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Minutes of Executive Board Meeting 87/55

10:00 a.m., March 27, 1987

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	P. E. Archibong, Temporary
	Jiang H.
	Yang W., Temporary
	D. C. Templeman, Temporary
J. de Groote	H. G. Schneider
	E. Feldman
	M. Hepp, Temporary
	T. Alhaimus
	S. K. Fayyad, Temporary
G. Grosche	
J. E. Ismael	J. Reddy
A. Kafka	H. A. Arias
T. P. Lankester	
	O. Isleifsson, Temporary
M. Massé	D. McCormack
Mawakani Samba	C. V. Santos
Y. A. Nimatallah	I. A. Al-Assaf
	L. P. Ebrill, Temporary
G. Ortiz	V. J. Fernandez, Temporary
H. Ploix	S. de Forges
G. A. Posthumus	
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
K. Yamazaki	M. Sugita
S. Zecchini	N. Kyriazidis

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

Also Present

IBRD: P. Nouvel, Europe, Middle East and North Africa Regional Office. Asian Department: G. Szapary. European Department: L. A. Whittome, Counsellor and Director; B. Rose, Deputy Director; P. Beaugrand, H. B. Junz, G. F. Koppits, H. O. Schmitt, J. Somogyi. Exchange and Trade Relations Department: J. T. Boorman, J. A. Buyse, L. Hansen. External Relations Department: P. E. Gleason. Fiscal Affairs Department: A. A. Tait, Deputy Director. IMF Institute: O. B. Makalou. Legal Department: H. Elizalde, A. O. Liuksila, R. Munzberg. Research Department: J. A. Frenkel, Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; R. R. Rhomberg, Deputy Director; D. Folkerts-Landau, P. Isard, D. J. Mathieson. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; R. W. Furstenberg, O. Roncesvalles. Western Hemisphere Department: L. L. Pérez. Office of the Managing Director: R. Noë, Internal Auditor. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. Bertuch-Samuels, M. B. Chatah, G. D. Hodgson, J. Hospedales, P. Péterfalvy, I. Puro, N. Toé, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, H. Alaoui-Abdallaoui, F. E. R. Alfiler, J. R. N. Almeida, O. S.-M. Bethel, H. S. Binay, F. Di Mauro, W. N. Engert, L. Hubloue, S. King, K.-H. Kleine, M. Lundsager, V. K. Malhotra, T. Morita, R. Msadek, C. Noriega, J. K. Orleans-Lindsay, D. Saha, G. Schurr, H. van der Burg.

1. HUNGARY - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Hungary (SM/87/59, 2/27/87; and Sup. 1, 3/23/87). They also had before them a background paper on recent economic developments in Hungary (SM/87/69, 3/16/87).

Mr. de Groote made the following statement:

My authorities agree with the staff that the years 1985 and 1986 were disappointing, especially in contrast to the success of the policies initiated in 1982-83, which had led to a spectacular reversal in the current account position. They agree that this was not caused solely, or even predominantly, by circumstances outside their control, such as the unfavorable evolution of the terms of trade or the impact of the Chernobyl accident on their trade with the West. The pace of fundamental reform has slowed down from what was initially envisaged, and this slowdown is correctly identified by the staff as the major cause of the unsatisfactory performance over the past two years. This Board had already concluded, two years ago, that progress beyond 1984 depended on decisive additional steps being taken in the direction of market regulators, once the traditional demand-management policies had yielded their full results.

The internal and external uncertainties which, during the past two years, have delayed the continuation of fundamental reform have now been lifted. An internal process of deliberation and discussion has been going on at all levels of economic decision making, starting with grass roots dissatisfaction over the remaining rigidities of the controlled economy and the centralized allocation of resources, and culminating in the adoption of official positions by the Party and the Government. These reform-oriented decisions are clear and irreversible, and have found their most immediate expression in the appointment of determined younger leaders to most of the positions of economic responsibility. These new leaders have found their options strengthened especially by Mr. Gorbachev's impetus toward structural reform. The Soviet leadership is following the course of events in Hungary with great attention. In response, the Hungarian leaders feel it their duty to demonstrate the viability of the Hungarian model, which now more than ever serves as an example for other reformers.

During the 1984 and 1985 Article IV consultations, I shared with the Board my concern about the undue slowness of the reform movement. At that time, the Chairman of the Board effectively provided the reform-minded leaders in Hungary with advice and criticism, and the Board members have greatly aided my authorities to gain the gradual acceptance of the need to accelerate the reform process. I hope the openness with which we have acknowledged the shortcomings of past policies will allow the Board today to accept my view that we are on the eve of a second phase of fundamental reform, a phase of even more radical change than during the period 1982-1984. I am certain that the staff is convinced, as I am, that the entire political environment in Hungary is now ready to take the decisive steps toward establishing a full-fledged market economy. We expect this second phase of reform to be implemented fully before the winter.

At the end of 1987, the value-added tax and the personal income tax will go into effect. The correct functioning of such taxation systems implies that before their implementation the prices of consumer goods and inputs will have become fully cost-related and transparent. A price and salary reform is thus on the way; it will allow for wage differentiation according to performance both within and between enterprises: this is an important step indeed in a country where a worker in industry earns more than an engineer. For that reason, it is a politically courageous step as well. Now is also the time to embody in practical decisions the interdependence between price realism, cost control, and market motivations: prices must be transparent and cost determined for profits to orient the activity of productive units. Subsidies will have to be eliminated to permit prices to become cost related. The taxation of value added and of diversified individual income is predicated on the market determination of prices, and in turn, reinforces the effectiveness of market mechanisms. Of all the factors that are now set into play, the transformation of enterprises into joint stock companies is one of the most revealing features of the reform. It is now widely perceived that the modernization of entrepreneurial functions requires an active role not only of the managers but also of the owners of the enterprise. Economic agents must be motivated to increase the equity value of the enterprise and to enhance its long-term development. The existence of a stock market will sanction the management of the capital value of each enterprise by giving a day-by-day assessment of its activities and policies, while the bankruptcy procedures now in operation will ensure that the entry and exit of productive units occurs in response to economic considerations alone. All in all, it is hoped that the changed role of the enterprises will modernize the concept of the socialized ownership of productive resources.

The banking reform already operational is an essential supporting element of this process of evolution. Further steps will include the liberalization of interest rates, concomitant possibilities for price fluctuations in the value of bonds, and development of means by which the banks can collect their resources from households. The success of joint ventures with the International Finance Corporation, and the openness of the Hungarian economy to direct investment from the West, are other significant signs of the change that is under way.

The liberalization of the economy now being enacted may lead to some temporary pressure on the current account, in the form of expanded input demand, pending the results of the reform of exports. If so, my Hungarian authorities expect to continue receiving the active assistance of the Fund. They fully realize that a program would include demand-management measures to correct the excessive internal absorption of output over the past two years. It is particularly revealing in this connection that yesterday the Council of Ministers decided that the deficit will be cut from Ft 44 billion to Ft 37 billion and that consumer prices will be allowed to increase by up to 9 percent this year. These are decisions preliminary to a more fundamental process, and it is likely that further steps will be taken in these two important areas. In any event, my authorities would like a possible Fund-supported program to be integrated into an overall approach based on the support of the balance of payments effects of the systemic changes they are implementing.

Mr. Grosche made the following statement:

Hungary managed to overcome a severe balance of payments crisis through a successful stabilization program, but the country is again facing large external and internal imbalances. Certainly, Hungary had to face adverse external circumstances in 1986. However, the staff and the authorities seem to agree that the substantial deterioration in Hungary's external accounts has been largely homemade, reflecting a grave mismatch between domestic supply and demand.

After regaining access to international capital markets, Hungary has managed successfully to improve its external debt profile. The breathing space thus created will allow the debt service ratio to continue declining during the remainder of this decade even if the authorities were to address the existing imbalance in a rather gradual manner. However, as the staff's medium-term scenarios show, this would only mean a shift of the ultimate adjustment burden into the future. In the meantime Hungary could well face another confidence problem vis-à-vis the financial markets. I therefore fully subscribe to the staff's assessment that "the external and internal imbalances are such that the time for gradualism is past and forceful action is required now." I also fully share the staff's diagnosis of why and where things have gone wrong in the past two years.

It appears that the roots of Hungary's economic problems are largely of a systemic nature. Concerns about the political and social acceptability of structural change and the preoccupation with other priorities often prompted the authorities to do too little too late, and to give with one hand while taking away with the other. Progress was hampered because the economy received conflicting signals from the authorities. The result was that the ambitious structural reforms did not materialize to the extent initially envisaged. Moreover, while the supply responsiveness of the economy was not sufficiently improved, the authorities' expansionary fiscal and credit policies aggravated the mismatch between supply and demand in 1985 and 1986.

The authorities now face a twofold task: (1) for the more immediate period ahead, they must achieve a substantial tightening of domestic demand by reducing the budget deficit and by reversing the expansionary trend in the growth of the money supply and domestic credit; and (2) they must accelerate the pace and broaden the scope of structural change. While no less urgent than appropriate financial policies, this second pillar of the reform effort needs to be based on a firm medium-term strategy so as to avoid the past shortcomings of inconsistent, ad hoc measures.

On the first point, I welcome the recent decisions described in the supplement to the staff report (SM/87/59, Sup. 1, 3/23/87). If properly implemented, they should help to reduce markedly the existing macroeconomic imbalances. However, the success of the monetary program depends crucially on the actual achievement of the fiscal target, which in turn, relies to a considerable extent on a windfall revenue gain that is unlikely to repeat itself next year. More efforts to place the budget on a sounder footing are therefore warranted. Additional staff comments on the appropriateness of the announced measures would be helpful.

With regard to the second point, I welcome Hungary's efforts to overcome its economic problems by introducing market-oriented reforms. The risks involved in such an approach have been pointed out on several occasions, most recently during our seminar on adjustment policies in centrally planned economies (Executive Board Seminars 86/3 and 86/4, 2/28/86). However, once the fundamental decision has been made to take this approach, success depends critically on the unwavering commitment to follow through. Otherwise, reform measures that are carried out only halfheartedly--or are partially reversed in the process because of pressures from vested interests--are likely to aggravate problems instead of achieving the desired improvements.

Having said this, I endorse the staff's specific recommendations regarding the different areas that need to be tackled. Prices and wages need much better to reflect cost, productivity performance, and relative scarcity. While the authorities have clearly recognized the need for greater flexibility in the wage and price determination system, the measures introduced thus far have met with little success. I appreciate the authorities' concern about the potential conflicts between different objectives and priorities that could arise from moving too rapidly in the area of prices and wages. Nevertheless, I feel that the approach taken by the authorities--to liberalize yet at the same time to interfere through regulations and guidelines--involves high costs in terms of efficiency, without actually achieving the desired increase in flexibility. As the staff points out, the more effective and constructive way to underpin price and wage liberalization would be: (1) to strengthen the financial responsibility of enterprises by allowing them to make decisions on the basis of cost effectiveness; (2) to stop penalizing successful enterprises and supporting inefficient ones; (3) to improve financial discipline by restricting access to credit; and (4) to adapt and rationalize the tax system in order to support greater wage differentiation and strengthen the incentives for productive enterprises.

