FOR AGENDA

EBS/83/110

CONFIDENTIAL

May 27, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Hungarian People's Republic - Midterm Review Under Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on the midterm review under the stand-by arrangement for the Hungarian People's Republic. A draft decision appears on pages 35 and 36.

It is proposed to bring this subject to the agenda for discussion on Friday, June 24, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mrs. Junz (ext. 72967) or Mr. Hole (ext. 74015).

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Hungarian People's Republic - Midterm Review Under Stand-By Arrangement

Prepared by the European Department and the Exchange and Trade Relations Department

(In consultation with other Departments)

Approved by L. A. Whittome and Subimal Mookerjee

May 27, 1983

I. Introduction

A 13-month stand-by arrangement for Hungary in an amount equivalent to SDR 475 million (126.7 per cent of quota) was approved by the Executive Board and became effective on December 8, 1982. Under the arrangement, Hungary, thus far, has made two purchases totaling SDR 225.6 million. These drawings, together with a purchase of SDR 72.0 million under the compensatory financing facility on December 13, 1982, brought Fund holdings of forint as of April 30, 1983 to 179.4 per cent of the present quota of SDR 375 million; excluding the purchase under the compensatory financing facility, holdings amounted to 160.2 per cent of quota (Table 1).

Discussions with Hungarian officials for the midterm review of the stand-by arrangement were held in Budapest, April 13-May 9, 1983 by a staff team consisting of Mrs. Junz (Head, EUR), Messrs. Hole (EUR), Belanger (ETR), Ms. Salop (EUR), Mr. Somogyi (EUR), Mr. Nivollet (EUR, EP), and, as secretary, Mrs. Carlson (EUR). The Hungarian representatives included senior officials of the National Bank of Hungary, the Ministry of Finance, the Ministry of Foreign Trade, the Central Planning Office, and the Central Statistical Office. The head of the mission and various mission members also met with the Deputy Chairman of the Council of Ministers, Mr. Marjai; the Minister of Finance, Mr. Hetenyi; the President and the First Deputy President of the National Bank, Messrs. Timar and Fekete; the Chairman of the National Materials and Price Board, Mr. Csikós-Nagy; and the Deputy Chairman of the Central Planning Office, Mr. Pulai. Mr. Coene, Assistant to Mr. de Groote, Executive Director for Hungary, was present for part of the discussions.

In the attached communication to the Managing Director, the Hungarian authorities review developments thus far under the stabilization program and set out their principal policy intentions for the remaining period of the stand-by arrangement. The next purchase under the stand-by arrangement is subject to Board approval of the performance criteria being proposed by the authorities, as well as of other proposed policy understandings, and would become available following satisfactory completion of the present review. The phasing of the remaining purchases

Table 1. Hungary: IMF Position September 1982 to December 1983

(In millions of SDRs)

	Actual				Proposed		
	Sept. 3 1982	Oct. 31 1982	Dec. 31, 1982	Apr. 30, 1983	2½ months to July 15, 1983	2½ months to Sept. 30, 1983	3 months to Dec. 31, 1983
Purchases	--	81	215	83	83	83	83
Reserve tranche	--	81	--	--	--	--	--
Stand-by arrangement	--	--	143	83	83	83	83
Ordinary resources	--	--	95	38	38	38	37
Borrowed resources	--	--	48	45	45	45	46
CFF	--	--	72	--	--	--	--
Repurchases	--	--	--	--	--	--	--
Stand-by arrangement	--	--	--	--	--	--	--
CFF	--	--	--	--	--	--	--
Net purchases	--	81	215	83	83	83	83
Fund holdings 1/							
Total (cumulative)	294	375	590	673	756	839	922
Holdings in per cent of quota	78.3	100.0	157.2	179.4	201.5	223.7	245.9
(Excluding CFF)	(78.3)	(100.0)	(138.0)	(160.2)	(182.3)	(204.5)	(226.7)

Sources: IMF, Treasurer's Department and staff projections.

1/ At end period. Holdings in per cent of quota are based on total holdings to two decimal places in relation to Hungary's quota of SDR 375 million.

under the stand-by and the prospective development of Fund holdings of forint in the period until the end of the stand-by are set out in Table 1.

In the IBRD, two proposals for medium-term project loans for Hungary--one to improve crop yields and grain storage (US$131 million) and one to rationalize the use of energy (US$109 million)--are scheduled to be considered by the Executive Directors on June 14, 1983. Subject to their approval, disbursements are expected to amount to about US$30 million in fiscal year 1983/84 (July 1-June 30) and to about US$100 million in 1984/85. An appraisal report on a third project, for promoting exports to the convertible currency area, is under preparation.

II. Performance to Date Under the Stand-By

1. Background

The basic objective of Hungarian economic policy in recent years has been to achieve a large and lasting improvement in the external current account in convertible currencies. A massive loss of reserves in the first quarter of 1982 had led to a tightening of financial policies and an intensification of import restrictions. However, these measures did not suffice to alleviate the external liquidity situation and, in the latter part of 1982, the Hungarian authorities embarked on a more concerted adjustment program. This program, which included demand management measures, exchange rate adjustment, and continuation of the process of structural reform measures, was supported by the present stand-by arrangement.

The principal target of the stabilization program was to improve the external current account balance in convertible currencies by some US$550 million between 1981 and 1982 and by a further US$750 million between 1982 and 1983, altogether equivalent to a swing of about 5 3/4 per cent of projected GDP in 1983. External adjustment on this scale was necessitated by a very heavy schedule of maturing medium- and long-term foreign debt in 1983-85, as well as by an exposed financial position arising from the need to roll over large amounts of short-term debt. Against this background, the Hungarian authorities aimed to make the balance of payments less vulnerable to external shocks and shifts in financial market sentiment so as to secure their basic goals of continuing to meet all foreign debt obligations and of returning the economy to a balanced growth path.

In order to achieve the targeted shift in the current account balance in convertible currencies, a significant reduction in domestic demand was considered necessary. Accordingly, real domestic demand was projected to fall by 1.2 per cent in 1982 and by 3-4 per cent in 1983. Whereas real consumption expenditures had been programmed to continue to grow in 1982, albeit much more slowly than in earlier years, they were to fall absolutely--for the first time in many years--in 1983. Real private consumption expenditures were to be reduced through curbs on wage increases, higher taxes (especially higher social security contributions), and a quickening of the rate of price increases, mainly associated with cuts in consumer price subsidies. A wide array of measures was to help curtail the volume of fixed investment, make the use of capital resources and of imports more efficient, and contain stockbuilding. These measures included cuts in state investment outlays, the freezing of enterprise liquidity held in reserve and investment funds, and the taxing away of a part of enterprise earnings set aside for investment purposes. In addition, government current expenditures were programmed to decline in real terms in 1983. These fiscal measures were flanked by monetary policy actions that increased interest rates on enterprise credits, reduced the rate of credit expansion, and sought to improve the incentive to save both in financial assets and in the form of housing.

As an integral part of the adjustment effort, the authorities adopted a more active exchange rate policy vis-à-vis the convertible currency area which was geared to promoting a more rational use of imports and to raising the profitability of exports. Thus, during the second half of 1982, the forint was depreciated by some 11 per cent against the basket of convertible currencies to which it is pegged. This depreciation reversed about one half of the real appreciation that had occurred over the two previous years, when a strong forint policy, largely aimed at shielding the domestic economy from imported inflation, was pursued (Chart 1). In addition, within the overall restraint on investment, incentives for investments that would expand capacity for exports in convertible currencies were strengthened.

The *demand management measures* adopted by the authorities were designed to bring about a further improvement in the balance of payments over the very short term and were to be accompanied by structural policies that would improve the efficiency of the economy and strengthen the external balance in the medium term. In particular, steps were envisaged that would make the wage and price regulation system more flexible, enhance the mobility of production factors, and diversify the channels of financial intermediation.

Consistent with the overall policy objectives, performance criteria were set on net domestic assets of the National Bank of Hungary, net credit to the state budget from the banking system, net foreign liabilities in convertible currencies of the specialized financial institutions, and the contracting of new medium- and long-term foreign debt in convertible currencies by the Government and by nonfinancial entities. The customary provisions regarding the exchange and trade system and a midterm review were also included as performance criteria.

2. Developments in 1982

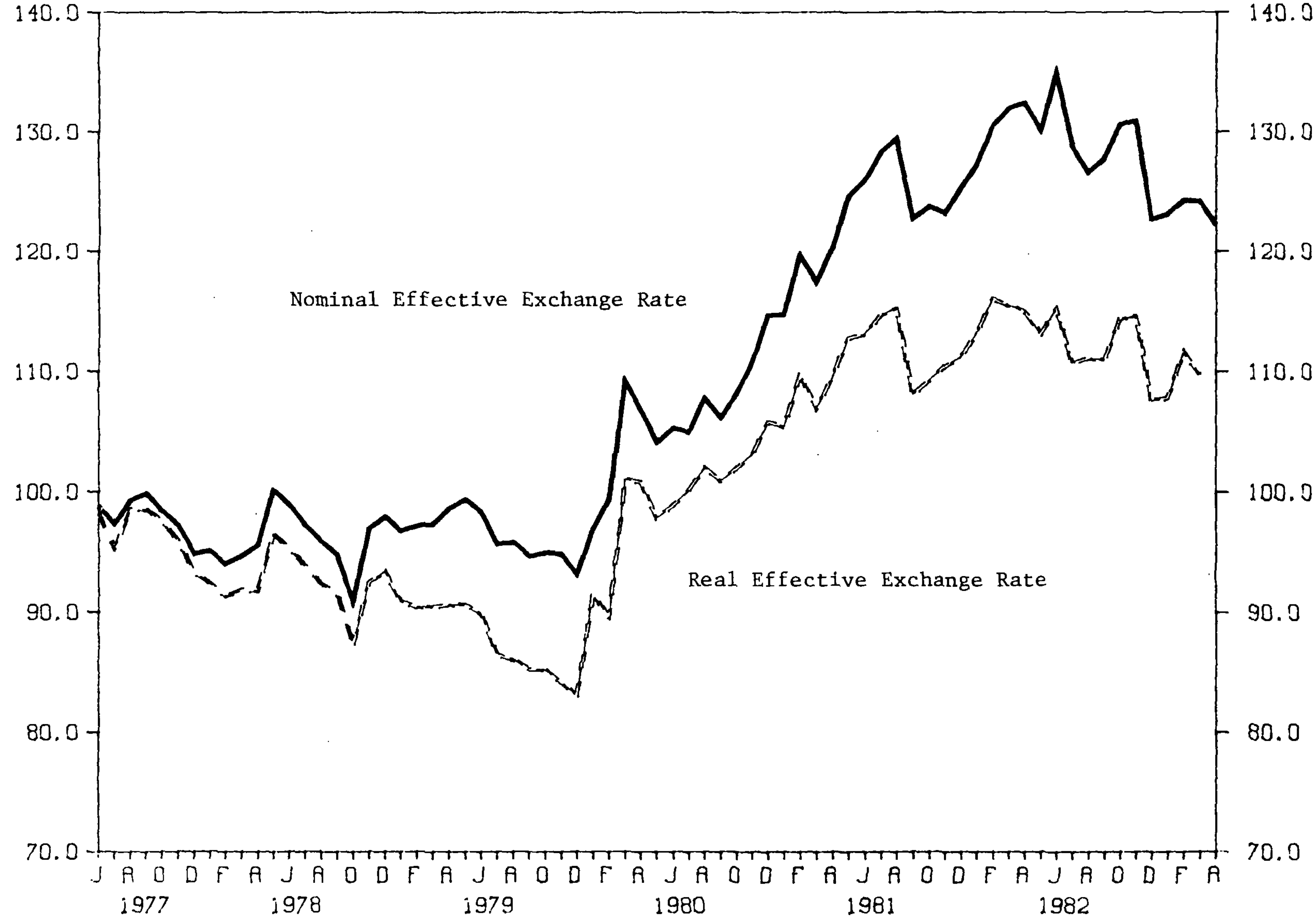
In 1982, developments in the current account balance in convertible currencies met expectations. In fact, the outcome was fractionally better than expected, as the deficit was reduced to just under US$150 million from over US$700 million in 1981. Final domestic demand, in real terms, remained unchanged in 1982, in line with the projections underlying the

