or to other types of economies without further study. It was likely that the procedure would eventually involve setting up additional rigid quantitative performance criteria, an approach that might conflict with the Fund's principle of uniformity of treatment of members. In assessing a country's economic performance and achievements, the Fund should take full account of the impact of the authorities' social and political policy objectives. He supported the proposed decisions.

Mr. Wicks remarked that Mr. de Groote had clearly set out both the specific measures that his Hungarian authorities had in mind and the thinking that lay behind them. His only reservation was to prefer a more cautious assessment than that by Mr. de Groote of past performance and future prospects.

Commenting on the progress of the Hungarian economy, Mr. Wicks said that the gains achieved by the authorities were most welcome. For example, almost 5 percent of GDP had been moved into the external sector since 1981. The wage and pricing policies for enterprises had been liberalized, and cuts in subsidies were planned. Additional helpful information had been provided by Mr. de Groote on that topic. While such achievements represented real progress, more needed to be done, as suggested by the analysis of medium-term external prospects in Table 11 of EBS/83/268. Failure to achieve the projected improvement in the convertible currency current account in 1983 had left Hungary's capital account weaker than expected and its financing position somewhat uncertain.

With maturing debt forecast to remain at almost $1.5 billion between 1984 and 1988, Hungary could not afford to ease its adjustment effort if it were to attract the $1 billion of gross financing needed each year in medium-term capital inflows, Mr. Wicks commented. It would be imprudent to assume that shortfalls from current account targets could readily be financed by increased borrowing from the international capital markets. Targets helped to bolster confidence and failure to achieve them could erode it. It was unfortunately true that, with short-term debt of $1.3 billion and convertible currency reserves of only $0.7 billion, and with a medium-term and long-term debt service ratio rising to 40 percent in 1984--60 percent if short-term maturities were included--Hungary remained highly vulnerable to capital outflows if confidence waned again. Against that background, it was disappointing that the current account surplus of $600 million aimed at in the original stabilization program for 1983 was now considered unlikely to be reached until 1987.

The authorities' intention to remove import restrictions was welcome, Mr. Wicks added, although it was unfortunate that the removal was to be delayed until the second half of 1984. When the Executive Board conducted the mid-term review, the timetable for the removal of the restrictions would have to be considered. The failures and the successes, and there had been many successes, of the previous few years needed to be examined carefully and the lessons used to provide a securer basis for future programs. In particular, the progress made by the Hungarian authorities toward introducing a stronger element of market signaling into the economy was welcome; performance in that regard should be monitored closely under any new Fund arrangement.

Turning to areas for future action by the authorities, Mr. Wicks suggested that the overshoot of domestic demand in 1983 was worrying, because domestic demand restraint was a principal instrument of macroeconomic adjustment in the Hungarian economy. The overshoot was partly due to the buoyancy of the private sector, an understandable phenomenon in the current period of transition. However, investment demand had increased too rapidly even in the sectors in which the traditional methods of official control had been operating, particularly through the State Development Bank. The subceiling on the Bank's activities under the new program was, therefore, welcome. In other areas, subsidies would continue to account for 26 percent of the state budget in 1984, although the information provided by Mr. de Groote at the beginning of the meeting might mean that the figure would be somewhat lower. He hoped that the authorities could take further action on subsidies as quickly as possible. On the revenue side, reform of the tax system was welcome; he hoped that the authorities could soon take more than just the "first step" referred to on page 17 of EBS/83/268 toward a uniform system of personal income taxation.

Improvements in the tax system could not be the whole answer in regulating and smoothing personal incomes, Mr. Wicks considered. Savings incentives also needed to be improved. The 2 percentage point increase in the interest rates for household deposits was welcome, but it was questionable whether that increase would do much more than offset the expected increase in the rate of inflation. He hoped that the authorities would consider the development of new financial instruments to attract savers, even if they required higher deposit rates. It was also a matter of concern that, as in 1983, the policy measures proposed might be insufficient to restrain demand to its projected level. If such a development appeared likely, or if the external position deteriorated from the path projected in Table 6 of EBS/83/268, he hoped that the package of measures proposed for introduction in the summer would include action to restrain demand. The burden of adjustment should fall on consumers, for example, through reductions in subsidies.

A few years earlier Hungary had had the astonishing investment ratio of 35 percent of GDP, Mr. Wicks remarked. At present, the ratio was only 25 percent, but it was worth asking whether the quality of such investment had been, and was at present, adequate. Did the staff or the authorities have a firm view on how much of the extraordinary high volume of investment would earn a reasonable rate of return? Was the investment subject to proper systems of appraisal? Were the reductions in investment in the areas of lowest return? Although the subject was more usually dealt with by the World Bank, the Fund needed to have a clear assessment of the overall picture, particularly in view of the large share of GDP devoted to investment.

The policy of economic decentralization as a means of improving national resource planning within the political and social framework existing in Hungary deserved high praise, Mr. Wicks commented. An important element of that policy was the process of pushing financial responsibility down to the level of the individual enterprises. The process would be strengthened if a system of financial intermediation between enterprises could be introduced over a period of time; he understood from Mr. de Groote's statement that ideas along those lines were under consideration. A possible first step would be for enterprises with cash surpluses to lend them, at a proper rate of interest, to enterprises in cash deficit. He welcomed the authorities' intention to separate the commercial and central banking functions of the National Bank so that private sector savings could be channeled, again at proper rates of interest, to the state enterprises. There were clearly significant problems in that area, but a system broadly along such lines would strengthen price signals within the framework of the state and social enterprises.

It was always disturbing when a member met most of the performance criteria specified by the Fund while its economy failed to respond as planned, Mr. Wicks went on. Unfortunately, such a development had occurred in Hungary. For example, the current account surplus originally forecast to be $500 million in 1983 was currently estimated to be only $300 million. No doubt the result was partly caused by a decline of only 0.5 percent in fiscal expenditure rather than the 3 percent decline programmed at midyear. Among other examples, real personal consumption had remained stable, instead of falling by 2 percent. Such developments raised the question whether the program had been poorly designed in the first place and whether the Fund understood enough about the Hungarian economy. Furthermore, had the performance criteria contained a degree of elasticity that had made it easy for the authorities to meet them without affecting the real economy? He invited the staff or Mr. de Groote to comment on such questions.

He had a number of technical reservations with regard to the new program, Mr. Wicks continued. The program was essentially a 6-month holding operation pending a package of further measures in the summer. He understood the considerations on which that approach had been based and he shared the staff's view that the momentum of adjustment, particularly structural reform, should not be allowed to flag. However, Directors had been informed that the authorities wished to have the new program replaced later in the year by an 18-month arrangement. It would perhaps have been more appropriate to have had a special 6-month or 9-month program pending the further measures. Such an arrangement would have met the authorities' intentions clearly without compromising their freedom of maneuver. The proposed midterm review would amount almost to a renegotiation if the program continued beyond the summer. Furthermore, the provisional nature of the program made it questionable whether the phasing of drawings described on page 45 of EBS/83/268 was appropriate. Fifty-three percent of the drawings were to be made before the structural reforms were implemented. In sum, it would have been preferable on technical grounds to have put forward a relatively modest six-month program, to be followed by the longer arrangement when the expected stronger structural measures were introduced.

His technical points of reservation were directed more to the Fund staff than to the Hungarian authorities, Mr. Wicks added. The latter's efforts had his warm endorsement; he hoped that they would find the results to date sufficiently encouraging to broaden their scope and application, particularly with regard to private sector enterprises. He firmly supported the proposed decision, although it would have been easier to do so if the program, which was generous, had been shaped in the somewhat different way that he had outlined.

Mr. Erb said that he agreed with the staff's overall assessment of the Hungarian program. Considerable progress had been made in restoring the current account, the overall balance of payments, and the foreign debt situation to a more sustainable basis, despite adverse developments beyond the authorities' control. Unfortunately, there had been slippage in the credit area, and a stronger effort would be required in 1984. More important, the Hungarian authorities had embarked on a difficult, but promising, effort at market-oriented structural reforms aimed at increasing the efficiency and resiliency of the economy. Such reforms were necessary to establish the basis for higher and steadier economic growth and a stronger external payments position.

The improvement in the ratio of current account to GDP between 1981 and 1983 and the setting of a target of $400 million for a current account surplus in 1984 were steps in the right direction, Mr. Erb continued. However, the improvement in the 1983 current account balance had been partly attributable to continued import restrictions, and the debt service ratio of over 40 percent in 1984 continued to be too high. Excess domestic demand had certainly contributed to the shortfall on the current account target, although drought and adverse terms of trade developments had also been important. It was encouraging that the continued progress in strengthening the current account position had led to an improvement in capital flows and in the foreign financial market's perception of Hungary's balance of payments position toward the end of 1983. It should be possible for Hungary to provide for contingencies in 1984 by judicious stand-by borrowing from foreign banks.

