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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/7

10:00 a.m., January 13, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J.-C. Obame, Temporary
C. H. Dallara	M. K. Bush
J. de Groote	H. G. Schneider
B. de Maulde	S. de Forges
	T. Alhaimus
H. Fujino	
G. Grosche	B. Goos
Huang F.	
J. E. Ismael	Jaafar A.
	J. Hospedales, Temporary
	M. Foot
	I. Puro, Temporary
	L. Leonard
	A. Abdallah
	M. A. Weitz, Temporary
	J. E. Suraisry
P. Pérez	J. de la Herrân, Temporary
	A. Steinberg, Temporary
C. R. Rye	
G. Salehkhou	O. Kabbaj
	A. Vasudevan, Temporary
S. Zecchini	

L. Van Houtven, Secretary
J. K. Bungay, Assistant

Also Present

IBRD: J. Chaffey, T. King, Europe, Middle East and North Africa Regional Office. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; P. C. Hole, M. Z. Khan, G. F. Kopits, J. Somogyi, P. W. Stanyer. Exchange and Trade Relations Department: J. T. Boorman, R. Pownall. Fiscal Affairs Department: V. Tanzi, Director; A. A. Tait, Deputy Diector; L. Garamfalvi, M. Z. Yucelik. Legal Department: H. Elizalde, A. O. Liuksila. Research Department: T. A. Wolfe. Bureau of Statistics: M. J. Ellyne, B. Gurgen. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: W.-R. Bengs, G. Nguyen, P. Péterfalvy, D. C. Templeman. Assistants to Executive Directors: I. Angeloni, A. Bertuch-Samuels, K. Celebican, G. Ercel, R. Fox, S. Garnjarerndee, L. Hubloue, Z. b. Ismail, S. King, S. Kolb, J. A. K. Munthali, M. Rasyid, M. Sarenac, A. J. Tregilgas.

1. HUNGARY - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Hungary (SM/85/290, 11/1/85; and Sup. 1, 1/10/86). They also had before them a report on recent economic developments in Hungary (SM/85/338, 12/27/85).

The Deputy Director of the European Department, summarizing the information contained in Supplement 1 to SM/85/290, noted that in August 1985 the staff had expected the current account of the balance of payments to recover in the rest of the year. The outcome had in fact been a further deterioration, particularly in the third quarter of 1985. Although there had been an improvement in the fourth quarter, the staff was estimating that the current account deficit in convertible currency would approach $0.5 billion for 1985. Moreover, the recovery of production had not materialized to the extent expected at the time of the consultation discussions, and the authorities were currently estimating that an increase in GDP of only 1/2 a percentage point would be recorded. The deterioration of the budget had continued throughout 1985 and a deficit of about 1 percent of GDP was estimated for the entire year. A further deterioration was foreseen in the budget for 1986, which had just been approved by the parliament. Finally, the authorities had assigned high priority to the reduction of inflation in 1986--lowering the target to 5 percent--which would make economic management, the reduction of subsidies, and the liberalization of wages and prices more difficult.

Mr. de Groote said that Hungary's performance had to be considered over a longer period than the 12 months on which the 1985 consultation was based. A major shift of resources toward the balance of payments had offset the severe liquidity crisis of 1982: the sizable surpluses recorded in the current account in 1983 and 1984 had restored the country's creditworthiness. The early voluntary repurchase that had taken place in November 1985, corresponding to the scheduled repurchases of the first three quarters of 1986, had illustrated the extent to which the external position had been restored. The Fund's financial assistance and the positive evaluation given by the Board and the staff on Hungary's economic performance in 1983 and 1984 had greatly contributed to the country's successful re-entry as a borrower on the international financial markets. The voluntary medium- and long-term lending of the commercial banks had thus made it possible to raise gross convertible reserves to more than seven months of convertible imports and to improve the time structure of the debt.

The results for 1985 had lagged behind expectations, Mr. de Groote continued. According to the authorities, that was not primarily due to the slower than expected results of the corrective policies adopted, nor to the larger than forecast imports induced by the foreign trade liberalization, but to several unexpected difficulties outside their control. The expected revival of the world economy had not materialized; the prices of Hungary's exports, particularly of agricultural commodities, processed foods, steel, aluminum, and chemicals, had thus fallen sharply; the effects on the current account of such a severe deterioration of the terms of trade had been compounded by unusual climatic conditions, which had increased the demand for imported energy and reduced the supply of exportable goods. Accordingly, not even the expected performance in the second half of 1985 would make it possible to reach the original 1985 targets for income growth and the convertible current account.

The authorities were confident that the unsatisfactory results for 1985 represented only a temporary setback in the process of continuous improvement and did not represent a reversal of the trend, Mr. de Groote indicated. The policies that had been set in place, which were embodied in the next five-year plan, gave priority to obtaining a sufficient current account surplus and reducing external indebtedness. For the period 1986-90, a reduction of net indebtedness in foreign currency of $1 billion was envisaged. Credit would be allocated and interest and tax preferences given to enterprises that generated additional profitable exports. Measures would be adopted to facilitate the flow of foreign investment and the operation of joint production ventures with foreign participation. The banking system would be changed; several banks with foreign participation would soon enter into operation. As of January 1, 1987, the two-tier banking system would be in operation, with commercial banking activity being disassociated from the central banking activities. Regulations that were to be announced would provide the legal framework for the reorganization or, if necessary, the liquidation of loss-making enterprises. A program had been worked out jointly with the World Bank to modernize the structure of industry and to improve its competitiveness. Moreover, with the assistance of Fund experts, a comprehensive overhaul of the tax system was envisaged: a personal income tax would be generalized, and a value-added type of tax would be introduced on the activity of enterprises. Finally, the authorities were relying on the positive effects of the new, democratic forms of enterprise management and leadership that were being established.

The authorities were certain that those measures would reverse the unsatisfactory results that occurred in 1985, Mr. de Groote went on, because they were part of a process of structural adjustment toward a system of autonomous management, implying the establishment of full managerial and financial autonomy of enterprises, individual incentives for workers, and improved profit-generating capability for the economy as a whole. All those facts and intentions had to be taken into consideration in any evaluation of the Hungarian economy.

Mr. Goos commended the Hungarian authorities for having successfully overcome a serious liquidity crisis while maintaining the country's external debt servicing capacity. However, the policies directed toward those ends had not been without considerable cost, as shown by recent developments in investment and real wages. Against that background, and in view of the setback experienced as a result of unfavorable weather conditions at the beginning of 1985, the shift to a more expansionary overall policy stance was understandable to some extent. However, there was little doubt that the immediate results of that policy shift had been disappointing and worrying, in view of the latest information on the external accounts in convertible currencies and the budget. Those developments were clearly a matter for serious concern and indicated the need for renewed adjustment efforts, if the gains achieved in previous years were not to be permanently reversed.

While agreeing with the thrust of the staff's recommendations on what might be an appropriate course of action to bring the economy back to a sustainable path, Mr. Goos noted that the Hungarian economy was operating under a number of systemic constraints that could not be ignored and that might have been given greater emphasis in the staff appraisal. Given the basic assumption that the authorities would remain committed to the idea of a centrally planned economy, reforms would have to be limited to the introduction of some market-oriented elements aimed at improving overall economic efficiency without putting the basic system into question. Moreover, in view of the existing political ties, modifications in the regulatory framework could be expected to take place only gradually. Another constraint that had to be taken into account in the formulation of adjustment policies related to the fact that a large share of Hungary's external trade would continue to be carried out with its partners in the Council for Mutual Economic Assistance (CMEA), a constraint that was also mentioned by the staff in its assessment of Hungary's economic outlook.

His general remarks should not be seen as an attempt to detract from the basic validity of the staff's recommendations, and he wished to stress that easier access of the country to international financial markets was certainly no reason for complacency, Mr. Goos pointed out. His authorities felt strongly that the country's creditworthiness and longer-term growth potential would continue to depend critically on a policy of decisive and sustained structural reform aimed at promoting modernization of and innovation in the economy. That the bold steps already taken in those areas in recent years had produced disappointing results thus far was puzzling. The country's slow progress in modernizing its economy and the poor competitive position of its export industries might have occurred because a large proportion of capital goods had to be imported from the CMEA area, and those goods did not always meet the highest technological standards. On that point, less restrictive regulations for foreign direct investment, including joint ventures with partners from industrial countries, might help to improve the situation.

Another factor that might have prevented the structural reform measures from having achieved their full potential could be their lack of comprehensiveness, Mr. Goos commented. Consequently, the success of the reform exercise had perhaps been undermined by continued rigidities in certain sectors of the economy. Such rigidities might similarly have affected the ongoing changes in the organization of enterprises. While those changes were certainly important steps in the right direction, the new form of management might be of little help as long as sales and procurement markets of enterprises remained subject to widespread regulations.

He concurred with the staff's criticism of the recent easing of credit policy and the various forms of special government assistance in favor of certain enterprises, and he was disappointed to note that the Government intended to continue such policies in 1986, Mr. Goos stated.

On exchange rate policy, although the authorities' concern about the immediate inflationary impact of a devaluation could not be easily dismissed, he was inclined to agree with the staff that a devaluation of the forint could strengthen the external position of the country and that, in any event, it would be a more effective means of achieving that objective than the various administrative incentives provided to exporters, Mr. Goos went on. Furthermore, appropriate fiscal and monetary discipline would--at least in the longer run--be much better geared to the task of keeping inflation under control than an overvalued exchange rate would be, in particular, if such discipline was accompanied by effective supply-side measures to strengthen the productivity of enterprises and their responsiveness to changes in demand. That conclusion was consistent with the findings of a recent study by the Fund's Research Department entitled, "Devaluation in Modified Planned Economies: A Preliminary Model for Hungary" (DM/85/59, 9/18/85). While that study took note of several factors that would limit the effectiveness of a devaluation within the existing price and exchange rate system, it also suggested that the role of the exchange rate as a policy instrument could be enhanced by further successful modifications of the economic system.

The medium-term balance of payments and debt projections were quite sensitive to the underlying assumptions, Mr. Goos remarked. One major uncertainty concerned the role of the Soviet Union as one of Hungary's major trading partners. Future developments would depend crucially on the extent to which the Soviet Union was prepared to import Hungarian products against payment in convertible currencies; in that regard, without such imports by the Soviet Union, Hungary's external current account in convertible currencies would have been in deficit in recent years. Furthermore, the authorities' expectation of sizable trade surpluses with both the East and the West appeared optimistic. Experience suggested that an increase in exports to the ruble area tended to result in export losses vis-à-vis the convertible currency area if those exports could also be marketed in industrial countries. Moreover, the authorities' expectations regarding reductions of external indebtedness were ambitious.

He was seriously concerned about the slippages and the imbalances that had occurred during the past year in the domestic and external accounts, Mr. Goos said. Those slippages and the uncertainties surrounding export prospects clearly called for sustained structural adjustment efforts accompanied by appropriate macroeconomic policies. Finally, he welcomed Hungary's recent announcement of a voluntary early repurchase, which he took as an indication of the authorities' willingness to maintain close cooperation with the Fund.

