FOR AGENDA

EBS/82/206

CONFIDENTIAL

November 10, 1982

To: Members of the Executive Board

From: The Secretary

Subject: Hungarian People's Republic - Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on a request from the Hungarian People's Republic for a stand-by arrangement equivalent to SDR 475 million. A draft decision appears on page 35.

This subject, together with Hungary's request for a purchase under the compensatory financing facility (EBS/82/205, 11/10/82) has been tentatively scheduled for discussion on Wednesday, December 8, 1982.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

HUNGARIAN PEOPLE'S REPUBLIC

Request for Stand-By Arrangement

Prepared by the European and Exchange and
Trade Relations Departments

(In consultation with the Fiscal Affairs, Legal, and
Treasurer's Departments, and the Bureau of Statistics)

Approved by L. A. Whittome and Subimal Mookerjee

November 10, 1982

I. Introduction

In the attached letter, dated October 13, 1982, the Government of Hungary requests a 13-month stand-by arrangement in an amount of SDR 475 million or 126.7 per cent of quota. The Hungarian People's Republic became a member of the Fund on May 6, 1982 and paid its subscription on September 3, 1982. It drew its reserve tranche on October 27, 1982, and the Fund's holdings of forint amounted to SDR 375 million or 100 per cent of quota on October 31, 1982. The Government of Hungary is also expected to request a drawing under the compensatory financing facility for an the export shortfall in the year ending June 1982. The requested drawing, if approved, would be for SDR 72.0 million or 19.2 per cent of quota.

If the full amount of the proposed stand-by arrangement is purchased, the Fund's holdings of forint, excluding any purchase under the CFF, would amount to SDR 850 million. Financing of the proposed stand-by would be SDR 245.739 million from ordinary resources and SDR 229.261 from borrowed resources. A waiver of the limitation in Article V, Section 3(b)(iii) of the Articles of Agreement is required.

Purchases are available in five installments, with the first of SDR 142.5 million (38 per cent of quota) immediately following approval of the stand-by arrangement; the second of SDR 83.1 million not before March 15, 1983; the third of SDR 83.1 million not before June 30, 1983; the fourth of SDR 83.1 million not before September 15, 1983; and the fifth of SDR 83.2 million not before December 15, 1983 (Table 1). Of the total amount available under the arrangement, 47.5 per cent would be purchased before the review scheduled for June 1983.

Negotiation of the stabilization program described in the attached letter and analyzed below took place in Budapest from September 3 to October 2, 1982. The Hungarian representatives included the Deputy

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

(In millions of SDRs)

	Actual		Proposed				
	Sept. 3 1982	Oct. 31 1982	2 months to Dec. 31, 1982	3 months to March 31, 1983	3½ months to July 15, 1983	2½ months to Sept. 30, 1983	3 months to Dec. 31, 1983
Purchases	--	81	215	83	83	83	83
Reserve tranche	--	81	--	--	--	--	--
Stand-by arrangement	--	--	143	83	83	83	83
Ordinary resources	--	--	95	38	38	38	37
Borrowed resources	--	--	48	45	45	45	46
CFF	--	--	72	--	--	--	--
Repurchases	--	--	--	--	--	--	--
Stand-by arrangement	--	--	--	--	--	--	--
CFF	--	--	--	--	--	--	--
Net purchases	--	81	215	83	83	83	83
Fund holdings 1/							
Total (cumulative)	294	375	590	673	756	839	922
Holdings in per cent of quota	78.3	100.0	157.2	179.4	201.5	223.7	245.9
(Excluding CFF)	(78.3)	(100.0)	(138.0)	(160.2)	(182.3)	(204.5)	(226.7)

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

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

Chairman of the Council of Ministers, the President and the First Deputy President of the National Bank of Hungary, the Deputy Chairman and State Secretary of the Central Planning Office and other senior officials. The staff mission included Messrs. de Fontenay (EUR), O'Connor (STAT), Mountford (EUR), Somogyi (EUR), Bélanger (ETR), and Miss Jones (EUR) as secretary, with the assistance for part of the time of Mrs. Junz, Mr. Thakur, Ms. Salop (all EUR), and Mrs. Ecevit (RES). Mr. de Groote, Executive Director, participated in the main policy discussions.

II. Background

Hungary experienced renewed balance of payments difficulties in 1981 and in early 1982, culminating in a massive outflow of short-term capital and a fall in official reserves from US$1,724 million at end-1981 to US$476 million at end-March 1982. This liquidity crisis occurred in large part because of a heavy foreign debt burden, accentuated by a high proportion of short-term debt, which greatly increased the economy's vulnerability to the unfavorable environment that developed in late 1981 on international capital markets. At the same time, the substantial current account deficit made foreign debt management more difficult.

Hungary's external debt rose rapidly during the 1970s, mainly as a consequence of economic policies pursued in the period 1973/78. The authorities sought to shield the domestic economy from the sharp deterioration in the terms of trade that Hungary, like most countries, suffered in the wake of the first oil shock in 1973/74. 1/ Policies in this period were designed to achieve ambitious growth rates, protect the standard of living of the population, and insulate the domestic price level from the accelerating inflation being experienced abroad. By 1978 the current account deficit had widened to US$1.4 billion, equivalent to 9 per cent of GDP, with most of the deficit on convertible currency account (US$1.2 billion). Heavy foreign borrowing over several years to finance the large current account deficits raised the foreign debt to US$8 billion at end-1978 (47 per cent of GDP).

By 1978/79 the authorities recognized the need to adjust to the more difficult world economic environment. Economic priorities were shifted from the promotion of growth to achievement of a sustainable balance of payments position. The growth of domestic demand was dampened, by severe reductions in investment and by a slower increase in consumption. With a view to shifting resources to the external sector and to making the economy more efficient, renewed impetus was given to economic reforms. The adjustment effort had considerable initial success, though it entailed a sharp slowdown in growth. The current account deficit in convertible currencies was reduced to US$0.4 billion in 1980. In the meantime,

1/ For a more detailed description of economic developments and policies, see SM/82/176 (8/25/82) and SM/82/186 (9/17/82).

however, there was a further accumulation of foreign debt to US$10.3 billion by the end of 1980, and the debt service ratio on convertible currency debt rose to 30 per cent.

Progress toward a sustainable payments position stalled in 1981. Domestic demand policies were less effective than intended, and private consumption rose 2.5 per cent in real terms. Enterprise investment in excess of the plan targets, and a recovery in stockbuilding, were financed by a sharp improvement in enterprise profitability and by ready availability of credit. At the same time, the external economic environment became more difficult. Foreign demand in the main Western export markets declined in real terms. Despite these adverse circumstances, the trade balance in convertible currencies improved somewhat, due to a gain in the terms of trade. The trade balance in nonconvertible currencies remained virtually unchanged, as higher export volumes offset a continued deterioration in the terms of trade. Interest payments on convertible currency debt rose steeply in 1981 in response to higher international interest rates, and were the main factor explaining a sharply higher current account deficit (despite the favorable trade performance). This was financed partly by net capital inflows, although on a smaller scale than in previous years, and by a decline in official reserves.

The higher current account deficit in 1981, and concerns about the level and maturity structure of Hungary's foreign debt, were among the factors explaining a hardening of attitudes by foreign lenders in late 1981 and early 1982. External events, in particular developments in Poland and the debt problems of Romania, also played a large part in bringing about a virtual cessation of new medium- and long-term lending, and led to substantial withdrawals of short-term deposits. As a result mainly of these outflows of short-term capital, together with a continued current account deficit (US$266 million in the first quarter of 1982) and seasonal factors, total official reserves in convertible currencies fell to US$479 million at end-March 1982, equivalent to only about six weeks of imports in convertible currencies.

In response to this external liquidity crisis, the Hungarian authorities strengthened their adjustment efforts in the course of 1982. The measures introduced by stages in the first half of 1982 were largely a strengthening of those implemented late in 1981 to curb the growth of enterprises' investible resources and their access to bank credit. The share of enterprise funds channeled to compulsory reserves was raised, thus reducing the flow of resources available for investment and for profit sharing. The new measures also included increases in interest rates on loans to enterprises, and an additional 25 per cent tax on most new investment projects (other than those related to convertible currency exports and savings of energy and raw materials). 1/ The decision to

---

1/ The tax is assessed on the full cost of the investment when the project is started and is payable from after-tax profits withheld in the development funds of companies. Exemptions are granted for the expansion of capacities to promote exports to the convertible currency area, for energy conservation, and for the recycling of waste materials.

restrain enterprise fixed investments was supplemented by cuts in budget allocations for state-controlled investment and measures to slow down stockbuilding.

In contrast to the strong measures to curb investment, the efforts to constrain consumption in 1982 were initially rather mild, involving mainly a tightening of wage policy and increases in consumer prices of energy. In mid-year, however, a major new policy package intended also to assist the balance of payments and to reduce budgetary expenditures was introduced. Several measures were taken to raise consumer prices and reduce subsidies, and thus to reduce real incomes. The rise in consumer prices accelerated in the latter part of 1982 owing to administrative price increases in the form of cuts in subsidies (on gasoline, cereals, construction materials, and long distance passenger transportation fares) or increases in turnover taxes (on coffee, cocoa, citrus fruits, and spices), and also to market price increases stemming in part from the 7 per cent depreciation of the forint in July 1982. It is estimated that administative price increases in 1982 were in total equivalent to about 1.7 per cent of the disposable incomes of the population. For the year as a whole, consumer prices are expected to rise by 7 per cent, implying a decline in real wages of about 1.5 per cent. In addition to higher interest rates on medium- and long-term credits to enterprises, the availability of credit to enterprises was more strictly controlled. These measures were supported by a further raising of interest rates in October by 2 percentage points, to a level of 14 per cent for most loans. The budget meanwhile, benefited from the reductions in subsidies and investment and, on the revenue side, from the imposition of the 25 per cent investment tax, a tariff surcharge on imported component parts, and higher turnover taxes on those items for which consumer prices were raised in the second half of 1982. For the year as a whole, the budget deficit is now forecast to be between Ft 13 billion and Ft 15 billion (about 1.8 per cent of GDP), no more, or slightly less, than the original estimate. All told, domestic demand in 1982 is forecast to decline by more than 1 per cent in real terms.

As a result of the reduction in domestic demand, the July 1982 devaluation and other specific measures to improve the trade account, 1/ and an exceptionally favorable agricultural crop, the current account in convertible currencies is expected to move from a deficit of US$361 million in the first half of 1982 to a surplus of US$199 million in the second half of the year. For the year as a whole, the trade surplus is projected to increase to an estimated US$0.5 billion, in total, of which US$0.8 billion in convertible currencies, and a current account deficit of US$432 million is forecast, of which less than US$200 million in convertible currencies.

1/ These include a reduction in the quotas for consumer goods, the elimination of ad hoc tariff exemptions or reductions, the elimination of exemptions from the so-called "forint cover" scheme (see SM/82/186), and temporary import restrictions introduced in September 1982.