The authorities have taken a number of welcome steps in this regard, such as the creation of a legal framework for the shutting down of enterprises, and the acceptance of layoffs. These shifts in attitude toward enterprises seem to have paved the way for a more rational managerial behavior. However, it also appears that this alone will not be sufficient to achieve the required change.

The accounting system of the enterprises has to be improved, and I welcome the measures to that effect envisaged by the authorities. In addition, I was impressed by Mr. de Groote's indication that his authorities are thinking about exposing enterprises to market valuation, particularly by issuing shares and having them traded on a stock market still to be established.

The newly created commercial banks would be in a much better position to assume their role of efficient intermediators if they were allowed to increase their capital base and take deposits from private households.

The introduction of a personal income tax and a value-added tax, along with the abolition of the cumbersome present system and the scaling back of subsidies, will greatly assist the reform process. It is hoped that rapid progress can be achieved in this regard, although relatively little appears to have been done to allow for a smooth implementation of the new taxes. Perhaps the staff or Mr. de Groote could provide some additional information on the present status of this reform.

These remarks should have made it clear that I cannot see adjustment and reform succeeding if they are conducted in a piecemeal fashion, especially in the context of Hungary's highly centralized economic system. Liberalizing one aspect of economic life automatically exposes problems in, and inconsistencies with, others. A comprehensive strategy--or in the words of the staff, a clear and coherent blueprint and timetable for reform, together with adequate financial policies--is needed to achieve the medium- to long-term objectives. The staff's alternative scenario provides useful guidance, but the results are by no means the maximum that could be achieved if Hungary's economic potential were allowed to unfold properly.

Mr. Fernando made the following statement:

Hungary is adopting a policy framework intended to promote adjustment in many areas of the economic and financial system based on the market mechanism. For a country that has relied on state planning and execution to determine resource allocation, this is conceptually and in practical terms a fundamental transition, although the beginnings are hesitant. The timely and effective implementation of the required measures calls for attitudinal change not only on the part of policy formulators, but at least equally, of those with responsibility for implementation. It involves an accommodative public consciousness together with confidence in the objectives and the methods of achieving them. In this respect, we recognize the authorities' continued acceptance of the policy framework for adjustment.

A period of promise and achievement in the initial phase of reform has given way to doubt and uncertainty, to the point of eroding many of the gains. No doubt exogenous factors like the weather and reverses in the export market have inflicted losses on living standards, but ultimately the adjustment effort is intended to secure the resiliency of the economy in the face of such destabilizing events.

Given the degree of openness of the Hungarian economy, improving and maintaining a sustainable balance of payments is a priority. In fact, to meet the target of 2 percent growth that was set in the November 1986 policy review, a two thirds contribution is expected from the balance of payments outturn. This is dependent on, but also feeds back into, the modernization of the economy--in particular its industry--greater efficiency, and improved productivity.

Hungary made remarkable improvements in the initial years of its reform efforts, which were supported by stand-by arrangements with the Fund. The upturn was recognized quickly by the international financial community, which helped the country to improve its debt profile and build up reserves through increased access to the capital market on competitive terms. This increased access could, however, be self-defeating if the improvements are not safeguarded and reinforced. A high level of external debt and a high debt service ratio require a clear and sustained impetus in the external sector, and also further increases the vulnerability of the economy to developments in the world economy. In the event, the past two years recorded deficits that were financed by considerable market borrowing.

It is a matter for concern that the lack of complementary policy action, inadequate and delayed responses, and poor implementation despite agreements in principle have all contributed to a difficult economic situation. Throughout 1986 and even as recently as March 11, 1987, the exchange rate has been adjusted with a view to improving competitiveness in foreign markets. At the same time, the continued tendency of the authorities to influence prices administratively has diluted the market stimulus provided by exchange rate action.

Hungary's fiscal performance has been disappointing, with expenditure continuing to climb while revenue gathering has declined, partly as a result of the failure to implement agreed policy. In particular, the subsidies to meet inflation targets and the capital transfers to loss-making public enterprises have been a large drain on the budget. In a situation in which job vacancies exceed the number of unemployed workers, the authorities' preoccupation with guaranteeing the same job for current workers, while at the same time acknowledging the need for restructuring, is difficult to understand. Industrial restructuring, which inevitably involves retrenchment and redeployment of the work force, should be more tolerable in Hungary than in most countries undertaking adjustment programs in the face of high unemployment and an increasing labor force. Hence we welcome the latest actions taken by the authorities to reduce these supply-side rigidities--such as the bankruptcy law and the allowance for transitional unemployment, as well as the job relocation support scheme and retraining arrangements. We urge the authorities to accelerate sharply their implementation of these policies. Staff comments on the adequacy of these measures would be helpful.

The authorities are looking to a large extent to the newly established banking system to help enforce financial discipline on the enterprises. It has been quite rightly pointed out that this is very much a function of the banking sector's ability to appraise the creditworthiness of an enterprise. Indeed, it is difficult for the authorities to ensure such financial discipline and difficult for others to judge performance.

Both before and since the decentralization of banking, the loss-making enterprises have had ready access to financial support--directly from the budget or from bank credit. Given the prevalence of subsidies and exemptions, the calculation of operating surpluses or deficits is hazardous. State enterprises are undercapitalized. The dividing line between working capital requirements and loss-financing becomes quite thin. Moreover, one wonders whether sufficient experience exists in the state banking sector that can be relied upon to differentiate between the viable and nonviable enterprises--and whether the banking response could extend to the rehabilitation of nonviable enterprises. We raise these questions not to emphasize doubt, but rather to focus on the need for other supporting policies to enforce better financial discipline.

We hope that the rapid implementation of the authorities' intended enterprise restructuring, and the curtailment of budget expenditures on account of price adjustments, will help to restrain monetary expansion, which has reached a dangerous level, and is incompatible with program objectives, as well as with the current liquidity overhang. We would also urge the authorities to reinforce and supplement the measures to enhance the impact of the decentralized banking system. In particular, the authorities should review the policy of not allowing commercial banks to intermediate the financial resources of households. I am happy to hear from Mr. de Groote that this matter has already been contemplated and that action is expected soon. The types of financial paper that have emerged to facilitate financing offer an advantage in this area.

We would, however, sound a note of caution in respect of refinancing credits. The authorities are fully aware that this is an infusion of primary credit to the system. Better budgetary discipline will be blunted in its impact if refinance windows, under government impetus, are open too wide. The end use of such credit is frequently difficult to monitor and the numbers seeking such facilities will swell as the restructuring effort takes effect. Hence we welcome the most recent decision to limit the refinancing available to each bank to a factor of the state's share in the equity.

Hungary has demonstrated once to the satisfaction of the international financial community that it has the will and potential to seek a greater integration and cooperation with the international economy. The World Bank has a large ongoing program there. We would be happy to see the authorities seek a companion arrangement with the Fund in order to put the adjustment mechanisms back on track, on a more secure and lasting basis. We support the proposed decision.

Mr. Templeman made the following statement:

We generally concur with the findings in the staff report and we share the staff's and, apparently, the authorities' disappointment at the pattern of economic developments in Hungary in 1985-86. Our disappointment concerns more the opportunities that were lost over the past two years to improve Hungary's long-term economic outlook than concern about the immediate deterioration in economic performance itself. A number of important structural reforms aimed at increasing the role of markets in allocating resources have been moving forward, but to date, these reforms have not been sufficiently comprehensive, nor have they been implemented consistently and continuously. Moreover, in the past two years, they have not been supported by complementary financial policies. One gains the impression that an underlying ambivalence, inertia, and inconsistency in policy formulation and implementation have been the main source of rather piecemeal reforms and of stop-and-go financial policies during this period. In that connection, Mr. de Groote's statement this morning does provide some reassurance.

If Hungary is to achieve a more acceptable level of economic growth and a more sustainable balance of payments and foreign debt position, then a favorable environment must be created for the reallocation of labor and capital resources. The management of enterprises must have sufficient autonomy to be able to take advantage of economic growth opportunities, and a way needs to be found to create incentives for enterprise management to pay greater attention to economic efficiency and profitability, both over the short term and in the longer run. If markets for goods, labor, capital, and foreign exchange are sufficiently liberalized, then managements will be exposed to the test of the market, and the need for constant government intervention will be reduced greatly. In other words, enterprise management needs to be rewarded for success, and penalized for failure. It should be possible for new enterprises to enter the field and, if necessary, for old ones to fail.

There are some encouraging signs in the labor field. For example, the chronic shortage of labor could permit greater labor mobility to be achieved, with relatively little danger of increased unemployment. However, the labor shedding that should ensue needs to be selective, based on the result of enterprises facing a true test of relative productivity and profitability. Other positive factors include changes in law and attitudes with regard to the acceptance of the need for greater wage differentiation to facilitate labor mobility; a willingness to tolerate some frictional unemployment, the approval of financial assistance for job relocation; the introduction of a personal income tax so that the motivation to work in the socialist and private sectors of the economy will be based on economic factors and not on artificial tax incentives; the adoption of legislation that would allow loss-making firms to go bankrupt while allowing healthier firms to take over the assets of such sick companies; and the creation of a banking system with the possibility of credit allocation based on company-specific credit evaluations. Of course, while these changes in law and attitudes create a potential for more efficient allocation of capital and labor, they do not ensure it.

Despite these movements toward reform, government intervention still tends to impede the desired resource reallocation in several ways. These include continued wage and price controls, preferential credit arrangements, and fiscal subsidies and tax incentives combined with high tax rates on successful enterprises.

Some progress has been made in recent years in relaxing price controls and in adjusting administered prices. However, the significance of the abolition of the "competitive" pricing method mentioned in the supplement to the staff report (SM/87/59, Sup. 1, 3/23/87) is not clear, and we would welcome staff comment. In any case, the price control and monitoring system still seems complex and intrusive. A more complete and automatic pass through of exchange rate adjustments would help to align domestic prices with those in international trade, and more transparent and realistic enterprise pricing would be possible, if special fiscal and monetary privileges and penalties were largely eliminated.

The staff seems to conclude that the effects of public tax and expenditure policy on the enterprise sector have been perverse, tending to subsidize inefficient enterprises, while taxing the more efficient ones to finance such subsidies. However, the comprehensive tax reform to be introduced in 1988 with the advent of a value-added tax and a personal income tax should help to reduce the burden of taxes on enterprises, simplify the tax system, and reduce the distortions that have been created by the widespread use of differential tax rates and special tax incentives and exemptions. Nevertheless, we share the staff's concern about the authorities' failure to prepare the way for these major tax reforms by more comprehensive price deregulation, a reduction in the number of turnover tax rates, and a dismantling of wage regulations and related taxes on wages.

The significant rise in the budget deficit last year has added to the problem of monetary management, particularly in the context of rather underdeveloped monetary tools and financial markets. Credit developments in 1986 led both to an excess of credit expansion and to a pattern of credit allocation whereby much of the growth of credit was used to finance a rising budget deficit and to provide for working capital, rather than to finance long-term productive investment. The supplement to the staff report indicates that these developments were more adverse than originally believed, but that the authorities are taking measures both to reduce the expected 1987 budget deficit and to rein in and redirect credit and monetary expansion this year. Staff comment on these latest measures would be helpful.

