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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/118

10:00 a.m., August 1, 1984

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
J. de Groote	H. G. Schneider
B. de Maulde	
	M. Teijeiro
	M. K. Bush
	M. Lundsager, Temporary
	S. R. Abiad, Temporary
	K. Murakami, Temporary
	I. R. Panday, Temporary
R. K. Joyce	
	H. A. Arias, Temporary
	G. Grosche
	N. Coumbis
R. N. Malhotra	
	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	
	O. Kabbaj
	S. M. Hassan, Temporary
M. A. Senior	
	A. K. Juusela, Temporary
N. Wicks	T. A. Clark
	Wang E.

J. W. Lang, Jr., Acting Secretary
J. C. Corr, Assistant

Also Present

Asian Department: G. Szapary. European Department: P. B. de Fontenay, P. C. Hole, H. B. Junz, J. K. Salop, J. Somogyi, P. W. Stanyer. Exchange and Trade Relations Department: M. Guitián, Deputy Director; S. Mookerjee, Deputy Director; G. Belanger, C. F. J. Boonekamp. Fiscal Affairs Department: V. Tanzi, Director; A. L. Antonaya, A. A. Tait. Legal Department: A. O. Liuksila, J. K. Oh. Western Hemisphere Department: R. A. Elson, J. Ferrán, M. R. Figuerola, T. F. Lehwing, J. Martelino, R. K. Rennhack. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. El-Khouri, L. Ionescu, W. Moerke, G. E. L. Nguyen, P. Péterfalvy, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, R. L. Bernardo, M. Camara, V. Govindarajan, D. Hammann, S. Kolb, A. Koné, E. Olsen, G. W. K. Pickering, E. Portas, D. J. Robinson, J. E. Rodriguez, C. A. Salinas, Shao Z., Wang C. Y.

1. HUNGARY - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the midterm review of the stand-by arrangement with Hungary (EBS/84/144, 7/3/84; and Cor. 1, 7/26/84).

Mr. de Groote made the following statement:

> In EBS/84/144, the staff provides a factual summary of the course of the Hungarian economy from the end of 1983 to the early part of 1984. I should like to inform the Board of new developments since then and to contribute to the appraisal of the Hungarian situation.
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> As of June 30, 1984, Hungary was in compliance with every performance criterion set forth in the stand-by arrangement. With respect to the lapse from the short-term external debt criterion recorded at the end of March 1984, the Hungarian authorities wish to point out that, as of June 30, Hungary was in compliance with that limit as well.
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> The latest available data on the country's external balance show a healthy improvement: the current account in convertible currencies produced a surplus of $80.6 million in the first half of 1984, a substantial increase beyond the surplus of $19 million forecast in the revised program. At the same time, the current account in nonconvertible currencies has recorded a marked improvement, connected with an increase in the volume of exports to both convertible and nonconvertible areas, although the increase in market shares in the convertible currency area was to a certain extent offset by adverse price developments. Imports from both areas have behaved as envisaged in the program, and the authorities are able to proceed as planned in lifting the import restrictions introduced in 1982.
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> The behavior of the capital account during the first half of 1984 was also positive. The National Bank of Hungary was successful in the smooth financing of its debts and in improving the structure of the newly obtained loans and credits. Hungary's reserves increased markedly, amounting to $1.39 billion by June 30, 1984. Moreover, the outflow of short-term capital does not reflect any adverse change in the market's appraisal of Hungary. On the contrary, it is due to Hungary's success in keeping short-term liabilities in line with the very low limit accepted by the Government for such liabilities under the present stand-by arrangement. The Hungarian authorities consider Hungary's excellent relationships with the Fund and the World Bank to be important factors contributing to the achievement of these favorable changes. The international financial community relies more and more on the judgment of the Executive Boards of the two institutions in its own appreciation of Hungary's performance.

The Hungarian authorities are concentrating their efforts on stabilizing the results so far achieved and on trying to reach, after a current account surplus of $297 million in 1983, the $400 million current account surplus in convertible currencies targeted for 1984. They intend to achieve this objective despite adverse developments on the international economic scene, beyond the control of the Hungarian economic policymakers, which endanger this otherwise realistic program. To counter these developments and the threat that they pose for the strict implementation of the demand management goals, the Hungarian authorities have decided to strengthen the original program. At the same time, the supply situation is developing more favorably than programmed.

The additional demand management measures undertaken by the Hungarian authorities, outlined in the letter of intent of May 18, are part of these efforts. Of these demand management measures, the following have been implemented during the first half of the year:

- The Hungarian forint was devalued by 5 percent, with effect from June 26, to protect the external balance target from losses entailed by changes in the terms of trade and interest rates.

- This devaluation permitted a further step to be taken toward restoring the import system in effect before September 1, 1982, by the July 3 abolition of the reference limits regulating raw material imports, except for those on products falling under the six import quotas that entered into force on January 1, 1984, which are expected to be continued until January 1, 1985.

- To increase the propensity to save, the rate of interest for household time deposits with maturities longer than two years was raised on July 1.

- Price subsidies have been further reduced, and the unification of turnover taxes has been continued, resulting in several consumer prices increases starting July 12. These include the prices of detergents, kitchenwares, soft drinks, dry cleaning, and municipal freight tariffs. The unification of turnover tax rates will set their level above the average of present tax rates; it is planned to cut the number of different turnover tax rates from 80 to 4. Further steps are being taken to reduce producer subsidies in manufacturing, construction materials, mail and telecommunications, retail trade, and the like. Before August 1, the Government will make decisions on the increases to be imposed on railway freight tariffs and postal services.

- Budgetary policy has been made more restrictive, and the rate of credit expansion was lower at the end of June than anticipated.

The generally restrictive character of economic policies was largely responsible for a significant slowdown in investment activities by the end of the first half year, without the need for further direct intervention. The purchasing power of the population, mainly in the newly established forms of enterprises, continued to increase. However, it was accompanied by rising productivity in this sector, and there was also a higher propensity to save, strengthened by new bond issues to the population. The yield on bonds is substantially higher than the rates of interest paid on savings.

The latest available data confirm that the increase in domestic supply is significantly higher than projected in the program and also helps to offset the effects of recent adverse developments in the world economy.

Industrial production increased by more than 4 percent during the first half of 1984, an increase almost totally directed toward exports: industrial export sales increased by 17 percent till May, while domestic sales increased by only 2.1 percent. In the agricultural sector, better weather improved the harvest outlook substantially. The supply of livestock also seems higher than expected. Thus, the increase in agricultural production in 1984 may be large by comparison with last year, when severe drought produced poor results. This increase in agricultural production could produce significantly greater exports in the second half of this year.

The Hungarian authorities consider that the economic reforms, which they will continue implementing in the next few years, are a precondition for further adjustments that are not achievable through demand management techniques. The Central Committee of the Hungarian Socialist Workers' Party took, in April, the political decision to speed up the reform process. The preparation of several important elements of the reform package will be finalized and appropriate measures will be specified by autumn 1984.

The Government has officially expressed its desire to start negotiations with the Fund in the second half of August, in order to secure both financial and technical assistance for the reform program. The reform measures being prepared will integrate increased reliance on market instruments with Hungary's basic socialist objectives so as to achieve better resource allocation and to attain, within the constraints of available resources, a higher level of economic activity. As outlined in various government documents, these economic reforms will focus on the following basic goals, which have already been announced in my statement of January 13, 1984 at EBM/84/5:

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

- Wage reform: wages will be freely determined on the basis of a social consensus to be attained by balancing the interests of different social forces.

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

- Reform of the financial intermediation system: capital flows will be channeled through an independent banking system based on market principles and profit motivation and using new financial instruments.

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

As they elaborate and prepare specific reform measures, the Hungarian authorities are encountering a number of problems of a systemic nature concerning the operation of the economic mechanisms. These problems might cause frustrating delays in the reform process. To aid in achieving the timely solution of these problems, they have applied to the Managing Director for technical assistance from the Fund in devising and introducing the value-added and personal income tax system in Hungary, this assistance to include the training of personnel. Requests for additional assistance in other areas, such as the financial intermediation system, are also being considered.

The Hungarian authorities are convinced that their cooperation with the IMF and the World Bank has been valuable, successful, and productive. The developing dialogue with the Fund and the Fund's assistance have contributed greatly not only to maintaining Hungary's solvency during the most difficult periods, but also to giving substance to the reform ideas. The Hungarian authorities want to continue this relationships beyond the international debt crisis situation.

They are well aware that the continuing process of Hungary's adjustment needs the Fund's financial assistance to guarantee more room for maneuver in the financial markets and to ease the balance of payments constraints. The introduction of market mechanisms in a country accustomed to a dirigist management system is likely to involve a number of uncertainties that could temporarily affect the current account at certain moments and can be overcome only if that country has the approval and the prestige of the Fund standing behind it. The specific measures will more easily be accepted and implemented in a more timely way if the Hungarian authorities are able to count on the availability of Fund resources. The Hungarian authorities also know that the immense expertise that the Fund makes available to its members will be a crucial element in facilitiating their adjustment efforts.

They hope that the new series of negotiations with the Fund will result in a new program for Hungary that will be based on these intentions.

Mr. Wang noted with satisfaction that Hungary had made further progress, both in economic performance and in structural reform, since the 1983 Article IV consultation (EBM/84/5 and EBM/84/6, 1/13/84). All the performance criteria set forth in the stand-by arrangement had been met as of June 30, 1984; the achievements in the external sector were especially encouraging. The current account in convertible currencies had improved by $400 million in 1983. The trade surplus had reached $880 million, and the deficit on current services and transfers had declined markedly to about $580 million. In the first half of 1984, the current account in convertible currencies had shown further improvement, to a surplus of $80.6 million, although the terms of trade had again worsened. The capital account in convertible currencies had also improved significantly, from a net outflow of $1.1 billion in 1982 to a net inflow of $150 million in 1983. The growth of official reserves in convertible currencies had increased sharply, from $1.1 billion at the end of 1982 to $1.6 billion at the end of 1983. Those improvements had been achieved despite unfavorable external conditions: weaker terms of trade and increasing interest rates in the international markets had made the task much more difficult.

The authorities' efforts in the face of those unfavorable conditions and their quick responsiveness and effective adjustment measures should be highly commended, Mr. Wang continued. According to the authorities' projections, the current account surplus in convertible currencies would reach $0.7 billion in 1988/89; gross external debt in convertible currencies would be reduced by $1.5 billion between the end of 1983 and the end of 1989, and the debt service ratio would decrease from 40 percent in 1984 to 25 percent by 1989. Those prospects were indeed encouraging.

Such remarkable achievements had been accompanied by a series of reform measures, Mr. Wang noted. As Directors were aware, the reform drive in Hungary had made continuous headway; the determination and capability of the authorities in carrying out needed reforms was evident in the resolutions adopted three months earlier by the Central Committee of the Hungarian Socialist Workers' Party. A comprehensive program of structural reform was already in preparation, and specific details of the required measures were being worked out. The social objectives of a socialist system and the possible risks linked with reform measures should be taken into account; therefore, more time for consideration of the reforms and more room for maneuver in introducing them were necessary. He was confident that the authorities would decide on the appropriate timetable for the implementation of concrete reforms.

The Hungarian economy and the reform process continued to be affected by unfavorable external conditions at present, Mr. Wang commented. As the staff pointed out, the further worsening in the terms of trade, together with higher international interest rates, posed a serious threat to the attainment of the current account target. At the same time, the authorities needed to achieve a strengthening of the external current account in nonconvertible currencies, the deficit on which had widened in 1983 and early 1984. In those circumstances, the authorities' intention to replace the present stand-by arrangement with a longer, structurally based arrangement in order to support their reform program was appropriate. He fully supported their efforts and hoped that a new agreement could be reached as soon as possible.

Mr. Grosche remarked that Hungary had made commendable progress in improving its external accounts, re-establishing its good standing in international financial markets, checking domestic demand, and tackling some of its structural problems. The turnaround in the current account of the balance of payments, from minus 3.2 percent of GNP in 1981 to 1.5 percent of GNP in 1983 constituted an improvement of almost 5 percentage points, a remarkable achievement. The authorities' intention to stick to the objectives of the program for 1984 was particularly impressive. Mr. de Groote had pointed out that they had already implemented a number of additional demand management measures, which should help to achieve the $400 million current account surplus in convertible currencies targeted for 1984. Demand management policies had been widely and decisively used. While domestic demand needed to be tightly controlled, additional measures would have to be taken to enhance the allocative efficiency of the economy. Fortunately, the positive results achieved thus far should allow some breathing space to shift the emphasis away from the adjustment-at-all-costs strategy toward measures that were supply-side oriented and that emphasized efficiency and the responsiveness of enterprises and labor to market forces.

