FOR AGENDA

EBS/84/144
Correction 1

CONFIDENTIAL

July 26, 1984

To: Members of the Executive Board

From: The Acting Secretary

Subject: Hungary - Staff Report for the Mid-Term Review Under Stand-By Arrangement

The following corrections have been made in EBS/84/144 (7/3/84):

Page 11, para. 3, lines 14-15: for "Indirect revenue effect..." read "In addition indirect taxes were raised with a revenue effect..."

Page 26, Table 11, under title: add "(In millions of U.S. dollars)"

Page 29, Table 13: for "(In billions of U.S. dollars)" read "(In millions of U.S. dollars)"

Page 44, Table 2, column 5, penultimate line: for "989.1" read "898.1"

Corrected pages are attached.

Att: (4)

However, net domestic credit in the first quarter once again overshot its target. This overshooting resulted mainly from a further increase in the pressure on enterprise liquidity as increased import deliveries, both under bilateral agreements and from the ruble area, absorbed deposits and caused arrears in enterprise contributions to the State lending and Intervention funds. Net domestic assets of the National Bank of Hungary in the first quarter of 1984 were fractionally below their program ceiling despite a lesser strengthening of the external current account in convertible currencies than had been projected. The smaller current account surplus was more than offset by a greater accumulation of foreign liabilities by the nonbanking sector than had been anticipated.

c. Public finance

The fiscal measures that squeezed enterprise liquidity in 1983, improved the budget balance and financed an accumulation of Ft 9.7 billion in the extrabudgetary State lending and Intervention funds. In 1983, the State budget itself recorded a deficit of Ft 1.7 billion (0.2 percent of GDP), significantly lower than the program forecast of Ft 6.0 billion (Annex Table 7). The improvement in public finances derived entirely from a buoyancy of revenues, as outlays, particularly on subsidies, exceeded program projections by a significant margin.

In the first quarter of 1984, the flow of revenues was strengthened further with a small increase in indirect taxation and the implementation of a 10 percentage point increase in the social security tax on wages, estimated to raise budgetary revenues by almost Ft 30 billion. The increase in social security contributions is motivated by the need both to narrow the gap between social security receipts and expenditures and to raise the cost of labor, so as to reduce the degree of labor hoarding in the economy. The underlying budget surplus was further increased by large reductions in consumer and producer price subsidies. These cuts were effected in two steps, the bulk being introduced in January when consumer price subsidies for meat, other basic foods, public catering, household energy, and construction materials were reduced. In toto, such measures taken to end-May are estimated to reduce budget outlays in 1984 to Ft 16.0 billion below actual outlays in 1983 (Table 6). In addition, indirect taxes were raised with a revenue effect in 1984 of Ft 2.6 billion; in an effort to streamline the tax system the number of indirect tax rates was reduced as was that applying to the so-called production taxes. The latter are designed to skim profits from high-yielding lines of business and have tended to discourage enterprises from entering new activities. Finally, the schedule of depreciation allowances was simplified through a marked reduction in the multiplicity of depreciation rates and the authorities are contemplating a reduction of the 40 percent tax on depreciation flows.

The revenue raising aspects of the 1984 State budget included fiscal adjustments that effectively nullified the effects on enterprise profitability of the 3 percent devaluation of the forint in February. Coincidentally with the devaluation, rebates of indirect taxation on exports

Table 6. Hungary: Consumer and Producer Subsidies in 1984

(In billions of forint)

	Consumer subsidies	Producer subsidies	Total
1983 outturn	66.6	29.0	95.6
Effect of January measures	(-13.0)	(-2.0)	(-15.0)
Effect of March measures	(-1.0)	(--)	(-1.0)
End-May position	52.6	27.0	79.6
Further measures	(-1.5)	(-2.5)	(-4.0)
1984 revised projection	51.1	24.5	75.6
Change from 1983	(-15.5)	(-4.5)	(-20.0)

Source: Ministry of Finance.

IV. Medium-Term Balance of Payments Outlook

Over the medium term, the authorities believe that the current account surplus in convertible currencies can be increased gradually to US$0.7 billion in 1988-89 (Table 11). Taking into account the bunching of maturities on medium- and long-term debt in the next several years and assuming that medium- and long-term gross borrowing is maintained at its present level, such a performance would make it possible to avoid too sharp a reduction of reserves, while achieving an orderly reduction of external debt (Table 12). Gross external debt in convertible currencies (including liabilities to the Fund) would be reduced on a cumulative basis by US$1.5 billion from end-1983 until end-1989, making it possible to reduce the debt service ratio gradually from nearly 40 percent in 1984 to 25 percent by 1989.