Despite this swing of the current account into surplus in the second half of 1982, the external liquidity position has remained very tight as Hungary's access to the international capital markets remains constrained. A modest recovery in international reserves, to US$738 million in June 1982, was made possible largely by assistance from the BIS and use of other short-term borrowing. Despite the successful completion of a syndicated bank loan in August and a further credit from the BIS, the liquidity position remains precarious. It is against this background that the authorities decided to strengthen further their adjustment efforts in 1983 and to request a stand-by arrangement with the IMF.

III. The Program

1. Objectives

The Hungarian Government's economic policies for the program period are essentially geared to improvement of the external liquidity position. Faced with large repayments on the medium- and long-term foreign debt in convertible currencies in 1983-85 and the need to roll over large amounts of short-term debt (which represented 25 per cent of total debt in convertible currencies at the end of June 1982), the Hungarian authorities have concluded that they must aim at a massive improvement in their current account position. Specifically, their goal is to achieve a current account surplus in convertible currencies of US$600 million in 1983, compared with deficits of US$730 million and US$160 million (estimated) in the two preceding years. Given the large interest payments on outstanding foreign debt, a current surplus of this magnitude will require a trade surplus of about US$1.1 billion in 1983, or 22 per cent of projected exports (both in convertible currencies). It should allow some reconstitution of reserves and a modest reduction in foreign debt.

The required strengthening of the external position is to be brought about both through a reduction in domestic demand and through the stimulation of exports. In this sense, the program is a significant intensification of the stabilization effort initiated in 1978. Domestic demand is to be reduced by 3-4 per cent in real terms in 1983 (Table 2) through tight controls of household real incomes, enterprise investment, and the State budget. A more active exchange rate policy will also make a contribution to the balance of payments adjustment by raising the profitability of foreign sales. In addition to demand restraint and exchange measures the program adopted by the Hungarian authorities includes measures to improve the structure and efficiency of industry and strengthen export incentives. The program is thus intended to further the aims of economic reform.

2. The macroeconomic setting

Given the urgency of the adjustment effort, the authorities have accepted that the policies being adopted will inevitably erode the standard of living of the population. Decisions affecting incomes, consumer

Table 2. Hungary: GDP Projections

(In billions of forint, deflators 1981 = 100)

	1981	1982 (Estimates)			1983 (Projections)		
	At current prices	At 1981 prices	At current prices	Deflator	At 1981 prices	At current prices	Deflator
Consumers expenditure 1/	470.8	474.1	505.4	106.6	463.5 - 466.1	537.4 - 540.2	115.9
Percentage change	...	0.7	7.3	6.6	-2.2 - (-1.7)	6.3 - 6.9	8.7
Government current expenditure 2/	79.1	80.6	83.8	104.0	76.1 - 77.8	83.3 - 85.1	109.4
Percentage change	...	1.9	5.9	4.0	-5.6 - (-3.5)	-0.6 - 1.6	5.2
Gross fixed investment	205.2	200.1	208.2	104.1	185.1 - 187.5	203.7 - 206.4	110.1
Percentage change	...	-2.5	1.5	4.1	-7.5 - (-6.3)	-2.2 - (-0.9)	5.7
Final domestic demand	755.1	754.8	797.4	105.6	724.7 - 731.4	824.4 - 831.7	113.7
Percentage change	...	--	5.6	5.6	-4.0 - (-3.1)	3.4 - 4.3	7.7
Change in stocks 3/	16.2	7.0	7.5	...	7.0 - 7.5	8.4 - 8.9	...
Percentage contribution to growth	...	-1.2	-1.1	...	-- - 0.1	0.1 - 0.2	...
Domestic demand	771.3	761.8	804.9	105.7	731.7 - 738.9	832.8 - 840.6	113.8
Percentage change	...	-1.2	4.4	5.7	-4.0 - (-3.0)	3.5 - 4.4	7.7
Exports of goods and services 4/	303.2	317.8	321.6	101.2	339.1 - 338.3	367.6 - 366.7	108.4
Percentage change	...	4.8	6.1	1.2	6.7 - 6.5	14.3 - 14.0	7.2
Imports of goods and services 4/	313.2	304.1	315.6	103.8	298.5 - 300.1	340.6 - 342.4	114.1
Percentage change	...	-2.9	0.9	3.8	-1.8 - (-1.3)	7.9 - 8.5	9.9
Foreign balance 4/	-10.0	13.7	5.6	...	40.6 - 38.2	27.0 - 24.3	...
Percentage contribution to growth	...	3.1	2.0	...	3.4 - 3.1	2.6 - 2.3	...
Subtotal	761.3	775.5	810.5	104.6	772.3 - 777.1	859.8 - 864.9	111.3
Percentage change	...	1.9	6.5	4.6	-0.4 - 0.2	6.1 - 6.7	6.4
Valuation adjustment on stocks 3/	12.4	12.4	12.5	...	12.4	12.6 - 13.8	...
GDP	773.7	787.9	823.0	104.6	784.7 - 789.5	872.4 - 878.7	111.3
Percentage change	...	1.8	6.4	4.6	-0.4 - 0.2	6.0 - 6.8	6.4

Sources: Central Statistical Office, Statistical Yearbook; and staff estimates.

1/ Includes purchases of goods and services by foreign travelers in Hungary, social benefits in kind in the form of health, social, and cultural services financed from the state budget, and depreciation on housing but excludes purchases of goods and services by Hungarian travelers abroad.

2/ Excludes social benefits in kind.

3/ Value of stockbuilding includes increment stemming from difference between the acquisition cost of outgoing inventories and the acquisition value incoming inventories. Change in value of stocks due to administrative price increases is excluded. For stockbuilding in real terms, movements in stocks are valued at base period prices. In the base year of the demand deflators (e.g., 1981), stockbuilding at current prices contains the increment from valuation ("valuation adjustment on stocks" item of Ft 12.4 billion in 1981), whereas stockbuilding at constant prices excludes this item (resulting in an increase of stocks at "comparable" 1981 prices of Ft 16.2 billion in 1981). In the presentation of the Central Statistical Office, 1981 stockbuilding at current prices is Ft 28.6 billion and stockbuilding at comparable 1981 prices is Ft 16.2 billion. In the projections, changes in stocks were conceptually calculated at replacement costs and the valuation on stocks item was introduced to make the GDP figures comparable with the official presentation.

4/ Merchandise trade is at f.o.b./c.i.f. valuation on customs basis, with the following major adjustments: only the value added content of goods passing through Hungary for reprocessing and of reexports is included. Services exclude tourism, which is in consumers expenditure, and factor incomes, which are not covered in GDP, and deviate for other reasons from the b.o.p. data.

prices, and savings have been taken, or are foreseen under the program, in order to reduce private consumption by 1.5-2 per cent in real terms in 1983. Renewed emphasis is to be placed on slowing down the growth of household nominal disposable income. A reform of the wage system in 1983 will ensure a deceleration in the rise of nominal wages (including earnings in agricultural cooperatives), from about 5.5 per cent in 1982 to 4.5 to 5 per cent in 1983. The reform eliminates the latitude of enterprises to grant tax free wage awards on the basis of the formerly applied performance indicators and imposes tighter constraints on wage increases free of tax under the centrally determined wage scheme (see Section 6). The right of firms to make use of reserves for tax free wage increases has been revoked for 1983, and the new wage system provides no scope for the creation of such wage reserves in the future. The growth of disposable labor income will also be moderated by an increase in the pension contributions of individuals. Contribution rates will be raised for higher incomes and the base will be widened. Social benefits are projected to continue rising more rapidly than labor incomes, mainly due to demographic factors and some automatic increases built into the system. On the whole, the increase in disposable household income is forecast to slow down from rates of 7-7.5 per cent in the preceding two years to 5.7-6.3 per cent in 1983.

The limitations on nominal income growth are to be supplemented by a consumer price policy designed to curtail the purchasing power of households and to foster a shift toward a pattern of private consumption more in line with the needs of external adjustment. About 6 percentage points of the average increase in consumer prices in 1983 will stem from the carry over effect of measures taken in the previous year (including the devaluation). Further increases in centrally controlled prices foreseen for 1983 are estimated to add 1-1.5 percentage points to the rise in consumer prices. Subsidies on passenger transportation fares will be lowered or abolished as of January 1, 1983. A rent increase in the middle of the year will raise the consumer price index by almost 1 per cent at an annual rate. Earlier plans to raise the prices of meat and other basic consumer goods have been postponed, but further cuts in consumer price subsidies will entail increases in the prices of household energy and of gasoline. As a result of these and other measures, the rise in the consumer price index is expected to pick up to about 9 per cent in 1983.

Against the background of a decline in real disposable household income by 2.5-3 per cent, the propensity to save is likely to decline in 1983 as consumers adjust their spending behavior to tighter income constraints. However, several measures are foreseen to stimulate the voluntary savings of the population. They include higher interest rates on term deposits, which will prevent a reduction in real rates of interest, the introduction of new savings instruments, coupled with higher interest rates on credits to households and tighter conditions for installment credits. Accordingly, it is expected that the fall in the savings ratio can be limited to about one half of a percentage point.

Government current expenditure in 1983 is slated to remain below its level of 1982 in real terms. While basic public services, including social, health, and educational services, provided to the population free of charge will not be cut, savings are foreseen in nonbasic services.

State investment outlays will also be cut back, for the fourth year in a row. State expenditures on fixed investment will be concentrated on the completion of work in progress, such as the nuclear power station, and on improvements in infrastructure. A wide array of measures will continue to constrain fixed investment by enterprises, including a reduction in investment subsidies from the budget, the transfer of part of enterprises' withheld earnings to compulsory reserve funds and the 25 per cent tax on new enterprise investment. Interest rates on investment credits have been raised, early redemption of outstanding investment loans has been encouraged, and conditions for the disbursement of new credits have been tightened. In the light of these decisions, real fixed investment in the socialist sector is forecast to fall significantly in 1983. However, no decline is foreseen in private sector investment, which is mainly in dwellings and some agricultural machinery. In the framework of a comprehensive reform of the housing system the authorities have initiated a shift in the responsibility for the construction and maintenance of dwellings from the public sector to private individuals (see Section 6). The proportion of private savings absorbed in net housing investment is estimated to rise from about 75 per cent in 1982 to some 85 per cent in 1983. Gross fixed investment in the economy as a whole is foreseen to fall by 6.5-7.5 per cent in 1983, compared with annual declines in the range of 2.5-6.5 per cent in the preceding three years, and the ratio of fixed investment to GDP would fall to 26 per cent from about 30 per cent in 1981 and 28 per cent in 1982. To prevent a pickup in the accumulation of inventories following a marked deceleration in 1982, interest rates on working capital credits have been raised and conditions for the availability of such credits have been tightened. Existing lines of credit for working capital are being cancelled when stocks can be mobilized for exports.

Total domestic expenditure in real terms is thereby expected to fall by 3-4 per cent in 1983. Real GDP in 1983 is likely to remain at about its 1982 level, however, as a result of the significant improvement projected in the real foreign balance. In addition to the expected increase in exports, the demand for imports will be dampened by the curtailment of domestic absorption, measures taken to economize on imported inputs and to shift the structure of production toward less import-intensive activities, and by the effect of the depreciation of the forint and the import restrictions introduced in September 1982.