Mr. de Maulde remarked that at the Board's discussion of the 1984 Article IV consultation with Hungary (EBM/85/37, 3/8/85), he had expressed the view that despite the authorities' commendable progress achieved, the comprehensive economic policies envisaged in the 1984 program had apparently been replaced by a more gradual implementation of the reforms. Unfortunately, the staff reports for the 1985 Article IV consultation showed that his earlier perception had been correct, and he had not been reassured by Mr. de Groote's statement at the present meeting. The results for 1985 were disappointing in comparison with those for 1984, which had still been benefiting from the impetus given by the program with the Fund. Two areas were of major concern: the external sector, where the projected surplus of the current account had turned out to be a sizable deficit; and the real economy, where some scheduled structural reforms had been delayed.

The slippages had been numerous and worrying, Mr. de Maulde continued. As demonstrated by the virtual disappearance of the budgetary surplus in 1985, the authorities had lost fiscal control of the budget and had exercised insufficient restraint over the distribution of credit and on the wage policy. To offset the decline in exports, the authorities had set up artificial tax incentives, while for imports the existing system was more restrictive than the one that had prevailed before September 1982. The deficit in the external sector endangered the objective of reducing the external debt; in fact, the ratio of debt to GDP had increased sharply in 1985 from 43 percent to 48 percent. The new five-year plan, introduced in January 1986, embodied ambitious targets, with a high degree of priority given to improving the external position. However, experience had already shown that the plan was unrealistic and that its main assumptions would have to be reviewed.

In sum, the most recent policies were not working, Mr. de Maulde considered. Rather than following up their efforts to bolster market mechanisms and loosen structural rigidities in the framework of a reasonable overall financial discipline, the authorities had tried to return to the former centrally planned decision-making process and to the maze of patchwork administrative measures. That trend should be reversed quickly, in view of the increasing risk of losing the confidence of the international community. It was essential to make the tools of domestic prices and the exchange rate work again; those tools were closely linked, since a flexible exchange rate policy alone would be meaningless if there were no passthrough in domestic prices. Although the advance price increase target for 1986--namely, 5 percent compared with more than 7 percent in 1985--was not in itself objectionable, it should not become a rationale for increased rigidities and distortions in the whole economy. A flexible exchange rate policy could only play a useful role if domestic prices became sufficiently flexible. At the same time, the authorities should resume their efforts to effect structural reforms in the economy and should exercise much more responsibility and flexibility in the management of the productive sector. In that area, it seemed that some of the sense of direction had been lost. The World Bank, which had a key role to play in that area, should emphasize policy-oriented lending in the future. Any comments by the representative of the World Bank on the Bank's plans for structural reforms would be welcome.

Mr. Pérez observed that some of Hungary's hard-won advances over the past two or three years might be offset by the insufficiently firm set of policies recently implemented by the authorities, who seemed to have lost momentum in maintaining their earlier reforms. That point had already been made by some Executive Directors on the occasion of the Board's discussion of the 1984 Article IV consultation and, unfortunately, no substantial measures appeared to have been taken by the authorities during 1985 to avoid the loss of momentum.

The state budget had suffered an even greater deterioration than expected, Mr. Pérez added. Such a deterioration not only implied a substantial deviation from the original budgetary figures but also, and more important, it demonstrated a lack of efficiency on the revenue side. The unfavorable weather conditions during the past winter might provide some explanation for the poor results, but the real cause of the disruption seemed to be deeper and of more concern, as could be inferred from the sizable amounts of transfers to enterprises and shortfalls in tax payments from those same entities--a trend that was projected to continue in 1986.

The external sector was probably the most delicate area of the Hungarian economy, Mr. Pérez commented. Despite the authorities' stated intention to improve the current account balance and reduce the external debt, the results had been discouraging. Instead of implementing an effective exchange rate policy, the authorities had relied for the most part on temporary measures to rehabilitate the external sector, such as rebates and subsidies aimed at increasing exports. Those measures, apart from being costly and inefficient, did not help to improve the allocation of resources. Moreover, the doubts of some Hungarian representatives about the effectiveness of exchange rate management as an essential economic policy tool would probably disappear if the devaluation were accompanied by more disciplined financial policies. A tightening of monetary and fiscal policies was a necessary precondition for any major variation of the exchange rate; otherwise, the favorable effects that could result from a devaluation might well be short-lived. Nevertheless, he was encouraged by the liberalization measures that were being implemented, and he hoped that further steps would be taken in that direction.

The slowdown of the reform process in Hungary was one of the main reasons responsible for the poor performance registered in the economy during 1985, Mr. Pérez observed. He welcomed the improvements in the management of enterprises but noted that more progress would have been achieved if parallel measures had been taken to eliminate the obstacles preventing further price liberalization, reduced subsidies, and elimination of some tax exemptions. In that regard, he was glad to learn that a tax reform was under way, with assistance from the Fund. Both direct and indirect taxation would benefit substantially from the introduction of a personal income tax and a value-added tax. The former would allow the authorities to shift the burden of taxation from production and enterprises to consumption and households, respectively, while the latter would contribute to the increased efficiency of indirect taxation. He wondered if the authorities intended the value-added tax to have a neutral impact on total revenues or if they planned to use it as a device to increase those revenues.

The Hungarian authorities should resume the adjustment process and reforms geared to making the economic system more efficient, Mr. Pérez said; otherwise, the increase in international creditworthiness that Hungary had achieved during the past two years might vanish. Although the new five-year plan offered an ample and welcome spectrum of targets, it was somewhat ambiguous in the definition of specific policy measures and means to achieve the targets. Staff comment on the adequacy of measures in the five-year plan would be welcome.

Mr. Steinberg noted that after the authorities had overcome a severe liquidity crisis and restored Hungary's access to foreign capital markets, in 1985 the economy had drifted. The staff report (SM/85/290, 11/1/85) showed mixed prospects for 1985, but the later paper on recent economic developments (SM/85/338, 12/27/85) had been much bleaker. The convertible currencies current account was once again in deep deficit, after a remarkable improvement between 1981 and 1984; the foreign debt, in convertible currencies, had risen by more than $2 billion to $11 billion in September 1985; economic growth had stagnated; and the state budget was once again in deficit. Moreover, adverse exogenous developments, such as the hard winter of 1985, had caused production shortfalls and bottlenecks due to energy shortages, as stocks had been too low initially; oil imports had had to be increased, against the background of the more extensive use of energy in producing goods for export to the non-ruble area; and the terms of trade had continued to deteriorate. However, domestic policies had also played a disruptive role. Easy fiscal policy and an accommodating monetary policy had succeeded in shielding the domestic economy from the production shortfall and thus had shifted most of the burden to the external sector.

It seemed that the authorities' indecisiveness in setting economic goals and in working toward their achievement was one of Hungary's main problems, Mr. Steinberg added. In 1985, for example, the authorities had viewed economic reform as the only way to improve living standards while reducing the burden of foreign debt, yet the latter goal had been suspended in view of Hungary's easier access to international financial markets. The general thrust of economic reform was intended to promote a reduction in direct state intervention in economic activities and greater reliance on market forces. However, high priority would be given in 1986 to improving the external position, an emphasis that in previous years had led to increased state intervention in the economy. And relying on market forces meant, inter alia, allowing relative prices to affect allocation of resources, but that could not be done when prices were heavily subsidized and allowed to move only within narrow margins. The authorities' views were divided on the effectiveness of a devaluation in improving the trade balance, given the possibility of an insufficient supply response. However, at the beginning of 1985, in recognition of the need to provide financial incentives for convertible currency exports, the authorities had raised the tax rebate from 2 percent to 7 percent. Those were only a few examples of the internal inconsistencies.

Taking advantage of the country's improved creditworthiness, the authorities had made a timely effort to extend the maturity structure of the external debt, Mr. Steinberg observed; nevertheless, by building up their reserves with borrowed money to the level of seven to eight months of imports, they might have created the impression that they expected the renewed access to the capital markets to be temporary.

The restructuring of a stagnant economy could be painful, Mr. Steinberg stated. The Hungarian economy had not only experienced scant growth recently, but most of the decline in net fixed investment had taken place outside the traditional sectors, thereby delaying the restructuring of the economy that could foster the needed growth. Growth was crucial to the achievement of Hungary's economic goals. A growing economy could better sustain structural changes and provide for higher living standards. To achieve a higher GDP growth rate, the authorities needed to generate additional domestic and foreign savings and channel them into productive investments. Enhanced efficiency could also improve the productive utilization of existing capital goods. Given the uncertainty of further inflows of foreign capital, and the authorities' announced intention to reduce external debt, the focus would have to be shifted from foreign savings to domestic sources in the form of higher domestic savings and productivity.

Interest rates on savings deposits, the most effective instrument for encouraging household savings, had been negative in real terms and thus could not perform their function well, Mr. Steinberg commented. Accumulated funds or profits in the public enterprises, which could be used to finance firms' investment programs, were not necessarily being invested in the most productive areas and, even when they were, the resources might not be fully utilized, due to labor shortages and lack of mobility. Increased productivity could be an important element in production growth, but it might entail more changes in the remuneration system. Projected gains in productivity had not taken place in 1985, and the authorities had made little progress thus far in tackling the problem of inefficient enterprises. The authorities were currently more aware of the problems, however, and had recently introduced a supplementary pension savings scheme to encourage personal savings, and had provided tax incentives to stimulate convertible currency exports and to encourage conservation of energy and materials. Nevertheless, the expected budget deficit for 1986 caused concern.

Setting the right priorities was the most important objective, provided that the priorities were attainable within various constraints and available resources, Mr. Steinberg said. He did not wish to judge the authorities' socioeconomic priorities, but he pointed to the inherent conflict between the balance of payments and external debt goals on the one hand and higher living standards on the other, which would be competing for the same available resources--unless a dramatic increase in productivity took place. The conflict could be resolved if the authorities postponed attainment of the goals that were less crucial to the country. Hungary's external position might currently be in a more dangerous state, jeopardizing the country's credit standing. Maintaining creditworthiness, which the authorities had high on their priority list, might become more difficult to achieve if the authorities devoted more attention to policy measures and to progress reports on the achievements of their pronounced economic objectives.

Ms. Bush said that the developments in the Hungarian economy during 1985 made a general statement about the economy rather difficult. Some progress had been made in further eliminating controls--e.g., in the enterprise sector--which had increased the likelihood that economic agents would be able to make rational decisions, and there was evidence of some increase in labor mobility, including a shift toward the private sector. In other areas, moves toward tighter control over prices might have impeded the process of effective resource reallocation. The developments in the convertible currency current account had been most disappointing, and the substantial increase in the level of external debt was likely to cloud the medium-term outlook by increasing the debt service burden. It was clear that the severe winter had had an adverse impact on both imports and exports; nonetheless, it appeared that the authorities had paid less attention than previously to the need for a strong convertible currency current account position. Furthermore, efforts to strengthen the current balance with the nonconvertible currency area could limit the prospects for a stronger balance with the convertible area. Another disturbing possibility was that the ease with which Hungary had secured additional financing from the international capital markets in 1985 might be undermining the adjustment effort. It was clear from the medium-term outlook that debt servicing would continue to absorb a substantial share of convertible currency receipts. The authorities should place continued emphasis on strengthening the convertible currency current account, which would require an appropriate exchange rate and domestic pricing policy.

