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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/157

3:00 p.m., December 8, 1982

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
	E. M. Ainley, Temporary
J. de Groote	
	A. Le Lorier
A. Donoso	
	C. Dallara
	T. Alhaimus
A. H. Habib	Jafaar A.
T. Hirao	T. Yamashita
R. K. Joyce	
	J. R. N. Almeida, Temporary
G. Laske	
	L. Barbone, Temporary
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
F. Sangare	
	J. L. Feito
J. Sigurdsson	
Zhang Z.	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

I. Szalkai, Assistant General Manager, National Bank of Hungary. Asian Department: H. Neiss, Deputy Director; 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. Somogyi. Exchange and Trade Relations Department: S. Mookerjee, M. Allen, G. Belanger, H. W. Gerhard, M. Guitian, E. B. Maciejewski. 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. Secretary's Department: B. J. Owen. Treasurer's Department: D. Berthet, 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: S. R. Abiad, C. J. Batliwalla, A. B. Diao, S. El-Khouri, M. A. Janjua, P. Kohnert, H.-S. Lee, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, H. Arias, M. Camara, L. E. J. Coene, T. A. Connors, G. Ercel, I. Fridriksson, M. J. Kooymans, P. Leeahtam, W. Moerke, V. K. S. Nair, Y. Okubo, E. Portas, J. Reddy, C. A. Salinas, D. I. S. Shaw, H. Suzuki, P. S. Tjokronegoro, Zhang X.

1. HUNGARIAN PEOPLE'S REPUBLIC - 1982 ARTICLE IV CONSULTATION, STAND-BY ARRANGEMENT, AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors continued from the previous meeting (EBM/82/156, 12/8/82) their consideration of 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 equivalent to SDR 475 million (EBS/82/206, 11/10/82; and Sup. 1, 12/6/82), and for a purchase equivalent to SDR 72 million under the compensatory financing facility (EBS/82/205, 11/10/82; and Sup. 1, 12/6/82). They also had before them a report on recent economic developments in the Hungarian People's Republic (SM/82/186, 9/17/82; Cor. 1, 12/1/82; and Cor. 2, 12/3/82).

Mr. Salehkhou remarked that, among centrally planned economies, Hungary had gone furthest toward reconciling the concept of central planning with liberal instruments and mechanisms. Indeed, reforms introduced mainly after 1968 had gradually moved economic policies away from an excessive reliance on administrative and regulatory measures and had begun to emphasize the need for market incentives, competition among various sectors of the economy and among state-owned enterprises, and, more generally, a more efficient allocation of resources. More recently, the reforms had aimed at extending to the industrial and services sectors the system of ownership, production, and management that had initially been introduced in agriculture. The reforms provided for competition among state, cooperative, and private units, for a substantial autonomy of management, and for the free determination of prices of a number of products.

External factors and delays in adequately adjusting economic policy to new developments had resulted in a serious setback to the momentum of reforms in 1974 and had produced a sharp deterioration in Hungary's terms of trade, Mr. Salehkhou noted. The failure to reduce economic growth in line with the less favorable environment of the mid-1970s had led to large current account deficits and to a substantial accumulation of foreign debt. An even more serious setback had been suffered by the Hungarian economy in 1981 and early 1982, when foreign demand for, and the prices of, main exports had slackened markedly. In combination with soaring international interest rates, the slack in demand had wiped out the commendable improvement achieved in the current account deficit in 1979 and 1980.

It was clear that strong domestic demand and other internal developments and policies were in part responsible for Hungary's external difficulties, Mr. Salehkhou commented. However, the authorities' efforts to adjust internal and external imbalances and to introduce structural reforms had also been hindered by exogenous economic factors. Their efforts had suffered mainly from the political and economic difficulties experienced by a number of neighboring countries. As international banks had become overcautious in their assessment of all Eastern European economies, medium-term foreign loans had fallen off sharply, while capital outflows had increased substantially.

In contrast to their response to the 1974 crisis, the authorities seemed to have reacted to the current difficulties in a timely fashion and with appropriate policies, Mr. Salehkhou remarked. To alleviate the liquidity shortage, they had adopted a wide range of measures aimed at curtailing domestic demand. The comprehensive package of measures tackled both consumption and investment and covered most areas of economic policy while continuing to strengthen the impetus of the reform movement. In that regard, it was surprising to note in the staff appraisal on page 21 of SM/82/176 that the measures were not considered by the staff to be sufficient. The staff view obviously did not take appropriate account of specific conditions in Hungary or of the sensitivity of some measures, particularly those aimed at curtailing consumption and real income in a country where the standard of living was relatively low. While he could agree with the thrust of the staff appraisal--particularly with the call for a more active role for the exchange rate and for further liberalization of the pricing system--sustainable progress could be achieved only gradually, and internal stability and the cooperation of the people would be necessary if such progress was to be achieved.

The program to be supported by resources under the requested stand-by arrangement was a comprehensive one and represented a good example of the authorities' serious attitude toward adjustment and structural reform, Mr. Salehkhou considered. Unfortunately, the success of the program--as in so many developing countries--would depend as much on developments beyond the control of the authorities as on the full implementation of program policies. In that regard, he welcomed the authorities' commitment, as stated in the letter of intent, to take any additional measures necessary to achieve the program's objectives. Should the impact of adverse exogenous factors intensify, the Fund should stand ready to show flexibility and understanding in supporting any additional measures taken by the authorities.

He had been grateful for the reference by the staff to the restrictive measures in foreign markets that adversely affected Hungarian exports and those of developing countries in general, Mr. Salehkhou said. Most of those measures were implemented by Western countries and were directed toward curtailing--if not preventing--exports by economies that had achieved higher competitiveness in some sectors such as textiles, clothing, chemicals, and agriculture. In that regard, his chair could fully support the stand recently reaffirmed by the Managing Director against the trend of protectionism that had been growing for some years. Protectionism had hit Third World countries particularly hard and tended to hamper their efforts toward adjustment and growth. He also hoped that exchange restrictions would be emphasized in Article IV consultations with all member countries, regardless of whether or not they used Fund resources. Finally, as the staff had convincingly argued the case for a purchase by Hungary under the compensatory financing facility, he could go along with the request. Indeed, he could warmly support all three proposed decisions.

Mr. Alhaimus noted that the staff paper had described in some detail the nature and causes of the economic problems facing Hungary. A number of those problems had been due to, or aggravated by, developments on the international scene--such as the recession in industrial countries, stagnating tendencies in the growth of world trade, and protectionism--as well as developments in the region. The Hungarian authorities should be commended for their determination in recent years to implement a series of broad-based policy changes designed to reduce imbalances in the economy and to mitigate the consequences of exogenous developments.

Although a large number of policy measures had been introduced only since 1978, the authorities had for some time shown awareness of the need for corrective measures, Mr. Alhaimus observed. They were intended to improve resource allocation, in particular by introducing flexibility in the price system with the immediate objective of improving the balance of payments. Of course, the reorientation of the transition mechanism and the change in the mode of determining the basis of cost/price relationships would be time-consuming and could frequently involve trial and error. The scope for effective use of traditional market-oriented financial instruments could expand only gradually in an economy that remained largely centrally planned and had a rather simplified financial system.

