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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/156

10:00 a.m., December 8, 1982

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

Executive Directors	Alternate Executive Directors
	A. B. Diao, Temporary
	C. Taylor
J. de Groote	H. G. Schneider
	J. Delgadillo, Temporary
	C. Dallara
M. Finaish	T. Alhaimus
A. H. Habib	Jaafar A.
T. Hirao	T. Yamashita
R. K. Joyce	
	C. Robalino
G. Laske	G. Grosche
	L. Barbone, Temporary
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	
	J. L. Feito
J. Sigurdsson	
Zhang Z.	Wang E.

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

Also Present

I. Szalkai, Assistant General Manager, National Bank of Hungary. Asian Department: W. J. L. Evers, L. A. de Wulf, F. Le Gall. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, P. C. Hole, A. G. Mountford, B. Nivollet, A. Singh, J. Somogyi, S. M. Thakur. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; D. K. Palmer, Deputy Director; M. Allen, G. Belanger, H. W. Gerhard, M. Guitian, S. Kanesa-Thasan, E. B. Maciejewski, P. J. Quirk. External Relations Department: G. P. Newman. Fiscal Affairs Department: M. J. Fetherston. Legal Department: G. P. Nicoletopoulos Director; W. E. Holder. Research Department: L. U. Ecevit, N. M. Kaibni. Treasurer's Department: A. M. Al-Samarrie. Bureau of Statistics: A. G. Muirriagui, J. C. O'Connor. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: J. R. N. Almeida, C. J. Batliwalla, S. El-Khouri, M. A. Janjua, P. Kohnert, H.-S. Lee, P. D. Péroz. Assistants to Executive Directors: E. M. Ainley, H. Alaoui-Abdallaoui, H. Arias, M. Camara, L. E. J. Coene, T. A. Connors, R. J. J. Costa, G. Ercel, I. Fridriksson, G. Gomel, M. J. Kooymans, W. Moerke, V. K. S. Nair, Y. Okubo, J. Reddy, J. Schuijer, D. I. S. Shaw, P. S. Tjokronegoro, Zhang X.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Jaafar Ahmad, Alternate Executive Director, to the Board.

2. HUNGARIAN PEOPLE'S REPUBLIC - 1982 ARTICLE IV CONSULTATION, REQUEST FOR STAND-BY ARRANGEMENT, AND USE OF FUND RESOURCES - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1982 Article IV consultation with the Hungarian People's Republic (SM/82/176, 8/25/82; and Cor. 1, 12/1/82), together with requests for a 13-month stand-by arrangement in an amount equivalent to SDR 475 million (EBS/82/206, 11/10/82; and Sup. 1, 12/6/82) and for a purchase in an amount equivalent to SDR 72 million under the compensatory financing decision (EBS/82/205, 11/10/82; and Sup. 1, 12/6/82). They also had before them a report on recent economic developments in Hungary (SM/82/186, 9/17/82; Cor. 1, 12/1/82; and Cor. 2, 12/3/82).

Mr. Istvan Szalkai, Assistant General Manager of the National Bank of Hungary, was present.

The staff representative from the European Department made the following statement:

> Last September, when the negotiations on the stand-by arrangement before Executive Directors were taking place, the Hungarian authorities requested that some of their commitments and policy intentions be excluded from the letter of intent and conveyed separately and confidentially to the Managing Director. They were in the initial stages of formulating the plan and state budget for 1983 and needed time to get some of the key points of the program incorporated formally. The letter of intent does not, therefore, mention the program targets for cash incomes of the population and for investment, which the staff views as essential for the successful implementation of the program, nor their commitments on exchange rate policy and energy prices.
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> On the occasion of a recent visit to Hungary, the staff was pleased to find that rapid progress had been made in putting the program into place and in translating the commitments made in September into official targets for the 1983 plan and budget, although these have not yet been officially approved and released. In particular, the plan will fully reflect the commitments of a 3-4 per cent reduction in real domestic expenditure, of a 4-5 per cent decline in real wages, which is consistent with a decrease in cash incomes of the population in real terms of 3-3.5 per cent, and of a reduction of 2-3.5 per cent in gross fixed investment in the socialist sector in current prices (about 6.5-8 per cent in real terms). The budget is also expected to reflect the commitment

of a reduction in the deficit to Ft 8 billion in 1983. Finally, recent decisions on the exchange rate and energy prices, mentioned in the supplement to EBS/82/206, go beyond the commitments made in September. These are encouraging signs that the authorities are serious about their stabilization efforts and are determined to take additional measures if necessary to achieve the objectives of the program.

The main purpose of the recent staff visit, however, was to ascertain that payments arrears, which had emerged in mid-1982, would be fully eliminated by early December, to ensure that net domestic assets of the National Bank of Hungary were below the continuous ceiling for the fourth quarter of 1982, and to review progress in implementing the program. The staff mission found that arrears, which had reached a peak of about $200 million at mid-year, were down to less than $100 million at the end of October, less than $50 million at mid-November, and were in the process of being fully eliminated by end-November. Complete elimination of all arrears has been confirmed since. Net domestic assets at the end of October were below the ceiling. The latest information collected by the mission is included in the supplement to EBS/82/206.

Providing additional information, the staff representative said that the forint had been devalued by an additional 1 per cent on December 7, 1982. The decision on the 20 per cent increase in gasoline prices had been taken, effective December 4, 1982.

Mr. de Groote made the following statement:

The Hungarian authorities have greatly appreciated the open and constructive discussions on the Article IV consultation, as well as the subsequent negotiations which have culminated in today's request for a stand-by arrangement and a compensatory financing facility drawing. Those discussions were not always easy, since both parties were moving in unknown territory and thus naturally tended to display even more prudence than would have been needed under normal circumstances. Unfamiliarity with the basic transmission mechanism of the Hungarian economy, together with the need to act in the midst of a transition, led the staff to incorporate additional safeguards into the various adjustment measures, in order to further ensure that the program objectives would be achieved; at the same time, the staff found the options seriously narrowed by the sudden withdrawal of private bank funds from Hungary in the wake of the Polish crisis and other adverse financial circumstances.

The program submitted to the Fund introduces a new phase in an evolution that finds its origin in the introduction in 1968 of the New Economic Mechanism, a global strategy for gradual reform of the economy that is moving Hungary in the direction of a more decentralized, open economy in which regulated market mechanisms play an important role within a general socialist framework. One of the main purposes of the 1968 reform was to improve the level of consumption and the standard of living of the population. Substantial progress was initially achieved in this area, supported by favorable external conditions. In the second half of the 1970s, the level of consumption and investment was maintained through extensive foreign borrowing, despite adverse developments in foreign markets and increasing scarcity of labor and domestic resources. The reduced access to external borrowing in the early 1980s revealed the underlying weakness of an economy that had relied considerably on short-term borrowing, while maintaining a high level of domestic consumption. It is today the conviction of the authorities that the resulting balance of payments difficulties hinder the basic process of liberalization and threaten thereby the targeted improvement of the standard of living: in the absence of external financing, the achievement of a sustainable balance of payments situation can no longer be brought about by a mere acceleration in the pace of economic reform.

The authorities have, therefore, defined a new option, which should help safeguard the benefits of the liberalization once the adjustment to the new balance of payments conditions has been achieved. From my contacts with the major political leaders, and from their public declarations, I am convinced that there exists a consensus to maintain the process of liberalization while accepting the immediate necessity for transitional adjustment; that obviously amounts to postponing temporarily the objective of increasing the standard of living.

This combination of short-term constraints and long-term objectives explains why Hungary needs the use of Fund resources: the Government and the Hungarian Socialist Workers' Party, fully aware of the imperatives of the new situation, and building on the existing consensus that adjustment is needed, are determined to apply stringent policies, but the country needs financing through the transition period to avoid an excessive reliance on deflationary measures. The Fund's contribution is thus both timely and important, because it will permit the process of transformation of the economy to continue under present conditions of scarce external bank financing.

The relevance of the measures taken during the current adjustment period can only be appreciated against the background of the fundamental options regarding the process of liberalization. In some of their aspects, the present adjustment policies might in appearance contradict these options; in substance, these policies are intended to realize over time the very aims of the reform which are clearly spelled out in the resolution of May 7, 1966, of the Central Committee of the Hungarian Socialist Workers' Party, which is the basic document for the introduction of the "New Economic Mechanism." The conceptual framework of this system provides that:

- producers should be able to decide, within their own ambit, what and how much to produce and offer for sale, as well as where and how much of the necessary inputs to purchase;

- producers and users should be free to establish commercial or cooperative relationships; sellers and buyers should be free to agree on the conditions of sale, including, within the limits of governmental regulations, prices;

- buyers should be free to choose, within limits dictated by the national interest, between domestic and imported goods, and sellers should be free, within the same limitations, to choose between domestic and export markets.

To allow market mechanisms to work, firms were given more latitude in deciding on investments and hiring labor. Profits became the measure of a firm's success and the source of incentive payments and funds for new investments. As the logical complement to these moves, prices were liberalized in order to reflect the joint effect of production costs, valuation by the market, and state preferences. In a decentralized environment, the efficient allocation of resources through the price mechanism is predicated on the existence of effective competition. Establishing domestic competition thus required the breaking up of the existing industrial concentrations, and the active stimulation of cooperatives and small-scale private activities, while the development of foreign competition necessitated a liberalization of imports and, in view of the small size of the domestic market, a realistic exchange rate regime. Economic data from 1968 to 1973 bear vivid witness to the success of the new economic mechanism.

The subsequent reversal, from 1973 to 1978, of the trend toward decentralization should be seen as an attempt to protect the level of consumption by isolating Hungary from external disturbances caused by the inflationary boom of 1972 and 1973, the oil shock of 1973, and the recession that followed in 1974 and 1975, and to maintain the growth momentum by increased reliance on foreign borrowing. To shield Hungary from external price developments, export taxes and above all import subsidies were instituted. Hungary's domestic prices thus became increasingly insulated from the world market. Movements in producer prices were similarly prevented from affecting consumer prices. Reduced reliance on the price system opened the door to direct government intervention and limited the freedom of firms in making decisions.

The economic difficulties that ensued, both domestic and external, made it clear that this kind of regulation would not durably improve Hungary's economic performance, and led to the recognition that decentralization of decision making had to be resumed, that the profit motive had to be reintroduced, and that the price system had to be rationalized. With balance of payments difficulties regarded as a possible threat to the process of liberalization, the central role of exports in the process of economic growth received special emphasis. The need to let firms make decisions about all aspects of export activities and to reduce the scope of government preferences and of central investments was also recognized. These are the guiding principles underlying the new phase of reform introduced at the beginning of 1980, which took the process of liberalization beyond the stage reached in 1973.

The path followed by the Hungarian economy since the introduction of the New Economic Mechanism in 1968 has led, through periods of acceleration and deceleration, to the present existence of an economic system that combines, in a flexible manner, a large-scale socialist sector with cooperatives and small-scale activities. These are not parallel systems having independent existences, as in many other countries; they are, instead, the pragmatically orchestrated elements of a larger system in which they are all equally subject to the same set of market rules. The system is indeed guided by a decentralized decision-making process governing production, prices, and investments, while the public authorities reserve to themselves the setting of global macroeconomic guidelines with regard to savings and investment as well as the decisions with respect to the development of infrastructure, social investments, and large-scale investments. This unique system, which blends market elements with state preferences, has gradually developed its own internal coherence; it has succeeded in making available a wide range of goods and services unparalleled in the other East European countries and has helped to establish a highly developed agricultural and food-processing sector. Such an outcome would of course have been impossible without the existence of a high level of political consciousness growing out of a dialogue among all levels of Hungarian society, and a sophisticated process of consultations, in which the authorities' decisions are constantly discussed: there is a strong conviction in that society that bureaucracy is not the most efficient organizer of economic progress. That conviction was strengthened by the failure of the attempt, in the mid-1970s, to recentralize the economy; now, further liberalization is viewed in Hungary as the only option.

