NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/6

3:00 p.m., January 13, 1984

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

Executive Directors	Alternate Executive Directors
	N. Toé, Temporary
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
	R. J. J. Costa, Temporary
R. D. Erb	M. K. Bush
	T. Alhaimus
T. Hirao	
	Jaafar A.
R. K. Joyce	L. Leonard
	C. Robalino
	G. Grosche
G. Lovato	
	A. S. Jayawardena
	S. El-Khouri, Temporary
J. J. Polak	
A. R. G. Prowse	
	H. Alaoui-Abdallaoui, Temporary
	E. I. M. Mtei
M. A. Senior	
J. Tvedt	
	C. M. Hull, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

I. Szalkai, Assistant General Manager, National Bank of Hungary. European Department: 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. External Relations Department: G. P. Newman. Fiscal Affairs Department: M. J. Fetherston, B. J. Nivollet. Legal Department: W. E. Holder. Treasurer's Department: D. Williams, Deputy Treasurer; D. Gupta. Western Hemisphere Department: G. Oliveros. Personal Assistant to the Managing Director. S. P. Collins. Advisors to Executive Directors: S. R. Abiad, C. J. Batliwalla, S. E. Conrado, G. E. L. Nguyen, L. Ionescu, P. Péterfalvy, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: M. B. Chatah, L. E. J. M. Coene, G. Ercel, I. Fridriksson, V. Govindarajan, D. Hammann, J. M. Jones, H. Kobayashi, M. J. Kooymans, M. Rasyid, Wang C. Y.

1. HUNGARIAN PEOPLE'S REPUBLIC - 1983 ARTICLE IV CONSULTATION AND STAND-BY ARRANGEMENT

The Executive Directors resumed from the previous meeting (EBM/84/5, 1/13/84) their discussion of the staff report for the 1983 Article IV consultation with Hungary, together with a request for a 12-month stand-by arrangement in an amount 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).

The staff representative from the European Department noted that the decision to allow wages in the lowest bracket to increase by 10 percent and those in the top bracket by 25 percent did not mean that average wages would be increased. There would be greater opportunities for wage differentiation. The minimum wage applied to only about 2 percent of the labor force. More generally, the need to increase the price of labor relative to that of other factors of production was in part a matter of demography. The labor force in Hungary was shrinking; in addition, there had been a tendency to hold labor in areas of low productivity. Greater wage differentiation, not only within enterprises but among the different wage categories, was thus needed to encourage the release of labor from low productivity to higher productivity endeavors. The dismantling of the system of microcontrols should also offer a great opportunity to reduce the size of the bureaucracy and put the labor released to more productive use.

Trade with the nonconvertible currency area at present accounted for between 45 percent and 50 percent of total trade flows, the staff representative noted. As explained in the staff report, the overshooting of demand in 1983 and its containment had had a greater impact on the convertible currency balance because of Hungary's ability to substitute imports from the nonconvertible currency area for imports from the convertible currency area. But the relatively large deficit with the countries of the Council for Mutual Economic Assistance (CMEA) would have to be narrowed over time; any widening of that deficit in the meantime would constitute a claim against future output just as much as a deficit with the convertible currency area did. One of the reasons for trying to elicit a greater response on the supply side of the economy was to obtain the means of working down part of the cumulative deficit with the CMEA countries.

The high liquidity in the economy, particularly in the banking system, was partly related to the demand management problems of 1983 and early 1984, the staff representative from the European Department explained. Hungary's inability to import and to invest had led to drawdowns of stock or to increased liquidity in some enterprises. As explained in the staff report, the general liquidity overhang in the enterprise system was partly being taxed away by the confiscation of some development funds and the conversion of reserve funds into bond holdings, and partly internalized in the enterprise system. As enterprise liquidity began to be skimmed off in a more predictable and guided macroeconomic way, the presumption was that enterprises would find the financial assets in which to invest their liquid resources and that they would also be developing the managerial capacity to handle those investments responsibly. The implication for reform was that progress in those areas should be given priority over almost all other reform measures.