Priority was being given not only to improve living standards but also to strengthen the external position, and the authorities' success in the latter area was evidenced by a reduction in net convertible currency debt and continued reductions in the debt service ratio, Ms. Bush pointed out. However, it was regrettable that the authorities had relied on containing the rise in real domestic absorption, instead of strengthening the growth of output, in order to attain a stronger external balance. It would have been far better to have accelerated implementation of the reform program aimed at developing competition and reliance on market forces. That point merited emphasis because output growth and efficiency would be enhanced by such acceleration, and the need to contain domestic absorption would be reduced because output would rise to meet demand, as opposed to an approach under which demand was forced down to meet supply constraints. Indeed, the staff report (SM/85/290, 11/1/85, page 19) indicated that the authorities recognized the potential benefit of such measures: "The Hungarian authorities have concluded that the continued reduction of external debt would only be compatible with an improvement in living standards if economic efficiency could be raised. They have accordingly decided to give a new impulse to a program of economic reforms aimed above all at developing competition and reliance on market forces within the economy."

The importance of output growth was also underscored by the deviations from the authorities' five-year plan, Ms. Bush said. While in previous years deviations from the plan had been caused by the strength of demand, in 1985--for the first time since 1980--it had been output growth that had been below planned targets.

If the authorities intended to contain real domestic absorption in order to secure a surplus in the external accounts, the price mechanism should be used to the extent possible, Ms. Bush considered. However, the authorities had said that prices would be increased by only 5 percent in 1986, as opposed to the planned 6 percent increase. While she understood the authorities' concern about inflation, it was important to recognize the contribution of the supply-demand imbalance to inflation. There might be some short-term costs, such as higher inflation, if prices were allowed to reflect international prices, but those price movements would bring longer-term benefits to the economy by stimulating supply and restraining demand. Furthermore, shifts in relative prices were useful to encourage the reallocation of resources. The Hungarian representatives reportedly believed that price liberalization had contributed to the rise of consumer prices in 1985, which was not surprising since prices had been bottled up for some time by administrative controls.

Several changes in the past year and some that were being contemplated for the year ahead seemed to have enhanced the prospects for improved enterprise performance, Ms. Bush added. That could yield improvements in the current account position if developments in the world economy, as indicated by world market prices, were permitted to influence internal prices. With the increased role for market incentives--specifically profitability--in the enterprises, it was important to let appropriate prices evolve, a point that gave rise to additional concerns about the 5 percent ceiling set on consumer price increases. Specifically, that ceiling might squeeze the profitability of those enterprises producing consumer goods and could have a number of detrimental effects. When a number of price controls were being lifted, self-management was being expanded, and remuneration of managers was being linked to profitability, selective price controls could limit profitability and thus increase managerial resistance to liberalization. The authorities' revisions in the enterprise operations could be very helpful to productivity. In particular, the lifting of restrictions on activities and the linkage of manager remuneration to profitability could be most effective, if allowed to function properly. The latter change had been pointed out in SM/85/344

(12/31/85), "The Design of Adjustment Programs in Planned Economies," as being a particularly useful tool in bringing about microeconomic changes in planned economies.

The easing of credit policies in 1985 could have contributed to the deterioration of the current account position, Ms. Bush noted. Given the need for a convertible currency current account surplus over the next several years in order to permit the desired reduction in the external debt, appropriate credit policies must be maintained continuously. She hoped to see a firm timetable for the prompt implementation of the financial sector reforms that the authorities continued to contemplate. Those reforms could go far toward increasing the authorities' ability to utilize indirect tools of monetary policy while enhancing the allocation of financial resources and perhaps even increasing the level of financial savings in the economy. Nonetheless, she was concerned that the authorities had not presented any firm timetable for those measures.

Fiscal developments in 1985 had been disappointing, and a deficit of 2 percent of GDP was expected for 1986, Ms. Bush commented. The various subsidies that had been granted to enterprises carried obvious costs to the budget and appeared to run counter to the goal of increasing enterprise accountability. She remained convinced that the high proportion of domestic resources consumed by the Government seriously impaired the economy's growth potential by limiting its capacity to produce for export and domestic investment.

The efforts made thus far to liberalize the foreign investment regime were welcome, Ms. Bush remarked. She was pleased to learn of Hungary's early repurchase, and encouraged the authorities to continue to reduce the burden of external debt. The high degree of administrative control over trade remained disappointing, despite some expanded access by enterprises to foreign trade rights; it was important in that regard to have a more liberal system in 1986. Finally, the implementation of economic reforms to increase reliance on market forces and competition was, in her view, the best and most efficient route to the lasting adjustment that was needed by the Hungarian economy.

Mr. Rye observed that Hungary had made considerable strides in recent years in strengthening its balance of payments and its debt servicing capacity; unfortunately, developments had been much less favorable over the past year and economic performance had fallen well short of expectations. While the deterioration had been due in part to unfavorable external developments and seasonal influences, it had also been caused by slippages in policy implementation, which threw into doubt the optimism of the authorities that the deterioration would be short-lived. It would be hard to contest the staff's assessment that, while budget and credit policies in 1985 had been set initially so as to prevent a deterioration in the external balance, as the year had gone by, slippages had occurred and the policy reaction to the worsening of the trade balance had been weak. Notable among the slippages were the sharp deterioration in the budget balance, which resulted largely from a combination of increased current transfers to enterprises and low levels of tax payments by enterprises; the easing of credit policy, explained both by the deterioration in the budget and by the pickup in credit to enterprises, largely for financing working capital; and the real effective exchange rate appreciation of 6 percent, on average, compared with a year earlier.

Moreover, the authorities seemed to have backed away from their earlier commitment to economic reforms, Mr. Rye continued. In recent years, they had acknowledged the role that reductions in direct state intervention in economic activities and increased reliance on market forces could play while macroeconomic policy instruments were introduced to guide the economy. However, progress in the implementation of reforms had been uneven in 1985; in particular, the numerous tax exemptions, subsidies, and special measures introduced in favor of enterprises affected by the economic slowdown contradicted the authorities' previously declared intention to encourage financial discipline in enterprises, avoid direct intervention in their business, and adopt only measures that would affect all enterprises equally. Such policy reversals seemed to be explained in part by the relatively increasing importance that the authorities attached to keeping down consumer prices. However, perhaps the authorities were giving too much priority to the specific price objective, at the cost of increasing constraints upon policy implementation. The authorities were faced with a choice if they wished to resume reducing the external debt while moderating inflation: they could achieve balance of payments targets by an adjustment strategy that placed excessive emphasis on reducing investment and restricting imports (at the cost of a further delay in the much-needed restructuring of industry) or they could put stricter financial policies into place to constrain domestic demand pressures. Otherwise, they would need to accept a more gradual reduction of consumer price increases over the next five years, so as to give themselves more room for maneuver and a better chance to reach their basic economic goals.

It was unwise to be dogmatic about the most appropriate policy choices for centrally planned economies, where some particular constraints applied, Mr. Rye added. Nonetheless, if Hungary's economic development was to proceed and foster an improvement in living standards while leading to a reduction in the external debt burden, then the authorities must pursue more vigorously the economic reforms that would increase efficiency and stimulate investment and exports in new, more promising sectors. He therefore encouraged the authorities to give early consideration to a package of policy measures that might include the following: a more flexible exchange rate policy, which was more desirable than special fiscal incentives and preferred credit conditions; policies aimed at the development of a capital market and a more competitive and efficient financial system, to ensure that enterprise and household savings were channeled to the most efficient users; a stricter credit policy, particularly for working capital credit; a reduction in subsidies, to discourage firms from granting excessive wage increases and building up inventories of imported products and materials; and the early introduction of a personal income tax--which would make more acceptable greater pre-tax income differentiation--and of a value-added tax, which would allow for a further reduction in the direct taxation of enterprise profits, thereby raising the incentive for enterprises to reduce their costs and increase their profits.

Mr. Ismael recalled that at the discussion of the 1984 Article IV consultation with Hungary (EBM/85/37, 3/8/85), he had commended the authorities for their determination to strengthen the balance of payments and improve the external debt position. The results of adjustments under two successive Fund stand-by arrangements had been impressive: the current account balances had been turned around from sizable deficits to surpluses over the past two years; normal market access had been restored; impressive gains had been made in the accumulation of gross external reserves; and the debt maturity had been lengthened on average, and the short-term debt reduced. Unfortunately, in spite of those achievements, Hungary remained vulnerable to external developments. Gross debt had risen sharply from an equivalent of 43.5 percent of GNP in 1984 to 48.5 percent in 1985, and the debt servicing ratio had risen sharply to almost 49 percent, which served to underscore the importance of sustaining the external current account surpluses in convertible currencies, in both the short and medium terms. In that context, the shortfall in the current account in convertible currencies in 1985 was disturbing, especially as it had occurred so soon after the authorities had achieved their remarkable success of the previous three years under Fund adjustment programs. The latest information from the staff (SM/85/290, Sup. 1, 1/10/86) underscored the seriousness of the current situation in Hungary.

The corrective measures taken by the authorities in both the fiscal and monetary fields in the face of a deteriorating current account position had been inadequate, Mr. Ismael considered. Some of the policies adopted in 1985 had not been supportive of the external sector, and the progress made earlier toward strengthening the financial position under Fund programs appeared to have eroded steadily, with the sharp deterioration in the state budget reflecting mainly the increased burden of subsidies. Neither the prospective deficit in the 1986 budget nor the easing of credit policy was consistent with the overriding objective of preserving the external balance. Adverse weather conditions and weakened export prices had understandably led to the need for greater financial assistance in various forms. Nevertheless, such assistance must be viewed as only temporary and should not preclude the implementation of fundamental adjustments. In view of the less-than-optimistic outlook for commodity prices and for the world economy in general, he strongly urged the authorities to be more cautious in their budgetary spending in the years ahead.

The authorities had recently given greater emphasis to the role that a more flexible exchange policy could play in improving external competitiveness, and they apparently attached importance to preserving domestic price stability in the short run, Mr. Ismael noted. It was perfectly legitimate for the authorities to maintain that position, especially if they had good reason to believe that the economy was not in a position to respond sufficiently on the supply side, at least in the short term. Besides, such stability could serve in the medium term to strengthen Hungary's exports.

He wondered whether the two views of the authorities on the effectiveness of the devaluation in improving the trade balance were general views or whether they referred specifically to the exchange rate of the forint, Mr. Ismael said. Staff comment on whether the forint exchange rate was overvalued would be helpful.

Although it was too early to assess the likely outcome of the medium-term plan, it was noteworthy that the external outlook remained vulnerable to adverse economic developments, Mr. Ismael mentioned. The continued high debt to export ratios underscored the need to maintain surpluses in the convertible current account of the balance of payments. The authorities should also be prepared to take the necessary corrective measures in defense of the external position, although such an effort would be difficult to maintain for a prolonged period unless it were accompanied by growth and an improvement in the standard of living. Therefore, the authorities' intention to improve competition and rely more on market forces deserved full support.