At the same time, further progress is needed in developing Hungary's financial markets. Some quite positive steps have already been undertaken in the form of creation of the new banking system, the decontrol of interest rates on credits and deposits with enterprises, plans for the use of new tools of monetary management by the National Bank, and the emergence of a modest bond market. Nonetheless, more ambitious measures could be adopted to permit the banks to collect deposits both from enterprises and households, and to lend to both sectors. Such an expanded financial role for the banks would permit a reduction in the large-scale and growing intermediation of financial flows through the budget, and would permit the banks to exert an independent role in the allocation of scarce capital. However, a system of true cost accounting for business may be a necessary precondition for effective risk assessment and credit allocation by the new banks. In addition, the growth of a securities market where enterprises could tap financial savings, without the crutch of government guarantees, would also provide a test of economic efficiency.

Turning to the external accounts, one cannot help but be disappointed to see the sharp shift in the current account balance in convertible currency from a surplus of about $300 million in both 1983 and 1984, to a deficit exceeding $1.4 billion in 1986. Furthermore, the targeted deficit of $0.7 billion for 1987, while lower than the 1986 deficit, is still substantial, and doubts remain as to whether it can be achieved. Admittedly, the exchange rate adjustments since 1986 must have gone some way to preserve Hungary's international price competitiveness, but the policies to shift supply and demand relationships away from domestic absorption into exports do not seem to be fully in place.

Over the medium term, the staff's balance of payments and foreign debt scenarios are not altogether reassuring, with debt and debt service ratios in 1991 of 58 percent and 34 percent, respectively, under the basic scenario, and 51 percent and 31 percent, respectively, under the front-loaded adjustment scenario. Policy measures to accelerate and strengthen the pace of adjustment beyond that in the basic scenario would certainly seem to be worth pursuing. Careful attention also needs to be given to protecting Hungary's access to international financial markets. Over the past couple of years, the use of foreign borrowing for partial early debt repayments and for lengthening maturities and reducing costs has improved Hungary's debt profile, but such easy access to credit may also have delayed economic adjustment. In the meantime, growing current account deficits cannot help but have an adverse effect on Hungary's creditworthiness.

In conclusion, some very positive structural reforms are under way, but this reform effort needs to be carried forward in a more comprehensive and consistent manner, and it must be accompanied by more restrained fiscal and monetary policies. The staff report mentions a high-level policy review that was to produce revised policies for 1987 and a new three-year adjustment program from 1988 to 1990. We would welcome a clarification from staff concerning the relationship to this policy review of the fiscal and monetary measures described in the supplement, and we wonder whether any additional information is available about the status of the three-year adjustment program.

Mr. Fernandez made the following statement:

Some of the doubts expressed by Executive Directors at the 1985 Article IV consultation with Hungary (EBM/86/7, 1/13/86) regarding the prospects for the economy were well founded. A combination of external factors and expansive demand management policies resulted in a deterioration of the balance of payments and the fiscal deficit. Nevertheless, we support the authorities' efforts to implement fully the structural reforms already initiated or planned, since they point in the right direction. However, these reforms should be adopted in a stable short-term macroeconomic environment. In this regard, developments in 1986 did not help to make the economy more efficient and open, nor did they facilitate the implementation of the proposed reforms.

The stop-and-go macroeconomic policies that have been put into practice in recent years do not maximize the medium- and long-term growth potential of the economy. More stable and preannounced policies would enhance the attainment of balanced growth and would aid the implementation of structural reforms. Shifting policies reduce credibility and give misleading signals to economic agents; as a result, economic efficiency suffers. A short-term policy mix should attempt explicitly to control the rate of inflation, reduce the current account deficit, and obtain a balanced growth of internal and external components of the GDP. It should be recognized that negative exogenous factors in 1986 have contributed to a worse than expected performance of the economy, as far as the growth rate and the current account balance are concerned. However, expansionary fiscal and monetary policies do not seem to be the correct response to deal with external and internal difficulties. The balance of payments is an effective bottleneck that will become a problem if internal financial discipline is not maintained. Given the multiple rigidities and interventions on the supply side of the economy, one should not expect a sustainable growth path from demand-management policies.

We welcome the authorities' intention to decelerate sharply the rate of credit expansion in 1987, which was one of the more negative aspects of economic developments in 1986. The fiscal deficit, which is fully monetized, was 3.7 percent of GDP in 1986, compared with a surplus of 2.7 percent of GDP in fiscal year 1984. These numbers represent a dramatic shift in the fiscal accounts, and it is necessary to stop this trend, which seems to be linked historically to the deterioration of the current account. We believe that the authorities recognize the danger of the present fiscal policy stance, as they have announced that they will try to reduce the fiscal deficit in 1987. The other main source of credit acceleration was the increased recourse to working capital credits by enterprises. We also welcome the intention of the authorities to deal with this negative aspect of the monetary program.

The external sector accounts deteriorated markedly in 1986, as a result of both exogenous factors and expansionary fiscal and monetary policies. Nominal devaluations aimed at depreciating the real effective exchange rate will not be successful if they are not accompanied by restrictive monetary policies. Repressing the rate of inflation can show a temporary gain in competitiveness, but this approach of giving wrong price signals to the economic agents will be harmful in the medium term. The exchange rate--an endogenous variable--will eventually reflect mainly inflation differentials. In this context, artificial incentives to exports would produce an allocation of resources that would not be in line with international relative prices. We are encouraged to see that no changes were introduced in the quasi-automatic import licensing system in 1986, and that, in addition, a small but telling reduction in import tariffs has recently been put into practice. To control the cost of servicing the debt, consistent and comprehensive measures should be implemented to increase internal savings in order to reduce Hungary's highest current account deficit in recent years.

This chair supports most of the structural reforms that the authorities have undertaken to provide the economic system with market signals for the allocation of resources. Although the authorities continue to intervene in fixing prices and monitoring the economy, significant progress has been achieved in several areas of the economy and new liberalization measures are under way. The authorities are correctly aiming most of these actions at increasing the efficiency of the economic system by promoting rational enterprise behavior.

Progress has been made in some key areas. Positive developments in the financial system include the newly established banking system that involves greater decentralization, the liberalization of interest rates on enterprise credits and deposits, the beginning of a capital market including the development of a secondary market, and the adoption of a bankruptcy law. With regard to the tax system, the authorities have announced that the value-added tax and a comprehensive personal income tax will be implemented without delay. Positive developments in the labor market range from the recognition of frictional unemployment to a greater wage differentiation and labor mobility.

In conclusion, this chair would like to encourage the Hungarian authorities fully to put into practice their reform program. To increase efficiency and growth potential, the authorities must, at the same time, support the above-mentioned reforms with a stable and coherent macroeconomic policy management, because it is very important to make reforms credible and irreversible.

Mr. Sliper made the following statement:

Some of us, when reviewing the economic policies of centrally planned economies, approach the task with some trepidation. In part this trepidation rests on the fact that many of us have been trained in western universities, and are in the business of providing policy advice to governments based on the premise that the majority of goods and services can be allocated most efficiently by the market. In part, however, my trepidation is based on questions as to the compatibility of a centrally planned system with a system in which a considerable proportion of resources and decision making is in private hands.

Hungary provides an interesting case study in this regard, especially as it has declared publicly on several occasions that it wishes to move more vigorously to a system in which prices and incentives play a fuller role in allocating resources, and in which there is greater decentralization of decision making. Mr. de Groote's remarks indicate that this stance is going to be pushed even faster and that Hungary is readying itself for a second reform era.

The central conclusion of the staff report is that a large gap exists between the general direction of change and the specific policies and programs; stated more crudely, there has been a gap in the past between the rhetoric and the substance in respect of economic management. The authorities seem to want to loosen some of the controls and regulations surrounding the enterprise sector but have not been able to do so consistently and coherently. The State's role seems akin to a hand on a sponge: it removes a series of controls at one time but then reimposes them in another form somewhere else, with the effect that prices are not able to reflect fully supply and demand considerations.

One of the vital lessons that has been brought home to western governments in the past ten years is that actions aimed at fine tuning the economy are unlikely to succeed, but it seems that this lesson has not been fully absorbed in Hungary. Certainly in the area of taxation of enterprises, an array of taxation measures has been substituted for another, all designed to modify economic behavior in a variety of ways. I must admit to some sympathy with senior and middle managers in Hungarian enterprises who have tried to keep track of all the rules and regulations surrounding taxation and wage policy over the past few years. Although I found the discussion of these reforms fascinating reading, the administrator in me recoiled at the thought of having to translate these measures into guidelines and then to set up procedures to monitor performance.

Two other lessons have been brought home to mixed economies in the last ten years: (1) the damaging effects of stop-and-go policies aimed at using the budget as a stabilizing instrument; and (2) the vital importance of controlling money and credit and ensuring that domestic credit expansion does not get out of line with underlying growth. Again, neither of these lessons appears to have been absorbed in Hungary; 1986 was a bad year for the authorities in respect of both fiscal and monetary policy. Management in both areas was poor, but perhaps the most disturbing feature is the speed at which the deterioration was allowed to occur. The two-year turnaround in the budget balance--from a surplus of 2.7 percent of GDP to a deficit of 3.7 percent--represents a dramatic change. Similarly the 14 percent growth in M2 clearly represents an accommodating monetary stance.

The supplement to the staff report suggests that the authorities are aware of the extent to which monetary and fiscal policies were allowed to deteriorate. However, there is a lack of specifics on the fiscal and monetary policies, and on how they will be tightened. Admittedly the authorities have moved on the exchange rate, but I have doubts on the effectiveness of this move in isolation, given the formal and informal indexation mechanisms existing in the economy.

We do get the impression that the authorities have prepared the way for an economic policy direction that is more market oriented and outward looking. We agree with the staff that it is now timely for the broad intentions to be translated into a coherent package of policy reforms. The imbalances that have occurred add urgency to the need for the authorities to give up the strategy of fine tuning and stop-and-go budgetary policies and to embark on a more radical reform path. This comment applies especially to the areas of the public enterprises and tax policy. In the public enterprises, incentives and prices must be allowed to flow through more effectively than in the past. While some important framework measures have been put in place--for example, the bankruptcy provisions--real reform can only come about if managers have more effective control over prices, with the requirement that the central agencies loosen their grip on price setting.

The Government is preparing the public for a major reform of the tax system. However, the staff report suggests that the direction is far from clear and that the necessary groundwork is not in place. We would urge the authorities to give careful consideration to the tax reform strategy. Opportunities for meaningful tax reform do not come about that often, and piecemeal reform can be very damaging to the introduction of an efficient, neutral tax collection system.

In conclusion, we wish the authorities well and urge them to come up with a more forceful program of economic reform coupled with an urgent tightening of financial policies.

Mr. Pineau made the following statement:

It is always saddening to observe how rapidly one country's economic situation can deteriorate when appropriate policies are no longer followed. In Hungary it seems that, unfortunately, both the short- and long-term policies have been inaptly oriented since 1985. It is clear from the staff report that the economy was not in a position to respond flexibly to a sustained domestic demand expansion fueled by a lax wage policy and a strong fiscal impulse. Recently the structural reforms have been so hesitant and inconsistent that they have actually weakened the overall functioning of the economy. As a consequence, the authorities must now address the dual problem of short-term financial stabilization and medium-term rehabilitation of economic structures.