As the staff mentioned at several points in EBS/84/144, Mr. Grosche continued, the control of domestic demand was crucial to the further easing of the pressure on the balance of payments. Resources equivalent to another 1.75 percent of GNP would have to be shifted to the external sector in 1984. The list of measures presented on pages 18 and 19 of the staff report was impressive, but it would be interesting to know whether and to what extent the envisaged set of measures might affect incentives in the nonsocialist sector. For example, tax exemptions applying to private sector activities were to be cut back radically; it would be regrettable if economic activities in the nonsocialist sector were exposed to harmful disincentives. Such an approach could unjustifiably restrain an innovative and flexible element in the economy.

The overall burden of adjustment had been borne in 1983, and would have to be borne again in 1984, largely by gross fixed investment, Mr. Grosche observed. However, it was encouraging that in the revised program for 1984 the decline in investment would be slightly smaller than in the original program, whereas consumer expenditure and government current expenditure were to be reduced somewhat more. The measures to be taken to limit domestic demand included an increase in savings incentives, particularly a rise of 1 percentage point in interest rates on certain household deposits. In view of the low savings ratio, expecially for financial savings, there was certainly scope for increasing household savings in Hungary; nevertheless, because inflation in 1984 was expected to be 9.4 percent, interest rates would remain negative in real terms, despite the increase. Thus, the impact on savings would probably be limited.

On structural policies, Mr. Grosche welcomed the authorities' decision in April 1984 to speed up the reform process. As Mr. de Groote had remarked, economic reforms were a precondition for further adjustments that were not attainable through demand management techniques. However, most of the measures to be implemented and the timetable were still being worked out. One measure already decided upon was the phasing out of consumer and producer price subsidies. Other distortions were probably harder to overcome. The staff stated that the greater part of the adjustment burden continued to be borne by profitable enterprises through constraints on investment and by industrial workers through wage restraint. Both structural weaknesses ran counter to the intended increases in labor productivity. The authorities should liberalize the wage system and aim at greater wage differentiation. The staff also stated that those enterprises that had adopted a liberalized system had experienced productivity increases above average. Unfortunately, there appeared to be no statistics in EBS/84/144 on the evolution of productivity or on nominal and real wages; such statistics would have helped Directors in assessing the effects of wage reforms.

The diversity of extrabudgetary funds, such as the development fund and the reserve fund, was somewhat confusing, Mr. Grosche considered, as was their impact on the investment decisions of individual enterprises. Perhaps the staff could elaborate on the economic rationale for those funds. In the not too distant future, it might be appropriate to design an institutional framework with a more clear-cut division of responsibilities among the state, the National Bank of Hungary, and the enterprises so as to strengthen self-responsibility and self-determination of enterprises.

Progress in the external sector thus far had had a positive impact on Hungary's ability to service its outstanding external debt, improve its access to international financial markets, and increase sharply its gross official reserves, Mr. Grosche said. The listing of the import restrictions imposed in 1982 was welcome. In Chart 2 of EBS/84/144, which set out alternative scenarios for external developments, the staff underlined quite clearly the necessity of further improving the current account. To attain that goal, the authorities should not hesitate to make flexible use of exchange rate policy, as they had done thus far, in maintaining adequate profitability of exports. On those grounds, the recent real appreciation of the forint was a cause for concern. It would be useful to know whether the 5 percent devaluation in June 1984 had already been incorporated in Chart 1 of EBS/84/144 or whether it would offset, at least partially, the real appreciation of the exchange rate depicted in that chart.

The Hungarian authorities were to be commended for keeping internal demand under firm control in order to generate the necessary export drive, Mr. Grosche stated. Smooth servicing of foreign debt and some reduction in the amount of such debt would continue to be primary objectives of policy. He agreed with Mr. de Groote that substantial further adjustments were needed that were not achievable through demand management techniques alone. It was time for the supply side of the Hungarian economy to be strengthened. He supported the authorities' efforts to increase the responsiveness of the economy to market forces and urged them to take timely steps to simplify and deregulate enterprise operations, particularly with regard to setting prices and wages, and also to increase competition among enterprises.

Ms. Bush said that the continued adherence of the Hungarian authorities to the goals embodied in the current stand-by arrangement was welcome, particularly their compliance with all performance criteria, including the commitment on short-term debt, as of June 30, 1984. With regard to the renewed effort being made to get the economy back on the planned adjustment path in 1984, it was encouraging that the authorities appeared to be on track toward achieving the principal 1984 economic target of a $400 million current account surplus in convertible currency transactions; she hoped that the planned cut of 1 1/4 percent of GDP in domestic demand could be achieved through the various measures already taken or expected to be taken.

As for the longer-term aspects of the adjustment effort, Ms. Bush remarked, it appeared that the authorities were at an important turning point in terms of the need to develop improved macroeconomic tools for influencing an economy in which the private sector was gradually coming to play a more important role. As the staff had pointed out, the lack of such tools had created the need for an adjustment effort that, of necessity, had thus far concentrated on compressing investment, controlling industrial wages, and manipulating the prices of basic consumer goods. Unfortunately, that approach tended to divert resources away from private households and the efficient business sector toward government, with the likely outcome that the more profitable and dynamic areas of the economy might end up bearing the brunt of the adjustment effort. Moreover, the opportunity was created for the Government to use some of the resources siphoned from those areas to help financially weak businesses.

There were a number of institutional and structural changes that should make it easier to address directly the weaknesses and excesses in the economy, such as a more direct method of addressing excess demand in the private sector without destroying incentives to save and invest, the creation of more efficiently functioning markets for allocating resources, and the setting of realistic prices for goods and services, Ms. Bush continued. In that connection, she supported the request of the Hungarian authorities for Fund technical assistance with taxation and financial intermediation. She was pleased that the increased ability to introduce wage differentiation seemed to be helping productivity growth. In the fiscal area, steps had been taken to close the gap between social security contributions and benefits, and there had been simplification of indirect tax rates, production tax rates, and appreciation schedules. The staff and Mr. de Groote had mentioned plans for a comprehensive reform of the personal income tax; she hoped that, with Fund technical assistance, an income tax system could be devised that would not create economic disincentives. She welcomed the considerable progress that had been made in reducing subsidies, although some subsidies continued to exist.

The investment rate had declined steadily in recent years, Ms. Bush noted. That decline could conceivably be healthy, as the quality of investment, rather than simply its volume, was currently receiving more attention. It would be interesting to know the relative size and pattern of investment by the large state enterprises as compared to investment in other parts of the economy. One of the more important issues in need of attention was the development of channels for efficiently transferring financial savings from the households to enterprises, a process that would presumably require a broader array of financial instruments than existed at present. Consideration was apparently being given to the creation of a commercial paper market as an alternative to short-term bank lending; reform and decentralization of the banking system appeared to be a possibility. What was the likelihood of such steps being taken? Did the staff believe that they were useful? Did it have alternative suggestions to make?

In international trade, Ms. Bush went on, the elimination of the import surcharge earlier in 1984 was welcome, as was the reaffirmation of Hungary's commitment to eliminate by the end of 1984 the licensing restrictions introduced in late 1982. Those measures should help to improve the efficient allocation of resources and should be tolerable, provided that control over domestic demand and a flexible exchange rate policy were sufficiently supportive.

In sum, Ms. Bush added, she continued to be impressed by the adjustment effort being made by the Hungarian authorities. There had been slippages; however, the response to changing conditions had generally been good. There remained a rather narrow margin for error in the short term, and much remained to be done in the longer term with regard to the structural and institutional areas. She agreed with the view that Hungary's close cooperation with the Fund and the World Bank was perceived as a favorable factor in international financial markets. The Hungarian authorities planned to begin negotiations with the Fund in the second half of August 1984 to seek continued financial assistance in support of the economic adjustment and reform effort; she could not prejudge her chair's attitude toward a specific request for a new stand-by arrangement or extended arrangement. However, continued reform efforts were not only worth the effort but also essential for sustained economic growth and financial stability, with or without Fund financial support.

Mr. de Maulde remarked that Mr. de Groote had pointed clearly to the basic problems. Hungary's major challenge was no longer the restoration of macroeconomic equilibria; it had convincingly proved that it had become adept at that task. The present challenge was to move toward a more efficient and flexible economic system, allowing the country to achieve the same or better results with less waste, less energy, and a higher standard of living for the society as a whole.

The remarkable accomplishments described by the staff were most welcome, Mr. de Maulde continued. On the external side, the authorities had almost succeeded in meeting their 1983 target; they would probably have been completely successful if it had not been for the drought in the summer of that year. As for 1984, he welcomed the fact that the authorities and the staff agreed on the need to shift about 1.75 percent of GNP from the internal to the external sector and on the measures that would have to be taken to achieve that objective. He fully endorsed those measures and was confident that they would lead to the desired results. He also welcomed the removal of the import restrictions imposed in 1982, which meant that Hungary was making progress toward a real restoration of the balance of payments while improving the efficiency of the economic system.

The remarks by the staff and Mr. de Groote on the capital account demonstrated that the confidence of the rest of the world in Hungary's economic and financial future was on the way to being restored, Mr. de Maulde considered. In that connection, he emphasized the extremely useful role played by the World Bank in arranging its cofinancing packages. The cooperative effort, led by the Fund and the Bank, to solve together the adjustment and financing issue in Hungary was clearly a model for the treatment of severe debt problems. More examples of similar success would be welcome; they would require, in principle, the same dedication and willpower already demonstrated by the Hungarian authorities. It was necessary to say "in principle" because Hungary had had, and would continue to have, to use greater willpower and suffer greater costs in carrying out its adjustment process than would have been necessary if the supply side of its economy were more flexible. Unless the reforms outlined by Mr. de Groote with regard to prices, wages, the decision-making process, and the tax and financial systems were carried through with determination, the recovery would remain fragile; in attempting to preserve it, Hungary would continue to suffer unnecessary costs.

Trade provided one example, Mr. de Maulde suggested. On page 18 of the paper, the staff observed that Hungary had faced a fall in the prices in its export markets early in 1984; on page 22, the staff noted that foreign markets were growing by about 5 percent per annum. The questions that came immediately to mind were whether Hungary was selling the right products abroad and whether its enterprises were aggressively exploring their potential markets and adjusting their production according to the markets' willingness to pay. He strongly suspected that an assumption along those lines would be only partially valid and that a number of bureaucrats could usefully be shifted toward producing statistics--a job in which they excelled--to make room for imaginative and creative management. Such an approach would create less restraint on domestic demand with a given amount of export receipts, or more exports with a given level of internal demand. Similarly, on page 32, the staff stated that after-hours work had declined in enterprises that had initiated wage differentiation, which clearly meant that labor efficiency was increasing in those enterprises, or, in other words, that the same number of people was creating more wealth with the same investment outlay as before.

Many questions could be raised on the fundamental subject of economic reform, Mr. de Maulde commented, particularly with regard to agriculture, which had been the Achilles' heel of socialist economies up to the present. Given that the subject before Directors was the midterm review, he would postpone his comments in that regard until the next Article IV consultation with Hungary. He supported the extension by the Fund of technical assistance for the reform of the tax system and, eventually, the financial intermediation system. Had parallel requests for technical assistance been addressed to the World Bank with regard to prices, wages, and management, all areas in which the Bank had the better expertise?

Mr. Wicks recalled that at the time of the approval of the stand-by arrangement with Hungary (EBM/84/5 and EBM/84/6, 1/13/84), he had expressed regret that the program had not included stronger structural measures in continuation of the reform process, particularly on the supply side of the economy. Admittedly, supply-side reforms took time to implement, and the authorities intended to put forward a program of that nature at the end of the current arrangement; furthermore, Mr. de Groote had pointed out that the reform process had recently been given renewed impetus. He agreed with the Hungarian authorities that further economic reforms were a precondition for effective adjustment; he hoped that the Fund would be able to provide technical assistance, and perhaps other assistance, in that area. Meanwhile, the program under review, although it contained many worthwhile measures, had to be regarded as a holding operation.