CHART 1

HUNGARY

NOMINAL AND REAL EFFECTIVE EXCHANGE RATE 1/

(1976 = 100)



SOURCE: STAFF ESTIMATES

1/ WEIGHTED AVERAGE OF RELATIVE WHOLESALE PRICES ADJUSTED FOR EXCHANGE RATES. WEIGHTS ARE BASED BOTH ON THE DIRECTION OF TRADE (1978-1980) AND, IN THE CASE OF EXPORTS, ON COMPETITION IN THIRD MARKETS. SEASONALLY ADJUSTED.

adjustment program. But the distribution of the adjustment burden was somewhat different from that envisaged, with fixed investment and government current expenditures lower and household consumption higher than expected. Moreover, inventories declined less than anticipated, so that between 1981 and 1982 total domestic demand fell only by 0.4 per cent, in real terms, rather than by the 1.2 per cent that had been programmed (Table 2).

The stronger-than-programmed development of domestic demand went hand in hand with a larger-than-expected increase in supply. The latter originated from (i) strong growth (by 5 per cent) of agricultural production; (ii) a rapid increase of activity in the private sector with recorded incomes from such activity rising by 15 per cent--more than twice the rate of increase of total household income; (iii) an above-average increase in industrial productivity, that virtually offset the effects of the 4 3/4 per cent reduction in the statutory workweek; and (iv) an increase in imported materials following accelerated deliveries of oil from the U.S.S.R.

Industrial production grew as projected by about 2 per cent, but value added in manufacturing rose at twice that rate, largely because of more efficient use of energy and material inputs in response to earlier price adjustments. All told, GDP in real terms expanded by 2.5 per cent in 1982 over 1981, compared with the 1.8 per cent rate of growth that had been projected. The real foreign balance contributed about 3 percentage points to that growth, as originally programmed. Consumer prices rose by 7 per cent, which was the rate targeted in conjunction with the measures aimed at containing household purchasing power, but that rate of increase was decelerating toward the end of the year.

Financial policies were broadly on course in the second half of 1982 and all performance criteria were met through end-December 1982. The fiscal outturn in 1982 was close to expectations in that the state budget deficit, at Ft 12.5 billion, was slightly below the forecast range and the consolidated budget deficit, at Ft 17.1 billion, was within that range. In fact, the 1982 budget was rather more restrictive in terms of absorption of domestic resources than the targeted deficits implied, as intergovernmental credits from the CMEA, which are treated as a source of nontax revenues, fell far short of anticipations. This shortfall was offset fully by a reduction in expenditures and an increase in other tax revenues. Furthermore, financing of the state budget by the National Bank of Hungary and the specialized financial institutions remained significantly below the provisions of the program.

The total outstanding stock of credit at end-1982 was about Ft 7 billion below forecast, largely because of the smaller budget recourse to bank financing, although credit extensions to enterprises and households were also below target. Despite the relatively subdued growth of domestic credit, broad money as well as M1 were significantly above their end-year targets, largely owing to a surge in enterprise deposits, associated in part with the effect of the devaluations on profits.

Table 2. Hungary: Macroeconomic Variables, Programmed and Actual for 1982

(Percentage changes, millions of U.S. dollars, and billions of forint)

	1982	
	Program	Actual
	(Percentage changes in volumes)	
Consumer expenditure	0.7	1.1
Government current expenditure	1.9	1.8
Gross fixed investment	-2.5	-2.8
Final domestic demand	--	0.2
Stockbuilding (in per cent of GDP in 1981)	-1.2	-0.6
Domestic demand	-1.2	-0.4
Exports of goods and services	4.8	3.5
Imports of goods and services	-2.9	-3.8
Foreign balance (in per cent of GDP in 1981)	3.1	3.0
GDP	1.8	2.5
	(In millions of U.S. dollars)	
Current balance, convertible currencies	-162	-149
	(In billions of forint)	
Budget deficit	13.0-15.0	12.5
Domestic credit, end-period	703.9	697.0
Of which: State budget	32.4	29.3

Sources: EBS/82/206 (11/10/82) and data provided by the Hungarian authorities.

With an absolute fall of the volume of demand and a more competitive exchange rate, the external current account in convertible currencies moved into surplus in the second half of 1982, and for the year as a whole the current account deficit was reduced to US$149 million from US$727 million in 1981--an improvement equivalent to 2.5 per cent of GDP (Table 3). This improvement was achieved under more difficult trading conditions than originally foreseen. In particular, in late 1982 world market prices for Hungarian products were lower than had been expected. In addition, with keener competition, Hungarian exporters had to reduce prices even further because the tightness of the external financial situation did not permit them to meet the very generous credit terms offered by a number of other sellers. These price cuts contributed to an expansion of the volume of exports in convertible currencies by nearly 11 per cent in 1982, virtually all of which represented gains in market shares. Nevertheless, the fall in prices was so large that export revenues in convertible currencies in 1982 remained only at about their 1981 level. Over the same period, import payments in convertible currencies fell as projected by more than 7 per cent and the trade surplus in convertible currencies was slightly less than foreseen. This was more than offset, however, by a stronger-than-expected performance on account of net services and transfers.

The current account deficit in nonconvertible currencies, at US$220 million, was also somewhat less in 1982 than had been projected, but at higher levels of both exports and imports. In contrast with earlier years, the deficit was financed primarily by short-term credits (Table 4).

The net outflow of capital in convertible currencies of more than US$1.3 billion in the first quarter of 1982 was followed by a reflow of about US$0.4 billion in the second and third quarters. But in the fourth quarter a further small capital outflow was recorded despite an increase in temporary short-term inflows aimed at bolstering reserves. But with purchases from the Fund of US$235 million in December and with the turnaround in the current account during the course of the year, gross international reserves in convertible currencies rose to US$1,112 million at end-December (equivalent to over three months of payments for merchandise imports from the convertible currency area) (Table 5). This represented a US$0.7 billion improvement over the low point reached at end-March 1982. Nevertheless, the level of reserves in convertible currencies remained more than US$0.5 billion below the end-1981 position, and the unwinding of the temporary inflow of bank deposits at end-year had to be expected in early 1983 as well.

3. Early 1983

The economic developments that dominated late 1982 spilled over into early 1983. Specifically, the strong growth of activity in the private sector and the bumper crops of 1982 were translated into significantly higher household incomes than had been anticipated. Real incomes from the sale of farm produce in the first quarter of 1983 were 6.5 per cent above the year-earlier level, and real nonwage incomes rose by 13 per cent over the same period. The buoyancy of nonwage incomes reflected both the

Table 3. Hungary: Balance of Payments in Convertible Currencies, Quarterly, 1982-1983

(In millions of U.S. dollars)

	1982					1983				
	I	II	III	IV	Total	I	II	III	IV	Total
Exports	1,200	1,199	1,065	1,412	4,876	1,161	1,143	1,259	1,357	4,920
Imports	-1,069	-1,049	-865	-1,127	-4,110	-1,012	-891	-964	-991	-3,858
Trade balance	131	150	200	285	766	149	252	295	366	1,062
Freight and insurance (net)	-57	-50	-31	-82	-220	-45	-50	-54	-56	-205
Travel (net)	21	37	65	53	176	21	49	71	65	206
Investment income (net)	-320	-315	-214	-127	-976	-174	-165	-165	-165	-669
Government expenditure (net)	-10	-12	-7	-16	-45	-11	-12	-12	-12	-47
Other current receipts (net)	-43	83	11	38	89	25	24	29	27	105
Unrequited transfers (net)	12	12	14	23	61	11	11	12	14	48
Current balance	-266	-95	38	174	-149	-24	109	176	239	500
Medium- and long-term capital										
Export financing (net)	-107	-30	-37	-18	-192	-7	-22	-33	-35	-97
Other	96	-57	232	-11	260	-69	56	-159	-220	-392
Inflows	(445)	(79)	(460)	(170)	(1,154)	(133)	(248)	(124)	(108)	(613)
Outflows	(-349)	(-136)	(-228)	(-181)	(-894)	(-202)	(-192)	(-283)	(-328)	(-1,005)
Short-term capital										
Export financing (net)	-64	57	-9	-145	-161	-18	33	-50	-150	-185
Other (net) 1/	-1,268	296	-38	98	-912	-297	-200	50	100	-347
Overall balance	-1,609	171	186	98	-1,154	-415	-24	-16	-66	-521
Monetary movements										
Monetary gold (increase -)	440	-38	-56	37	383	-164	...	...	...	-164
Foreign exchange (increase -)	1,169	-133	-130	-370	536	488	-68	-75	-26	319
Use of Fund resources	--	--	--	235	235	91	92	222	92	366

Sources: National Bank of Hungary; and staff estimates.

1/ Includes errors and omissions.

Table 4. Hungary: Balance of Payments
in Nonconvertible Currencies, 1981-1983

(In millions of U.S. dollars)

	1981	1982	1983 Original Proj.	1983 Revised Proj.
Exports	4,017	4,207	4,332	4,321
Imports	-4,423	-4,465	-4,545	-4,528
Trade balance	-406	-258	-213	-207
Freight and insurance (net)	-110	-91	-121	-121
Travel (net)	117	81	66	72
Investment income (net)	-20	14	-11	-11
Government expenditure (net)	3	3	5	5
Other current receipts (net)	245	28	87	86
Unrequited transfers (net)	2	2	3	3
Current balance	-169	-221	-184	-173
Medium- and long-term capital				
Export financing (net)	-26	12	5	5
Other	502	87	108	108
Inflows	(582)	(133)	(221)	(221)
Outflows	(-80)	(-46)	(-113)	(-113)
Short-term capital (net) 1/	-392	160	71	60
Overall balance	-85	38	--	--

Sources: National Bank of Hungary; and staff estimates.

1/ Includes errors and omissions.