Mr. Huang considered the most characteristic feature of recent developments in Hungary to be the skillful efforts of the Hungarian authorities to reform the economy. The transition from a centrally planned system toward one with an enhanced operation of the market mechanism was difficult, the more so because Hungary was facing a politically and geographically unfavorable external environment. In the light of the fundamental changes the country was undergoing, any assessment of the performance of the economy should not neglect the important time lag factor, since some reform measures did not generally produce immediate results. He was pleased to note that the ongoing reform had received new impetus in 1985, and he believed that the Hungarian authorities would benefit in the future from the new initiatives.

In 1985, the Hungarian economy had been adversely affected by an exceptionally harsh winter, Mr. Huang continued. Lower prices for agricultural and other traditional exports, weak demand for manufactured exports, and rising protectionism among Hungary's trading partners had resulted in a sharp deterioration in the non-ruble trade balance. However, the commendable efforts of the authorities to meet their export commitments to the CMEA partners should not be ignored, as the current account deficits in nonconvertible currency had been turned into surpluses.

Hungary's bright long-term economic prospects had given the country easy access to international capital markets, Mr. Huang observed. However, in 1985 both the gross debt in convertible currencies and the debt service ratio had reached record high levels. Because of the persistent vulnerability of the Hungarian economy to external factors, the authorities should maintain a more cautious stance toward foreign borrowing and should quickly implement policies to encourage investment and exports in new and promising sectors.

The Hungarian authorities had rightly decided to give priority to containing prices, but they still needed to choose an appropriate method by which to achieve their goal, Mr. Huang commented. A ceiling of 5 percent on prices for the next five years, as stipulated in the new five-year plan, appeared straightforward, but such a rigid ceiling could certainly impair the functioning of prices as signals of the demand and supply conditions of the markets. It could also delay the urgently needed correction in distorted prices, whereas the adjustment in relative prices was an essential part of the ongoing reform. Some indirect economic policy measures, particularly in demand management, might be more appropriate to tackle the problem of inflation than the proposed administrative restrictions.

Mr. Foot commended the Hungarian authorities for their brave but necessary effort to push ahead with reforms against a somewhat hostile external environment and joined others who had applauded Hungary's early repurchase from the Fund. Still it was clear that the authorities did not yet have the necessary grip on fiscal policy, as evidenced by the unexpected deterioration in 1985, and planned policies seemed inconsistent with the target for a current account surplus in 1986 and future years, a target that might not be sufficient in itself to maintain international confidence, given Hungary's high level of debt. The exchange rate and related external policies in particular were inconsistent with the stated current account goal. Moreover, the target of a 5 percent rise in consumer prices, while praiseworthy in itself, might not be desirable at the present time. Certainly the mix of policies currently in process implied that such an ambitious goal could be met only by administrative action to keep prices down and to slow even more the pace of economic reform. Reform was difficult to control, and its impact difficult to predict; moreover, in the context of the freeing of a long-controlled and unsatisfactory set of prices, its consequences, in the short run at least, were not always all desirable. The natural response in such a situation was to postpone reform or to intervene piecemeal to limit its pace; but a better, more dynamic response was to press forward. Mr. Rye's list of suggested policy changes would serve the authorities well in that task.

Mr. Leonard noted that the Hungarian authorities had responded fairly successfully to the liquidity crisis of 1982. There had been a return to international creditworthiness, and reserves had been raised to a comfortable level. Hungary's recent early repurchase from the Fund was a welcome indication of the progress that had been achieved and of the milieu of greater confidence in which the economy was operating. However, the form of Hungary's adjustment had not been entirely satisfactory, because it had resulted in a contraction in investment and a restriction on imports. The authorities indicated that they were anxious to shape economic developments into a pattern that would better meet national needs. In 1986, they were aiming for a current account surplus of $150-200 million, a restructuring of external debt, and a further accumulation of reserves. At the same time, they planned to liberalize the economy and give greater play to market forces. Over the medium term, the restructuring of the economy was to continue with further surpluses in the current external account, a net reduction in foreign debt, closer containment of inflation, and protection of the purchasing power of wages in the socialized sector. The authorities' definition of their objectives provided a backdrop against which the actual management of the economy and the measures being employed could be assessed.

He supported the authorities' policy of promoting economic efficiency and adaptation through greater reliance on private initiative and market forces, but was disappointed at their response to the slowdown in exports and economic growth, Mr. Leonard stated. The decision to provide special fiscal incentives in the form of tax incentives and subsidies and the easing of credit policy to promote exports entailed a substantial budgetary burden; those measures were, moreover, inconsistent with the economic liberalization and the financial discipline that should be a feature of macroeconomic management at present.

The authorities should support export growth with a more flexible exchange rate, keeping in mind the short-term price and cost implications, which could be contained through financial discipline and restraint on domestic demand, Mr. Leonard continued. Exchange rate flexibility would help to reshape the economy by encouraging import substitution and giving scope for the development of nontraditional activities. The full effects of such flexibility could only be realized if the changes in relative prices that it generated were allowed to flow through the economy.

The authorities' hesitation to introduce a complex package of market instruments in an economy that had relied for so long on centralized decision making was understandable, Mr. Leonard commented. The difficulties of change were not to be minimized, but the effort of setting hesitations aside and proceeding without delay should be amply repaid through the incentives that would be provided for better economic performance and making structural adjustment easier. The reorganization of enterprises in accordance with the principle of self-management was a significant step in that process, but its value could be lessened if as a result wage increases took precedence over investment earnings. That danger would need to be watched, although there were some defenses against it as a result of the linkage of remuneration to profitability and of the recent government decision to impose punitive taxes on enterprises that granted excessive wage increases. Effective competition through import liberalization would also help, although the degree of liberalization might need to be tempered in the light of current balance of payments constraints.

He was disturbed by the recent expansion of external debt and the prospects of its continuation for some years to come, Mr. Leonard said. The extent of the debt and the high debt service ratio meant that Hungary remained vulnerable to unfavorable external developments and to any loss of confidence in the authorities' readiness to proceed with the reform of the economic system. The fragility of the medium-term outlook was borne out by the sensitivity of the projections up to 1990 to small variations in the underlying assumptions on export prices and the ability of exporters to maintain their share of external markets. Furthermore, the projections, depended, in part at least, on the outturn in 1985, which had fallen short of the goals envisaged.

Thus, the authorities should take heart from the results already achieved by their economic reforms and should resolutely continue with them in the future, Mr. Leonard concluded. In doing so, they would be well advised to develop a broader range of macroeconomic instruments for maintaining adequate control over aggregate demand without direct intervention, and to make appropriate policy adjustments if adverse pressures developed in the domestic economy or if the external environment was less favorable than expected. Risks were involved in the transition to economic management by such instruments, but there were equal risks involved in alternative approaches.

Mr. Vasudevan remarked that, according to the supplementary paper, Hungary's current economic situation was less satisfactory than it had been when SM/85/290 (11/1/85) had been issued. The deterioration challenged the authorities to adopt policies to meet problems in the medium term and complicated their pursuit of the economic reform program, which was intended to improve efficiency by reliance on market forces. Given the objectives of the economic reform and adjustment process, the authorities would need to severely restrain monetary and fiscal developments. In that respect, they seemed conscious of the need to continue with both adjustment and economic reforms, as exemplified by raising the rate of profit on enterprises, lowering the investment tax rate, increasing the stock of investment credits, providing incentives for raising personal savings, and continuing restraint on extending subsidies.

Most of the current uncertainty was related to the question of how the real sector would evolve, Mr. Vasudevan considered. The annual growth of real GDP, at barely 0.4 percent in 1985, had been the lowest recorded in any one year since 1980. Hungary's real GDP growth rate had averaged 6.3 percent in the years 1971-75 and about 5 percent in 1976-78, but had been at low levels since 1979. Similarly, real personal consumption had shown a decelerating growth pattern, having increased only moderately in 1985. Real wages in the socialist sector, which had grown by an annual average of 3.3 percent in 1971-75 and by about 0.7 percent in 1976-80, had declined in the period 1981-85.

The low growth rates were reflected in the recent trends in gross fixed investment, which had declined since 1980, averaging about 3.4 percent a year in the five years ended in 1985, Mr. Vasudevan said. Such investment had grown very rapidly in the 1970s--particularly in the first half of the decade--and had led to excess capacities, longer gestation periods, and an imbalance in the investment pattern. A recovery in fixed investment was needed even at the cost of a fiscal deficit in 1986.

Although the staff had outlined a number of fiscal and financial incentives for improving fixed investment, it was not clear to what extent those incentives would result in achieving the stated objective. Staff comment on the areas targeted for increased fixed investment, as well as on the present state of capacity utilization, would be helpful. Further, he wondered whether the proposed new investments would create export capacity, foster creation of goods at competitive prices, and bring about the application of up-to-date technology.

Developments in 1985 had been, as a number of Directors had pointed out, a matter of concern: the growth rate had been negligible, budget deficits and external current account deficits had occurred, and bank credit had increased, Mr. Vasudevan commented. Whether they would be temporary or not depended on exogenous factors, including weather conditions. The fact that the budget for 1986 had planned for a deficit of 2 percent of GDP did not necessarily prove that the authorities were seeking to reinforce the setback of 1985. Although the rate of enterprise profit tax would be raised, the new tax concessions and the reduction in the investment tax rate were intended to bring about a recovery in investment and lead to higher exports and conservation of energy. He hoped that those measures would have the desired effect. The intention to introduce a value-added tax and a personal income tax in the coming years was welcome, and he encouraged the authorities to continue with the program of tax reform.

Perhaps the high credit expansion in 1985--partly due to the rise in working capital credits for enterprises and in subsidized housing loans to households--had been an overreaction, but it had been intended to ensure that the ill effects of sluggish economic activity would not become widespread because of a restrictive credit policy, Mr. Vasudevan considered. In spite of the credit increase, however, domestic prices had not increased sharply, nor had availabilities of goods been very widespread. The 1986 credit guidelines would permit a rise in the stock of investment credits but it was not clear whether that would lead to a rise in credit for financing fixed investment, and a clarification from the staff would be helpful. He noted that credit ceilings would continue in effect in 1986, and that the banking system would operate interest rate policy more flexibly. The planned liquidity expansion would be consistent with the reduction in the tolerable limit of inflation from 6 percent to 5 percent in 1986.

The sharp fall in exports, especially of energy products, and a sharp decline in the terms of trade, had been largely responsible for the current account deficit in 1985, estimated at 2.3 percent of GDP, Mr. Vasudevan observed. He wondered to what extent protectionism had interfered with the volume of Hungary's exports. Imports in convertible currencies had risen sharply in volume, and the large increase in the volume of imports of capital goods and transportation equipment from the non-ruble area in 1985 was an indication that the country's future growth potential would not be adversely affected.

The authorities' awareness of the need to be competitive in the international markets was evidenced by the decline in the real effective exchange rate of the forint since March 1985, Mr. Vasudevan noted. While the authorities should pursue an active exchange rate policy, they should also continue providing the necessary financial incentives to encourage exports. Given the uncertainty of demand for Hungary's goods, and growing protectionist tendencies, the authorities should proceed cautiously with regard to eliminating all import restrictions.

The improvement in Hungary's current account position in 1983 and 1984 had undoubtedly facilitated the country's access to international capital markets, Mr. Vasudevan said. However, the resort to net short-term borrowing in 1985 was a matter of concern. The improvement in Hungary's international reserves, which had enabled the authorities to make a welcome early repurchase from the Fund, could not be sustained without a rapid rise in exports and a reduction over time of the debt to GDP ratio and debt service ratio.