Key elements of the program were particularly welcome, Mr. Wicks continued, such as the elimination of the liquidity overhang in the enterprise sector--which should make the conduct of an effective macroeconomic policy easier--the ending of import restrictions by the end of 1984, and the substantial cut in subsidies. However, subsidies continued to account for more than 25 percent of state budgetary expenditure. It was also a matter for concern that, for similar reasons as in Hungary's first stand-by arrangement, the trend in the first part of the present arrangement suggested that the central objective of a $400 million surplus on the current account in convertible currencies would be missed by a significant margin.

In that regard, the overshoot in domestic demand was particularly worrying, Mr. Wicks considered. He agreed with the staff that the temporary factors that had accommodated the increase in domestic demand in 1983 could not be relied upon to do the same in 1984. The measures that the authorities had taken to reverse the increase in demand so as to make room for the necessary transfer of resources to the external sector were, therefore, welcome, as was the decision to support those measures by a modest depreciation of the forint. According to Mr. de Groote, the current account was at present doing better than projected in the revised program; nevertheless, as the staff emphasized, the measures taken by the authorities left little margin for error and, consequently, little room for maneuver. The authorities' would have to be extremely careful to ensure that domestic demand, particularly state investment, remained on track, and they would have to act promptly to correct any slippages that might occur.

It would be especially important to restrain consumption in the personal sector, in view of the increase in consumer prices projected for 1984, Mr. Wicks suggested, and it was questionable whether the proposed increase of 1 percent on certain household deposits would prove a sufficient stimulus to private savings. The buoyancy of private consumption in 1983 had partly been due to the rate of credit expansion to households. He invited the staff and Mr. de Groote to comment on the adequacy of present interest rates and on whether the authorities had plans for further action in that area. While the shift of demand restraint away from investment and toward private and government expenditure was welcome, a disproportionate burden was falling on investment by profitable enterprises, which could have adverse effects on growth and export potential in the medium term. The staff had commented on the effects of subsidies to loss-making enterprises from the off-budget intervention fund; it was encouraging that the authorities were determined to keep expenditures from that fund below the budgeted level.

It would be most important to set up a framework in which investment funds could be channeled effectively to those enterprises with profitable investment opportunities, Mr. Wicks said. He agreed with the staff and the authorities that an improvement in the system of financial intermediation and the development of some form of capital market would be important as well. In that regard, the reference in the letter of intent to establishing "the institutional framework for a secondary market" in communal and enterprise bonds was interesting; the authorities should give that proposal priority. It would also be useful to know how far the proposed separation of the commercial and central banking functions of the National Bank in Hungary had proceeded. More generally, it would be helpful if the staff could provide, perhaps in the next report on recent economic developments in Hungary, a detailed assessment of the framework and effectiveness of Hungarian investment policy, especially how far that policy had encouraged efficient investment in the tradable sector. The staff might need to draw on assistance from the World Bank for such an analysis. A few years earlier, the Hungarian National Bank had introduced a specific scheme to encourage export-oriented investment. Although the scheme had affected only about 5 percent of total investment, initial indications had suggested that it had been successful.

It would be extremely important to meet the targets for the current account in convertible currencies, Mr. Wicks stressed, not just for their own sake, but also to maintain and foster the confidence of the international financial community. He supported, therefore, the authorities' medium-term objective of increasing the current account surplus in convertible currencies to $0.7 billion by 1988-89 in order to allow a reduction in outstanding debt. The alternative scenario of a constant current account surplus in dollar terms was not viable in practice. While Executive Board discussions of members with centrally planned economies tended to focus on the convertible currency account, the balance on the nonconvertible account could not be ignored. He welcomed the substantial improvement projected for 1984. More generally, it would be useful to consider in more detail the interlinkages between the convertible and nonconvertible accounts--and not merely in Hungary--together with their implications for Fund policy. Finally, he welcomed the authorities' intention to press on with their program of economic reform, especially to strengthen the supply side in the five areas mentioned by Mr. de Groote. His authorities wished the Hungarian authorities every success in making early progress in that direction.

Mr. Joyce commented that the general thrust of the stand-by arrangement continued to be appropriate, despite the shortcomings in actual economic performance. Although the shortcomings were attributable, in part, to poor weather and weaknesses in export markets, they were also a result of the authorities' inability to exercise effective control over the growth of income. Indeed, unless corrective action were carried through effectively, a continuation of current economic trends could make the achievement of the external targets difficult. Therefore, the authorities' determination to ensure that the program returned to its original path was encouraging, as was the staff's endorsement of measures already taken. Despite those encouraging indications, however, he agreed with the staff that there was little room currently available to the authorities for discretionary action. He strongly endorsed the staff's suggestion that the authorities should formulate contingency plans, particularly if such plans could also help to advance the implementation of measures within the structural adjustment program.

In addition to the immediate need to strengthen demand management restraint, Mr. Joyce continued, the probable tight financial position of Hungary over the medium term highlighted the importance of supporting that effort through greater progress in structural adjustment. While the Hungarian authorities should be congratulated on the pragmatic way in which they had dealt with their economic problems to date, a greater degree of responsiveness to market forces and increased competition among enterprises would greatly assist efforts to increase exports and domestic growth over the coming years. As his chair had pointed out at previous Executive Board discussions of Hungary, his authorities were concerned about the disproportionate weight of adjustment being borne by the profitable enterprises, particularly because that disproportion itself created imbalances in the economy. The structural adjustment measures taken thus far were commendable, but they were only a beginning. In view of those considerations, the implementation of a supply-oriented arrangement would be desirable; he regretted that such a program had not been put in place, as had been hoped earlier in 1984. However, it was encouraging, as Mr. de Groote had indicated, that the Central Committee of the Hungarian Socialist Workers' Party had taken the political decision to speed up the process of reform and adjustment, and that Hungary had requested that negotiations for an arrangement with the Fund should begin in August. He encouraged the staff and the authorities to work toward implementating such an arrangement.

If the current account target were to be met, effective measures would have to be taken to ensure that income growth was kept within appropriate bounds, Mr. Joyce suggested. Under current conditions, the emphasis of demand restraint would have to continue to be on the private sector, where income was the most buoyant. While that sector also tended to be highly productive, growth in private sector income had been exceeding growth in productivity in that sector. He welcomed, therefore, the measures introduced to restrain private sector demand in 1984. In particular, the measures to soak up the large overhang in the liquidity of enterprises should help to improve the effectiveness of monetary and credit policies, as well as to limit the increase in import demand resulting from the easing of import restraint.

Although restraint in the private sector was unavoidable in 1984, Mr. Joyce added, it was essential that over the medium term policies should be followed that permitted expanded production in the export sector. In addition to the maintenance of a stable demand management stance, structural measures were needed to induce a shift of resources into profitable activities and to increase the sensitivity of the trade sector to changing international market conditions. The devaluation of the forint would help to ensure the competitiveness of Hungarian exports for the present, but the authorities would have to continue to pursue a flexible exchange rate policy, particularly in view of the continued strength of the U.S. dollar and the weight accorded to it in the currency basket to which the forint was currently pegged. Indeed, the authorities might wish to examine the composition of that basket to determine whether it could usefully be restructured.

He agreed with the staff that strengthening of the external position could not be sustained without substantial improvements in resource allocation and in the efficiency of enterprises, Mr. Joyce stated. The recent shift in policy had brought about the elimination of import restrictions imposed in 1982; the accompanying efforts to improve the responsiveness of the economy to market forces through adjustments in the prices and wages systems had been moves in the right direction. Moreover, Hungary's improved creditworthiness, which he believed resulted from the adjustments already made under the program supported by the Fund, was also welcome. The key elements of the restructuring process in industry were the implementation of measures to reduce the demand for resources by unprofitable enterprises as well as action to ensure greater wage flexibility and differentiation.

The staff's concern about the disbursement of fiscal resources through extrabudgetary lending and the intervention fund was warranted, Mr. Joyce remarked. The performance criteria on bank credit to the state and on overall net domestic credit should ensure control over aggregate financing. However, the provision of assistance to unprofitable enterprises risked reducing access to needed resources by sectors with higher growth potential. He welcomed the expected reduction in 1984 in producer and consumer subsidies because it would assist in raising price sensitivity and in improving the efficiency of resource allocation. The authorities would need to keep their policies in that area constantly under review, to ascertain that there was a clear understanding of the costs as much as the benefits that would result from such financial assistance. It was also encouraging that efforts to rationalize the wage system were beginning to bear fruit. If carried forward, those efforts would continue to help to increase labor productivity and to bring about more realistic pricing of labor. Attempts to improve labor productivity continued to be at an early stage; further measures would be needed in that regard as adjustment proceeded.

The Hungarian authorities had demonstrated their determination to bring the present stand-by arrangement back on track, Mr. Joyce observed, and it was encouraging that they continued to show that it was possible to achieve an effective marriage between a resort to market forces and continued dedication to their socialist system. Their experience served as an important lesson for other member countries that continued to favor such a political system; it demonstrated once again that the Fund could be helpful to each member irrespective of its political organization. He congratulated the authorities for their acceptance of the need to plan for basic structural changes in the economy, and he supported those efforts, whether assisted by the Fund or not. His chair would be prepared to look sympathetically at a request for future assistance from the Fund if a viable program of structural change were proposed and if the Hungarian authorities could demonstrate that the assistance of the Fund in support of such a program was required.

Mr. Polak recalled that the program under the stand-by arrangement had been presented to the Executive Board in January as an interim program. Although it had been described as a one-year program, Directors had been advised from the beginning of the authorities' intention to replace it in the course of 1984 by a program based on a comprehensive set of measures of structural reform. Thus, the present program--which involved a significant use of resources amounting to 80 percent of quota--had been presented as a six-month holding operation, which, for that reason, did not include important fundamental changes. Instead, as Mr. de Groote had specifically said in his statement at EBM/84/5, the emphasis had continued to be placed on administrative cuts in imports, confiscation of reserve funds of enterprises, and global budgetary measures on the demand side only. Not surprisingly, some Directors had wondered why the original proposal had not been in the form of a six-month stand-by arrangement, to be followed by a more comprehensive program in support of the reform measures once such measures had been agreed.

Those background considerations had not been mentioned by the staff in its report until the last page of the appraisal, Mr. Polak continued. The staff--and the authorities in their letter of intent--indicated that top level political approval had been obtained in April for a reform effort, but that the specific details still needed to be worked out. After the third purchase under the present arrangement, scheduled for August 15, 1984, there would remain only one purchase, to be made on November 15. Thus, although the authorities stated their continued interest in replacing the present arrangement with an arrangement based on reform measures, it was questionable whether that aim continued to be realistic.

The staff's analysis confirmed that additional internal adjustment was necessary to achieve the external aims of the program, particularly the attainment of a $400 million current account surplus in convertible currencies, Mr. Polak remarked, and that, for the moment, adjustment was being pursued by the traditional measures to which Mr. de Groote had referred. In the process, the burden of adjustment tended to fall where it should not, on wage earners in the socialized sector and on profitable enterprises, whose investment was being cut, inter alia, by the heavy-handed technique of confiscating past profits, a method that could hardly be considered an encouragement to the accumulation of future profits.

One dominant idea of the Hungarian authorities seemed to be that the expansion of domestic supply in the private sector, for example, through the activities of small partnerships, contributed to solving the problem of external balance, Mr. Polak commented. If people took in one another's washing, or grew vegetables for one another's consumption, or engaged in similar activities, national income would certainly be raised, but such activities increased national consumption without improving the foreign balance. Indeed, as the staff argued in its appraisal, the impact on the foreign balance could be negative because those people who made more money in the private sector through sales at home would wish to spend part of the additional income on foreign goods. In such circumstances, the answer was not to discourage the growth of private activity, which was most welcome, but to control the resultant expenditure on domestic and foreign goods by means of the tax system and the exchange rate. The recent 5 percent depreciation of the forint had been an appropriate step in that regard.

He agreed with the staff and Mr. de Groote that major reform measures were essential at present to lift Hungary's economic performance, albeit satisfactory by Eastern European standards, to a higher plateau, Mr. Polak stated. Mr. de Groote had mentioned five major areas in which reform on the supply side of the economy was necessary for that purpose. The essential point was not that something should be done in each of those areas but that an integrated reform effort should be put in place in which the different parts supported each other. For example, the freeing of wages and of production decisions would require a good income tax system. Freedom of investment decisions would require a price system and interest rates that were sensible guides to such decisions. There would also need to exist financial market conditions that permitted enterprises to judge their own investment decisions against those of other enterprises through a domestic capital market; in other words, there would be a need for a mechanism of financial intermediation.