Some corrective measures aimed at reducing the current imbalances have recently been taken; I would like to raise some questions about the adequacy of these decisions in the present context. First, on the budget side, the reduction of Ft 10 billion in the fiscal deficit planned for this year amounts to 1 percent of GDP, which is in addition to another 1 percent cut already scheduled for 1987 in the initial budget. Given the magnitude of last year's fiscal deterioration--2.4 percent--this curtailment does not appear excessive. Moreover, the retrenchment could have been brought about entirely by cuts in outlay instead of having half of it stemming from additional revenues. Staff comments on the size and composition of this fiscal package would be helpful. Second, in the light of the widening current account deficit, the new depreciation of the currency seems warranted. Nevertheless, some reservations can be reasonably expressed about the effectiveness of the adjustment, since the corporate sector is not allowed to pass it through to domestic prices, except for energy. This rigidity of the price system, which partly results from the will to promote exports, leads me to deal briefly with some of the structural problems of the economy.

A few systemic weaknesses are likely to act as a drag on the medium-term growth potential, and we encourage the authorities to tackle them. The overwhelming burden of the government sector remains a basic feature of the Hungarian economy. Total fiscal revenues and expenditures still account for more than 60 percent of GDP. To a large extent this public involvement is self-defeating, since many special subsidies or incentives are offset by countervailing ad hoc taxes or levies. As long as the central authorities insist on having a hand in every aspect of economic activity, their quest for a more market-oriented economy will remain fruitless. In this respect, we would like to remind the authorities of the very promising steps they took at the beginning of this decade to liberalize their economy, and to urge them to reassert their political will so as to follow through this initial line. Mr. de Groote's remarks are a clear indication that such a will does exist.

The promotion of a more efficient process of mobilizing and allocating available resources should also retain all the attention of the authorities. The repressed rate of inflation, which is a serious hindrance to the conduct of economic policy, should be tackled in a more open way. To this end, a much more thorough reshaping of the financial system would be instrumental, and it should involve, inter alia, a less subservient position to the Government's financing needs. It would help reorient the financial system toward intermediating household savings and corporate investments. A move in this direction also appears to be a precondition to significant modernization of monetary policy techniques.

The international financial community is very sensitive to the developments in Hungary. The authorities' previous official commitments have created high expectations; we hope that they will now implement policies more in line with their declared intentions.

Mr. Lankester made the following statement:

Like Mr. Sliper, I approach the task of commenting on a centrally planned economy with some humility. I welcome Mr. de Groote's indication to the Board that decisions are being taken that will lead to the establishment of a fully fledged market-based economic system. As Mr. de Groote has suggested, after the disappointments of the past few years, the economy now seems to stand at a crossroads.

The authorities have already implemented a number of measures to strengthen the performance of the economy. Although many of these measures went in the right direction, they have been piecemeal in nature and on occasion have had to be overridden by administrative and other controls. The overall results of these efforts perhaps have not been as great as some had hoped. The growth performance in particular has been disappointing, at about only 1.5 percent a year since 1979. At the same time, the balance of payments has weakened significantly, with the current account showing a deficit of nearly $1.5 billion in 1986. The deterioration of the current account position has also been associated with a further rise in the debt burden.

The Seventh Five-Year Plan, which was adopted in early 1985, downgraded the importance of improving the external position, and attempted instead to give greater priority to strengthening growth and living standards. While I can understand the pressures that led the authorities to such a shift, I wonder whether the apparent conflict they perceive between growth and strengthening the external position is a real one. It seems to me that these objectives could be tackled simultaneously by measures to improve the operation of the economy. Indeed, that is probably the view of the authorities now in the light of the sort of reforms they are planning to initiate. Before commenting on individual policy measures, I should note that if any further package of measures is to be successful, it must be both comprehensive and consistent. I agree with the staff and Mr. Sliper that even if piecemeal policy reforms are in the right direction, they may have negative side effects if they are not supported by consistent policies in other areas.

The authorities clearly recognize the need to make enterprises more accountable for their own performance. As the staff puts it, "a first priority is to stop taking resources from the healthy to give to those with little or no viability." The measures to introduce bankruptcy and to link managerial pay more closely with performance both work in this direction. As the staff suggests, more needs to be done to strengthen financial responsibility. The recent reforms of the banking system should help in this respect, but the present complex system of subsidies, transfers, and artificial prices makes it difficult to establish the economic returns being generated by different firms. A more widespread review of the accounting framework would appear to be in order to improve the relationship between financial and economic performance. Furthermore, although the reforms of the banking system are helpful, they are still fairly limited. A considerable amount remains to be done if distortions in effective interest rates are to be removed. The role of the banks is also limited to some extent because they are generally unable to carry out the usual function of intermediating the flow of savings between the household and corporate sectors.

A related issue is to ensure that resources are used efficiently. With the marked labor shortages that characterize the economy, it is clearly important for the wage determination process to contribute to ensuring that resources are allocated efficiently. The authorities have made significant efforts over recent years to tackle this problem, but the fact that there have been three major overhauls of the wage system in the past six years suggests that they have yet to find the ideal solution. Part of the difficulty seems to have been that other demand policies have not supported the wage reform process and that the authorities have therefore had to use the wage system to try to achieve a range of objectives simultaneously.

In this connection, I was encouraged to see that the authorities are considering introducing a personal income tax. This should help to improve the neutrality of the system by ensuring that earnings from different sources are equally taxed. It would also seem to be a useful way of achieving the authorities' social objectives while allowing some widening of the wage distribution, which is currently very compressed. If this reform effort is to be effective, however, it will presumably be necessary to relax the system of wage controls; otherwise, the introduction of the income tax, without simultaneously allowing for some widening of differentials, could be counterproductive.

Again, reform in one area will obviously need to be supported by policies in other areas. Wage reform that is not supported by appropriate aggregate demand policies would be at best ineffective, and at worst, damaging. At present, excess demand seems to have resulted in a significant liquidity overhang. This poses a major threat to the reform process, because if it is not tackled, there is a danger that any price or wage liberalization will be reflected rapidly in pressures on the authorities' inflation objectives. It is the problems of controlling wages against this background that have led the authorities to impose such a complex system of regulations. The maintenance of appropriate demand policies would help to allow the modification of this system, which seems to include marginal tax rates of up to 500 percent.

Similar considerations also apply to the price system. Further measures to liberalize and to simplify the price system would obviously be desirable. They are only likely to be effective, however, if they are supported by adequate demand policies; if not, there are only likely to be pressures for administrative intervention either in the form of direct controls or by means of increased subsidies. In this connection, I found the staff's description of the price determination system interesting. I note, from the supplement to the staff report, that some modifications to the system have been announced recently, and in particular that the "competitive" pricing method has been abolished. Two questions arose from this: has the operation of the overall price system in recent years allowed significant changes in relative prices, and how does the staff regard the abolition of the so-called competitive method?

The need to ensure that the price system works effectively is also relevant to the important question of strengthening the external position, which weakened very sharply in 1986. If the recent devaluation of the forint is to be effective in increasing incentives to export, it will obviously need to be allowed to feed through into domestic prices and particularly into relative prices.

In conclusion, I can only agree with the staff that, in the light of the deterioration in the internal and external imbalances, the time for gradualism is now past. Continuation of the present situation is not only likely to undermine the confidence of the international financial community, but it also seems unlikely to achieve the strong growth that the authorities desire. However, such a package needs to be comprehensive and mutually consistent if it is not to prove ineffective and lead to a further reliance upon administrative controls.

Mr. Isleifsson made the following statement:

The staff report succinctly describes the adverse situation of the Hungarian economy and the deep-seated structural problems with which it is beset. I am in general agreement with the staff appraisal.

The Hungarian model involves a mixture of a centrally planned economy and a market-oriented economy; however, in view of the inefficiencies in the economy, one cannot help having serious doubts as to the merits of this mix. Thus, I welcome the indications that Hungary is set to go all the way toward a fully fledged market economy, and Mr. de Groote's statement was certainly encouraging in this connection. Only by thorough and comprehensive systemic change can greater efficiency be brought to the economy.

A transparent price system is of primary importance to signal relative scarcities and to guide resources toward their most productive use. Only a transparent price system can engineer a cessation of the practice of extracting resources from healthy enterprises to allocate to those with little or no viability. Wages have to be formed in a more flexible manner to reward individual work effort and to create incentives for efficiency in the workplace. I share the view of the staff that for reasons of both economic progress and social equity, a more result-oriented wage system needs to be implemented.

The staff is correct in pointing out that liberalization of the wage and price system requires appropriate changes in the tax system and in recommending an early adoption of the proposed modified personal income tax. I support the staff's recommendations pertaining to the implementation of a value-added tax, together with an abolition of the investment tax.

While I welcome the recent reform in the banking system, this can only be considered a first step. The fiscal budget now carries the intermediation function. The banking reform has to be followed up by allowing banks, along with the capital markets, to become the main channel for the intermediation of financial resources. A second major step is to liberalize the setting of interest rates, together with deregulation of the banking system so that banks can gather deposits from and lend to both households and enterprises.

I also welcome the steps the authorities have taken to encourage enterprises to make decisions on the basis of cost effectiveness, and I note the modification of the law on corporate associations. It would be helpful to have staff comments on the authorities' policy with regard to ownership of enterprises and on the extent to which an increased role for the private sector is envisaged.

The staff makes a strong case for tightening demand, and I support its view on this issue. The authorities ought to consider, however, that the traditional demand-management policies--including monetary, fiscal, and exchange rate policies--can hardly be fully effective in the absence of fundamental structural reforms. Exchange rate policy has to be supported, inter alia, by a transparent price mechanism capable of transmitting such stimuli. Furthermore, monetary policy is likely to be impaired in a system in which financial intermediation, to a large extent, is effected through the fiscal budget and in which interest rates are set at the authorities' discretion.

Hungary cannot afford to repeat the experience of the past years, with loose financial policies and only timid efforts to implement systemic structural reform. Despite accommodative financial policies in recent years, and a sizable accumulation of external debt, growth in the economy has been sluggish. It is disturbing that, given the size and structure of the external debt, more than half of export receipts in convertible currencies are required to service the debt. The recent worsening of the external accounts--with the combined current account deficit in 1985 and 1986 estimated at about $2 billion--is a source of great concern. However, Hungary has built up substantial official reserves, estimated at end-1986 at 7-8 months of imports. I would appreciate any comments from Mr. de Groote or the staff on the authorities' reserve and debt-management policies.

Sluggish growth, the substantial external deficit, the accumulation of debt, and loose financial policies all suggest that the economy is on an unsustainable course. Welcome initiatives for reform have been taken, but they are not enough. However, Hungary may now have a unique historic opportunity to move toward the twin goals of efficiency and equity by allowing market forces to play their role, reducing administrative controls, and eliminating the excessive regulation of the economy. I welcome the authorities' efforts to outline a comprehensive program designed to improve efficiency in the economy and to contain the economic imbalances, and I urge them to move forcefully in their reforms. Hungary has already completed two stand-by arrangements. Have there been any discussions between the staff and the authorities on possible Fund support for any additional arrangements?

In conclusion, the piecemeal approach has been tried and found wanting in Hungary. What is required is decisive, quick action.