Table 5. Hungary: International Reserves and Other Foreign Assets, 1980-1983

(In millions of U.S. dollars)

	1980	1981	1982	March 1983
International reserves				
Convertible currencies				
Gold 1/	92	69	25	38
Foreign exchange	1,978	1,624	1,087	600
Official reserves	(1,853)	(1,482)	(771)	(331)
Other readily marketable assets 2/	(125)	(142)	(316)	(269)
Total	2,070	1,693	1,112	638
Nonconvertible currencies	113	28	66	84
Total	2,183	1,721	1,178	722
Other foreign assets				
Convertible currencies	1,256	1,219	1,539	1,561
Short-term 3/	(685)	(595)	(773)	(788)
Long-term	(571)	(624)	(766)	(773)
Nonconvertible currencies	413	510	318	327
Short-term	(139)	(238)	(89)	(101)
Long-term	(274)	(272)	(229)	(226)
Total	1,669	1,729	1,857	1,888
Total international reserves and other foreign assets	3,852	3,450	3,035	2,610

Source: National Bank of Hungary.

1/ Valued at SDR 35 per ounce. Gold is valued at $42.22 per ounce prior to 1978, $126 per ounce in 1978 and $226 per ounce thereafter in official reserve statistics.

2/ Excluded from the official Hungarian definition of reserves.

3/ This item includes working balances of the specialized banks and claims of enterprises in the form of export bills and suppliers' credits. Prime export bills are discountable at the National Bank, with recourse. The National Bank regards this facility as a means of providing domestic liquidity to the enterprises and normally holds the bills to maturity rather than rediscounting them on foreign markets.

continued strong underlying growth rate of private sector activity and the pronounced response to the enlarged scope for such activity that had been put in place early in 1982. By contrast, wage incomes in the socialist sector and social benefits, which represent about three quarters of total cash incomes, increased along the lines that had been projected.

The better supply situation and the failure to pass the effects of the forint devaluations in 1982 fully into consumer prices allowed a somewhat slower rise of the inflation rate than had been programmed, and the combination of relatively fast income expansion and somewhat lower inflation resulted in an overrun of personal consumption expenditures. At the same time, enterprise profits, although declining, were down considerably less than expected and the resulting comfortable liquidity situation of enterprises coupled with the very mild winter led to a stronger growth of capital formation than anticipated.

While domestic demand was more buoyant than desired, the external economic environment continued to deteriorate. Three developments, largely outside the control of the authorities were at play. First, export prices remained much weaker than anticipated. Hence, further strong export performance in volume terms was not matched by equivalent revenue flows. As a result, export receipts in convertible currencies in the first quarter of 1983 were slightly below their year-earlier level and the balance on current account was in deficit by US$24 million compared with an expected US$62 million surplus. Some speeding up of import payments and delays of exports in anticipation of a depreciation of the forint in early April also appear to have contributed to the weak first quarter performance.

Second, there was a renewed outflow of capital (US$390 million) in the first quarter. In large part, this resulted from the reversal of the temporary financing obtained in late 1982, but there was also an additional drain of other short-term deposits by some foreign banks, mainly reflecting increasing caution by the banking community regarding its international exposure generally, and its regional exposure in particular. As a result, external debt in convertible currencies fell by US$0.4 billion in the first quarter, with short-term debt, at US$1.4 billion, reduced to about one half its end-1981 level (Table 6).

Third, in a keenly competitive trading environment, Hungary had no alternative but to continue, within the limits of its possibilities, to provide credit to export customers. At the same time, export receivables increased in the wake of payments difficulties experienced by some customer countries. 1/ In the light of all this, and notwithstanding the second purchase under the stand-by, gross international reserves in convertible currencies declined by US$474 million over the three months to end-March. This left them US$100 million below their September 1982 level, as against a projected improvement of US$290 million.

1/ Receipts, that the Hungarian authorities consider to have been delayed beyond reasonable commercial practice, increased from US$205 million in September 1982 to US$245 million in March 1983.

Table 6. Hungary: Foreign Debt, 1980-83

(*In millions of U.S. dollars; end of period*)

	1980	1981	1982	March 1983
Total foreign debt	10,314	10,026	8,989	8,864
In convertible currencies	9,090	8,699	7,715	7,329
By original maturity:				
Short-term	3,347	2,849	1,764	1,410
Long-term	5,743	5,850	5,951	5,919
By type:				
Financial loans 1/	8,616	8,050	6,653	6,146
Trade-related credits 2/	293	402	661	797
Intergovernmental credit	6	6	5	4
Other 3/	175	241	396	382
In nonconvertible currencies	1,224	1,327	1,274	1,535
By original maturity:				
Short-term	558	243	249	525
Long-term	666	1,084	1,025	1,010
By type:				
Financial loans	532	260	225	503
Trade-related credits	23	15	39	38
Intergovernmental credit	635	1,038	974	959
Other	34	14	36	35

Source: National Bank of Hungary.

1/ Syndicated loans, bonds and notes, bank to bank credit and deposits and balances of nonresident banks.
2/ Including bankers' acceptances.
3/ Mainly downpayment for Hungarian exports; and import documents in the process of settlement.

As it became clear that both domestic consumption and investment were developing more strongly than targeted and that the external situation was more difficult than expected, the authorities in the early months of 1983 took measures to keep domestic demand within the programmed bounds. These measures were directed mainly at curbing capital formation and included (i) freezing a certain amount of liquid funds of both the State and the enterprises; (ii) tightening credit availability, in part by cancellation by the National Bank of a portion of agreed credit commitments and closer scrutiny of new credit applications; and (iii) forcing the early redemption by enterprises of certain outstanding investment credits. About Ft 4.5 billion in investable funds was withdrawn in this manner, with only part of the early credit repayments being re-lent by the National Bank. These measures were supported by additional devaluations of the forint vis-à-vis a basket of currencies of 1 per cent in February and 3 per cent in April. The effects of the April devaluation were to be passed fully into consumer prices.

III. Program for the Remainder of the Stand-By

During the second quarter of 1983, it became increasingly clear that the measures taken earlier in the year would not suffice to bring the economy back to the targeted path. Although the higher domestic incomes were being generated by larger supply availabilities, the latter were fully necessary to meet the external balance requirements, which had been enlarged in volume terms by the weak price performance. On prevailing trends, the authorities estimated that the current account target of a surplus of US$600 million in convertible currencies might be undershot by up to US$200 million. Recognizing that such a shortfall could seriously strain the external liquidity position in circumstances in which the capital balance also was performing well below expectations, the authorities decided to strengthen their domestic restraint program and to take further measures to ensure the continued competitiveness of Hungarian exports.

On the basis of the trends that had crystalized during the first four months of 1983, it seemed that about 3 3/4 per cent of projected real domestic demand--or Ft 7 billion in nominal terms--would have to be immobilized to bring the economy back into line with the current account target (Table 7). In addition, the heavy reliance on restraint of the enterprise sector and state investments would have to be broadened to include consumption expenditures in a more direct manner. Accordingly, it was decided that about Ft 5 billion, of the total Ft 7 billion additional restraint, would have to come from household incomes. The authorities specified the measures necessary to implement this decision in late May.

The targeted reduction in household disposable income is to be brought about through four principal avenues: (i) the removal of price controls on a number of goods and services, some reduction in consumer price subsidies, and increases in certain administered prices; (ii) a freezing of wages in the government sector; (iii) measures to increase the propensity to save; and, as needed, (iv) a further depreciation of the forint, the effects of which would be passed through fully into

Table 7. Hungary: Projections of Domestic Demand for 1983

(In billions of forint)

	Prior to new measures		Program	
	At 1981 prices	At current prices	At 1981 prices	At current prices
Consumers expenditure	480.0	544.9 1/	475.5	542.8
Percentage change	-1.1	5.9	-2.0	5.5
Government current expenditure	81.1	87.2	80.5	86.5
Percentage change	--	4.6	-0.7	3.8
Gross capital formation	195.0	242.3	194.6	241.4
Percentage change	-7.8	1.7	-8.0	1.3
Domestic demand	756.1	874.4	750.6	870.7
Percentage change	-2.8	4.6	-3.5	4.1
Memorandum item:				
Percentage increase in deflator on consumers expenditure	...	7.0	...	7.6

Source: Staff estimates.

1/ Consumers expenditure estimated on the basis of disposable household income of Ft. 573.6 billion and a savings ratio of 5 per cent. Nominal household consumption would have to be lowered by an additional Ft. 3.1 billion to obtain, on the basis of a 7 per cent rise in the consumption deflator, the 2 per cent real decline in consumers expenditure projected under the program. This raises the overall excess in domestic demand prior to new measures to about Ft. 7 billion.

consumer prices. Investment expenditures will be restrained, actually by more than the targeted Ft 2 billion, including (i) first steps toward a unification of interest rates at a higher average level; (ii) the withdrawal of working capital funds from enterprises and the freezing of an additional portion of their development funds; (iii) increases in the average effective rate of the construction and the investment tax; and (iv) further cuts in the official funding of investment activity.

1. Price and incomes policies

As an early step to rein in private consumption expenditures, the authorities decided on a virtual freeze of wages in the government sector. This is expected to reduce the increase in the wage bill in 1983 over 1982 by 0.4 per cent, or Ft 1 billion, below what it otherwise would have been. This measure, together with the overhaul of the wage system instituted at the beginning of the year, will bring the rise in the wage bill for the year down to 3.1 per cent from 4.8 per cent in 1982. Mainly because incomes from private activities and social benefits are likely to increase more rapidly than wages paid by state and cooperative enterprises, nominal disposable income of households is forecast to grow (by 5.7 per cent) faster than the wage bill, but more slowly than in 1982 (7.3 per cent).

In order to syphon off further purchasing power, the restraint of the growth of nominal incomes is being buttressed by additional increases of consumer prices, primarily through a reduction of the number of government-controlled prices, by some lowering of consumer price subsidies, and by passing on to consumers the effects of the latest and of any further devaluations of the forint. These measures, together with the expected year-on-year rise in consumer prices stemming from market forces and from the carry-over of earlier administrative price increases, are forecast to lead to an acceleration in the rate of consumer price rises to 8-8.5 per cent in 1983 from about 7 per cent in 1982. Correspondingly, real disposable incomes are slated to fall by 1.8 per cent in 1983 compared with an 0.8 per cent rise in 1982.

The restraint of consumption demand is to be supported by measures aimed at raising the personal savings rate. In particular, the housing reform of 1983, which shifts the burden of the financing and maintenance cost of housing from the state budget to private households, is expected to result in a marked increase in investment in, and improvement of, private dwellings. This is estimated to absorb household savings equivalent to 1/2 of 1 per cent of disposable incomes. At the same time, in order to contain the likely decline in financial savings associated with the shift of savings into home ownership, the authorities have decided to encourage greater purchases of communal bonds by private households and are preparing to raise the interest rate on long-term savings deposits. All in all, the savings rate is projected to rise to 5.2 per cent from 5 per cent in 1982.

2. Fiscal policy

Budgetary restraint in 1983 is to be tightened beyond the earlier targets. The deficit in the state budget is to be more than halved to Ft 6 billion, or 0.7 per cent of projected GDP for 1983. In fact, with the recently introduced measures, the operational deficit could be even smaller, but the general practice to record excess revenues in below-the-line accounts so as to accumulate expenditure reserves would tend to keep the official outturn at the targeted Ft 6 billion. In addition, at the Ft 6 billion figure, the effective improvement in the net budgetary stance as against 1982 amounts to Ft 14.5 billion, or 1.6 per cent of GDP, because a further decline, of about Ft 8 billion, in intergovernmental credits is expected in 1983.