It would not be surprising if the transition to a more market-oriented system ran into, in Mr. de Groote's words, "problems of a systemic nature," Mr. Polak suggested. Technical assistance by the Fund might help with such problems, and the Fund should be happy to provide such assistance; however, the problems would probably be such that the Hungarians themselves would have to find politically acceptable solutions. To do so might take time, which again raised the question whether a replacement program before the November 15 drawing was realistic.

A major role for the price mechanism was scarcely compatible with the large role that continued to be played by consumer and producer subsidies, Mr. Polak remarked. Those subsidies had been cut in 1984 by Ft 20 billion but still represented Ft 75 billion, 8 percent of GDP. There was also the question of more than Ft 60 billion in other subsidies, which apparently represented exchange losses on exports to countries that were members of the Council on Mutual Economic Assistance (CMEA). Those losses could also be considered consumption and production subsidies; if energy was imported at an overvalued rate--and apparently most energy imports came from Eastern Europe--then the price of energy was being kept artificially low in terms of domestic currency. Almost certainly, the situation indicated that there was an exchange rate issue that deserved to be looked into, although it related primarily to dealings with nonmember countries, as part of a general move in the direction of a more market-oriented economy.

The concept of a capital market would need to be dealt with seriously, Mr. Polak added. In view of the greater freedom to start businesses, enterprises would need to be able to decide whether to employ available capital themselves or to channel it to other enterprises. It would probably not be necessary to copy all the credit instruments in Western markets, but at least a selection would have to be made of those instruments that could function effectively in the Hungarian socialist setting. Of course, the assets of enterprises, after payment of taxes, should not be subject to confiscation for purposes of demand management. If liquidity had to be withdrawn in future, following the welcome tightening that had already taken place in 1984, interest rates should be raised. The situation highlighted again the basic principle that, within the limits that were fully compatible with the principles of a socialist state, reliance on the price mechanism in one area of the system would prove fully beneficial only when it was part of such reliance in all major areas of the economy. He supported the proposed decision and welcomed the resumption of early policy discussions with Hungary.

Mr. Coumbis said that he agreed with previous speakers that Hungary had made commendable progress in strengthening its internal accounts. In recent years, the primary objectives of Hungarian economic policy had been to generate a substantial, sustainable surplus in the current account in convertible currencies and to integrate market instruments into all economic activities in order to achieve better resource allocation and higher economic activity. Considerable progress had been realized in both areas in 1983 and in the first quarter of 1984, although some of the targets set in the 1983 program had not been fully attained. The policies followed by the authorities in 1983 had been extensively analyzed and criticized at the time of the 1983 Article IV consultation with Hungary and the Executive Board's approval of the current stand-by arrangement in January 1984. The weak points of the policies applied in 1983 could be found mainly in the authorities' inability to constrain effective demand and thereby to absorb resources from the internal sector in favor of the external sector. To remedy that situation a package of measures had been introduced successfully by the authorities during 1984.

Some of the measures were structural, and several deserved emphasis, Mr. Coumbis continued. Consumer and producer subsidies had been reduced drastically in order to raise prices so as to affect consumption and increase revenues. Social security contributions had been increased by 10 percent to narrow the gap between social security receipts and expenditures and to raise the cost of labor; gross inflows into development funds of public enterprises had been taxed; and compulsory reserves funds had been dissolved in order to reduce the liquidity of public enterprises and oblige them to reduce their investment outlays. The results of those policies had been partially successful. All performance criteria had been met as of March 1984, with the exception of the limit on short-term external debt; investment spending by enterprises had been in line with the projection for 1984 as a whole, although state investment had been 15 percent above the 1983 level, and there had been indications of possible overruns in consumption demand. There had also been indications that the target of a current account surplus in convertible currencies of $400 million would not be attained. In fact, the higher than targeted increase in domestic demand, the expected worsening of the terms of trade, and the rise in interest rates in international markets suggested that the current account surplus in 1984 might be no greater than $250-300 million.

Nevertheless, the authorities indicated in their letter of intent their determination to safeguard the external surplus of $400 million, Mr. Coumbis noted. The magnitude of the external debt falling due in 1984, the need to increase the holdings of international reserves, the authorities' desire to consolidate the recent improvement in Hungary's credit rating, and their decision to lift during 1984 the import restrictions imposed in 1982 did not permit any slippage from the agreed target.

The authorities had acted promptly to strengthen the original program, Mr. Coumbis considered. He welcomed their early detection of the deviation from the program and their decision to apply promptly the new set of measures. He was confident that the 1984 program would be more successful than its predecessor. The Hungarian authorities understood better the criteria and objectives of the Fund and had at their disposal more efficient policy instruments to affect macroeconomic variables. However, as Mr. de Groote had pointed out, further adjustments of the economy could not be achieved through demand policies alone. Structural reforms, which would support the supply side of the economy and would continue to be implemented in the coming few years, were a precondition of further successful adjustment efforts. The authorities had taken the political decision to speed up the reform process, and the reform package would be finalized and appropriate measures specified by the fall of 1984. The Government had officially expressed its desire to start negotiations with the Fund in the second half of August in order to secure both financial and technical assistance.

Thus, Hungary's case represented an interesting and difficult experiment in which time was needed to fashion a program of structural reforms, Mr. Coumbis said. None of the supporting institutional changes should be planned in haste, and the Executive Board should bear in mind that, in addition to economic constraints, there were social and political constraints. Because the authorities had demonstrated their determination to make their economy more adaptable and responsive to market forces in order to improve its efficiency, the Fund, in cooperation with the World Bank, should be ready to help Hungary, technically and financially, to complete the structural reforms.

Mr. Kabbaj remarked that it was encouraging that, through the previous and current stand-by arrangements, Hungary had been able to correct some recurring disequilibria in the balance of payments and to set the stage for more fundamental corrections in various aspects of the economy. He joined the staff in supporting the authorities' desire to strengthen the basis of the economy so as to raise its responsiveness to market forces and to conclude a multiyear structural adjustment program with the Fund.

Despite slippages from the targets and, therefore, a not wholly satisfactory outcome, Mr. Kabbaj continued, the 1983 stand-by arrangement had proved successful in turning a huge current account deficit into a sizable surplus while generating increaseed output in both the public and the private sectors. The satisfactory balance of payments performance had come about despite adverse external trade factors, including weaker export prices and unfavorable climatic conditions that had affected certain agricultural export crops. However, there had been slippages from the program targets, particularly in relation to consumption and final demand. Indeed, the strength of both elements had continued into 1984.

The objectives of the 1984 program had been to consolidate the gains obtained thus far, Mr. Kabbaj observed, and to move the economy toward further rationalization. Therefore, the monetary and credit targets had been tailored to optimize available financial resources and to set more realistic goals for the financial resource needs of the economy in tandem with the objectives for the external accounts. In order to mop up excess liquidity, gross inflows into development funds had been reduced, and financial resources available to the enterprise sector had been controlled. In the fiscal area, revenues had been increased through various measures, including a rise in the social security tax on wages and greater indirect taxes. In 1983, the deficit in the state budget had turned out significantly lower than the program forecast, mainly owing to greater revenue increases, while expenditure had actually exceeded the program target. In 1984, measures had been taken to reduce consumer and producer price subsidies, action that should strengthen the budgetary performance.

The external sector had shown improvement in 1983 and 1984, Mr. Kabbaj went on. The current account in convertible currencies had shown a surplus of close to $300 million in 1983, which had been lower than the program target mainly because of a deterioration in the terms of trade. Exports had performed strongly in volume terms, while imports had also risen more than expected owing to the easing of import restrictions.

As to the future, Mr. Kabbaj commented, he shared the staff's assessment that, in view of an external climate marked by continued terms of trade losses and higher international interest rates, there was a need for a considerable shift of resources into the external sector. The series of measures outlined on page 18 of the staff report, some of which had already been adopted, should help to achieve the objectives of the program, in particular the $400 million current account surplus and the lifting of additional import restrictions. However, caution was needed so as not to allow slippages in other key areas of the economy, including the credit sector. For example, there was clearly a need for continued restraint on private and public consumption. Domestic absorption in 1983 had expanded by 2 percent of real GDP, fueled mainly by higher imports, a trend that had continued into 1984. The point was clearly recognized by the authorities in their letter of intent. Indeed, in view of the rundown of stocks at the beginning of 1984, and the proposed elimination of additional import restrictions, every effort should be made to prevent overruns of domestic demand in 1984.

During the Executive Board's discussion of Hungary the previous January (EBM/84/5 and EBM/84/6, 1/13/84), Mr. Kabbaj recalled, the continued decline in real investment and the question of the quality, as well as the quantity, of investment had been singled out for special analysis because of the crucial role that such investment played in determining the long-run sustainability of the economy. In assessing the quality of current and past investments and their potential profitability, the staff had referred to a cutoff point of about 15 percent being used by the authorities as a yardstick by which to judge new projects. In view of the rise in inflation and the increases in imputed interest costs, had the authorities revised the existing arrangements? Had the World Bank's study of the question finally been issued? With regard to the general need for caution, the authorities should stand ready to formulate contingency plans and to act if the program moved off course. The need for such precautionary measures would become even more acute when the authorities completed the structural measures proposed in their letter of intent.

Mr. Malhotra stated that Hungary had made considerable progress in turning around its current account balance between 1981 and 1983. The 1984 program appeared to be on track, and the authorities had already undertaken corrective measures to deal with deviations that had occurred mainly as a result of exogenous developments; for example, subsidies had been cut, liquidity in some sectors had been reduced, and a number of steps had been taken to improve the tax structure. The authorities continued to face the complex task of reducing domestic demand and diverting it to the external sector; they would have to pursue that objective with diligence in the course of 1984.

The statement by Mr. de Groote with regard to the authorities' intentions in the areas of prices, wages, taxes, financial intermediation, and the decision-making process was most interesting, Mr. Malhotra continued. He encouraged the staff and management to pursue discussions with the authorities in order to reach an understanding on the nature of the intended reforms and the role that the Fund could play in supporting such an effort. In that regard, as Mr. Polak had correctly pointed out, while technical assistance would have a role, the basic questions were related to the socialist structure of Hungarian society and to the extent to which the authorities could go in bringing about reform. He urged that, in conformity with the Articles of Agreement, the staff should pursue the ideas proposed by the authorities, bearing in mind that the Hungarian system was essentially different from the market economies with which the Fund normally dealt and that, therefore, too much speed might not be appropriate.

Mr. Prowse remarked that, while he agreed with the staff's appraisal and welcomed the progress that had been made, some developments in Hungary had been disappointing. It was useful to have the restatement of the areas on which economic reform would focus, as set out in Mr. de Groote's precise recapitulation of the objectives announced in January 1984; nevertheless, he agreed with Mr. Polak that an impression had been given that the reform measures would have been specified in greater detail by the present stage. Indeed, he had carefully noted and had placed a good deal of weight on Mr. de Groote's statement to Executive Directors in January that the Hungarian authorities had submitted a shorter, less ambitious program because they had intended to transform it into a comprehensive program later in 1984. At present, not only was there a need to elaborate and to specify the reform measures that would provide an appropriate basis for requesting further assistance from the Fund, but, in addition, some of those measures should be implemented.

Although the present discussion constituted only a review of an ongoing, successful stand-by arrangement, Mr. Prowse continued, the main underlying question continued to be economic reform. On the basis of the analysis in EBS/84/144 and earlier analyses by the staff, it appeared that a point had been reached where the capacity to adjust the Hungarian economy through the measures embodied in Fund performance criteria would shortly be exhausted, unless reform were undertaken to a much more significant extent than it had been thus far. In that regard, he agreed with the comments by Mr. de Maulde and some other speakers. In the Executive Board's discussion in January, there had been references to the kind of performance criteria that might be appropriate for members with centrally planned economies, an issue that had not been taken up by the staff in its report, perhaps because the present occasion constituted only a review of the stand-by arrangement; however, the Board would have to consider the issues further before a new arrangement could be approved. It was important that the authorities should be aware that there was concern in the Executive Board that the disappointing lack of elaboration or precision with regard to the reform program might indicate a reluctance on their part to acknowledge the need for action.

