

December 7, 1982 - 82/222

Statement by Mr. de Groote on
the Hungarian People's Republic
Executive Board Meeting 82/156
December 8, 1982

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

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

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

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

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

- producers should be able to decide, within their own ambit, what and how much to produce and offer for sale, as well as where and how much of the necessary inputs to purchase;
- producers and users should be free to establish commercial or cooperative relationships; sellers and buyers should be free to agree on the conditions of sale including, within the limits of governmental regulations, the prices;
- buyers should be free to choose, within limits dictated by the national interest, between domestic and imported goods, and sellers should be free, within the same limitations, to choose between domestic or export markets.

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

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

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

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

organizer of economic progress. That conviction was strengthened by the failure of the attempt, in the mid-1970s, to recentralize the economy; now, further liberalization is viewed in Hungary as the only option.

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

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

6. The present program rests on a substantial tightening of domestic demand and more particularly on a restraint of investment, which will be reduced by over 10 per cent in real terms from 1981 to 1983. The demand for credit by enterprises has therefore been limited by a more active use of interest rate policy, which has brought the real interest rate on loans to enterprises to about 9 per cent in the latter part of 1982; this leaves hardly any scope for further action in this area. Furthermore, to avoid evasion of the credit controls, the substantial liquidity surplus

in the enterprise sector is being sterilized through different measures. Moreover, new investments are heavily taxed except for those in the export sector or those directed toward energy conservation. These actions on investments are supplemented by a reduction in private consumption to be accomplished by various price increases that raised the consumer price index to 9 per cent above its level a year ago, by reductions in subsidies, and by limitations on wage increases. Restraint on public consumption will also be supportive of the balance of payments.

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

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

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

The achievement of the balance of payments objectives requires at times the adoption of measures that go against the trend of a country's accepted policies and seem to contradict the Fund's fundamental options.

Faced with an immediate liquidity shortage, the Hungarian authorities could thus not wait for their earlier measures to produce beneficial effects, but had to impose direct controls on some imports. They are aware that such measures are not consistent with the basic philosophy of their system and should therefore be temporary; being of an emergency nature, they are expected to be phased out gradually as the international financial and economic climate improves.

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

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