The adjustment efforts undertaken by the authorities in recent years, as well as the policy changes proposed in the stand-by arrangement, had far-reaching implications and involved both short-term and long-term sacrifices, Mr. Alhaimus commented. Real investment had shown an average decline of 5.5 per cent since 1980, which compared unfavorably with the substantial increase in the preceding three years and with the targeted annual increase of 1.4 per cent during 1981-85. While the adjustment measures were expected to contribute to an improvement in the external account during 1982 and 1983, it would be a difficult task for the authorities to revive the momentum of growth in the economy. The reduction in investment in real terms and the related measures in the fiscal and monetary areas had implications for both growth and employment. While the problem of redundant labor was not acute, serious unemployment had been avoided mainly at the cost of a deterioration in productivity, which raised the broader question of medium-term strategy, particularly with respect to sectoral priorities, changes in the composition of investment and, more important, improvement in productivity. Perhaps the services and housing sectors and small enterprises could generate noninflationary growth while absorbing labor that had been made redundant in industry.

The staff had rightly underscored the scope and importance of increases in productivity, Mr. Alhaimus considered. Overall investment in the economy had been at about 25-30 per cent of GDP, but the growth rate in recent years had been minimal, and no improvement was expected for 1983, which seemed to suggest an unusually high capital/output ratio. One area in which productivity might be increased--and redundant labor absorbed--was that of agriculture. Water resources remained underutilized, and a decline had recently been reported in irrigated areas because of increases in water rates, prices of irrigation equipment, and fuel costs.

Perhaps the staff should also have more closely examined the availability of technology as a determinant of productivity.

He had some difficulty in assessing the impact of the adjustment in energy prices in 1973/74 on Hungary's current account, Mr. Alhaimus said, although both the staff and Mr. de Groote seemed to have considered it important. Available data seemed, however, to indicate that the import of mineral fuels and lubricants from nonsocialist countries had accounted for a small percentage of imports--approximately 2.3 per cent--during 1977-81. The bulk of those supplies had come from socialist countries where, as noted by the staff, oil prices had not been adjusted to the world level before 1977.

Executive Directors should have no difficulty approving Fund support for the stand-by program, which essentially continued the process of policy changes initiated in 1978, Mr. Alhaimus observed. Turning to the policies themselves, he noted, first, that the program provided for a 3-4 per cent reduction in domestic demand in real terms--as opposed to a 1 per cent reduction in 1982--and he wondered whether the change would be sustainable as a regular policy feature. The incidence was mainly on investment, which had long-term implications. Second, he had the impression that credit availability under the program might be stringent and might affect genuine credit needs in certain sectors. As reported by the staff, small enterprises that were playing an increasingly important role in the economy had not been receiving adequate credit. As for possible changes in the interest rate, he was inclined to support the view that the effectiveness of the interest rate as a policy tool to mobilize savings might be limited, given the simple financial system and other features of the Hungarian economy. Similarly, the use of adjustments in the exchange rate in the context of continued restrictions on Hungary's exports in foreign markets together with domestic supply constraints seemed unlikely to achieve the intended objectives.

Third, Mr. Alhaimus said, he saw little justification for generalizing the use of performance criteria relating to changes in domestic absorption. They had not been used before and might not be easily applicable in different economies. Data on real cash incomes and investment in the socialist sector were supposed to be reported to the staff on a monthly basis; however, given problems with statistical accuracy and the fact that statistics often became available only with a time lag, he had some doubts about their usefulness. It would perhaps be more helpful if the staff monitored the progress of small enterprises, housing, and other sectors that were likely to generate noninflationary growth. On another matter relating to performance criteria, he observed that the staff would be visiting the country on a quarterly basis; he wondered why the staff preferred quarterly visits rather than the more normal half-yearly reviews of stand-by programs. Finally, while the demand management measures and other policies contemplated in the program were expected to contribute to the improvement in the country's balance of payments during 1982/83, the time frame for the solution of the problems facing Hungary went well beyond the program period. It would therefore be helpful to know how the financial markets perceived the recent and proposed policy changes, and whether their perceptions would lead to a resumption of a net inflow of capital.

The request by the Hungarian People's Republic for a drawing under the compensatory financing facility met all the requirements under the relevant decision, Mr. Alhaimus considered. Although the staff had made reference to overvaluation of the forint and the possibility of excess demand, the major factors behind the shortfall remained largely beyond the control of the authorities. The export shortfall was temporary and reversible, and the stand-by program--as well as the letter of intent--clearly indicated that the authorities were cooperating with the Fund to find solutions to the balance of payments problem. He could therefore agree to the request.

Mr. Malhotra stated that he could fully support both the requests for a stand-by arrangement in the amount of SDR 475 million and for a purchase under the compensatory financing facility, which met the test of balance of payments need and amply demonstrated Hungary's strong and determined efforts toward adjustment. He had been impressed by the adequacy of information so willingly provided by the authorities to the Fund staff and had been pleased to see that, over the years, the Hungarian Government had been following a pragmatic and flexible policy within a broad socialist framework. The adjustment program was a comprehensive one, comprising a number of steps already taken or intended in the areas of incomes, consumption, investment, fiscal restraint, prices, exchange rates, interest rates, and exports.

He had been struck by the tendency of his colleagues, in assessing the program and instruments to be adopted by the Government of the Hungarian People's Republic, to emphasize the importance of the various elements usually considered suitable for market-oriented economies, Mr. Malhotra continued. The authorities were attempting to make the necessary adjustments within the framework of Hungary's existing economic system; they were not attempting to re-create the economy in the image of market-oriented economies. However, despite differences in the systems of centrally planned and market-oriented economies, there was a great similarity in the problems faced by them. The efforts of the Fund had to be directed toward finding a set of policies that would enable each country to bring about a sustainable external position, avoiding repetition of the conventional wisdom or philosophy that had been developed in the context of market-oriented economies.

Apart from the inadequacies of internal policies that might have resulted in the current strains on Hungary's external account, its major difficulties appeared to have been due, at least in the short run, to two main factors, Mr. Malhotra said. The first was the adverse external environment facing Hungary's exports, and the second was the major strain in the nontrading account because of the debt servicing burden. The debt problems of Hungary were hardly unique; many countries had a tendency to overborrow, and the commercial banks were increasingly intent on substituting short-term lending for medium-term loans together with increased interest charges. The result was a severe debt servicing problem, which caused difficulties for the commercial banks themselves as well as for the borrowing countries. Sooner or later, the Fund would have to address the problem and provide advice to both member governments and the banking community about how to alleviate over time the ever-increasing burden of debt and debt servicing.

Commenting on the section of the staff report that provided a quantification of what Hungary's exports to certain areas of the industrialized world might have been if they had not encountered restrictions, Mr. Malhotra observed that, whatever the delays or deficiencies on the part of the Hungarian authorities in adjusting to the evolving situation, the major and immediate strains on the economy were exogenous: reduced demand for Hungary's exports, and persistent and increasing protectionism.

Taking up the various elements of the program itself, Mr. Malhotra observed that some of the instruments--such as interest rates--had limited use in a country like Hungary. Overemphasis on areas not particularly relevant to the program under discussion could perhaps be avoided. There were of course a number of points on which he could agree with the views of his colleagues. In particular, he shared the skepticism of many of them regarding the projections for the growth of demand for exports and the assumptions underlying those projections. The situation would no doubt have to be carefully monitored.

Responding to comments of some other Directors, Mr. Malhotra recalled an observation to the effect that the usual practice was to conclude an Article IV consultation discussion before addressing requests for use of Fund resources. He was glad that the staff and management had not been overly preoccupied with precedent in the Hungarian case. Generally, where a balance of payments need was established and a quick response by the Fund was required, a flexible approach could improve the Fund's credibility vis-à-vis its members. It had also been observed that the financing proposed in the Hungarian case appeared to be large by comparison with what had been provided to new members in the past. Again, the Fund should worry less about past practices and more about whether there was a balance of payments need and whether or not the adjustment program was appropriate. Once those conditions were satisfied, adequate financing should be provided. There was no point in having a strong adjustment program without sufficient financing to support it.