The question of fundamental economic reform had to take into account the purposes of the Fund, Mr. Prowse stated, a point that was relevant not only in Hungary's case but also in the case of other members with centrally planned economies. In that light, a number of the points made by Mr. de Groote had been worrying. For example, Mr. de Groote had said that the authorities

> ...are well aware that the continuing process of Hungary's adjustment needs the Fund's financial assistance to guarantee more room for maneuver in the financial markets and to ease the balance of payments restraints. The introduction of market mechanisms...is likely to involve a number of uncertainties which could temporarily affect the current account at certain moments and which can be overcome only if that country has the approval and the prestige of the Fund standing behind it. The specific measures would more easily be accepted and more timely implemented if the Hungarian authorities are able to count on the availability of Fund resources.

That statement seemed to make the case for what was sometimes referred to in the Executive Board as a "classic" stand-by arrangement, meaning an arrangement that, in Mr. de Groote's phrase, allowed "the prestige of the Fund" to stand behind the measures being adopted. In such a case, the program itself could be more important than the financial resources provided by the Fund, raising the question of the extent to which the Fund should underwrite the massive restructuring of economies. Was such restructuring an appropriate objective for which the Fund could offer extensive financial support?

The staff might have been too lenient in its assessment of exchange rate policy, Mr. Prowse suggested. In the course of a short private visit to Hungary earlier in the year, he had noted a large difference between the official rate and the parallel-market rate. While casual observation of that kind could be misleading, foreign exchange transactions had certainly been taking place in the parallel market--although he had not participated in such transactions himself--and the differential between the two rates had been about 60-70 percent. Perhaps foreign visitors to Hungary had been seeking hard currency, but it was also a matter of concern that in some cases it had not been possible for foreigners to use domestic currency to settle their accounts, such as hotel bills. He invited the staff to say whether the situation that he had described suggested that the exchange rate was overvalued and whether there was a need to look carefully at the level of the rate and at exchange arrangements.

The program had set quantitative performance criteria up to September 30, 1984 when the last purchase would take place, Mr. Prowse noted, while "indicative limits" had been set for December 31, 1984. It appeared that there was not much constraint on the authorities to observe the indicative limits at the end of the year. In Table 5 of the report, the staff indicated that net domestic credit in the fourth quarter of 1983, for which a program target of an increase of 0.1 percent over the previous 12 months had been set, had turned out to have increased by 2.4 percent. As the staff described that variable as the pivotal target in the program, it was a matter of concern that net domestic credit had again exceeded the program target in the first quarter of 1984. In those circumstances, it might be desirable if the performance criteria for the fourth quarter of 1984 should indeed be regarded as such, rather than as "indicative limits." In addition, if another arrangement were approved, it would be useful to consider whether performance criteria should be set for the final quarter of the program with regard to such important financial variables. None of the quantitative performance criteria in the program applied in the fourth quarter of 1984; they all took the form of indicative limits.

Mr. Orleans-Lindsay stated that the Hungarian authorities should be commended for the progress that they had made toward achieving a surplus on their external current account, one of the objectives of the program implemented during the past year. As other speakers had remarked, more needed to be done, particularly to streamline domestic policies so as to give full support to a sustainable external position, which was healthy at present. The package of measures that had been introduced to correct the domestic financial imbalances was welcome; he encouraged the authorities to persevere in their efforts to pursue structural adjustment and looked forward to the investment program that they were in the process of formulating.

The staff representative from the European Department recalled that Mr. Prowse had raised the question of the differential between the parallel and the official exchange rate. The staff had also observed the differential, and the authorities had explained that they accepted the situation because the volume of transactions was not particularly large; they had also said that they paid more attention to differentials in foreign markets, particularly in Austria, where they were very narrow.

It was disappointing that the authorities had not been in a position to elaborate the details of their reform program, the staff representative continued, but the 1984 policy measures did, in fact, include a number of basic reforms, such as the reductions in subsidies, the liberalization of the wage system, the relaxation of some of the rules on price formation, the initial changes in the tax system, the increase in social security taxes, and the absorption of the liquidity overhang in the enterprises, which was a precondition of enterprise autonomy. Furthermore, in financial intermediation, there had been some small changes aimed at providing venture capital through the banking system; a small start had been made in forming a bond market; and there was the beginning of intermediation through the cooperative system, although the cooperatives were not yet able to receive deposits. While much more remained to be done, those measures represented at least an initial step in the right direction.

Part of the explanation for the delays that had occurred lay in the point referred to by Mr. Polak, the staff representative remarked, namely, that the reform measures should be introduced in an interlinked fashion. Liberalizing only the price system, for example, would not bring about maximum benefits if the wage system were not also liberalized and if enterprises were not allowed, as at present, to make their own production decisions. Enterprises could not respond as forcefully as they might to changes in demand, both in domestic and foreign markets, not only because of the state of development of the financial markets, but also because they would not have complete freedom to change production lines if the need to do so were perceived. On the other hand, it was unclear to what extent the delays represented an undue willingness to put off the necessary reforms, rather than an appropriate degree of circumspection.

It would be regrettable, as one Director had suggested, if demand restraint measures were formulated in such a way that they impeded the dynamic growth of private sector activities, the staff representative commented. The successful expansion of the private sector meant that it had come to represent about 17 percent of labor money income; it could not, therefore, be left wholly uncontrolled and untaxed. In that regard, the efforts to overhaul the tax system and to introduce personal income tax should be supported. In addition, more instruments needed to be made available for household savings. In that connection, the bonds being issued represented an almost negligible part of the growth in savings potential. A similar point could be made on the enterprise side; not only was there almost no intermediation between the household sector and the enterprise sector, but there was also little intermediation among enterprises. Additional leeway of up to Ft 2 billion had been provided under the domestic credit ceiling in the program for the development of a commercial bill market, but, unfortunately, it appeared that there had been no use made of that leeway. On that evidence, the program could be considered to be a little less tight than it might have been.

During the past few years, there had been a decline in labor productivity, but it had increased sharply in early 1984, the staff representative observed. The increase in the first five months of the year had been 5.1 percent on an annual basis, compared with 3.2 percent for all of 1983. Although it was difficult to be certain at present, the staff and the authorities believed that the increase in wage differentiation had played a considerable part in the boost in productivity.

State investment represented about 40 percent of total investment, the staff representative noted. The authorities were still using the 15 percent rate-of-return yardstick to extend credit for investment, a rate that they had discussed in detail with the World Bank. The World Bank's comprehensive study of investment in Hungary was not likely to begin until later in 1984. In judging whether the 15 percent yardstick was appropriate in a period of "rising inflation," Executive Directors might wish to note that much of the present inflation resulted from the correction of relative prices and withdrawal of subsidies. The underlying rate of inflation appeared to be much lower, about 6 percent, and inflationary expectations did not yet appear to have been affected. Thus, on the investment side, the outlook for inflation in 1984 did not constitute a reason to increase the rate of return. However, the current negative rate of return on savings deposits should be corrected because the stream of savings depended on current incentives. In that regard, the staff shared the concerns expressed by Executive Directors about the level of deposit rates. Although the recent bond issues provided a better rate of return than savings deposits, the volume was insignificant and did not provide the necessary flexibility. The absence of a secondary market meant that the rate of return on bonds ought to be higher than it was.

The quality of investment was affected by the intermediation through the budget of funds from profitable enterprises to loss-making or marginal firms, the staff representative went on. Although the problem was not unique to Hungary, it was, nevertheless, serious and would need to be dealt with forcefully. The authorities intended to make further cuts in subsidies, but a number of basic subsidies would remain in areas considered particularly important, such as culture, education, and the like. The staff was more concerned about the subsidies that would remain on public transportation and private energy consumption. The subsidies to cover losses arising from trade with CMEA countries resulted from the fact that prices governing such transactions were often insufficiently realistic. As one Director had suggested, the issue of interlinkages between trade in nonconvertible currencies and trade in convertible currencies could usefully be looked at on a wider basis than that of Hungary alone.

The use of indicative limits in the fourth quarter of a 12-month stand-by arrangement was common, the staff representative from the European Department stated, because the final drawing under the arrangement normally took place before the end of the year. The overshooting that had occurred in the fourth quarter of 1983 had been taken into account when the current program was being agreed with the authorities. If it had not been expected that there would be a further program in 1985, it might have been appropriate to space the 1984 purchases differently.

The Deputy Director of the Exchange and Trade Relations Department remarked that quantitative targets could be used as performance criteria only when there were subsequent drawings that depended on adherence to them. In Hungary's case, the stand-by arrangement ended at the end of December 1984; there would, therefore, be no drawings thereafter. For that reason, the limits at the end of the fourth quarter were indicative.

Mr. Prowse said that he understood the explanation given by the staff. However, his point had been that a drawing ought to be dependent on adherence to the limits at the end of the fourth quarter. In other words, there should have been five drawings under the program, not four. It was unsatisfactory, particularly in the case of a pivotal variable such as net domestic credit, to argue that a deviation in the fourth quarter could be corrected in the next quarter because there was a prospect of a further program. Such a situation implied that the new program would begin on a less satisfactory basis than otherwise would be the case. In Hungary, it appeared that the limit on net domestic credit in the first quarter of 1984 had been looser than warranted because correction in a single quarter of the overshooting that had occurred in the fourth quarter of 1983 would have required a too precipitous degree of tightness. In general, performance criteria should apply throughout the period of a program, particularly when there was to be a subsequent program.

Mr. Clark stated that he supported the remarks by Mr. Prowse.

The staff representative from the European Department noted that the target for domestic credit had been set in terms of gross domestic credit in 1983, but in terms of net domestic credit in 1984. It had, therefore, been possible to correct a good deal of the overshooting that had occurred in the fourth quarter of 1983 in the first quarter of 1984. However, she accepted that the limits that applied to the final quarter of 1984 should be as realistic as possible, regardless of whether a drawing was attached to them, and that the authorities should consider them so.

Mr. Kabbaj recalled that he had raised a question similar to Mr. Prowse's at the time of the Executive Board's approval of the current stand-by arrangement with Hungary. The staff had replied that the procedure followed in relation to Hungary was the same as in other 12-month stand-by arrangements. However, he could not recall many cases similar to Hungary's; indeed, he had the impression that, in many other cases, drawings had taken place after the end of the "operational" stand-by arrangement. All members should receive similar treatment.

The Deputy Director of the Exchange and Trade Relations Department commented that under a multiyear arrangement the ceilings at the end of one program year had at times been treated as performance criteria so that the first drawing in the next program year became dependent on observance of those criteria. It appeared that Mr. Prowse was suggesting that, when successive stand-by arrangements were envisaged, the ceilings at the end of one arrangement should be performance criteria so that the initial drawing under the next arrangement depended on the observance of those ceilings. Such a practice had not been followed in the past, but the question could be considered.

Mr. Prowse explained that his aim had been to consider a more general principle, which would include not only the possibility described by the Deputy Director of the Exchange and Trade Relations Department, but also the possibility of setting performance criteria at the end of the program under a one-year stand-by arrangement.

Mr. Malhotra remarked that while it was always possible to increase the number of drawings, as Mr. Prowse had suggested earlier, the question should be treated with moderation; it would be impracticable to make a large increase in the number of drawings under a one-year arrangement.

A second Deputy Director from the Exchange and Trade Relations Department commented that the issue raised by Mr. Prowse dealt with a legal point, because drawings could not be effected after the end of an arrangement. If performance criteria were established for the end of the period of a given stand-by arrangement--say, for the end of the fourth quarter of a one-year stand-by arrangement--time would be needed to collect the data necessary to assess whether the criteria had been adhered to; thus, in effect, the arrangement would have to be extended beyond its original duration.

Mr. Prowse remarked that in the present circumstances the program under the arrangement had lasted effectively only 9 months, not the full 12 months.

The first Deputy Director of the Exchange and Trade Relations Department, replying to a question by the Chairman, noted that the staff was preparing a paper on the correspondence between the phasing of drawings and performance criteria. The paper would address the issues, including the question raised by Mr. Prowse, for both single and multiyear arrangements, of the relationship between phasing and performance criteria and of the interlinkage of performance criteria for successive program years. It was also intended that the paper would include a formal proposal that, as a rule, end-year performance criteria should be used in multiyear arrangements.