Monetary policy had been weak in 1983, Mr. Erb considered, despite continued moderation in overall credit expansion, a sharp cut in the growth of credit to the Government, and continued deceleration in the growth of broad-based money. Imposition of a ceiling on credit extended by the State Development Bank in 1984 might be necessary to close a loophole in credit restraint, although such direct controls were not altogether consistent with the broader move toward adoption of market-oriented monetary instruments.

Turning to the proposed program, Mr. Erb endorsed the principal objectives proposed for 1984 and beyond. Further restraint on both private and public consumption would be required. While restraint on consumption appeared necessary, the authorities were also contemplating a further decline in real investment, and the staff suggested that such a development might be acceptable because of the continuing high ratio of investment to GDP. However, a pattern of five successive years of negative real growth of gross fixed investment could not help but cause concern about the burden of adjustment placed on investment. If previous investments had constituted a relatively inefficient use of capital, while new investments were more efficient, the argument might have validity. He joined Mr. Wicks in raising questions about the efficiency of past investments. It was interesting that excess demand in 1983 had been due, in part, to the unexpected strength of income growth in private sector activities, Mr. Erb observed. The situation highlighted both the responsiveness of the economy to previous liberalization efforts and the need to proceed with economic reforms, including the development of macroeconomic policy tools that could cope with unexpected changes. Interesting and encouraging signs of the awareness of the need for such reforms appeared throughout EBS/83/268, in particular on pages 22, 35, and 36. However, there might be a temptation to introduce new institutional arrangements and new policy tools gradually or piecemeal. It was doubtful whether such an approach would be the most appropriate.

There were a number of uncertainties that would require close monitoring of foreign and domestic economic developments and prompt responses by the Hungarian authorities both in the area of demand management and in structural reform, Mr. Erb suggested. Some specific issues could be raised at present. For example, the staff referred to a new "intervention fund" to help enterprises in extreme financial difficulty. Was there a danger that the fund would be used to bail out inefficient firms? Furthermore, although the real effective exchange rate for the forint had depreciated by 8 percent between June 1982 and September 1983, the chart on page 16a of EBS/83/268 indicated a steady appreciation of the forint between 1978 and 1982. In light of his concerns in that regard, he welcomed Mr. de Groote's statement that an additional 3 percent exchange rate adjustment would be made at the end of January. Was the staff confident that the present exchange rate was reasonably realistic?

The midterm review scheduled to be completed by the end of June would be particularly important in assessing progress in a number of areas, Mr. Erb commented, especially regarding the authorities' proposed development of a comprehensive program of structural reform. To assess such a program, it would be necessary to see specific reform proposals and details of the expected timing of their implementation. In addition, it would be necessary to examine the balance of payments implications of such reforms and external financing requirements. It was not clear what was the purpose of the suggestion that the proposed arrangement might be replaced by a new 18-month arrangement to cover the remainder of 1984 and 1985 if the reform program were ready by midyear. Hungary had already made progress in adjusting its economy; further structural reforms could be expected to improve economic performance and Hungary's access to alternative sources of foreign finance. In such cases, the need for continued financial assistance from the Fund was not self-evident. Although he would not rule out the possibility of such support, a careful assessment of the need for temporary balance of payments financing would have to be made at the time of the review. He supported the proposed program.

Mr. Lovato said that he supported both the proposed decisions. With regard to the request for a stand-by arrangement, he endorsed the broad design of the follow-up program being undertaken by Hungary, and he shared the staff's view that the essentials of the adjustment strategy could be seen in the continued endeavor to compress real domestic absorption so as to release the resources required for generating increasing surpluses in the current account with the convertible currency area. The appraisal of economic performance under the expired stand-by arrangement provided useful insights into both the adjustment already undertaken, as indicated by the estimated transfer of almost 2 percent of GDP from the domestic to the external sector and, of the amount of adjustment remaining to be accomplished in order to attain a viable external position in the medium term. The forecasting exercise described in Table 11 of EBS/83/268 provided the needed medium-term outlook.

In the shorter run, for example, within the period of the proposed one-year arrangement, it was clear that more progress needed to be made in advancing the Hungarian economy toward a sustainable balance of payments position, Mr. Lovato continued. The staff estimated that the target of a larger current account surplus--$400 million compared with $300 million in 1983--would entail a further transfer of resources to the external sector equivalent to 0.5 percent of GDP. In the existing world economic environment, such a transfer might require greater restraint in real domestic demand than envisaged by and acceptable to the authorities. There appeared to be some disagreement between the authorities and the staff on that point; he invited the staff or Mr. de Groote to comment.

Turning to specific aspects of Hungary's economic situation and the policy intentions underlying the proposed program, Mr. Lovato remarked that, in incomes and prices, the overriding concern appeared to be the need to ensure the required restraint in consumer demand. It was intended that real disposable incomes should decline; the result should be somewhat lower consumer spending, provided that the personal savings ratio, already low, did not decrease further. When the previous stand-by arrangement with Hungary had been discussed by the Executive Board (EBM/82/157, 12/8/82), several Directors had raised the issue of the low savings rate in Hungary and possible ways of increasing it in the medium term, such as a more flexible interest rate policy and the development of an improved structure of financial instruments.

There appeared to be a persistent "pro-consumption bias" in the authorities' attitude with regard to the desired composition of domestic demand in the adjustment period, Mr. Lovato observed. In 1984, as in previous years, consumption was intended to fall only modestly, while capital formation would decrease at a substantial pace following a continuing downward trend over a number of years. Although he could agree with the staff that a careful selection of high-yielding investment projects could lessen the detrimental consequences of a such a declining trend, it would be preferable in the medium term to change the current demand mix in favor of productive investments. At the time of the Executive Board discussion of the previous program, consideration had been given to the practicality of an informal performance criterion relating to household cash incomes. During the midterm review, it had been suggested that such a criterion could be an effective monitoring device in a centrally planned economy that had embarked on the difficult course of gradual decentralization. There was no mention of the possibility in EBS/83/268; he invited the staff to comment on the question.

The authorities' primary concern in the area of credit policy was to devise mechanisms to enhance centralized monetary controls in order to contain enterprise liquidity and to prevent overruns on capital investment, Mr. Lovato noted. To date, such mechanisms had not adequately supported the policies of demand restraint. The design of the performance criterion for credit expansion was, therefore, appropriate; the automatic adjustment implicit in the credit ceilings, to be triggered if the total of the reserve and development funds confiscated from enterprises turned out to be less than expected, should ensure that monetary developments were better monitored and managed within the desired path. The safeguards adopted with respect to the previously unchecked credit expansion by the State Development Bank, which had led to the setting of a specific ceiling on its lending activities, should help to reduce higher than programmed investment. In SM/83/261, the staff had referred to the more liberalized interest rate policy conducted in the previous two to three years. He invited the staff to comment on the effect of such a policy on the savings ratio and on the current stance of interest rate policy, including the possibility of further developments during the program period.

The momentum for an active export and import-substitution policy appeared to exist, Mr. Lovato considered. The exchange rate for the forint was properly geared to the pursuit of competitive advantage, and new export incentives and facilities could lead to the improved export performance expected under the program. The projected easing of import restrictions was welcome. The earlier licensing system was to be put in place again, relying on the notion that in a centrally planned economy the volume of imports could be predetermined to suit a current account target. It was worth asking how the authorities viewed the problem of reconciling such a licensing system with the attempt to achieve a chosen current account target in a more market-oriented setting through demand-restraining financial policies.

With regard to structural reform, Mr. Lovato went on, he agreed with the staff that it was necessary to improve the workings of market stimuli and to increase the efficiency of domestic resource use. As the Hungarian authorities considered the economic reform that they would continue to implement in 1984 to be a precondition of further adjustment, he could support Mr. de Groote's suggestion that the Fund should consider the introduction of market instruments as a performance criterion in addition to the usual demand management criteria. He welcomed the initial steps that the Hungarian authorities had taken in that regard, and he encouraged them gradually to adopt the badly needed market instruments that would help them to reform and to improve their economic system.