3. Fiscal policy

Budgetary policy was tightened progressively in 1982. The authorities intend to continue this effort at fiscal restraint in 1983 by reducing the budget deficit to no more than Ft 9 billion (about 1 per cent of GDP) from Ft 15 billion in 1982 (Table 3). Fiscal policy is

Table 3. Hungary: The State Budget 1/

(In billions of forint)

	1978 (Outcome)	1979 (Outcome)	1980 (Outcome)	1981 (Outcome)	1982 Approved budget	1982 Estimated outcome	1983 Preliminary estimate
Expenditures							
Investment	77.3	81.9	69.6	59.7	55.3	54.0	54.0
Price support	126.5	135.4	131.8	144.5	152.9	150.0	148.0
Social security	53.6	62.2	77.7	90.4	97.3	93.0	107.0
Health, education, culture	46.1	49.6	56.0	67.6	72.6	74.0	78.0
Defense, internal security	24.2	25.5	27.8	30.9	32.6	31.0	32.0
Other	58.7	60.6	64.6	89.0	95.8	96.0	103.0
Total expenditures	386.4	415.2	427.5	482.1	506.5	503.0	522.0
Revenue							
Direct taxes							
Wage taxes and social security contributions	59.4	60.8	53.7	63.7	71.8	74.0	83.0
Profit taxes	97.0	99.2	102.6	121.1	115.2	108.0-110.0	113.0-114.0
Production taxes	57.3	60.7	21.9	20.6	28.5	28.0	29.0
Taxes on capital	28.8	30.9	2.4	1.1	0.6	0.6	0.5
Total direct taxes	242.5	251.6	180.6	206.5	216.1	210.6-212.6	225.5-226.5
Indirect taxes							
Turnover taxes	30.6	52.0	131.9	152.7	162.1	166.5	170.0
Tariffs and import taxes	32.8	31.3	22.0	23.7	26.8	25.0	25.0
Total indirect taxes	63.4	83.3	153.9	176.4	188.9	191.5	195.0
Other revenues	77.0	76.7	88.5	89.7	86.5	85.9	92.5 2/
Total revenues	382.9	411.6	423.0	472.6	491.5	438.0-490.0	509.0-510.0
Budget deficit	3.5	3.6	4.5	9.5	15.0	13.0-15.0	8.0-9.0

Sources: Ministry of Finance; *Official Gazette*; and staff estimates.
1/ Fiscal year is same as calendar year.
2/ Includes unallocated revenues of Ft 4 billion.

also intended to help achieve the overall macroeconomic objectives of the stabilization program in other ways: on the expenditure side through cuts in subsidies and on the revenue side by helping to reduce the excess liquidity of enterprises through higher profit taxes and social security taxes paid by employers.

The stronger budgetary performance forecast for 1983 (Table 2) is based partly on the impact of measures introduced during 1982. They are estimated to reduce expenditures by Ft 4.8 billion, and increase revenues by about Ft 8.5 billion over original estimates. Additional measures that will be implemented in 1983 include rent increases which will save about Ft 0.5 billion in subsidy expenditures, and higher agricultural producer prices which should reduce subsidies to agriculture by some Ft 1.5 billion. Two major tax increases are planned for 1983. The first will raise by 3 percentage points to 30 per cent the rate of social security contributions paid by employers. The second measure, which is still at the planning stage, would increase pension fund contributions by individuals probably through a steep increase in the progressivity of this tax. A number of other tax initiatives are also under consideration.

One important reform, from a medium-term perspective, will not have a significant impact on the 1983 budget. This concerns the decision to switch the responsibility for part of state housing construction and maintenance to the private sector. Although this will give rise to additional private sector demands for credit in 1983 (see Section 4) it is expected that the reduction in direct budget allocations for housing construction will be largely offset, at least in the 1983 budget, by increases in interest rate subsidies and other social benefits to ease the transition to the new system.

The measures already decided by the Hungarian authorities form the basis for the preliminary budget estimates shown in Table 2. Under normal procedures for preparation of the budget, a final proposal will be completed in late November 1982 for presentation to Parliament for debate and approval in December. In its preliminary form, the budget for 1983 shows an unchanged level of capital expenditures in nominal terms compared with 1982, following several years of steep cuts. It was explained that this reflected the fact that whereas government expenditures on fixed investment and capital grants to enterprises would decline, capital transfers to local authorities have to be raised to offset a fall in the councils' other revenues. Current expenditures in 1983 would show only a modest increase in nominal terms (4.6 per cent) and would therefore decline in real terms. The small increase in total current expenditures, despite the cuts in some items, was mainly related to increases in social security payments (9 per cent in 1983).

The finances of those parts of the governmental sector that are outside the State Budget are not expected to show any major change in 1983, and should not give rise to any increased use of bank credit. The development expenditures of local authorities are forecast to decline further, in line with cutbacks in recent years, so that with essentially unchanged total revenues their recourse to bank credits should drop from Ft 3.3 billion in 1982 to Ft 2.6 billion in 1983. The combined deficit of the extrabudgetary sector (specialized state funds) is expected to show a smaller deficit in 1983 than in 1982.

4. Monetary and credit policies

The financial program constitutes strengthening of the restrictive financial policies followed by the Hungarian authorities since the beginning of 1982. Total net domestic assets of the National Bank of Hungary, which rose by 18 1/2 per cent in the year to June 1982, are projected to decelerate to 5 1/2 per cent during the year to December 1982, to 1/2 per cent in the year to June 1983 and to decline by 2 1/2 per cent in the year ending December 1983. The growth in gross credit to enterprises and Government (including the refinancing credits to other financial institutions) from the National Bank of Hungary is projected to decelerate from about 4 1/2 per cent in the year ending June 1982, to about 4 per cent by end-1982 and to 3 1/2 and 3 per cent, respectively, in the years ending June and December 1983. Although enterprise deposits are projected to increase during 1983, the increase is to occur in the relatively less liquid forms of such deposits, namely the enterprises' reserve and development funds. Total domestic credit from the banking system as a whole is programmed to increase by about 5 3/4 per cent in the year ending December 1983, compared with over 7 per cent in the year ending December 1982. The contribution of domestic credit to the growth of broad money is projected to decline from 15.4 percentage points in 1981 to 12.6 percentage points in 1982 and 10.5 percentage points in 1983 (Tables 4 and 5).

Except for 1980, when velocity fell, reflecting in part institutional changes, the velocity of both narrow and broad monetary aggregates has been very stable in recent years. Changes in the composition of holdings of monetary assets, however, have resulted in a rapid decline in the velocity of circulation of currency, reflecting the gradual expansion of private sector activity and increased monetization of the rural economy. These trends are expected to continue in 1983 (Table 6). A somewhat smaller decline than that of the recent past is envisaged in the case of the velocity of currency, reflecting a higher expected rate of inflation as well as the increase in interest rates--factors which are likely to offset the increase in the demand for money stemming from the continuing growth of the private sector and the expanding role of the so-called "second economy." The rate of expansion of currency in circulation--used almost exclusively by the household sector--is projected to decline from an estimated 9.3 per cent in 1982 to 8.5 per cent in 1983.

Table 4. National Bank of Hungary: Net Domestic Assets and Its Counterparts

(In billions of forint; end of period)

	Actual				Projections			
	1980	1981		1982	1982	1983		
	IV	II	IV	II	IV	I	II	IV
I. Net foreign liabilities in convertible currencies 1/	148.1 2/	138.9	166.5	169.8	172.5	167.1	163.3	158.6
II. Currency in circulation	72.8	74.3	81.3	82.8	88.9	87.6	90.2	96.5
III. Net domestic assets (I + II)	220.8	213.2	247.8	252.6	261.4	254.7	253.5	255.1
Net credit to the state budget	10.3	11.0	19.2	23.6	25.4	20.7	24.4	26.6
Investment credits	119.0	115.0	122.7	115.2)				
Working capital credits	161.7	180.4	170.6	190.9)	490.0	499.7	500.5	505.4
Refinancing credits, etc.	161.1	167.8	178.1	177.3)				
Less: Enterprise reserve funds 3/	-38.3	-40.7	-40.0	-51.7)	-166.5	-173.5	-180.6	-185.6
Other funds of enterprises	-117.6	-116.4	-119.6	-113.9)				
Deposits by other financial institutions 4/	-55.5	-66.9	-66.1	-70.8	-68.3	-76.4	-63.4	-70.1
Net foreign liabilities in nonconvertible currencies	-9.9 2/	-19.1	-4.8	-8.0	-4.8	-9.4	-10.1	-5.1
Unclassified liabilities (net)	-10.1	-17.8	-12.3	-10.0	-14.4	-6.4	-17.3	-16.1
Memorandum items:								
Net foreign liabilities of specialized banks in convertible currency 1/	37.4 2/	49.1	50.6	44.9	45.8	46.9	47.7	47.8
CECB claims on state budget	--	--	--	--	7.0	7.0	7.0	15.0
National Savings Bank								
Credit to households	107.2	110.7	119.9	123.8	134.9	138.3	143.0	150.5
Deposits of households	145.3	151.8	160.1	167.7	175.1	178.5	179.3	190.0

Sources: National Bank of Hungary and Fund staff estimates.

1/ Projections are based on the exchange rates prevailing at the end of September 1982.
2/ Partly estimated by Fund staff.
3/ Beginning June 1982, data relate to the funds redeposited by the CECB and exclude the amount of enterprise reserve funds on lent to the state budget by the CECB (see memorandum item).
4/ Excluding enterprise reserve funds redeposited by the CECB.

Table 5. Hungary: Monetary Survey

(In billions of forint, end of period)

	1980	1981				1982				1983 1/		
	IV	I	II	III	IV	I	II	III	IV 1/	I	II	IV
Domestic credit	603.5	611.9	630.8	645.4	657.0	660.8	678.0	685.8	703.9	712.5	722.0	744.9
Claims on state budget (net) 2/	10.3	6.7	11.0	13.3	19.2	10.8	23.6	22.6	32.4	27.7	31.4	41.6
Claims on enterprises, etc. 3/	480.1	490.8	502.2	507.6	510.3	521.0	522.5	524.0	527.8	537.5	538.3	543.2
Claims on households	107.2	107.9	110.7	117.3	119.9	121.2	123.8	130.4	134.9	138.3	143.0	150.5
Real estate investment	5.9	6.5	6.9	7.2	7.6	7.8	8.1	8.8	8.8	9.0	9.3	9.6
Money	155.3	154.3	154.7	152.3	167.0	156.9	158.3	160.4	176.8	170.8	175.9	189.7
Currency in circulation	72.8	74.8	74.3	73.6	81.3	80.0	82.8	85.4	88.9	87.6	90.2	96.5
Demand deposits of households	4.5	4.9	5.1	5.5	5.8	6.3	6.7	7.3	7.1	7.4	7.7	8.4
Current accounts of enterprises 4/	67.4	67.2	64.7	62.6	69.4	60.6	59.1	62.0	71.1	66.1	68.3	75.1
Unfinished settlements	10.6	7.4	10.6	10.6	10.5	10.0	9.7	5.7	9.7	9.7	9.7	9.7
Quasi-money	186.8	193.6	192.8	192.2	198.1	205.5	208.2	204.8	205.9	212.4	213.3	227.3
Households	136.6	140.7	141.1	141.7	147.9	152.5	153.4	154.0	159.3	161.9	162.2	170.7
Enterprises	50.2	52.9	51.7	50.5	50.2	53.0	54.8	50.8	46.6	50.5	51.1	56.6
Savings bonds	4.2	5.2	5.6	5.9	6.4	7.3	7.6	7.9	8.7	9.2	9.4	10.9
Enterprises' reserve funds	38.3	39.0	40.7	40.5	40.0	45.8	51.7	53.7	55.8	63.9	68.2	68.9
Net foreign liabilities 6/	209.9	192.5	209.9	219.9	224.1	227.8	226.9	234.6	226.2	226.0	224.5	214.5
Other items (net) (by difference)	9.0	27.3	27.1	34.6	21.4	17.5	25.2	24.4	30.5	30.2	30.7	33.6

Sources: National Bank of Hungary and Fund staff estimates.