The Deputy Director of the European Department, noting that the budgetary problems that had arisen in 1985 were expected to continue in 1986, remarked that one development of particular concern was that the current account deficit in 1985 had not resulted from an investment push but rather from a dissaving of the public sector. In response to a query from Mr. Pérez, he observed that the value-added tax would not be introduced specifically to raise revenue. It was supposed to be revenue neutral although, by broadening the tax base, it might be used eventually to raise additional revenue. Receipts had declined in 1985, not so much because of problems with revenue collection but rather because the authorities had decided to grant tax rebates to enterprises that had experienced difficulties or to allow them to delay their payments.

The effect of the exchange rate on exports was a topic that Fund staff and the Hungarian authorities had been discussing since Hungary had become a member of the Fund, the Deputy Director recalled. There was still a view in Hungary that devaluation would have no effect on increasing exports; yet, as a number of Executive Directors had noted, that view had been contradicted to some extent by the various subsidies and fiscal incentives that the authorities had been granting to exporters. Moreover, the authorities had devalued the forint against the ruble in 1985 precisely in order to terminate the subsidies that they had been granting to firms exporting to the CMEA partners, the subsidies were to be replaced by higher prices, which had resulted from the devaluation. In the staff's view, it was more efficient to offer a general incentive to all firms to expand exports rather than to subsidize individual firms, particularly since the subsidies often went to firms producing--at a loss--products that were difficult to sell abroad.

There had been a real appreciation of the forint of about 10 percent since 1980, which had been accompanied by a decline in the market share of Hungarian exports in convertible currency markets, the Deputy Director continued. That alone suggested that the forint was overvalued, a point that the authorities recognized. Nonetheless, because of their inflation target, the authorities had chosen to tackle the problem by subsidies, preferential credit allocation, and other administrative measures, rather than by an exchange rate adjustment. It should be remembered, of course, that a devaluation alone would not have the desired effect unless it was accompanied by appropriate financial policies.

Hungary's five-year plan was internally consistent, the Deputy Director mentioned; any problems lay with the assumptions or with some of the policies that were aimed at achieving certain targets. The staff's medium-term projection exercise, prepared for the forthcoming World Economic Outlook, had yielded less optimistic results than those in the five-year plan. At most, the staff could see a reduction in net external debt of about $500 million by 1990, in spite of some improvement in the terms of trade and a projected reduction in interest payments due to the recent downward trend in interest rates. Moreover, the plan contained little information about how monetary policy would be conducted, and it only referred to a number of administrative measures--tax rebates, various exemptions to encourage conservation of energy or raw materials and to stimulate exports--by which fiscal policy goals would be achieved. Thus, the staff continued to have doubts that the policies in place were adequate to achieve the targets of the five-year plan.

The adjustment that had taken place in recent years in Hungary had resulted in a much lower level of investment than in the past, and at some stage a recovery of investment had to take place if the productive apparatus was to be modernized and reformed, the Deputy Director considered. Tax incentives and the reduction of the investment tax rate were intended to promote investment in the exporting sector and in energy conservation. There was no known measure of capacity utilization in Hungary, but it was recognized that there was a continuing problem in some sectors of the economy where capacity was not utilized fully but enterprises were kept in business and allowed to produce at a loss; other sectors were doing much better.

Credit for fixed investment under the credit policy targets for 1986 was expected to be about the same as it had been in 1985, the Deputy Director noted. Not knowing the projected repayments of past credit, however, the staff could not answer questions on new disbursements. Finally, some Hungarian exports were hampered by protectionism: meat, textiles, and metal products in particular were affected by restrictions abroad.

Mr. Vasudevan noted that the data in Table 25 of SM/85/338 did not indicate that subsidies had increased either in nominal terms or as a percentage of GDP; in fact, the subsidies had been declining. Although specific mention had been made that the subsidies for exports had been very high during the past year, he did not see any support for that statement in the data in Table 25. It was also unclear how that rise would have affected export performance.

The Deputy Director of the European Department replied that Mr. Vasudevan had correctly noted that while the subsidy amounts in Table 25 had not changed much, there had been a small decrease in 1985 compared with 1984, largely due to the increase in administered prices as of January 1, 1985, which had reduced consumer subsidies. However, that was not the whole story. The table on subsidies did not include the various tax rebates that had been granted in 1985 to enterprises experiencing difficulties.

Mr. Vasudevan remarked that he had expected in the medium-term strategy to find an investment plan, giving details on the sectors in which investments would be made and indicating whether capacity utilization was one of the considerations governing the decision to create additional capacity in certain industries and not to create it in others, given the demand projections. It was true that the 1986 investments would go into areas that were export oriented or that led to conservation of energy; however, nothing had been said about the medium term, and it was essential to realize that investment was an important factor to be reckoned with in the medium term.

The Deputy Director of the European Department responded that Mr. Vasudevan had rightly noted that the five-year plan usually included a sectoral allocation of investment, which was similar to the data in Table 12 of SM/85/338 for 1985 and 1986. However, the staff had not yet seen Hungary's new five-year plan and thus did not have the projected sectoral allocation data.

Mr. de Groote observed that the remarks of Directors had been very useful because, at the present stage of Hungary's evolution, many options were still open. There was no doubt that the comments and criticisms offered by his colleagues would strengthen the determination of those who wished to halt the deterioration of the situation in Hungary that only a year earlier had been regarded as a model of successful adjustment. He hoped that those comments would elicit timely, appropriate policy responses from the authorities, before the markets themselves imposed adjustments that would then necessarily be harsher and more detrimental to growth.

The strong determination of the Hungarian Socialist Workers' Party to restore a surplus in the current account was evidenced by the decision of the thirteenth Party Congress, in the spring of 1985, to continue to give priority to attaining a surplus in the current account, Mr. de Groote said. The determination of the Government was equally evidenced by the recent measures that he had cited earlier and by the objectives of the 1986-90 plan. It was not yet clear how the current account surplus could be restored if the target of a maximum increase in prices of 5 percent was maintained. It might indeed be difficult under that constraint to adjust exchange rates whenever needed, to free the prices and let them respond to market conditions, and to ensure a better allocation of resources, including labor. Serious consideration might thus have to be given to the possibility of reconciling the price target with the growth and balance of payments targets. The likelihood of obtaining systemic benefits from further reforms would be compromised if the price system was not allowed full play, and he would bring that point to the attention of his Hungarian authorities.

Hungary was between two systems, not yet reaping the full benefits of a market economy, Mr. de Groote commented. The authorities were making genuine efforts to implement systemic reforms as rapidly as possible. The comment had been made that seemed to convey the notion that Hungary as a centrally planned economy was bound to remain trapped by certain options in enhancing its productivity, and Mr. de Groote was not sure that he could agree with that interpretation. On the contrary, the Hungarian authorities had been implementing measures to transform their economy, in the framework of a socialist regime, from a system of a command economy to one of market incentives and to obtain the systemic advantages in terms of increased productivity that the market system afforded. Hungary could no longer be classified statistically as a command economy; the constraints that were peculiar to such economies could not be identified as a permanent cause of less efficiency in Hungary, inasmuch as the authorities were attempting, by very specific measures, to obtain the advantages of the market and incentive regulators. However, more time seemed to be needed than had been expected to formulate and implement those reform measures, and, to a large extent, the beneficial effect of the measures already taken had not fully materialized. Finally, forces outside the control of the authorities--the weather and unfavorable terms of trade--had been present, and Hungary was no different from other developing countries in its vulnerability to such conditions.

He regretted that agreement on a new stand-by arrangement had not been reached toward the end of 1984 to implement a program of fundamental reform, because that would have provided a framework from which to monitor later events and would have shown clearly the link between adjustment and reform, Mr. de Groote continued. For example, it would have been useful to show, through specific arrangements and commitments, that the current account could attain a viable stance only if the reform process accelerated.

Hungary had maintained friendly and constructive relations with the Fund since its membership in May 1982, Mr. de Groote noted. Fund financing and assistance had been essential in helping Hungary proceed with fundamental reforms in the direction of market-oriented mechanisms while simultaneously remedying its liquidity situation. The authorities had no intention of changing the course of their policies, and he believed that many of the measures that had been taken would yield demonstrable results before the conclusion of the 1986 Article IV consultation. He had been interested in Mr. Vasudevan's observation that there had been a strong increase in imports of capital goods from the convertible area in 1985. That was a good sign for the future expansion of output, especially because the increase in imports had taken place through autonomous enterprises, where competition had grown faster. Finally, Hungary had demonstrated its ability to react quickly to unfavorable circumstances by reorienting its policies. There was good reason to believe that the fundamental trend toward balance of payments rehabilitation through structural reform would continue.

The Chairman made the following summing up:

Executive Directors commended the authorities for their success in restoring Hungary's normal access to international capital markets and rebuilding a comfortable level of external reserves. The voluntary early repurchase made by Hungary in November 1985 was warmly welcomed as another indication of the close cooperation with the Fund that had evolved since membership. At the same time, Directors expressed serious concern about recent developments in the Hungarian economy. They regretted in particular that success in restoring Hungary's creditworthiness had been accompanied by a weakening of the momentum to consolidate the adjustment process and to lay a solid foundation for a sustainable improvement of living standards.

Discussing the marked deterioration of the current account balance in convertible currencies in 1985, Directors acknowledged that some special factors, including the severe winter and the erosion of certain export prices, had been partly responsible for the shortfall. They stressed, however, that the disappointing results were also attributable to the absence of timely and adequate measures to safeguard the current account target. Several Directors reiterated the views that had been expressed during the Board discussion of the 1984 Article IV consultation: the authorities had then been urged to press ahead with economic reforms to improve the efficiency and adaptability of the economy, and to take action if the currrent account surplus fell short of the official target.

With regard to the current account shortfall in 1985, Directors underscored that the easing of credit policy and the weakening of financial constraints on enterprises through tax alleviations and subsidies had compounded the balance of payments problem. They saw the sharp deterioration of the budgetary accounts in 1985 as the main domestic counterpart of the erosion of the external current account. Directors pointed out that the rise in Hungary's ratio of external debt to GDP from 43.5 percent in 1984 to 50 percent in 1985 and the deterioration of the debt service ratio to unprecedentedly high levels had increased Hungary's exposure to adverse developments in the world economy and in the international credit markets, as the hard-won confidence of the international financial community could not be taken for granted.

With respect to the outlook for 1986 and the years beyond, Directors welcomed the declared intention of the authorities to give priority to the restoration of a convertible current account surplus and the reduction of foreign debt. It was noted that Hungary's obligations to its CMEA partners entailed a heavier demand than in the past on the supply of Hungarian high-quality exportables and the need for a larger volume of imports settled in convertible currencies.