The Fund program's main objective is to ensure a $600 million convertible currency surplus in the current account of the balance of payments for 1983 after a reduction of the deficit by about $600 million in 1982. This represents a major adjustment, equivalent for that two-year period to about 6 per cent of GDP in 1981. The authorities are fully confident that the balance of payments objective for 1983 will be achieved, as already this year's current account deficit in convertible currencies is expected to be about $100 million instead of a projected $162 million. This overperformance is the result of continuous implementation of adjustment measures since the end of 1981, in line with the fundamental option of restoring and maintaining external balance, and it has given a strong incentive to go further on the path of adjustment in 1983.

It is the authorities' conviction that the present program, which relies heavily on demand management, is only an answer to the immediate problem of reduced access to external financing. The authorities are indeed concerned that the reduction in investment will have, in the medium term, an adverse impact on technical development and on the improvement of productivity, thereby affecting the competitiveness of Hungary's exports. The lack of potential for productivity increases in some sectors, particularly in those not related to exports, does not provide incentives for workers to compensate for their decrease in income by higher efficiency. A solution for Hungary's external equilibrium can therefore be seen only in a broader and dynamic framework, which would emphasize supply considerations, such as a more economic use of resources, a better management of enterprises, and a more decentralized capital allocation introducing new techniques such as bond financing. Along those lines some measures have been taken, and others are under consideration with the view of increasing Hungary's export capacity. In a letter that Mr. Marjai, Deputy Chairman of the Council of Ministers, addressed to me yesterday, he confirmed that the political authorities fully support this medium-term approach. Moreover, he stressed that reform in Hungary requires that the present restrictive policies for ensuring external equilibrium should be overtaken in due time by growth-oriented supply policies. It is in this area of medium-term structural adjustment, the fundamental option underlying the reform since 1979, that Hungary expects to develop further close collaboration with the Fund.

The present program rests on a substantial tightening of domestic demand and more particularly on a restraint of investment, which will be reduced by over 10 per cent in real terms from 1981 to 1983. The demand for credit by enterprises has therefore been limited by a more active use of interest rate policy, which has brought the real interest rate on loans to enterprises to about 9 per cent in the latter part of 1982; this leaves hardly any scope for further action on interest rates. Furthermore, to avoid evasion of the credit controls, the substantial liquidity surplus in the enterprise sector is being sterilized through different measures. Moreover, new investments are heavily taxed except for those in the export sector or those directed toward energy conservation. These actions on investments are supplemented by a reduction in private consumption to be accomplished by various price increases that raised the consumer price index to 9 per cent above its level a year ago, by reductions in subsidies, and by limitations on wage increases. Restraint on public consumption will also be supportive of the balance of payments.

As an additional safeguard, the staff has introduced a performance clause concerning the evolution of domestic absorption, which, by imposing direct control over the real cash incomes of the population and over investments in the socialist sector, would ensure that domestic demand develops as expected. This is the first time we have used this kind of performance criterion, and it constitutes a recognition that our traditional indirect means of controlling aggregate demand are not necessarily effective in this type of economy. That we can do it now is due to the exceptional quality and prompt availability of statistical data in Hungary. However, the use of such a clause in one particular type of economy does of course raise the question whether it might not also usefully be applied in other programs. We have indeed seen in recent cases before this Board that the use of traditional performance criteria sometimes did not enable the country in question to achieve its balance of payments and other objectives.

The cash incomes criterion should be viewed as a guideline rather than as a quantitative target, because the final effect of income restraint on private consumption will also depend importantly on the savings ratio. It is rather unclear now how the savings ratio will behave, since two contradictory forces will be at work. The reduction in real income will tend to produce a decrease in the savings ratio as households try to maintain their level of consumption in real terms. The increase in interest rates, on the other hand, should exert a positive effect on savings. It is, however, the view of some of the better-informed observers of the Hungarian economy that the use of interest rates will have hardly any effect on savings. When the performance criterion on real cash incomes is reviewed, a judgment will need to be made about all these elements to see whether the economy is moving in the intended direction.

The correction of the external balance will result mainly from the increased restraint of domestic absorption. It can be assumed that appropriate exchange rate adjustments can exercise some influence to the same effect. The Hungarian Government therefore decided in July to devalue the forint by 7 per cent and again in November by 3 per cent. It is not certain, however, whether these adjustments will have a significant impact as long as foreign demand remains subdued and Hungarian exports continue to be subject to restrictions in foreign markets.

The achievement of the balance of payments objectives requires at times the adoption of measures that go against the trend of a country's accepted policies and seem to contradict the Fund's fundamental options. Faced with an immediate liquidity shortage, the Hungarian authorities could thus not wait for their earlier measures to produce beneficial effects, but had to impose direct controls on some imports. They are aware that such measures are not consistent with the basic philosophy of their system and should therefore be temporary; being of an emergency nature, they are to be phased out gradually, the authorities expect, as the international financial and economic climate improves.

The different measures embodied in the program submitted for approval will undoubtedly entail a significant reduction in the standard of living as expressed in quantitative economic terms. This will be compensated by qualitative elements intended to stress the social values in the system: a more equitable allocation of housing through housing reform, a broadening and extension of workers' participation in the management of enterprises, and a democratization of political life. This progress in the implementation of social and democratic values is highly appreciated by the public, and it is important that it can be pursued at a moment when quantitative improvements had to be slowed down. It is remarkable that, while in most cases restrictive economic programs can be implemented only through the imposition of political restrictions, in Hungary such a program is associated with an improvement of social and democratic conditions.

Hungary's membership in the International Monetary Fund is an important sign of its full participation in the international payments system. Its gradual insertion into that system has developed far beyond the symbolic stage. Your acceptance of today's request will be a clear sign of support for Hungary's economic reform and will provide the resources that will make the continuation of this process possible under most difficult circumstances. The international banking community should fully perceive the significance of the support given by the Fund to Hungary's options and should be prepared, in line with the recommendations that the Managing Director has convincingly expressed in a number of recent cases, to assure its share of support for the further expansion of Hungary's economic reform.

Extending his remarks, Mr. de Groote added that the targets for the reduction of real domestic expenditure, real wages, and investment, to which the staff representative had referred, had not only been accepted by the Party; they had also been published in the Official Gazette. However, although the public had been made fully aware of the decision, it had yet to pass through the second stage of approval by the Government.

A recent change in the foreign exchange system had raised from Ft 400 to Ft 2,000 the equivalent amount of foreign currency that could be held by a private individual without a surrender obligation, Mr. de Groote stated. Holdings by Hungarian citizens of that fairly large amount of foreign currency were not subject to continuous checking. In addition, effective December 7, 1982, interest rates paid on the foreign exchange accounts of residents deposited with the National Savings Bank for one year or more had been raised and would be set at the prevailing level of international market rates, with payments to begin in January 1983. The savings accounts in foreign currency of Hungarian citizens were also not subject to control.

Finally, Mr. de Groote observed, although Hungary had repaid all outstanding payments arrears vis-à-vis the convertible currency area, other countries had not paid debts due to Hungary. There had been a slight deterioration in the external accounts because quite significant payments in respect of both commercial and noncommercial debts due from some IMF members had not been made. The Governor of the National Bank of Hungary hoped that other countries would take the necessary steps to reduce those arrears, in the same spirit in which the Hungarian People's Republic had settled its own accounts.

Mr. Polak noted that the staff had provided a good insight into Hungary's problems, of both domestic and foreign origin, and the efforts being made to overcome them. In addition, Mr. de Groote had added an interesting perspective on the working of the Hungarian economy and on the possible trade-offs between economic and noneconomic satisfaction.

The fact that Hungary, so shortly after having become a member, had taken the step of applying for an arrangement with the Fund was welcome, Mr. Polak continued, even if it was sheer necessity that had driven the country into the arrangement. Developments in short-term credit markets had been almost disastrous for Hungary and for some neighboring countries. The near exhaustion of Hungary's reserves had been remedied temporarily by the BIS and by related commercial bank bridging credits. But the use of the Fund's resources was a necessary complement to the emergency financing that had been taking place over the past half year.

There were many additional reasons, Mr. Polak went on, making it desirable for Hungary to enter into stimulating and constructive discussions with competent outside experts. Internally, Hungary was in the midst of introducing more rational conditions of production within its socialist framework; externally, it had to find an alternative to the exchange rate policy that it had pursued throughout the 1970s, which could loosely be described as an extreme form of the hard-currency option, exceeding even the most conservative policies of surrounding countries.

On the first of those aspects--the price/wage profit mechanism--Mr. Polak observed, developments in Hungary as reflected in the staff papers should be studied with great attention, in order both to learn what made the Hungarian economy tick and to draw important lessons for other socialist countries with which the Fund had financial arrangements. As further background, the recent discussion on centrally planned economies continued to be of benefit. Hungary had gone a considerable distance, differentiating wages and guiding enterprises by the profit system. In addition to allowing enterprises to set profits and then wages on the basis of value added, the authorities had introduced other interesting supplementary arrangements, including the additional taxation of excess profits. However, it was not clear from the Hungarian experience whether or not the system was effective. The purpose was of course to keep wages within the limits of enterprise income, but the effect might have been to make enterprises anxious to pay higher wages in order to boost prices and to increase the value added. They were thereby allowed, under one guideline, to pay still higher wages, and under another guideline to make the profits from which taxes could be paid on wages above the norm.

All in all, Mr. Polak observed, the staff and the Hungarian authorities seemed to have concluded that the price and market-related mechanism could not be fully trusted and that for 1983 the way to keep wages under control would be to put a 3.5 per cent ceiling on any increase. Similar developments could be observed with respect to the use of profits, other than the effect on the payment of bonuses. As noted in the staff reports, profits were supposed to influence investment, thereby achieving a decentralization of decision making. But profits could of course have various sources, such as increases in prices and subsidies. Thus, as with wages, it had finally been concluded that investment decisions should be severed from profit indications. The penultimate paragraph on page 3 of Supplement 1 to EBS/82/206 described how in the end the financial resources of enterprises that were available for investment and for wage payments had to be separated from decisions taken with respect to investment and wages: some funds were frozen, others set aside, reallocated, or taxed. A new investment tax had been introduced for the purpose of restraining investment. In short, the original purpose of using profits as a guide in determining what enterprises could do had been greatly altered by recent measures, which had no doubt been necessary. At the same time, there was a welcome re-emphasis on the principle of autonomy of enterprises, as stressed in the last paragraph of Supplement 1.

It was necessary to take a deeper look at the possible causes of the policy conflicts, Mr. Polak considered. Many of the problems seemed to have a common origin: the absence of competition and of prices set in markets. In spite of all the measures that had been taken to split up enterprises and to encourage the establishment of small-scale enterprises, the Hungarian economy was not yet really exposed to competition. Import restrictions limited competition from abroad. Hungary's own important industries, those that exported to a large extent, were not faced with active competition, if for no other reason than that the Government had devised a no more than quasi-competitive system requiring the markup at home to be no more than equal to the average export profit rate of the enterprise. That device was intended to keep down domestic prices, but the staff had indicated that it sometimes operated in the opposite direction, inducing firms to drop the production of exports returning a low profit rate in order to raise their average profit rate and as a result become less subject to that form of quasi-competition.

The absence of any market at all for surplus financial means had also clearly had unfavorable effects throughout the economy, Mr. Polak noted. It was true that debit interest rates were not unduly low, but enterprises could not use their excess liquidity freely. Clearly, they found ways to use their money; interenterprise credit presumably represented an unregulated credit market, which thus had its uses and should not be viewed too harshly by the Fund, either in Hungary or elsewhere. The building up of excess stocks was also probably a general phenomenon in centrally planned economies. Savings accounts were almost the only form of investment available for those with excess funds. Credit interest rates were low, a feature of centrally planned economies. An increase in interest rates on savings accounts would in fact seem to be in conflict with the effort to restrain wages or to reduce them in real terms.