Key assumptions underlying these projections are: (1) increases of import and export prices for nonruble trade of 4 percent per year; (2) an average annual rate of increase of non-oil imports by trade partners of 5 percent; (3) an average rate of interest on external debt in convertible currencies of 10 percent, implying an average six-month LIBOR of 10.5 percent; and (4) the maintenance of incentives adequate to sustain and to ensure further small increases in the share of exportables in domestic production. Import projections are estimated to be consistent with rates of growth of GDP of 2-3 percent per year.

Several areas of uncertainty should be noted. First, a key constraint underlying the above projections is the need to achieve a concurrent strengthening of the external current account in nonconvertible currencies, as repayments on loans contracted to ease the transition to higher oil prices fall due. Indeed, this deficit is projected to be reduced from US$260 million in 1983 to US$50 million in 1984, reflecting a further strong increase in the volume of ruble exports. The speed with which the deficit is eliminated may affect the projected strengthening of the trade balance in convertible currencies. Second, the projections of the external current balance in convertible currencies are very sensitive to the assumptions for the terms of trade and for interest rates on international capital markets.

Third, the likely pattern of the improvement in the external current balance depends to a large extent on the nature and speed with which measures are introduced to improve the allocation of resources and domestic supply. Present projections assume that the investment share in GDP is maintained, with the improvement in the current balance resulting from stronger domestic savings. An accelerated economic reform program with higher investment and imports, could produce a smaller current account surplus in convertible currencies in 1985-86, while increasing the probability that higher current account surpluses can materialize in subsequent years. Under any circumstances, a growing nominal external surplus must remain a central policy objective if external debt is to decline to more acceptable levels. In the absence of such a decline, the associated rapid increase in gross borrowing requirements

Table 11. Hungary: Balance of Payments in Convertible Currencies, 1983-1989

(In millions of U.S. dollars)

	1983	1984	1985	1986	1987	1988	1989
Exports	4,848	4,994	5,180	5,600	5,990	6,409	6,857
Imports	-3,970	-3,916	-4,190	-4,510	-4,865	-5,257	-5,683
Trade balance	877	1,078	990	1,090	1,125	1,152	1,174
Services and transfers (net)	-580	-678	-540	-540	-505	-492	-474
Of which:							
Investment income (net)	(-662)	(-671)	(-640)	(-620)	(-580)	(-555)	(-525)
Current balance	297	400	450	550	620	660	700
Medium- and long-term capital							
Assets	-65	-100	-100	-110	-120	-130	-140
Liabilities	60	-309	-307	-236	-260	12	81
Inflows	(1,276)	(1,226)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)
Outflows	(-1,216)	(-1,535)	(-1,507)	(-1,436)	(-1,460)	(-1,188)	(-1,119)
Short-term capital							
Assets	-239	-80	-100	-105	-110	-115	-120
Liabilities	393	-487	100	100	100	100	100
Overall balance	446	-576	43	199	230	527	621
Monetary movements							
Monetary gold (increase -)	-368	49	...	...	...	...	...
Foreign exchange (increase -)	-430	77	-43	-56	58	-246	-435
Use of Fund resources	352	450	—	-143	-288	-281	-186
Memorandum items:							
Real growth rate (percent)							
GDP	0.8	0.2	1.5	2.5	2.6	2.6	2.6
Domestic expenditure	-1.7	-2.3	1.8	1.8	2.2	2.4	2.6
Ratios to GDP							
Investment	26.7	25.1	25.3	25.3	25.3	25.5	25.7
Domestic savings	28.7	29.4	29.3	29.9	30.3	30.6	30.8

Sources: Data provided by the Hungarian authorities; and staff estimates.