Directors shared the doubts expressed by the staff as to whether the announced policies were adequately geared to the tasks of restoring a current account surplus and reducing the foreign debt, and they observed that the easy external financing might well be weakening the necessary resolve to pursue the adjustment process. They expressed their concern, in particular, at the prospective deterioration in public finances, and stressed the need for Hungary to raise the domestic savings ratio. They regretted that the goals of promoting the efficient use of energy and material inputs and strengthening export capacity in industry continued to be pursued by offering special fiscal incentives and preferential credit facilities, and that further sizable budgetary support was scheduled to be granted to weak industries. As a result, the share of government expenditures in GDP was planned to rise again in 1986 and, despite an increase in the profit tax rate, the budget deficit was to widen further. Many Directors also expressed concern that monetary policy might remain too accommodating.

Directors noted that the self-imposed ceiling on consumer price increases, which had become a policy priority and would be lowered further to 5 percent in 1986, limited the scope for needed changes in relative prices, reduced subsidies, greater pay differentials, and an active exchange rate policy. Directors stressed that price flexibility was an essential tool to achieve a more efficient allocation of resources. A number of Directors also questioned the authorities' decision to allow the forint to appreciate in real effective terms and urged the authorities to pursue and maintain a flexible exchange rate policy designed to strengthen competitiveness vis-à-vis the convertible area.

Directors welcomed the renewed impetus in 1985 toward improving the economic management system and the steps envisaged for the subsequent period, including the introduction of a flexible system of interest rates in 1986. They saw the changes in enterprise management and in wage and price determination, together with a less restrictive import regime, as promising. Directors placed renewed emphasis on the need to open up the economy more to foreign competition in order to ensure the efficient functioning of a more liberalized economic system. They noted that the continued reliance on special financial incentives, the increased resource transfers through the budget from efficient to inefficient enterprises, and the narrowing of the scope for relative price changes were not consistent with the declared intention to strengthen the response of enterprises to market forces, to encourage greater financial discipline, and to reinforce the profit motivation of enterprises.

In sum, most Directors expressed disappointment and concern on the recent slippages in Hungarian economic performance. They considered that the balance of payments deterioration and the rapid growth of external debt in 1985 were important signals that could not be ignored and had to be acted upon urgently, given the dangers of relying too heavily on external markets. They felt that the policy momentum toward adjustment and reform had weakened over the past year. Hence, they urged the authorities to tackle the tensions and imbalances of their economy in a way that would promote economic efficiency and growth. They felt that achievement of the external objectives would better be met by a combination of demand management and structural measures rather than dependence on administrative devices. They underscored the importance of price flexibility, which was viewed as a basic ingredient of economic reform; exchange rate flexibility; a more competitive financial system; a stricter budgetary policy and a reform of the taxation system, including the introduction of a personal income tax and value-added tax; a stricter credit policy that relied more on indirect monetary instruments; and a reduction in subsidies.

Directors suggested that Hungary could not rely on external borrowing to achieve lasting improvements in living standards but would instead need to raise economic efficiency through the resumption of economic reforms.

It is expected that the next Article IV consultation with Hungary will be held on the standard 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Hungary, in the light of the 1985 Article IV consultation with Hungary conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions, including a restrictive multiple currency practice, are maintained by Hungary in accordance

with Article XIV. The Fund encourages the authorities to pursue policies that would permit them to remove these restrictions and practices as soon as possible. Moreover, the Fund encourages the authorities to take early steps to eliminate the remaining bilateral payments arrangements with Fund members.

Decision No. 8181-(86/7), adopted
January 13, 1986

2. TURKEY - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Turkey (SM/85/332, 12/18/85; Cor. 1, 1/10/86; and Sup. 1, 1/8/86). They also had before them a report on recent economic developments in Turkey (SM/85/334, 12/23/85).

Mr. de Groote made the following statement:

I would like to express the thanks of my Turkish authorities to the staff for the balanced assessments provided in the 1985 Article IV consultation and for the highly informative recent economic developments papers, with which they broadly concur. For the first time in seven years, this Article IV consultation for Turkey is not accompanied by the use of Fund resources: in view of the progress Turkey has made in adjusting its economy, especially in the external sector, the authorities have decided not to seek further access to Fund resources.

Mustering political determination, the Turkish authorities launched in January 1980 a comprehensive adjustment program supported by the Fund to meet the need for market-oriented reforms and for an outward-looking redirection of the economy. This program has been extremely successful: the economy was placed on the right track toward the achievement of sustainable growth and balance of payments viability in the medium term. Because the economy's performance was somewhat less satisfactory in 1983 than during the preceding two years, the new Government, which took office in December of that year, immediately adopted measures aimed at getting the economy back on the adjustment path, while continuing and extending the reforms begun in 1980. The authorities' economic strategy has focused on reducing the inflation rate, improving the external performance, increasing the open-market orientation of the economy, and intensifying structural reforms. They consider that optimizing the relationship between growth and the balance of payments, ensuring the better allocation of resources, and permitting an adequate rate of growth are essential preconditions of a sustainable balance of payments position.

In pursuit of these goals the Turkish authorities have continued to implement a wide range of policy measures and have achieved considerable progress, especially in the areas of growth, external accounts, public sector, and structural reform. Flexible exchange rate and realistic interest rate policies, as well as greater reliance on market forces with reduced government intervention in the economy, have further improved resource allocation. The authorities have further encouraged the desired outward-looking orientation of the economy by continuing, in 1984 and 1985, the liberalization of imports and by the removal of certain exchange restrictions.

A favorable outcome in the industrial sector, and to a somewhat lesser extent in the agricultural sector, and a positive contribution from the foreign balance raised real GNP by about 6 percent in 1984, and by an estimated 5 percent in 1985. These growth rates are among the highest in the world for this period. For 1985, the estimated ratios of gross domestic saving and investment to GNP are 17.5 percent and 19 percent, respectively, compared with 17.1 percent and 20 percent in 1984. Despite some decline in the inflation rate in the course of the year, the average level of price increases for 1985 is expected to be around 40 percent, due partly to excess liquidity in the economy partly because of policy-induced price adjustments, especially exchange rate and State Economic Enterprise (SEE) prices, and partly to the initial impact of the introduction of a value-added tax (VAT).

The outward-looking orientation of the economy has provided an encouraging improvement in the balance of payments. Continued increases in exports, together with a somewhat slower growth of imports and a significant rise in tourist receipts and worker remittances, reduced the current account deficit to about 1.5 percent of GNP ($800 million) in 1985. It is noteworthy that this gain was achieved in the face of protectionist measures taken by Turkey's main trading partners in the industrial world, during a two-year period when import liberalization was being speeded up and external debt relief phased out. In addition, several export incentives have been reduced. On the other hand, Turkey's good record for debt servicing and its continued adjustment efforts, sound economic policies, and encouraging balance of payments performance have increased the confidence of the international capital markets, permitting larger medium- and short-term inflows. Since the implementation of measures to encourage foreign direct investment, which included simplification of regulation and elimination of a number of formalities, the growth of these flows has been slow but steady. In the light of the great interest shown by foreign investors in Turkey, however, the Government expects a substantial increase in foreign direct investment over the medium term.

The scenarios for Turkey's medium-term balance of payments prospects under various assumptions, given in Appendix II of the staff report, show the debt service ratio declining to about 18-20 percent in 1990, compared with 29 percent in 1985. The Turkish authorities believe that an export-led economic strategy, together with prudent demand management and continuous structural reforms, can result in a medium-term economic performance even better than that projected by the staff. They share the staff's view that the trade-off between growth and external constraints will be eased by the ongoing vigorous structural reforms. Short-term external debt rose to 21 percent of total external debt in 1984. This was due mainly to the process of external liberalization and to the increased reliance of the Turkish economy on the savings of expatriate workers. The resultant foreign exchange deposits in the Central Bank and in the commercial banks are hardly comparable to external debt, since most belong to expatriate workers and Turkish citizens who plan ultimately to use them for transactions in Turkey. Besides, as the staff rightly points out, the ratio of trade-related short-term debt to total trade, about 12 percent, is still quite low by international standards. The Turkish authorities nonetheless are attentive to the behavior of short-term external debt. They have recently imposed a 20 percent reserve requirement for commercial banks on their newly opened foreign currency deposits, and have obliged them to collect a withholding tax of 1 percent on the interest they pay on these accounts. In addition, the maximum required foreign exchange cover for short-term trade credits has been raised from 40 percent to 50 percent.

Monetary aggregates came under additional pressure in both 1984 and 1985, largely due to the improvement in the balance of payments, an increase in the reserve money multiplier, the effects of continued deregulation in the financial system, and the unfavorable budgetary performance of 1984. The intentions and efforts of the authorities did not succeed in containing monetary aggregates within the projected limits. Although the real interest rates on commercial bank lending have remained positive, unexpected price developments caused interest rates on deposits, which were increased in nominal terms in September 1984, to become negative in real terms for most of 1984 and the first quarter of 1985; since then, they have also been positive. Over the past two years, the authorities have continued to introduce institutional changes and reforms to improve the management of monetary policy and the efficiency of financial resource allocation. Besides legislated banking reforms, the Central Bank has been authorized to review interest rates on deposits monthly, in light of the behavior of prices and interest rates at the weekly auctions of government securities. The ongoing reform in the reserve requirement system is aimed at improving the efficiency of monetary policy and at reducing the cost of financial intermediation. Moreover, the authorities intend to follow a more formal approach to monetary programming and to monitor its implementation closely.

The Turkish authorities believe that the success of their program will depend greatly on improving trends in the public sector, both with respect to reducing its borrowing requirements and to making structural changes in the SEES. To this end, several measures have been introduced. Once the initial difficulties were overcome, the VAT, which is similar to that adopted by the EEC countries, has given encouraging results in a very short time. The authorities are pursuing the aim of improving the efficiency of the SEES by a realistic pricing policy, by enhancing the effectiveness of their management, by obliging them to operate in a competitive climate, and by tightening their access to budgetary transfers and to central bank credit. In addition, the Government is examining a wide-ranging plan for privatizing the industrial sector SEES, on which studies are still proceeding. Overall, the consolidated budget deficit has decreased from 4.9 percent of GNP in 1984 to 2.3 percent in 1985, while the public sector borrowing requirements has fallen from 7.9 percent of GNP to 4.6 percent.

In 1986, the Government firmly intends to continue pursuing tight monetary and fiscal policies, while maintaining real positive interest rates and a flexible exchange rate policy to reduce the inflation rate and further improve the balance of payments. In order to ensure meeting the projected targets for real growth (5 percent), inflation (25 percent), current account deficit (1.5 percent of GNP or $700 million), the consolidated budget deficit (1.3 percent of GNP), the public sector borrowing requirements (3.9 percent of GNP), and M2 growth (30 to 40 percent), the authorities announced, in December 1985, a wide range of policy measures, especially in the areas of fiscal and monetary policies, the SEES, and import liberalization. Thirteen tax laws have been amended with a view to increase revenues and enhance the efficiency of tax administration and collection. A system of certified public accountancy and an advance tax collection scheme have been introduced. Several goods and service prices of SEES have been sustantially increased. The Government decided that, with very few exceptions, the Treasury will no longer compensate SEES for duty losses. Additional measures have been announced to further liberalize imports and reduce the tax rebate on exports. The general rate of import guarantee deposits has been lowered from 15 percent to 3 percent. As a part of the ongoing reform process, the rate of the legal reserve requirement will undergo four consecutive cuts of 1 percentage point, which will reduce it from 19 percent to 15 percent, between the beginning of February and the end of September 1986, and no interest is to be paid on these required reserves after December 31, 1985.