The strengthening of the budget position mirrors the strong focus on restraining government wage payments and investment expenditures, as well as a sizable increase in direct taxation (Table 8). This orientation was already evident in the approved budget and was reaffirmed in the new measures, which include increases of the construction and investment taxes and a freeze on government wages. By contrast, outlays for consumer price subsidies, even after the new measures, are projected to remain above earlier targets (Table 9). This increase reflects partly the higher volume of consumption expenditures recorded earlier in the year, but, more important, the effect on outlays that stem from having passed the effects of the devaluation of the forint up to March 1983 and this year's increase of agricultural procurement prices only partially into consumer prices. The increase in consumer turnover taxes in 1983, however, is projected to be three times that for consumer price subsidies; the authorities take the view that the difference between these two aggregates--rather than the respective level of either--is the important macroeconomic variable.

3. Money and credit policies

The authorities have decided to restrain investment activity further and to continue to reduce the overhang of enterprise liquidity. With effect from July 1, 1983, interest rates on the stock of outstanding credits will be raised to the levels charged for new credits. 1/ Also, as of that date, rates charged by the National Bank will be a uniform 13 per cent on short-term credits and 14 per cent on longer term credits. The estimated effect of this change on enterprise costs is Ft 2 billion in the first full year. In order to offset the direct effect of this increase in costs on export profits, the authorities have decided to devalue the exchange rate of the forint by 1 per cent, effective by the end of June.

1/ The only exceptions to this rise will be certain credits on agricultural investments that were granted before the early 1970s, on condition that the debtor commits himself to early redemption, and certain credits for exports in convertible currencies predating the introduction of the interest rebate system.

Table 8. Hungary: The State Budget

(In billions of forint)

	1981 Outcome	1982 Approved budget	1982 Program estimate	1982 Preliminary outcome A 1/	1982 Preliminary outcome B 1/	1983 Approved budget	1983 Original program estimate	1983 Revised program estimate
Expenditures								
Investment	59.7	55.3	54.0	52.8	55.9	55.6	54.0	55.0
Price support	144.5	152.9	150.0	146.5	146.5	159.1	148.0	155.0
Social security	90.4	97.3	98.0	98.5	98.5	106.9	107.0	106.9
Health, education, culture	67.6	72.6	74.0	73.0	71.7	74.0	78.0	73.5
Defense, internal security	30.9	32.6	31.0	33.0	33.0	34.2	32.0	34.2
Other	89.0	95.8	96.0	93.9	92.1	103.9	103.0	103.4
Total expenditures	482.1	506.5	503.0	497.9	497.7	533.7	522.0	528.0
Revenues								
Direct taxes	206.5	216.1	210.6-212.6	211.7	212.5	245.8	225.5-226.5	246.0
Wage taxes and social security contributions	(63.7)	(71.8)	(74.0)	(74.5)	(75.3)	(84.4)	(83.0)	(84.4)
Profit taxes	(121.1)	(115.2)	(108-110)	(111.5)	(111.5)	(129.9)	(113-114)	(129.9)
Production taxes	(20.6)	(28.5)	(28.0)	(25.2)	(25.2)	(30.5)	(29.0)	30.7
Taxes on capital	(1.1)	(0.6)	(0.6)	(0.5)	(0.5)	(1.0)	(0.5)	(1.0)
Indirect taxes	176.4	166.1	191.5	196.1	196.1	207.5	195.0	205.8
Turnover taxes	(152.7)	(162.1)	(166.5)	(168.3)	(168.3)	(182.4)	(170.0)	(180.7)
Tariffs and import taxes	(23.7)	(30.8)	(25.0)	(27.8)	(27.8)	(25.1)	(25.0)	(25.1)
Total taxes	382.9	382.2	402.1-404.1	407.8	408.6	453.3	420.5-421.5	451.8
Other revenues	89.7	82.5	85.9	77.4	76.6	70.2	92.5 2/	70.2
Total revenues	472.6	491.5	488-490	485.2	485.2	523.5	509-510	522.0
Budget deficit	9.5	15.0	13.0-15.0	12.5	12.5	10.2	8.0-9.0	6.0
Memorandum items:								
Expenditures and revenues of development funds of local councils excluded from state budget								
Expenditure	14.8	12.6	12.6	15.2	15.2	12.4	12.1	12.4
Tax revenues	5.9	5.2	6.0	6.3	6.3	5.3	6.1	5.3
Nontax revenues	4.8	4.1	3.3	4.3	4.3	3.4	3.4	3.4
Deficit	4.1	3.3	3.3	4.6	4.6	3.7	2.6	3.7
Consolidated deficit 3/	13.6	18.3	16.3-18.3	17.1	17.1	13.9	10.6-11.6	9.7

Sources: Ministry of Finance and staff estimates.

1/ A = in the structure of the approved budget for 1982.
B = in the structure of the approved budget for 1983.
2/ Contains Ft 4 billion of unallocated other revenues.
3/ Consolidation of state budget deficit with deficit of development funds of local councils.

Table 9. Hungary: Budgetary Expenditures on Subsidies

(In billions of forint)

	1981	1982			1983		
	Outcome	Approved budget	Program estimate	Preliminary outcome	Approved budget	Original program estimate	Revised program estimate
Consumer price support	62.1	65.4	64.4	64.2	69.2	64.0	67.5
Modernization grants	25.4	24.6	30.0	26.7	32.8	29.0	30.2 1/
Producer price support	17.9	20.5	19.6	18.3	19.8	19.0	19.8
Tax rebates to exporters	16.5	18.4	15.0	14.4	13.9	14.0	13.9
Import subisides	2.4	5.8	2.5	0.9	2.5	3.0	2.5
Subsidies to agricultural enterprises	9.2	8.7	8.7	9.0	8.6	11.0	8.6
Other	11.0	9.5	9.8	13.0	12.3	11.0	12.3
Total	144.5	152.9	150.0	146.5	159.1	148.0	155.0
Memorandum item:							
Consumer turnover taxes	66.4	73.0	72.5	74.2	85.9	79.0	86.8
Producer turnover taxes	86.3	89.1	94.0	94.1	96.5	91.0	93.9 1/
Total	152.7	162.1	166.5	168.3	182.4	170.0	180.7

Sources: Ministry of Finance and staff estimates.

1/ The differences from the approved budget reflect offsetting downward revisions in producer subsidies and turnover taxes.

Table 10. Hungary: Consolidated Monetary Survey

(In billions of forint, end of period)

	1980	1981				1982				1983			
	IV	I	II	III	IV	I	II	III	IV	I	II 1/	III 1/	IV 1/
Domestic credit	603.5	611.9	630.8	645.4	657.0	660.8	678.0	685.7	697.0	708.6	716.1	732.1	734.5
Claims on state budget (net) 2/	10.3	6.7	11.0	13.3	19.2	10.8	23.6	22.5	29.3	23.9	28.4	33.1	34.5
Claims on enterprises, etc. 3/	486.0	497.3	509.1	514.8	517.9	528.8	528.6	532.8	534.1	548.5	547.4	550.2	548.0
Claims on households	107.2	107.9	110.7	117.3	119.9	121.2	123.8	130.4	133.6	136.2	140.3	148.8	152.0
Money	155.3	154.3	154.7	152.3	167.0	156.9	158.3	160.1	183.0	166.8	167.7	173.3	190.0
Currency in circulation	72.8	74.8	74.3	73.6	81.3	80.0	82.8	85.4	87.3	87.6	93.6	93.0	94.6
Demand deposits of households	4.5	4.9	5.1	5.5	5.8	6.3	6.7	7.1	8.2	8.4	8.9	9.4	10.1
Current accounts of enterprises 4/	67.4	67.2	64.7	62.6	69.4	60.6	59.1	62.0	76.6	60.1	53.3	59.9	73.9
Unfinished settlements	10.6	7.4	10.6	10.6	10.5	10.0	9.7	5.6	10.9	10.7	11.9	11.0	11.4
Quasi-money	186.8	193.6	192.8	192.2	198.1	205.5	208.2	204.9	204.6	211.4	212.3	211.0	216.2
Households	136.6	140.7	141.1	141.7	147.9	152.5	153.4	154.1	159.4	165.7	165.3	164.8	171.2
Enterprises	50.2	52.9	51.7	50.5	50.2	53.0	54.8	50.8	45.2	45.7	47.0	46.2	45.0
Savings bonds	4.2	5.2	5.6	5.9	6.4	7.3	7.6	7.9	8.2	9.0	9.4	9.5	10.3
Enterprise reserve funds 5/	38.3	39.0	40.7	40.5	40.0	45.8	51.7	53.7	55.2	35.2	36.9	39.7	42.0
Frozen development funds	--	--	--	--	--	--	--	--	--	3.1	5.9	7.6	9.0
Net foreign liabilities 6/	209.9	192.5	209.9	219.9	224.1	227.8	226.9	244.2	237.5	256.0	256.4	253.0	242.1
Other items (net) (by difference) 5/6/	9.0	27.3	27.1	34.6	21.4	17.5	25.2	14.9	8.5	27.1	27.5	38.0	24.9

Sources: National Bank of Hungary and staff estimates.

1/ Projected.
2/ Claims of the National Bank of Hungary and the Central Exchange and Credit Bank.
3/ Includes real estate investment and a small and relatively stable amount of credit extended by the Foreign Trade Bank, in addition to the claims of the National Bank of Hungary (direct claims plus refinancing credits extended to the State Development Bank).
4/ Including forint cover deposits against imports (Ft 24.7 billion at the end of 1981; Ft 45.9 billion at the end of 1982; and Ft 26.1 billion at end of 1983).
5/ Figures for 1983 reflect estimated transfers of Ft 19 billion of enterprise reserve funds to the National Bank in connection with the settlement of currency valuation changes.
6/ Projections are based on exchange rates prevailing on April 8, 1983.

On January 1, 1984, the interest rate on loans by the State Development Bank will be raised to 14 per cent, with an estimated annual cost to the enterprise sector of Ft 1-1.3 billion. On that date, the existing preferential interest rates and interest rebates also are expected to be eliminated (partly through conversion into outright subsidies from the state budget), thereby completing the unification of the interest rate structure.

Further, enterprise liquidity is being cut by Ft 10 billion, through estimated withdrawals of Ft 9 billion and Ft 1 billion, respectively, for development funds and working capital funds. The latter withdrawal is concentrated on enterprises carrying excessive inventories. In addition, in order to offset the accumulated losses from official exchange rate adjustments in the balance sheet of the National Bank of Hungary, enterprise reserve funds accumulated before 1980 have been debited retroactively to end-March by an equivalent amount, estimated at about Ft 19 billion. No compensation through National Bank credits is foreseen for these withdrawals.

The authorities also consider it desirable--in conjunction with the policy adjustments now being made--to lower the credit targets for 1983. Domestic credit extended by the banking system had originally been programmed to rise by 5.8 per cent from end-1982 to end-1983. The new target contemplates a growth rate of 5.4 per cent (Table 10). The target for the growth of broad money in 1983 has been almost halved from 9.3 per cent to 5.2 per cent. Given the projected rise in nominal GDP of 5.9 per cent, conformance with that target would be consistent with the continuation of the recent upward trend of velocity of broad money (Table 11).