Mr. Joyce commented that, notwithstanding the considerable slippages in the recently completed stand-by arrangement, the Hungarian authorities had succeeded in implementing significant adjustment measures; in general, performance to date had been encouraging. Despite problems in particular areas, notably the overruns in private consumption and enterprise investment, the initial and overriding objective of the previous program had clearly been met. The focus of Directors' concerns a few months earlier had been the management of the international liquidity problem facing Hungary and the need to convince creditors of the soundness of Hungary's economic management; in that regard, there appeared to be much less, if any, widespread concern at present about Hungary's ability to meet its external payments obligations. In fact, the financial markets had responded positively to Hungary in recent months. In 1984, it was intended that the Fund's resources should not only cover part of the capital account deficit but that also contribute toward increasing Hungary's international reserves. There was also a possibility that Hungary might secure additional foreign borrowing, in which case the Fund's resources could be devoted even more extensively to the important task of rebuilding reserves. Thus, it could be argued that a good basis had been laid in the efforts to achieve a sustainable external position.

However, substantial progress would continue to be required over the coming years in both demand management and structural adjustment, Mr. Joyce continued. On that basis, he supported the request for a new stand-by arrangement. There would probably be much less room in 1984 than in 1983 for slippages in domestic demand restraint without causing a corresponding deterioration in the external balance. He was concerned about the continued emphasis on promoting financial stability in the short term rather than on measures to promote a strong and enduring improvement in the balance of payments over the medium term. Therefore, he welcomed the authorities' current intention to consider replacing the requested stand-by arrangement by mid-1984 by an 18-month arrangement in support of structural reform. He emphasized the importance of the implementation at an early date of substantial structural reforms accompanied by appropriate demand restraint. Particularly welcome in that regard were the announcements that Mr. de Groote had been able to make at the beginning of the meeting concerning the steps already taken in recent weeks and the proposed new policy changes about to be implemented.

There were a number of risks in the present policy stance, Mr. Joyce considered, particularly if the authorities did not look more to the medium term. The overrun in domestic demand in 1983 had tied up resources that might have been diverted to export markets, and conditions in 1984 would, if anything, make the external sector more vulnerable. Perhaps greater domestic demand restraint than expected by the authorities in 1984 might prove desirable, given the greater sensitivity of imports to domestic demand as a result of import liberalization and strong competition in export markets. The midterm review and the early negotiation of the longer-term structurally oriented program were vital. He hoped that the authorities would be prepared to take additional measures, as they had done in 1983, in the event of slippages. The performance criteria had been set only to March 1984, presumably reflecting, in part, the stated intention of the authorities to consider negotiation of a new program. If such a negotiation did not take place, the Executive Board would have to consider at the midterm review what the appropriate criteria might be for a shorter-term program.

Another area of concern was the continued emphasis on restraining investment demand and capital spending, Mr. Joyce went on. As his chair had pointed out at the time of the midterm review of the previous stand-by arrangement (EBM/83/90 and EBM/83/91, 6/24/83), restraint in investment relative to consumption, if taken too far, carried the risk of producing adverse consequences for economic growth in the medium term; in that sense, a more balanced approach to adjustment might be desirable. While the longer-run consequences of the policy could be mitigated by ensuring that resources were concentrated in the most profitable enterprises, the failure of the authorities to take such action successfully to date suggested that events might not turn out that way.

Commenting on structural adjustments, Mr. Joyce welcomed the measures to be implemented under the proposed arrangement, particularly the reduction in subsidies and the phasing out in 1984 of the import restrictions enacted in 1982. The staff correctly stressed the importance of pursuing further structural adjustment at an early date if the gains of the past two years were not to be eroded. The existence of structural distortions had constrained, and continued to constrain, Hungary's international competitiveness and its ability to pursue economic policies geared toward a sustainable medium-term position. He had considerable sympathy with the authorities in their concern about their ability to move quickly, and with their view that they were somewhat limited in that regard because of the tighter external constraints. Nevertheless, it should be emphasized that the continued presence of rigidities resulted in pressures building up within the economy over the years and that the inevitable delays in rectifying the situation would only make the cost of adjustment higher. The position underscored again the importance of the authorities' stated intention to request by mid-1984 an 18-month arrangement involving extensive structural reform.

Commenting on Mr. de Groote's suggestion with regard to the introduction of market-oriented instruments as additional performance criteria in countries with centrally planned economies, Mr. Joyce remarked that the suggestion was interesting and went to the heart of the problem. Hungary remained dedicated to socialist economic methods and policies, and obviously the authorities did not wish to depart from them. At the same time, they were grappling with the problem of how to introduce more flexibility into the system so that market forces could play a more effective role within the socialist framework. He congratulated the Hungarian authorities on the way in which they were tackling that problem, for the issue was not easy. In some ways, Hungary was making more progress than most socialist economies in that respect.

Mr. Tvedt observed that, despite continued sluggish activity in its export markets, Hungary had been able to make progress in various areas of the economy in 1983. An important development had been the changed attitude of the international financial markets toward Hungary, allowing a return to more orderly financial flows. The economy was at a critical stage in its development, in which various inefficiencies were being weeded out of the system and in which it was being moved toward a more decentralized system of macrocontrols. Although the process entailed fundamental changes in the Hungarian economy, he supported the view that the period of transformation should be as short as possible. The more prolonged the adjustment process was, the more difficult it might become, especially if the impact of the various changes deviated markedly from expectations. The staff indicated how difficult it was to anticipate the response to the various institutional changes. It was regrettable that Hungary was having to undergo those changes in an environment of weak export demand, making the adjustment all the more difficult to implement.

Progress had been made in various fields of economic policy, Mr. Tvedt continued, and additional measures were in the pipeline, as Mr. de Groote had indicated. He strongly commended the Hungarian authorities for their efforts so far and he encouraged them to continue. Despite important changes, however, a wide array of administrative rigidities and restrictions remained. One example was the import restrictions that had accounted, in part, for the improvement in the current account in 1983. Moreover, certain institutional arrangements appeared to have led to unprofitable investment and to inefficient use of both labor and capital. An early conclusion of the comprehensive program of structural reform would be welcome, particularly if it could be linked to a stand-by arrangement to replace the arrangement under consideration at the present meeting.

In previous discussions of the Hungarian program, Mr. Tvedt recalled, it had been repeatedly emphasized that private consumption would have to bear the brunt of the burden of adjustment. Unfortunately, that development had not occurred so far, and investment had continued to decline, with potential detrimental effects on the future development of the economy. In such circumstances, it was vitally important that investment should be concentrated in the most productive areas. If such action were taken, the present level of investment in relation to GDP might be enough to sustain adequate growth in the medium term.

A number of areas of the program required clarification, Mr. Tvedt considered. Interest rates on household time deposits were to be raised on March 1, 1984 to provide an incentive for personal savings. According to previous staff papers on Hungary, the authorities had been reluctant to use interest rate policy actively as an instrument for mobilizing household savings. What role was currently envisaged for interest rates in the Hungarian economy? The real exchange rate had depreciated from its peak in mid-1982, but it remained at a relatively high level. Although real exchange rate levels could be difficult to calculate and to interpret, as the staff had pointed out in the paper SM/83/263, "Issues in the Assessment of Exchange Rate of Industrial Countries in the Context of their Economic Policies" (to be discussed by the Executive Board at Seminars 84/1 and 84/2, 1/30/84), he invited the staff to comment on the present exchange rate and on whether further depreciation might allow for a quick dismantling of the import restrictions imposed in 1982. A further area for clarification was the high liquidity of the banking system; did the situation have implications for developments in 1984? He supported the proposed decisions.

Mr. Grosche commented that EBS/83/268 was carefully worded and that its high quality had benefited from the frequent exchanges of views between the Hungarian authorities and the staff. In the staff's view, the disappointing behavior of the current account was explained largely by the deterioration of the terms of trade and the effects of the drought on export performance, while the spillover into net imports of domestic demand in excess of the program targets appeared to have been small. He invited the staff to explain how such a clear distinction could be drawn and to comment on the reasons for the unusual lack of a spillover from domestic demand to the external account.

The measures that had been part of the previous stand-by arrangement had obviously not been successful in checking domestic demand, Mr. Grosche continued. The staff conveyed the impression that liquidity within the enterprise sector and the income generated by private activity could not easily be controlled by the existing policy instruments. Apparently, credit policy had not contributed to the containment of liquidity. In that regard, he supported Mr. Wicks's comments on the technical aspects of the program. On the other hand, the program had clearly helped Hungary to maintain its international solvency. That Hungary had improved its access to international financial markets should be regarded as encouraging. However, notwithstanding such positive developments, the Hungarian authorities should be careful because the low international reserves and the high external debt provided only limited protection against sudden shortages of liquidity.