Mr. Joyce remarked that, if the Executive Board were to return to a more general discussion of the issues under consideration, it would be useful also to consider whether, in the case of a country undertaking major structural change financed initially under an extended arrangement, it would be possible for the Fund to exercise closer surveillance in the period after the end of such an arrangement, because structural adjustment often required a period longer than the normal three years of an extended arrangement.

Mr. Kabbaj said that in the majority of cases an arrangement was approved by the Board after the beginning of the program period, so that, in practice, the period of the arrangement, which would be the 12 months following Executive Board approval, extended beyond the period of the program. It appeared, therefore, that there would be time available to collect the data necessary to judge adherence to performance criteria established for the fourth quarter of the program period.

The second Deputy Director from the Exchange and Trade Relations Department replied that the issue raised by Mr. Kabbaj concerned the appropriateness of the phasing of the drawings under the arrangement. If for any reason the period of the program differed too much from the period of the arrangement, problems could arise with the phasing of the drawings.

The Chairman stated that Directors had raised a number of important points. It would be useful to have work done by the staff on whether there had been a tendency for overshooting of targets to occur in the final quarter of one-year stand-by arrangements, including consideration, if there had been such a tendency, of how the problem might be dealt with.

Mr. de Groote said that the assistance given by the Fund and the opinions of Executive Directors had played an important role in Hungary's adoption and implementation of a Fund-supported program. His Hungarian authorities shared the view expressed by all Directors that Hungary could continue to adjust only if a change in the economic system were implemented. Many years before the country had become a member of the Fund, Hungary's leaders had realized, through their own reflections on the shortcomings of rigid planning, the merits of the market-oriented policies that the Fund advocated. Although Hungary could rely on its own careful and critical analysis of its problems and on the lessons to be drawn from its gradual movement toward liberalization of economic mechanisms, the fundamental nature of the reform envisaged in the months ahead meant that the country was about to enter largely uncharted territory. Although it was relatively easy to state that market-oriented mechanisms would be adopted, it was more difficult to decide which specific mechanisms would be set into operation, to choose the sectors where the liberalization should begin, and to establish safeguards that would prevent the new forces coming into play from unsettling the current account or creating an imbalance between supply and demand.

It was encouraging that Executive Directors had realized that the role of the Fund would be even more essential in the almost unique transformation from one economic system to another that Hungary was undertaking, Mr. de Groote continued. Advice, technical assistance, suggestions, and criticism would be needed at every stage of the liberalization. There could be no more challenging role for the Fund to play in its relationship with a member. However, the risk for Hungary would be equally great if the experiment were to fail; indeed, the changes being undertaken had profound significance for the world as a whole. The coming months would be historically decisive. The Government and the Central Committee of the Hungarian Socialist Workers' Party had accepted a set of guidelines clearly recognizing that market mechanisms were the appropriate method for achieving the objectives of socialism. It was not necessary to elaborate on the momentous nature of that decision. Through the benefit of continued contacts with the Vice Prime Minister, Mr. Marjai, who bore the primary responsibility for economic policies in Hungary, he could assure Executive Directors that the decisions to which he had referred were real and that they were being set down in effective operational terms.

His Hungarian authorities expected the Fund to play an active role in the orientation of the new policies, Mr. de Groote stated. It would no longer be sufficient simply to describe past developments. The staff, scheduled to visit Hungary several times before the end of 1984, would be expected to help those among his Hungarian authorities who supported the views of the Fund. He and his authorities appreciated the high quality of the staff members who had been involved thus far in discussions of the problems that the country faced.

Many Executive Directors had already made important contributions to the decisions that were taking shape, Mr. de Groote considered. Their observations on the need to establish a market-oriented financial intermediation system, to create autonomous commercial banking institutions, to introduce a value-added tax and an appropriate income tax system, to find more effective resource allocation mechanisms, and to establish self-determination of enterprises had already been incorporated in some of the decisions currently being implemented. He hoped that Directors would continue to contribute to the discussion of policy options, not only on the occasion of future Executive Board reviews of Hungary's economy, but also through contact with Hungarian officials who came to the Fund, and, possibly, through working visits to Budapest, which he would be willing to organize.

Technical assistance and advice alone would not suffice to help Hungary to move safely toward a supply-oriented system, Mr. de Groote suggested. Financial assistance was also indispensable, because of the uncertainties concerning the effects on the current account of the reform measures that were about to be implemented. Financial assistance would support a new kind of program that would have to consider systemic changes as performance criteria. Some elements of that nature already existed in the present program. Creativity would also be required on the part of the Fund to enter into what would be new territory for it, too, a point on which Mr. Prowse had made some stimulating comments. In that connection, the Fund would be asked not to carry the whole financial burden of the adoption by Hungary of a new system, but rather to meet only the unavoidable balance of payments needs that would most probably result from the transition to mechanisms whose effects on the balance of payments were still hard to see, but that would probably result in higher import demand during the transition period.

He wished to repeat that the further necessary adjustments could not occur unless fundamental changes were introduced in Hungary's economic mechanisms, Mr. de Groote remarked. One aspect of the progress thus far under the program being discussed by the Board underlined that point: in order to rein in the excessive expansion of internal absorption, the burden of adjustment had had to fall primarily on investment, as Ms. Bush had observed; thus, the country's growth prospects were being jeopardized by the very measures that ought to help to restore them. The explanation for the anomaly was that reliance had to be placed on extremely awkward techniques to control the evolution of internal demand in the absence of the usual tools of macroeconomic management, which required an organized financial system, a pricing mechanism that would allocate resources sufficiently, and flexibility in wage determination. There was, therefore, no conflict between the systemic aspects and the demand management aspects of the new program to be worked out: demand management would have to be built into a more effective overall system so that it would be less disruptive of growth.

Before the present meeting, Mr. de Groote went on, one Executive Director had asked him why further measures and further Fund assistance were needed when developments had turned out so favorably for Hungary under the present program. Hungary's success in implementing the program, which had been aimed primarily at restoring through emergency measures a viable balance of payments position and thereby Hungary's creditworthiness, should not be confused with the obvious need for fundamental reform and further careful management of internal absorption. Hungary had demonstrated that it could act quickly and stick to its commitments: the transfer of resources to the balance of payments over two and a half years had been approximately equivalent to 7 percent of GDP. Such a remarkable achievement, which had been necessary to deal with the situation arising from developments in the world economy, did not by itself establish a basis for growth-oriented adjustment. That goal could be achieved only with new mechanisms. In that regard, he agreed fully with Mr. Polak's emphasis on the need for those mechanisms to be coherent among all sectors, the only way in which reliance on the price mechanism would be effective.

He accepted Mr. Polak's criticism that the expected implementation of the measures had not yet fully taken place, Mr. de Groote said. However, he was confident that the measures would be more easily adopted in the light of the outcome of the Executive Board's discussion. With regard to another remark by Mr. Polak, Hungary wished to achieve a good performance not only by Eastern European standards, but by European standards in general, by Fund standards, and by Hungarian standards. He would shortly report the comments and the decision of the Executive Board to his Hungarian authorities. In addition to the specific suggestions that had been made, the spirit of the meeting, including the support expressed for the needed fundamental reform and for the role of the Fund in that respect, would encourage his authorities that the prospects for future cooperation with the Fund were good.

As to the remarks on the differential between the official and the parallel exchange rates for the forint, Mr. de Groote stated, the differential had never been of the order indicated by Mr. Prowse. According to the monthly statistical bulletin of the Austrian National Bank, the divergence between the rates had generally been about 5 percent, although on occasion it had risen to about 10 percent for short periods. It had disappeared completely after the recent depreciation of the forint. In so far as a parallel market existed, it appeared to be used primarily by travelers from neighboring countries who were willing to sell forints at a discount in order to obtain convertible currencies that they could not obtain in their own countries.

The Chairman made the following concluding remarks:

Directors were in general agreement with the thrust of the staff appraisal in the report for the midterm review under the stand-by arrangement with Hungary. In reviewing the policies pursued by Hungary under the arrangement, Directors drew attention to the improvement in Hungary's standing in international financial markets, which was in marked contrast with the situation in 1982. They attributed that improvement to the commendable pursuit of adjustment policies under the current and previous stand-by arrangements, on the basis of which the current account in convertible currencies was expected to improve by about 2 1/2 percent of GDP. Given the high level of Hungary's foreign debt and the burden of debt service in the coming years, Directors welcomed the reaffirmation of the authorities' commitment to achieving in 1984 the program's target of a surplus of $400 million in convertible currencies and their efforts to ensure the sustainability of such a surplus in the future. They commended the supplementary measures that were being implemented to offset the disappointing price developments in foreign markets and the incipient overruns on domestic absorption that had become increasingly apparent since early in 1984.

Directors also welcomed the recent moves to ease import restrictions, in particular the elimination of the system of reference limits, and the commitment to remove by the end of 1984 the remaining restrictions imposed in September 1982.

In commenting on the midyear policy adjustments, in particular the 5 percent devaluation of the forint in June, Directors welcomed the authorities' willingness to take further measures, if the need should arise, to safeguard the achievement of the program's objectives. They emphasized, in view of the experience of the last few years, the need for the authorities to take timely action to respond to possible unexpected adverse external and domestic circumstances.

Directors took note of the indications that the overhang of enterprise liquidity appeared to have been drained away and that enterprise investment was proceeding somewhat below program projections. However, they expressed concern that, despite reductions in recent months, investment expenditures under the control of state authorities had been above program levels in the first half of 1984. Such a distribution of investment raised the question of the ability of the economy to generate capacity of adequate size and quality to meet future external and domestic demand. Some speakers expressed concern that the burden of adjustment might be falling excessively on the most profitable enterprises in the country, and with regard to the increasing rate of disbursements expected to be made to ailing enterprises in 1984 from the extrabudgetary Intervention Fund.

In light of the continued buoyancy of personal incomes, attention was also drawn to the importance of sustaining households' propensity to save. In that respect, several Directors questioned whether interest rates, which seemed to continue to be negative in real terms, were adapted to the objective of raising savings. Directors emphasized that vigilance was required to monitor developments closely. Indeed, the authorities had little margin for error, and overruns on domestic absorption could well jeopardize the balance of payments objectives.

Directors recalled the authorities' earlier intention to replace the present stand-by arrangement at midyear with a supply-oriented program of longer duration. They warmly welcomed the steps taken by the authorities under the program for 1984 to introduce structural reforms, in particular the forceful reductions in subsidies and the opening up of the trade system. They underscored, however, the urgency and required breadth of further measures to improve both the adaptability of the economy to market signals and the efficiency of resource use. In that context, Directors noted that, with the policy instruments currently at the disposal of the authorities, further emphasis on demand restraint alone could no longer help to reduce imbalances in the economy and, therefore, that the authorities should concentrate their efforts on improving the supply response of the economy. Directors stressed in that respect the importance of price reform and liberalization. While welcoming the reduction of consumer and producer subsidies already decided, several Directors observed that the remaining price subsidization in the economy was high in terms of GDP and had to be further addressed. Directors also underlined the importance of further flexibility and differentiation of wages.

They stressed the importance of taking resolute steps to improve the financial accountability of enterprise management and they commended the intended overhaul of the tax system. Increasing financial accountability of both enterprises and households had to go hand in hand with the establishment of a financial system that allowed for a wide range of financial assets and that encouraged the flow of savings between sectors through channels other than the budget. The possibility of the Fund's technical assistance in the field of financial intermediation and in taxation was welcomed.

Directors thus emphasized that they viewed the decisive implementation of wide-ranging specific reform measures as a key element in ensuring that the progress made in adjusting to the external circumstances of the last few years could be consolidated and sustained. At the present most important turning point, the Executive Board encouraged the staff to pursue and intensify its active collaboration with the Hungarian authorities on these fundamental, interlinked matters.

The Executive Board then took the following decision:

1. Hungary has consulted in accordance with paragraph 4(b) of the stand-by arrangement for Hungary (EBS/83/268, Sup. 2, 1/16/84) and paragraph III.1.h. of the letter dated December 2, 1983 annexed thereto in order to review policies and to establish performance criteria subject to which purchases may be made by Hungary during the period after June 29, 1984 through January 12, 1985.

2. The letter dated May 18, 1984 from the Deputy Chairman of the Council of Ministers and the First Deputy President of the National Bank of Hungary setting forth the policies and measures which the Government of Hungary will pursue for the period through January 12, 1985 shall be annexed to the stand-by arrangement for Hungary, and the letter of December 2, 1983 shall be read as supplemented by the letter of May 18, 1984.