1/ Projected.
2/ Claims of the National Bank of Hungary and the Central Exchange and Credit Bank.
3/ Includes a small and relatively stable amount of credit extended by the Foreign Trade Bank, in addition to the claims of the National Bank of Hungary (direct claims plus refinancing credits extended to the State Development Bank, as shown in Table 4).
4/ Including forint cover deposits against imports (Ft. 24.7 billion at the end of 1981, and Ft. 33.3 billion at the end of June 1982).
5/ Primarily development funds.
6/ Projections are based on the exchange rates prevailing at the end of September 1982.

Table 6. Hungary: Velocity of Money 1/

	Currency	Money	Broad Money 2/
1976	12.21	5.08	2.33
1977	12.12	5.19	2.32
1978	11.66	5.19	2.28
1979	11.29	5.21	2.27
1980 3/	10.54	4.92	2.18
1981 3/	10.04	4.80	2.15
1982	9.67	4.79	2.15
1983	9.45	4.78	2.14

Sources: National Bank of Hungary and staff estimates.

1/ Defined as ratio of nominal GDP to money, using averages of beginning and end of year money stocks. For 1983, the mid-point of the range of projections for nominal GDP is used.
2/ Includes savings bonds and some nonresident deposits.
3/ Velocity calculations using average money stocks apportion the decline in velocity in 1980 between 1980 and 1981.

A sizeable increase in the deposits of enterprises is projected to take place during the program period. The total of their current account, development and reserve funds is projected to rise by about 11 1/2 per cent during 1983. One reason for this high level of enterprise liquidity is the relatively high level of profits in 1982. The squeeze on enterprise investments as a result of the 25 per cent tax on new investments and the increase in the cost of obtaining investment funds is also expected to lead to unused liquidity. Measures are also envisaged to tighten the rules governing the replenishment of the enterprise reserve funds. Even so, given the difficulty of accurately estimating the developments in enterprise deposits, the authorities have underscored their intention to restrict the growth of credit to enterprises further, in the event that the expected increase in enterprise deposits does not materialize.

Net recourse of the state budget to financing from the banking system is to be reduced from Ft 13.2 billion in 1982 to Ft 9.2 billion in 1983. As a result of a new institutional arrangement involving a channeling of a part of the enterprise reserve funds to the State Budget via the Central Credit and Exchange Bank, the bulk of the budget deficit would no longer be financed directly by the National Bank of Hungary. This institutional change does not alter the total financing available for the budget from the banking system which is a performance criterion under the program. In view of the seasonal pattern of state tax revenue, credit to the State Budget is programmed to decline sharply in the first quarter of 1983 and rise in the second half of the year.

Gross credit to enterprises has slowed down since the first quarter of 1982. It is projected to increase by 3 per cent in 1983, compared with an increase of 8.2 per cent in 1981 and 4 per cent in the 12-month period to June 1982. Credits for investment have shown a pronounced decline in 1982 and are projected to increase little in 1983. The growth of working capital credits is projected to decline. Reflecting in part the restrictive credit policies followed so far this year, enterprises have begun to accumulate unpaid bills as their financial situation has tightened. Such interenterprise credits, ultimately financed by a drawdown of enterprise deposits, could undermine the effectiveness of controls on credit expansion. The credit ceiling, however, is defined net of enterprise deposits, and would require that gross credit be reduced correspondingly with any smaller than expected increase in deposits, thus preventing sources of credit outside the banking system from financing an unsustainable level of enterprise activity.

In order to restrain the demand for credit from enterprises, the Hungarian authorities have used interest rate policy more actively since 1981. Interest rates on investment credits, and on working capital credits, were raised twice in 1981 (January and September) by a percentage point each time. In January 1982, they were raised by an additional percentage point and the rates on investment credits and medium-term working capital credits were raised by a percentage point effective July 1, 1982. Most recently, effective October 1, 1982, interest rates on most enterprise credits were raised by 2 percentage points so that the rate on working capital credits now stand at 14-16 per cent and those on investment credits stand at 13-15 per cent (Table 7). As a result, real interest rates on loans to enterprises have increased from an average of 4-5 per cent during 1981 to 7-8 per cent in the latter part of 1982. Although the authorities were earlier reluctant to use interest rate policy actively as an instrument for mobilizing household savings, they have decided to raise interest rates on household time deposits by 2 percentage points by end 1982. The authorities expect that, despite the projected adverse developments in household incomes, the increase in deposit rates will stimulate the growth of household deposits with the National Savings Bank.

Credit to households is provided exclusively through the National Savings Bank and is predominantly for housing. In a major policy change, partly reflecting the shift of a greater portion of the financing of housing construction from the State Budget to the National Savings Bank as well as the continuing high demand for housing, credit to households is projected to increase by 11 1/2 per cent in 1983, compared with 12 1/2 per cent estimated for 1982. The authorities intend to finance

Table 7. Hungary: Interest Rates

(In per cent per annum)

	From Jan. 1, 1981	From Sept. 1, 1981	From Jan. 1, 1982	From July 1, 1982	From Oct. 1, 1982
Interest rate on credits:					
State development loans	8	9	10	11	13
Investment credits:					
Long-term	9	10	11	12	14
Medium-term	10	11	12	13	15
Short-term	10	11	12	12	14
Working capital credits:					
Medium-term	10-11	11-12	12-13	13-14	15-16
Short-term	10	11	12	12	14
Credits to households					
Housing Loans:	0-6	0-6	0-6	0-6	0-6
Hire purchase loans	6-8	6-8	6-8	6-8	6-8
Personal loans	8-10	8-10	8-10	8-10	8-10
Deposits of households:					
Time and saving deposits	2-5	2-5	2-5	2-5	2-5
Saving notes	6-7	6-7	6-7	6-7	6-7

Source: National Bank of Hungary.

this relatively large expansion of credit through the increase in deposits of households that is expected to occur. In view of the uncertainty regarding the effects of the increase in interest rates and the higher expected rate of inflation on household financial savings, however, the authorities intend to restrict the extension of credit to households more than currently envisaged, if the actual increase in household deposits is less than expected.

5. Balance of payments outlook and policies

Balance of payments developments in 1982 were dominated by the exceptionally large deficit in respect of convertible currency payments during the first quarter. Reflecting primarily a large capital outflow as short-term deposits held at the National Bank were withdrawn, gross official reserves (including gold) fell by more than US$1.2 billion during the three-month period ended March 31, 1982 (Table 8). The liquidity situation eased somewhat in the second and third quarters, but remained precarious as the increase in holdings of reserves was financed in part by occasional reliance on overnight deposits and, at times, by delaying payments. Short-term assistance was obtained from the BIS in April (US$210 million) and again in September (US$300 million). At the end of September 1982, gross official holdings of foreign exchange in convertible currencies amounted to US$718 million, less than half the amount held at the end of 1981.

The strategy formulated by the authorities to cope with present balance of payments difficulties relies primarily on achieving a sharp improvement in the current account balance in 1983. The target adopted by the authorities envisages a current account surplus in convertible currencies of US$600 million in 1983, representing a cumulative improvement of US$1.3 billion over the two-year period since 1981. The external current balance in nonconvertible currencies in 1983 would show a deficit of about the same magnitude as in 1981, but lower than in 1982.

The improved performance on current account is expected to reflect improvements in respect of both the trade balance and the balance on other current transactions. To this end, and in addition to a curtailment of domestic absorption, policies have been adopted which aim at increasing the supply of exportables and import substitutes. First, the exchange rate for the forint was depreciated by 7 per cent against a basket of currencies on July 13, reversing in part the real effective appreciation of the forint in the preceding two years. The authorities also intend to follow a more active exchange rate policy in 1983 in spite of their concern that a rate of inflation approaching 10 per cent could stimulate dissaving by households. Second, efforts to promote exports to the convertible currency area have been intensified. Changes were introduced to strengthen incentives for investments aimed at increasing export capacity and to shorten the gestation period for qualifying investments: the interest rebate paid from the time of completion of the investment and provided that export commitments are satisfied was raised from 30 per cent to 45 per cent; and the period

Table 8. Hungary: International Reserves and Other Foreign Assets, 1980-1982

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

	1980	1981	1982 March	1982 June	1982 September
International reserves					
Gold 1/	111	69	18	22	27
Foreign exchange					
Convertible currencies	1,884	1,624	455	588	718
Official reserves	(1,759)	(1,486)	(249)	(421)	(451)
Other readily marketable assets 2/	(125)	(142)	(206)	(177)	(267)
Nonconvertible currencies	113	28	6	128	22
Total	2,108	1,721	479	738	767
Other foreign assets					
Convertible currencies	1,257	1,220	1,334	1,283	...
Liquid assets of the Foreign Trade Bank	(109)	(...) 4/	(...)	(...)	(...)
Other short-term assets 3/	(577)	(596)	(633)	(565)	(...)
Long-term assets	(571)	(624)	(701)	(718)	(...)
Nonconvertible currencies	413	510	460	346	...
Short-term	(139)	(238)	(193)	(81)	(...)
Long-term	(274)	(272)	(267)	(265)	(...)
Total	1,670	1,730	1,794	1,629	...
Total international reserves and other foreign assets	3,778	3,451	2,273	2,367	...

Source: National Bank of Hungary.

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

2/ Excluded from the official Hungarian definition of reserves.

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

4/ Included with other short-term assets.

of time by which export earnings must exceed the value of the investment was changed to four years from initiation of the investment rather than three years from completion of the investment (with up to three years allowed for completion of the investment).

In addition to the above measures aimed at achieving a lasting improvement of the balance of payments, and while these measures and supporting fiscal, monetary and incomes policies take effect, the authorities introduced, effective September 1, 1982, measures to restrict imports. Imports of several primary products were made subject to quantitative restrictions while imports of component parts became subject to a 20 per cent surcharge. Imports subject to these restrictions amounted to US$1.5 billion in 1981, equivalent to 30 per cent of total imports from the nonruble area. Valued at 1981 prices, quotas announced for 1982 were set about US$60 million below 1981 imports. The value of imports subject to these restrictions and the 1982 quotas are shown in Table 9. The authorities are committed to removing these restrictions gradually during the period of the stand-by arrangement.