Turning to the new program, Mr. Grosche noted that it concentrated to almost the same extent as the previous program on the curtailment of domestic demand. The planned actions would generally carry on the adjustment begun under the first arrangement. Given the failure of previous forecasts, it was probably realistic at present to envisage a current account surplus of only $400 million compared with the $600 million expected under the earlier program. The lower forecast should provide some cushion against risks. The current account deficit in nonconvertible currencies would have to be substantially reduced; the external performance of the Hungarian economy had been helped considerably to date by foreign financing in trade among countries belonging to the Council for Mutual Economic Assistance (CMEA), which would no longer be available to the same extent.

The envisaged curtailment of domestic demand appeared adequate to achieve the planned improvements in the external balance, Mr. Grosche considered. As other Directors had pointed out, the authorities would have to be more vigilant under the new arrangement. Overruns could easily spill over into foreign demand. It was a matter of concern that demand curtailment primarily took the form of a cutback in investment. He invited the staff to comment on whether such action would seriously impair the long-run growth prospects of the Hungarian economy or whether projects with a relatively low rate of return would be affected initially. He had received, perhaps wrongly, the worrisome impression that there was always sufficient financing available to bail out loss-making enterprises, while profit-making firms saw their funds confiscated. He invited the staff to comment on that issue also.

Turning to structural aspects of the economy, Mr. Grosche urged the Hungarian authorities to continue to free their country from institutional rigidities. A comparison with countries in a similar position made it clear that Hungary had already gone a long way toward market-oriented policies and had already achieved remarkable success by doing so. However, considerable progress would be achieved only if the momentum in introducing further structural reform were not lost. He strongly welcomed the authorities' intention to put together by mid-1984 a comprehensive program of structural reforms. At present it was difficult to assess the impact of those reforms because they would be made public only toward the middle of the year. It was more important to take fundamental decisions and to set a precise timetable for action than to move in marginal steps in various directions. Activism could be harmful when it was purposeless.

In that regard, Mr. Grosche went on, he had been impressed by Mr. de Groote's proposal to regard the introduction of market instruments as an additional performance criterion. While the proposal might appear unusual, it was intended to apply to an unusual situation, at least from the standpoint of Fund experience. It deserved careful examination. He could support the proposed decisions. In doing so, he assumed that credit lines were available, or would be available soon, to finance the borrowed resources part of the drawings. He invited the staff to say how much of the $6 billion in credit lines currently being arranged by the Fund would remain after Hungary's request had been approved.

Mr. de Maulde said that the Hungarian authorities should be commended for having basically achieved all the performance criteria under the previous stand-by arrangement. The deviations from program targets had been limited to two areas. First, there had been a shortfall in the improvement of the current account balance, specifically the trade balance, in which the Executive Board could fully accept Mr. de Groote's explanation that the circumstances had been beyond the authorities' control because a drought had accounted for more than half of the shortfall and because there had been a sharp deterioration in the terms of trade. Second, credit to enterprises had expanded at a faster rate than programmed, apparently due to an oversight in the design of the program, which had not included in the performance criteria loans extended by the State Development Bank. He welcomed the discovery of that omission and its rectification through a limit on such loans under the new stand-by arrangement. In general, adjustment had taken place under the previous arrangement. The staff's concern about the overruns on domestic absorption and fixed investment was unwarranted. Those developments implied only that Hungary had been able to attain the broad external target in a less punitive fashion than envisaged under the program. He agreed with the view that the economic improvements were rebuilding the confidence of the financial community, a factor that would help Hungary to restructure its external debt and to rebuild its foreign reserves.

Commenting on the program under the proposed stand-by arrangement, Mr. de Maulde remarked that he agreed with the thrust of the staff appraisal. The program relied on the usual transfer of resources from the domestic to the external sector; it should work if the assumptions made with regard to the international environment were fulfilled. The assumptions included the expectation that the non-oil imports of Hungary's main trading partners would increase by 4 percent, that there would be annual increases in both export and import prices of 6 percent, and annual increases in GDP of 2-3 percent in the 1985-88 period. A short discussion of the sensitivity of the program to different outcomes in the international environment would have been welcome. He found no problem in the idea of Fund credit being extended to a country running a current account surplus. It was associated at present with a comprehensive set of import restrictions that were to be removed progressively in the period ahead; while the removal of those restrictions would certainly be in the best long-term interest of Hungary, it entailed grave short-term risks, which the Fund's assistance would help to reduce.

The staff's analysis of the external balance appeared to concentrate on the convertible currency area, with little said about the nonconvertible currency area, Mr. de Maulde went on. He invited the staff or Mr. de Groote to comment on the likely development of Hungary's trade and financial relationships with Eastern Europe. For the time being, the management of the exchange rate was appropriate, but Hungary would have to remain careful to maintain the rate at a realistic, although not overcompetitive, level, something more easily said than done. On the domestic side, the information provided by Mr. de Groote at the beginning of the meeting showed that the Hungarian authorities were taking their commitments seriously. The reduction in investment to 25 percent of GDP ought not to create undue difficulties; it was not particularly low in comparison with the rate in major developed countries. He agreed with Mr. Wicks that the main problem was the quality rather than the quantity of investment.

Of course, scarce resources should be managed more carefully, Mr. de Maulde commented, and the development of a system of realistic prices and of responsibility at the enterprise level should be encouraged. However, while the Fund was well qualified to judge the overall macroeconomic picture and the external balance, the assessment of structural questions might better be done by others; in that regard, he welcomed the growing involvement of the World Bank in Hungary. Two World Bank loans had been approved for Hungary in June 1983, one in the agricultural sector and one in the energy sector, and two further industrial projects were under study for 1984. He hoped that future work between the Bank and the Fund would be closely coordinated.

He agreed with the staff's recommendations on savings and interest rates, Mr. de Maulde added, and he welcomed Mr. de Groote's remarks on the authorities' intentions regarding prices and, presumably, wages in the manufacturing sector. It was clear that Hungary had embarked on the task of putting into effect "a system where the market must exert a leading influence on the planned economic process," in Mr. de Groote's words. The task was extremely delicate and arduous from an economic, social, and political point of view. The Fund could learn much from Hungary's experience; both it and the wider financial community should stand ready to help the courageous and imaginative efforts that the authorities had begun. He looked forward to the discussion that would take place if the authorities put forward a new program of structural reform. At that time, Directors could consider more closely Mr. de Groote's extremely interesting suggestion about new performance criteria.

Mr. Salehkhou stated that the performance of the Hungarian economy under the 1983 stand-by arrangement had clearly been below both the Fund's and the authorities' expectations, particularly with respect to the program's objective of achieving a considerable improvement in the external current account with the convertible currency area. The factors responsible for the lower than expected performance included a severe drought that had resulted in an important loss of exportable products, and a large deterioration in Hungary's terms of trade. Other factors had been related more to domestic developments, including difficulties in implementing demand management policies, leading to considerable overruns on domestic consumption and fixed investment. It was also expected that the end-December ceiling on net foreign liabilities in convertible currencies of the specialized institutions would not be adhered to, resulting in the breach of an important performance criterion. Furthermore, there had been only limited progress with regard to the removal of the import restrictions introduced in September 1982, which had been expected to be eliminated before the end of 1983.

Although performance under the previous program had fallen short of the main targets, Mr. Salehkhou continued, significant progress toward adjustment had been achieved in 1983, considerably easing the pressure on the balance of payments. The improvement in the external current account balance and the greater than expected reduction in the Government budget deficit were particularly welcome. The current account surplus of $300 million in 1983 represented an improvement of about 5 percent of GDP since 1981.

The 1983 program with Hungary appeared to have improved the staff's knowledge of that centrally planned economy and of its economic and financial relationships, Mr. Salehkhou remarked. The particular structure of the Hungarian economy had clearly created a number of uncertainties about the impact of the various program instruments. Additional uncertainties might have resulted from the fact that external and domestic adjustment was being accompanied by crucial structural changes aimed at reconciling the central plan with liberal instruments and mechanisms. The changes were shifting the focus of economic policy from reliance on administrative and regulatory measures to greater use of market incentives and the promotion of competition among the various sectors of the economy and among state-owned enterprises. Thus, the experience in 1983 should enhance the design and monitoring of the program for 1984.

The staff could have been more informative about the performance of the program and its success if it had included in its report a table summarizing the state of implementation of the various measures and policies, Mr. Salehkhou considered. Such a summary table had been presented in many previous reports reviewing stand-by and extended arrangements. It appeared likely that a performance criterion for the end of December 1983 could not be met, yet he understood from the staff that the failure to observe the ceiling would have no effect on Hungary's drawings under the program because the last purchase had taken place earlier in December. He invited the staff to comment on the purpose of such performance criteria, particularly since the same comment could be made about the performance criteria under the proposed new stand-by arrangement. Indeed, the last drawing would be available to Hungary in mid-November 1984, more than a month before the last performance criteria in the program took effect.

