EBS/82/206
Supplement 2

CONFIDENTIAL

December 9, 1982

To: Members of the Executive Board

From: The Secretary

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

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Hungary agreed at Executive Board Meeting 82/157, December 8, 1982.

Att: (1)

Stand-By Arrangement - Hungarian People's Republic

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 December 8, 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