Regarding an observation that, where it was difficult to set the usual performance criteria of a financial nature, it might be useful to look to other kinds of performance criteria, Mr. Malhotra considered that it would be better at the time of the review to see whether the adjustment program as a whole was headed in the right direction. It would not be particularly helpful to turn wage reductions or growth targets into performance criteria. Wage restraint was practiced in many economies, including market-oriented economies, often on an experimental basis; and Directors were well aware of the difficulties in bringing such experiments to a successful conclusion. It should not be assumed that the authorities of a centrally planned economy would have any less difficulty in restraining wages.

A question had been raised regarding Fund support in a situation in which the major cause of the external imbalance had been a large capital outflow, Mr. Malhotra recalled. In his view, in providing financial support to a member country, the Fund had to take into account the overall balance of payments position; in treating the problem, while the Fund would naturally analyze the various contributing causes of external imbalance, the decision whether or not to provide financial support would hinge on the country's balance of payments need.

Several of his colleagues had expressed some impatience with the import restrictions resorted to by the Government of Hungary to correct its balance of payments problems, Mr. Malhotra noted. As had been observed even by the critics of the restrictions, the Government was committed to liberalizing those measures over a relatively short time. Such restrictions represented only one element in the authorities' overall approach in resolving the country's difficulties on the external account side. While it might be argued that the authorities should place total reliance on reducing domestic absorption as a means of reducing imports, it had to be recognized that restraint in incomes and consumption would not necessarily lead to a reduction of imports in the short term. In the circumstances, he counseled more patience, especially given a general retreat from the system of open trading by many strong economies. The exports of Hungary and other developing countries had faced restrictions from other groups of countries that were economically stronger; it was therefore surprising that the temporary use of import restrictions by Hungary should receive so much criticism.

Mr. Sangare said that, like other Directors, he was in broad agreement with the staff appraisal and had no difficulty in supporting the proposed decisions. In recent years, the Hungarian economy had experienced a marked deceleration in the growth of output; moreover, the convertible currency trade deficit had widened, mainly as a result of a rapid increase in the volume of imports and a deterioration in the terms of trade. The balance of payments problems had been compounded by the cost of servicing a heavy debt burden, which included a high proportion of short-term debt. Fortunately, according to the latest information, most of the outstanding arrears had been repaid; however, with the rise in international interest rates, the current account deficit in convertible currencies had led to a massive outflow of short-term capital and a rapid rundown of official reserves. In response to those adverse developments, the authorities had initiated significant changes in their economic policies since 1978/79, with a view to restoring and sustaining external equilibrium while maintaining the living standards of the population and improving economic efficiency. In light of the severity of the current liquidity situation, it was encouraging to note that the authorities had seized the earliest opportunity to implement a stabilization program, which appeared reasonable and consistent with the long-term objectives outlined in the sixth Five-Year Plan. The measures contemplated under the program indicated the authorities' determination to redress the economic and financial situation within a reasonably short time.

In recent years, adjustment efforts in Hungary had been accompanied by structural reform designed to improve efficiency in the economy, Mr. Sangare continued. The authorities would need to pursue that reform with renewed vigor if they wished to achieve a viable balance of payments position in the medium term. In particular, they should conclude their consideration of the rules governing wage determination in order to implement the necessary changes as programmed. The new system of awarding wage increases should encourage labor mobility while allowing enterprises to make significant and rapid improvement in their performance. The restructuring of inefficient enterprises, the implementation of energy conservation measures, and the effort to achieve savings in the use of raw materials were equally important.

In the area of fiscal policy, the authorities intended to reduce the overall budget deficit in relation to GDP from 1.8 per cent in 1982 to 1 per cent in 1983, Mr. Sangare observed. To achieve that target, they planned, inter alia, to reduce recurrent expenditure in real terms; and the targeted reduction in domestic expenditure had already been accepted and publicly announced. The authorities had also indicated that certain services--such as social, health, and education services--would not be affected, and he would be grateful if the staff could elaborate on the source of savings for current expenditure and on whether the decision not to cut the various services mentioned would undermine the medium-term objectives of the program.

In the monetary field, he welcomed the strengthening of financial policies, which was expected to reduce the availability of domestic bank credit to the Government and public enterprises, Mr. Sangare stated. He also noted the intention of the authorities to make active use of interest rate policy in order to restrain demand for credit and to encourage domestic savings; on the other hand, he could appreciate the observation by Mr. de Groote that changes in interest rates might have little effect on savings. Also, he agreed with Mr. Polak that raising savings while restraining wages would bring about no significant change if the only source of investment was through savings.

Remarking on the external sector, Mr. Sangare observed that the authorities intended to achieve a current account surplus in the balance of payments of $600 million in convertible currency by the end of 1983. They expected a considerable improvement in the trade balance as well, mainly through an expansion of exports. Both the authorities and the staff, however, recognized that such a target might be difficult to achieve if the demand for and prices of major exports to Western Europe did not improve. In light of the report of the recent meeting of the GATT, and the difficulties faced by Hungary of late in disposing of export commodities in Western markets, he had serious reservations about the prospects for improvement in demand and prices. Moreover, the developing countries--including some oil exporting countries--had been experiencing difficulties with external payments, and the expansion of exports to those countries might also prove difficult. Nevertheless, the Hungarian authorities should be commended for taking steps to improve their export competitiveness through, inter alia, active exchange rate policies.

The external debt situation in Hungary was worrisome, and the difficulties had been aggravated by the high proportion of short-term debt and the cautious approach of banks toward borrowers, including Hungary, Mr. Sangare commented. It was to be hoped that the adoption of the stabilization program would restore the confidence of the banks. Finally, with respect to Hungary's request for a purchase under the compensatory financing facility, he could support the proposed decision, since all the relevant requirements had been met.

Mr. Diao stated that he could support all the proposed decisions.

The staff representative from the European Department, responding first to specific questions by Directors, recalled that Mr. Polak had inquired how the figures on real cash incomes of the population fitted together with the rest of the program, particularly with the figures on consumption. The staff had estimated that real cash incomes would decline by 3-3.5 per cent, which was consistent with a decrease in real wages of 4.5-5 per cent. The assumed decline in real cash incomes had led the staff to project a decrease in real disposable income of 2.5-3 per cent, because income in kind tended to increase faster than cash income. The staff was also looking for consumption to decline by 1.7-2 per cent, because it expected a drop in the savings rate of something less than one percentage point.

In response to a question by Mr. Laske, the staff representative noted that the system for achieving a moderation in wage increases to only 3.5 per cent in 1983 was already in place. Decisions had also been taken to increase social security and pension fund contributions. He agreed with Mr. Laske that the authorities should perhaps rely more heavily on income taxes; toward that end, the authorities were studying the overhaul of the fiscal system in Hungary, and they might be able to implement the necessary changes in the not too distant future. Mr. Laske had also inquired why enterprises were so liquid in present circumstances. In part, their liquidity was a carryover from the past, when they had accumulated reserves; it was also due to restrictions placed on investment--particularly the investment tax--which made it difficult for enterprises to undertake investment projects. As a result, enterprises tended to hold on to their liquidity. With regard to Mr. Laske's questions on energy prices, he noted that prices had been increased substantially in April and in June and again more recently. There remained subsidies on some consumer items--mainly heating oil--but, as part of the adjustment program, the authorities would be undertaking to raise energy prices beyond what would be required from a straight passthrough of the depreciation of the forint.