Speaking of the program for 1984, Mr. Salehkhou remarked that the requested arrangement appropriately aimed at strengthening the considerable gains achieved in 1983, particularly in the external sector, and--two long-term objectives--at promoting market-oriented policies and improving the allocation of resources. Achievement of the new program's objectives would undoubtedly require a closer monitoring of domestic aggregates and a stricter implementation of demand management policies than in 1983, when considerable overruns in consumption and fixed investment had undermined the success of the program. The measures already implemented or envisaged under pricing, credit, and fiscal policies appeared to be adequate to contain domestic demand within the program target and to prevent a repeat of the 1983 experience, because the authorities stood ready to take additional measures if actual developments deviated from the planned course. Furthermore, the important structural reforms announced in the authorities' letter of intent, if fully implemented, should speed up the transition toward a more competitive economy. The Fund should encourage Hungary to seek an extended arrangement, which would be more appropriate for implementing such structural reforms and adapting the economy to the new mechanisms under consideration.

While he agreed in general with the staff's appraisal and could support the proposed decisions, Mr. Salehkhou went on, the economic impact of the program policies should be monitored closely, particularly in view of the excessive burden of adjustment being placed on investments by the enterprise sector. The objective of further improving the maturity structure of Hungary's external debt remained central to the program. The authorities had made a significant improvement in the previous two years by reducting the part of the short-term debt due in convertible currencies. However, the information in SM/83/261 indicated that the terms on which new loans had been contracted had been significantly less favorable during that period than earlier, despite the considerable progress achieved in strengthening Hungary's external position and the broadly satisfactory performance under the Fund program. Such a development was indicative of the unhelpful attitude adopted by lenders, which could exacerbate the difficulties facing the developing countries and have a significant adverse impact on their adjustment efforts.

Mr. Jaafar said that he broadly agreed with the staff appraisal, particularly with the view that continued reliance on demand restraint would be necessary for 1984, although the proposed program would prove more demanding on the domestic economy than the previous stand-by arrangement. Continued stringency was required because of the overriding need to maintain external solvency. There was little room for maneuver because of the high debt service burden of the country. Nevertheless, for the longer run, conditions had to be created so that supply could be enhanced and trade promoted. Therefore, he welcomed the various measures taken by the authorities aimed at structural reform and greater liberalization, particularly in relation to prices, wages, financial intermediation, and the decision-making process.

In view of the experience in 1983, Mr. Jaafar continued, Directors needed more assurances that the targeted surplus of $400 million in the current account for 1984 was not overoptimistic. The current account target for 1983 had proved to be too ambitious because the buoyancy of domestic demand had turned out to be stronger than expected. The possibility of a similar occurrence in 1984 as a result of the various reforms taking place in the economy could not be discounted. Cash receipts from private earnings would probably be similar to the 1983 figure, even though the proposed program envisaged a decline in real disposable income. It was also reasonable to believe that real savings might not remain at the level of 1983, as the program assumed. The economy continued to lack adequate incentives to stimulate savings. The 2 percent increase in the deposit rate announced for the 1984 program period could prove insufficient, particularly in view of the current 9 percent inflation rate and the continuing lack of attractive alternative instruments to encourage savings.

He fully endorsed the plan to improve financial intermediation in 1984 through greater use of commercial paper and through the adjustment of interest rates on deposits to take greater account of changes in market conditions, Mr. Jaafar remarked. If consumption did not reach the targeted level, the full burden of adjustment might, unfortunately, again fall on investment. He was concerned that, in such circumstances, a larger reduction in investment might be required in order to stay on course under the program, thereby exacerbating the already severe cutbacks planned for 1984. Such a development would undermine the efforts to promote growth and domestic adjustment. He agreed with other Directors that the quality of investment should be emphasized.

Export performance and import substitution needed to be better than envisaged in the program, Mr. Jaafar considered, in order to guard against expected shortfalls. Improvements in that regard would both ease the burden of adjustment on aggregate demand and contribute directly to the current account. He urged the authorities to be more imaginative in pursuing policies that would free domestic resources for exports at a faster pace than programmed. The essential framework had been put in place, including, in particular, the recent reform of the exchange rate, which had improved competitiveness and profitability in export production. The recent reforms aimed at removing institutional and structural rigidities were also welcome moves in the right direction, although much more remained to be done. The authorities should aim at removing altogether those forces that continued to inhibit the response of domestic agents to changes in foreign markets. More generally, Hungary's best hope in both the short term and the long term lay in the recovery of world trade. Recent developments in protection by major countries were not helpful.

Although he could support import restraint as a temporary measure, Mr. Jaafar added, he agreed with other Directors that it should be removed as soon as possible in the interest of promoting investments and better resource allocation. However, it was possible to conceive of a scenario in which import restraint might again become necessary as a temporary measure if events turned out to be similar to those in 1983. He was grateful to the staff for producing a medium-term analysis of the Hungarian debt in convertible currencies along the lines shown in Table 11 of EBS/83/268. It would be helpful if, in future, the staff could provide an analysis of alternative scenarios so as to help Directors to judge the robustness of the assumptions made under the program. In view of the uncertainties that could be encountered in 1984, his chair attached considerable importance to the midterm review under the arrangement. He could support both decisions.

Mr. Senior stated that he strongly supported Hungary's request for a stand-by arrangement. It was clear that economic performance during 1983 had been satisfactory. Indeed, performance under the program supported by Fund resources had basically been on track, and practically all the quantitative performance criteria had been met. Although there had been slippages in regard to the original targets and objectives of the program, no one could question the fact that significant adjustment had taken place. If anything, it could be argued that the original program's targets had been optimistic, especially when account was taken of the international economic environment and of the fact that the Hungarian economy was undergoing basic transformations with regard to the policy instruments used to manage economic performance. The authorities should be commended for their achievements in the previous two years, which had brought about a marked shift in the current account in convertible currencies, from a deficit of $730 million in 1981 to a surplus of more than $300 million in 1983. Such performance constituted an improvement of more than $1 billion in two years, equivalent to about 5 percent of estimated GDP in 1983. The program for 1984 placed further adjustments in the current account within a medium-term context aimed at bringing about by the end of 1988 practically the same degree of improvement as had been planned for 1983--a welcome correction in favor of realism.

Hungary's case well exemplified the point that the Fund should move cautiously when dealing with planned economies, Mr. Senior continued, not only because the Fund was not completely cognizant of how such economies worked, but also because it was forced to make policy recommendations in an economic environment or policy framework undergoing significant changes, in great part as a consequence of those same recommendations. The staff's statement on page 19 of EBS/83/268 correctly illustrated the point, noting: "To a large extent, the demand overruns were associated with the authorities' attempts to free the economy, and illustrate the difficulties in moving from a centralized system of microcontrols to a decentralized system of macrocontrols." As a corollary, the Fund should be cautious in its policy recommendations and in its quantitative projections, bearing very much in mind that an indiscriminate adaptation of instruments commonly used in market economies might not necessarily be appropriate to the circumstances and characteristics of planned economies. Further study of those economies was needed, a point that his chair had made in the past; however, the papers before Directors represented an improvement over previous ones dealing with the problems of planned economies.

Caution was particularly advisable when dealing with recommendations and judgments in regard to structural adjustments aimed at increasing supply in the medium term, Mr. Senior suggested. There was no doubt of the need for structural reforms in Hungary to consolidate the tangible results achieved so far. He fully agreed with the staff that exclusive reliance on demand restraint could not be maintained much longer. A more balanced approach to policy formulation was required, and he welcomed the steps that the authorities had taken in that regard. However, structural measures or supply-oriented policies had to be viewed in a different context from that traditionally used in the Fund. His chair had argued that the traditional interpretation of supply-oriented policies--that the intention was to create an economic climate conducive to investment (some would say private investment)--was not necessarily applicable to developing countries. For planned economies, it was totally inadequate. The incentives for production were not the same as in market economies, nor were the policy instruments similar; and even if they were, the transmission mechanisms were probably different. Therefore, he could not wholly agree with certain statements made by the staff with regard to structural adjustments, as in the first paragraph on page 22 of EBS/83/268. He could agree with the remarks in the same paragraph that "none of the supporting institutional changes should be fashioned in haste," advice that the authorities would surely heed.

Commenting on Mr. de Groote's opening statement, Mr. Senior said that, like Mr. Zhang, he could not support the idea of introducing additional performance criteria dependent on the adoption of market instruments. Such a policy would represent a serious step in a direction that the Fund should eschew if it intended to respect the social and political realities of its members.