Reflecting in part the impact of the measures described above as well as some recovery of foreign demand and normal seasonality, the trade surplus in convertible currencies is expected to nearly double to more than US$500 million during the second half of 1982 (Table 10). Major factors underlying this projected improvement include: (1) good crops, in particular of wheat and maize, which will contribute to stronger exports in late 1982-early 1983; (2) improved export orders for several categories of manufactured products, in particular, machinery, metals and chemicals; and (3) lower import volumes in response both to the newly introduced restrictions and weaker domestic demand.

For 1982 as a whole, a trade surplus of US$800 million in convertible currencies is projected, compared with a surplus of US$450 million in 1981 and despite a deterioration of 1.5 per cent in the terms of trade. Weak demand for certain categories of manufactured exports (e.g., aluminium, chemicals and transportation equipment) and generally weak prices for both primary commodities and manufactured products severely depressed export performance during the first half of the year. While a stronger performance of export volumes is expected during the second half of the year, export receipts in convertible currencies are projected to increase by only 1 per cent for the whole year. Almost 90 per cent of the improved performance in respect of the trade balance is expected to result from lower imports, reflecting both lower volumes and prices. In addition to weaker domestic demand and the effect of import restrictions, changes in the composition of domestic demand, in particular the sharp slowdown in stock accumulation, played a significant role in reducing the demand for imports.

A strengthening in export growth and weak import demand are expected to result in a further increase of the trade surplus in convertible currencies to more than US$1.1 billion in 1983. Taking into

Table 9. Hungary: Import Restrictions Introduced September 1982

	Imports			Licenses Issued	Quota[1/]	Imports			Licenses Issued	Quota[2/]
	1980	1981	Jan.-July 1982	Jan.-Aug.		1980	1981	Jan.-July 1982	Jan.-Aug.	
	Volume (tons)					Value (million forint)				
Imports subject to quotas										
Iron ore	183,419	339,600	103,530	173,900	290,000	363.2	623.8	169.5	...	...
Asbestos, long fibred	6,763	2,627	2,854	4,500	4,500	187.5	78.0	93.8	...	...
Caustic soda, solid	27,769	4,443	3,403	5,000	5,000	321.2	54.0	36.5	...	...
Organic chemical basic material	...	...	...	...	...	1,595.8	1,654.5	880.1	1,204.0	1,680.0
Aliphatic ketones, aldehydes acids	...	...	17,204	...	...	995.3	1,091.8	449.8	716.0	1,050.0
Aniline colors, auxiliary chemical materials for the textile, leather and fur industries	...	...	...	...	...	2,005.0	1,719.2	858.8	1,267.0	2,000.0
Natural rubber	17,710	14,238	6,678	10,800	13,000	971.4	715.3	251.3	...	...
PVC	11,454	9,397	4,362	5,600	8,000	449.4	321.4	139.1	...	...
Plastic basic materials[3/]	38,984	...	20,008	...	...	2,763.2	2,587.0	1,389.0	2,141.0	2,300.0
Zinc oxide, titanium dioxide and litophone	17,883	18,163	7,255	10,400	13,000	643.0	640.9	280.5	...	...
Cellulose based silk	6,439	6,845	3,037	4,900	6,700	979.7	1,023.0	463.5	...	...
Fibrous semi-finished product for the paper industry	107,076	92,619	46,478	69,500	95,000	1,779.5	1,631.4	797.7	...	...
Paper and cardboard	78,418	88,939	57,875	72,400	95,000	2,027.8	2,239.0	1,365.7	...	...
Raw cotton	30,167	25,167	11,814	15,700	16,700	2,035.8	1,722.0	824.9	...	...
Rawhide	31,168	24,565	20,683	24,700	25,000	1,727.3	1,369.9	1,253.8	...	...
Protein fodder of the vegetable oil industry/soya meal	618,321	597,913	343,697	502,700	600,000	6,105.8	6,871.9	3,483.7	...	...
Husked rice	23,151	19,223	5,400	9,400	11,000	360.0	342.5	93.2	...	...
Total	...	...	...	...	...	25,310.9	24,685.6	12,830.9	...	...
Imports subject to surcharge	...	...	...	...	...	22,649.0	26,729.0	13,272.0	...	...

Source: Data provided by the Hungarian authorities.
1/ If quota specified in volume.
2/ If quota specified in value.
3/ Except PE, PP, PS, PTFE, PVC and moulding powders.

Table 10. Hungary: Balance of Payments in Convertible Currencies, 1982-1983

(In millions of U.S. dollars)

	1982					1983				
	I	II	III	IV	Total	I	II	III	IV	Total
Exports	1,200	1,199	1,173	1,349	4,921	1,218	1,254	1,277	1,503	5,252
Imports	-1,069	-1,049	-979	-1,016	-4,113	-986	-1,017	-1,011	-1,096	-4,110
Trade balance	131	150	194	333	808	232	237	266	407	1,142
Freight and insurance	-57	-50	-53	-54	-214	-49	-52	-52	-57	-210
Travel	21	37	59	71	188	25	52	74	89	240
Investment income	-320	-315	-192	-163	-990	-147	-146	-145	-142	-580
Government expenditure	-10	-12	-12	-12	-46	-12	-12	-12	-12	-48
Other current receipts	45	-15	--	--	30	--	--	--	--	--
Unrequited transfers	12	12	13	15	52	13	13	14	16	56
Other	-88	98	--	--	10	--	--	--	--	--
Current balance	-266	-95	9	190	-162	62	92	145	301	600
Medium- and long-term capital										
Export financing	-107	-30	-21	5	-153	-10	-10	-31	-13	-64
Assets maturing	(...)	(...)	(45)	(58)	(...)	(32)	(37)	(32)	(42)	(143)
New lending	(...)	(...)	(-66)	(-53)	(...)	(-42)	(-47)	(-63)	(-55)	(-207)
Other medium- and long-term	96	-57	125	-74	90	-41	-2	-129	-185	-357
Inflows	(445)	(79)	(332)	(113)	(969)	(146)	(145)	(171)	(117)	(579)
Outflows	(-349)	(-136)	(-207)	(-187)	(-879)	(-187)	(-147)	(-300)	(-302)	(-936)
Short-term capital (net)										
Export financing (net)	-64	57	-48	-84	-139	123	15	-66	-125	-53
Other short-term 1/	-1,268	296	-14	-159	-1,145	-53	-107	86	82	8
Total	-1,609	171	51	-122	-1,509	81	-12	5	60	134
Monetary movements										
Monetary gold (increase -)	440	-38	-26	--	376	...	...	...	...	...
Foreign exchange (increase -)	1,169	-133	-25	-115	896	-172	-80	-96	-152	-500
Use of Fund resources 2/	--	--	--	237	237	91	92	91	92	366

Sources: National Bank of Hungary; and staff estimates.

1/ Includes errors and omissions.
2/ Includes drawings under CFF.

account the impact on the supply of exportables of the reduction of domestic demand and, improved export incentives and competitiveness, and bumper crops, nonruble exports are projected to increase by 10 per cent, reflecting increases in both volume and price. The increase in the volume of exports is expected to be consistent with a growth in foreign demand for non-oil imports of 3-4 per cent. Fairly strong performances are projected for most branches of industry, with particularly large increases for exports of agricultural products and processed foods, chemicals, machinery and engineering goods. In contrast, and despite the gradual removal of recently introduced restrictions, payments in convertible currencies for imports are projected to remain unchanged in 1983 as weaker domestic demand and the depreciation of the forint reduce the demand for imports from the convertible currency area.

Substantial improvements are also expected from mid-1982 in respect of current payments other than trade, in particular, travel and investment income. Increases in hotel capacity since late 1981, easier visa regulations and the depreciation of the exchange rate applied to tourist spending (47 per cent since early 1980, before the exchange rate system was unified) have already resulted in a significant increase in earnings of convertible currencies from tourism. Further increases are projected for the second half of 1982 and for 1983. In contrast, spending by Hungarian tourists abroad, which had been increasing rapidly in recent years, slowed significantly in the first half of 1982 and is expected to remain below its 1981 level in both 1982 and 1983, reflecting both weaker income growth and the increase in the relative cost of foreign travel due to the depreciation of the forint.

The rapid increase in external debt in convertible currencies and high rates of interest on foreign capital markets in recent years) resulted in a widening of the deficit on investment income to US$1.1 billion in 1981 and to more than US$1.2 billion (annual rate) during the first half of 1982. However, substantially lower deficits are expected from the second half of 1982 as a consequence of the lower average cost of foreign borrowing. A lower deficit in respect of investment income had already been expected from the second quarter of 1982 but did not materialize as the tight liquidity situation and restricted access to loans on favorable terms required that capital be raised in currencies and on terms which resulted in sharply higher borrowing costs. However, subsequent changes in the currency composition of external debt and the general easing of interest rates reduced the average rate of interest from 15 per cent during the first half of 1982 to about 10 per cent in the third quarter. Commissions and fees were also significantly lower in the third quarter as the easier liquidity situation reduced the need for recourse to loans and deposits of very short maturities.

The improved performance on current account and the use of Fund resources are expected to make it possible both to reduce borrowing from market sources and to increase official holdings of reserves, thus reducing the vulnerability of the balance of payments to shifts in market sentiment such as took place in late 1981-early 1982. Two main elements of the debt management strategy envisaged for the second half of 1982 and for 1983 are to reduce external debt gradually and to make greater use of loans guaranteed by foreign export credit agencies, thus reducing the risk for private foreign lenders. For similar reasons, and until current unsettled conditions stabilize, it is envisaged that the reduction in foreign debt may have to take the form primarily of a reduction of debt in medium- and long-term maturities. On present indications, external debt in convertible currencies, most of which is owed to commercial lenders, is projected to be reduced from US$8.7 billion at the end of 1981 to US$7.5 billion at the end of 1983 1/ (Table 11).

Despite the large capital outflow in the first quarter of 1982, short-term foreign liabilities (with an average maturity of about two months) remain at the high level of US$1.9 billion (Table 12) and thus leave the balance of payments subject to the risk of further substantial capital outflows. For this reason, a key objective of policy is to reconstitute holdings of reserves. Gross official reserves in convertible currencies are targeted to increase to about US$875 million by the end of 1982 and US$1,375 million by the end of 1983.

Salient features of the balance of payments outlook beyond 1983 include: (1) a large increase in debt service payments in convertible currencies in 1984, reflecting a bunching of maturities in respect of medium- and long-term debt; and (2) the need to effect a significant reduction of the external current deficit in nonconvertible currencies. The amortization schedule in respect of medium- and long-term external debt in convertible currencies outstanding at the end of June 1982 shows an increase in payments by about US$300 million in 1984, to more than US$1.2 billion (Table 11). Accordingly, and despite lower interest payments, the projected decline of the debt service ratio in convertible currencies in 1983, from 33 per cent in 1982 to 27.5 per cent, is expected to be fully reversed in 1984, leaving relatively little scope for reducing the surplus on current account in convertible currencies targeted for 1983.