The staff representative from the Exchange and Trade Relations Department considered that it would not be right to characterize the program as a holding operation that ought more appropriately to have been supported by a six-month stand-by arrangement, as suggested by Mr. Wicks. Although most of the so-called structural reform measures were yet to be carried out, measures relating to the reform were already included in the program--as pointed out in the staff report and in Mr. de Groote's statement. The reference in the letter of intent to further structural reform measures to be delineated in mid-1984 for implementation beyond 1984 in no sense detracted from the comprehensiveness of the program for 1984 being launched under the proposed stand-by arrangement. The proposed program was fully comparable in content with other annual programs that had been presented for the approval of the Executive Board.

As many Directors had recognized, the adoption of market instruments or the monitoring of their implementation as performance criteria would have to be looked at in each individual case, the staff representative from the Exchange and Trade Relations Department said, and not as a general approach to all centrally planned economies. The suggestion by Mr. de Groote that nonquantitative performance criteria could be used in stand-by programs had of course been made in the specific context of Hungary. Moreover, it should be noted that, technically speaking, nonquantitative performance criteria were already used in stand-by arrangements in the form of preconditions and review clauses.

Mr. Zhang remarked that before further consideration was given to either the general or the individual application of such performance criteria, it would be necessary to study the appropriateness of the whole concept of applying those criteria in centrally planned economies.

The staff representative from the Exchange and Trade Relations Department responded that he had taken Mr. de Groote's observation to be indicative of the country's own interest in the use of such criteria. If there was broad agreement between the Fund and the member, their use should present no problem.

Mr. Joyce observed that, as he understood Mr. de Groote's proposal, macroeconomic performance criteria would still be required, but they would be combined with the introduction of market instruments.

The Chairman, responding to Mr. Grosche's question about the availability of borrowed resources, said that if the Executive Board approved the proposed stand-by arrangement for Hungary, the gap between the Fund's commitments to members and its available resources would be SDR 4.8 billion. The new credit lines that were anticipated to be available in the near future, which should amount to SDR 6 billion, would leave a surplus in terms of borrowing lines of SDR 1.2 billion. Although it was probable that arrangements in an amount of SDR 1 billion in borrowed resources would be canceled in the near future, some would be succeeded by new programs and arrangements. In general the new arrangements would involve a somewhat smaller commitment of borrowed resources as a result of the quota increase. The sum of the present surplus, plus a certain proportion of the amounts under cancelled stand-by arrangements, would have to be looked at in terms of the Treasurer's estimate of borrowing needs for 1984 of SDR 2.5-4 billion.

Mr. de Groote said that if a six-month stand-by arrangement had been proposed, together with the amounts that would have had to be associated with it, rather than a one-year arrangement, the wrong impression might have been conveyed not only to the financial markets but also to Hungary itself. The amount of an arrangement was sometimes of much greater public interest than its duration, and it was important to let it be known that Hungary would receive financing from the Fund in an amount appropriate to the type of performance it had recorded in 1983 and was envisaging for 1984. The measures already implemented and those to be taken fully justified a one-year program. Hungary should not be penalized for having announced its desire to adopt additional, more fundamental measures in the course of the current year, for which it intended to seek further assistance.

How far-reaching the changes were likely to be could be gleaned from a speech to the Hungarian National Assembly by Mr. Faluvegi, President, National Planning Office, on December 25, 1983, Mr. de Groote commented. Mr. Faluvegi had said, among other things, that there were to be changes in the basic wage system, and that the new, more flexible wage regulations would be applied more widely. At the same time, firms would be allowed to offer higher salaries to young professionals, technical and economic experts, and people working in unsatisfactory conditions. The changes would be introduced in 1985, after the whole of 1984 had been devoted to preparation. The main themes would be a greater reliance on market forces, the granting of more decision-making powers to individual firms, and an increase in the efficiency of economic management. On the subject of efficiency, the Government intended to submit its ideas to the Committees of the National Assembly in the first half of 1984, prior to the development of a program embracing the nation as a whole.