Mr. Alhaimus observed that during 1983 Hungary had continued to make important changes in its economic framework and policy stance, reflected in the rapidity and decisiveness with which the authorities had been implementing the various adjustment measures, including those required under the Fund program. Significant adjustment had already taken place during the program period in terms of reduced cost-price distortions, increased attention to relative prices, and further rationalization of the use of available resources. In particular, there had been a turnaround in the current account position in spite of the decline in output and investment in the socialist sector. There had also been slippages in performance. It was hardly surprising that such slippages had occurred, given the rapid liberalization of the economy within the institutional environment and the inevitably experimental stage of Hungary's experience with market-oriented adjustment programs.

When the program had been discussed by the Executive Board in mid-1982, Mr. Alhaimus recalled, some Directors had indicated that questions were bound to arise "about the way in which signals given by changes in prices...profits and wages, and in interest rates and exchange rates, were transmitted, how they were received, and how rapid the transmission was." Those questions were closely related to what the staff had termed "the difficulties in moving from a centralized system of microcontrols to a decentralized system of macrocontrols." Looking beyond the narrow focus on target attainment, any assessment of Hungary's adjustment policies and the pace of implementation had to take into account the basic fact that moving in the direction of a more decentralized open economy within a socialist framework involved constraints on the pace and strength of the policies that could realistically be introduced.

Reviewing the financial program for 1984, Mr. Alhaimus said that he had no difficulty with the staff assessment of the underlying adjustment path and the adequacy of the policies to meet the program's objectives. The program properly emphasized the importance of further strengthening the external liquidity position in the period ahead in order to ease the pressures on the balance of payments and to enhance the country's ability to cope with its external financial obligations. The central objective was the achievement of a current account surplus in convertible currencies that would be larger than the surplus realized in 1983. The need for such an outcome in the current account could hardly be overstated. Nevertheless, it would be useful to recall an important remark, made when the 1983 program had been discussed, that in Hungary "the concept of a sustainable current account deficit became that of the need for a prolonged surplus in order to allow the country to repay external debt falling due." The question arose whether the achievement of a current account surplus was sustainable beyond a reasonable period, particularly if external shocks were to develop, as had occurred during 1983.

The authorities' prudence with regard to the program's assumptions and targets was encouraging, Mr. Alhaimus went on, as reflected in their expectations about the possible adverse evolution of the terms of trade with the convertible currency area as well as in their assessment of the impact of the 1983 drought on the level of agricultural exports. To offset those factors, the program envisaged a further reduction in domestic demand through a package of restraints on incomes and prices, reflected in budget, credit, and interest rate policies. Nevertheless, the realization of the $400 million surplus with the convertible currency area in 1984 would to an important extent be predicated on maintaining export receipts at a level close to that achieved in 1983. Such an outcome involved, in turn, the assumption of a higher balance on services, particularly with industrial countries, and the maintenance of Hungary's present export market shares in certain Middle Eastern countries. However, those expectations might be constrained by the uncertainties surrounding the fiscal policies and the level of external receipts of trading partners.

The program involved a further reduction in gross fixed investment as part of the effort to contain the growth in domestic absorption, Mr. Alhaimus remarked. He was encouraged by the staff's emphasis on the risks associated with such an approach in terms of its consequences over the medium term and long term for output growth and employment. In addition, Hungary's recent experience had shown that the decline in investment in the socialist sector had been accompanied by an increase in private sector investment. It was worth asking whether the private sector investments were being channeled to areas that should have priority in the allocation of scarce resources.

With regard to the program's duration, Mr. Alhaimus noted that Mr. de Groote had stated that "the authorities have submitted a short and less ambitious program, which they intend to transform into a more comprehensive program later in the year." That approach involved a procedure that ought not to be prejudged at present. It might be more practical to follow the experiment carefully and to assess the desirability of transforming the program in light of the success achieved in implementing the planned adjustments. The proposed new program was worthy of Fund support because it was designed to consolidate the achievements won so far and to carry further the process of economic and financial adjustment.

Mr. Prowse commented that, while he supported the proposed decisions, he agreed with Mr. Wicks's comment concerning the possibility of a shorter stand-by arrangement in the present interim period. The staff's view of the program seemed to be that it was, on balance, acceptable, but that a great deal needed to be tightened up. In the proposed decision concluding the 1983 Aticle XIV consultation, emphasis should be placed on the statement that "the Fund encourages the Hungarian authorities to take early steps to eliminate the bilateral payments agreements." The issue would be an important element in future discussions with the authorities, and it would be in their interest to take such considerations into account in framing their overall policies. With regard to the performance criteria under the previous arrangement, there appeared to be confusion as to whether the criteria for the fourth quarter of 1983 had been met in full. He invited the staff or Mr. de Groote to clarify the question.

The whole question of performance criteria in centrally planned economies had been raised in an interesting way by Mr. de Groote in his statement, Mr. Prowse continued. The Executive Board had looked at the issue before both in general and in the particular case of Hungary. In December 1982, a number of Directors had favored what had been referred to as "a focus on real variables" in an economy in which standard financial indicators of performance might have deficiencies. They had noted that such real variables had not been formal performance criteria at that time, and that, despite monitoring efforts, there had been a higher than usual risk that observance of the formal financial performance criteria might not ensure achievement of program targets. Indeed, that concern had been justified by subsequent events. The performance criteria had been met--or almost met depending upon the clarification that he had just requested--yet serious slippages had occurred. Therefore, further thought would need to be given to the nature of performance criteria for the Hungarian economy, a "pioneering" case that continued to have important implications both for the Fund and for the country itself.

At the previous Executive Board discussion of Hungary (EBM/83/90 and EBM/83/91, 6/24/83), Mr. Prowse recalled, the staff had indicated that thought was being given to the development of targets for real aggregates as possible formal performance criteria for centrally planned economies and that, while the staff recognized the diversity among those economies, Hungary might be a useful test case. He invited the staff to comment further on that issue. Although some Directors had raised the issue of uniformity of treatment of members, it did not appear that performance criteria had to be uniform for all members. The Executive Board should be able to adopt nontraditional criteria if it chose to do so.

In the case of Hungary, the Fund was dealing with traditional performance criteria in a nontraditional setting, Mr. Prowse considered, even though the performance criteria were well supported by a range of structural adjustment measures. Mr. de Groote had suggested in his statement that an alternative approach might involve quantitative planning controls, perhaps another name for "real aggregates," and had concluded that such an approach was not realistic. However, it was not clear why quantitative planning objectives would not be realistic performance criteria in an economy such as Hungary's. The idea should be considered further at the time of the midyear review, especially if a new program were to be proposed for later in the year. Mr. de Groote had gone on to suggest that "a more realistic approach" to specifying quantitative performance criteria would be to adopt, "in addition" to the traditional criteria of demand management measures, "the introduction of market instruments" and their close monitoring.

A number of Directors had supported further exploration of that concept; however, some serious reservations in principle deserved to be made, Mr. Prowse went on. While the Fund was obliged to encourage both efficiency and stability in members' economies, it should do so within the economic framework chosen by the country. The country might seek to have its economic framework evolve, and no doubt the evolution would be influenced by its discussions with the staff and consultations with the Executive Board. The Fund could certainly help to frame a program that reflected the objective of seeking changes in economic structure, but that was a different position from the suggestion that such steps ought to be made performance criteria. It was also questionable whether such performance criteria would be consistent with the Articles of Agreement.

Taking up the staff's assessment, Mr. Prowse remarked that it was sound, although it appeared to focus as much on the forthcoming review and the possible new program as on the present program, and it appeared to be addressed as much to the Hungarian authorities as to the Executive Board. In that sense, it reflected the context in which recent discussions had taken place. There were significant points on which the staff expressed concern. For example, referring to the problem of diverting resources toward trade with the convertible currency area, the staff concluded: "...the policies decided upon appear to strike only a balance," whereas, in the staff's view, they ought to "err on the side of overfulfillment." The staff went on to say: "...moreover, as private and public consumption are to decline only moderately...the main burden of adjustment, for the fifth consecutive year, falls on gross fixed investment." Although investment would continue to constitute 25 percent of GDP, an impressive performance, and although it could be argued, as the staff pointed out, that previous investment levels might not have been sustainable, the question was more complex. The staff added: "The longer-run consequences of reliance on cutbacks in investment could be lessened by ensuring" more efficient use of resources allocated to investment. However, it concluded: "While efforts to deal with this problem have been longstanding, so far they have tended to founder in the absence of financial responsibility at the enterprise level." The staff also expressed concern about the nature of wages policy, saying that "...[it] is at some odds with the goal of achieving greater wage differentiation and a general higher cost of labor relative to capital." Directors should note the points of concern made by the staff.