Responding to Mr. de Maulde's question whether there were any alternatives to the 25 per cent investment tax, the staff representative observed that the instrument had been adopted to deal immediately with the miniboom in investment in 1981 and early 1982, which had threatened to develop out of control. It was important to note that the tax did not apply to a wide array of investment projects, particularly in the export sector; nonetheless, he was certain that it would be replaced by some more flexible form of control in future.

The effect of restrictions on Hungarian exports and the need for restructuring the Hungarian economy as a result of those restrictions had been questioned by Mr. Prowse, the staff representative recalled. The staff and the Hungarian authorities agreed that restructuring was necessary, and some changes had already been initiated. However, the process was a slow one, and there remained large segments of the economy--agriculture, textiles, chemicals, and steel--that continued to bear the full brunt of those restrictions.

In reply to Mr. Sigurdsson's question on the causes of the disappointing results of the tax-based incomes policy in Hungary, the staff representative said that part of the problem was related to the use of subsidies. Since subsidies contributed to profits, they also contributed to increases in wages. The undesirable consequences of the close link between increases in profits and increases in wages was the main reason why the staff and the Hungarian authorities were in favor of revising the existing system of wage determination. The most profitable firms were still allowed to give larger wage increases than the less profitable ones. Furthermore, they were better able to do so since they could afford to pay the taxes assessed on wage increases at the progressive rate. Mr. Sigurdsson had also questioned a section of the staff report comparing agricultural prices and producer prices. The intent of the staff had been to point out the practice in agriculture of restraining producer prices and compensating for the restraint through subsidies on inputs to producers. As a result, production had not been discouraged, although the practice had been costly to the budget.

Regarding Mr. Joyce's question concerning the relationship between the amount of purchases from the Fund and the amount of lending to Hungary by the Bank for International Settlements (BIS), the staff representative noted that part of the BIS loan had been repaid in September at the time that the second tranche of the loan had been granted. It might be more significant to relate the amount of purchases from the Fund to the increase in reserves under the program, especially since one of the purposes of the program was to strengthen Hungary's reserve position and protect it against potential deterioration if the capital account should turn out to be less favorable than expected. Mr. Joyce had also inquired about debt repayments in 1984 and 1985. Table 11 of EBS/82/206 showed amortization of medium-term and long-term debt in those years to be approximately $1.4 billion, which seemed to justify a strong and early effort to improve the external situation.

In response to Mr. Hirao's inquiry about possible adverse effects on export capacity of cutting back on investment, the staff representative commented that some adverse effects had already occurred; however, there were a number of exceptions to the measures to reduce investment in favor of the export sector. The 25 per cent investment tax, for example, did not apply to the export sector, and there were a number of interest rate incentives; moreover, the amount of credit allowed by the program left some room for an expansion of capacity in the export sector. Mr. Hirao had also asked what factors, besides improved exports and the restrictions on imports, would contribute to the projected current account surplus for 1983. Certainly the reduction in interest income was an important element, and the improvement in travel income should contribute to the surplus as well.

The cost of the additional social services provided by the authorities had been questioned by Mr. Sangare, who had suggested that those costs might inhibit the efforts of the authorities to meet the program targets, the staff representative recalled. It should be noted that there were a number of safeguards against such a development, and they were built into the program in the form of a commitment on the budget. Moreover, with respect to the intention to improve housing for Hungary's population--the authorities had agreed that the increase in credit to housing would be related to an improvement in the savings of the population.

Turning to more general issues, the staff representative noted that a number of Directors had questioned the assessment by some Hungarian economists that interest rates had little effect on saving. The staff considered that there were basically three determinants of saving in Hungary: inflationary expectations, shortages, and interest rates. The Hungarian authorities were certainly concerned about price developments and shortages, and Mr. Barbone had probably been correct in pointing to the absence of shortages in Hungary as one reason for the relatively lower rate of savings in that country than in some other Eastern European countries. The authorities were well aware of the need to avoid shortages of consumer goods and had taken steps--in spite of restrictions on imports--to ensure that such shortages did not occur.

He could not agree that interest rates had no effect on saving, the staff representative continued. It was of course difficult to argue the point, since interest rates had changed very little in Hungary; however, rates on deposits were becoming increasingly negative, and the authorities had agreed to take steps to remedy the situation by raising some interest rates on term deposits. They also intended to introduce saving schemes of the sort that allowed households to obtain loans at reduced interest rates if they had saved for several years. Certainly, that would be one area that would be looked at carefully during the review. Some Directors had asked about the effects of higher loan rates on enterprises; one such effect had been a discouragement to stockbuilding, which had become clearly excessive in 1981 and early 1982. From that point of view, the increased rates had been useful. In response to questions about possible new instruments of saving, he noted that the authorities were in the process of developing bonds that could be sold by enterprises--initially to financial institutions and perhaps later on to individuals--both as a means of financing and of ensuring greater mobility of capital within the economy.

A number of questions had been raised on the exchange rate, particularly with respect to an assessment of the appropriate rate for the forint, the staff representative recalled. The staff had attempted to assess the exchange rate of the forint in relation to the current account target used for the program and the need for Hungary to achieve additional gains in market shares. At the same time, it had had to take into account the increases in costs in Hungary relative to what costs were expected to be in other countries. Obviously, the rate of cost increases in Hungary would be lower than in competitor countries because wages were to be limited to an increase of only 3.5 per cent. The staff also had to take into account the real appreciation in the exchange rate since 1980, which had to be corrected in order to improve competitiveness. As some Directors had indicated, necessary adjustments to the exchange rate in order to improve competitiveness were related to the question of export prospects and developments as well as to the results that could be expected from a reduction in domestic demand. Once those reductions were achieved, exports might improve; and any further decisions on the exchange rate would require a careful assessment of the results of the effort to restrain domestic demand.

Several Directors had questioned the export projections in the program in view of the latest prospects for demand in the industrial countries, the staff representative noted. On the occasion of the staff's September visit to Hungary, it had been clear from the available World Economic Outlook and OECD data that the original export projections had been too optimistic. While they had been adjusted downward, the export projections might still be on the high side; on the other hand, the staff was aware that countries like Turkey and Portugal had managed to effect large increases in exports in circumstances similar to those faced by Hungary. When viewed against the total imports of western industrial countries, the export volume of Hungary was relatively small; and it was easier for a small exporter to gain market shares with suitable policies--particularly exchange rate policies--than for a larger exporter or group of exporters. In that regard, Mr. de Maulde had asked a pertinent question about the effect on Hungary of similar efforts by Yugoslavia and Romania to improve their trade balance. The direct effect had been small; although Yugoslavia absorbed about 6 per cent of Hungarian exports in convertible currencies, those exports were mostly agricultural products. To some extent, Hungary, Yugoslavia, and Romania competed with one another; however, even all three together represented only a small share of total imports into the industrial countries.

Commenting on the capital account, Mr. Taylor had rightly emphasized that the success of the program would depend as much on developments outside Hungary as on the efforts of the authorities to implement the program, the staff representative recalled. While that was true for export developments, it was also true for the capital account, and Mr. Taylor had pointed to the need for improving the flow of information on Hungary. The authorities had already begun to cooperate in meeting that need by providing up-to-date information, particularly on reserves and balance of payments developments, which would be included in the January issue of IFS.

There appeared to have been little change in recent months in the willingness of the commercial banks to lend to Hungary, the staff representative continued. In recent discussions with the banks, the staff had attempted to impress upon them the importance of not jeopardizing the adjustment efforts being made by the Hungarian authorities and had asked them, at a minimum, to consider refinancing a large share of their lending to Hungary. As could be noted from the program, there was no need for the banks to put any new money into the country; on the other hand, any effort by the banks drastically to reduce their exposure in Hungary could cause the program to fail.