Table 13. Hungary: Quantitative Performance Criteria

	Dec. 31, 1983	March 31, 1984		June 30, 1984	Sept. 30, 1984	December 31, 1984	
	Actual	Actual	Limit	Limit	Limit	Limits	Indicative limits of original program
	(In billions of forint)						
Net domestic assets of National Bank of Hungary	261.7	261.4	262.0	262.5	264.0	260.0	256.2
Net bank credit to the State, under the understanding that no borrowing from the State Insurance Company will occur in 1984	28.9	22.5	22.5	19.8	16.4	11.0	19.1
Credit granted by State Development Bank	148.0	149.9	150.0	154.5	157.2	164.0	163.7
	(In millions of U.S. dollars)						
Net foreign liabilities in convertible currencies of specialized financial institutions	1,088	1,122.1	1,130	1,085	1,055	1,055	1,085
New long-term foreign debt in convertible currencies by nonbank borrowers	1.4	...	26.3	—	--	25.0	--
Total short-term debt in convertible currencies	2,123	1,680	1,350	1,500	1,550	1,600	1,600

Sources: EBS/83/268 (12/16/83): Letter of Intent of May 18, 1984, and data provided by Hungarian authorities.

V. Staff Appraisal

The mid-year review showed that the original program had been well suited to achieving the central objective of a US$400 million surplus on the external current account in convertible currencies in 1984. The measures set forth in the attached letter of intent, therefore, aim to correct for deviations from the program rather than attempt to chart new directions. These deviations stem from changes in the international environment and from a tendency for private sector incomes to be more buoyant than expected. Essentially the same problems had been apparent under Hungary's first stand-by arrangement and there has been a reluctance to take timely countermeasures, in part because the limited number of instruments available to the authorities at this time concentrates adjustment on investment, wages in the industrial sector, and prices of basic consumer goods. This continued concentration of the adjustment burden, as noted in previous reports, itself is creating some imbalances in the economy, while correcting others. In particular, the tendency for incomes to overrun the targets needs to be addressed directly and, during the remainder of the program, it will be necessary to ensure that overruns either not be repeated or be neutralized in a timely fashion. The authorities have argued that the generation of incomes in the private sector, of its nature, is paralleled by higher production. But experience shows that this does not occur forint-for-forint and that, in any event, there tends to be a mismatch between the structure of supply so generated and that of demand. Accordingly, the combination of measures agreed with the authorities aims to deal somewhat more directly with the sources of the deviation from target than hitherto and should reduce domestic absorption sufficiently to permit achievement of the external target.

To induce the desired response from households and enterprises, the present measures rely more on market processes than heretofore. In this respect, three elements are worth noting:

First, the early moves toward elimination of the import restrictions go some way toward re-establishing an import system that allocates resources more on the basis of price than on the basis of administrative guidance.

Second, the large overhang of both freely usable and conditional liquidity of enterprises appears to have been drained by the measures taken in late 1983 and early 1984. In the past this overhang had blunted the National Bank's efforts to tighten liquidity. Currently, the tight credit policy, together with the reduced ability to finance fixed investment and stock accumulation from own resources, has cut enterprise investment below expected levels, suggesting that such expenditures may finally have come under control. Accordingly, the removal of import restrictions can proceed without undue danger to the external target, so long as the monetary authorities remain vigilant in adhereing to their targets and the budgetary authorities curtail the financing of State investment as projected.