Although current difficulties have focused attention on the balance of payments in convertible currencies, a smaller, but still significant, adjustment is required in the balance in nonconvertible currencies. The availability of foreign financing to ease the process of adjustment to the change in the relative price of energy in intra-CMEA trade made it possible for Hungary to run sizeable current account deficits in nonconvertible currencies through the late 1970s and early 1980s. In addition, in 1982, transport bottlenecks and disruptions in some CMEA trade partners contributed to a substantial increase of the external current deficit in nonconvertible currencies (Table 14). It is expected,

---

1/ Including drawings from the Fund.

Table 11. Hungary: Debt Service Payments, 1981-1985 1/

(In millions of U.S. dollars)

	1981	1982	1983	1984	1985
Amortization 2/					
On debt contracted before 6/31/82	826	879	886	1,215	1,143
On debt contracted after 6/31/82	--	--	50	170	266
Total	826	879	936	1,385	1,409
Interest payments 3/	1,014	1,004	731	711	692
Total	1,840	1,883	1,667	2,096	2,101
Memorandum items:					
Debt outstanding, end of period	8,699	7,497	7,515	7,315	7,115
of which use of Fund resources	(--)	(237)	(603)	(...)	(...)
Debt service ratio (per cent) 4/	32.7	33.4	27.5	32.7	30.4

Sources: National Bank of Hungary; and staff estimates.

1/ Convertible currencies only.
2/ Medium- and long-term debt only.
3/ Includes short-term debt.
4/ Amortization and interest as a per cent of exports of goods and services.

Table 12. Hungary: Foreign Debt, 1980-82

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

	1980	1981	1982 March	1982 June
Total foreign debt	10,314	10,026	8,724	8,948
In convertible currencies	9,090	8,699	7,391	7,384
By original maturity:				
Short-term	3,347	2,849	1,702	1,857
Long-term	5,743	5,850	5,689	5,527
By type:				
Financial loans 1/	8,616	8,050	6,652	6,459
Trade-related credits 2/	293	402	438	473
Intergovernmental credit	6	6	6	5
Other 3/	175	241	295	447
In nonconvertible currencies	1,224	1,327	1,333	1,564
By original maturity:				
Short-term	558	243	248	467
Long-term	666	1,084	1,085	1,097
By type:				
Financial loans	532	260	267	482
Trade-related credits	23	15	17	26
Intergovernmental credit	635	1,038	1,034	1,036
Other	34	14	15	20
Memorandum item:				
Forint/$ (end of period)	32.213	34.430	34.781	35.748

Source: National Bank of Hungary.

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

Table 13. Hungary: Projected Balance of Payments in Convertible Currencies, 1981-1985

(In millions of U.S. dollars)

	1979	1980	1981	1982	1983
Exports	4,063	4,863	4,877	4,921	5,252
Imports	-4,230	-4,587	-4,432	-4,113	-4,110
Trade balance	-167	276	445	808	1,142
Freight and insurance (net)	-187	-237	-216	-214	-210
Travel (net)	72	84	133	188	240
Investment income (net)	-366	-409	-1,100	-990	-580
Government expenditure (net)	-37	-43	-47	-46	-48
Other current receipts (net)	-181	-85	11	40	--
Unrequited transfers (net)	40	46	47	52	56
Current balance	-826	-368	-727	-162	600
Medium- and long-term capital					
Export financing	-111	-124	-104	-153	-64
Other	901	794	617	90	-357
Inflows	(...)	(1,605)	(1,443)	(968)	(579)
Outflows	(...)	(-811)	(-826)	(-878)	(-936)
Short-term capital (net)1/	-222	150	-412	-1,284	-45
Overall balance	-258	452	-626	-1,509	134
Monetary movements					
Monetary gold (increase -)	200	-212	366	376	...
Foreign exchange (increase -)	58	-240	260	896	-500
Use of Fund resources	--	--	--	237	366

Sources: National Bank of Hungary; and staff estimates.

1/ Includes errors and omissions.

Table 14. Hungary: Projected Balance of Payments in Nonconvertible Currencies, 1981-1985

(In millions of U.S. dollars)

	1979	1980	1981	1982	1983
Exports	3,886	4,015	4,017	4,104	4,332
Imports	-4,279	-4,434	-4,423	-4,413	-4,545
Trade balance	-393	-419	-406	-309	-213
Freight and insurance (net)	-77	-95	-110	-109	-121
Travel (net)	107	107	117	63	66
Investment income (net)	-15	20	-20	-5	-11
Government expenditure (net)	-2	3	3	5	5
Other current receipts (net)	261	174	245	82	87
Unrequited transfers (net)	2	2	2	3	3
Current balance	-117	-208	-169	-270	-184
Medium- and long-term capital					
Export financing	5	-44	-26	25	5
Other	136	154	502	63	108
Inflows	(...)	(...)	(582)	(175)	(221)
Outflows	(...)	(...)	(-80)	(-112)	(-113)
Short-term capital (net)	-5	108	-392	183	71
Total	19	10	-85	--	--

Sources: National Bank of Hungary; and staff estimates.

however, that the external current deficit in nonconvertible currencies will have to be substantially reduced from 1983, thus limiting the scope for relaxation of the current restrictive stance of domestic policies.

6. Structural Reforms

In conjunction with the adjustment efforts directed at the immediate balance of payments problem, the Hungarian authorities intend also to pursue the program of structural reforms, 1/ which are designed to improve the efficiency of the economy and to underpin a sustainable strengthening of the external balance in the medium-term. A major step to increase the productivity and the mobility of labor will be undertaken in 1983 with a comprehensive overhaul of the rules of wage determination. It has been widely recognized that an important feature of the system linking tax free annual wage increases to improvements in the performance of enterprises relative to the preceding year has tended to discourage firms from seeking markedly better results in a given year as this might jeopardize their ability to raise wages in the succeeding year. This system encouraged enterprises to grant more uniform wage awards than would be desirable for shifting labor to efficient firms. The new regulations on wage determination to take effect in 1983 will eliminate the performance indicators. A highly progressive tax will be applied on the annual increase in the average compensation of employees beyond a tax-free allowance. 2/ For enterprises whose profitability is strongly affected by factors outside the control of management, the amount of tax free increase in wages will be determined by the central authorities. Enterprises exporting to the convertible area will be entitled to grant tax exempt wage increases in excess of the above limit, in proportion to the increase and the profitability of these exports.

Progress in adapting the structure of the economy is also expected as a result of the tighter financing conditions on enterprises, which should force a more efficient use of available resources, and from the authorities' decision to reduce certain subsidies. Budget support for the purchase of farm equipment and other agricultural inputs will be reduced considerably in 1983. The effect of these measures on the financial position of farms will be mitigated by increases in the procurement prices for farm products, and in part by permitting large agricultural units to make exceptional drawings on their reserve funds.

Additional measures are envisaged to restructure inefficient enterprises, with a view to channeling resources to more effective uses. Under one proposal, inefficient or unprofitable enterprises would be subjected to a compulsory restructuring procedure. This might entail making the remuneration of management contingent on an improvement in

---

1/ The economic reform measures of recent years are described in SM/82/176 (8/5/82) and SM/82/180 (9/17/82).

2/ The potential for tax-free wage increases remains determined by the level of profitability, defined as the ratio of profits to the sum of fixed assets and the wage bill.

the company's financial position, or replacement of the management, or liquidation of the enterprise. Ailing enterprises subject to restructuring would be prohibited to invest, even for replacement purposes, until programs are drawn up holding out the promise to restore profitable operations. In a further effort to direct factors of production toward more efficient uses, the authorities are devising means of achieving some mobility of withheld earnings among enterprises.

A new program adopted by the Government is aimed at economizing on inputs of energy, raw materials, and semifinished goods in the production process. The current practices of enterprises provide considerable scope for rationalization, which would have a marked impact on the external balance, since energy, raw materials, semifinished products, and spare parts account for about one half of merchandise imports. Moreover, greater cost efficiency would boost the competitiveness of exports. The scheme supplements the credits at preferential interest rates granted to enterprises for energy and raw materials conservation investments.

While external adjustment has prompted the need for a curtailment of real incomes, the authorities have taken initiatives to improve living conditions and the provision of government and housing services to the population. A progressive elimination of the intermediate level of district councils will permit savings in budget expenditures and reduce red tape. The reform of the housing system will provide for greater equity in housing availability and contribute to better supply and quality of housing by an extension of various incentives to private owners. The cost to the budget of housing programs will be reduced by gradual cuts in rent subsidies until they are completely eliminated in 1988. Housing allowances will be limited to low income families, and rent support will be reduced selectively. These savings in budgetary support for housing will be offset in large part by new financial incentives to the acquisition of private houses in the form of lump sum allowances and preferential housing loans.

7. <u>Performance criteria</u>

In addition to the quantified performance criteria described later, it has been understood that the development of domestic absorption will be monitored very closely in order to ensure compliance with the main targets of the program (Table 15). Although the relevant figures lack the degree of statistical accuracy that would permit them to be used as the basis for formal performance criteria, data on real cash incomes of the population and investment in the socialist sector will be reported to the staff on a monthly basis, within four weeks of the end of the previous months. These indicators will be monitored to ensure that their evolution is consistent with the goal of a 3-4 per cent decrease in domestic demand in real terms. Cash incomes of the population include nearly all payments for wages and salaries, social benefits, interest and cash receipts from sale of agricultural products from private plots. The authorities can readily control real incomes during the year by adjusting either the turnover tax or the subsidies on consumer goods.

Table 15. Hungary: Summary of Program for Stand-By Arrangement, 1983

1. Assumptions:

a. Real GDP growth: nil. Agricultural production: up 3 per cent. Consumer prices: up 9 per cent.

b. Growth of foreign convertible markets: 4 per cent; terms of trade deterioration: 1.3 per cent (convertible trade) and 3.2 per cent (nonconvertible trade); interest rate on debt: 9.7 per cent; growth of tourism receipts: 20 per cent; current account deficit in nonconvertible currencies: Ft 7 billion.

c. Ratio of money and quasi-money to GDP: 0.467 (0.465 in 1982).

2. Targets: Current account surplus in convertible currencies: $600 million or 2.7 per cent of GDP. Overall balance of payments surplus (in convertible currencies): $134 million.

3. Principal elements:

a. Demand management: domestic demand down 3-4 per cent. Strict control of real incomes and investment. Public consumption will not increase in real terms.

b. Budget: budget deficit will be reduced in 1983 to the equivalent of 1 per cent of GDP, from 1.6 per cent in 1982 as a result of tax increses and reduction in subsidies implemented in 1982 and 1983 and of restraint on expenditures.

c. Money and credit: limits on expansion of net domestic assets of the National Bank of Hungary (down 2.5 per cent during 1983) and of bank credit to the State. Increases in interest rates on loans and households' term deposits.

d. Price and wage policies: significant reduction in subsidies to take place in 1983. Wage awards to be reduced by raising taxes enterprises must pay on wage payments. Increases in pension fund contributions by employees.