As to what could be realistically expected on that score in the future, Mr. de Groote continued, his Hungarian authorities were confident of being able to present a major program in six months' time, encompassing measures that would represent a definite movement toward a market economy. Obviously, a great deal of technical preparatory work would be necessary, including the introduction of a value-added tax, the organization of capital markets, and the elimination of subsidies, which would not be easy without upsetting the whole balance between the different elements of the economic system. It might take longer than six months to prepare for the adoption of such fundamental changes. Granting Hungary a one-year stand-by arrangement would give the correct impression to financial markets and Hungarian public opinion, and would provide the authorities with the necessary time to draw up the appropriate measures.

On the nature of the performance criteria, Mr. de Groote explained, it had been far from his mind to suggest that the Fund should impose on countries criteria related to the introduction of market-related mechanisms. He had wished to explore the possibility of a systematic attempt by the Fund to integrate certain supply-oriented measures in programs that it supported. In Hungary, the authorities themselves felt that in order to improve the supply response, they needed to take measures related to structural adjustment, and they looked favorably on the possibility of incorporating such measures in a Fund-supported program. In other countries, he could well imagine that a further centralization of economic decisions might be desirable. The argument in favor of supply-oriented mechanisms in a program under a stand-by arrangement was not a dogmatic one: if the member country agreed, and if the general political options permitted it to do so, the performance criteria could be related to market mechanisms, centralization of economic decision making, or whatever else was appropriate in the country under consideration. Since there were apparently no legal obstacles to such an approach, he had been curious to learn whether the Executive Board would agree to consider performance criteria which, as Mr. Joyce had described them, would provide a framework within which action on both the supply and the demand sides could be combined.

The process of implementing market-oriented mechanisms was not a smooth one, Mr. de Groote observed. Paradoxically, it was necessary to intervene in the economic process in order to establish or to re-establish market mechanisms. Economic policy had to be designed to guide the economic and financial system toward a market system. As Mr. Erb and other Directors had recognized, it was necessary to envisage drastic change rather than to follow a gradual approach. On the other hand, the economy could not be transformed into a market economy without a transition period. The best example of the contradictions inherent in the process of moving to a market economy was that the successful development of the private sector in the economic partnership in Hungary was at the origin of the excess of domestic absorption over the targets. It was also paradoxical that the adjustment of internal demand had had to fall mainly on investment. As had been noted during the discussion, investment was still at a high level in Hungary, and the concern of the authorities was indeed to ensure that any reduction in total investment coincided with better investment decisions.

Economic discussions in Budapest did not take place in a closed circle, as was sometimes felt, Mr. de Groote remarked. The problems faced by Hungary had already been discussed in public circles and in the Hungarian press. A recent speech to the National Assembly by the Minister of Finance, which had been published in the press, was evidence of the authorities' conviction that the movement toward a market-oriented economy was under way, and of the broadly shared belief that underlay the letter of intent and the stand-by arrangement before the Executive Board. The strict demand management program notwithstanding, the Government was systematically looking for ways in which to grant more decision-making powers to enterprises. Where market forces were strong enough some administrative restrictions could be eliminated. It might, for instance, be possible to empower certain companies to fix domestic prices without regard to government regulations and to disregard the present rules compelling exporting firms to combine their foreign and domestic earnings when export prices acted as a brake on domestic prices.

The Finance Minister had gone on to say that firms with useful ideas for expansion could have their investment capital enlarged through bond issues, Mr. de Groote continued. As the first bonds were likely to be sold to expand the natural gas supply and the telephone service, the purchasers of the bonds would obtain a direct economic advantage. The Government would no longer subsidize inefficient enterprises showing no sign of improvement. Subsidies to firms combined with those on consumer prices would amount to Ft 160 billion in 1983. He hoped to reduce them to Ft 142 billion in 1984.