Mr. McCormack made the following statement:

I share the trepidation expressed by Mr. Sliper and other Directors, because I cannot claim to have any expertise concerning the operation of nonmarket economies. My first point concerns the direction in which the Hungarian economic system is tending to go. Hungary used to be advanced by some observers as a model of how to achieve an appropriate transition from reliance on administrative controls toward the use of market mechanisms. However, it is clear from the staff report that this picture would have to be fairly heavily qualified today. The staff refers in its appraisal to "a forest of regulations" and "a plethora of exemptions and special incentives," even as the authorities debate the merits of further reforms. The authorities have tended to fall back upon greater reliance on administrative controls when shortcomings or frictions in the reform process begin to emerge. This is not to say that the authorities have abandoned their efforts to produce major structural reforms, and Mr. de Groote's statement was very encouraging in this regard. The point is rather that, in the face of unexpected difficulties of economic management, what might be called the administrative reflex has tended to reassert itself. The result has been an accretion of controls, with loopholes being stemmed by the tightening of one administrative measure or another, and it is difficult to determine the overall economic impact of the measures in effect.

Two examples illustrate how practice has fallen short of precept. First, in the tax area, the authorities are pledged to the introduction of a personal income tax system and a system of value-added taxation. However, there remains in place a system of turnover taxes numbering no fewer than 100. Second, the system of wage policy is intended to conserve labor by means of an extremely complicated scheme of differential taxation of earnings. However, the actual impact of the wage system has been to narrow wage differentials unduly, with consequent adverse effects on the allocation of scarce labor resources. To some extent, the problem has been that the authorities have tried to achieve more than one objective, using a single policy instrument. They have attempted to restrain demand pressures through incomes policy, and also to increase the mobility of labor and the allocative efficiency of the labor market. The result, however, is that the authorities have fallen between two stools and indeed may have exacerbated some of the rigidities of the labor market.

The conclusion one quickly reaches is that hesitant, piecemeal implementation of reform has given rise to conflicting signals. What seems to be called for now is for the authorities to give renewed vigor to the reform effort by reaffirming the direction of the reform and by establishing concrete calendars for the achievement of key tasks. This is more easily said than done, as the dismantling of a complex administrative system obviously gives rise to timing and phasing difficulties. The staff rightly points out that what is required is the "formulation of a clear, coherent blueprint and timetable for the economic reform, together with a marked tightening of financial policies."

A priority of the reform effort must be the enforcement of effective financial discipline on the enterprise sector. The network of subsidies, taxes, and tax exemptions for enterprises has made it nearly impossible to separate profitable enterprises from loss-makers, and greater transparency of the balance sheets therefore should be given high priority. The first step has been taken by the adoption of the new bankruptcy law, but more needs to be done. The complicated system of wage controls should be simplified and liberalized. Price controls, whether enforced formally or through moral suasion, have to be eased, and subsidies should be reduced or eliminated. The latter points are particularly important if the recent devaluation of the forint is to be successful. Enterprises need to be informed that if they are inefficient, they will not be rescued by budgetary subventions. Finally, managers of enterprises should be reassured that the pace and direction of reform will not be altered in order to meet purely temporary setbacks. The cycle of stop-and-go measures has to be reversed.

Reform efforts in the real sector of the economy need to be complemented by measures of financial reform. The introduction of the new banking system represents a very significant step in this direction; however, I would urge the authorities to go further. The present financial system is marked by a nearly complete separation in financial intermediation between the enterprise and the household sectors. Household savings are placed with the national savings bank and savings cooperatives, and these in turn make advances primarily for mortgage finance at highly subsidized rates of interest. There is no means at present for household savings to be used by the enterprise sector. While acknowledging how much has been achieved in recent years, I would urge the authorities to give a high degree of priority toward remedying this failure of financial intermediation. I would also encourage them to develop further the somewhat limited capital markets within Hungary.

In this connection, I noted that recent legislation has been passed to permit the creation of joint stock and limited liability companies by legal entities, that is, by enterprises and cooperatives. I wonder whether, in the context of improving financial intermediation in Hungary, there might not be scope for extending this legislation to private individuals in order to encourage the development of an equity market.

Finally, I would like to raise one question on which the staff or Mr. de Groote might wish to comment. If what is required in Hungary's present circumstances is a greater commitment to the process of economic reform and macroeconomic stabilization, I wonder whether it is opportune for the authorities to consider a stand-by arrangement with the Fund. Such an arrangement might promote what the staff describes as a front-loaded adjustment process with a consequent favorable impact on the balance of payments in the medium run.

Mr. Kyriazidis made the following statement:

The deterioration of the economic situation in Hungary in 1986 is disturbing. The slowdown in economic growth, the deterioration in the external accounts, and the increase in the external debt burden as well as in inflationary pressures compose a rather dark picture. Some external developments such as a substantial deterioration in the terms of trade and the adverse effects of the Chernobyl accident appear to have contributed partly to these results.

I agree with the staff that the worsening economic situation in Hungary is attributable chiefly to significant slippages in macroeconomic policies in part caused by, and in part compounding, structural and regulatory weaknesses. The system contains many contradictions, reflecting perhaps the stage of development of the structural reform initiatives undertaken by the authorities. These reform initiatives provide the potential for a much-improved basis for regaining sustainable growth, and this is to be warmly welcomed. However, managing the evolution of a centrally planned system toward a structure that will enhance its supply flexibility and capability of response to growth stimuli is obviously an extremely complicated and time-consuming task. The cohabitation of a socialist structure and market-oriented mechanisms is not a comfortable one, and resolving the contradictions inherent in such a cohabitation requires clear choices and the political determination to apply them, without the ambivalence that the staff appears to discern in the Hungarian authorities' attitude. The authorities have given conflicting signals in a number of fields, including the incompatibility of their wage and taxation policies with their attempts to increase labor mobility and provide incentives for higher productivity; important contradictions between policy goals and regulatory measures are also evident in the tax reform project, the subsidy system, and the reformed banking structure. The way out of this dilemma is for the authorities to establish clearly the economic model to which they wish to conform, and to effect the structural and regulatory adjustments that are essential, within the framework of that model, to make the economy efficient and to achieve their chosen goals. However, one must approach the reform efforts of the Hungarian authorities with a substantial degree of humility. I am very happy therefore to hear from Mr. de Groote that the authorities are firmly set on this road, that their choices have been made, and that they recognize that the time of gradualism is past.

Regardless of the authorities' choice of the direction of their economic reform, it is essential for them to pursue the reform goals within the framework of appropriate macroeconomic policies that can ensure overall domestic balance and a sustainable external position. It is from this point of view that developments in 1985 and 1986 are worrisome. According to the staff, the fiscal impulse shifted from a contractionary 4.3 percent of GDP in 1983/84 to an expansionary 4.7 percent of GDP in 1985/86. Furthermore, the staff expresses some doubts as to whether the budgetary goals for 1987 can be achieved by the means indicated by the authorities, implying that the fiscal stimulus may continue to be expansionary in 1987. What is particularly disturbing in this respect is that no policy changes have yet been put into action to achieve the necessary narrowing of the deficit in 1987. The slippages in monetary policy are also considerable. The budget deficit financing requirements and the relaxation of credit policy to accommodate the strained financial position of a number of large enterprises have led to an impressive acceleration in the growth rate of monetary aggregates and the creation of a large liquidity overhang, which might well prove to be a serious destabilizing factor within the framework of the two-tier banking system, in the absence of strong tightening measures. The macroeconomic outlook for 1987 should indeed be a cause for concern. The staff's assessment to the effect that the macroeconomic goals set out in the current plan are internally incompatible and may well lead to a compromise of the external target is a portent.

It is reassuring, of course, that the authorities have instituted a high-level policy review to devise the necessary adjustments to the plan for 1988 and 1989, as well as the necessary corrective measures for 1987. I am greatly encouraged by Mr. de Groote's statement as to the intention of the authorities in this respect.

Mr. Yang made the following statement:

The performance of Hungary's economy in 1986 was generally unsatisfactory. Output grew by about 1 percent, against the planned 2.3-2.7 percent target. The imbalance between excess domestic demand and lagging supply widened further, resulting in a growing current account deficit and a sizable foreign debt. As Hungary is pioneering unprecedented economic reform, it would be naive to expect the reform process to be entirely smooth, particularly when the adverse exogenous developments of 1986--such as the sharp deterioration in the terms of trade, the severe drought in the summer, and the Chernobyl accident--have added to the already difficult situation. However, this is by no means an excuse for not facing up to existing problems. We note that the authorities have been aware of the growing imbalances, and that a reassessment of the policy orientation is under way.

In order to correct the current internal and external imbalances, the authorities urgently need to curb excess demand through restrictive measures. However, the long-term invigoration of the economy will crucially depend on the thorough and forceful implementation of the economic reform. Only the structural changes brought on by the reform can provide a solid basis for sustainable economic growth. It is understandable that the unfolding reform program may follow a cautious pace, owing to the authorities' lack of experience, but the reform program per se must be comprehensive. The piecemeal approach would create an environment in which fragmentary reform measures might not fit well into the existing system, and the resultant effects might deviate seriously from the original intention.

The staff rightly points out that the price mechanism cannot perform its allocative function unless financial responsibility within the enterprises is strengthened. If the enterprises are not responsible for their own profits and losses, no rational price system can be formed, and there will be no incentive for enterprises to improve their efficiency. The adoption of the bankruptcy law is certainly an important step in dealing with the loss-making enterprises. Another important reform measure that cannot be neglected is to eliminate the monopolistic position of the large enterprises. Healthy competition will place enterprises under great pressure to enhance their productivity and cost performance. Additionally, under the precondition of maintaining the characteristics of socialist ownership, further experiments in the public issue of equity stock may be worthwhile for purposes of restructuring enterprises.

At the 1985 Article IV consultation with Hungary (EBM/86/7, 1/13/86), this chair called for a cautious stance on foreign borrowing. In the light of the growing size of the foreign debt and the future debt service burden, now it may become imperative to limit further borrowing, particularly from commercial sources. Nevertheless, encouraging foreign direct investment by the adoption of more outward-looking policies could be a desirable alternative.

We understand that a new stand-by arrangement with Hungary has been under consideration. We believe that at this critical stage it would be most helpful that the Fund could provide important assistance to support Hungary's adjustment efforts. In concluding, we support the proposed decision.

Mrs. Hepp made the following statement:

It is very interesting to analyze the experience of Hungary, a socialist country that took the route of introducing important reforms to become a more market-oriented economy. During the past few years, there have been serious efforts to further modernize the economy, resume sustainable growth, and improve the external balances. Noteworthy among structural reforms are the measures to improve the efficiency of enterprises, including the bankruptcy legislation and the initiatives aimed at the restructuring or closure of inefficient companies. In addition, the decentralization and establishment of a new banking sector, continued liberalization of trade, and the announced tax reforms are important steps in the right direction.

The success achieved through the adjustment efforts undertaken during 1983-84, supported by two Fund stand-by arrangements, led to a favorable attitude of the international financial community toward Hungary. However, developments in 1985 and 1986 show an adverse trend with respect to economic performance in the previous years, resulting in less than 1 percent real GDP growth during 1986 and an important deficit in the current account. This has raised the stock of net debt in convertible currencies from 22.5 percent of GDP at the end of 1984 to 36 percent of GDP at the end of 1986.