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

Investment in the socialist sector represents about 85 per cent of total gross fixed investment. Housebuilding is the main component excluded from its coverage. Unless there should be an unanticipated change in the savings ratio, control over real cash incomes and investment in the socialist sector should ensure that private consumption and investment are in line with the target set for domestic demand. These two indicators will, therefore, be among the main areas of scrutiny during quarterly staff visits and the mid-term review. Public consumption in turn is to be controlled indirectly through the performance criterion on bank credit to the State.

The formal quantitative performance criteria (Table 16) are: (1) A quarterly ceiling on the net domestic assets of the National Bank of Hungary, defined as currency plus net foreign liabilities in convertible currencies. The definition of the credit ceilings on a net basis stems from the large and potentially volatile liquidity position of enterprises. The projected improvement in the balance of payments in convertible currencies for 1983 is reflected in the decline in the net foreign liabilities of the National Bank of Hungary, as well as in changes in the net convertible foreign liabilities of the specialized banks and enterprises; (2) A quarterly ceiling on the net credit of the banking system to the State for the financing of the budget deficit; (3) A ceiling on the net foreign liabilities in convertible currencies of the financial institutions other than the National Bank of Hungary; and (4) a limit on the contraction of new foreign debt in convertible currencies with an original maturity of one year and up to and including 12 years by borrowers other than those listed under (1) and (3) above.

In addition to the quantitative performance criteria, the program also contains as performance clauses: (1) the customary provisions on the restrictive system; and (2) a review to reach understandings on policies and performance criteria for the period June 30-December 31, 1983, including a review of exchange rate policy and of progress in eliminating the import restrictions recently introduced.

IV. Staff Appraisal

Although the Hungarian authorities have since 1978 given priority to the achievement of a sustainable external payments position and have consequently allowed domestic demand to grow at much more moderate rates than before, they have been faced, since the end of 1981, with an acute liquidity squeeze necessitating stronger adjustment measures. The size of the foreign debt and the relatively large share of short-term maturities have made Hungary vulnerable to changes in sentiment among foreign lenders, particularly commercial banks. The change in bankers' attitudes experienced since late 1981 was dramatically reflected in massive withdrawals of short-term deposits in the first quarter of 1982. It was due partly to political considerations but

Table 16. Hungary: Quantitative Performance Criteria

	1981	1982	1982	1983	1983
	Actual		Limits		Indicative limits
	Dec. 31	June 30	Dec. 31	March 31	Dec. 31
	(In billions of forint)				
Net domestic assets of National Bank of Hungary	247.8	252.6	261.5	255.0	255
Net bank credit to State	19.2	23.6	32.5	28.0	42
	(In millions of U.S. dollars)				
Net foreign liabilities in convertible currencies of the specialized financial institutions	1,471	1,257.7	1,230	1,310	1,330
New foreign debt in convertible currencies by nonbank borrowers	...	...	...	50	...

Source: Annex II.

also to the realization that the rise in interest rates and the world recession were putting pressure on the external current account in convertible currencies and straining the country's debt servicing capability.

During 1982, the Hungarian authorities have reacted to the deterioration of their liquidity position by taking stabilization measures designed to eliminate the current account deficit. These measures included a tightening of credit, a rise in interest rates, depreciation of the forint, increases in indirect taxes and reductions in subsidies, a freezing of investment funds, a penalty on firms undertaking new investment projects, a dampening of wage increases, and new import restrictions. These measures, together with the reduction in foreign interest rates and an increase in agricultural exports due to bumper crops, are expected to reduce the current account deficit in convertible currencies in 1982 to less than US$200 million from US$727 million in 1981, the improvement being experienced entirely in the second half of the year.

The program presented in the attached letter extends and strengthens the stabilization effort already initiated. It includes strict controls on real incomes, investment and credit, and a further increase in interest rates. The Hungarian authorities also intend to follow a more active exchange rate policy. The staff would have preferred that the reduction in real disposable incomes take place largely through a reduction in subsidies on consumer goods rather than through wage moderation, so as to achieve a better structure of relative prices. Nevertheless, the authorities are committed to a significant reduction in subsidies during the program period.

The staff welcomes the authorities' statement that they intend to pursue the reform of the economic system with a view to improving its efficiency. There is indeed a large potential for raising productivity and thereby the growth rate without worsening the external position. In this respect, the staff welcomes the stated intention to eliminate the import restrictions introduced in September 1982. These restrictions are incompatible with an efficient functioning of the production system.

The program presented by the Hungarian Government is designed to achieve a surplus on the current account in convertible currencies of US$600 million in 1983. This represents an improvement since 1981 equivalent to 6 per cent of 1982 GDP, and it will require a trade surplus equivalent to 22 per cent of convertible currency exports. Such an improvement represents a considerable effort and is contingent on the perseverance with which measures to restrain domestic demand are implemented. Although the size of the adjustment effort seems appropriate in present circumstances additional measures could well be required if some of the assumptions underlying the program, particularly as regards exports and households' savings, are not borne out.

The staff believes that the program constitutes an important effort by the Hungarian authorities. It should allow some reconstitution of reserves and a reduction of foreign debt, and give Hungary a good chance to weather its current difficulties, provided that there is not a further adverse change in the attitude of private lenders vis-à-vis Hungary and a resumption of net capital outflows. The program, while principally intended to alleviate the immediate pressure on reserves, is also consistent with the longer-run need for improving the efficiency of the economic system. It is therefore worthy of Fund support. Accordingly, the following draft decision is proposed for adoption by the Executive Board:

1. The Government of Hungary has requested a stand-by arrangement for a period of 13 months 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) of the Articles.

Stand-by Arrangement--Hungary

Annexed hereto is a letter dated October 13, 1982 from the Deputy Chairman of the Council of Ministers of the Hungarian People's Republic and the President of the National Bank of Hungary requesting a stand-by arrangement and setting forth (a) the objectives and policies that the authorities of Hungary intend to pursue for the period of the stand-by arrangement; (b) understandings of the Hungarian People's Republic with the Fund regarding a review that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of the Hungarian People's Republic will pursue for the remaining period of this stand-by arrangement.

To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period of 13 months from , 1982 Hungary will have the right to make purchases from the Fund in an amount equivalent to SDR 475 million, subject to paragraphs 2, 3, and 4 below, without further review by the Fund.

2. a. Purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 142.5 million until March 15, 1983, the equivalent of SDR 225.6 million until June 30, 1983, the equivalent of SDR 308.7 million until September 15, 1983 and the equivalent of SDR 391.8 million until December 15, 1983. None of these limits shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Hungary's currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of supplementary financing or borrowed resources beyond 12.5 per cent of quota.

3. Purchases under this stand-by arrangement shall be made from ordinary and borrowed resources in the ratio of 2 to 1 until purchases under this arrangement reach the equivalent of SDR 140,625,000 and then from ordinary and borrowed resources in the ratio of 1 to 1.2; provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Hungary will not make purchases under this arrangement that would increase the Fund's holdings of its currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota:

a. during any period in which:

(1) the limit on net domestic assets of the National Bank of Hungary referred to in paragraph 12(a) of the annexed letter; or

(2) the limit on the net credit from the banking system to the state budget referred to in paragraph 12(b) of the annexed letter; or

(3) the limit on net foreign liabilities in convertible currencies of the specialized financial institutions referred to in paragraph 12(c) of the annexed letter; or

(4) the limit on the contraction of new foreign debt in convertible currencies referred to in paragraph 12(d) of the annexed letter,

is not observed; or

b. during the period after June 29, 1983 until the policies of the program have been reviewed and suitable performance criteria have been established in consultation with the Fund as contemplated by paragraph 12(f) of the annexed letter, or after such performance criteria have been established, while such clauses, having been established, are not being observed; or

c. during the entire period of this stand-by arrangement if Hungary:

(1) imposes or intensifies restrictions on payments and transfers for current international transactions; or

(2) introduces or modifies multiple currency practices; or

(3) concludes bilateral payments agreements which are inconsistent with Article VIII; or

(4) imposes or intensifies import restrictions for balance of payments reasons.

When Hungary is prevented from purchasing under this arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Hungary and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Hungary's right to engage in the transactions covered by this arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility; or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally

to suppress or to limit the eligibility of Hungary. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Hungary and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this arrangment shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Hungary, the Fund agrees to provide them at the time of the purchase.

7. The value date of a purchase under this stand-by arrangement involving borrowed resources will be normally either the fifteenth day or the last day of the month, or the next business day if the selected day is not a business day. Hungary will consult the Fund on the timing of purchases involving borrowed resources.

8. Hungary shall pay a charge for this arrangement in accordance with the decisions of the Fund.

9. a. Hungary shall repurchase the amount of its currency that results from a purchase under this stand-by arrangment in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Hungary's balance of payments and reserve position improves.

b. Any reductions in Hungary's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

c. The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will be normally either the sixth day or the twenty-second day of the month, or the next business day, if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

10. During the period of the stand-by arrangement, Hungary shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Hungary or of representatives of Hungary to the Fund. Hungary shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Hungary in achieving the objectives and policies set forth in the attached letter.

11. In accordance with paragraph 14 of the annexed letter, Hungary will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government, or whenever the Managing

Director requests consultation, because any of the criteria in paragraph 4 above have not been observed, or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Hungary has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Hungary's balance of payments policies.

Letter of Intent

Dear Mr. de Larosière;

1. The Hungarian economy enjoyed several years of balanced growth and a satisfactory external situation following the 1968 reforms, until changed world economic conditions after 1973/74 presented a considerably more difficult economic environment. Like many countries the Hungarian People's Republic suffered a large scale loss of terms of trade in 1974/75. The scope for export expansion was limited by the ensuing recession in the industrialized countries which are a significant market for Hungarian exports, and due to the import restrictions having been introduced at the same time. Nevertheless, a relatively high rate of growth was maintained through 1978, and the main impact of the more difficult external conditions was felt in a steady worsening of the convertible trade balance and a rapid accumulation of foreign debt.

2. Since 1978 the Hungarian authorities have endeavored to correct the external disequilibrium, in particular by slowing the growth of domestic demand. At the same time the process of economic reform has been given a new impetus since 1978, with price reforms and measures to improve economic management and competitiveness as well as adjusting the national economy to changing world conditions. Producer prices were brought into close alignment with world market prices, and consumer prices have been adjusted gradually so as to reflect more closely the actual costs and market scarcities of goods. Following the price realignments, and after a gradual narrowing of the gap between the commercial and noncommercial rates of exchange, started in early 1979, the rate of exchange of the forint against convertible currencies was unified in October 1981. A number of other institutional changes also took place in this period, which were designed to improve the adaptability and efficiency of the economic system.