The lesson to be drawn was that the competitive price mechanism, for all its faults, was valuable if complex, Mr. Polak concluded. If Hungary wanted the benefits of a profit and price mechanism, it would have to accept real competition, even though competition would have its costs. Import restrictions would have to be relaxed, as indeed had been agreed as part of the program under the stand-by arrangement. The possibility of overproduction by some enterprises and the failure of certain others would have to be accepted, yet indications in the staff papers suggested that it was still exceedingly difficult to hold that attitude in Hungary. Financial competition would also be required, calling for more facilities for intermediation, as the staff had suggested on pages 19 and 20 of SM/82/176. He felt sure that Hungary could draw on the financial experience of its people to provide treasurers for their enterprises who would be able, if the necessary intermediation facilities were set up, to optimize the use of funds and thereby avoid the great distortion in the use of liquidity that existed at present for lack of an effective capital and money market. In that connection, the maintenance of the many special funds of enterprises, which were the legacy of earlier more precise planning mechanisms, would have to be abandoned.

He appreciated the recognition in the staff reports that some of the weaknesses in the present system, for all the efforts being made, could not be corrected in the short term, Mr. Polak said, and that accordingly the performance criteria or other guidance mechanisms of the Fund would have to be different from the routinely employed ones. First, the essence of the improvement on current account had to lie in curtailing domestic demand, but it was not clear that that could be achieved with monetary, fiscal, and wage policies. There had been too many slippages in the past, and too many were still possible under the change in Hungary's practices in those three areas. The staff had therefore adopted the concept of direct control over real disposable income as well as over investment in the socialist sector, which accounted for most investment in the country. Both were to be monitored on a monthly basis. As the staff had indicated, real disposable income could be adjusted instantly by an adjustment of turnover taxes and subsidies. As Mr. de Groote had indicated, the control of real disposable income had to be more severe than the desired result in terms of real consumption because of the operation of the marginal savings rate. There had not been enough time for him to find out whether or not the staff had taken that factor into account in the figures provided in its opening statement. In passing, he had also found it hard to reconcile the statements in Table 15--which summarized the assumptions and principal elements of the stand-by arrangement, relating to the reduction in subsidies in connection with the budget deficit and with price and wage policies--with the small decline in the large item in the state budget in Table 3 for price support.

The second element of realism in the staff's way of handling the guidance of the Hungarian economy for purposes of the stand-by arrangement was the definition of credit control as being net of changes in enterprises' deposits, Mr. Polak said. It was not the small netting change that the staff so often had to make in adjusting those complicated items on the balance sheets of banks. Enterprise deposits were just about the only commercial deposits in the whole system; by netting out the asset and liability sides of the banking system, the staff was making a fundamental change in the use of credit control as guidance to the economy. The standard monetary approach to the balance of payments, which the Fund had been using for a long time, was that, on the basis of some assumed numbers for the velocity of money and the evolution of GNP, the control of credit, by affecting the money supply, would determine developments in foreign exchange reserves. But in the arrangement for Hungary, the assumption of a constant velocity had been abandoned, for good reasons, and the starting proposition was that enterprises, more or less at will, could either borrow from the banks or use up their excess liquidity in the form of deposits. If he understood it correctly, and apart from changes in currency in circulation that were presumably predictable and constant, the staff was trying to guide not so much credit but the remaining item in the balance sheet of the central bank, which was the net foreign assets of the commercial banking system. Although he could agree with the staff that, as had been discovered in other cases, little confidence could be placed in credit controls addressed simply to the expansion of credit in economies with large pockets of dormant funds, as in Hungary, he was less certain that the staff had been right to turn the approach into an indirect test of the foreign assets of the banking system, when it should perhaps have considered dropping controls on credit. He did not want to suggest that he was against the staff's new indicator but would welcome an additional explanation of what the staff was trying to accomplish with it.

On the exchange rate, Mr. Polak mentioned the striking statement in the staff apppraisal that "exchange rate policy has not been used actively in Hungary to achieve balance of payments targets." The point was not that Hungary had not followed an active exchange rate policy; on the contrary, it had, but it had aimed it at a different objective. In a lecture given two years before Hungary had joined the Fund, Mr. Fekete, the First Deputy President of the National Bank of Hungary, had indicated that since 1971 Hungary had followed an active exchange rate policy for the purpose of avoiding imported inflation. The aim was to reflect the differential movement in prices between the outside world, where inflation had been rampant, and Hungary, where prices had risen less, even though from 1971 to 1980 price decontrol had proceeded rapidly. According to the staff, the policy of substantially appreciating the forint not only against the U.S. dollar but also against the deutsche mark or any basket of currencies had still produced a depreciation in real terms by mid-1980. Of course, since that time, prices in Hungary had risen more than in the outside world, partly because of necessary corrective price adjustments. The staff suggested that there had been a real appreciation of 15 per cent in the forint from early 1980 to June 1982; subsequently, there had been three devaluations, of 7 per cent, 3 per cent, and 1 per cent.

Against that whole background, the important question was whether Hungary had switched its exchange rate policy, after 10 years, from one that did not have a balance of payments objective, or whether it had only made some hesitant moves in the right direction under the pressure of events, Mr. Polak continued. The staff's calculations of purchasing power parity seemed to suggest that the adjustment had been about enough, but the figures were not fully convincing. The period for which the calculations had been made was lengthy, and came at the end of a long stage of deliberate disregard for the competitive aspects of the exchange rate. Many important changes had taken place since. In the mid-1970s, the expansion of real demand in Hungary had been higher than in surrounding countries. A final mark against the routine compilation of data on purchasing power parity was the notable worsening of Hungary's fundamental position resulting from the reversal of credit flows, to which an adjustment would have to be made. The conclusion with respect to the exchange rate was not clear, although there were important question marks for the staff to keep closely in view. It was possible that the new measures of domestic restraint would release the resources needed to improve the current account of the balance of payments. Together with a somewhat better exchange rate, and certain supporting domestic measures relating to price incentives, the necessary flow of Hungarian exports into the difficult markets of surrounding industrial countries might be produced. If not, it would have to be concluded by the middle of 1983 that urgent attention should be paid to the exchange rate, and without the use of statistics on purchasing power parity going back 10 years or more.

He had been pleased by both the Hungarian effort and the staff's innovative work in trying to design a stand-by arrangement that he trusted would be effective in Hungarian conditions, Mr. Polak stated. He therefore concurred in the decision concluding the Article IV consultation and in the decision on the stand-by arrangement. He had been swayed to support the compensatory drawing partly by the argument presented by Mr. de Groote, but mostly because he had great confidence in the competence and objectivity that the staff had always brought to bear in presenting the many requests for compensatory financing to the Executive Board. His one question was to ask the staff whether it would be prepared to be somewhat more explicit about its assumptions on recovery in other industrial countries that underlay its estimates for the recovery in Hungarian exports in the two postshortfall years.

Mr. Laske commented that the staff papers provided an excellent analysis of the structural and institutional aspects of the economic system, its transformation under the reforms begun in 1968, and the difficulties that Hungary confronted at present. Nevertheless, he was still not sure that he had really understood how the Hungarian economy worked.

The Hungarian authorities had requested Fund assistance in two forms, Mr. Laske continued, a drawing under the compensatory financing facility and a stand-by arrangement in the higher credit tranches. The existence of a balance of payments need, which was a prerequisite for financial assistance from the Fund, was obvious. The need was indeed serious because Hungary had been exposed to a massive withdrawal of foreign credit, which it had used extensively as a basis for its strategy of economic growth and restructuring during recent years. Moreover, Hungary had been experiencing--for the size of its economy--a quite large current account deficit that would have to be corrected rather quickly with adequate demand management policies. The program presented addressed the major areas of weakness in the economy, and he could thus lend his support to the request for the stand-by arrangement. There was also no doubt in his mind about the export shortfall. All the requirements of the compensatory financing decision had been met, and he could therefore support the request for a compensatory drawing as well.

Hungary's severe external payments problem was due to its high level of foreign debt, a large part of which was short term or fell due for repayment in the near future, Mr. Laske noted. The change in sentiment among commercial banks about lending to Eastern European countries, which had started to intensify in the middle of 1981, had affected Hungary heavily. It had not been possible to extend maturities, and short-term deposits had been withdrawn, thus exposing Hungary's external reserves to a heavy drain. The authorities had had to take recourse to extremely short bridging loans, which would have to be repaid soon. An improvement on current account clearly had to be achieved rapidly to enable Hungary to service its external debt and to rebuild confidence in international credit markets so that the flow of funds would not be cut off completely. Some rebuilding of the international reserves of the National Bank of Hungary would also be desirable, so as to gain more room for maneuver. Under those circumstances, the necessary shift of resources from the domestic to the external sector could be brought about only by drastically curtailing the domestic absorption of resources. The authorities had fully recognized that necessity and were willing to intensify the adjustment policies upon which they had embarked in the middle of 1981 when the first signs of an impending crisis had become visible. He was confident that those policies could achieve the established objectives, unless exogenous circumstances interfered.

The desired and necessary cutback in the domestic absorption of resources was being sought by the authorities through measures in the four important areas of investment, personal incomes, fiscal policy, and monetary policy, Mr. Laske observed. Over the past two years, the authorities had already endeavored to cut investment and to reduce the growth in personal income, with success in respect of the former but not the latter. Personal income and private consumption had continued to rise, a disappointing performance due apparently to the system of wage determination, which did not appear to be geared in an optimal way to the requirements of the overall economy and of the external situation in particular. As Table 27 of the report on recent economic developments showed, industrial wages had increased in real terms in both 1981 and 1982. The generous wage awards were attributed to the favorable profit situation of enterprises, to which the authority to grant wage increases was related.

The targets for incomes development that had been indicated in the statement by the staff representative were both impressive and, apparently, ambitious, Mr. Laske remarked. Their achievement would require substantial restraint in adjusting wages, and it was not clear to him whether the necessary decisions had already been taken. Complementary action might also be necessary to bring about a decline in real wages, to make upward corrections in consumer prices, and, in the process, to cut subsidies. An interesting feature of the Hungarian wage system was that practically no income taxes were levied. The fiscal system relied almost exclusively on indirect taxes like excise taxes, and taxes on turnover and profits for enterprises. Because a major objective of adjustment policies was the containment of private consumption, the possibility of directly taxing wage income might be worth consideration.

The economic reforms pursued by the Hungarian authorities for more than a decade, Mr. Laske went on, aimed at bringing prices into better line with production costs. But even after that relatively long period, important consumer prices continued to be heavily subsidized, most notably for gasoline and other forms of energy, whereas world market prices had increased dramatically for almost ten years. As the staff representative had informed the Executive Board in his statement, action had been taken to adjust the prices of energy products, but he was not in a position to judge with any precision the adequacy of the adjustment with respect to achieving the targets set. In its appraisal of the request for a stand-by arrangement (EBS/82/206), the staff noted that efforts to contain incomes and consumption spending should have relied more on cuts in subsidies. That would definitely have the additional benefit of making a further and faster move toward correcting the relative price structure. He hoped and indeed expected that the authorities would be prepared to take further action, in addition to the measures announced at the present meeting by the staff representative, if the turn of events was different from what was hoped. In that context, he had noted with great interest that the authorities would provide monthly data on developments relating to the cash incomes of the population as well as to investment in the socialized sector of the economy. That was a welcome innovation, which was pertinent to the particular economic setup in Hungary, and he trusted that it would enable the staff to monitor closely progress under the program. But it would be of equal importance for the Hungarian economy to press ahead with restructuring industries and inefficient enterprises. In that respect, he associated himself with the analysis presented by Mr. Polak.