As noted by the staff, the widening gap between the growth of supply and domestic demand and a significant easing of financial and credit policies, along with some exogenous factors, have contributed to the worsening of domestic and external balances. During 1986 the fiscal balance continued to deteriorate, shifting from a surplus of 2.7 percent of GDP in 1984 to a deficit of 3.7 percent in 1986. The deterioration in the monetary and credit areas was reflected in a 14 percent growth of M2, along with a domestic credit expansion of more than 26 percentage points. In general, we agree with the staff's explanations of the performance in 1986.

However, in March 1987, the authorities took a number of measures related to exchange rate, price, fiscal, and monetary policies. These measures show that the authorities are aware of the difficult situation and are prepared to make a timely response which, we hope, will help reverse the adverse trends observed in the past two years. These decisions are aimed in the right direction; we would welcome staff comment on the adequacy of the measures adopted.

In sum, we are concerned about the slippages and imbalances that occurred during the past year in the domestic and external accounts. Thus, we welcome the measures adopted as an indication of the authorities' willingness to resume the path of a sustainable and sound growth, and we support the proposed decision.

Mr. Ebrill made the following statement:

Hungary faces the double task of restoring macroeconomic balance to the economy and of transforming it into a more efficient, more productive entity. On the first task, Hungary will have to strengthen its macroeconomic management so as to reduce the fiscal deficit, the current account deficit, and external debt. On the second task, Hungary will have to follow supply-side structural policies to reform the economy fundamentally, so as to improve resource allocation and enhance efficiency. I agree with the staff diagnosis that deep-seated problems exist that need structural reforms. There is simply too much regulation, and too many resources are being absorbed by less productive economic units. For problems of that sort, gradualism and incoherent policies may no longer be effective. There has to be a more comprehensive and well-articulated strategy of reform.

The authorities should begin by accelerating their efforts to reform the tax system, with a view to increasing savings and encouraging investment. At the same time, they should dismantle the heavy regulations, so as to direct the increased savings into more productive investments. Wage and price systems will have to be liberalized further, and interest subsidies will have to be eliminated, so that relative prices will reflect relative resource availability, helping to improve the general allocation of resources. It is also important for the public budget to play a lesser role in the distribution of financial resources, and for commercial banks along with the nonbank capital markets to be allowed to play the intermediation role for the channeling of financial resources. Underlying all this is the need for the political conviction to permit private economic units to perform their economic functions more freely, so as to develop effective markets for improving the general performance of the economy. Finally, I support the proposed decision.

Mr. Fayyad made the following statement:

Hungary's economic outturn for 1986 clearly confirms that the concerns expressed by the Board at the conclusion of the 1985 Article IV consultation (EBM/86/7, 1/13/86) were well founded, as both the current account balance and the fiscal balance continued to deteriorate. This deterioration was accompanied by rapid growth in external debt, which is a source of particular concern in view of the authorities' earlier success in correcting the external imbalance in 1983-84 and in restoring the country's creditworthiness.

Unfortunately, many of the factors that had led to the negative economic outturn in 1985 continued to affect the Hungarian economy adversely in 1986. The weakening of financial constraints on enterprises, the easing of credit policy, as well as several exogenous developments such as recurrent bad weather and weakened export markets, notably in the Middle East, have contributed significantly to the unfavorable outturn in 1986. Furthermore, the impact on the Hungarian economy of these adverse developments was undoubtedly exacerbated by the failure of the structural reforms to elicit the timely supply response that was necessary to prevent the rising domestic demand from spilling into the external sector. The import liberalization measures, though desirable from a broader perspective, have also compounded the pressures on the balance of payments, given the lack of adequate support from financial policies. Largely brought about by an uneven implementation of reform measures, the failure of the supply response has led to the erosion of most of the gains realized in the process of overcoming the liquidity crisis of 1982. However, the difficulties that the authorities have encountered thus far in effecting structural reforms are derived perhaps not only from domestic constraints, but also from an external environment that has, until recently, not been very supportive of the type of reforms that they are seeking. Nevertheless, as Mr. de Groote has indicated, recent developments in this regard could provide the authorities with a valuable opportunity to contribute to, and benefit from, the emergence of a regional environment that is more inclined toward such reforms.

I offer two final thoughts on the market-oriented structural reforms as they pertain to the Hungarian experience. First, importance must be attached to the recognition of, and commitment to, the notion that structural reforms are interconnected, and that their success requires a coordinated, comprehensive approach. Second, since it does take some time before structural reform can be expected to produce the desired results, it is crucial that the demand side of the economy be appropriately managed in order to ensure a supply-demand balance during the adjustment period. Having said that, one should not fail to acknowledge the serious manner in which the authorities are trying to deal with the present situation, as reflected in the recent efforts to reorient policies toward the correction of the external and internal imbalances. In this connection, like other speakers, I would appreciate comment from the staff on the extent to which it believes the set of fiscal, monetary, and exchange rate policies outlined in the supplement to the staff report will affect the current projection for 1987 and beyond. In any event, it is safe to say that this policy reorientation provides some ground for optimism that the authorities will do what is necessary to restore the hard-won external confidence and to steer the economy back toward a viable course.

The staff representative from the European Department recalled that Directors had rightly pointed to the enormous deterioration in the fiscal balance that had begun in 1984 and had continued through 1986. They had also noted that the deterioration had accelerated so much that the authorities now were working against time, and that strong effective action was needed to halt that trend, let alone to reverse it. Thus, although the authorities indicated that they would recapture a large part of the working capital credits extended late in 1986 as a means of tightening monetary policy and reducing the liquidity overhang, much more needed to be done on the fiscal side. Therefore, the authorities' proposed reduction of the budget deficit by Ft 7 billion was totally insufficient to achieve their goals. Given the need for broad-based reform initiatives, the staff was disappointed with the measures announced to date, and hoped that the policy review in process would lead to a reinforcement of the authorities' measures. It was not clear to the staff how the policy review for 1987 was related to the fundamental review for 1988-90. It was hoped that the current review would be fundamental in its focus--although that did not currently seem to be the case--in order to ensure that the appropriate groundwork was being laid for the introduction of the value-added tax and the personal income tax at the beginning of 1988.

She had some concerns about the way in which the tax reform would be implemented, the staff representative continued. In discussions of the tax reform, the authorities tended to emphasize the revenue-raising side of the proposed tax changes, without detailing the balancing tax cuts that would make the reform indeed revenue neutral, and that would lead to a reduction of the tax burden on enterprises and result in a simplified, transparent tax system. Some of her concerns were shared by the Fiscal Affairs Department staff, which had been in Hungary on a number of occasions in connection with technical assistance missions.

The introduction of both those taxes presupposed fundamental changes in the pricing mechanism, to allow the pass-through of relative price changes, and in the wage system, the staff representative added. Given the demand-management problems facing the authorities, they tended to try to retain existing regulations, while putting in place basic changes. However, it was important for the authorities to recognize that the fundamental changes that they sought could not be effected if the regulations were not dismantled, thereby permitting the market signals to bring about changes in resource allocation, which was the intent of the reform measures. From that point of view, the staff was not convinced that the groundwork had been laid or was being laid adequately for the implementation of the tax reform, and she hoped that comments by the Directors would add to the impetus for a smooth and appropriate implementation of the tax reform.

It was disappointing to hear that the authorities' revised target for the rise in the consumer price index for 1987 was 9 percent, the staff representative went on. The implementation of the tax reform implied a higher rate of inflation than that, because some of the underlying changes in the system, together with the effects of the devaluation, had already mandated a rise in the consumer price index of 8.5 percent.

As Hungary's pricing system had operated previously, the authorities had felt obliged to insulate a part of the domestic price system from the effects of the devaluation in order to give exporters an edge in profitability beyond that permitted for suppliers of the domestic market, the staff representative noted. The so-called competitive price system incorporated shadow world market prices to help smooth the effects of the monopolistic pricing tendencies in large companies so that domestic prices were allowed to rise with the foreign value of world market prices; however, that arrangement diminished the effectiveness of a devaluation that aimed at increasing profit margins for exporters. At the same time, such partial and artificial ways of continuing to tinker with the price system to achieve particular objectives were not very effective in the medium term, and thus the envisaged competitive price system certainly would constitute a large step forward. However, the staff was concerned about the so-called transitional operational system, which might result in more, not less, guidance from the Price Office. The staff hoped that the authorities could find a way to accept the once-over price changes that would be inherent in moving from one system--of considerable guidance--to another system, with much more liberalized prices.

In 1982-83, the authorities had cut back subsidies considerably, and relative prices had been allowed to adjust accordingly, the staff representative indicated. However, since the reversal of that policy stance in recent years, relative price positions had also been reversed, which had led to an enormous rise in subsidies and tax exemptions, with unfortunate effects on the budget balances.

The medium-term scenarios amply illustrated the enormous task of external debt management that was facing the authorities, the staff representative mentioned. The financing needs for 1987 were about $2.5 to $3 billion, and despite the prepayment of some of the debt that would have fallen due in 1988, the financing needs in 1988 would still be about $1.75 billion; moreover, additional funds would be needed, in line with whatever current account deficit emerged.

For some time, the authorities and the staff had been discussing a classical stand-by arrangement in support of the reform effort in Hungary, the staff representative from the European Department said. As Mr. de Groote had indicated, the authorities were aware of the role that the Fund could play in assisting their reform efforts.

Mr. de Groote observed that the Hungarian authorities were in the process of taking a number of decisions to accelerate the adoption of a full-fledged, market-oriented economic system. The preliminary steps taken by the Government--such as setting new targets for the consumer price index and for the reduction of the deficit--did not exclude the possibility that the authorities would soon be taking additional steps. The authorities concurred with Directors that progress toward achieving a fully market-oriented economy depended on comprehensive structural reform. Nevertheless, it was important not to underestimate the difficulties associated with taking steps toward the second phase of reform, particularly in the light of the discussion that such reform generated at all levels of the decision-making process and in public opinion.

Although the authorities had not taken any official steps on the question of a stand-by arrangement with the Fund, they remained mindful that the envisaged reform measures could lead to a balance of payments problem that might require temporary assistance from the Fund, Mr. de Groote continued. They considered such assistance to be in the framework of a systemic approach, but were fully aware that Fund assistance was available only to meet balance of payments needs, and that any such assistance would have to be accompanied by a program that incorporated demand-management measures as an important component of a broad-based approach.

His own optimism about the future was based on the fact that the internal political environment in Hungary had changed so much in the recent past, Mr. de Groote stated. The new generation of economic leaders--including top-level economists in the Ministry of Finance and the Planning Office--was familiar with, and committed to, the merits of market techniques. He was thus optimistic about the reform process in Hungary.

The Chairman made the following summing up:

Directors indicated their disappointment at the progressive deterioration in Hungary's external performance over the past two years. While acknowledging the adverse influence of exogenous factors, they pointed to a significant relaxation of financial policies and the slowdown in implementing structural reforms as the main factors in the surge in domestic demand and the stagnation of output. Indeed, they remarked that the fiscal expansion and monetary ease had not only injected excessive purchasing power into the economy but did so largely by redistributing financial resources from profitable to nonprofitable enterprises through an elaborate system of taxes, subsidies, and credit allocation.