Regarding questions on subsidies, the staff representative said that it was important to make a distinction between the rates and the amounts of subsidies in Hungary. The rate of subsidies on a number of consumer items had been reduced; however, with the increase in prices and in consumption, the volume of subsidies tended to remain quite high. Indeed, total subsidies represented 18-19 per cent of GDP, a figure that the staff considered unsustainable. The authorities had promised to make an effort during 1983 to reduce reliance on subsidies further, and the recent measures that they had taken represented a step toward that end.

With respect to the emphasis that had been placed on the removal of import restrictions, the staff representative considered that it was important for the Hungarian economy to operate with fewer restrictions in order to avoid shortages of consumer goods as well as of spare parts or raw materials that could impede production and exports, a development that had already occurred in some neighboring countries. The authorities were committed to a reduction of restrictions, recognizing that the Hungarian economy needed greater competition in order to be more efficient. The staff was satisfied with the information that had been provided on quotas, tariffs, and other measures to restrict imports; it was less satisfied with its understanding of administrative measures, for example, or of the authorities' use of the licensing system to restrict imports. The staff would be inquiring further into those areas.

A number of questions had been raised on the use of performance criteria in the program, the staff representative observed. It should be noted at the outset that the ceilings on real cash incomes and investment were not performance criteria in the strict sense of the term, although the staff had agreed with the authorities that they were key targets in the program and would be monitored on a monthly basis. Up-to-date information in those two areas was readily available in Hungary, and the staff intended to look at the figures and ask appropriate questions if the data were inconsistent with program targets. Such a monthly reporting requirement was hardly unusual; on the contrary, it was used in practically all programs, albeit for other data such as those on reserves or foreign debt. He wished to stress again, however, that the monthly monitoring of the ceilings on real cash incomes and investment did not represent performance criteria. It was only on the occasion of reviews that the Fund could ask the Hungarian authorities to take additional measures to bring real incomes and investment in line with targets.

It was of course possible to turn the ceilings into performance criteria, the staff representative remarked. After all, credit ceilings were often used as an indirect way of controlling domestic demand and imports in circumstances where monetary statistics were more available or of better quality than data on consumption, incomes, and investment. However, in a country where data on incomes and investment were readily available, he saw no reason why they could not be used directly so long as their use did not represent stricter conditionality. Conditionality was related to the reductions in domestic demand that were being required of Hungary; the ceilings were being used merely to monitor the adjustment effort, and, in that regard, they provided a better monitoring device than those that might normally be used.

With respect to the actual performance criteria in the program, the staff representative explained that the concept used for the formal credit ceilings was a net concept in the sense that it was defined as credit net of enterprise deposits, which was equivalent to foreign liabilities plus currency. There were two reasons why the concept had been used in the case of Hungary. The first was related to the high degree of liquidity in the economy, particularly for enterprises, and the staff had wanted to control the reduction in liquidity and to make certain that its projections for velocity would be borne out. If enterprise liquidity did not increase as much as expected--i.e., if velocity increased faster than anticipated in the program--the use of the net concept would force the authorities to react to the increase in velocity by tightening credit. The other reason the approach had been used was that it tended to cover a problem that had occurred in some other countries with respect to interenterprise credit. The use of interenterprise credit permitted enterprises as a group to achieve a higher level of activity than projected under the program; to the extent that the higher level of activity was associated with higher payments for imports or higher payments for wages, this higher level of activity would manifest itself in the form of some enterprise drawing down on its deposits. The net concept for credit allowed analysts to "catch" the leakages into wages payments or imports that inevitably were associated with an expansion of interenterprise credit.

Finally, with respect to the procedure for bringing the program to the Executive Board, the staff representative from the European Department observed that both management and staff had been reluctant to accept the request of the Hungarian authorities to include in the letter of intent only part of their policy commitments. At the same time, it had been recognized that there was a problem of timing because negotiations on the program had been taking place during the early stages of the formulation of the budget and the plan for 1983. The authorities had not wanted to include in the letter of intent the targets for the budget and the plan, which had not yet been approved by top levels in the Party or by Parliament. It was for that reason, that the staff and management had agreed to the authorities' exceptional request, which should not be viewed as a precedent.

The Deputy Director of the Exchange and Trade Relations Department agreed with a point raised earlier by Mr. Taylor that the staff should have explained in its paper why the proposed transaction was to be treated under the enlarged access policy. The decision on enlarged access provided that, when a member faced a payments imbalance that was large in relation to its quota, and when the nature of the adjustment justified a repurchase period that was longer than the normal three-to-five-year period, enlarged access could suitably be employed. Hungary's need to draw on the Fund exceeded four credit tranches--the maximum that could be accommodated under the normal tranche policies--and the adjustment period was likely to be prolonged, certainly beyond 1983.

In response to a question by Mr. Joyce, the Deputy Director noted that Hungary's case was consistent with the interpretation given by Executive Directors in 1961 to Article VI, Section 1(a) on the use of Fund resources for capital transfers. In the late 1950s, when many European countries had adopted convertibility, it had been found that a substantial movement of short-term funds had been taking place between those countries and others and that an outflow of such funds tended to create difficulties in the balance of payments in the same way as an adverse development in any other item in the balance of payments. When payments imbalances developed, it was difficult to identify quickly the precise source of the trouble; and the use of Fund resources could not be reserved to any particular source to the exclusion of others. In view of those considerations, the Executive Board in 1961 had made it clear that the Fund's resources could be used to alleviate balance of payments problems brought about by capital transfers. In that regard, it could be added that the Articles of Agreement defined current transactions rather broadly and included in the definition normal short-term banking and credit facilities and payments of moderate amounts for amortization of loans or for depreciation of direct investment.

The rationale for the ceiling on net domestic assets--defined as currency minus net foreign assets--had already been explained, the Deputy Director continued. He would only add that the use of such a ceiling was not uncommon; indeed, it was used quite often in programs in the Western Hemisphere where both government deposits and bank deposits were netted out, leaving currency minus net foreign assets. In the Hungarian case, the National Bank was also the commercial bank, and enterprise deposits had been netted out, again leaving currency minus net foreign assets. The netting out of particular deposits was also not an innovation; in many programs, for example, advance import deposits were netted out because it was felt that the use of those deposits could undermine the credit objective. Hence, the form of the ceiling was quite conventional and its purpose was the same as that for any other ceiling on net domestic assets; it provided a limitation to credit policy in order to achieve the net asset target.

The staff representative from the Research Department, responding to questions regarding Hungary's request for a purchase under the compensatory financing facility, agreed with those who had noted that the outlook for growth in the industrial countries was currently less optimistic than it had been earlier. However, the industrial countries had accounted for only 22 per cent of the total exports of Hungary in 1981/82. Imports of the industrial countries had initially been expected to grow in 1981/82 by 5 per cent in volume terms, but the latest information suggested growth of only 3 per cent. Because growth in other markets was roughly unchanged, the reduction in the market growth for industrial countries as far as all Hungary's markets were concerned would represent a reduction from 5 per cent to 4 per cent. The staff's projection for the 12 months ending June 1983 indicated growth in volume of about 6 per cent, and the volume projections--taken in conjunction with the markets' growth--suggested that there would be a gain in Hungary's market shares for the postshortfall year.

While the outlook was currently less optimistic than in September, certain positive developments had taken place that had been unforeseen at the time, the staff representative remarked. Specifically, the outturn of agricultural production had been much better than expected in September, which implied that larger than expected supplies of agricultural products--particularly cereals--were currently available for export. It was expected that those exports would find ready markets, mainly in other CMEA countries. On balance, therefore, the staff felt that the projections for 1982/83 and 1983/84 represented a reasonable outlook for Hungary's exports.