Referring to fiscal policy, Mr. Laske noted his impression that, as a percentage of GDP, the deficit in the state budget was not so large, compared with the figures recorded in other countries. But the intention of the authorities to compress the deficit further was nevertheless essential for the achievement of the program objectives. The envisaged cuts in subsidies, and those already decided upon, would certainly assist in restraining current expenditure; and the increases in enterprise taxes and in social security contributions would help to bolster revenue. The contribution of income taxes to revenue had declined constantly since 1978, the earliest year for which data were given in the report on recent economic developments, and direct income tax had yielded no revenue at all in 1981. Once more, therefore, he wondered whether direct income taxation should not be considered, not only for the control of personal income but with a strengthening of state revenue in mind.

The general objective of the reform launched in 1968, Mr. Laske recalled, was to substitute indirect control of the economy, through appropriate financial arrangements, for direct intervention by the authorities in the economic process. Yet the staff reported that subsidies continued to be a pervasive feature of the institutional framework, as Mr. Polak had already commented. Expenditure on subsidies still accounted for about 30 per cent of total budget expenditure, a proportion that had changed little if at all in the past four to five years.

As for monetary policy, Mr. Laske added, the intensified use of interest rates to control enterprise investment and to stimulate cash savings of households was a useful and welcome reform measure. It was somewhat baffling, however, to learn that enterprise liquidity was ample and thereby threatened to undermine the effectiveness of credit policies. The staff had taken adequate precautions in defining the quantitative targets in the area of credit policy to take account of that fact, a welcome innovation that was again pertinent and appropriate to an economy with the structure and institutional framework of Hungary's. But he had failed to find any fuller explanation for the comfortable liquidity position of the enterprise sector than the mention in the staff report that it was a reflection of the favorable profit situation in which enterprises had found themselves. He wondered whether the profit situation of the enterprise sector in the aggregate was all that good; Table 26 in SM/82/186 showed that in each of the past three years, subsidies paid out of the government budget to enterprises had been substantially larger than their profits after taxes. Henceforth, enterprises were apparently to be required to place part of their reserve funds with one of the specialized banks, which in turn would make the funds available to the state budget. While that institutional change would reduce the need of the Government to turn to the central bank for budget finance, it might also be effective in reducing the ample liquidity situation in the enterprise sector.

Interest rates had been adjusted upward twice in the past year, especially rates for investment credit, Mr. Laske observed. Yet the increasing use of interenterprise credit could undermine the effectiveness of interest rate policy with respect to the extension of credit. More energetic steps might perhaps need to be taken to bring the situation under better control. No change had so far been made in interest rates on consumer loans or on rates on deposits of households with banking institutions; those rates had remained negative in real terms and if they were not adjusted would remain so, especially at a time when the rate of inflation was beginning to edge upward as a result of price adjustments. Serious consideration should, therefore, be given to adjusting rates on household loans and deposits so as to give an adequate incentive to private savings and to eliminate the subsidy element inherent in negative real rates for consumer credit.

The entire package of adjustment measures was aimed at the restoration of a sustainable balance of payments position, Mr. Laske noted. From 1981 to 1982, a significant reduction of the current account deficit in convertible currency had already been achieved. That trend would have to be prolonged and intensified. The current account projection for 1983 was for a surplus of $600 million, with the main contribution to come from a reduction in interest payments; the prospects in that respect were good, with the progressive decline in international lending rates. A small reduction in Hungary's substantial foreign indebtedness was also expected, but that would be possible only when the foreign trade results were as good as forecast, thereby producing a current account surplus. He could not suppress a feeling of unease about the optimism of the export projections. It would be important to restrain the demand for imports, primarily by holding down overall domestic demand, and not by imposing direct restrictions on imports of the type introduced in the past year. He was pleased to learn that the authorities intended to remove those restrictions over the program period.

Following the appreciation of the forint in real terms over the past 18-24 months, Mr. Laske continued, a development that must have contributed to the emerging external problem, the authorities had adopted a more flexible exchange rate policy. The devaluation in July 1982 of 7 per cent, and the subsequent devaluations of 3 per cent and 1 per cent in November and December, were welcome evidence of that new flexibility. The exchange rate instrument should be used in a more active way to achieve corrections in the external sector.

It was indeed good to note in the supplement to the staff paper on the request for a stand-by arrangement, Mr. Laske said, that the reduction of the current account deficit had been larger than expected, that progress had been made in containing domestic demand, and that the budget deficit was expected to be somewhat smaller than originally programmed. Cash incomes of the population had stagnated and industrial investment had declined recently, both developments being measured in real terms. The strategy of placing heavy stress on restraining consumption and productive investment might well meet the requirements of the immediate situation, but with a somewhat longer-term perspective in mind, it might become advisable to shift the burden of restraint even further toward current consumption, so that productive investment could be maintained at a level that would secure the basis for balanced growth at a later stage once a viable external position had been regained.

To conclude, Mr. Laske made a more procedural point relating to the information provided in the statement by the staff at the beginning of the discussion on essential program objectives that had been mentioned neither in the paper on the stand-by arrangement nor in the letter of intent from the Hungarian authorities. He realized that the staff had adopted that procedure at the request of the authorities, whose reasons for holding back that type of information were understandable. But the procedure should not be allowed to become a permanent feature in the presentation of requests for the Fund's financial assistance; he considered its use in dealing with Hungary's request to be a rare exception.

Mr. de Maulde remarked that he had personally been fascinated by Mr. de Groote's discussion of the New Economic Mechanism and the difficult compromises that had been struck in the recent past between long-term policy options on the one hand, and, on the other, the attempts of the authorities in the shorter term to shield Hungary from external shocks through the resumption of various forms of control, taxation, and subsidies. As Mr. de Groote had aptly put it, the Fund had been moving in unknown territory; if further explorations of that kind were undertaken, they should bring about a continued improvement in the Fund's ability to give effective help to members with centrally planned economies. Although there was certainly much to say and to ask about the fundamentals of Hungary's economy, especially in the first Article IV consultation with the new member, he would limit his comments to the program under the stand-by arrangement.

Broadly speaking, Mr. de Maulde continued, the program appeared to address adequately the main issues raised in the appraisal of the staff report for the Article IV consultation. Domestic demand had been checked in 1982. Cash income of the population would barely increase in real terms, and investment and stockbuilding would decline. The target set for 1983, of a further real decline in domestic demand by 3-4 per cent, was associated with a more balanced sharing of the adjustment burden between consumption and investment. As far as consumption was concerned, the authorities had chosen to put more emphasis on wage moderation than on a reduction in subsidies on consumer goods in order to avoid an upsurge in the rate of inflation, which might in turn undermine the confidence of the public. However, a significant reduction in subsidies was due to take place during the program period. Steps had already been taken in 1982, and others were scheduled for 1983. Subsidies on passenger transportation fares would be lowered or abolished as of January 1, 1983, and a substantial rent increase would be implemented in the middle of that year, notwithstanding the deterioration in the relative incomes of urban workers that those measures would entail. Gasoline prices would soon be raised by 20 per cent, which should more than offset the impact of the three recent devaluations, despite the time that had elapsed since the first exchange rate adjustment in July. Beyond the immediate time horizon of the program, the priority would remain of widening the scope of so-called competitive pricing in order to achieve a better structure of relative prices. He wondered whether the coexistence of two types of exchange rates--vis-à-vis convertible currencies and the ruble--that served different purposes might not prove to be counterproductive in that respect.

The reform of the wage system, to be implemented in 1983, did allow for a better relationship between wages and productivity, Mr. de Maulde hoped. Yet he doubted whether enough was being done to stimulate private savings. Apart from the change toward the private financing of housing construction, which could induce an increase in household deposits, it seemed appropriate to issue more instruments, such as savings bonds designed to finance the budget deficit, because the rate of growth of claims of the banking sector on the state budget had been quite high over the past three years.

As for investment, a wide array of measures had been taken, Mr. de Maulde observed. The decline in the ratio of fixed investment to GDP from 30 per cent in 1981 to 26 per cent in 1982 was impressive in an economy where the demand for housing was far from being satisfied. The measures designed to reduce the flow of working capital credit seemed justified by the large volume of inventories in the economy. Yet the additional 25 per cent tax on most new investments, described on page 4 of EBS/82/206, could have rather brutal effects because it would raise significantly the threshold of viability of new projects. Could Mr. de Groote or the staff say whether there were no other more efficient ways to mop up the excess liquidity of enterprises?

Referring to the other instruments of demand management--fiscal and monetary policies--he was in agreement with the staff's comments, Mr. de Maulde remarked. A rapid adjustment of domestic prices to changes in world prices via the exchange rate would be essential to contain the growth in price subsidies. The level of expenditures and the budget deficit in view for 1983 appeared appropriate. As he had already mentioned, further progress might be made in increasing the share of nonbank financing of the deficit. Of course, one way to reduce the excess liquidity of enterprises was to increase the level of taxes, as had already been done. Another way would be to offer savings instruments to enterprises, it being understood that the proceeds would not be used to expand credit available to the budget but rather be a substitute for bank financing.

On the monetary side, the credit targets represented a significant slowdown of the rate of growth registered in 1981-82, Mr. de Maulde noted. Moreover, the design of those targets--net of enterprise and household deposits--should avoid the financing of an unsustainable level of activity. However, as such, the targets might prove insufficient to avoid the risk of a disintermediation of funds out of the banking system. An increase in deposit rates for households certainly seemed warranted and might eventually facilitate an upward revision of the structure of lending rates for housing finance.

A sharp improvement in the current account balance in 1983 was justified, Mr. de Maulde considered, not only in light of the present attitude of commercial banks toward extending further credit but also from a longer-term perspective. There would be a bunching of maturities in 1984 and 1985 in respect of medium-term and long-term debt in convertible currencies, and sizable current account deficits in those currencies were no longer sustainable, given the unavailability of foreign financing, as Mr. Laske had already mentioned.

He would not elaborate on the structural reforms that should strengthen in the medium term the outward orientation of the Hungarian economy, Mr. de Maulde said. For the more immediate future, the various export incentives would seem to be effective. More important, perhaps, the active exchange rate policy implemented since July 1982 and continued up to the present should offset the real appreciation of the forint that had taken place in the two preceding years. In that respect, and taking into account Hungary's resort to import restrictions, which he too hoped would be temporary, he would like to learn from the staff what was a relevant point of reference for determining the exchange rate of the forint. Charts 5, 6, and 7 in SM/82/176 revealed a rather hectic movement of past exchange rate levels, and the choice of a given point of reference in time did not appear self-evident.

In connection with the assumptions underlying the external target of the program, Mr. de Maulde noted, foreign demand was forecast to grow by 3-4 per cent in 1983. He fervently hoped that that expectation would be fulfilled. Hungary's relatively modest share in the goods imported by its trading partners suggested that further gains in market shares might perhaps be feasible. At the same time, it was a fact that three neighboring countries--Hungary, Romania, and Yugoslavia--were expected to expand exports and to curtail domestic demand. What degree of interexchange was there in the external trade of those three countries? To what extent were they in competition with one another to gain new market shares in their likely increase in marginal exports? Those questions could obviously not be answered in full straightaway but would have to be given hard thought in the forthcoming World Economic Outlook exercise.

Finally, Mr. de Maulde stated, he had no difficulty in supporting the request for a compensatory financing purchase, because it met all the necessary criteria.