Against that background, Directors expressed their broad agreement with the views on the appropriate direction of policies expressed in the staff appraisal in the report on the 1986 Article IV consultation with Hungary. Directors also welcomed the indications given by the Hungarian authorities that they were aware of the opportunities lost in the past two years, that the reform movement was regaining momentum, and that Hungary was poised to embark on a second major phase of fundamental reform. In that light, Directors welcomed the potentially important reform measures that had been, or were planned to be, introduced in several areas in Hungary. They singled out the banking reform, including greater interest rate flexibility, the bankruptcy legislation, the labor relocation scheme, industrial restructuring, as well as some import liberalization. They also commended the planned introduction of a value-added tax and a comprehensive personal income tax, effective January 1, 1988.

Several Directors took note of the recent decisions to reduce the budget deficit and to tighten credit in combination with a further depreciation of the forint. Past fiscal policy had clearly complicated the task of monetary management and for the present, Directors felt that reliance on credit policy continued to be excessive in view of the still high budget deficit. Directors urged the authorities to further tighten fiscal policy with particular emphasis on expenditure restraint and, more fundamentally, to reduce the pervasive role of the public sector in the economy. They also emphasized the need for the authorities both to adhere to the target of halving the external current account in convertible currencies in 1987 and of bringing it into balance by 1988, and to take the additional macroeconomic measures necessary to correct the excessive internal absorption of resources, as well as to exercise greater caution in further borrowing abroad.

Directors stressed the need to achieve better internal balance if any improvement in the external balance was to be lasting. In that respect they considered the setting out of a coherent framework for the economic reform measures and their prompt implementation essential, and they questioned the extent to which the reforms currently under way met those criteria. They urged the authorities to implement, and build upon, the recent institutional reforms by encouraging commercial banks to operate on the basis of return and risk considerations and by reforming the accounting framework. It was deemed equally important to apply the bankruptcy law to financially weak enterprises and to phase out the financial assistance provided to them and, more generally, to move decisively toward a more efficient process of financial intermediation.

While endorsing the authorities' declared intention to go ahead with the tax reform on January 1, 1988, a number of Directors expressed concern about the slow progress in taking the preparatory steps that would need to include the phaseout of the fiscal and regulatory constraints on relative price changes and wage differentials. They regarded faster progress toward unification of the many turnover tax rates and the repeal of a number of consumer subsidies as essential if the beneficial impact of the value-added tax on resource allocation was to ensue. Analogously, early removal of the earnings regulations and allowance for wider before-tax pay differentials would be logical companions of the new income tax. However, recent policy measures, particularly in the wage area, did not seem to be compatible with those aims.

In general, Directors felt that the lack of adequate action to meet the concern expressed at the discussion of the 1985 Article IV consultation with Hungary--over the balance of payments deterioration and rapid growth of external debt in 1985--had intensified both the underlying domestic structural distortions and the external deterioration, at the cost of a considerable further increase in foreign indebtedness and in the debt service ratio, which a number of Directors singled out as a cause of concern. As a result, a far greater task of adjustment lay ahead, which needed to be addressed with urgency. All speakers agreed that the time for gradualism and piecemeal approaches to economic reform had passed. A clear and coherent blueprint and an unwavering commitment were now needed. Thus, Directors called for a credible, consistent, and accelerated reform effort supported by adequately restrictive demand-management policies and a realistic exchange rate policy, including a full pass-through to domestic prices, as the means to correct the external imbalance in the near term and to attain sustainable growth over the medium term. An insufficient policy effort would run the risk of inducing a turnaround in the favorable market sentiment toward Hungary that had emerged since the 1983-84 stabilization program.

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 1986 Article XIV consultation with Hungary, in the light of the 1986 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. 8562-(87/55), adopted
March 27, 1987

2. SDR ALLOCATIONS - FIFTH BASIC PERIOD - CONSIDERATIONS PERTAINING TO RESUMPTION

The Executive Directors considered a staff paper on the considerations pertaining to the issue of a resumption of SDR allocations during the fifth basic period (SM/87/63, 3/4/87). They also had before them a background paper on the SDR in reserve management practices of monetary authorities (SM/87/72, 3/17/87).

Mrs. Ploix made the following statement:

Some of my colleagues have asked me recently whether my authorities had changed their stance on SDR allocations. They have not. Of course, we welcome this opportunity to discuss this important matter again. I hope that today we shall be able to break away from the rather repetitive and conventional character of our previous discussions on this matter. For my part, I will refrain from repeating our traditional and well-known arguments in favor of an SDR allocation. Thanks to the two stimulating papers prepared by the staff, I am able to concentrate on two additional arguments: (1) how the protracted debt problem enhances the suitability of the SDR as a reserve asset, and (2) how the removal of the rigid regulations applied to the use of SDRs could increase its attractiveness.

The main conclusions of our last review of the debt situation are clearly relevant to today's meeting. I will not repeat all of them here, but will stress only that the virtual drying up of net financing coming from the private sector has had a direct bearing on the cost of reserves. Countries, irrespective of their exchange system, cannot do without reserves, and precautions are of overwhelming importance for economies experiencing a weak external position. This explains the efforts made by these countries to maintain their reserve/import ratios, but the price to be paid has become prohibitive.

I recognize that the secondary market for bank loans to capital-importing developing countries does not meet all the requirements of a full-fledged marketplace. Nevertheless, the estimates given in SM/87/63, 3/4/87 are indicative of the effective cost incurred by the concerned countries if they want to supplement their reserves. Such a cost looks even higher since it is charged for the use of resources that are not inherently directly productive. In order to minimize the effects of a poor allocation of badly needed and costly resources, if the funding of external reserves could be based more broadly on SDR allocations, it could prove instrumental in helping indebted countries better to concentrate their adjustment efforts so as to meet their external obligations.

One should not forget that, if the carrying of SDR-denominated reserves is free, the net use of the SDRs implies the payment of a market-related interest rate. In this respect, the SDR embodies one of the basic features of any external asset, and its fairly low utilization cost appears as a valuable advantage in the present context. Thus, there is a need for more SDRs in the system. That is exactly my authorities' opinion. I will only add that all the ritual objections raised against a new allocation, namely, the inflationary risk in industrial countries or the loosening of adjustment efforts in developing ones, have already been dealt with in our previous discussions. Moreover, my personal feeling is that any lingering reluctance could be dispelled easily if the attractiveness of the SDR as a reserve asset were steadily promoted.

The SDR does not compare well with alternative assets. I understand that SM/87/72 will be discussed more thoroughly in the near future, but I take this opportunity to present a few comments on its thrust. It is necessary to improve the characteristics of the SDR with a view to fostering its role not only as a means of payments but also as a portfolio instrument.

To an outsider, the attitude of the Fund toward this matter appears schizophrenic: the Fund simultaneously advocates the opening up and development of capital markets while doing its best to restrain the usability of its own asset. In the present climate of widespread deregulation, the Fund would be well advised to opt for a more open approach, instead of resorting to the stick without the carrot--minimum holdings or reconstitution requirements, which aggravate the SDR's drawbacks.

I would emphasize more specifically the need to ease all the cumbersome rules that are currently applied. If the SDR is to compete effectively with other reserve assets, it must become as easily tradable as any other portfolio instrument. All the suggestions described in SM/87/72 have to be thoroughly reviewed with this aim in mind. More leeway could be given to member countries in the agreement on the exchange rate and the timing used for transactions. The lack of confidentiality that can deter some countries from using their SDRs could easily be corrected by a relaxation of the publicity requirements. A more far-reaching solution should also be looked into, namely, the abrogation of the requirement of need. Such a requirement has already been abrogated for the reserve tranche. By the same token, the idea of authorizing commercial banks to hold and use SDRs is worth studying and I look forward to reading the paper under preparation on this subject.

For the time being, my authorities do not have a firm opinion on these proposals, but would very much favor thorough analyses of the issues in order to foster some progress. Such moves could imply changes in the Rules and Regulations or even in the Articles of Agreement. I would like the staff to study this point with an open mind before our next discussion.

I am not advocating a "big bang" opening of a worldwide efficient SDR market, but only studies of slight modifications of obviously outdated regulations and--unfortunately--practices. After all, promoting one of the Fund's financial products will not jeopardize the financial integrity of the institution.

Mr. Ismael made the following statement:

The staff paper provides a fresh and useful insight on the issue of resuming SDR allocations in the fifth basic period, a problem that has preoccupied the Board for some time. I hope that the new evidence will help to convince those who have been objecting to a new allocation that an increased amount of SDRs in the system would promote the purposes of the Fund. This chair agrees with all the findings in the staff paper and is convinced by the arguments presented for resuming SDR allocations.

In particular, I agree that the direct savings associated with the substitution of currency reserves with SDRs can be substantial. These savings can help to alleviate the international debt problem to a significant extent. The potential savings from the substitution of SDRs for borrowings are significant enough to make the Fund want to secure them for the benefit of the large majority of its membership. In this connection, the staff can perhaps highlight another implication of its findings, namely, the reduction in aggregate external debt if reserve supplementation through SDR allocations had replaced borrowings as a means of acquiring reserves in the fourth basic period. Given the powerful effects of compound interest, the savings calculated by the staff for the fourth basic period would have resulted in a reduction of some $48 billion in the external debt of the countries shown in Table 4 of SM/87/63 at the end of 1986: $10 billion for Group II, and $19 billion each for Groups III and IV.

Of greater significance would be the indirect benefits. The staff argues rightly that reserve supplementation would reduce the global deflationary effects stemming from the trade and payments restrictions and other forms of import compression required to produce the necessary surpluses to generate reserves if market access is restricted. In the debt strategy, reserve supplementation can usefully complement the efforts of debtor countries undertaking adjustment.

For the sustained success of the reserve substitution exercise, the staff paper has listed three requirements: participants should restore reserves after periods of use, replenish their holdings of SDRs, and service their obligations to the SDR Department before servicing private market debts. This chair is prepared to consider feasible measures to achieve these requirements, especially to enhance the attractiveness of the SDR as the principal reserve asset in the international monetary system. If the latter objective can be met to the extent that holders would voluntarily reconstitute their SDR holdings through appropriate adjustment policies, the benefits of an SDR-based reserve system would be increased significantly.

In conclusion, I am convinced that a resumption of SDR allocations would serve the purposes of the Fund, especially in managing the debt problem and promoting a sustained non-inflationary growth of the world economy. This chair supports strongly an allocation of SDRs while measures to enhance the attractiveness of the SDR are being examined. The annual allocation can be increased when a feasible overall framework is in place to ensure the sustained viability of an SDR-based reserve system.

Mr. Kafka made the following statement:

Once more we are debating the question of an allocation of SDRs, which would be the first one since the allocation made at the end of 1981, in connection with the last General Review of Quotas. I hope that we shall decide this time to make an allocation before the next Review, and independently of it. There can be no question that the sporadic nature of SDR allocations has detracted from the development of the SDR and the benefits that the international community could have derived from it.