With respect to the question concerning the practice of including nonconvertible currency receipts from exports in the compensatory financing facility calculations, the staff respresentative from the Research Department observed that the compensatory financing decision referred only to total exports, and the practice had been to include all export receipts in the coverage of the facility. Several cases had been dealt with in the past in which part of the trade of the requesting member had been conducted in nonconvertible currencies. While the staff recognized that there might be difficulty in such instances in determining whether the shortfall was beyond the control of the member, that problem did not arise in Hungary's case, where the sector of trade conducted in nonconvertible currencies had given rise to an excess rather than to a shortfall. Nonetheless, the entire matter should perhaps be looked at in the context of the general review of the compensatory financing facility.

Mr. Zhang stated that he continued to be concerned about the data being requested from the Hungarian authorities for monitoring by the staff. It seemed to him that it was not usual practice to request such data, even when there were cases in which programs called for a reduction in real incomes and investment. The staff might think of its request as not involving stricter conditionality, but he believed that centrally planned economies were perhaps being treated somewhat differently from market-oriented economies, and that the sort of monitoring proposed by the staff could not be regarded as standard. On a related point, he wondered whether the authorities had been told, when the program was being negotiated, that the particular data requested represented a novel approach by the staff.

Mr. Malhotra asked for clarification of the suggestion that the availability of information on incomes and consumption tended to strengthen the case for developing performance criteria based on that information. The area of incomes policy and wage restraint was complex and not an easy one for developing performance criteria. It was more difficult than determining the size of the budget deficit or the size of the increase in credit. Stronger economies had found it difficult to enforce strict incomes policies. He did not believe that simply because statistical information on incomes and wages was readily available, performance criteria based on that information could be laid down.

The staff representative from the European Department, responding to questions by Mr. Zhang, observed that planned economies were far different from market economies and the staff--given its limited experience with centrally planned economies--had not reached a point at which it could state that the use of credit ceilings provided adequate control over economic developments in those economies. Far more study was needed, and, until that study was complete, it seemed only reasonable for the staff to make use of other devices that were available to monitor economic developments in centrally planned economies.

The Deputy Director from the Exchange and Trade Relations Department added that the issue in question had been discussed by the Executive Board in connection with a staff paper on planned economies. That paper had indicated that "in a strictly controlled economy, the authorities have the ability to control a number of macroeconomic magnitudes directly." The examples given had included government expenditure, wage expenditure, and investment expenditure. As he recalled the discussion, Executive Directors had supported experimentation by the staff in the use of those elements. In the case of Hungary, the information requested was not to be used as performance criteria but rather as indicators of economic developments that could later be taken up in the review of the program.

The Chairman considered that there had been no effort to impose any special conditions on the Hungarian authorities; indeed, the request for particular kinds of information had evolved from a dialogue between the authorities and the Fund staff. Personally speaking, he saw no reason why the staff should refrain from using data that were readily available in Hungary and that would help staff and management determine at an earlier stage whether the main targets of the program were on track. Uniformity of treatment was not in question in the Hungarian case; the Fund was attempting in an evenhanded way to ensure appropriate adjustment, but that did not mean that the tools of diagnosing the problem had to be identical in all cases. It was clear that a centrally planned economy had different characteristics from a market-oriented economy, and the kinds of information readily available in each were quite different. Since the Hungarian authorities were willing to provide the staff with monthly data on wages and investment, it seemed only reasonable that the information should be used to monitor progress under the program.

Mr. Zhang remarked that the responses by the staff and the Chairman had eased some of his concerns, although he was still somewhat worried about management's suggestion that it was legitimate to ask for whatever was available in centrally planned economies simply because the approaches usually taken by the Fund did not seem to apply to those economies. That sort of philosophy could lead to greater demands on some countries than on others.

The Chairman agreed with Mr. Zhang that the Fund should not use its lack of knowledge about certain kinds of economies as an argument for overburdening the authorities with more sophisticated, detailed, or demanding statistical requests. That was not the intention of the staff and management. The idea was to formulate a program that would be successful, and the Hungarian authorities themselves were eager to show the public that their efforts were working. No attempt was being made to ask the authorities to exceed their statistical capabilities; rather, the staff was trying to develop, in consultation with the authorities, a set of instruments that would eventually make the program work better. If the Fund were to limit its requests for information to the more traditional net domestic asset ceilings while knowing that information on such ceilings was scanty, it would be missing the mark.

The Director of the European Department added that the staff already knew enough about centrally planned economies to recognize that the traditional credit ceiling approach did not work in the same way as it did for more market-oriented economies, so that the use of such an approach would weaken the understanding of both the country and the Fund and make it more difficult to deal with the country's problems. In the circumstances, it was important to supplement or adapt the diagnostic tools, while maintaining the principle of uniformity of treatment. For any country, the Fund was looking toward an adjustment of the external accounts, and it was important to find out where the problem lay before proceeding to that end. The work done in the Hungarian case had grown out of work begun on another planned economy, and it was already apparent that even centrally planned economies were sufficiently different from one another that the particular instrument used in the Hungarian case would not work in another. Uniform treatment was being sought to achieve the appropriate results; at the same time, it was important for both the country and the Fund to look for relevant instruments or approaches devoted toward that end.

Mr. de Groote observed that the staff mission to Hungary had carried out its discussions with patience, competence, and understanding of the Hungarian situation. At no time had the approach taken been regarded by the Hungarian authorities as something unacceptable; to the contrary, the authorities felt that the detailed discussions were proof of the importance that the Fund attached to understanding the Hungarian situation.

It was not obvious to all that Hungary needed to become a member of the Fund and the World Bank or that important measures needed to be taken toward a strengthening of market forces, Mr. de Groote continued. The encouragement and the suggestions that had been provided by his colleagues in the course of the discussion would certainly add weight to the arguments of those who had been working for years to obtain membership in the Fund and to develop an arrangement of the sort proposed for approval. There was nothing in what Executive Directors had been suggesting with regard to subsidies, profit incentives, and the necessity to establish the sort of financial market that would ensure a better mechanism for the intermediation of financial savings that would not be subscribed to in general terms by the Hungarian authorities.

Commenting on Hungary's economic system, Mr. de Groote noted, first, that the reference to Hungary as a centrally planned economy was perhaps not quite accurate. The Hungarian authorities considered their economy to be a socialist one, and they wished to continue to give priority to certain social objectives, especially in the area of income distribution. In the course of discussions that he had held with Hungarian experts on income distribution, he had come to the conclusion that there was no other industrial or semi-industrial society in the world in which income was distributed with so much equality. The objective of maintaining that equality would remain at the center of any further evolution of the Hungarian economy. Generally speaking, there was nothing in Hungary like a compulsory central plan whereby companies or enterprises were instructed to produce and deliver certain amounts of goods. Rather, broad targets were indicated, and ways of achieving those targets were provided. It was in that respect that Directors should view the statement made in his earlier intervention that all mechanisms in the economy were centered around some form of market allocation of resources with, of course, a number of drawbacks and hindrances.

There was general agreement in Hungary that one of the major problems faced by the economy was in saving and investment, with the high liquidity of enterprises compounded by the existence of subsidies, Mr. de Groote continued. The situation was further complicated by the relationship between subsidies and the profitability of enterprises after taxes. It should be assumed that, in any further steps taken by the authorities toward modernizing the Hungarian economy, the gradual elimination of subsidies would be at the forefront of changes in future; and that approach would have important effects in a number of other areas.