Mr. Taylor said that he supported Hungary's requests for the 13-month stand-by arrangement and for the drawing under the compensatory financing decision. He also supported the proposed decision in the staff report for the Article IV consultation. The discussion was manifestly important for a number of reasons: it provided the first opportunity to assess the economy of an important new member, an economy of a kind with which the Fund was still relatively unfamiliar and about which it was trying to improve its knowledge and understanding, and also an economy that had fallen upon serious problems. Ordinarily, given the circumstances and the difficulty of the subject matter, he would have preferred the normal practice of discussing the Article IV consultation before tackling the requests for use of the Fund's resources. But he recognized that there were good reasons for merging the two stages, reasons that indeed had made it necessary to consider lending to Hungary on a scale larger than was usual for new members and that in fact included a substantial element of enlarged access resources. He could support that approach in view of Hungary's acute needs, although he did feel that the staff should be prepared to set out a little more explicitly why countries like Hungary qualified to use enlarged access resources, with specific reference to the criteria in the March 1981 decision.

There could be no doubting the severity of the problems facing Hungary, Mr. Taylor continued. As the staff had noted, progress toward a sustainable balance of payments position had stalled rather abruptly in 1981 and early 1982. The combination of a large current account deficit, a substantial burden of external debt--much of it short term--and a sudden and widespread withdrawal of confidence on the part of commercial lenders had led to a liquidity crisis from January to March. Although the crisis had been caused in part by factors beyond Hungary's control, it was apparent that the adjustment measures adopted before the middle of 1982 were in themselves not adequate to deal with the emergency, and further strong action was required. Therefore, he welcomed the authorities' clear recognition of the need to strengthen their adjustment efforts in the context of an approach to the Fund for a stand-by arrangement. As acknowledged in the letter of intent, the highest priority had to be given to restoring external liquidity. Thus, the authorities had little choice but to aim for a current account surplus in convertible currencies that was sufficiently large to allow for some rebuilding of reserves to enable Hungary to meet its international payments obligations over the medium term.

It was, of course, difficult at the present stage to judge whether or not the program would be adequate to meet that central objective, Mr. Taylor commented. The outcome would depend to a considerable extent on developments in the world economy and on the attitude of Hungary's creditors. However, he had been particularly impressed by the pragmatic and flexible approach taken by the Hungarian authorities and by the strength of their commitment to economic reform, despite the current difficulties. Mr. de Groote's perspective on the continuation of the economic reform was particularly encouraging. Certainly, he hoped that the authorities would continue to move gradually, within their chosen economic framework, toward a more market-oriented and outward-looking economy. In that respect, Mr. Polak's comments on the importance of generating genuine competition in the economy had been wisely put and should be given serious thought by the authorities.

The measures already adopted and those proposed represented a considerable move in the right direction, Mr. Taylor considered. It was encouraging to learn from the staff representative that the authorities appeared to be on track to meet their initial targets under the program, and seemed to be prepared to rein back domestic demand to a level more consistent with restoring external balance, even though lower demand would inevitably mean some decline in living standards. The projected improvement in the convertible currency current account would of course depend greatly on whether the proposed reduction in private consumption was fully achieved. It would therefore be essential for the reform of the system of wage determination and the planned increases in administered prices to be implemented effectively. Those measures must not be undermined by weak fiscal management or slippages in wage policy, as had happened in 1981 and perhaps in the earlier part of 1982, or by heavy dissaving. The firm action taken in recent weeks to contain domestic absorption was therefore much to be welcomed.

Like others, Mr. Taylor added, he also welcomed the movement in the direction of greater fiscal restraint, with the aim of reducing the budget deficit in 1983 to the equivalent of about 1 per cent of GDP, a modest figure by any standard. The continuing cutback of real investment expenditure from its rather high level should contribute to an easing of import demand, as a substantial proportion of hard-currency imports consisted of machinery and manufactured goods, which presumably found their way into the investment effort. He most certainly endorsed the more active use of interest rates and credit policies in recent months. The move to raise interest rates for depositors was a step in the right direction, although it was evident from Table 7 of EBS/82/206 that the rates for household deposits--even allowing for the projected increase of two percentage points--were likely to remain negative in real terms. The increase might therefore be insufficient to divert resources away from consumption as intended. While he understood the authorities' reluctance to go too far or too quickly in that direction, it was a subject for reconsideration in the mid-term review.

It was heartening to be informed that the current account in convertible currencies was likely to be in near-balance in 1982, Mr. Taylor went on. The depreciation of the forint and the special incentives to exports should assist the achievement of the current account target for 1983. Like the staff, he attached considerable importance to the authorities' commitment to phase out the emergency import restrictions introduced in September over the program period. In addition, he fully supported paragraph 2 of the proposed decision concluding the 1982 Article XIV consultation, and would encourage the authorities to eliminate existing multiple currency practices and bilateral payments agreements with Fund members as quickly as possible.

Looking ahead at the prospects for the program, Mr. Taylor remarked, there seemed to be a good chance that it could lead to the hoped-for improvement in the external position, although it would be simplistic to judge the program in isolation. Hungary had been subject to an adverse external environment, and the situation remained difficult. As the staff had pointed out, there were still major uncertainties with respect to both the current and the capital accounts. It might be difficult to achieve the projected increase in export volume if there were little or no growth in Hungary's major export markets. Furthermore, export prices were likely to remain relatively depressed if recent experience served as a guide. If export performance were less favorable than expected, additional measures might be required to reduce domestic absorption and help the trade balance still further. In that respect, he joined others, Mr. Laske and Mr. de Maulde in particular, in the caveats that they had expressed.

As for the external financing position, a key feature for consideration, Mr. Taylor observed, it appeared from Table 10 that the staff was assuming net short-term inflows in 1983 of some $350 million--before deducting repayments to the Bank for International Settlements--and new medium-term financing of the order of $580 million. But in the nature of the case it would be touch and go whether external financing on that scale would materialize. Implementation of the Fund program was unlikely, by itself, to have an immediate impact on the assessment by the banks of Hungary's external position, which remained weak. At present the banks seemed reluctant to increase their exposure to countries in Eastern Europe, and it was possible that access to capital markets could be tightened further in 1983. The high level of short-term debt in relation to reserves meant that Hungary was extremely vulnerable to sudden shifts in confidence on the part of commercial lenders; and its credit standing could be affected by payments difficulties or possible rescheduling operations in neighboring countries. In those circumstances, there could be further withdrawals of short-term funds that would make it extremely difficult--if not impossible--for Hungary to rebuild reserves as planned under the program.

Given the uncertainties, Mr. Taylor commented, the authorities would have to keep a close watch on the external accounts in the coming weeks and months. If exports did less well than expected or if external finance were not forthcoming, they would have to be willing to act quickly to strengthen the current account still further. The mid-term review would provide an important opportunity to look at the situation again. He welcomed the intention of the authorities to stay closely in touch with the Fund and their willingness to review developments with the staff in early 1983. He noted the interesting new monitoring procedures, to which others had referred, which had been designed to help achieve the program's objectives. If those experimental procedures were successful, they might usefully be extended to programs in other centrally planned economies. It had to be said, however, that monitoring alone might not suffice; there might be a need for action to correct any divergences that emerged. He had noted Mr. de Groote's opening comment to the effect that the targets for constraining domestic demand and the growth of cash incomes in real terms had been publicly announced; the announcement could do nothing but good in supporting a general appreciation of what the program was trying to achieve. Nevertheless, he had some doubts about the ability to control effectively those items of expenditure and income in an economy where domestic liquidity was relatively high and the incentives to save quite low. He would welcome a staff comment on that point.

It would be important for the authorities to keep the banks and Hungary's other creditors fully informed about economic developments, Mr. Taylor stated, and not merely to inform the Fund and the governments concerned. Intelligence received from the banking community indicated that it was difficult to find out and understand what was happening in the economy on an up-to-date basis. Therefore, he encouraged the staff and the authorities to go as far as they possibly could to make authoritative and comprehensive information widely available to the international financial community.

Referring to the request for a compensatory financing drawing, Mr. Taylor recognized that access to compensatory financing was normally reserved for primary producers. However, a number of countries like Hungary, which depended mainly on industrial exports, had drawn under the facility. Hungary's request met all the relevant criteria, and he could therefore support it without difficulty.

In sum, Mr. Taylor remarked, there was no doubt about the authorities' determination to carry out a major adjustment effort in unpropitious circumstances. If the program was to succeed, they would need a measure of good luck as well as good judgment, and they would have to be prepared to act quickly to amend the program if necessary.

Mr. Barbone joined others in noting that the numerous and comprehensive papers and statements under discussion permitted not only a better understanding of Hungary's economy but added a little to the Fund's knowledge and practical experience of centrally planned economies. He could agree with Mr. de Groote that it was a unique system, in which elements of central planning were mixed with built-in incentives and the exercise of competition--at least to a certain extent--among producers. It was the result of the courageous resolve of the authorities first to experiment with and then to maintain a new set of rules of the game, even in an economic environment like that of the 1970s and the early 1980s, which in many other countries had been rather more conducive to retrenchment.

He recalled that in the course of the seminar on the application of Fund policies in centrally planned economies (Seminars 82/3 and 82/4, 6/25/82), one of the characteristics of such economies that had been singled out was the generalized existence of an import plan, providing specific directives on what goods were to be imported during the period of its execution, Mr. Barbone mentioned. That characteristic did not seem to be present in Hungary, at least judging from the rather concise description on page 116 of SM/82/186. Yet the existence of an import plan had been one of the reasons why Romania had been able to obtain a dramatic turnaround in its current account, as described in EBS/82/73 (4/29/82), and Supplement 1 (6/14/82). He thus asked to what extent Hungary's current licensing system was comparable to an import plan. More specifically, he wondered whether a global limit on the quantity of importable goods was set during the preparation of the annual plan, or whether in fact the import plan had effectively been abolished in 1968, at the beginning of the reform. The question was not purely academic because it was clear that the power of the authorities, as well as the measures they would have to take to redress an imbalance in the current account of the balance of payments, would be rather different if the volume of imports could be predetermined to suit a specific current account objective instead of having to be achieved through a reduction in domestic absorption.

Judging from the format of the stand-by program, Mr. Barbone went on, it was clear that, although they had had to resort to import restrictions, the authorities were at present putting the emphasis on the containment of domestic absorption. That was obviously the most appropriate course for a country trying to achieve a more efficient allocation of productive resources by using economic stimulus rather than administrative directives. It led him however to comment on the appropriateness of the current structure of economic incentives, on which Mr. Polak had elaborated at greater length. In particular, he would like to know more about the future role of profits as the main stimulus to the efficient conduct of enterprises. The present problems had been compounded by the better than expected performance of enterprises and the fact that high profits had allowed them to pay higher wages and maintain a high level of investment.

The authorities' reaction had been to increase the tax on investment and to reform the wage system in order to bring wage growth more into line with the required degree of restraint, Mr. Barbone noted. Those measures were naturally quite appropriate in the present situation; however, he was somewhat perplexed as to the ultimate effect on the efficiency of enterprises. Profits would clearly motivate better economic performance if they had favorable consequences for the enterprise. Profits, in fact, were not distributed to stockholders, because there were none, and managers had no direct interest in seeking profits for themselves as they might under more familiar economic systems. Therefore, it would appear that measures restricting the usability of enterprises' financial surpluses deprived the managers of the two most important avenues for investing profits, thus undermining the whole logic of the market-related incentive system. As a consequence, it could be expected that although investment and wages would be brought more into line with adjustment needs, general economic performance might deteriorate. He wondered whether the staff or the Hungarian authorities had given any thought to that problem. For instance, would it be possible to think of shifting the focus of incentives toward high-yielding export projects?

Another puzzling feature of the Hungarian economy, and one of direct relevance for the prospects of a successful implementation of the adjustment program, Mr. Barbone observed, was the extremely low personal savings ratio, which contrasted sharply with that in other centrally planned economies that the Executive Board had had an opportunity to examine. High savings ratios in socialist countries had previously been explained on grounds of an insufficient array of consumer goods, leading to forced savings. In Hungary, the personal savings ratio was quite low--comparable to that in the United States, for instance--and it seemed moreover to be declining. Was that the result of the availability of consumer goods better suited to satisfy consumer preferences, or was there some other structural reason? The answer to that question would be important, particularly because of the crucial role that savings behavior would play in the course of the program for 1983. It might also shed some light on the perennial question of whether high interest rates would stimulate higher savings or, in the case of Hungary, at least counterbalance the effect on savings of lower real disposable incomes.