It might indeed be useful in future reports on the Hungarian economy to include more information on trade with CMEA countries, Mr. de Groote remarked. An interesting feature that might well deserve further analysis was the deterioration in the terms of trade of Hungary and other countries in similar circumstances owing to the delayed effect of movements in international oil prices. The price of oil imports from the Soviet Union, under the Bucharest formula, was based on a five-year moving average of world market prices; Hungary was presently paying a much higher price for imported oil from the Soviet Union than it would otherwise pay, although by the same token, it had benefited from a lower oil price during earlier years. But the impact on the balance of payments might be significant in certain circumstances in future and could not be overlooked.

There was no doubt that Hungary had fully implemented the performance clauses under the previous stand-by arrangement, Mr. de Groote observed. In referring in his opening statement to the adherence of some countries to performance criteria while the underlying economic situation was deteriorating, he had not been thinking of Hungary, as Mr. Wicks seemed to have understood. The Hungarian economy had shown dramatic improvement in all respects, independent of the full implementation of performance clauses. Of course, the practice of the Fund was to allow a country to make its first drawing as soon as a stand-by arrangement was approved, so that the final drawing always took place before the end of the arrangement. The fact that Hungary had observed the performance clauses up to its last drawing did not mean that it could ignore them until the stand-by arrangement came to an end. He had therefore pointed out at the previous meeting that although there might have been some marginal slippages in meeting the last performance clause--for instance, those relating to the domestic liabilities and foreign assets of the banking system--it was an accepted principle and a matter of ordinary practice for a member country to remain subject to performance clauses even when it could draw no more from the Fund. The important point was that during what might be regarded as a transition period, the general direction of Hungary's policies had been correct, any slippages having been due to a less favorable export performance than targeted because of the drought and unfavorable terms of trade.

The Chairman remarked that one aspect of the letter of intent already encompassed a market-oriented measure as a performance criteria. The clause allowing Hungary to expand credit pari passu with the rediscounting of commercial bills by the National Bank of Hungary linked performance to a structural, market-oriented measure.

The Chairman then made the following summing up:

On the occasion of the second Article IV consultation with the Hungarian People's Republic, Executive Directors also approved a request for a new stand-by arrangement in support of a one-year stabilization program. Much of the discussion focused on the authorities' continuing efforts to achieve a sustainable external position and to improve the efficiency and market orientation of the economy.

Directors were pleased to note the considerable improvement in the current account in convertible currencies in 1982 and 1983, equivalent to some 5 percent of the 1983 GDP, in particular that this had been broadly based, resting on a sizable gain in export market shares and a reduction of the invisibles deficit, as well as on a cutback of imports, which was a less favorable development.

Directors also welcomed the improvement in the attitude toward Hungary of international financial markets, which had eased the position on the capital account. They noted, however, that the performance of the current account in 1983 fell well short of both the initial program and the targets estalished at mid-year. While recognizing that a major part of the slippage stemmed from exogenous factors, like the drought and adverse price developments, Directors were concerned about the overrun on domestic demand and noted that the current account would have been much weaker if the import restrictions introduced in September 1982 had been removed over the course of 1983, as had been planned.

Against this background Directors welcomed the authorities' commitment to eliminating the import restrictions during 1984 and the targeting, at the same time, of a further improvement in the current balance in convertible currencies. They pointed to the critical importance of a tightening of demand management policies as a necessaary foundation for meeting the current account target, and, in view of the experience of 1983, stressed that a firm hold on investment spending, as well as more resolute restraint on consumption, would be necessary conditions for preventing an overrun on imports as restrictions were lifted.

In this context, Directors generally applauded the authorities' efforts to address, in the 1984 program, the sources of the 1983 demand overrun. In particular, they welcomed the decision to put a cap on lending by the State Development Bank, which had been a major factor in the overrun of bank credit in 1983. Several Directors supported the authorities' plan to reduce the liquidity overhang in the hands of enterprises, but they also advocated the use of alternative or additional means to limit investment spending, such as higher interest rates or active use of an investment tax. More generally, Directors urged the authorities to move forward as rapidly as possible on their program for strengthening decision making and financial responsibility at the enterprise level.

