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Minutes of Executive Board Meeting 90/123

10:00 a.m., July 27, 1990

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Z. Iqbal, Temporary
G. K. Arora	L. E. N. Fernando
C. S. Clark	G. C. Noonan
Dai Q.	
T. C. Dawson	
J. de Groote	J. Prader
E. T. El Kogali	
	S.-W. Kwon
E. V. Feldman	
	M. A. Fernández Ordóñez
	N. Kyriazidis
	A. M. Othman
M. Fogelholm	I. H. Thorláksson
M. R. Ghasimi	
G. Grosche	B. Goos
J. E. Ismael	T. Sirivedhin
	L. M. Piantini
	J.-F. Cirelli
	K. Kpetigo, Temporary
	P. Wright
G. A. Posthumus	G. P. J. Hogeweg
	K. Ichikawa, Temporary

L. Van Houtven, Secretary and Counsellor
B. J. Owen, Assistant

Also Present

IBRD: K. Chandreshekar, Office of the Senior Vice President, Finance; W. A. McCleary, Europe, Middle East and South Africa Regional Office. European Department: M. Russo, Director; P. B. de Fontenay, Deputy Director; C. Bartholdy, G. Bélanger, A. R. Boote, G. Szapary. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; T. Leddy, Deputy Director; E. Brau, M. Fisher, S. Kanesa-Thasan, R. G. Kincaid, J. V. Valderrama. External Relations Department: R. R. Brauning. Fiscal Affairs Department: M. S. Lutz. Legal Department: F. P. Gianviti, General Counsel; P. L. Francotte, R. Leckow, J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; J. G. Borpujari, H. P. G. Handy, H. Ghesquiere, C. A. Sisson. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J. Ferrán, Deputy Director; C. Cha, C. S. Lee, C. M. Loser, E. Sumar, E. C. Suss, E. Williams. Advisors to Executive Directors: J. O. Aderibigbe, M. A. Ahmed, G. García, K.-H. Kleine, J.-L. Menda, A. Napky, A. Raza. Assistants to Executive Directors: T. S. Allouba, H. S. Binay, B. Bossone, Chen M., B. R. Fuleihan, M. A. Ghavam, J. Gold, M. A. Hammoudi, M. Hepp, C. J. Jarvis, P. Kapetanovic, H.-J. Scheid, C. Schioppa, J.-P. Schoder, M. J. Shaffrey, D. Sparkes, Wang J.

1. HUNGARY - STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION OF PERFORMANCE CRITERIA

The Executive Directors considered a staff report on the first review under the stand-by arrangement for Hungary, together with a request by Hungary for the modification of performance criteria (EBS/90/129, 7/10/90).

Mr. de Groote made the following statement:

When we agreed to give Hungary a stand-by arrangement on the eve of the elections in March 1990, we were expressing the confidence of the international community in the outcome of the democratic process, but we could not then really expect that the first review would reflect such a correction of the external accounts. For the first quarter, the convertible current account is practically in balance, a result that stands in sharp contrast to the $450 million deficit projected for that period. The official current account forecast for the year as a whole has been revised downward from $550 million to $400 million, and it is now expected that it might even roughly achieve balance, given the likelihood that the second quarter results will be equally good and that the Government's resolve to make the attainment of a balanced current account a central goal of all policies will be implemented henceforward. Of course, such an outcome assumes that the external environment will remain unchanged. After the huge surplus of 1989, trade in nonconvertible currencies shows a small deficit for the first quarter of 1990.

I find two aspects of these recent changes in Hungary's trade with the West and the East particularly significant. First, the shift of resources away from the bilateral, state-controlled trade with Eastern markets has been easier than expected. This must mean that at least part of Hungary's exports have been competitive, for I also find it significant that the shift occurred under circumstances which generally signal temporarily worsened, rather than improved, economic performance. Here, of course, I refer to the profound political changes and intense political debate that have led to free elections and the coming to power in Hungary of a new Government.

The adjustment of the current account has been accompanied, as expected, by a moderate decline in GDP; by price increases which may amount to about 25 percent this year and which largely reflect the further liberalization of prices; and by some deterioration of fiscal income which, thanks to lower than expected expenditures, did not cause any substantial slippage from the consolidated public sector deficit target. The Government, which assumed office at the end of May, reacted expeditiously by raising indirect taxes and energy prices and by revenue measures which reduce the preferential treatment of state enterprises. While these measures should furnish a considerable safety margin, my authorities still firmly intend to correct any further slippages that may occur in the course of the program, to monitor with rigor the behavior of monetary and credit conditions, and to follow a flexible exchange rate policy.

I am convinced that the decisiveness of the Government's actions to keep the program on track, combined with the remarkable results in the current account, will contribute greatly to strengthening Hungary's spontaneous access to the financial markets. Such access is indispensable for the implementation of the present program, and a fortiori for the success of the comprehensive program of systemic reform that the Government plans to launch before the end of the year. The staff correctly stresses that "foreign bank creditors...have an important responsibility in maintaining exposure on the strength of evidence of firm and sustained adjustment." Hungary's commitment to full and uninterrupted debt service was announced by Prime Minister Antall in one of his first public statements immediately after taking office. The means of honoring this commitment are now more clearly evidenced by the reversal of the current account's deterioration and by the Government's demonstrated will to rapidly enact all measures necessary for keeping this account in balance. Failure by the markets to respond to this accomplishment and this intention would not stop at undermining Hungary's chances for effective adjustment: it would more generally call into question the very meaning and purpose of Fund-monitored adjustment programs.