The Turkish authorities have shown their firm determination to carry through their economic program by continuous actions aimed at more sustainable, outward-looking development, and greater reliance on free market principles. This process, in the view of my Turkish authorities, is continuous, requiring unabating effort and the timely implementation of the necessary measures. There is clear evidence, in the wide range of measures just taken, of their determination to succeed with the economic program for 1986.

Mr. Steinberg observed that, following Turkey's mixed economic performance in 1984, the goals set by the authorities for 1985 resembled what had recently been characterized as the objectives of the Baker plan: strong growth, coupled with a reduction in both the inflation rate and the current account deficit. The measures taken by the authorities, together with positive external developments, had resulted in achievements that were close to the authorities' objectives. Real GNP had grown by nearly 5 percent, compared with the target of 5.5 percent, the rate of inflation had dropped to its 1981-83 level, and the current account deficit had been reduced from $1.4 billion in 1984 to about $0.8 billion in 1985, compared with the target of $0.7 billion.

To finance its balance of payments needs, Turkey had raised short- and long-term capital from both the World Bank and the commercial banks, Mr. Steinberg went on. Turkey's renewed ability to raise long-term capital in the international capital markets in recent years was remarkable, given the country's recent inability to roll over its short-term debt. Data available for 1985 suggested that the marked improvement in the current account was due mainly to the devaluation of the lira, domestic demand restraint, positive real interest rates, and the liberalization of foreign trade. The decline in inflation in 1985 that had occurred in spite of the devaluation process reflected mainly the drop in agricultural prices, but the lower rate of growth of domestic demand had also been a contributing factor.

The change in public sector demand apparently reflected the cut in the public sector deficit, which was even sharper when the surplus of the new extrabudgetary funds was taken into account, Mr. Steinberg continued. However, it was not so easy to depict developments relating to private sector demand. The discussion of incomes policy in the staff report was insufficient; however, real wages in the public sector seemed to have been stable in 1985, while private disposable income had risen.

The positive outcome of 1985 had been achieved despite the excess liquidity caused by the expansionary monetary policy, Mr. Steinberg commented. It would have been better if the reduction in reserve ratios had not taken place in 1985, in the wake of the already fast-growing monetary base and other financial aggregates. Since the authorities had agreed with the staff's view on the existence of excess liquidity, he wondered why they had not pursued a tighter monetary policy. He also wondered why the staff considered that the M2 target for end-1986 was about right. Even if the projected GNP growth rate and the inflation rate were considered realistic, should monetary policy be so accommodating, particularly when liquidity was deemed excessive? He also wished to know how the control mechanism of the Central Bank, the weakness of which had been cited as an important factor in Turkey's inability to meet the 1985 targets, was being strengthened.

The authorities had let the lira appreciate in real terms in 1984 to decelerate the rate of inflation, but at the expense of Turkey's balance of payments, Mr. Steinberg considered. Many countries had unsuccessfully attempted such shifting of emphasis between the balance of payments and inflation. The most successful way to tackle the balance of payments deficit and a high rate of inflation was to adjust simultaneously the various factors contributing to the domestic and external imbalances.

The World Bank loans to Turkey were substantial, about 9 percent of total Bank disbursements in 1985, Mr. Steinberg added. The staff report (Appendix IV and Table 3) was the first to contain a detailed description of the various conditions on the World Bank's structural adjustment loans. While the listing of the issues and their developments between 1980 and 1984 was a commendable progress report, the staff should evaluate how the structural adjustment loans were contributing to the achievement of Turkey's macroeconomic goals.

The authorities were to be commended for having continued to liberalize their exchange and trade regimes, in spite of the protectionist pressures faced by their own exports in several markets, Mr. Steinberg commented. They were also to be congratulated for their intention--manifested by the numerous measures announced in December 1985--to continue pursuing tight monetary and fiscal policies, real positive interest rates, and a flexible exchange rate policy to reduce inflation and further improve the balance of payments.

Mr. Dallara said that the Turkish economic performance and policy management in recent years was an example of how a combination of prudent macroeconomic policies and structural changes could help a country that had experienced serious external debt problems to restore a more acceptable rate of growth and a more sustainable external position. The progress achieved had enabled Turkey to make the transition from dependency on debt relief, concerted commercial and official lending, and prolonged financial support from the Fund to the re-establishment of external confidence and creditworthiness and, thereby, reliance on voluntary lending. Nevertheless, the current economic situation in Turkey demonstrated the economy's continued vulnerability and underscored the importance of consolidating the progress achieved to date both by the continuation of sound policies and reinforcement of some other policies to establish the proper balance between economic growth and external viability. Indeed, the need to find that proper balance should be the main priority of Turkish economic policies in the years ahead. Over the past decade, Turkey had had difficulty from time to time, not in achieving economic growth, but in maintaining sustainable economic growth and a viable external position. Turkey had made substantial progress toward solving that dilemma but had yet to find the exact policy path for a durable solution. Turkey's serious external debt problems had emerged prior to those of many other countries and, although each country's economic and political circumstances were unique, there were lessons from the Turkish experience that might well have broad applicability. In fact, one was tempted to say that Turkey's performance was fully consistent with the Baker initiative in advance of its formulation.

The authorities had recognized the need to implement a broad and comprehensive economic program, which had included not only the consolidation and strengthening of macroeconomic policies but also the introduction of structural changes to increase the openness and competitiveness of the economy, Mr. Dallara continued. Consequently, the relative size of public revenue and expenditure had declined, support of state enterprises had decreased as a share of government spending, the public deficit had been cut substantially, import liberalization had proceeded, artificial export incentives had been reduced, pricing policies of the state enterprises had been made more realistic, and flexible interest rates and exchange rates had been maintained. The success of the authorities' broad approach could be seen in the evolution of a number of key macroeconomic variables: real economic growth in the past four years had been positive, ranging from 3 1/2 percent to 6 percent, both public and private real fixed investment had been rising steadily, with private investment having increased on average by about 5.5 percent a year, and domestic savings had been 17-18 percent of GNP. Moreover, the growth of employment had accelerated, although that had served basically to stabilize the unemployment rate. All those achievements had occurred together with a strengthening of the balance of payments, while short-term capital had been positive in the past three years and the overall balance of payments had been in small surplus in each of the past four years.

Nevertheless, there had also been problems, particularly in 1984, Mr. Dallara noted. One of the more troublesome problems for Turkey had been inflation. After accelerating rapidly in 1984, the rate of price increases had declined in 1985; but the Turkish authorities and the staff agreed that inflation remained a matter of concern, underscored in part by the authorities' difficulties in implementing monetary policy. In 1984, M2, including foreign exchange deposits, had grown by more than 73 percent. The corrective steps that had been taken from mid-1984 onward had been helpful, albeit insufficient to rein in the monetary aggregates in 1984; the system of monetary targeting excluding an aggregate for the entire banking system remained a cause for concern. Through November 1985, M2 and M2 including foreign exchange deposits had grown at rates of 56 percent and 63 percent, respectively. For 1986, a growth target for M2 of 30-40 percent would be an important step toward achieving better restraint. However, he, like the staff, doubted whether current monetary policy could accomplish the reductions in monetary growth needed to meet that goal. The package of monetary measures that had been taken recently had clearly enhanced the prospects for meeting the targets, but he wondered if the staff or Mr. de Groote could supplement the data in SM/85/334 with an assessment of the overall adequacy of those measures.

The Government had wisely transferred to the Central Bank authority to set interest rates, although interest rate policy would need to be flexible if rates were not allowed to be determined directly by market forces, Mr. Dallara observed. He welcomed the reform of reserve requirements aimed at cutting interest paid on reserves while reducing reserve requirement levels, but he shared the staff's concern that excessive monetary expansion might occur from too rapid or too deep a cut in required reserves. Completion of a study of ways to reduce the lag in submission of banking data might permit a shift to a broader monetary aggregate. The fifth World Bank structural adjustment loan to Turkey had included some financial market reforms, and he wondered if the authorities were considering further reforms that might be worthy of support.

Fiscal developments had complicated monetary management significantly at times during the past few years, with the deficit of the consolidated public sector having ranged from 6 1/2 percent to 8 1/2 percent of GNP between 1982 and 1984 and then having fallen to about 4 1/2 percent in 1985, Mr. Dallara added. Although the reduction was welcome, the public sector deficit remained high. Within the context of overall developments, some positive accomplishments in the fiscal area merited attention. The ratio of revenues to GNP had fallen from over 22 percent in 1982 to 18-19 percent in 1984 and 1985. While the authorities' deliberate effort to improve incentives by a cut in income tax rates partly explained the decline in the tax burden, the weakness of the tax collection remained troublesome. On the expenditure side, there had been a welcome decline in the ratio of spending to GNP. On the other hand, interest payments had risen from less than 5 percent of total spending in 1982 to over 12 percent in 1985. The decline in transfers to the state enterprises from almost 15 percent of total budgetary expenditures in 1982 to less than 4 percent in 1985 had been one of Turkey's more positive achievements; it had not only made possible the consolidation of the fiscal position, but it could also have a lasting effect on the efficiency of the public sector and the economy as a whole.

Nonetheless, state enterprise deficits were projected to exceed 2 1/2 percent of GNP in 1986, which pointed clearly to the continuing need for reforms, Mr. Dallara went on. The second and third World Bank structural adjustment loans had targeted the state enterprise sector among others, and the authorities were studying a wide-ranging plan for the privatization of state enterprises in the industrial sector. He wondered if the Bank might eventually also be involved in that effort. He also asked for comments on the possibility and desirability of reducing the public service financing requirement by an increase in the corporate tax rate and by advance payment of income taxes based on value-added tax data.

He welcomed the strengthened current and overall accounts of the balance of payments, Mr. Dallara remarked. A flexible exchange rate policy had been, and would continue to be, crucial to provide adequate incentives for export growth and to permit continued import liberalization. The substantial real effective appreciation of the lira throughout 1984 had been disturbing, although it had been largely reversed in 1985. A flexible interest rate policy would also be important to contain capital outflows and to preserve Turkey's creditworthiness. A considerable increase in the foreign banks' medium- and long-term exposure in Turkey in 1984 attested to the clear recovery in market access. However, nearly $900 million of the overall rise of $2.3 billion in borrowing had been in the form of short-term credit. The staff and the authorities had differed on the degree to which the increase in short-term debt represented a problem, and he would welcome further comments. The authorities had taken some steps to reduce the potential volatility of the foreign exchange deposits. Making a less liquid asset available to expatriates as an attractive alternative to the current scheme of highly liquid deposits might help to lessen the potential volatility associated with those deposits.

The authorities had introduced several measures to liberalize trade, Mr. Dallara noted, including the reduction in the number of prohibited import items, the shortening of the prior approval list, the reduction in the advance import deposit rate, the virtual removal of restrictions on exports, the abolition of the preferential export tax, and the lowering of the export tax rate. Nevertheless, the prior import deposit still had not been completely abolished, the stamp duty rate on some imports had been raised, and export tax rebates had been introduced for agricultural goods. He wondered whether the authorities had further plans for trade liberalization beyond the measures that had been announced recently; additional trade liberalization would enhance Turkey's overall medium-term economic prospects.