Table 1. Hungary: Selected Economic and Financial Indicators, 1982-84

	1982	1983	Revised program 1984
	(Annual percentage changes, unless otherwise specified)		
National income and prices			
GDP at constant prices	2.8	0.8	0.3
GDP deflator	5.7	5.1	5.6
Consumer prices	6.9	7.3	9.4
External sector (on the basis of U.S. dollars) 1/			
Exports, f.o.b.	-0.7	-5.0	3.9
Imports, c.i.f.	-11.8	-5.1	-1.3
Export volume	7.2	4.9	7.1
Import volume	-5.5	2.3	-2.1
Terms of trade (deterioration -)	-1.1	-2.4	-3.8
Nominal effective exchange rate (depreciation -)	7.4	-2.0	-2.4
Real effective exchange rate (depreciation -)	3.6	-4.2	-2.7
Government budget			
Revenue, excluding grants	2.8	12.1	3.9
Total expenditures	3.3	9.7	0.3
Money and credit			
Net domestic credit 2/	1.8	2.3	1.0
Domestic credit	6.1	5.3	4.4
Government	52.6	-1.4	-61.9
Enterprise and households, etc. 3/	4.8	5.6	7.1
Money and quasi-money	6.4	4.5	3.8
Velocity (GDP relative to M1) 4/	4.6	4.7	4.7
Interest rate (annual rate, over two-year term deposit)	5.0	5.0	8.0
Domestic credit as a share of M2 5/	11.0	9.6	8.0
	(In percent of GDP)		
Overall public sector balance 6/	-1.6	-0.3	2.0
Central Government budget balance	-1.4	-0.2	1.9
Domestic bank financing	1.2	--	-1.9
Gross domestic investment 7/	28.5	26.7	24.7
Gross domestic savings	29.3	28.7	27.7
External current account balance, including grants 1/	-0.3	1.5	1.9
External debt 1/	34.9	38.7	34.1
Inclusive of use of Fund credit	36.0	41.5	39.2
Debt service ratio (in percent of exports of goods, services and private transfers) 1/	32.7	34.2	39.2
Interest payments (in percent of exports of goods, services and private transfers) 1/	17.4	13.1	13.3
	(In millions of SDRs, unless otherwise specified)		
Overall balance of payments 8/	-961	477	-567
Gross official reserves (months of imports) 9/	3.6	5.6	5.4
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. Trade figures adjusted for increased re-exports since September 1982 (staff estimates).

2/ Excluding valuation effects.

3/ Including real estate investments.

4/ End-year stock figures.

5/ Percentage contribution to M2 growth.

6/ Includes State budget and local authorities' net borrowing from National Savings Bank.

7/ Including stockbuilding.

8/ In convertible currency.

9/ Gold is valued at the price of US$226 per ounce.

Table 2. Hungary: Gross Domestic Product, 1982-83

(In billions of forint, deflators 1981 = 100)

	Final 1982			Preliminary outturn 1983			Revised program 1984		
	At 1981 prices	At current prices	Deflators	At 1981 prices	At current prices	Deflators	At 1981 prices	At current prices	Deflators
Consumer expenditure	485.8	515.1	106.0	487.5	552.8	113.4	484.0	596.7	123.3
Percentage change	1.3	7.8	6.5	0.3	7.3	6.9	-0.7	7.9	8.7
Government current expenditure 1/	78.6	82.4	104.8	80.1	87.9	109.7	77.7	90.3	116.3
Percentage change	1.0	6.5	5.5	1.9	6.7	4.6	-3.0	2.7	6.1
Gross fixed investment 1/	205.2	215.7	105.1	194.3	217.7	112.0	179.4	213.5	119.0
Percentage change	-1.6	3.5	5.2	-5.3	0.9	6.6	-7.7	-1.9	6.2
Final domestic demand	769.6	813.2	105.7	761.9	858.4	112.7	741.1	900.5	121.5
Percentage change	0.5	6.5	6.0	-1.0	5.6	6.6	-2.7	4.9	7.8
Stockbuilding	10.3	27.9	...	4.7	22.1	...	8.0	21.0	...
Percentage contribution to GDP growth	-0.6	0.4	...	-0.7	-0.7	...	0.4	-0.1	...
Domestic demand	779.9	841.1	107.8	766.6	880.5	114.9	749.1	921.5	123.0
Percentage change	-0.1	6.7	6.8	-1.7	4.7	6.5	-2.3	-4.7	7.1
Exports of goods and services	319.1	321.8	100.9	341.1	361.0	105.8	361.7	398.2	110.1
Percentage change	3.5	4.6	0.9	6.9	12.2	4.9	6.0	10.3	4.0
Imports of goods and services	304.5	315.0	103.5	307.1	343.4	111.8	308.2	369.3	119.8
Percentage change	-3.8	-0.4	3.5	0.9	9.0	8.1	0.4	7.5	7.2
Foreign balance	14.6	6.8	...	34.0	17.6	...	53.5	28.9	...
Percentage contribution to GDP growth	3.0	1.8	...	2.4	1.3	...	2.4	1.3	...
GDP	794.5	847.9	106.7	800.6	898.1	112.2	802.7	950.4	118.4
Percentage change	2.8	8.7	5.7	0.8	5.9	5.1	0.3	5.8	5.6

Sources: Data provided by Hungarian authorities and staff estimates.

1/ After reclassification of expenditures for the reconstruction of roads and bridges from government current expenditure to fixed investment.