On the issue of competition, it was useful to mention that a great number of new enterprises had been created from the ten previously existing trusts, Mr. de Groote observed. There had been horizontal integration in those trusts, so that competition at present was between the different companies that had been created from the large holding companies. A number of small enterprises had also been established, either at the initiative of the State or by cooperatives, common councils, and individuals. Those that were not state property could not be directed by, or lose their assets to, the State; as they were completely responsible for their assets and their losses; there were occasionally failures and bankruptcies in that sector. While the authorities had no intention of implementing a textbook model of competition in Hungary, they were giving priority to supporting pragmatic solutions to problems through a combination of market incentives and normal state intervention in economic policy. It was certain that the prices of a number of commodities would continue to be subsidized, that prices would be fixed for certain modes of transportation and that some of the basic productive sectors would remain nationalized. It was also certain that investment would continue to be directed toward priority aims. The real question concerned the method by which those aims would be effected.

At present, Mr. de Groote noted, financial resources were allocated directly to various companies, although the system was evolving along the lines suggested by Mr. Polak and others. In future, a combination of measures--such as appropriate taxation of companies and selective credit policies--would orient activity toward those sectors targeted to expand. Also, a better-functioning financial market would be organized. The outcome would be a "mixed" economy--as in many industrial countries--with better mechanisms for ensuring the appropriate allocation of resources.

With regard to the profit motive, workers at present participated directly in the real profits of companies in the sense that more profitable companies could pay higher wages, Mr. de Groote commented. In future, the link between wages and profits would be even stronger, as subsidies were reduced or eliminated. Moreover, the internal financing of investments would diminish in favor of external financing because of the reduction in subsidies and in liquidity available to enterprises. In other words, enterprises would be more and more in the hands of the regulatory credit institutions, which would have greater influence than in the past on the orientation of activity toward a better allocation of resources.

Regarding comments on the exchange rate in Hungary, Mr. de Groote said that he could agree with Mr. Polak's presentation of the system that had existed during the 1970s, when the exchange rate had been used specifically to offset imported inflation. The authorities had in his view switched policies since that time, as evidenced by the successive steps taken to adjust to the exchange rate. It was generally accepted in Hungary that, if the transfer of resources from internal absorption to the balance of payments was insufficient to meet the balance of payments objectives, additional measures would have to be taken, including exchange rate adjustment if warranted. Still, there were some temporary difficulties that would have to be taken into account; for example, because of the high level of subsidies, which were introducing artificialities into the system, many exporting companies had abundant liquidity, which necessitated supplementary taxation measures. However, with the elimination of subsidies and the necessity for enterprises to go through normal credit mechanisms to find financing, he was certain that further exchange rate adjustments would be used if the need for them could be demonstrated.

It had been suggested by Mr. de Maulde and others that the coexistence of the two exchange rates in Hungary had established some coherence in the system, Mr. de Groote recalled. Attention should be drawn to the fact that there was a differential turnover tax on transactions with the ruble area, so that, in fact, once commodities arrived at the level of enterprises, they were all priced at world price levels. The purpose of the extension of world pricing was to ensure that there were not two exchange rates at the level of enterprises and that, by an administrative device, all commodities were "transformed" when they appeared as inputs at the level of enterprises and were priced at the exchange rate for nonruble transactions.

Turning to the program itself, Mr. de Groote observed that Hungary had already taken great strides in the direction required by the Fund program. The improvement in the current account position had been dramatic and would be more so in 1983; indeed, the turnaround in the position on current account would be equivalent to 6 per cent of GDP over the years 1982 and 1983, in spite of the elimination of all arrears in the non-ruble area and the unit price reduction for exports to the non-ruble area of 2.5-3 per cent since the beginning of 1982. The situation could be better still if other countries had not placed such heavy restrictions on Hungarian exports. The improvement in the balance of payments was to be brought about through a reduction in domestic expenditure of about 4 per cent in 1983 following a reduction of 1.2 per cent in real terms in 1982. Those reductions would be occurring in the midst of a slowdown of activity in which output and investment in the socialist sector would diminish substantially in the coming years. Also, important corrective price adjustments had already been taken, and further adjustments would be considered if warranted. In that connection, Mr. Dallara had pointed out that there was no contradiction between the long-term objectives of the Hungarian authorities and the different measures they were obligating themselves to implement in order to correct the more immediate problem of the balance of payments disequilibrium. The staff also considered that there was no such contradiction. The Hungarian authorities themselves were convinced that, in order to correct the immediate problem in the short run, they would have to make further steps toward liberalizing the economy, reinforcing market mechanisms, and introducing competition from abroad. In that respect, they considered their import restrictions to be only temporary because they went against the authorities' own medium-term objectives.

Regarding the assumption of a 3-4 per cent increase in world demand in 1983, Mr. de Groote noted that consumption of consumer goods in Hungary was diminishing, and what was not sold at home would be sold outside Hungary in markets much less sensitive to variations in demand than the market for investment goods. A portion of the commodities not consumed in Hungary would be sold in the ruble area, although against convertible currencies, which should help the authorities to achieve their purposes.

The most important question related to the program was whether the direction of policies was correct and whether the policies themselves were sufficient, Mr. de Groote remarked. The policies were essentially directed at action on total expenditure, incomes policy, and price adjustment and somewhat less so on budgetary and monetary techniques. Generally speaking, the different measures envisaged in the program were impressive. There would be a limitation on the increase in nominal wages, pension contributions would increase, subsidies to families would be substantially reduced, and prices of public services had already been or would be readjusted upward. Moreover, social security taxes for enterprises would be increased, gasoline prices would continue to rise, and interest rates on investment would remain at the high level of about 11 per cent in real terms.

Many structural elements were to be added to the measures that he had already mentioned, Mr. de Groote continued. In particular, competition among the managers and pressures on ailing enterprises would be increased, and a discussion was under way on establishing new financial techniques. The authorities did not have a preconceived set of policy instruments but were looking in a flexible way at the broad range of instruments available to see what could be used most effectively to achieve both the short-term and longer-term goals. In general, the Hungarian economy would be adjusted through action in all major available policy areas, including fundamental reform of economic structures.

On the question of performance criteria--which had been raised by a number of Directors--it should be noted that the Hungarian authorities had been fully aware of the elements of novelty in requests for information by the staff, Mr. de Groote said. However, they had been pleased that the quality of their statistics had enabled the Fund to make such requests and had agreed to provide the information. As he had suggested in his earlier intervention, it might be useful to employ similar methods in other countries where traditional tools did not work well. It was important to find appropriate means to reach the objectives of adjustment, and the Hungarian authorities were satisfied that the method chosen by the staff was appropriate.

With regard to the financing of Hungary's deficit and the potential financial needs of the economy in future, Mr. de Groote observed that it was important to ask whether the economy would be able to adjust with the resources that the Fund was being asked to provide or whether supplementary resources would be needed. In the period 1984-86, the current surplus could not represent more than about 2.5-3 per cent of GDP, and, even if supplementary measures were taken, the current surplus would be no more than $600 million. That figure had to be viewed against the reimbursement obligations, and reimbursements would absorb approximately 30 per cent of export receipts in the coming years. Since reimbursement would represent about 5-6 per cent of GDP and the surplus would be no higher than 3 per cent of GDP, there would be a need--even excluding reserve reconstitution--for about $500-600 million a year, assuming a realistic level of exports on the basis of current assumption. The picture could of course change if there were to be an upsurge in world demand in 1983 and if--with favorable rescheduling--short-term debt could be replaced by longer-term debt at maturity. The situation would also be helped if some of the import restrictions on Hungarian exports were gradually eliminated. When all was said and done, it was also clear that Hungary remained vulnerable to shifts in banking funds, although there were clear distinctions between Hungary and other neighboring countries; and those should become clearer once the Hungarian program was implemented. Perhaps the banking community would then understand that it would have to intervene to make further progress possible.