Referring to the stand-by arrangement itself, Mr. Barbone considered that the program was highly experimental, at least in some parts, and quite imaginative as well. It certainly had some exceptional features, when compared to those of other programs, reflecting the present unsettled times.

Hungary would have to exercise a high degree of adjustment and restraint in growth, Mr. Barbone noted, as a result of the difficult situation prevailing in international capital markets, which had exposed a strategy adopted during the 1970s that had been unsustainable without large capital inflows. The concept of a sustainable current account deficit therefore became that of the need for a prolonged surplus in order to allow the country to repay external debt falling due. The swing in the current account of the balance of payments that was being sought in the program was certainly quite substantial; it was therefore imperative that prompt action be undertaken should the situation appear to be worsening. In that respect, he wished to point out that at least one assumption of the program appeared to be too optimistic, as the latest data in Supplement 1 to EBS/82/206 showed, namely, that convertible currency export markets would grow by 4 per cent in 1983. The assumption was certainly heroic, but, for a successful outcome, it was probably realism that was needed. From Table 58 and the description on pages 90-91 of the report on recent economic developments, it could be inferred that almost 68 per cent of exports settled in convertible currencies went to Western Europe, the United States, or developing countries. A rate of growth of exports of 4 per cent to that group of countries would in fact be welcomed by all, if it were in fact attainable in the coming year. He asked the staff whether it still considered that assumption to be realistic, in light of the continued depressed state of the world economy and, among other things, the dismal results of the recent GATT meeting.

Should that assumption on external market growth turn out to have been too optimistic, Mr. Barbone added, the authorities would be left with little choice but to intensify the adjustment effort. He noticed in that respect that a large part of the reduction in aggregate demand was to be borne by investment, even though household consumption would be cut for the first time in some years. He had also noted, from page 34 of EBS/82/206, that the staff would have preferred an outright reduction of subsidies as a means of inducing a decrease in consumption, rather than wage moderation; price increases would in fact probably have to be one component of a possible further tightening of policies, if need be. He could however sympathize with the authorities in their desire to implement politically difficult measures in a way that maximized popular support rather than create additional problems.

As for the performance criteria to be used in the program, Mr. Barbone recalled that the position of his chair was that, if traditional criteria lost their effectiveness as intermediate targets in countries with given social systems, as appeared to be the case, then other instruments should be sought. In that sense, the monitoring of real cash incomes of the population and of investment in the socialist sector would ensure a much closer adherence to the set targets of the program. However, he could also understand that such controls might prove politically difficult, and might, in other contexts, lead to allegations of excessive interference of the Fund in matters of closer concern to others, as had been mentioned during the seminar on the application of Fund policies in planned economies. It might therefore be advisable to assess the working of the new set of informal criteria at a later stage. In addition, he asked the staff to confirm his interpretation of the passage on page 30 of EBS/82/206, namely, that although relevant data would be communicated monthly, the program would be evaluated on a quarterly basis, as was customary. He also shared Mr. Polak's doubts about whether traditional performance criteria need be maintained at all, if they were thought to be ineffective.

Finally, Mr. Barbone said, he had no major objections to the staff's analysis of the request for a compensatory financing purchase, with the possible exception of its optimism about the development of external demand, an attitude that seemed however to be rather common in staff papers accompanying such requests. On a more general question, he had noticed that exports both to the convertible and nonconvertible areas had been used in calculating the shortfall. In Hungary's case, exports to the nonconvertible area actually contributed negatively to the shortfall, being in excess of the geometric trend. However, if the contrary had been true, namely, that while exports to the convertible area were above the trend, exports to the nonconvertible area were for some reason considerably below it, so as to produce an overall shortfall, he asked whether the member would still qualify for compensation under the compensatory financing decision. The inference in EBS/82/205 was in the affirmative, although it might at least appear peculiar to finance a deficit in convertible rubles with a purchase of SDRs. That was a issue that might need to be considered at a later stage.

Mr. Dallara remarked that among the comprehensive set of papers on the Hungarian economy, the clear and concise outline of the program's assumptions, targets, and adjustment measures in Table 15 of EBS/82/206 was of special note. In addition, the supplementary statement made by the staff representative had helped to clarify important issues. He supported the draft decisions to be taken in connection with the Article IV consultation, the stand-by arrangement, and the drawing under the compensatory financing facility.

As with all Article IV consultations, Mr. Dallara continued, the consultation with Hungary served to point out first, the general trends in economic developments and policies over a period of time; second, the areas of policy success; and third, the shortcomings in economic and financial policies and performance. Therefore, the Article IV consultation could serve to a certain extent as a guide in judging the adequacy and appropriateness of the adjustment policies to be pursued under the stand-by arrangement. At the same time, for the very reason that Article IV consultations often helped to frame the adjustment needs of members, it might be helpful where practical, to the member concerned for the Board to undertake such consultations early, prior to considering requests for the use of Fund resources.

Hungary was in the difficult position of needing to continue with economic reforms that were largely structural, Mr. Dallara commented, and in the presence moreover of maladjustments in external balances characterized by a severe external financing constraint of uncertain magnitude and duration. The major immediate problem was for the authorities to adjust to the external constraint as efficiently and as effectively as possible. In his view, that meant that balance of payments adjustment should take place not only without sacrificing the important reforms already made, but while reforms continued to be implemented. The process of economic liberalization would be critical to the future long-term success of the Hungarian economy. The process, involving, among other things, as Mr. de Groote had pointed out, the need to allow market mechanisms to work--particularly on prices and the cost of production--together with the need to emphasize supply considerations--particularly the need to allow broad-based competition to flourish--could not be compromised in the short term if a sustainable balance of payments position consistent with stable growth would be not only achieved but also maintained. He was pleased that the Hungarian authorities seemed to hold a similar view of the need to adjust without sacrificing economic reforms. The program indeed appeared to have been framed with those objectives in mind; but if the need for further adjustment arose--a distinct possibility--the authorities would have to be diligent in keeping both short-term and structural objectives in mind.

The immediate goal of the Hungarian authorities, Mr. Dallara observed, was to continue the rapid adjustment of the current account of the balance of payments in 1983 in order to help ensure that it could weather any adverse developments that might occur in the capital account in 1983, and to build up depleted foreign exchange reserves. The objective of rebuilding reserves was a particularly important one in Hungary's case, and he welcomed the attitude of the authorities. Since GDP was not expected to increase in 1983, the desired current account adjustment clearly necessitated a sharp reduction in domestic demand. For that reduction to be achieved, he agreed with the authorities that it would be necessary for them to continue to pursue--and possibly to intensify--the tighter monetary and financial policies introduced in 1982, and to dampen domestic demand through prudent price and wage policies.

However, like the staff and other Directors, Mr. Dallara commented, he would have preferred for the authorities to give relatively more emphasis to the reduction in real disposable incomes through corrective price changes rather than through wage moderation, so that the structure of relative prices could be improved. A more rational structure of relative prices would not only be in keeping with the authorities' goal of economic reform and the long-term objective of promoting an efficient allocation of resources, but would also facilitate the current adjustment effort and enable the authorities to remove the import restrictions, which they were committed to do. He noted that certain corrective price changes had been made, and would encourage further adjustments.

With respect to monetary and credit policies, Mr. Dallara went on, he was glad that the program entailed additional safeguards to better ensure that domestic credit was restrained. In light of the problems encountered in some other programs with interenterprise credit, the innovation of defining the credit ceiling net of enterprise deposits was welcome. He asked the staff whether in its view that particular technique might prove useful and practicable in other programs where credit ceilings failed to control adequately the growth of credit.

The monitoring of the program by the use of data on real cash incomes of the population and an investment in the socialist sector was also intriguing, Mr. Dallara remarked. It should prove useful in ensuring that domestic demand was following the desired path and that adjustments were made as necessary.

On interest rates, the authorities had made important adjustments in rates for loans to enterprises, Mr. Dallara observed, which should help to allocate investible resources more efficiently. Perhaps the staff could indicate whether or not there were any signs that those changes in interest rates were having the desired effect of forcing inefficient firms out of business, or whether interest costs were simply being tacked on to prices. If the latter was true, what could be done to foster more competition in the goods market? On the broader question of competition, like Mr. Laske, he associated himself with Mr. Polak's comment. Interest rates were only one part of the process whereby producer prices in Hungary seemed to follow a cost-plus approach that did not encourage efficient deployment of the factors of production. That was a fundamental problem calling for fundamental action.

Referring once more to interest rates, Mr. Dallara considered that there was more room for interest rate action on the deposit side and with respect to loans for consumers. Interest rates on deposits needed to be raised to higher levels, especially as it was stated elsewhere in the paper on the stand-by arrangement that the authorities were concerned about dissaving by households stimulated by a rate of inflation approaching 10 per cent. Dissaving would surely be less of a problem if the authorities instituted positive real rates for deposits. While such a move would necessitate increasing the loan rates for housing, he agreed with Mr. Laske that that too would be desirable. From the experience of his own authorities, it was clear that difficulties could arise in allocating investible resources if housing or any sector was given significantly preferential access to credit.

Referring to the external sector, Mr. Dallara stated, the authorities clearly had an ambitious target for export growth. Economic activity in Hungary's export markets might well be lower than had been envisioned earlier. The exchange rate for the forint had recently been adjusted, but further adjustment would be necessary if Hungary was to meet its current account objectives. Yet exchange rate changes alone would not be enough; if they were to have their desired effect on domestic demand, the authorities had to ensure that exchange rate changes were promptly and fully reflected in the domestic price of tradables.

While he recognized the severity of the external situation faced by Hungary, Mr. Dallara added, he regretted that the authorities had resorted to increased import restrictions in 1982. He noted that those restrictions were to be lifted during the program period, and hoped that they would be lifted sooner rather than later. The information on import restrictions might be somewhat incomplete, and he would appreciate it if the staff could advise the Executive Board whether it was fully confident that enough detailed information was available to enable the Fund to monitor all elements of the performance criterion relating to the imposition or intensification of import controls.

In concluding, Mr. Dallara reiterated the importance that his authorities attached to the continuation of structural reforms for adjustment and growth over the medium term while the Hungarian authorities were pursuing the necessary short-term adjustment effort. It was essential in all economies to get the price structure right in order to foster the efficiency of the economy; he would define the price structure in its broadest sense to include goods, prices, wages, interest rates, and exchange rates. The authorities had taken steps toward a more rational price structure, but much remained to be done.

While his authorities supported Hungary's request for a compensatory drawing, Mr. Dallara noted, they had some concerns about the degree to which the shortfall was beyond the control of the Hungarian authorities. Convertible trade had surely been affected by insufficient action on the exchange rate during the shortfall year. With respect to nonconvertible trade, it seemed difficult to determine what was within or outside the control of the authorities, since it was not completely clear how such trade flows were determined. Finally, while he was not going to second-guess the staff on forecasts for the postshortfall years, as other Directors had pointed out, the level of activity in foreign markets assumed when the staff had written its paper was no longer a very likely outcome. The implication, if the authorities were firm in their determination to achieve a convertible current account surplus of the order of $600 million in 1983--and there was every indication that they were--was that further adjustment efforts might be required.

Mr. Prowse considered that the concurrent consideration by the Executive Board of an Article IV consultation, a stand-by arrangement, and a compensatory financing drawing was appropriate. Such a procedure might be followed rather more often.