3. These adjustment efforts met with considerable success in 1979 and 1980, and the economy appeared to be coming into equilibrium. Real growth of economic activity slackened considerably, to only 0.2 per cent in 1980. In 1979-80 exports in convertible currencies picked up, growing at about 24 per cent in dollar terms per annum, on average, while the annual growth rate of convertible currency imports declined to about 8 per cent. As a result, the trade balance in convertible currencies showed a small surplus in 1980, and the current account deficit according to the standard IMF definition was reduced in that year to $368 million, as compared with $1,232 million in 1978.

4. The progress toward a sustainable external position became more difficult in 1981, when external conditions worsened sharply. Although foreign demand in the main Western trading partners fell in real terms in 1981, the trade balance in convertible currencies improved to a record surplus of $445 million, while the trade balance in nonconvertible currencies remained roughly unchanged. Despite this favorable trade

performance, the current account position worsened, mainly on account of higher interest payments on our foreign debt because of the dramatic rise in interest rates on world financial markets. The current account deficit in convertible currencies more than doubled in 1981 to $720 million, equivalent to 3.2 per cent of GDP.

5. As the current account deficit widened, the capital account of the balance of payments and the international reserve position were adversely affected also by other events. In particular, commercial banks' attitudes toward lending to all socialist countries in Eastern Europe hardened in late 1981 and early 1982. Because of this, and some other factors, Hungary suffered massive outflows of short-term capital, particularly in the first quarter of 1982. These outflows were a predominant factor, and together with a continued current account deficit and seasonal variations, caused total reserves (as defined by the IMF) to fall from $2 billion at end-1981 to $560 million at end-March 1982.

6. Policies in 1981 were designed to continue the steady progress toward external adjustment achieved since 1979. In the event, however, there was a higher than intended rise in wages and in enterprise profits, and domestic consumption rose somewhat more rapidly than planned. Nevertheless, real wages still were about 2 per cent below their 1978 level and gross investment in real terms was 19 per cent lower. But in view of the unexpected sharp worsening of the external economic and financial environment in late 1981, it became apparent that the gradual tightening of policies would need to be strengthened in 1982.

7. Accordingly, the Hungarian authorities took additional measures to stimulate exports, curb imports and hold down domestic demand. Among other measures, the forint was devalued by 7 per cent in July 1982, interest rates were raised by 3-4 percentage points during 1982, consumer prices were raised by reducing subsidies or increasing indirect taxes, as well as by the effects of the devaluation, bank credit was severely restricted, and an additional 25 per cent tax was imposed on new investment. As a result of these measures, domestic demand is expected to decline by 2.5 per cent in real terms in 1982. The price measures affecting government administered prices alone represented about 2 per cent of private consumption. Direct controls on some imports were also introduced as a temporary emergency measure. The current account balance in convertible currencies for 1982 is now expected to show a $550-600 million improvement over 1981 in spite of the unfavorable international environment. This will represent a resumption of the movement toward a better external equilibrium started in 1978.

8. For 1983, the highest priority will continue to be given to the external liquidity position so that there may be no doubt about Hungary's determination to meet its international payments obligations. It has therefore been decided to start to reduce foreign indebtedness and to rebuild reserves by aiming at a surplus of $600 million in the current account balance in convertible currencies in 1983. This represents a

very considerable effort--the improvement between 1981 and 1983 is equivalent to about 6 per cent of 1982 GDP--and it will necessitate some painful measures which will further reduce a relatively low standard of living. Every effort will be made, however, to minimize this unavoidable reduction of the standard of living: the steps already initiated to improve the efficiency of the economy will be further pursued and intensified; voluntary saving by the population will be encouraged; export promotion will continue to be fostered actively, and some restructuring of the demand away from goods which have to be imported or can be exported will be sought. Programs for energy and raw materials savings will be strongly pursued. Mobility of resources will be enhanced so that factors of production can be employed more effectively and those released by the least efficient enterprises can be employed more productively, notably in export and import-substitution activities and in the services sector. The effects of measures designed to raise productivity, however, will take time to materialize fully. Meanwhile, reliance will be placed on measures that show quick effects.

9. The emergency nature of the situation has forced us to resort to import restrictions. It is our intention, however, to eliminate gradually during 1983 the restrictions introduced in September 1982. It is our hope that our efforts will be supported by a better international economic and financial climate and a lessening of the restrictions against Hungarian exports. In order to achieve a sustainable external balance, that does not rely on administrative restrictions, the Government of the Hungarian People's Republic intends in 1983 to strengthen its economic stabilization program.

10. To achieve the current account target for 1983, policies aimed at increasing efficiency in the economy will need to be bolstered by a further decline in real domestic expenditures. This will be brought about by:

Wage policy. Real wages will be reduced in 1983, in part by imposing strict wage regulations, in part increasing the consumer prices more than the nominal wages which will result in a significant decrease of state subsidies as well.

Budget policy. Public consumption will not increase in real terms in 1983; budget outlays for subsidies will be reduced gradually and significantly; inter alia, rents will be increased by an amount equivalent to a 1 per cent rise in the CPI on a full-year basis; agricultural subsidies will be reduced by Ft 3.5 billion (or Ft 1.5 billion net after deduction of increases in consumer subsidies); consumer prices will be raised; State investment expenditures will decline in real terms; spending by local authorities will be restrained.

Credit policy. Interest rates charged on all credits to enterprises, cooperatives, and local councils have been raised by 2 percentage points effective October 1, 1982. This increase applies also to existing credits. Interest rates on housing loans and savings deposits will be raised. Credit allocations for investment purposes will be curtailed and working capital credit extension guidelines will be tightened.

11. It is our intention to pursue actively in 1983 and in following years the process of economic reform. The present external difficulties will not be allowed to delay reform efforts; on the contrary, they make it imperative that these efforts be intensified, as more than ever waste and inefficiency cannot be afforded.

12. In support of its program, the Hungarian People's Republic is requesting from the IMF a stand-by arrangement totalling SDR 475 million. The execution of the program will be subject to the following performance criteria:

a. Net domestic assets of the National Bank of Hungary will not exceed Ft 261.5 billion in the period September 30-December 31, 1982, and Ft 255.0 billion by March 31, 1983.

b. Net credit to the State Budget from the banking system will not exceed Ft 32.5 billion by December 31, 1982 and Ft 28 billion by March 31, 1983.

c. Net foreign liabilities in convertible currencies of the specialized financial institutions will not exceed $1,230 million by December 31, 1982 and $1,310 million by March 31, 1983.

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

e. During the period of the stand-by arrangement, the Government of the Hungarian People's Republic will not introduce any multiple currency practices; impose any new or intensify any existing restrictions on payments and transfers for current international transactions; enter into any bilateral payments agreements with Fund members; or introduce any new or intensify any existing restrictions on imports for balance of payments reasons.

f. A review of policies under the stand-by arrangement will be held no later than the end of June 1983. At that time the Government of the Hungarian People's Republic intends to consult and reach understandings with the Fund on (a) ceilings for June 30, 1983, September 30, 1983, and December 31, 1983 on net domestic assets of the NBH, net credit to Government and enterprises, net foreign liabilities of the specialized financial institutions, and foreign debt, (b) other economic policy targets and instruments of the program.

13. The indicative ceilings for December 31, 1983 are Ft 255 billion for net dometic assets of the National Bank of Hungary; Ft 42 billion for net credit to the State Budget from the banking system; and $1,330 million for net foreign liabilities in convertible currencies of the specialized financial institutions.

14. The Government of the Hungarian People's Republic believes that the policies set forth above are adequate to meet the objectives of its program but it will take any futher measures that may become appropriate for this purpose. Hungary will consult with the Fund on the adoption of any such measures in accordance with the policies of the Fund on such consultations. In addition to the review referred to in paragraph 12 (f), we would welcome discussions with the Fund staff early in 1983 for the purpose of reviewing economic developments and progress toward the realization of our adjustment objectives.

Sincerely,

József Marjai

Deputy Chairman of the Council of Ministers,

Chairman of the Economic Committee of the Government

Mátyás Timár

Secretary of State

President of the National Bank of Hungary

Fund Relations with Hungary

Date of Membership:	May 6, 1982
Quota:	SDR 375 million
Fund holdings of forint:	SDR 375 million or 100 per cent of quota (as of October 31, 1982)
SDR holdings:	Nil
Exchange system:	The exchange rate of Hungary's currency, the forint, vis-à-vis the currencies of countries other than members of the Council of Mutual Economic Assistance, the People's Socialist Republic of Albania, and the Democratic People's Republic of Korea is linked to a weighted basket of nine currencies. As of October 29, 1982, the representative rate was Ft. 38.0301 per U.S. dollar.
Article IV consultation:	Discussions were held in Budapest, May 18-June 11, 1982. Staff report (SM/82/176) is to be discussed by the Executive Board on December 8, 1982.

Hungary: Selected Economic and Financial Indicators, 1981-82

	Actual 1981	Estimate 1982	Program 1983
	(Annual per cent changes, unless otherwise specified)		
National income and prices			
GDP at constant prices	2.5	1.8	--
GDP deflator	5.1	4.6	6.4
Consumer prices	4.6	7.0	9.0
External sector (on the basis of US dollars) 1/			
Exports, f.o.b.	-0.7	-1.3	10.1
Imports, c.i.f.	-1.0	-10.9	1.5
Non-oil imports, c.i.f.	-1.0	-10.9	1.5
Export volume	1.6	5.1	7.6
Import volume	3.5	-6.6	-2.0
Terms of trade (deterioration -)	2.2	-1.5	-1.3
Nominal effective exchange rate (depreciation -)	16.1	2.7	-6.7
Real effective exchange rate (depreciation -)	12.0	-0.4	...
Government budget			
Revenue, excluding grants	10.5	3.7	4.8
Total expenditures	12.8	5.1	3.7
Money and credit			
Domestic credit	8.9	7.1	5.8
Government	86.4	68.8	28.4
Enterprises and households	7.3	5.2	4.7
Money and quasi-money	6.9	4.6	9.0
Velocity (GDP relative to M1)	4.79	4.78	4.78
Interest rate (annual rate, one year savings deposit)	5.0	5.0	7.0
Domestic credit as a share of M2	15.4	12.6	10.5
	(In per cent of GDP)		
Overall public sector deficit 2/	1.7	2.0	1.2
Central Government budget deficit	1.2	1.6	1.0
Domestic bank financing	1.2	1.6	1.0
Gross domestic investment	30.2	27.7	25.9
Gross domestic savings	28.9	28.4	28.8
External current account balance Including grants (includes TR)	-4.0	-1.9	1.9
External debt	38.7	34.1	31.7
Inclusive of use of Fund credit	38.7	35.2	34.5
Debt service ratio (in per cent of exports of goods and nonfactor services)	34.1	34.2	28.4
Interest payments (in per cent of exports of goods and nonfactor services)	18.8	18.3	12.5
	(In millions of SDRs, unless otherwise specified)		
Overall balance of payments	-396	-1,275	125
Gross official reserves (months of imports) 3/	5.4	2.5	4.0
External payments arrears	--	--	--

1/ Nonruble transactions for trade, and convertible currencies for debt, debt service payments and reserves.
2/ Includes local authorities and State Budget.
3/ Gold is valued at the price of US$226 per ounce.