Directors praised the steps being taken with regard to the state budget, in particular the raising of the social security tax and the reduction of subsidies. They noted that these measures would contribute to a more rational production system by raising the cost of labor to enterprises and to more realistic expenditure patterns at the consumption level. They welcomed the authorities' expressed intention to move further, especially on subsidies, which even after the proposed cuts would continue to absorb an excessive share of budgetary expenditures and contribute to a biased cost and price structure in the economy.

Several Directors stressed the importance--particularly in a situation in which import restrictions were being eased, as they had to be--of timely exchange rate adjustments, which would also have the salutary effect of improving the profitability of exports and import substitutes.

A number of speakers were of the view that the demand management package for 1984 allowed little margin for error. Given the debt constraints and the still precarious situation of Hungary in international capital markets, slippages such as those experienced in 1983 in domestic demand were not permissible. These speakers urged the authorities to take prompt additional action to restrain demand in the event that an incipient overrun of demand or shortfall of supply appeared. At the same time, Directors endorsed the authorities' determination not to hold back the growth of the emerging private sector.

Virtually all speakers expressed concern regarding the imbalance of an adjustment pattern focused largely on consecutive reductions of investment. They stressed the need to restrain consumption more vigorously and to watch over the quality and efficiency of investment.

Directors commended the authorities for their efforts to move forward with measures of structural reform aimed at augmenting the efficiency and supply response of the economy. Notwithstanding the progress made to date and the measures already specified for 1984, it was generally felt that consolidation of the economic gains made thus far requried further moves, particularly to decentralize wage and price formation, to strengthen and broaden the system of financial intermediation, and to support efficient enterprises rather than subsidize the loss makers. Directors therefore urged the authorities to act in order to keep the momentum they had generated, and they endorsed the efforts toward fashioning a specific, decisive, and comprehensive program of structural, supply-oriented reform in the first half of 1984.

Directors noted the need for strict adherence to the economic targets adopted by the authorities, since demand overruns in the past had, in part at least, tended to be associated with efforts to free up the economy, and they stressed the importance they attached to a close monitoring of the program. In this respect, they underlined the crucial role of the midterm review of the program.

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

Executive Directors turned to the proposed decisions.

The staff representative from the European Department said that the Hungarian authorities had notified the Fund that they were not terminating the bilateral agreement with Brazil but modifying it to conform with the Fund's requirements; the last sentence of paragraph 2 of the proposed decision should be amended accordingly.

The decisions were:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision relating to Hungary's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1983 Article XIV consultation with Hungary, in the light of the 1983 Article IV consultation with Hungary conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Hungary maintains restrictions on payments and transfers for current international transactions as described in EBS/83/268, 12/16/83. With respect to the tighter import licensing and import quotas introduced in September 1982, the Fund urges their elimination at an early date. In the meantime, in the circumstances of Hungary, the Fund grants approval of these restrictions until June 30, 1984, or the completion of the review under the stand-by arrangement, whichever is earlier. For those restrictions maintained under Article XIV, the Fund encourages Hungary to pursue policies that would permit their elimination. In particular, the Fund encourages Hungary to take

early steps to eliminate its bilateral payments agreements with Fund members. In this respect, the Fund welcomes the modification of the bilateral agreement with Brazil.

Decision No. 7606-(84/6), adopted
January 13, 1984

Stand-By Arrangement

1. The Government of Hungary has requested a stand-by arrangement for a period of 12 months in an amount equivalent to SDR 425 million.

2. The Fund approves the stand-by arrangement set forth in EBS/83/268, Supplement 2.

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

Decision No. 7607-(84/6), adopted
January 13, 1984

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/5 (1/13/84) and EBM/84/6 (1/13/84).

2. HAITI - TECHNICAL ASSISTANCE

In response to a request from Haiti for technical assistance, the Executive Board approves the proposal set forth in EBD/84/7 (1/12/84).

Adopted January 13, 1984

APPROVED: May 23, 1984

LEO VAN HOUTVEN
Secretary