His chair fully supported the proposed decisions, Mr. Prowse added. The statement by the staff representative had been reassuring with respect to the substance of the program, which he had felt was not sufficiently well spelled out in the letter of intent. The core of the adjustment program in centrally planned economies had to be measures directly affecting the real economy. But it was also evident that the financial side could not be neglected. The staff had brought the two elements together as well as it could. The importance of the financial side was that it made the real adjustment smoother and more efficient; excessive liquidity, for instance, could weaken the commitment of enterprises to the plan. Firm or even strict credit and monetary policies should therefore be pursued.

The question that had occurred to him was whether the acceptance of a role for financial variables meant that they were adequate in themselves, Mr. Prowse observed. His tentative view was that those variables were desirable in centrally planned economies, but he was not certain that they were adequate to the task. Mr. de Groote had referred in his statement to a performance clause in the form of direct control over real cash incomes, and the staff representative had indicated the serious commitment of the authorities to respecting that target. If it could be achieved, there would be a good chance of making the adjustment effective. But such financial variables were not performance criteria, and he was not sure that their impact on real adjustment would be direct and clear enough to reassure the Executive Board that signals indicating that the adjustment program was not on track were received in a timely way. He joined other Directors, and indeed Mr. de Groote himself, in suggesting that a performance clause might be developed and might be relevant at least in other similar economies. He asked the staff whether it believed that that would be possible.

A number of problems would arise, Mr. Prowse admitted. First, the statistical information might not be available readily or in a timely fashion. At the same time, he recognized that the more traditional measures that might have been proposed for the program were also open to some doubt. Reading the letter of intent in the usual context, it seemed to lack adequate detail about interest rate or exchange rate policy. Yet as Mr. de Groote had remarked, some informed observers of the Hungarian economy believed that interest rates had hardly any effect on savings at all; he wondered whether the staff agreed, and if so, what were the likely implications for the program in the future? The suggestions being made about the need for positive real rates of interest might be irrelevant. The aim should perhaps be to render interest rates more effective, by means of developing a financial infrastructure.

It was evident from the staff papers, as it had been with respect to other centrally planned economies, Mr. Prowse recalled, that reviews of adjustment under the program would be of critical significance.

On the debt situation, Mr. Prowse noted the risk of a further substantial capital outflow. In that context, he asked the staff whether discussions with private commercial banks indicated that support for the Hungarian borrowing program, including short-term loans and supplier credits, was likely to be maintained.

Finally, Mr. Prowse stated, the staff had drawn attention on pages 87 and 88 of the report on recent economic developments to the significant effects on Hungary's exports of restrictive trade policies by its trading partners. Particular note was made of the effects of the Common Agricultural Policy of the European Community. It was mentioned that 46 per cent of Hungarian exports in convertible currencies were at present subject to restrictions, and that agricultural exports to the EC markets in 1981 had suffered a loss of about SDR 320 million as a result of restrictive provisions under the Common Agricultural Policy. Reference was also made to the barriers imposed by most developed and industrial markets. He wondered whether the staff believed that that market situation argued for some adjustment to the distribution and the commodity structure of the Hungarian export sector.

Mr. Sigurdsson welcomed the first Article IV consultation with the Hungarian People's Republic, as well as the opportunity to consider its requests for Fund assistance, which he fully supported. Hungary was facing a variety of economic problems. Those of a fundamental nature had evolved as a result of imperfect structural arrangements and the extensive use of subsidies, which in many ways was the central economic problem. The result had been distortions in relative prices and the maintenance of inefficient production units. Then there were more medium-term problems, such as those relating to the maturity structure of external debt. It would be unfair to say that Hungary had followed a careless external borrowing policy in recent years, but the term structure of its foreign debt had proved difficult to manage in a protracted recession, particularly when combined with a perhaps overcautious international financial community and increasing protectionism.

Hungary had, in fact, suffered severely from a rising incidence of protectionist measures, and the regional attitude of commercial banks, as reflected in the withdrawal or sharply diminished availability of credit as well as in significantly more costly terms on new loans, Mr. Sigurdsson observed. It was somewhat disquieting to note the large debt service burden of the coming two or three years and the demands that it would place on domestic policy if the authorities' objectives were to be attained. Finally, there was the immediate liquidity problem, which had developed early in 1982. The rundown of Hungary's international reserves needed to be dealt with quickly and firmly, and reserves restored to a more normal level.

The responses of the authorities to all of the emerging economic difficulties were in many respects commendable, Mr. Sigurdsson commented. Some of the policies initiated were by necessity of a longer-term nature because several sectors of the economy had been shielded for a long time and could not be modified instantly. The flexibility shown by the authorities and their apparent commitment to improving economic efficiency were encouraging. Furthermore, the recent shift of the primary emphasis to the maintenance of a sustainable balance of payments position exemplified prudence. For all those reasons, the Hungarian program was worthy of Fund support.

Among the measures that seemed to be of particular importance, Mr. Sigurdsson mentioned the significant progress made in simplifying the exchange rate mechanism, although much remained to be done. The authorities should aim at removing those exchange restrictions giving rise to multiple currency practices. Recent changes in exchange rate policy, with the devaluations of the forint, were in the right direction. The staff's recommendation that more active use be made of exchange rate policy, in order to achieve external balance, in combination with proper domestic policies of demand restraint, was certainly of the greatest importance. Second, the increasing reliance on price incentives and the promotion of efficiency in production was encouraging. Third, the system of wage determination was complicated and might have led to inefficiencies; it was thus in need of change. Fourth, interest rate developments and interest rate policies were worthy of notice.

Real rates on credit had become substantially positive, whereas deposit rates remained negative, although they would be less so at the beginning of 1983 if the planned increase in nominal rates took effect, Mr. Sigurdsson commented. Mr. de Groote's remarks on rates of interest on foreign currency accounts were interesting in that connection. He had noted the doubts of the authorities about the effectiveness of a general increase in interest rates in stimulating savings; the response, if it could be observed when the mid-term review took place in 1983, would be of great interest. As stated in the staff's papers, the financial market was not highly developed; against that background, it was important to encourage innovations, such as the planned savings bonds issue. Finally, the fiscal measures enacted and envisaged would play an important role in the adjustment effort. He noted in particular efforts to reduce subsidies and to establish more realistic prices for consumer goods and services. The reduction of the role of subsidies would indeed be crucial to the adjustment process.

Like the staff and other Directors, he had some worries about the recent intensification of restrictions, which was hardly compatible with a comprehensive liberalization effort, Mr. Sigurdsson considered. The sharp deterioration of the external position, and frustration caused by the various restrictions introduced in Hungary's export markets, had no doubt prompted the use of those measures. He noted that the restrictions were to be removed during the program period, and joined others in urging the authorities to eliminate them at the earliest possible opportunity.

Referring to the incidence of the burden of adjustment, Mr. Sigurdsson remarked, while he had understanding for the concerns of the authorities, he agreed with the staff that a greater share should probably fall on private consumption. Investment had declined continuously over a number of years, and it was necessary to be cautious so as not to endanger the growth potential of the economy.

Two more specific questions that he wished to raise, Mr. Sigurdsson added, related first to the incomes policy followed in Hungary, which was described in Appendix III to the report on recent economic developments. One interesting question was, of course, whether the problems of wage policy might not be rooted in subsidy policies--because subsidies might control the performance indicators, namely, profits--rather than in the system of tax-based income policy (TIP) itself. He would be interested to learn more about the effectiveness of the system as it had been implemented, as well as about the substance or the direction of the reforms that the staff and the authorities seemed to agree were needed.

His second question concerned pricing policy, Mr. Sigurdsson said. It had been stated on page 16 of the staff report (SM/82/176) that "while great emphasis has been laid on maintaining income parity between workers in agriculture and industry, social and incomes policy considerations have led not only to a subsidization of food prices but to the maintenance of agricultural producer prices well below industrial producer prices." He would appreciate a clarification from the staff as to whether that sentence was comparing the prices of agricultural and industrial inputs. On the price system in general, he was especially grateful for Appendix IV in the report in recent economic developments. The staff's papers offered an interesting insight into the problems of administered price and wage formation, showing that even when systems were as ingenious as some of the Hungarian ones were, they tended to produce inefficiencies and undesirable side-effects.

His only remark on the request for a compensatory financing drawing, Mr. Sigurdsson said, was to join Mr. de Maulde and others in finding the export projections for the postshortfall years to be somewhat optimistic, both as they related to the growth in foreign convertible markets in general and to Hungarian exports in particular. For that reason, he would welcome any additional comments by the staff.

In conclusion, Mr. Sigurdsson reiterated his support for the adjustment program embarked upon by the Hungarian authorities. Like some previous speakers, he was somewhat doubtful about the efficacy of credit ceilings as performance criteria in a system like Hungary's. The staff was undoubtedly right when it said that the direct targets on cash income of the population and on investment were essential for monitoring the successful implementation of the program. The staff representative's statement had been reassuring on that score.

Mr. Joyce said that Hungary's request for a stand-by arrangement appeared to his authorities to be based on a sound analysis of the situation in which the country currently found itself and on the continuation and strengthening of demand management policies that clearly provided the only effective way to cope with current liquidity problems. In addition, he joined other Directors in commending the authorities for the measures already taken to offset the deterioration experienced in 1981 and early 1982. Some of those measures were beginning to show results; he particularly welcomed the information provided by the staff confirming that the payments arrears that had emerged in mid-1982 would be fully eliminated by the middle of December. The authorities had clearly accepted that a significant reduction in private consumption and in real living standards was necessary if the program was to succeed; steps were being taken to reform the wage system, to reduce subsidies further, and to cut back on planned investment outlays, at least until the liquidity crisis had been met, since the planned cutback could not be continued for too long. None of that would be easy for Hungary, but the situation with which it was confronted was a particularly difficult one.

It was clear that the serious liquidity problems that Hungary confronted, if not all of the country's making, had been compounded by some of the actions either taken or not taken by the authorities, Mr. Joyce remarked. First, they had not moved quickly enough when they had found themselves caught with indebtedness that continued to rise and to have an increasingly short maturity. Simultaneously, they were faced with declining export markets, rising interest rates, and, last of all, a crisis of confidence in the banking community about the state of Eastern European economies. Second, the measures that the authorities had started to take in 1979-80 had not been sufficient unto the task, partly because the task itself became much heavier as the months went by. As a result, in 1981 the adjustment program had fallen short of its objectives. Inadequate control of wages and credit, and of both consumption and investment, had of course compounded the problem in the financial markets, which had perhaps not unreasonably assumed that Hungary had at least a potential for debt and debt servicing problems similar to those of some of its neighbors.

The task at present was to restore Hungary's international liquidity and to rebuild its credibility in financial markets, Mr. Joyce continued, and there was no better way of accomplishing it than through a successful execution of the stand-by program. Vigilance would be required, as other Executive Directors had stressed, and maximum flexibility, especially with respect to prices and incomes but to exchange rates as well. He felt sure that the authorities would want to keep in close consultation with the Fund during the program period. He trusted that they would be ready to take additional steps if the program targets showed signs of not being met, and that they would not delay action until there had been a review in the Executive Board. He was glad that additional funds were being made available to Hungary under the compensatory financing facility.

A number of distinguishing features made Hungary's situation of particular interest, Mr. Joyce remarked. Its socialist economy was not only one of importance but also one that was well launched on a process of major change in management and in the allocation of resources. The fact that the stand-by arrangement was being activated in the middle of that ongoing process raised questions about the way in which signals given by changes in prices, and more particularly in profits and wages, and in interest rates and exchange rates, were transmitted, how they were received, and how rapid the transmission was. As other Directors had said, the information in the staff papers on those aspects argued in favor of flexibility on the part of the Fund and its staff in analyzing an economy like that of Hungary and other socialist countries, which would obviously continue to operate differently from some of the economies in the industrial West. The need for flexibility on the part of the Hungarian authorities themselves was also thereby re-emphasized because one of the reasons why developments had gone a little awry was that some of the signals that they had hoped would be transmitted through the price/wage mechanism had in fact not been received in quite the way that theoretical examples indicated. He did, however, strongly support the structural changes that the authorities were making. Those changes were important not only for the future of Hungary but also for the success of the program upon which they had embarked with the Fund, even though the full benefits might not be reaped during the life of the stand-by arrangement itself.