3. Hungary will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Hungary's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota during any period in which the data at the end of the preceding period indicate that:

(i) the limit on net domestic assets of the National Bank of Hungary specified in paragraph 18.a. of the annexed letter of May 18, 1984; or

(ii) the limit on net credit from the banking system and the State Insurance Company to the state budget specified in paragraph 18.b. of the annexed letter; or

(iii) the limit on the credit granted by the State Development Bank specified in paragraph 18.c. of the annexed letter; or

(iv) the limit on net foreign liabilities in convertible currencies of the specialized financial institutions specified in paragraph 18.d of the annexed letter; or

(v) the limit on the contracting of new foreign debt in convertible currencies specified in paragraph 18.e. of the annexed letter; or

(vi) the limit on outstanding short-term foreign debt in convertible currencies specified in paragraph 18.f. of the annexed letter of May 18, 1984

has not been observed.

4. The Fund welcomes the elimination of the system of reference limits for import licenses and urges the elimination at an early date of remaining restrictions on import licensing and import quotas introduced in September 1982. In the meantime, in the circumstances of Hungary, the Fund grants approval of these restrictions until December 31, 1984.

Decision No. 7772-(84/118), adopted
August 1, 1984

2. COSTA RICA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Costa Rica (SM/84/156, 7/2/84; and Sup. 1, 7/25/84). They also had before them a report on recent economic developments in Costa Rica (SM/84/146, 6/29/84; and Cor. 1, 7/25/84).

Mr. Senior made the following statement:

My authorities value the Fund's advice, and for some time now they have maintained continuous consultations and very close cooperation with this institution. The experience under the program last year has cemented those relations even further, and my authorities expect to continue this close relationship in the near future under a new financial arrangement with the Fund. In general, they are in agreement with the comprehensive documents that the staff has prepared for our discussion.

As stated by this chair at EBM/83/104 (7/18/83), the occasion of the review of the previous stand-by arrangement, the program adopted by the authorities since 1982, which was supported by the use of Fund resources approved at the end of that year, was comprehensive, even ambitious. Indeed, several Directors had serious doubts and reservations about the possibility of its success and of the authorities' determination to carry it out. These reservations were further reaffirmed at the same meeting when the Board considered the review, even though performance under the program to that date had basically been on track. Special mention in this regard was made of Costa Rica's disappointing experiences under previous arrangements. Thus, it is with no small satisfaction that I underscore today the extremely good performance of Costa Rica under the 1983 stand-by arrangement: all performance criteria were met with ample margin, and there was even overperformance in the attainment of the program's objectives. Although, obviously, there still remains a long road to travel before internal and external disequilibria are totally redressed, last year's performance clearly represents very significant progress toward setting the Costa Rican economy on a path of sustainable, stable growth in the near future. The Costa Rican authorities should be commended for these achievements.

As indicated by the staff, the 1983 program's overall objectives were to contain inflationary pressures, promote orderly development of the exchange rate and foreign exchange market, and facilitate the resumption of foreign public debt service payments. For 1983 as a whole, the program's main targets were to reduce the overall nonfinancial public sector deficit to no more than 4.5 percent of GDP, increase public sector savings by the equivalent of 5 percentage points of GDP, reduce domestic bank financing of the nonfinancial public sector by the equivalent of 2 percentage points of GDP, and significantly reduce the inflation rate from about 95 percent in 1982 to about 40 percent by the end of 1983, which would be the equivalent of an average inflation rate of about 55 percent in that year.

In the event, practically all of the program's objectives and targets were achieved, some with ample margins. Inflationary pressures were effectively contained: the rate of domestic price increases decelerated to about 11 percent by the end of 1983. The exchange market was stabilized as confidence was regained and the free-market rate appreciated, and exchange rate unification was achieved in November 1983. By the end of 1983, practically all of Costa Rica's external debt arrears were eliminated, mainly through rescheduling agreements negotiated with foreign commercial banks and in the Paris Club. The overall nonfinancial public sector deficit was reduced to about 3 percent of GDP, public sector savings increased by more than 5 percentage points of GDP, and the public sector used domestic bank financing much less than envisaged in the program.

The program's implementation was quite successful in 1983, but it was not an easy thing to do. It demanded perseverance and determination, as well as flexibility on the part of the authorities, and a substantial sacrifice from the Costa Rican people. This combination, however, was essentially to the program's success. In this regard, I think there is no need to repeat once again the data on price and tariff adjustments introduced by the authorities or the results obtained in selected economic indicators. Suffice it to say that real GDP per capita has fallen in Costa Rica during the past four years, and real GDP increased slightly in 1983 for the first time in three years. Adjustment has been a necessary condition for future stable growth, but the Costa Rican effort once again clearly shows that it takes time for even appropriate financial policies to bear significant positive results in a small, developing economy; thus, the need for a certain degree of flexibility in program design and implementation.

Perhaps a case in point is the question of nominal and real interest rates that are required in program formulation. From the inception of the program in 1982 we strongly argued that interest rates should be adjusted on the basis of expected domestic inflation and interest rates abroad, and thus that it was not necessary to bring ex post facto real interest rates--i.e., nominal rates deflated by past, as distinct from expected, inflation rates--to positive levels right from the beginning. At the July 1983 review, it was already apparent that the greater than originally envisaged reduction in inflation had brought real interest rates in Costa Rica to significantly positive levels, even though there had been a reduction in nominal rates to adjust to this situation. In the event, the inflation outcome in 1983 has involved a marked shift in ex post real annual interest rates from negative 60 percent in December 1982 to positive 11 percent in December 1983. Higher nominal rates at the beginning of the program would have quite probably resulted in even higher real rates than the already very high levels observed at the end of 1983, which are still being maintained to date. The authorities' intention to follow a flexible interest rate policy, bearing in mind the level of real domestic rates and nominal international rates, would seem appropriate in order to encourage financial savings without choking investment or giving rise to cost-push pressures on prices.

As mentioned before, the success achieved in 1983, while signifying substantial progress toward a more sustainable internal and external situation, is still not nearly sufficient to justify a significant relaxation in the adjustment effort. Thus, the authorities have framed a new financial program that will be submitted to the Executive Board for further Fund financial support in 1984-85. Understandings in this regard have already been reached with the staff. The program for 1984-85 is a continuation of the comprehensive adjustment effort that had been undertaken since mid-1982 and will probably have to continue for still some time. As succinctly explained in the staff documents, the program is well balanced and in my view, deserves the support of the Fund. Although there are still some unknowns in the package and details that have to be worked out further, the main lines of the coming adjustment program draw on the successful experience of past years. Thus, the authorities intend to continue to carry out a flexible exchange rate policy, as indicated in the resolutions adopted by the Central Bank of Costa Rica as of June 22, 1984, so as to ensure the appropriate international competitiveness of Costa Rica's tradable goods and financial assets. The growth of domestic liquidity will be closely monitored in order to make compatible the desired overall balance of payments position with the projected holdings of monetary assets. In this respect, recent actions implemented by the Central Bank to limit the rate of growth of total banking system credit, as well as the flexible interest rate policy that they have been consistently adopting so far, clearly show the authorities' commitment to further progress in the attainment of their external adjustment objectives. Fiscal and debt management policies are designed to buttress the progress already achieved in this area, while alleviating the burden of financial stringency to be shouldered by the private sector. To this end, consumption taxes have been increased and further modifications have been made to the structure of the corporate income tax. Furthermore, a major expenditure cut has been sumbitted for parliamentary approval within the coming month. This set of policy actions prior to the program should contribute to its soundness and facilitate its early implementation.

In this respect, too, let me mention that the two pending obligations of Costa Rica to the Fund have already been fulfilled.

In sum, I would like to reiterate the importance that my Costa Rican authorities attach to the advice and cooperation of the Fund. They have benefited from this cooperation, which has allowed them to carry out a major effort to correct economic imbalances in the country. The set of economic policies embodied in the program implemented in 1983 and supported by Fund resources has gone a long way toward restoring the basis for sound economic growth, consistent with price stability and external balance. They believe that the progress thus far attained must be consolidated and, to that end, they are embarked upon the implementation of the first steps of a successor program, support for which will be requested from the Fund in due course.

Mr. Arias remarked that the Costa Rican economy had shown remarkable improvement recently under the one-year stand-by arrangement that had ended in December 1983. All performance criteria had been observed with substantial margins, a result that contrasted with the skepticism expressed by some Executive Directors in 1983. The rate of inflation had been reduced from 95 percent in 1982 to 11 percent in 1983, compared with a target of 40 percent; the overall deficit of the nonfinancial public sector had been set at 4.5 percent, but the outcome had been only 3 percent. All arrears had been eliminated. The exchange rate had been unified. Those results had greatly strengthened confidence in the policies of the Government.

The fiscal deficit in 1984, expected to be no more than 2 percent of GDP, would be financed mainly through long-term development credits, Mr. Arias continued, thereby improving the external debt profile. Welcome additional adjustments had been made to public utility prices, and the decision to freeze public sector hiring so as to eliminate the operating losses was to be commended. Those measures, together with the decision to reduce by 5 percent the rice subsidy, to increase the controlled sales prices of wheat by 2.5 percent and of beans by 20 percent, and the authorities' intention to withhold further wage increases in the public sector in 1984 were also commendable efforts. He encouraged the authorities to do everything possible to improve the financial position of the state-owned development corporations, which, through continuous financing, had been a burden to the Central Bank. In that regard, he noted the possibility of the authorities' selling part of their holdings in the National Development Association (CODESA). Progress in that area could facilitate the adjustment efforts.

Interest rates had been positive in real terms and had been monitored closely to keep them in line with foreign market trends, Mr. Arias observed. He encouraged the authorities to continue that policy. Costa Rica was in a position where substantial growth and diversification of exports were extremely important to medium-term recovery, which was based to a large extent on its participation in the U.S. Government's Caribbean Basin Initiative. He was confident that the policies adopted by the Costa Rican authorities would make those achievements possible.

Mr. Coumbis said that the Costa Rican authorities should be commended for the policies that they had applied since June 1982 and the results that they had attained in their effort to adjust their economy up to the end of 1983. The weak point in the adjustment program had been high wage increases in the public sector and a rapid expansion of bank credit to the private sector. However, during the discussions with the staff in March 1984, the authorities had expressed their intention not to permit further wage increases for public sector employees in 1984, and they had also indicated that the monetary program in 1984 envisaged a marked deceleration in the rate of domestic bank credit to the private sector.

Developments in 1984 had been discouraging, Mr. Coumbis continued. Monetary and fiscal policies had been much more expansionary than planned during the discussions in March. Thus, in the first five months of the year, overall government expenditure had increased at an annual rate of 34 percent, against a planned increase of 20 percent. In the same period, bank credit to the private sector had continued to expand at a rapid rate, although there had been a marked deceleration in the growth of deposits in the banking system. As a result, the trade deficit had increased substantially, and net international reserves of the Central Bank had declined by $84 million, compared with an increase of $50 million during the first five months of 1983. A marked reduction in the disbursements of long-term concessional aid had also contributed to the decline of reserves. The only good news had been a further deceleration of the rate of inflation to 5.7 percent.

The authorities had reacted to those developments with fiscal, monetary, and foreign exchange policy measures, Mr. Coumbis noted. However, there had been a considerable delay in the implementation of the measures necessary to restore stability. Furthermore, some of those measures--such as the deposit requirement of 100 percent for all import payments--were not reaching the target. There seemed to be no evidence of measures leading to reductions in government expenditures to the levels agreed during the discussions in March 1984. Although the authorities were considering additional revenue and expenditure measures, it seemed that there was no timetable for their implementation.