The role of savings and interest rates in a centrally planned economy needed to be considered, Mr. Prowse suggested. In a previous Executive Board discussion of Hungary, Mr. de Groote had observed that "better informed observers" believed that interest rates had hardly any effect on savings in the Hungarian economy. The situation appeared to have changed somewhat in light of the staff's assessment that "since savings instruments for households still are confined to savings deposits and recently introduced municipal bonds, income bulges can be largely absorbed by price erosion or taxation." However, it might also be that emphasis on traditional performance criteria in "nontraditional economies" was not wholly effective. Did the staff have further views on the question of mobilizing domestic savings through the operation of the interest rate structure?

Mr. Mtei stated that performance under the previous arrangement had demonstrated the willingness of the Hungarian authorities to cooperate with the Fund and to pursue their adjustment goals with determination. All performance criteria under the previous arrangement had been met, and there had been commendable improvements in the current account in convertible currencies, the principal objective of the stabilization program. Those achievements had been brought about despite the larger than expected deterioration in the terms of trade, lower prices of export commodities, and poor weather affecting agricultural exports. GDP had been virtually stagnant in 1983, in sharp contrast to the annual average rate of growth of almost 6 percent during most of the previous decade. Although weak external demand and the 1983 drought had contributed to a slowdown in output, the decline in investment, which had carried the main burden of adjustment for the previous five years, had also played a major role.

In Hungary's circumstances, Mr. Mtei continued, the efforts being made by the authorities to buttress short-term stabilization measures with policies aimed specifically at correcting structural deficiencies so as to lay the foundation for sustained economic growth, were welcome. A number of positive steps had already been taken in the recent past, including the decision to permit enterprises greater flexibility in the use of the price mechanisms, initiatives to restructure inefficient enterprises, efforts to rationalize the use of labor, measures aimed at expanding market-oriented activities, and the move forward to decentralization and the easing of administrative constraints. Putting all those measures firmly in place would no doubt take time, and quick results should not be expected. It should also be borne in mind that the strength of the recovery in Hungary would be related to developments in the world economy.

Had the staff projected the prospects for economic growth and the path that would be consistent with the maintenance of a viable balance of payments position in the medium term, Mr. Mtei inquired. The issue was of interest because the staff described the adjustment path as "reasonable and sustainable," while pointing to the concerns of the authorities about the continued imbalance in the pattern of adjustment and the consequences for future growth resulting from consecutive cutbacks in investment. The dichotomy between short-term policies and the longer-term objective of economic growth was a problem that many countries pursuing adjustment programs had to deal with. The example before the Executive Board provided further relevant considerations in shaping the Fund's thinking about the kind of supply-side policies necessary to bridge the gap between the short term and the long term.

Commenting on the authorities' decision to increase the relative cost of labor, Mr. Mtei wondered whether that policy was likely to lead to a more intensive use of capital and, if so, whether such a shift would be appropriate for an economy so heavily dependent on external sources for its energy supply. The impact of the policy on employment in Hungary also deserved consideration. On the financial side, the policies outlined for 1984 were clear and appeared to be moving in the right direction. Subsidies were to be reduced, as was the operating deficit of the social security fund, and the growth in wages was to be contained. A budget surplus equivalent to 1.3 percent of GDP was expected. Monetary policy was also restrained, consistent with the objective of maintaining a viable balance of payments position. Efforts were being made to mobilize savings, including an increase in the interest rate on household time deposits. However, deposit rates in general appeared to be below the rate of inflation.

Developments in the external sector would play a major role in determining whether the program would be successful, Mr. Mtei considered. Accordingly, the flexible exchange rate policy adopted by the authorities aimed at maintaining the competitiveness of exports appeared appropriate. However, improvements in the current account would also depend on the extent to which the authorities succeeded in containing imports, an objective that would be somewhat more difficult in wake of the decision to ease import restrictions from the beginning of 1984. Taking that factor into account, and given that Hungary's terms of trade were expected to deteriorate further in 1984, the target for the current account surplus in convertible currencies might be considered high.

Mr. Jayawardena said that he agreed with Mr. de Groote that the Fund's stand-by arrangement with Hungary in 1983 had been a qualified success in the country's circumstances. Some slippages had occurred, but most could be attributed to the sharp deterioration in the terms of trade and the drought-induced setback in agriculture. Furthermore, the slow recovery of the world economy had been a dampening factor. The larger than expected rise in gross investment and private consumption could be explained mainly as the spontaneous reaction of a long-repressed economy to liberalization. He did not believe that the slippages reflected weaknesses in the program or in Hungary's commitment to it. As the staff admitted, there had been strong adjustment in the Hungarian economy, a fact that augured well for the future.

Commenting on the proposed program for 1984, Mr. Jayawardena considered it reasonably constructed. He agreed with the general strategy of entering into the proposed arrangement while intending to put forward by midyear a longer-term program containing strong structural reforms. The impact of lower investment on output and income was not a matter for too much concern, because the incentive reforms contemplated were likely to ensure better use of existing investment and better resource allocation. For that reason, he considered the structural reforms crucial.

Structural reform in centrally planned economies was complex, Mr. Jayawardena continued. It involved fundamental changes, such as the introduction of market-oriented pricing, the creation of a free financial intermediation system, and the decentralization of decision making. Those were matters that sometimes cut through a politicoeconomic system. They were difficult, and, invariably, the initial effects and reactions were not very favorable; hence, the policies needed to be persevered in with much conviction and courage. The Fund should support them because they were desirable. Extended arrangements had been specifically contemplated with that kind of approach in mind. Indeed, in light of Mr. de Groote's statement regarding some of the initial measures taken by the authorities and the outline of Hungary's strategy, he was confident that Hungary was moving in the right direction.

He had some misgivings about Mr. de Groote's idea of incorporating the introduction of market-oriented instruments in Fund conditionality, Mr. Jayawardena stated. In a sense, the Fund's advocacy of economic liberalization already supposed a movement toward competitive markets. Mr. de Groote's proposal, however, appeared to be an attempt to move current macroeconomic criteria significantly toward the microeconomic level. The Fund should be cautious, lest it provoke unnecessary suspicions and hostility. As Directors were aware, microplanning had become an integral part of the politicoeconomic systems of centrally planned economies. Recently, such economies had tended to move away from highly centralized operations toward more market orientation, out of a self-realization of the weaknesses of the centralized system. The Fund should gently encourage such a move toward greater economic efficiency. If it moved forward strongly with "weapons of conditionality," it might create adverse reactions in the countries concerned, thereby jeopardizing the very process that the Fund should be encouraging.

Mr. Polak said that he supported the proposed decisions. He shared the concerns expressed by some Directors about Mr. de Groote's suggestion regarding the introduction of market-oriented instruments in centrally planned economies. Cases in which countries adhered to all the performance criteria and yet did not perform well were not limited particularly to centrally planned economies. Unfortunately, the Board had seen examples of such situations in all regions and all types of economies. While it was possible that the traditional performance criteria were less effective in centrally planned economies, particularly with regard to control of monetary aggregates, the answer was to look for other, more effective criteria, an approach that had been introduced in some arrangements in which the current account or the trade balance had been used as an indicator of the kind of performance that the Fund was seeking. The introduction of market instruments might well be useful in centrally planned economies, but everything depended on the particular measures and on the country in question. The Fund could be of considerable assistance in certain circumstances in helping the country to devise appropriate measures to achieve "the real objectives of the program," in Mr. de Groote's words. That kind of useful collaboration could not be promoted through a generalized approach that made the introduction of such market instruments either performance criteria or preconditions for an arrangement. An approach of that nature would run the risk of creating a confrontational atmosphere on the issue of the introduction of such instruments, and it would risk interfering with the right of countries to approach problems along their own preferred political lines.

The staff representative from the European Department stated that, in setting performance criteria, the Fund and the Hungarian authorities had been engaged in a shared learning process. The data on which the performance criteria for 1983 had been based constituted a relatively new series, as quarterly time series had not existed previously. The staff was confident that the shaping of the criteria for the 1984 program would benefit from the experience gained in 1983. On whether all quantitative performance criteria had been met, all criteria governing purchases had been met. That some criteria for the end of December 1983 had not been met was not surprising, given the trends in the economy in the second half of the year. The criteria for the 1984 program took into account that there had been overshooting in the fourth quarter of 1983, and they had been set in such a way that the situation should be stabilized.