Table 11. Hungary: Income Velocity of Money 1/

	Currency	Money	Broad Money 2/
1977	11.44	4.96	2.20
1978	11.00	5.03	2.18
1979	11.13	4.91	2.22
1980	9.71	4.55	2.04
1981	9.58	4.66	2.10
1982	9.67 3/	4.61	2.13
1983	9.43	4.70	2.14

Sources: National Bank of Hungary; and staff estimates.

1/ Defined as the ratio of nominal GDP to money, using end-year money stocks.
2/ Includes savings bonds.
3/ The increase reflects a smaller-than-usual end-year prepayment of wages and larger-than-usual end-year consumer spending associated with the more-than-seasonal increases in imports of consumer goods.

The downward revision of the target for the broad money supply largely reflects changes in the enterprise sector's liquidity position, notably the reduction in enterprise development and working capital funds. Furthermore, enterprise deposits are expected to be lower than forecast originally because advance deposits for imports will be lower, and other deposit components have been reduced by the additional restraint measures. Further, although profits in 1982 were higher than expected, their skewed distribution across industries actually permits greater withdrawals from, compared with replenishments of, enterprise reserve funds this year. In total, enterprise deposits--including reserve funds, which do not constitute part of broad money--are now forecast to decline by 10 per cent in 1983 in contrast with the originally projected 16 per cent increase. The additional monetary restraint is consistent with a downward revision of the end-1983 target for net domestic assets of the National Bank by 1.4 per cent compared with the original program (Table 12).

4. Outlook for domestic demand and activity

The measures now being adopted, together with those implemented earlier in the year, are expected to bring economic developments in 1983 back into line with the earlier forecasts (Table 13).

The combined effect of the price and incomes policy measures and the efforts to raise the propensity to save is expected to reduce private consumption expenditures in 1983 by 0.9 per cent below current trends, thereby restoring the targeted 2 per cent fall in real terms that had been projected originally.

On the basis of the restraint on state investment and the measures designed to increase the cost and to reduce the availability of funds, gross fixed investment is projected to fall at least by 6.7 per cent in real terms in 1983 over 1982. The entire adjustment is concentrated in the socialist sector, where fixed investment is scheduled to fall by 9 1/2 per cent, whereas investment in the private sector is expected to grow by 12 1/2 per cent in real terms. Should further measures to restrain fixed capital formation prove necessary, the authorities stand ready to increase the tax on new investments, and to freeze both enterprise deposits in proportion to the stock of their unfinished investments and the unutilized investment funds of local councils.

The largely unanticipated accumulation of inventories in the latter part of 1982, mainly stemming from the exceptionally good harvests and from advance deliveries of petroleum from the U.S.S.R., is expected to be reversed in the course of 1983. This reversal will be realized in part through the withdrawal of working capital funds from enterprises and the reduction of access to working capital credits. The resulting fall in stockbuilding, in real terms, coupled with the drop in fixed investment expenditures is expected to lower the ratio of domestic capital formation to GDP to 24.7 per cent in 1983, from 26.7 per cent in 1982 and 29.7 per cent in 1981.

Table 12. Hungary: Net Domestic Assets of the National Bank

(In billions of forint; end of period)

	Actual						Projected		
	IV 1980	II 1981	IV 1981	II 1982	IV 1982	I 1983	II 1983	III 1983	IV 1983
I. Net foreign liabilities in convertible currencies 1/	148.1 2/	138.9	166.5	169.8	164.0	167.0	163.3	159.6	156.4
II. Currency in circulation	72.8	74.3	81.3	82.8	87.3	87.6	93.6	93.0	94.6
III. Net domestic assets (I + II)	220.8	213.2	247.8	252.6	251.3	254.6	256.9	252.6	251.0
IV. Assets	452.1	474.2	490.6	507.0	509.1	516.1	522.2	524.0	525.2
Net credit to the state budget	10.3	11.0	19.2	23.6	22.1	16.7	21.2	20.7	22.1
Investment credits	119.0	115.0	122.7	115.2	120.6	112.4	113.9	115.7	120.0
Working capital credits	161.7	180.4	170.6	190.9	179.4	202.2	200.4	199.2	188.0
Refinancing credits, etc.	161.1	167.8	178.1	177.3	187.0	184.8	186.7	188.4	195.1
V. Liabilities	231.4	260.9	242.8	254.4	257.8	261.5	265.3	271.4	274.2
Enterprise reserve funds 3/4/	38.3	40.7	40.0	51.7	48.0	28.0	29.7	27.3	29.6
Frozen development funds	--	--	--	--	--	3.1	5.9	7.6	9.0
Other funds of enterprises	117.6	116.4	119.6	113.9	121.8	105.8	100.3	106.1	118.9
Deposits by other financial institutions 5/	55.5	66.9	66.1	70.8	73.0	77.1	73.9	72.3	73.7
Net foreign liabilities in nonconvertible currencies	9.9 2/	19.1	4.8	8.0	2.9	14.0	16.3	17.1	5.9
Unclassified liabilities (net) 1/ 4/	10.1	17.8	12.3	10.0	12.1	33.5	37.2	41.0	37.1
Memorandum items:									
Net foreign liabilities of specialized banks in convertible currency 1/	37.4 2/	49.1	50.6	44.9	43.9	43.1	42.0	41.5	41.9
CECB claims on state budget	--	--	--	--	7.2	7.2	7.2	12.4	12.4
National Savings Bank									
Credit to households	107.2	110.7	119.9	123.8	133.6	136.2	140.3	148.8	152.0
Deposits of households	145.3	151.8	160.1	167.7	175.8	183.1	183.6	183.7	191.6

Sources: National Bank of Hungary and staff estimates.

1/ Figures for 1982 and 1983 are based on the exchange rates prevailing at the end of June 1982.
2/ Partly estimated by Fund staff.
3/ Beginning June 1982, data relate to the funds redeposited by the CECB and exclude the amount of enterprise reserve funds on-lent to the state budget by the CECB (see memorandum item).
4/ Figures for 1983 reflect estimated transfers of Ft 19 billion of enterprise reserve funds to the National Bank in connection with the settlement of currency valuation changes.
5/ Excluding enterprise reserve funds redeposited by the CECB.

Table 13. Hungary: Macroeconomic Variables Programmed for 1983

(Percentage changes, millions of U.S. dollars, and billions of forint)

	1983 Program	
	Original	Revised
	(Percentage changes in volumes)	
Consumer expenditure	-2.2-(-1.7)	-2.0
Government current expenditure	-5.6-(-3.5)	-0.7
Gross fixed investment	-7.5-(-6.3)	-6.7
Final domestic demand	-4.0-(-3.1)	-3.1
Stockbuilding (in per cent of GDP in 1982)	--	-0.4
Domestic demand	-4.0-3.0	-3.5
Exports of goods and services	6.7-6.5	6.0
Imports of goods and services	-1.8-(-1.3)	-1.5
Foreign balance (in per cent of GDP in 1982)	3.4-3.1	3.0
GDP	-0.4-0.2	-0.4
	(Percentage changes in values)	
Disposable income of households	5.7-6.3	5.7
Of which: Wages and related incomes 1/	4.0	3.1
	(In millions of U.S. dollars)	
Current balance target, convertible currencies	600	600
	(In billions of forint)	
Budget deficit	8.0-9.0	6.0
Domestic credit, end period	744.9	734.5
Of which: State budget	41.6	34.5

Sources: EBS/82/206 (11/10/82) and staff estimates.

1/ Excluding agricultural cooperatives.

On the basis of the strengthened restraint program, total domestic demand, in real terms, is estimated to fall by 3.5 per cent in 1983 over 1982, as targeted. As the resources freed by the fall in domestic demand are expected largely to be shifted to the foreign balance, the projected fall in real GDP in 1983 is likely to be limited to less than 1/2 of 1 per cent (Table 14).

5. Balance of payments outlook and policies

a. 1983

With the strengthening of the adjustment program, the targeted improvement in the external current balance for 1983 is largely expected to be achieved, although the revised official projections anticipate a current account surplus in convertible currencies of US$500 million, compared with the original target of US$600 million (Table 15). The smaller projected surplus reflects mainly the very weak prices realized for exports during the first two months of 1983; for the year as a whole, the authorities project export and import prices in U.S. dollars for nonruble trade to decline by 5 per cent and 3 per cent, respectively, resulting in a further deterioration in the terms of trade by 1.5 percentage points. Less conservative price projections for the remainder of 1983, consistent with staff projections prepared for the recent World Economic Outlook, would tend to bring the trade and current account surpluses much closer to the original targets. 1/

On the more conservative basis, convertible currency receipts from exports (balance of payments basis) are projected to increase only slightly in 1983--some US$330 million less than forecast originally--largely as a result of a further marked volume increase (4.5 per cent). The shortfall in export receipts is now projected to be partly offset by a US$250 million downward revision of import payments in convertible currencies, mainly owing to softer prices, but also because the removal of the import restrictions introduced in 1982 is to be postponed beyond the end of this year. Weaker domestic demand, higher domestic currency prices, and the maintenance of the import restrictions are expected to bring about a decline in the volume of nonruble imports of 6.0 per cent between 1982 and 1983.

The deficit foreseen on current services and transfers, at US$550 million, remains in line with original expectations. The deficit on investment income will likely be larger than envisaged, because a greater-than-expected share of liabilities appears to have been contracted, or is being rolled over, in U.S. dollars, thus raising interest payments. But this larger deficit is expected to be offset by a larger surplus of other current receipts.

1/ Since the trade balance is in surplus, proportionately higher export and import prices would result in a wider surplus, even without assuming a more favorable performance in respect of terms of trade developments.

Table 14. Hungary: Gross Domestic Product

(In billions of forint, deflators 1981 = 100)

	1981: At 1981 comparable/current prices 1/	1982: At 1981 prices	1982: At current prices	1982: Deflator 2/	1983 3/: At 1981 prices	1983 3/: At current prices	1983 3/: Deflator
Consumers expenditure	479.7/477.7	485.1	514.5	106.1	475.5	542.8	114.2
Percentage change	...	1.1	7.7	6.5	-2.0	5.5	7.6
Government current expenditure	79.6/79.1	81.1	83.4	102.8	80.5	86.5	107.5
Percentage change	...	1.8	5.4	3.5	-0.7	3.8	4.6
Gross fixed investment	206.7	201.0	211.4	105.2	187.6	206.8	110.2
Percentage change	...	-2.8	2.3	5.2	-6.7	-2.2	4.8
Final domestic demand	766.0/763.5	767.2	809.3	105.5	743.6	836.1	112.4
Percentage change	...	0.2	6.0	5.8	-3.1	3.3	6.6
Stockbuilding	14.8/24.6	10.5	26.8	...	7.0	34.6	...
Percentage contribution to GDP growth	...	-0.6	0.3	...	-0.4	0.9	...
Domestic demand	780.8/788.1	777.7	836.1	107.5	750.6	870.7	116.0
Percentage change	...	-0.4	6.1	6.5	-3.5	4.1	7.9
Exports of goods and services	308.2	319.1	321.8	100.9	338.2	358.3	105.9
Percentage change	...	3.5	4.6	0.9	6.0	11.3	5.0
Imports of goods and services	316.4	304.5	315.0	103.5	299.9	336.8	112.3
Percentage change	...	-3.8	-0.4	3.5	-1.5	6.9	8.5
Foreign balance	-8.2	14.6	6.8	...	38.3	21.5	...
Percentage contribution to GDP growth	...	3.0	1.8	...	3.0	1.7	...
GDP	772.6/779.9	792.3	842.9	106.4	788.9	892.2	113.1
Percentage change	...	2.5	8.1	5.4	-0.4	5.9	6.3

Sources: Data provided by Hungarian authorities and staff estimates.