The staff paper starts out from the well-known fact that countries have been attempting to maintain approximately stable relationships between non-gold reserves and imports, despite floating exchange rates. Consequently, insofar as an increase in trade volume is to be expected, as projected in the World Economic Outlook, even on the assumption that prices will remain stable, reserves must also be allowed to grow in approximate proportion to this increase. Otherwise, deflationary pressure will be imposed on the world economy, which is already suffering from dangerously slow growth. The concentration of the paper on non-gold reserves is justified heuristically, but gold reserves should not be ignored. The relative concentration of gold reserves in the hands of industrial countries and the appreciation of gold in terms of other commodities and services since 1968, and since 1973 in particular, have given a large advantage to those countries that have been able to hold on to their appreciating gold reserves.

Total non-gold reserves in relation to imports of industrial countries are now as high as they have been at any time since the first oil shock. They are higher for all developing countries, owing to the growth of reserves of oil exporting countries, and also for the group of countries without recent debt-servicing problems. The situation of countries with recent debt-servicing problems is quite different. Their reserves in relation to imports have declined since 1984 and have been well below the average since the second oil shock, despite a recovery from the exceptionally low levels of 1981 to 1983; most disconcertingly, these reserves have fallen again since 1985.

Given the need to increase global reserves in order to avoid a deflationary impact on the world economy, the question arises why part of that global need should not be met by the activation of the SDR mechanism insofar as this would promise larger advantages than any other method. That the activation of the SDR mechanism is legitimate, even if it is not the only way to increase reserves, is a well-established principle. That the activation of the mechanism would be beneficial to countries with limited access to credit is obvious from SM/87/63, which points out that the carrying costs of reserves created by the

SDR system would be much smaller than those of reserves created by the private markets, on certain reasonable assumptions. It is possible to find certain minor mistakes in the staff's calculations; for example, it is not always entirely true that the borrowing costs for reserves cannot be different from the borrowing costs of funds for other purposes. Countries wishing to maintain--but not use--large reserves can at times borrow at a lower, albeit still excessive, cost--as long as they leave the borrowed resources on deposit with the same institution from which they are borrowing.

It is also possible to argue whether the estimates of borrowing costs based on the discounts at which the liabilities of certain countries are traded in the financial market are a correct reflection of the borrowing costs for such countries, because the international capital market is not by any means perfect. Even if a bank could sell an occasional loan of a country at a discount of only 50 percent, it is doubtful that the country could place additional loans at the corresponding interest rate. What cannot be doubted is that the carrying cost of borrowed reserves is extraordinarily high--probably higher than the staff suggests. For the countries with recent debt-servicing problems, the staff estimates imply that the annual cost would exceed 5 percent of the countries' annual interest payments (Table 4, SM/87/63, and Table A.38 of the October 1986 update of the World Economic Outlook). During the fourth basic period, the cost of paying this high spread, which is presumably underestimated, amounted to about 10 percent of the increase in debt of the countries with recent debt-servicing problems. SM/87/63 also shows that the borrowing costs for countries in Groups II and III--namely, industrial countries that borrowed significant amounts of foreign currencies, and developing countries with access to international financial markets--are by no means negligible, and neither is the cost that these country groups face if they must run surpluses to accumulate reserves. Finally, it should be mentioned that those costs are not the only ones that an SDR allocation could avoid or reduce. The potential instability of borrowed, as distinct from owned, reserves has often been cited as an important argument for allocation.

The paper also draws our attention to the indirect benefits of SDR allocations. If an important group of countries has to pay a high cost to hold needed reserves, that hurts those countries but others as well, because it has a deflationary impact. The paper also suggests that there need be no losses to creditor countries to offset the gains to debtors deriving from SDR allocations; creditor countries with SDR holdings in excess of their cumulative allocations would be largely unconcerned about the difference between the interest rates earned on their excess SDR holdings and the higher interest rates that could be earned by lending in private credit markets, since the risk-adjusted returns would be similar. Nor is any inflationary impact likely as long as new allocations of SDRs take place at a rate consistent with the volume of additional SDRs that countries jointly are prepared to hold. This volume is probably given by the growth of imports as an upper limit--and a fraction of that volume would justify a respectable annual allocation. There is, moreover, no reason to assume that the allocation of SDRs would weaken adjustment efforts. Reserves have been accumulated or restored since 1982, although it has required large adjustment efforts, which a lower reserve target could have avoided.

According to SM/87/63, an allocation of SDRs at the rate of SDR 3 billion annually would be just sufficient to leave the ratio of cumulative allocations to non-gold reserves in 1991 at their approximate average level during the fourth basic period. This can hardly be considered a satisfactory relationship. However, in order to achieve a sufficiently large allocation to make the SDR the system's principal reserve asset--as mandated by the Articles of Agreement--the "quality of the SDR," that is, its liquidity and usability, must be improved decisively.

The second paper (SM/87/72), which deals with reserve management practices, is based on a very interesting and perhaps unprecedented "public opinion poll" that the staff has undertaken to ascertain what would improve the quality of the SDR. We will be discussing this issue later, but I am convinced that we must improve the quality along the lines indicated in the paper, and must go as far as possible. I personally have always favored making it possible for the SDR to be held by the private sector, as well as by the public sector.

Mr. Zecchini made the following statement:

This is the first time that we are considering an SDR allocation for the fifth basic period, but we are of the opinion that the arguments that militated in favor of an allocation in the fourth basic period apply equally to the current period. The continuing long-term global need for reserve supplementation should be met through an SDR allocation in order to attain better the purposes of the Fund. The issue of reserve supplementation is not exclusively quantitative, since it involves qualitative aspects. Both quantitative and qualitative aspects are examined in SM/87/63, which has the particular merit of trying to broaden the scope of the analysis beyond the traditional types of arguments that have been raised in the past three years.

We broadly agree with the staff estimates of the evolution of the demand for non-gold reserves. The past long-run stability of the ratio of these reserves to imports for each of the groups of countries under consideration makes it a reasonable base to use in estimating the demand side of reserve supplementation. Of course, the validity of these estimates depends crucially on the projections of imports for the period under consideration, and it would be helpful to know the magnitude of the estimation confidence interval for the import projections.

If we assume that the staff projections are a fair estimate of the reserve demand, and if in the entire fifth period we continue to lack the necessary consensus for an SDR allocation, then we would have to face the consequences: by 1991 the SDR share of non-gold reserves most likely will drop to the lowest percentage level since its creation. At that level, the SDR will hardly be able to meet the functions it was created for, and therefore it would become much easier to argue for the liquidation of the SDR account. This is a scenario we strongly oppose, as we believe that the SDR has several important functions to fulfill.

As to the qualitative aspects of the reserve supplementation issue, we share the view that the present reserve system, whose supply side is dominated by the borrowed reserve component, is intrinsically more unstable than a system with a more balanced composition between borrowed and owned reserves. This is so for several reasons but it suffices to mention two of them. First, this system is more prone to shocks stemming from financial markets, and second, it is negatively affected by the imperfections that characterize the financial markets' assessment of the creditworthiness of any given country. Therefore, it is necessary to promote the expansion of the owned reserve component in central banks' portfolios.

Two main avenues are available for the acquisition of owned reserves: to run a balance of payments surplus vis-à-vis the reserve-currency countries; and to inject outside money into the international monetary system. Both avenues have to be used in the current period, since relying only on the first is not consistent with the Fund's objective of promoting greater welfare for the world economy. In fact, the present excessive reliance on the first avenue makes it more difficult to correct the external deficit of the major reserve-currency country and at the same time risks introducing a deflationary bias into the world economy. The experience of the 1980s points in this latter direction. Between 1982 and 1985 the improvement of the ratio of non-gold reserves of developing countries to imports has been achieved partly through import compression and implicitly through lower levels of economic activity on a worldwide scale.

As to the injection of outside money, the staff paper provides us with a new intriguing argument in favor of allocating SDRs, in addition to the arguments incorporated in Articles XVIII and XXII, and to those that have been presented in previous Board discussions on the subject. The staff introduces the notion of carrying costs of borrowed reserves and makes an estimate of these costs. This argument is valid and deserves our attention. The carrying costs, in our opinion, comprise two components. One is the risk premium discussed in the staff paper. The other occurs because if a nonreserve-currency country wants to accumulate foreign exchange reserves without running a surplus in the current account of the balance of payments, it has to borrow reserves and place them in monetary assets. In principle, the difference between borrowing cost and return on assets is a cost incurred by all countries except the reserve-currency countries. This cost component is the reflection of the lack of seigniorage.

In such a context, the allocation of SDRs can help reduce the inequalities in reserve accumulation costs among countries. More generally, an SDR allocation that actually replaces part of borrowed reserves can reduce the carrying costs of non-gold reserves to the extent that SDR assets do not involve a cost if they are not used, and if they are used, involve a cost lower than the market rates applied to nonreserve-currency countries. In the latter case, the staff mentions three conditions for the lower user cost; while the third condition is not necessary in our opinion, the first two are crucial.

The first condition requires that participants restore SDR holdings after periods of use, which cannot be prolonged periods. Past experience shows that the present system has some shortcomings. Therefore, while we favor increasing the supply of SDRs, we should also consider means to promote external adjustment and reconstitution of SDR positions, without changing the unconditional nature of the SDR asset. For example, in the most recent SDR discussion, we mentioned the possibility of raising SDR interest rates for the prolonged use of SDRs, and this system could be explored further. The objective is to preserve the liquidity of this monetary asset, and to this end, additional mobilization mechanisms should also be examined.

The second condition implies an increasing willingness of participants to hold SDRs both on a gross basis and on a net one. This condition cannot be fulfilled without improving the characteristics of the SDR, particularly its liquidity and usability, as well as the confidentiality of the transactions. As to the advisability of increasing the rate of return, this does not appear necessary, provided that we succeed in preserving the monetary nature of this asset by reducing the financial risks involved in net accumulation of SDRs. As long as the SDR has the same monetary features as those of major reserve-currency assets, there is no justification for seeking a return higher than that in those assets.

To conclude, I wish to reiterate our position in favor of a moderate allocation of SDRs in the current basic period. This should be coupled with significant improvements in the monetary characteristics of this asset. In this light, we look forward to discussing the papers the staff is preparing on these aspects of the SDR.

The Executive Directors then agreed to resume their discussion of SDR allocations in the afternoon.

3. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Arias, Alternate Executive Director.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/54 (3/25/87) and EBM/87/55 (3/27/87).

4. ISRAEL - TECHNICAL ASSISTANCE

In response to a request from the authorities of Israel for technical assistance in connection with the redrafting of income tax legislation, the Executive Board approves the proposal set forth in EBD/87/86 (3/23/87).

Adopted March 26, 1987

5. EXECUTIVE DIRECTORS' OFFICES - TEMPORARY STAFFING

The Executive Board approves the recommendations of the Committee on Executive Board Administrative Matters regarding the policy for dealing with ad hoc requests for temporary positions and for temporary changes in existing positions in Executive Directors' offices, and regarding the requests for two-year extensions of temporary additional positions for an Assistant to Executive Director and two Advisors to Executive Directors. (EBAP/87/65, 3/24/87)

Adopted March 26, 1987

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/109 and 86/110 are approved. (EBD/87/84, 3/20/87)

Adopted March 26, 1987

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and Advisors to Executive Directors as set forth in EBAP/87/63 (3/24/87) is approved.

APPROVED: October 28, 1987

LEO VAN HOUTVEN
Secretary