The staff welcomed the measures announced by Mr. de Groote at the outset of the meeting, the staff representative continued, although it should be pointed out that some of them went only part of the way toward fulfilling the undertakings in the letter of intent. For example, the authorities had said that they would reduce subsidy payments in 1984 by about Ft 20 billion, while the measures so far announced--to become effective at the end of January--would amount to a reduction of about Ft 10 billion. Measures later in the year would, therefore, have to be at a somewhat greater annual rate in order to achieve the Ft 20 billion savings in the full calendar year. The staff understood that the adjustment of the exchange rate by 3 percentage points that was currently under discussion would be accompanied by certain administrative measures to reduce tax rebates on exports and to eliminate some fees on imports; thus, it was not clear what the net effect of the adjustment would be on the external balance. The proposed increase in interest rates on savings deposits amounted to about only half the increase agreed in the letter of intent; moreover, at the present stage, it was difficult to assess the extent to which the increase would induce new savings or simply result in a shifting of existing savings to take advantage of the higher rates being offered on longer-term deposits.

Concern had been expressed that the policy measures adopted might not be enough to restrain demand sufficiently to achieve the stated goals, the staff representative observed. The staff believed that the measures and the goals were compatible, although there was little margin for error built into the program. Such a situation was not unusual, and it provided additional grounds for the staff's strong support for the authorities' determination to put into place further supply measures that would complement the demand management measures being undertaken.

The issue of the quality of investment was particularly important, the staff representative added. Little information was currently available to judge the adequacy of the rates of return on existing and new investment. The World Bank was studying the matter, and its preliminary comments might be available shortly. The staff was aware that the National Bank would not provide credits for new investment promising a rate of return lower than 15 percent, a rate that might appear slightly low relative to projects in industrial countries but that was probably not low in the Hungarian context. The staff was concerned, however, that too much emphasis might be placed on completing investments already under way and penalizing new investment, other than in areas where it was energy saving, export promoting, or import substituting. It was not prudent to complete a project that had been started unless its prospective rate of return indicated long-term viability. However, it had to be admitted that closing down projects already under way required an uncommon degree of courage.

The problem of taxing away the profits of successful enterprises and intermediating them through the budget to support loss-making firms was not confined to Hungary or to centrally planned economies in general, the staff representative remarked. To some extent, such a development was clearly taking place at present, but the Hungarian authorities had stated that they were determined to shorten the period during which restructuring decisions had to be taken by loss-making enterprises. The staff believed that such decisions could be made more expeditiously than was currently contemplated, and that action to increase the autonomy of enterprises, particularly financial responsibility, would have to include a speeding up of restructuring decisions and of the elimination of budgetary support or central bank credit.

The issues whether the new intervention fund constituted a bailout fund and whether an overlarge amount of financial resources was being placed in it were more matters of perception than real problems, the staff representative considered. For understandable reasons, the Hungarian authorities did not wish to project officially a large budget surplus, because of the pressure that would result from spending agencies. The authorities preferred to place the funds in expenditure categories that they did not intend to use, and they had indicated that the state lending and intervention funds would disburse about Ft 4 billion of the approximately Ft 30 billion of resources that they would have accumulated in 1984.

One Director had suggested that the Hungarian authorities might have been better advised to request a six-month arrangement and to judge at the end of that period whether a longer program would be appropriate, the staff representative recalled. However, Hungary's external financial situation remained precarious. A six-month arrangement might have raised questions in the mind of the international financial community whether or not the Fund really believed that the Hungarian authorities were progressing along the adjustment path satisfactorily. In addition, although the authorities were determined to fashion their structural adjustment program by mid-1984, there was always a possibility that such decisions would not be taken as speedily as hoped. For those reasons, a normal one-year arrangement appeared appropriate. The staff did not believe that the proposed purchases were heavily front-loaded. The first two purchases amounted to 53 percent of the resources available under the arrangement, not an unusual proportion, particularly given that liquidity needs in the first half of the year were greater than in the second half because of seasonal factors.

The staff agreed with the view that piecemeal introduction of structural reform measures would run the risk of damaging the coherence and effectiveness of the program as a whole, the staff representative stated. The authorities had had such a concern in waiting until midyear to put forward a comprehensive program. While the whole program might not be implemented over an 18-month period, the intention was to give a strong thrust in the direction of an improved system of price and wage determination, taxation, and financial intermediation, and to formulate the path toward the ultimate goals of economic reform beyond the time frame of the proposed program with the Fund.

Commenting on the external sector, the staff representative noted that the measured real effective appreciation of the exchange rate probably overstated actual relationships to some extent, as the staff had pointed out in SM/83/261. Nevertheless, given the sharp deterioration in the terms of trade that had occurred in 1983 and the further deterioration expected in 1984, it might not be easy to maintain Hungary's competitive position. An alternative indicator of competitiveness was Hungary's ability to maintain its share of export markets, and the available evidence in that regard indicated the advisability of an active exchange rate policy.

With regard to interest rate policy, the staff representative observed that the success of some of the bond issues in 1983 suggested that higher rates of return would bring about a considerable response in the savings behavior of households. Furthermore, the fact that the savings rate had appeared to remain relatively high, despite a negative real rate of return on deposits, was associated to a certain extent with the growth of the private sector. The latter development entailed an increase in demand for working balances, included in the household sector among the monetary and savings data that the staff had presented. The staff hoped that by the time of the midyear review it would be possible to distinguish between the two sectors so that developments in each of them could be followed separately. On the other hand, a factor that could explain the relatively high savings rate was that the authorities had shaped savings incentives in response to scarcities in the economy. For example, some savings instruments were housing related, or involved a lottery for jumping the queue for car purchases, or carried various other nonmonetary rewards. However, such schemes could not be expected to provide long-term disincentives to consumption, and the staff supported all the steps that the authorities were contemplating to increase the diversity of assets in which households could deploy their savings. In light of the inflation prospects, the situation strengthened the grounds for increasing nominal rates of interest on deposits.

The development of household cash incomes, described in earlier staff papers on Hungary had not been discussed in EBS/83/268, the staff representative remarked, a reflection of the staff's learning experience. A wider array of indicators was currently being monitored, and it no longer appeared appropriate to focus particularly on the narrow aggregate of household cash incomes, although the staff continued to follow developments in that area closely. The suggestion that the Fund might adopt quantitative indicators of the real side of the economy as performance criteria would be difficult to put into practice because the data for such targets would be available even later than some of the data currently being tracked. The staff believed that it had learned how to interpret the data being used at present and that it had identified those areas in which overshooting might occur.

The staff understood that Mr. de Groote's suggestion that the adoption of market instruments might be used as a performance criterion in centrally planned economies had been intended to apply specifically to the program of structural reform that the Hungarian authorities were intending to put into place and for which they hoped to receive Fund support, the staff representative explained. Monitoring the steps in the reform process in order to help the authorities implement it as smoothly and efficiently as possible could constitute a useful performance criterion in addition to, rather than as a substitute for, the normal performance criteria. The achievement of a viable balance of payments position with increased economic growth would very much depend on the authorities' implementation of the kind of supply-side measures contemplated in the structural reform program. Continued reliance on demand management measures alone might not prove as effective in the years ahead.

The authorities had been arranging contingency lines of credit with commercial banks in order to relieve pressure on reserves, the staff representative from the European Department stated. The staff hoped that the existence of those arrangements would be well received within the international banking community. The absence of a "cushion" for reserves had apparently been one factor causing the relatively high rates that Hungary had been facing in international financial markets, although the improvement in its financial position would have warranted lower rates. However, the relatively unfavorable terms and conditions under which the Hungarian authorities had borrowed in 1982 and early 1983 had not necessarily been unjustified, given the amount of pressure on reserves at that time and the uncertainty surrounding the authorities' ability to redress the external financial situation. In recent months, terms and conditions had improved considerably in relation to both cost and maturity structure. Finally, on the question of protectionist obstacles to Hungary's efforts, the staff was not aware that Hungary faced greater difficulties than any other country that exported such products as agricultural goods, steel, and textiles.

The Executive Directors agreed to resume 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/84/4 (1/9/83) and EBM/84/5 (1/13/84).

3. PHILIPPINES - FUND REPRESENTATIVE

In response to a request from the Philippine authorities for a Fund representative, the Executive Board approves the proposal set forth in EBAP/84/6 (1/9/84).

Adopted January 10, 1984

4. INTER-AMERICAN DEVELOPMENT BANK - RELEASE OF INFORMATION - CHANGE IN PROCEDURE

The Executive Board approves the proposal set forth in EBD/83/328 (12/20/83).

Adopted January 9, 1984

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/5 (1/9/84), is approved.

APPROVED: May 23, 1984

LEO VAN HOUTVEN
Secretary