1/ Values at current prices for items including depreciation on capital and for stockbuilding are different from values at "comparable" 1981 prices because in current price data fixed capital and stocks are valued at acquisition costs instead of replacement costs.

2/ Percentage changes in deflators consistent with changes in volumes and values of aggregates are different from deflator indices where "comparable" and current price data for 1981 are different.

3/ Projection.

Table 15. Hungary: Balance of Payments in Convertible Currencies, 1981-1984

(In millions of U.S. dollars)

	1981	1982	1983 Original proj.	1983 Revised proj.	1984
Exports	4,877	4,876	5,252	4,920	5,357
Imports	-4,432	-4,110	-4,110	-3,858	-4,197
Trade balance	445	766	1,142	1,062	1,160
Freight and insurance (net)	-216	-220	-210	-205	-220
Travel (net)	133	176	240	206	230
Investment income (net)	-1,100	-976	-580	-669	-650
Government expenditure (net)	-47	-45	-48	-47	-50
Other current receipts (net)	11	89	--	105	100
Unrequited transfers (net)	47	61	56	48	50
Current balance	-727	-149	600	500	620
Medium- and long-term capital					
Export financing (net)	-104	-192	-64	-97	-100
Other	617	260	-357	-392	-590
Inflows	(1,443)	(1,154)	(579)	(613)	(1,020)
Outflows	(-826)	(-894)	(-936)	(-1,005)	(-1,610)
Short-term capital					
Export financing (net)	31	-161	-53	-185	-145
Other (net) 1/	-348	-912	8	-347	100
Overall balance	-531	-1,154	134	-521	-115
Monetary movements					
Monetary gold (increase -)	177	383	...	-164	...
Foreign exchange (increase -)	354	536	-500	319	...
Use of Fund resources 2/	--	235	366	366	...

Sources: National Bank of Hungary; and staff estimates.

1/ Includes errors and omissions.
2/ Includes drawing of SDR 72 million under CFF in December 1982.

In contrast to the expected performance on current account, a substantially larger deficit on account of capital transactions is now projected for 1983. In part, the larger deficit reflects the reversal of the capital inflows that helped bolster the reserve position in late 1982. But significantly larger outflows are forecast now for short- and medium-term export financing, reflecting efforts to meet, at least partially, credit terms extended by other suppliers and also increasing delays in receipts from certain buyers. Other important factors include the continuation into early 1983, albeit on a lesser scale than in 1982, of withdrawals of maturing deposits by some banks, and larger amortization payments on medium- and long-term debt as the terms on loans contracted during the second half of 1982 were somewhat less favorable than had been anticipated. Gross official reserves in convertible currencies are projected to decline to US$0.8 billion by the end of 1983, equivalent to 2.5 months of imports, from US$1.1 billion at the end of 1982.

b. 1984 and beyond

A key feature of the balance of payments outlook beyond 1983 is the large increase in debt service payments in convertible currencies in 1984, which reflects a bunching of maturities of medium- and long-term debt (Table 16). The amortization schedule of medium- and long-term debt in convertible currencies as of end-1982 already shows an increase in payments due of US$465 million in 1984. When repayments of debt contracted this year are taken into account, amortization payments in 1984 are further increased to US$0.6 billion. Accordingly, the debt service ratio in convertible currencies, which is expected to decline from 32.5 per cent in 1982 to 30 per cent in 1983, is projected to rise sharply to 37 per cent in 1984, although it should fall back to about 33 per cent by 1985. Despite the projected steady decline in the stock of outstanding external debt, the gross borrowing requirement will rise until 1985, when, in the absence of a further worsening of the terms on which new debt is contracted, it should stabilize.

c. Restrictions

In addition to the various measures introduced from early 1982 with a view to achieving a lasting improvement of the external payments position, and while these measures were taking effect, the authorities adopted, effective September 1982, temporary measures to restrict imports. Imports of several primary products were made subject to restrictions, and imports of component parts became subject to a 20 per cent surcharge. In addition, all applications for import licenses were made subject to discretionary approval. Consistent with the intention of the authorities to remove these restrictions gradually, the quota and import licensing restrictions were eased partially effective January 1, 1983: the proportion of imports subject to quotas in 1983 was reduced by about 20 per cent compared to 1982, and importers handling large and frequent transactions were exempted from the discretionary individual licensing requirement introduced in September 1982, subject to prespecified quarterly limits

Table 16. Hungary: Medium-term Debt Analysis in Convertible Currencies, 1982-1986

(In millions of U.S. dollars)

	1982	Projected 1983	1984	1985	1986
Debt service payments					
Payments on existing debt					
Interest 1/	1,000	714	598	443	331
Of which: IMF					
Amortization	894	1,005	1,470	1,355	936
Of which: IMF	(--)	(--)	(--)	(--)	(103)
Payments on new borrowings 2/					
Interest	--	51	152	248	319
Amortization	--	--	140	251	784
Total	1,894	1,770	2,360	2,297	2,370
Total debt service payments/ exports of goods and services	32.5	30.1	37.1	33.5	32.5
Balance of payments					
Current account	-149	500	620	675	800
Exports of goods and services	5,819	5,877	6,358	6,862	7,300
Imports of goods and services	5,968	5,377	5,738	6,187	6,500
Of which: Interest payments	(1,000)	(765)	(750)	(691)	(650)
Capital account	-1,012	-1,078	-735	-525	-550
Of which: Gross borrowings	(1,154)	(613)	(1,020)	(1,221)	(1,217)
IMF (net)	235	366	--	--	-103
Gross reserves (months of imports)	3.2	2.5	2.0	2.2	2.4
Memorandum items:					
Debt outstanding (end of period)	7,715	7,299	6,809	6,509	6,106
Of which: IMF	(235)	(601)	(601)	(601)	(498)

Sources: National Bank of Hungary; and staff estimates.

1/ Includes interest on short-term debt.
2/ Average interest rate: 10.4 per cent. Average maturity, six years, including one year grace period.

in relation to 1981 imports. 1/ The value and volume of imports subject to the quota and surcharge restrictions are shown in Table 17. While the authorities intended to remove these restrictions fully during 1983, unfavorable developments on the capital account in early 1983 and prospects for the remainder of the year have made it unlikely that this timetable will be met. The authorities remain concerned about the negative effects of these restrictions on the efficiency of resource use and intend to eliminate them as soon as possible. Accordingly, a new deadline to eliminate these restrictions in 1984 has been adopted.

IV. Performance Under the Stand-By Arrangement and Performance Criteria for the Second Half of 1983

All performance criteria were met through March 31, 1983. The following quantitative performance criteria, which are specified in Table 18, will apply for the remaining period of the stand-by arrangement:

(1) limits on the net domestic assets of the National Bank of Hungary through December 31, 1983;

(2) a limit on net credit from the banking system to the state budget through December 31, 1983;

(3) a limit on net foreign liabilities in convertible currencies of the specialized financial institutions through December 31, 1983; and

(4) a limit on the contracting of new foreign debt in convertible currencies by the nonbanking sector.

The customary provisions regarding the exchange and trade system will continue to apply.

1/ Reference limits for individual importers for 1983 as a whole were set at 94.7 per cent, on average, of 1981 imports. Quarterly limits, below which imports are exempted from the individual licensing requirement, were set at 17.5 per cent of the annual reference limit for the first quarter and 18 per cent for the second quarter.

Table 17. Hungary: Import Restrictions Introduced September 1982

	Imports 1981	Imports 1982	Quota 1/	Imports 1981	Imports 1982	Quota 2/
	Volume (tons)			Value (millions of forint)		
Imports subject to quotas						
1982 quotas						
Iron ore	339,600	228,000	290,000	623.8	...	...
Asbestos, long fibred	2,627	4,500	4,500	78.0	...	...
Caustic soda, solid	4,443	7,000	5,000	54.0	...	...
Organic chemical basic material	...	...	...	1,654.5	1,594.0	1,680.0
Aliphatic ketones, aldehydes acids	...	...	...	1,091.8	944.0	1,050.0
Aniline colors, auxiliary chemical materials for the textile, leather and fur industries	...	...	...	1,719.2	1,608.0	2,000.0
Natural rubber	14,238	12,000	13,000	715.3	...	...
PVC	9,397	8,000	8,000	321.4	...	...
Plastic basic materials 3/	...	...	...	2,587.0	2,611.0	2,300.0
Zinc oxide, titanium dioxide and litophone	18,163	17,000	13,000	640.9	...	...
Cellulose based silk	6,845	6,000	6,700	1,023.0	...	...
Fibrous semifinished product for the paper industry	92,619	93,000	95,000	1,631.4	...	...
Paper and cardboard	88,939	96,000	95,000	2,239.0	...	...
Raw cotton	25,167	14,000	16,700	1,722.0	...	...
Rawhide	24,565	28,000	25,000	1,369.9	...	...
Protein fodder of the vegetable oil industry/soya meal	597,913	565,000	600,000	6,871.9	...	...
Husked rice	19,223	13,000	11,000	342.5	...	...
Total	...	...	...	24,685.6	...	...
1983 quotas						
Office equipment requisites	...	...	...	200.0	150.0	120.0
Aniline colors, auxiliary chemical materials for the textile, leather and fur industries	...	...	...	1,719.0	1,603.8	2,000.0
Motor vehicle tires (thousand units)	263	174	75	392.0	...	...
PVC powder and hard granules	9,400	8,000	8,000	321.0	...	...
Polystyrene and styrene capoliners	16,500	18,000	16,000	686.0	...	...
Fertilizers--nitrogene	--	9,000	12,000	--	...	...
phosphore	88,300	138,000	140,000	1,716.0	...	...
calcium	6,800	6,000	8,000	...	...	...
Plant protection chemicals	...	...	...	2,100.0	2,213.0	2,500.0
Paper and cardboard	88,939	74,100	98,000	2,232.0	...	...
Protein fodder of animal and vegetable origin	644,500	239,000	670,000	7,737.0	...	...
Fodder concentrate	6,200	7,000	5,000	156.0	...	...
Animal feed phosphate	72,400	73,000	75,000	901.0	...	...
Chemicals for feed	...	...	...	1,300.0	1,392.8	1,500.0
Total	...	...	...	19,460.0	...	...
Imports subject to surcharge	...	...	...	26,729.0	25,700.0	...

Source: Data provided by the Hungarian authorities.

1/ If quota specified in volume.
2/ If quota specified in value.
3/ Except PE, PP, PS, PTFE, PVC, and moulding powders.

Table 18. Hungary: Quantitative Performance Criteria

	Original Program					Revised Program		
	Dec. 31, 1982		Mar. 31, 1983		Dec. 31, 1983	June 30, 1983	Sept. 30, 1983	Dec. 31 1983
	Limits	Actual	Limits	Actual	Indicative limits	Limits	Limits	Limits
					(In billions of forint)			
Net domestic assets of National Bank of Hungary	261.5	251.3	255.0	254.6	(255.0)	256.9	252.6	251.0
Net bank credit to the State	32.5	30.1	28.0	23.9	(42.0)	28.4	33.1	34.5
					(In millions of U.S. dollars)			
Net foreign liabilities in convertible currencies of the specialized financial institutions	1,230	1,228	1,310	1,205	(1,330)	1,175	1,175	1,175
New foreign debt in convertible currencies by nonbank borrowers	...	0.2	50	0.2	(...)	...	...	50.2

Sources: EBS/82/206 (../../82); data provided by the Hungarian authorities; and Letter of Intent of May 9, 1983.