In concluding, Mr. de Groote commented, he wished to touch briefly on three general topics: the determination of the Hungarian authorities, how they envisaged the role of the Fund, and the pragmatism of economic policies in Hungary. It would have been difficult to include in the staff papers certain of the elements that proved the seriousness and determination of the Hungarian authorities. The political environment in Hungary was a peculiar one in the sense that everyone was aware of the advantages of the options taken, once it had been decided to implement a system essentially based on profit motives and market mechanisms. Those advantages were so obvious to the population that there was a great readiness to accept temporary sacrifices in order to maintain them. The decisions taken in Hungary were extensively discussed by all those involved in the decision-making process, which was essentially a democratic process. A great deal of publicity was given not only to the decisions themselves but to preliminary discussion of them; and a very active public opinion found its expression in the different elements of the decision-making process. Decisions were not simply imposed from above. Rather, the population knew in advance what to expect and was well versed in the different viewpoints of those engaged in the dialogue leading up to decisions.

Second, on the role of the Fund, Mr. de Groote stated that Hungary's association with the Fund was itself symbolic of the change in the country. The most prominent personalities in the economic sphere in Hungary had during the past year taken great risks by promoting Fund membership. And they had done so not so much to obtain money from the Fund--although financial resources were badly needed--as to gain advice in presenting and justifying the various improvements that they were making. Finally, he hoped that he had made it clear to his colleagues that the Hungarian authorities were particularly pragmatic in their approach to economic problems.

The Chairman made the following summing up:

> On the occasion of the first Article IV consultation with Hungary, Executive Directors also considered and approved requests for a stand-by arrangement and for a purchase under the compensatory financing facility. Much of the discussion therefore focused on the efforts made by the Hungarian authorities to improve the balance of payments position. It was generally recognized that the high level of external debt, together with the high proportion of short-term debt and renewed pressures on the current account since 1981--which reflected in part delayed and too timid adjustment measures--were among the main reasons for the serious liquidity problems facing Hungary in the first quarter of 1982, although it was also noted that events in other countries had indirectly contributed to these difficulties. The large capital outflow in early 1982 gave the Hungarian authorities no option but to accelerate substantially the improvement in the current account vis-à-vis the convertible currency area.
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> Directors welcomed the new initiatives of economic reform and the strengthening of demand management policies aimed at

external adjustment since 1979, although they observed that the tightening of policies had initially been rather gradual and that slippages had occurred in 1981 and early 1982. Directors considered that policies had been markedly changed in the right direction with the new measures introduced in the course of 1982, and they commended the Hungarian authorities for their determination and for their flexibility in formulating economic policy.

Directors noted that the brunt of the adjustment effort had until recently been borne almost entirely by investment, and they expressed concern about the longer-term implications for the competitiveness of the economy. However, they observed that the measures adopted since mid-1982 to restrain the growth of real private incomes meant that consumption was currently bearing a greater share of the burden of adjustment. Directors referred in particular to the commitment to a 4-5 per cent decline in real wages in the 1983 plan, which they regarded as a courageous decision and an important element in the program for the coming year. In this context, while welcoming the recent increases in prices of some subsidized goods and the adjustment of various fuel prices for consumers, many Directors stressed the need for a further major reduction in subsidies as well as for further corrective price adjustments.

With respect to credit policy, it was felt that the easy availability of credit to enterprises had contributed to the country's difficulties in 1981. The gradual tightening of credit policy, especially since mid-1982, was welcomed. It was noted that most borrowing interest rates for enterprises were positive in real terms, but that deposit rates were becoming increasingly negative in real terms. Higher deposit rates for households were considered desirable as a way of preventing a decline in the savings rate. Directors also stressed the importance of reorganizing the financial market and developing investment instruments. They welcomed the containment of the state budget deficit below the level foreseen in the budget plan in 1982 and the further cut envisaged in 1983. It was noted, however, that further and durable improvement of the budget would depend very much on the success of efforts to reduce the burden of subsidies, which remained excessive and continued to account for about 30 per cent of budget expenditure.

Turning to the balance of payments, Directors welcomed both the marked reduction in the current account deficit achieved in 1982 and the planned surplus for 1983. They expressed appreciation for the fact that the bulk of the improvement had been brought about through demand restraint and through measures designed to stimulate exports or to raise productivity. However, a number of Directors regretted that part of the improvement had been the result of administrative measures aimed at reducing imports. They attached considerable importance, therefore, to the commitment in the letter of intent to eliminate these restrictions during 1983. A number of Directors also noted with regret the restrictions maintained abroad that seriously hampered Hungarian exports and made the adjustment process much more difficult. Directors noted the depreciation of the forint by 7 per cent in July 1982, and more recently by a further 4 per cent in two stages, and welcomed the intention of the authorities to continue to follow an active exchange rate policy in the months ahead. Given that the projected increase in exports had struck a number of Directors as rather ambitious and perhaps too optimistic, and in view of the commitment to eliminate import restrictions, Directors considered an active exchange rate policy to be of crucial importance.

Directors stressed that, even if the target of a $600 million surplus on current account in convertible currencies were achieved in 1983, the liquidity position would remain precarious. In view of the high level of debt and heavy burden of maturities foreseen for 1983 and beyond, it was recognized that the external situation would remain heavily dependent on the attitudes of foreign lenders, which reinforced the importance of implementing a strong adjustment program that would bolster the confidence of foreign lenders in Hungary's policies and prospects. Directors emphasized the need for the authorities to take additional adjustment measures if developments in export and capital markets should turn out to be more unfavorable than expected. The provision of adequate information on economic developments and policies in Hungary was also viewed as desirable, as lack of information could contribute to a lack of confidence on the part of foreign lenders.

Executive Directors supported the Hungarian authorities' determination to pursue the reform of the economic system at the same time that they were making more immediate policy adjustments. In this connection, Directors attached great importance to the desirability of transferring resources from the less efficient to the more dynamic sectors and enterprises of the economy as well as to the need for promoting greater domestic and foreign competition.

The Executive Board then took the following decisions:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision in concluding the 1982 Article XIV consultation with Hungary, in the light of the 1982 Article IV consultation with Hungary conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Hungary maintains restrictions on payments and transfers for current international transactions as described in SM/82/186 (9/17/82) and Correction 1 (12/1/82) and Correction 2 (12/3/82), which were in effect at the time when Hungary became a member. The Fund encourages Hungary to pursue policies that would permit the elimination of these restrictions. The Fund also notes that Hungary maintains bilateral payments agreements with Fund members. The Fund encourages Hungary to take early steps to eliminate the bilateral payments agreements.

Decision No. 7262-(82/157), adopted
December 8, 1982

Stand-By Arrangement

1. The Government of Hungary has requested a stand-by arrangement for a period of 13 months from December 8, 1982 in an amount equivalent to SDR 475 million.

2. The Fund approves the stand-by arrangement attached to EBS/82/206.

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

Decision No. 7263-(82/157), adopted
December 8, 1982

Compensatory Financing Facility

1. The Fund has received a request from the Government of the Hungarian People's Republic for a purchase of SDR 72 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund approves the purchase in accordance with the request.

Decision No. 7264-(82/157), adopted
December 8, 1982

APPROVED: May 13, 1983

LEO VAN HOUTVEN
Secretary