He wished to call attention to a small shortcoming common to numerous other staff reports, Mr. Dallara said. The supplement to the staff report (SM/85/332, Sup. 1, 1/8/86) had indicated that the number of commodities subject to import licensing had been reduced from 625 to 245; such statistics were interesting to note, but he had found it difficult to assess the degree of importance, the volume, or the percent of total trade associated with those commodities. Although one might be able to assess the relative importance of such moves by looking extensively into the background data, an additional clarifying sentence or two in the staff report would have been helpful.

Turkey had good prospects for achieving an acceptable rate of real economic growth and a sustainable external position through the end of the decade, Mr. Dallara indicated. The three medium-term scenarios provided in SM/85/332 described the essential policy issues and problems that the authorities would be facing, and it was clear that the authorities needed to continue their efforts of economic adjustment and structural reform. He wondered whether the growth scenario had been based on assumptions on which the authorities were actually proceeding; if so, he shared the staff's concern about the compatibility of those assumptions with acceptable and sustainable current account and foreign debt positions. However, the so-called mixed scenario had allowed for a substantial average rate of growth that would be sustainable within the context of a favorable external position, and he wondered whether such optimism was warranted, given Turkey's recent difficulties in achieving the right balance in the economy. Mr. de Groote had suggested a solution to the problem when he had noted that the trade-off between growth and external constraints could be eased by the ongoing vigorous structural reforms in Turkey. He shared Mr. de Groote's view; if anything, the structural reforms should be enhanced, not merely continued. Finally, he hoped that the Turkish authorities could formulate and implement consistently a set of policies that would enable them to achieve all of those objectives over the years ahead.

Mr. Suraisry remarked that, since 1980, the authorities had introduced commendable adjustment measures, with particular emphasis on structural adjustment, to restore financial balance and put the economy on a sustainable growth path. As a result, the overall economic situation had improved and, more important, a great number of distortions and bottlenecks had been eliminated. However, as the authorities recognized, further measures were needed to reduce inflation and consolidate the gains achieved in the public finances and the external sector.

In particular, measures were urgently required to arrest monetary expansion, which had substantially exceeded the target in the past two years, Mr. Suraisry added. The authorities had already taken several steps to control monetary aggregates. Those steps had been somewhat successful, but in view of the high inflation rate, which the authorities were trying to lower, the monetary control mechanism needed to be strengthened, and foreign exchange sold to the Central Bank needed to be sterilized. He questioned the authorities' reduction of the reserve requirement applied to banks when there was a clear need to restrict the money supply to help lower inflation, and asked the staff to comment on that point, as well as on the role of the nonbank financial intermediaries. Deposits and demand for credit seemed to have shifted from the nonbank to the bank market, which could have helped to increase the rate of growth of the monetary base. Perhaps the staff could comment on the reasons behind that shift. The financial reform under way should try to redress the situation.

The budget performance had weakened in 1984 as a result of revenue shortfalls, and further measures were needed to strengthen it, Mr. Suraisry continued. Despite the strong measures taken to restrain expenditures, the authorities would be unable to achieve their initial objective of a balanced budget in 1985. Further cuts in expenditures would clearly be difficult; therefore, the emphasis should be on increasing revenues, whose ratio to GNP had declined to a low level. Strengthening the system of tax collection and increasing some of the tax rates were essential to improve the fiscal position and increase revenue. In that context, he commended the authorities on their recent revenue-increasing efforts. Inflation had to be checked if the authorities were to achieve a solid improvement in the budgetary position. He shared the staff's caution about the recent extrabudgetary funds. In 1984/85, those funds had contributed to the reduction of net borrowing by the public sector. It was important for those funds to support the efficient conduct of fiscal policy.

The authorities had maintained a commendable flexible exchange rate policy, which had been an essential factor of the improvement in the external sector, Mr. Suraisry observed. Although total external debt had increased over the years, it was still manageable, but the authorities were wise to maintain a cautious debt management policy. He did not share the staff's apprehension about the foreign exchange deposits at the central and commercial banks, but thought instead that the authorities had imaginatively attracted workers' remittances to the benefit of the economy. Nonetheless, there was merit in the staff's suggestion that the commercial banks' cover of foreign currency deposit liabilities should be increased; developments in that area should be monitored closely.

The authorities had made commendable progress in liberalizing the exchange and trade system, Mr. Suraisry commented. He sympathized with the authorities, who were complaining that the barriers against Turkey's exports in several markets did not help the Government's efforts to improve its creditworthiness, and that such protectionism was unfair, after Turkey had liberalized its exchange and trade system, as requested. Finally, he concurred with the authorities' decision not to consider further borrowing from the Fund; financial assistance from the World Bank would perhaps be more appropriate.

Mr. Foot remarked that in 1985 few other members had accomplished a growth of about 5 percent, a falling rate of inflation, an improved current account, and a smaller public sector borrowing requirement. Despite those encouraging developments, however, several areas of potential concern remained, and they would require careful monitoring, particularly in view of the need to maintain the confidence of external creditors.

He shared the staff's doubt about the authorities' projections for revenue and wage and salary expenditures in 1986, especially because the fiscal deficit had exceeded the planned figure for 1985, Mr. Foot said. The staff should comment on the fiscal outlook for 1986 in the light of the various measures that the authorities had recently taken, including an amendment of the tax laws, although he recognized the difficulty in assessing such a package until it had been in place for some time. The uncertainties introduced by the authorities' adoption of new extrabudgetary funds would make it difficult to interpret public sector accounts clearly, and they might operate in the future in a way that could run counter to overall budgetary policy.

The authorities had wisely recognized the dangers posed by the liquidity overhang, especially because the reduction in inflation in 1985 had resulted partly from trends in agricultural prices that might not be easily repeated, Mr. Foot observed. While he understood the authorities' desire to reduce the reserve ratio requirement, like other Executive Directors he wondered whether it was appropriate to do so in the current circumstances of rapid monetary growth.

Fluctuations in trade performance during 1985, which were apparently linked to exchange rate changes, had highlighted the need to remain competitive and maintain a flexible exchange rate policy, Mr. Foot stated. That would be essential if Turkey were to achieve the gains in market shares that had been assumed in the medium-term scenarios. He welcomed Turkey's progress in trade liberalization.

One should have an open mind on the question whether the buildup of foreign exchange deposits was a cause for concern because of their volatility, Mr. Foot considered. He wondered whether the experience of other members was relevant. Turkey was not the only country with a large expatriate population whose authorities might have sought to attract funds back to the country, and it would be useful to know whether such funds had turned out to be volatile in other cases.

Mr. de la Herrán said that the economy had in general terms performed positively. The authorities' measures had led to a mixture of favorable results--such as substantial corrections in the balance of payments and improvements in public enterprises--as well as some failures--including the overshooting of monetary ceilings and the consequent effects on the rate of inflation.

As inflation still remained high in Turkey, it was reasonable to think that there was a strong link between money supply behavior and prices, Mr. de la Herrán observed. Therefore, if one of the authorities' main objectives was to reduce inflation, tighter control of monetary variables to contain the rate of monetary expansion was essential. Turkey had an inherent problem of monetary control stemming from exogenous increases in money supply, namely, the strong influence exerted by workers' remittances, mainly through the "Dresdner Scheme." While that scheme was a positive factor for the balance of payments because it helped to offset the trade deficit, it also interfered with monetary control. Thus, it would be more appropriate to choose as a monetary target a broader variable, such as "M2X," namely, broad money, including foreign exchange deposits, in order to attain more accurate monetary control. He was encouraged to learn from the most recent data that the monetary aggregates were growing at moderate rates, and that the Central Bank was taking specific additional measures to regulate all movements of foreign currency deposits within the banking system. The introduction of legal reserve requirements and mandatory transfers of foreign currency to the Central Bank by commercial banks were positive steps toward the creation of a more sophisticated and efficient financial framework.

The points that he had raised on monetary policy were closely related to the apparent divergence of views between the authorities and the staff on the treatment as external debt of foreign currency deposits generated by workers' remittances, Mr. de la Herrân considered. Although in theory those deposits could be characterized as external debt, it was necessary to take their origin into account and to differentiate them from other sources of external obligations. He shared Mr. de Groote's assessment that such deposits were hardly comparable to external debt. Their degree of mobility was much less than that of speculative capital inflows. Provided that caution was exercised, the creation of such foreign currency deposits was a positive measure.

Mr. Grosche noted that, on balance, Turkey had made further progress in 1985. The external current account deficit had been reduced further, while fairly strong economic growth had been maintained. The authorities had taken further commendable steps to liberalize the external sector, and had made progress in reducing the fiscal deficit, although the improvement of the public sector finances had fallen short of their intentions. However, a number of less satisfactory developments, notably the troubling developments in monetary and fiscal policies, had cast some doubts on the sustainability of Turkey's progress achieved thus far.

Although the authorities had made progress in reducing inflation in the second and third quarters of 1985, it remained unclear whether the progress could be consolidated, Mr. Grosche remarked. The latest data suggested an acceleration of prices, fueled by monetary trends in 1985--in particular, the excess liquidity in the economy. It was therefore especially important for the authorities to cut the rate of monetary growth. Although monetary expansion had apparently slowed during the closing months of 1985, the rate of expansion had nevertheless remained high.

It was questionable whether the reduction of the reserve requirement in 1985 had been fully consistent with the need to improve the control over monetary developments, Mr. Grosche observed. Attempts to absorb liquidity through increased open-market transactions held less promise for success in view of the small markets, despite the World Bank's efforts. He welcomed the authorities' new policy to announce their monetary program publicly, including specific targets for some monetary aggregates for the coming year. However, that policy could be successful only if the authorities did not undermine their credibility by substantially missing their targets. In that respect, an improvement in the instruments of monetary control appeared particularly important. More use of auctions of government bonds to banks and nonbanks could be helpful. However, without a further major reduction in the public sector borrowing requirement, efficient monetary control would continue to be difficult to attain.

While the recently introduced package of fiscal measures should enhance the authorities' chances of achieving the targeted improvement of the budgetary position, it remained to be seen whether the measures were sufficient to realize the fiscal objectives for 1986, Mr. Grosche indicated. Potential risks to the achievement of the budgetary goal arose from the performance of the state economic enterprise sector, which still required considerable reorganization. In addition, it would be necessary to coordinate and supervise closely the operations of the new extrabudgetary funds, to prevent their operations from running counter to the overall stance of budgetary policy.

The staff's medium-term projections for Turkey clearly indicated that it would be extremely difficult to reconcile a high growth rate with the need to contain the current account deficit, Mr. Grosche noted. The so-called mixed scenario appeared to fit Turkey's situation best. In any case, strong export growth would continue to be essential. To date, the exchange rate policy had been broadly appropriate in supporting export growth. While a flexible real exchange rate policy was essential to maintain external competitiveness, it was important to realize that Turkey's export performance also depended on economic developments in its oil producing neighbors. He wondered whether the latest oil price developments would have a substantial bearing on the export targets for 1986.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/6 (1/10/86) and EBM/86/7 (1/13/86).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/8 (1/9/86) is approved.

APPROVED: September 2, 1986

JOSEPH W. LANG, JR.
Acting Secretary