Table 19. Hungary: Summary of Program for 1983 Under Review of Stand-by Arrangement

1. Assumptions:

a. Real GDP growth: nil. Agricultural production: up 1-2 per cent. Consumer prices: up 8-8.5 per cent.

b. Growth of markets in the convertible currency area: 2 per cent; terms of trade deterioration: 1.6 per cent (trade in convertible currencies expressed in terms of the U.S. dollar) and 3 per cent (trade in nonconvertible currencies); interest rate on foreign debt 10.2 per cent; growth of receipts from tourism: 11.3 per cent; current account deficit in nonconvertible currencies: $175 million.

c. Ratio of money plus quasi-money to GDP: 0.455 (0.460 in 1982).

3. Principal elements:

a. Demand management: domestic demand down 3.5 per cent. Strict control of real incomes and investment. Stimulation of savings of private households. Taxation and freezing of investable resources of enterprises. Public consumption will decline in real terms.

b. Budget: budget deficit will be reduced in 1983 to the equivalent of 0.7 per cent of GDP, from 1.5 per cent in 1982, as a result of increases in direct taxes and indirect taxes net of subsidies and of restraint on other expenditures.

c. Money and credit: broad money to grow by 5.2 per cent and domestic credit by 5.4 per cent from end-1982 to end-1983. Limits on net domestic assets of the National Bank of Hungary and on bank credit to the State. Increases of interest rates on the stock of bank credit to enterprises at lower interest rates than currently applied on new loans.

d. Price and wage policies: wage awards to be reduced by raising taxes enterprises must pay on wage increases. Increases in pension fund contributions by employees. Virtual freeze on wages in the government sector. Reduction in the number of government controlled prices and in consumer price subsidies.

e. Exchange and trade system: more active use of exchange rate policy for balance of payments adjustment. Import restrictions introduced in September 1982 eased during program period and eliminated in 1984.

V. Staff Appraisal

The basic objective of the Hungarian authorities continues to be the achievement of a large and lasting improvement in the external current account in convertible currencies. Virtually all economic policy objectives remain subordinated to the determination of the authorities to continue to meet their debt obligations and to strengthen the external position sufficiently to allow the resumption of a stable growth path. Consistent with this objective, the authorities moved early this year to rein in domestic demand when the external balance target appeared to be in danger.

The additional measures set forth in the attached letter of intent and specified further later in May, are programmed to reduce domestic demand by the equivalent of an additional 3/4 per cent of GDP below what it would have been otherwise. This should be sufficient to bring the economy back onto the track foreseen in the original program. However, the balance in the economy is likely to be somewhat different from that originally envisaged, with enterprise incomes and investment lower than earlier expected and real disposable incomes of the population somewhat higher. The latter overshoot results entirely from faster growth of activity in the private sector, whereas wage developments in the socialist sector are projected actually to be slightly below those foreseen earlier. While the overrun in budget outlays for consumer price support runs counter to the intention to move to a relative price pattern that reflects supply and demand balances better than in the past, it is more than offset, from a demand management point of view, by increased revenues from consumer turnover taxes. The freeing of some retail prices from government control will help both to absorb excess incomes and to establish relative price patterns that are more in line with supply and demand than hitherto.

Even with the strengthened adjustment program, the external liquidity situation remains very tight. Accordingly, the Hungarian authorities have been forced to conclude that it would be beyond the bounds of prudence to lift during 1983 the remainder of the import restrictions that were imposed in 1982, as had initially been agreed. They now undertake to continue to reduce these restrictions gradually and to eliminate them entirely in the course of 1984. The achievement of the target of a US$600 million current account surplus in convertible currencies in 1983 clearly has become more difficult under current trading conditions. Nonetheless it still appears within reach, although the projections agreed with the Hungarian authorities, based on the measures spelled out in the letter of intent, only foresee a current account surplus of around US$500 million in convertible currencies. These estimates are based on fairly pessimistic official price projections and the use of price projections more in line with those developed in the Fund would bring the projected current account balance in convertible currencies close to the US$600 million goal.

Given the additional measures announced, the short-term adjustment objectives have a high probability of being achieved and the authorities stand ready to bolster their efforts if needed. The authorities have attempted to fashion their short-term adjustment measures in line with their medium-term economic goals. Thus, the actions on the exchange rate, interest rates, and the wage and price regulatory system, and the measures to increase both the propensity to save and the availability of financial instruments, will contribute to those objectives. However, the Hungarian authorities in 1982 were faced with the need to adopt a program that would pay off in the very short term. By its nature, such a program tends to include measures that cannot always be such as to contribute to the longer-term balance in the economy. Indeed, they often tend to be at odds with that aim as evidenced to a significant degree in the recent policy packages. Thus, successive steps taken to absorb liquidity from enterprises, while achieving their short-term objective, have tended increasingly to penalize the most vital elements of the economy. In particular, because of their unpredictability, they have interfered with rational decisionmaking and resource allocation. Similarly, continued reliance on the stricter import allocation system, instituted in 1982, is worrying. Such an allocation system, based on past import needs, does not ensure the most efficient use of scarce external resources. Indeed, it could lead to unwarranted stockbuilding, because it provides a great incentive to use allocations fully, and it could also lead to the establishment of a gray market.

The transition of the economy from its present position to a sustained growth path will require the phased relaxation of these short-term measures and their replacement by a number of institutional changes that will allow market stimulae to affect savings and investment decisions more directly. In this connection, the determination of the Hungarian authorities to accelerate their economic reform program is not only to be welcomed, but is quite essential, particularly as, on current reading, little easing of external payments pressures can be expected over the near to medium term.

The staff believes that the measures implemented to address the immediate difficulties are adequate and justify support from the Fund. Accordingly, the following draft decision is proposed for adoption by the Executive Board:

1. Hungary has consulted in accordance with paragraph 4(b) of the stand-by arrangement for Hungary (EBS/82/206, Sup. 2, 12/9/82) and paragraph 12(f) of the letter dated October 13, 1982 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, 1982 through January 7, 1984.

2. The letter dated May 9, 1983 from the Deputy Chairman of the Council of Ministers and the Vice-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 7, 1984 shall be annexed to the stand-by arrangement for Hungary, and the letter of October 13, 1982 shall be read as supplemented by the letter of May 9, 1983.

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 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota;

a. 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 11(a) of the annexed letter of May 9, 1983; or

(ii) the limit on net credit from the banking system to the state budget specified in paragraph 11(b) of the annexed letter of May 9, 1983; or

(iii) the limit on net foreign liabilities in convertible currencies of the specialized financial institutions specified in paragraph 11(c) of the annexed letter of May 9, 1983 has not been observed; or

b. if the limit on the contracting of new foreign debt in convertible currencies specified in paragraph 11(d) of the annexed letter of May 9, 1983 is not observed.

Budapest, May 9, 1983

Mr. J. de Larosière
Managing Director
International Monetary Fund
Washington, D. C.

Dear Mr. de Larosière,

1. On behalf of the Government of the Hungarian People's Republic, and in accordance with our letter of October 13, 1982, we are writing to you (a) to review economic policies and developments since the initiation of the current stand-by arrangement; and (b) to set out economic policy targets and instruments for the remaining period of the program and to propose ceilings on net domestic assets of the National Bank of Hungary, net credit to government, net foreign liabilities of the specialized financial institutions, and foreign debt.

2. The main objective of our stabilization efforts in 1982, a reduction of the current account deficit in convertible currencies by US$500-600 million was achieved. In fact, the actual outcome was at the upper end of this range as our deficit was reduced from over US$700 million in 1981 to just under US$150 million in 1982. In order to achieve this outcome, the rate of growth of final domestic demand, in real terms, fell from 0.9 per cent in 1981 to about zero in 1982.

3. As outlined in our letter of 1982, the central objective of our policy for 1983 is the achievement of further progress toward a sustainable balance in our external financial position. Specifically, our aim is to improve our current account position in convertible currencies in 1983 by around US$3/4 billion to a surplus of US$600 million. This target implies a swing in our external balance in convertible currencies equivalent to 5.6 per cent of 1983 GDP between 1981 and 1983. To achieve such a large swing in our external position, a significant reduction in domestic demand was considered necessary. Accordingly, policy aimed to decrease real cash incomes of the population by 3-3.5 per cent, to reduce total fixed investment in the socialist sector by 2-3.5 per cent in value terms, to reduce public consumption in real terms, and to cut the budget deficit to Ft 8 billion. Taken together, these developments were to result in a decline in domestic expenditures in constant prices of 3-4 per cent in 1983 as compared with 1982. To bring this outcome about, reliance was being placed on a wide range of policy instruments: wage policy in conjunction with price policy aimed at reducing real wages; budget policy was to be tightened, in particular, outlays for subsidies were to be reduced gradually and significantly; and credit policy was to curtail investment activity of both enterprises and the State. In addition, interest rates on housing loans and savings deposits were to be raised in order to contain household liquidity.

4. In the latter part of 1982 and the opening months of 1983, output--mainly in the agricultural sector--rose faster than expected, and the better supply situation went hand in hand with a faster-than-expected increase in the incomes of the population. This, in turn, has led to

higher consumption expenditures than had been programmed. In addition, government current expenditures, especially for subsidies, were higher than had been expected at the time of our October 1982 letter. The latter development reflected a larger rise in producer prices than had been foreseen, thus increasing the gap between consumer and producer prices despite cuts in subsidy rates; to some extent, this was associated with the fact that the effects of the devaluation of the forint have not yet been reflected fully in consumer prices. In addition, the rise in the volume of consumer expenditures associated with the higher incomes contributed to the rise in subsidy outlays. Fixed investment in the first quarter of 1983 also was stronger than projected, mainly as a result of a mild winter.

5. The greater-than-planned rise in demand, although coupled with a better-than-expected supply situation, comes at a time when competitive conditions in world markets are much harsher than foreseen. Accordingly, the good export performance of the Hungarian economy in volume terms is not being accompanied by a commensurate U.S. dollar return. World market prices for Hungarian products have been lower than had been expected and with competition keener, Hungary has had to reduce prices still further, because its external financial situation did not allow the extension of the generous credit terms some of its competitors were able to offer. Accordingly, the greater volume of output that is being achieved cannot be made available to ease the restraint on domestic absorption but rather must be applied to meeting the external balance aims.

6. Against the backdrop of a much more adverse trading environment than had been anticipated, the target of a current account surplus in convertible currencies of US$600 million in 1983 appeared to be endangered and, it seemed that the outcome could fall short of that goal by US$180-200 million. In order to correct the apparent shortfall from our central target, we moved promptly to implement measures, to keep the development of real domestic demand and of export revenues on the path of our economic program as formulated toward the end of 1982. These measures curtailed investment activity of both the State and enterprises by freezing a certain amount of their liquid funds, by tightening credit availability, and, in the case of enterprises, by forcing early redemption of outstanding investment credits. All in all, about Ft 4.5 billion in investable funds have been withdrawn in this manner, and only part of the early credit repayments are being re-lent by the National Bank of Hungary to the export sectors of the national economy and for the purpose of rational import substitution. In addition, in order to compensate for the larger-than-expected fall in export prices, we devalued the forint by 1 per cent on March 1, 1983 and by a further 3 per cent on April 8, 1983. The effects of these latest changes are to be reflected in consumer prices. We shall continue to pursue an active exchange rate policy as needed.