The request by Hungary for Fund assistance seemed to him to be somewhat unusual because its underlying balance of payments need, at least at present, reflected capital account rather than current account flows, Mr. Joyce observed. He had accepted the request as valid and indeed had supported it, but he was not clear in his own mind about the implications in that respect of the provisions in Article VI governing use of the Fund's general resources for capital transfers. There were a number of countries running into serious liquidity crises, associated with substantial capital flight, and he was not sure whether there was any relationship between requests to use the Fund's resources under such circumstances and Article VI.

No doubt by chance, Mr. Joyce remarked, the amount of the stand-by arrangement was approximately equal to the amount of the loan extended by the Bank for International Settlements to Hungary in 1982, which presumably had to be repaid in 1983. Money of course was fungible, and it could be argued that the proceeds of the drawings on the Fund might be used in part to meet obligations to the BIS and to others. He simply wished in passing to draw attention to the much more general question of the timing and relationship of additional lending through the BIS or by member governments in anticipation of the negotiation of a full Fund program.

Referring to the current account forecasts, Mr. Joyce wondered whether they did not continue to be overoptimistic, although he stood to be corrected. While he welcomed the undertaking to remove import restrictions, he hoped that the forecast fall in imports had been based on the assumption that those restrictions would in fact be removed. On the export side, he was glad that the prospects for tourism had improved somewhat, but wondered whether the projections for exports were likely to prove optimistic, particularly in light of the somewhat slower than expected recovery taking place in Western Europe and in North America.

As for the capital account, Mr. Joyce joined others in being somewhat concerned about the debt maturity structure. The staff pointed out on page 24 of EBS/82/206 that there would be a large increase in debt service payments in convertible currencies in 1984, reflecting a bunching of maturities on medium-term and long-term debt. Was the staff in a position to provide any more information on how seriously the authorities viewed the problem and to what extent they expected to be able to make adjustments in order to deal with it?

Finally, Mr. Joyce said, he too had to admit to some confusion about how far and how fast the authorities in fact planned to go in the field of subsidies and prices. Like others, he had noted the intention to increase agricultural prices and reduce subsidies, but as he understood it, the commitment did not extend to basic consumer goods, including meat. Thus, he would welcome further information about what the authorities intended to achieve with subsidies and prices in 1983, over and above the steps described in the staff papers.

Mr. Hirao stated at the outset that he could support all the proposed decisions. It was clear from the staff's papers that the most urgent problem the Hungarian authorities faced was the current account deficit coupled with net capital outflows and the resultant deterioration of their liquidity position. Whereas it would have been important to restrain domestic absorption, domestic demand had continued to be stronger than planned. Earlier in 1982, the authorities had taken steps to alleviate the liquidity shortage in the external sector. Those steps had included a tightening of credit, a freeze of some government expenditures, higher interest rates, depreciation of the forint, and curbs on real wages and new investment. He joined the staff in welcoming those measures, and also endorsed its suggestion that a greater share of the adjustment burden should fall on consumption. The significant reduction in subsidies and in wage increases envisaged under the program were steps in the right direction. He also welcomed the information provided by the staff representative on the further steps being taken by the authorities to control cash incomes of the population. He had noted that the Hungarian authorities themselves recognized the danger of carrying the recent policy of cutting back on investment projects too far, because of the possibility of adverse effects on future export capacity. He wondered whether such effects had not already been felt, especially in light of the emphasis on investment cuts in the authorities' efforts since 1979 to restore external equilibrium.

In its appraisal in the staff report for the Article IV consultation, Mr. Hirao observed, the staff had expressed the view that "it would be prudent to aim for a large current account surplus in 1983, as external financing is likely to remain difficult, so long as a sizable share of exports continues to be absorbed by the servicing of Hungary's relatively large foreign debt." The program under discussion was designed to achieve a surplus of $600 million in 1983, which would require a surplus on trade account equivalent to 22 per cent of convertible currency exports. Like other Directors, a trade surplus of that magnitude seemed to him to be on the high side. Continuation of the recent upward trend in exports to oil exporting countries, as demonstrated by the increase in the number of joint projects with those countries, might well provide a favorable background for achieving that rather ambitious target. However, considerable efforts should be exerted in order to achieve the goal. It would be helpful if the staff could elaborate further on any other factors that would contribute to a trade surplus.

On credit policy, Mr. Hirao continued, it had been noted in the staff report that the excessive stockbuilding by enterprises in 1981 had been financed by the extension of credit. In addition, it was mentioned that the increase in interest rates by three or four percentage points in the summer of 1982 had not had the intended restrictive effect, partly owing to the better profit and liquidity position of enterprises. He hoped that the demand for credit would be limited by the current high level of real interest rates, which, as Mr. de Groote had noted, had reached 9 per cent, and by further measures to bring the excess liquidity of enterprises under control.

Finally, Mr. Hirao remarked, it was encouraging to learn from the staff papers that the efficiency of Hungarian agriculture was up to international standards. He hoped that that advantage could be maintained through appropriate policy measures.

Mr. Zhang welcomed the presence of the Hungarian representative, and supported the request by the Hungarian Government for a stand-by arrangement and for a drawing under the compensatory financing facility. It had been clearly demonstrated in the staff papers that Hungary had achieved considerable progress toward restoring internal and external balance during 1979 and 1980, but that it had experienced renewed balance of payments difficulties in 1982 as a result of the unfavorable environment that had developed in international financial markets in late 1981. Three broad observations could be made relating to the trend of developments in general, and to experience with the implementation of the economic reform program in particular.

The first observation, Mr. Zhang continued, was that while the reform program had significantly changed and would continue to change the structure of the country's economy toward a more market-oriented form, Hungary basically retained public ownership of the means of production and a central planning system. A large proportion of new investment was still planned and controlled by the Government. There was, however, a shift in the methods of implementing the plan, from administrative orders given to individual enterprises, to indirect influence on their activities through the market mechanism by means of fiscal, credit, and price policies. The greater scope for autonomous decisions by foreign trade enterprises was an integral part of that reform. In evaluating the economic results and in making policy recommendations, Directors should pay due regard to the specific policy and institutional framework in Hungary, which was different from that of a market economy.

The second observation that could be made, Mr. Zhang remarked, was that the basic aim of the reform program at the present stage was not to spur the rate of economic growth in the short term but to reduce the chronic trade deficit, particularly in relation to the convertible currency area, and to curtail the continued excessive demand for resources for investment. Thus, the measures adopted were not designed to achieve an immediate expansion of output but to effect a more efficient allocation of resources, achieve a more rational structure of production, and a better management of enterprises over the longer run.

The third observation was that the implementation of the reform program would continue to be determined to a considerable extent by external forces beyond Hungary's control, because the external sector constituted such an important part of the economy, Mr. Zhang stated. The current world recession and the increase in protectionism that had adversely affected Hungary's exports, together with unfavorable developments in international capital markets that had led to Hungary's recent liquidity crisis, were cases in point.

Full realization of the aims of the reform program would therefore clearly be long and difficult, Mr. Zhang remarked. Moreover, implementing a program for the sake of improving the balance of payments tended to be even more difficult when the economy was growing much more slowly than before. An acceleration of the process, irrespective of the existing domestic and foreign conditions, would tend to result in considerable disturbances that might, as in the past, again set back the process of reform. It was important to keep that factor in mind in evaluating the staff's appraisals of the current situation in Hungary, as well as the request for use of the Fund's resources.

In the staff report for the Article IV consultation, Mr. Zhang noted, the staff had described the measures taken by the Hungarian authorities during the first half of 1982 in order to alleviate the external liquidity shortage. Those measures included a tightening of credit, a freeze on some government expenditure, a reduction in new investment, curbs on real wages, and devaluation of the currency. The staff considered that "these measures do not go far enough in view of the seriousness of the external financing constraint." At the same time that the staff was urging the Hungarian authorities to aim at eliminating the current account deficit, it was also recommending that the existing exchange and trade system should not be made more restrictive but that policies should be pursued permitting the elimination of restrictions and the early removal of bilateral trade agreements. It seemed to him rather inconsistent to ask the Hungarian Government to avoid making the exchange and trade system more restrictive at a time when Hungary had been suffering considerable losses in export earnings due to various restrictive measures imposed by its main trading partners.

In requesting use of the Fund's resources, Mr. Zhang noted, the Hungarian Government had agreed to adopt new measures in the program for the stand-by arrangement. The weight of those measures fell on the reduction of domestic aggregate demand in both the investment sector and the consumption sector. While the authorities recognized that the reduction in investment would inevitably have an adverse effect on the future rate of growth, they were fully aware of the urgent necessity of restricting the growth of domestic demand for balance of payments purposes. The question was whether such action would by itself be adequate to bring about an immediate large improvement in the balance on current account vis-à-vis the convertible currency area. As a matter of fact, such an improvement would depend more upon Hungary's ability to increase its exports to that area. But as had already been pointed out, the severe recession in convertible currency countries, as well as the serious quantitative and other import restrictions that those countries applied, meant that the prospects were not bright. Furthermore, because of its debt service problem, Hungary remained vulnerable to instability in world financial markets, which was entirely beyond its control.

It was true that the staff had clearly recognized the impact of external factors on the fluctuation of government policies in the past, Mr. Zhang commented, but it did not seem to have taken that factor sufficiently into account in formulating recommendations for the near future. Experience had shown that in order to deal with immediate liquidity shortages, the Hungarian Government had had to impose direct controls on some imports. Furthermore, it was conceivable that new selective import restrictions might be needed in the future if the requirements of plan production were to be met.

Finally, Mr. Zhang asked the staff to clarify the purpose of the new informal performance criteria being imposed under Hungary's stand-by arrangement in the form of reporting monthly data on real cash incomes of the population and on investment in the socialist sector. Had such criteria been used in previous stand-by arrangements? What use would the staff make of those data? What was the precise link between the data and the review of the progress made in implementing the program? Did the imposition of new performance criteria reflect a tightening of conditionality, particularly in relation to borrowing by the centrally planned economies?

The Executive Directors adjourned their discussion until the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/82/155 (12/1/82) and EBM/82/156 (12/8/82).

3. COMOROS - 1982 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/82/297 (12/2/82). Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to postpone its consideration of the 1982 Article IV consultation with Comoros until not later than February 16, 1983. (EBD/82/297, 12/2/82)

Decision No. 7261-(82/156), adopted
December 6, 1982

4. ADVISOR TO MANAGING DIRECTOR

The Executive Board approves the appointment set forth in EBAP/82/409 (11/29/82).

Adopted December 6, 1982

5. EXECUTIVE BOARD COMMITTEES

The Executive Board approves the revised proposal set forth in EBD/82/296, Revision 1 (12/2/82).

Adopted December 6, 1982

6. PENSION COMMITTEE

The Executive Board approves the nomination set forth in EBAP/82/417, Supplement 1 (12/3/82).

Adopted December 7, 1982

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/82/411 (11/30/82), EBAP/82/413 (11/30/82), EBAP/82/415 (11/30/82), EBAP/82/416 (11/30/82), EBAP/82/418 (12/1/82), EBAP/82/419 (12/2/82), EBAP/82/420 (12/2/82), EBAP/82/422 (12/3/82), and by an Advisor to an Executive Director as set forth in EBAP/82/414 (11/30/82), is approved.

APPROVED: May 13, 1983

LEO VAN HOUTVEN
Secretary