As to the medium-term outlook for Costa Rica's balance of payments, Mr. Coumbis suggested, several points deserved emphasis. First, external public debt at the end of 1983 had been about 117 percent of GNP, and debt service payments had amounted to approximately 53 percent of exports of goods and services. Only at the end of the 1980s would external public debt decline to 97 percent of GNP, still a high figure. Second, on the assumption that half of the repayments of principal falling due over the next several years could be rescheduled, according to the staff's estimate, the debt service ratio would remain at about 40 percent through 1986 and decline to 28 percent only by 1987. Third, the size of Costa Rica's external debt was such that the staff had suggested that the major part, if not all, of the external credit used by Costa Rica should be on concessional terms. Moreover, the current account deficit could not exceed 5 percent of GDP over the medium term if Costa Rica were to meet its large repurchase obligations to the Fund and to improve its net international reserve position. However, the current account deficit in 1983 had been no less than 11 percent of GDP, and was expected to decline only to 8.6 percent in 1984. Thus, even if the staff's optimistic assumptions about the growth of exports in the next five years and the decline in interest rates were fulfilled, the authorities would have to intensify, or at least maintain for several years, the adjustment efforts initiated in 1982 and 1983 in order to bring the current account deficit down to 5 percent of GDP. Developments in 1984, however, indicated how difficult it would be for the authorities to apply adjustment policies for a long time.

The Costa Rican economy was facing serious problems, Mr. Coumbis observed, and there were no easy solutions. The adjustment policy would have to be applied by the authorities with vigor and determination throughout the rest of the decade. However, the Executive Board should bear in mind that Costa Rica needed concessional loans over many years for the adjustment effort to prove successful. In addition, in order to facilitate and make more effective the adjustment process and the country's development effort, many structural changes would have to be carried out. Reforms would be needed to improve the efficiency of the financial system and of the public sector; export promotion policies were also required.

It was encouraging that Costa Rica and the World Bank were cooperating closely, Mr. Coumbis remarked, and that some of the relevant issues had been taken up in the context of negotiations with the World Bank for structural adjustment loans. He was not aware of the extent of cooperation between the Fund and the Bank in Costa Rica's case. Costa Rica was an example where close cooperation between the two institutions, both in the short-term adjustment program and in the medium-term development plan, was absolutely necessary.

Mr. Teijeiro said that his chair welcomed the commendable performance of the Costa Rican economy under the 1983 stabilization program. Some of the achievements of that program were particularly remarkable, such as the deceleration in the rate of inflation, the unification of the exchange rate system, and the elimination of external arrears. It was also a matter for satisfaction that the authorities were well aware that further efforts should be undertaken, particularly in the fiscal area, so as to ensure consistency in the attainment of lower inflation and external equilibrium. However, it was a matter of concern that the reduction in the overall deficit of the nonfinancial public sector during 1983 had been offset to a large extent by significant losses experienced by the Central Bank, mainly because it had taken charge of payments due on all principal and interest on the external debt of the public sector.

Strengthening the current balance of public sector operations, including Central Bank operations, would be a major task within the context of the 1984 economic program, Mr. Teijeiro continued. The program envisaged a number of measures expected to yield higher revenues for the Central Administration, while other measures, especially a more realistic pricing policy, would strengthen the financial position of the rest of the public sector. While those measures represented steps in the right direction, greater emphasis should be put on adjusting expenditures. In particular, the past practice of granting salary adjustments far in excess of the inflation rate was a matter of concern and deserved particular attention. In the monetary area, the authorities' intention to reduce the rate of growth of total banking system credit and maintain positive real interest rates was welcome. Those measures would not only help with domestic monetary control, but also contribute to strengthening the external position.

With regard to the medium-term outlook for the Costa Rican economy, Mr. Teijeiro stated, the external payments situation would remain relatively weak until the end of the 1980s. Therefore, prudent external payments policies would be needed, especially with regard to external debt management and exchange rate policy. The positive achievement of a unified exchange rate should now be accompanied by a flexible management of the rate, to ensure that it would effectively reflect developments in the current account of the balance of payments and that Costa Rica competitiveness would be preserved.

A crucial element with regard to the external viability of the economy would be the magnitude of the public sector deficit, including losses by the Central Bank, Mr. Teijeiro suggested. Otherwise, pressures on the current account would remain, making it more difficult to achieve a sustainable position. The weakness of the external sector would also require that Costa Rica's debt structure should be changed through increased use of concessional credits. It was a matter of concern that arrears had once again emerged; the situation deserved immediate attention, and he hoped that measures to correct it would be promptly adopted. Finally, he encouraged the Costa Rican authorities to implement without delay the remaining policy actions needed to ensure a new financial arrangement with the Fund.

Mr. Clark said that, as previous speakers had noted, the Costa Rican economy had made significant progress in 1983, and all performance criteria under the stand-by arrangement had been met. It was particularly encouraging that real GDP growth had resumed, albeit at a modest rate, after the 12 percent decline over the previous two years, and that there had been a large drop in inflation, a sharp reduction in the fiscal deficit, the elimination of arrears, and the unification of the exchange rate. Unfortunately, as the staff reported in SM/84/156, Supplement 1, there appeared to be a danger at present that some of the progress would be undone in 1984. A particularly worrying symptom of the expansionary monetary and fiscal policies followed in the first half of 1984 was the recent surge in imports and, because liquid reserves were limited, the consequent increase in arrears, including arrears to the Fund. He welcomed Mr. Senior's indication that the authorities had managed to settle the latter in full.

The recent measures that the authorities had taken to bring monetary and fiscal policy back on track were welcome in the circumstances, Mr. Clark continued. Nevertheless, more remained to be done, especially in fiscal policy. He hoped that it would be possible to reach an agreement soon on a follow-on program so as to recoup and build on the achievements of 1983. There had been a striking reduction in the overall deficit of the nonfinancial public sector from 14 percent of GDP in 1981 to 3 percent in 1983, a result largely due to improvements in the public enterprises and to a sharp cutback in capital formation. The performance of the Central Administration in 1983 had been less good. Despite a substantial increase in revenue, expenditure had exceeded the target by more than 5 percent of GDP, largely because of what the authorities themselves recognized to have been an excessive public sector wage increase, far greater than that agreed in the private sector.

In order to restore a more satisfactory rate of capital expenditure without putting more pressure on the overall deficit, Mr. Clark remarked, it would be important for the central administration deficit to be cut; he welcomed, therefore, the target of a 2 percent reduction. However, that reduction depended on the introduction of a package of tax measures of which only about one third had been implemented thus far. It would also be important to restrain expenditure, particularly on wages, and it was encouraging that the authorities intended to grant no further wage increases in the public sector in 1984. Mr. Senior had stated that a major cut in expenditure had been submitted for parliamentary approval; he invited Mr. Senior or the staff to comment on the prospective size of its effect. Like the staff, he looked forward to the report of the commission reviewing public sector reform. Perhaps the staff could elaborate further on the issues of revenue earmarking and compulsory spending, neither of which had been discussed in detail in SM/84/156 or SM/84/146.

The reduction in inflation between 1982 and 1983 by two thirds on an average basis, and from 80 percent to 10 percent on an end-year basis, had been a remarkable achievement, Mr. Clark said. It would have been useful to have had more detailed discussion by the staff of the relative importance of the factors that had brought it about. Although the discussion in SM/84/146, which had pointed to the correspondence between inflation and the behavior of the free-market exchange rate, had been interesting, there were obvious questions about the direction of causation and whether both factors had been responding to other factors, such as wages or changes in the money supply. The answers to those questions had policy implications; perhaps the staff could shed further light on the issue.

One result of the sharp reduction in inflation had been a rapid rise in real interest rates, which had become positive, reaching 11 percent in real terms, Mr. Clark remarked. Further analysis of the effects of that substantial change on the real economy would also have been useful. In addition, it was surprising that there appeared to be an assumption of no change in money velocity between 1983 and 1984 in the monetary program of the Central Bank, despite the shift in real interest rates. He invited the staff to comment on that issue.

The medium-term prospect was dominated by the extremely difficult debt situation, Mr. Clark stated. Even after debt relief, the debt service ratio was projected to remain at about 40 percent for the next three years. Given the acute shortages of reserves, any slippage in domestic or external policies could, as recent experience had shown, result all too easily in a buildup of arrears. He welcomed, therefore, the fact that the medium-term scenario envisaged an increase in reserves, which would be an important part of any program. However, to achieve that increase would require firm domestic policies to restrain the growth of imports and sustain the growth of exports. It was encouraging that exports had done well thus far in 1984, but further diversification would be important in the medium term. He invited the staff or Mr. Senior to indicate what plans the authorities had in that regard.

Ms. Lundsager remarked that it was discouraging that, after a year of significant progress on several fronts, the Costa Rican economic situation had deteriorated in the first half of 1984. The growing fiscal deficit and the overly expansionary monetary policy were reflected in the widening of the trade deficit and the accumulation of new arrears. Among the major accomplishments of 1983 had been the fall in the inflation rate to 11 percent, compared with the program target of 40 percent. Real growth had been 1 percent when no growth had been expected, and the overall balance of payments had been in surplus, allowing the elimination of most external debt arrears. Those developments had been due to the implementation of a broad spectrum of policies, including price increases for electricity and petroleum products and decreases in some government expenditures, which had reduced the Government's need to borrow, thereby permitting a rapid expansion in credit to the private sector. The improved situation had allowed unification of the segmented exchange market. However, one unfavorable outcome had been the widening of the current account deficit to 11 percent of GDP. Although that deficit had been completely financed by aid and capital inflows, such a high proportion of GDP was unsustainable.

Commenting on developments in 1984, Ms. Lundsager noted that the policy measures originally planned had been aimed at continuing the progress made in 1983. Among the measures already implemented, she supported the cuts in the public enterprise budget and the freeze on public sector employment aimed at offsetting in part the large 1983 wage increase. However, those measures had been insufficient to maintain control over the fiscal sector, with the result that the overall fiscal deficit in the first five months of 1984 had been double the deficit for the same period in 1983. The staff reported in SM/84/156, Supplement 1, that the tax increases introduced in July should reduce that deficit. However, she urged greater emphasis on a reduction in expenditures, along the lines referred to by Mr. Senior. It would be interesting to have a description of the proposed measures.

She supported the changes in monetary policy that had been made in June 1984, Ms. Lundsager continued. They appeared to be designed to accomplish two goals, namely, to reverse the recent rapid growth in credit and to encourage savings through high real interest rates. Additional monetary and fiscal measures areas should be implemented as needed in order to contain the excess aggregate demand in the economy and maintain the low inflation rate.

It was disappointing that the authorities viewed new exchange restrictions as necessary, Ms. Lundsager considered. She agreed with the staff that the Fund should not approve those restrictions. The authorities planned to manage the exchange rate in view of developments in the current account, with the goal of maintaining the competitiveness of Costa Rican exports. While she could support that approach, it was worth noting that Costa Rica's expansionary macroeconomic policies had caused a substantial widening of the trade deficit thus far in 1984. It appeared, therefore, that a measured degree of exchange rate flexibility might not be enough to bring about a return to external equilibrium. Finally, Costa Rica faced high debt service payments over the medium term. While the Fund had a role to play in Costa Rica, she urged that the emphasis should be on helping the authorities to create an economic environment that would generate the foreign assistance and private capital inflows needed for continued economic development. However, in the final analysis, the burden lay on the Costa Rican authorities to implement and adhere to an adequate adjustment program.

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/84/117 (7/30/84) and EBM/84/118 (8/1/84).

3. CHAD - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1, AND NOTICE OF FAILURE TO REPAY TRUST FUND LOANS

1. The complaint of the Managing Director dated July 25, 1984 on Chad, in EBS/84/141, Supplement 1, is noted. The complaint shall be placed on the agenda of the Executive Board for October 1, 1984.

2. The notice of the Managing Director in EBS/84/141, Supplement 1, dated July 25, 1984, on the failure by Chad to fulfill obligations under Decision No. 5069-(76/72) on the Trust Fund, is noted. The notice shall be placed on the agenda of the Executive Board for October 1, 1984.

3. Consideration of the complaint in accordance with Rule K-1, and of the notice in relation to the Trust Fund, particularly affects Chad. The member shall be informed by rapid means of communication of these matters and of its right to present its views through an appropriately authorized representative.

4. A staff mission shall discuss with the authorities of Chad, as soon as possible, ways in which the member's financial obligations to the Fund will be promptly discharged. The Executive Board shall hold a meeting on September 12, 1984 to review the report of the mission and developments regarding the discharge of these obligations.

Decision No. 7773-(84/118), approved
July 31, 1984

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment set forth in EBM/84/160 (7/25/84).

Adopted July 30, 1984

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/158, Supplement 1 (7/30/84), and EBAP/84/161 (7/27/84) is approved.

6. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/84/163 (7/31/84) is approved.

APPROVED: May 14, 1985

LEO VAN HOUTVEN
Secretary