7. We consider, that these measures do not yet suffice to bring about a reasonable probability that our target of improving our external balance in convertible currencies by about US$700 million in 1983 can

be achieved. We therefore, are initiating measures that will reduce expenditures in 1983 by an additional Ft 7 billion, or 3/4 per cent of GDP, in order to keep domestic demand in line with our policy objectives.

a. Investment activity will be restrained further by:

(1) the unification of interest rates on investment credits, the cost of which to enterprises in the first year is estimated to amount to Ft 2-2 1/2 billion; the direct effect of this extra cost on export profits will be offset by a depreciation of the exchange rate of the forint estimated at approximately 3/4 percentage point;

(2) enterprise working capital funds will be withdrawn to the amount of Ft 1.2 billion in order to prevent excessive stock accumulation;

(3) state investment activity will be restrained further.

These measures will be in place before the end of June 1983. If further restraint is needed

(4) enterprise deposits will be frozen in proportion to their stock of unfinished investment and unutilized funds of local councils will be frozen.

b. In order to offset the larger-than-expected growth in consumer expenditures and to bring both consumer and government current expenditures back to trend, we will reduce incomes of the population by Ft 5 billion in 1983. This reduction will be accomplished by any one or any combination of the following measures:

(i) a reduction in the number of government administered prices;

(ii) a reduction in consumer price subsidies; such a reduction would incorporate an offset to the effect of lower-than-expected world market prices on the domestic price level, the effect of which is estimated so far to amount to about 0.5 per cent of the CPI;

(iii) a further devaluation of the forint, which will be allowed to be passed fully into consumer prices and export profits; it is understood that the approximate effect of a 1 percentage point devaluation of the forint vis-à-vis the currency basket translates into the equivalent of a reduction of disposable incomes of about Ft 1 3/4 billion. (This estimate reflects the full year effect; thus, devaluation by 1 percentage point effective June 1, 1983, for example, would reduce disposable incomes by about Ft 1 billion in 1983.)

(iv) a virtual freeze on wages in the government sector, which will reduce the increase in the projected wage bill for 1983 from 3.5 per cent to 3.1 per cent or by Ft 1 billion.

The measures noted under (i), (ii), and (iii) will be articulated by May 26, 1983 and depending on the choice of measures, those falling under (i), (iii), and (iv) would be implemented before the end of June, but any measures falling under (ii) would be implemented by mid-July 1983.

c. In order to promote the propensity to save, interest rates on fixed term household deposits will be raised. So as not to increase the call of the Saving Bank on National Bank credit, we are increasing lending rates to yield a commensurate amount. Further, we shall encourage greater purchase by households of communal bonds.

d. With the reduction in the budget deficit associated with measures such as (a) (iii) and (b) (iv) and possible action under (b) (ii) and the overall restraint on other budget expenditures the budget deficit will be reduced below the level as approved by the Parliament in December 1982, of Ft 10.2 billion, as well as below the target of Ft 8 billion, to Ft 6 billion. Attainment of this significant reduction in the budget deficit will require continuous strong efforts to restrain budget expenditures throughout the year. Accordingly, the State will not need to borrow from the National Bank in 1983. This reduction will not be offset by increased credit extension to the local authorities. Therefore, the credit restraint for government at all levels will allow credit extensions to other sectors to be restrained less than would otherwise be necessary.

e. In order to support the measures set out above, the National Bank of Hungary

(i) will follow credit policies aimed at holding the level of net domestic assets to no more than Ft 251.0 billion by the end of 1983, or Ft 4.2 billion below the indicative credit limit for end-1983 set out in the original program;

(ii) consistent with this, domestic credit of the banking system, which totaled Ft 697.0 billion at end-1982, will be no more than Ft 734.5 billion at end-1983 excluding credit extensions associated with the disbursements of the World Bank project loans;

(iii) in reducing total credit allocations below those earlier foreseen, the National Bank of Hungary will increase its efforts to curtail the flow of financial resources to inefficient enterprises and, in fact, will strengthen its moves to collect loans from such enterprises before they mature. The financial resources thus obtained will not be re-lent to the enterprise sector.

8. The additional measures indicated above are justified by the external situation which has been worse than earlier expected. The situation in 1984, given the rising maturity schedule for medium-term debt is not seen to be easier. Therefore, policy will need to aim for a further increase in the current account surplus in convertible currencies. Given the keen competition in world markets, this will not be easy to ensure, particularly

in view of the need to lift import restrictions before they, in turn, lead to distortions in the economy and a weakening of confidence in the forint. Accordingly, we will continue to pursue our policies of export promotion, rational use of imports, and restraint of domestic demand. The implementation of measures to keep the economy on the track foreseen in late 1982 will make the task of staying on track in 1984 that much easier.

9. The exceedingly tight external conditions persisting up to now and expected to persist through 1983, despite the notable success in our adjustment efforts, will not allow us this year to lift completely the import restrictions we imposed in late 1982. Nevertheless, steps were taken in early 1983 to ease these restrictions by reducing the trade coverage of imports subject to quotas and by reinstating the system of quasi-automatic licensing, up to specified limits, for large and frequent importers. We fully intend to continue to reduce these restrictions gradually and to eliminate them in 1984.

10. We noted in our letter of October 1982 that it was our intention in 1983 to pursue the continuing process of economic reform actively. We now endeavor to accelerate this process as we firmly believe that our adjustment efforts can be successful in the longer term only if supported by the more fundamental changes associated with the reform effort.

11. For the remaining period of the stand-by arrangement with the Fund, the following performance criteria are proposed:

a. net domestic assets of the National Bank of Hungary will not exceed Ft 256.9 billion on June 30, 1983; Ft 252.6 billion on September 30, 1983; and Ft 251.0 billion on December 31, 1983;

b. net credit to the state budget from the banking system will not exceed Ft 28.4 billion on June 30, 1983; Ft 33.1 billion on September 30, 1983; and Ft 34.5 billion on December 31, 1983;

c. net foreign liabilities in convertible currencies of the specialized financial institutions will not exceed US$1,175 million on June 30, 1983; US$1,175 million on September 30, 1983; and US$1,175 million on December 31, 1983;

d. in the nine months ending December 31, 1983, the contracting of new foreign debt in convertible currencies with an original maturity of one year and up to and including 12 years by borrowers other than those listed under a. and c. above, will be limited to the equivalent of US$50 million.

12. The Government of the Hungarian People's Republic believes the policy measures set out above to be adequate to meet the objectives of its economic program. We undertake to implement the measures set out above on or before the end of June 1983 and the measures yet to be specified before July 15, 1983. However, if further measures are needed,

the Government will move promptly to implement them. Hungary will consult with the Fund on the adoption of any such measures in accordance with the Fund's policies on such consultations. In addition, the Hungarian Government would welcome discussions with the Fund staff in the autumn of 1983 for the purpose of reviewing economic developments and the progress made toward the realization of our objectives.

Sincerely,

József Marjai
Deputy Chairman of the
Council of Ministers
Chairman of the Economic
Committee of the Government

János Fekete
Governor for the Fund on
behalf of the Hungarian
People's Republic

Hungary: Selected Economic and Financial Indicators, 1981-83

	1981	1982	Program 1983
	(Annual per cent changes, unless otherwise specified)		
National income and prices			
GDP at constant prices	2.9	2.5	-0.4
GDP deflator	5.2	5.4	6.3
Consumer prices	4.6	6.9	8.2
External sector (on the basis of U.S. dollars) 1/			
Exports, f.o.b.	-0.7	2.3	-0.2
Imports, c.i.f.	-1.0	-8.8	-8.5
Non-oil imports, c.i.f.	-1.0	-7.9	-10.7
Export volume	1.7	10.7	4.6
Import volume	3.6	-2.3	-5.5
Terms of trade (deterioration -)	2.2	-1.1	-1.6
Nominal effective exchange rate (depreciation -)	15.6	5.5	-6-7
Real effective exchange rate (depreciation -)	11.1	2.4	...
Government budget			
Revenue, excluding grants	11.7	2.7	7.4
Total expenditures	12.8	3.3	5.9
Money and credit			
Domestic credit	8.9	6.1	5.4
Government	86.4	52.6	17.8
Enterprises and households 2/	7.5	4.7	4.8
Money and quasi-money	6.7	6.2	4.0
Velocity (GDP relative to M1) 3/	4.67	4.61	4.7
Interest rate (annual rate, one year savings deposit)	5.0	5.0	7.0
Domestic credit as a share of M2 4/	15.6	11.0	9.7
	(In per cent of GDP)		
Overall public sector deficit 5/	1.7	2.0	1.1
Central Government budget deficit	1.2	1.5	0.7
Domestic bank financing	1.2	1.5	0.6
Gross domestic investment 6/	29.7	28.3	27.1
Gross domestic savings	28.6	29.6	29.5
External current account balance, including grants 1/	-3.2	-0.7	2.3
External debt 1/	38.7	32.9	31.2
Inclusive of use of Fund credit	38.7	33.5	34.1
Debt service ratio (in per cent of exports of goods and nonfactor services) 1/	35.0	33.0	31.1
Interest payments (in per cent of exports of goods and nonfactor services) 1/	19.3	17.4	13.5
	(In millions of SDRs, unless otherwise specified)		
Overall balance of payments 7/	-450	-1,045	-480
Gross official reserves (months of imports) 8/	5.4	3.6	3.1
External payments arrears	--	--	--

Sources: Central Statistical Office Statistical Yearbook; data provided by the Hungarian authorities; and staff estimates.

1/ Nonruble transactions for trade and convertible currencies for current account debt, debt service payments, and reserves.
2/ Including real estate investments.
3/ End-year stock figures.
4/ Percentage contribution to M2 growth.
5/ Includes local authorities and State Budget.
6/ Including stockbuilding.
7/ In convertible currency.
8/ Gold is valued at the price of US$226 per ounce.

Fund Relations with Hungary

Date of membership:	May 6, 1982
Quota:	SDR 375 million
Fund holdings of forint:	SDR 672.6 million (179.4 per cent of quota), which includes SDR 72.0 million (19.2 per cent of quota) under compensatory financing and SDR 93.2 million (24.9 per cent of quota) under enlarged access (as of April 30, 1983).
SDR holdings:	SDR 3.3 million
Exchange system:	The exchange rate of Hungary's currency, the forint, vis-à-vis the currencies of countries other than members of the Council of Mutual Economic Assistance, the People's Socialist Republic of Albania, and the Democratic People's Republic of Korea is linked to a weighted basket of nine currencies. As of April 30, 1982, the representative rate was Ft 41.6245 per U.S. dollar.
Article IV consultation:	Discussions were held in Budapest May 18-June 11, 1982. The staff report (SM/82/176, 8/25/82) was discussed by the Executive Board on December 8, 1982.