I particularly welcome the great attention that the staff has devoted in its paper to the needs of systemic reform, even though today's exercise bears only on the review of the stand-by arrangement's implementation. This conforms to the approach the Board adopted when it approved this stand-by arrangement as a transitional holding operation aimed at providing the new Government with a well-managed demand situation on which to base a comprehensive systemic program to be adopted in the near future. The frank conversations I had with my authorities this week in Budapest, particularly with Minister Rabar, have convinced me of the Government's determination to act swiftly and decisively on systemic reforms. The broad outlines of the program will be announced first by the Government, so that negotiations with the Fund could then start sometime in September. Contact will be maintained with the European Communities and the financial markets throughout the preparation of the program in order to develop a comprehensive financial package covering, in an organized way, the needs implied by the medium-term balance of payments projections.

As to the measures themselves, while it would be premature to speculate on their specific details, I can assure you that the Government sees eye to eye with the staff on the priorities. Elimination of subsidies, acceleration of the movement toward privatization, further steps in the modernization of the financial and banking systems, and an extension of the currency's convertibility, are agreed as the primary cornerstones of the program by Government and staff alike. Particular attention will have to be paid to the impact of the elimination of subsidies on prices and incomes, and to the various assumptions to be adopted with respect to future trade relations with the Union of Soviet Socialist Republics. The uncertainties surrounding this last issue will doubtless require that a medium-term structural program should include alternative sets of measures and funding possibilities corresponding to scenarios which would reflect various potential combinations of events in that country and their effects on the region. The suggestions that my colleagues on this Board may already make today on this issue and on the general requirements of the new program will form a highly appreciated input to my authorities' ongoing reflections. Let us all look forward to the day when we can assess together in this place the program that will resolutely break with the past, giving Hungary a modern and competitive economic structure and integrating the country with Western Europe. The excellent results achieved by the transitional program you are reviewing today should reassure us that Hungary can proceed to act upon the more fundamental program without undue risks.

Mr. Dawson made the following statement:

We welcome the reaffirmation of Hungary's commitment to the stand-by arrangement approved in March and the measures which the new authorities have taken to ensure that the program remains on track. This continued commitment to the Fund program sends an important positive signal to the international financial community about the new Government's policy intentions. At the same time, it provides the new authorities some breathing space to develop a substantially stronger and more comprehensive medium-term program. Nevertheless, as the staff report points out, the new Government faces the formidable tasks of accelerating the pace of structural reform, while maintaining external solvency and containing inflation. Consequently, the breathing space, such as it is, will have to be very brief.

Our immediate concern for the current program involves the external sector. Given the liquidity squeeze and reserve losses that have already occurred in the first part of the year, it is extremely important that the authorities make a determined effort to improve Hungary's international reserve position. For this reason, we would urge the authorities to consider raising domestic interest rates well above the current inflation rate as a means of increasing private demand for forints. Similarly, fully liberalizing foreign currency deposits in Hungary and paying competitive interest rates on them would encourage the repatriation of foreign currency holdings. Strong efforts to promote those sectors which would be likely to have a quick pay-off in terms of foreign exchange, such as tourism and energy conservation, would also be helpful in this regard.

I would note in passing that the authorities seem to be more optimistic now about the 1990 current account, having revised downward their deficit projection. In Hungary's position, a lower deficit for the year would, of course, be a most welcome development. At the same time, we recognize that there are still many uncertainties which could affect the 1990 outturn, not the least of which are developments in Hungary's regional trade.

A second concern about the program to date involves the higher than expected increase in domestic prices during the first half of 1990. As inflationary expectations are both pernicious and difficult to eradicate once they take root, it is important for the authorities to take prompt action to contain domestic price increases. One factor which appears to have helped fuel inflation is the strong growth in the public sector wage bill, which, despite large layoffs, still rose some 16 percent on a first quarter over first quarter basis. In this connection, stronger wage discipline appears to be needed, as a complement to continued monetary and fiscal restraint.

There can be no doubt that the immediate tasks of maintaining appropriately tight financial policies and reversing Hungary's reserve loss are challenging enough in and of themselves. Nevertheless, the authorities must not lose sight of the broader, and equally pressing, need for a thorough and speedy restructuring and reorientation of the country's economic system.

As I emphasized in March, we hope the authorities will resolve the ownership issue which has so far impeded the sale of state enterprises and undertake a far-reaching privatization program for both industry and agriculture. At the same time, the authorities will need to remove remaining price controls, eliminate anticompetitive practices, provide strong legal assurances for private property, and liberalize trade. A program with these elements would have enormous benefits for the economy. It would stimulate private investment, both domestic and foreign; increase competition, the pace of modernization, and economic efficiency; and reduce future strains on government finances. Although the full effects of such measures would only be felt in the medium to long term, there is an urgent need to develop and implement such a program so that the desired systemic change will begin to occur.

Second, we believe that once the authorities agree on a strong set of medium-term macroeconomic policies, a move to full convertibility of the forint would be a very positive step. To begin with, it is difficult to see how Hungary can attract the desired level of foreign investment, or fully integrate itself into the Western trading system--and, I might add, not only in Western Europe but the rest of the world as well--without taking this important step. Indeed, the fact that other countries in the region are making their currencies convertible increases the urgency of Hungary doing the same. At the same time, a fully convertible exchange rate system would help ensure that the exchange rate was maintained at an appropriate level; at present, the considerable differential between the official exchange rate and the black market rate suggests that the official rate is not at an equilibrium level. Finally, we believe that the international community would read a decision to make the forint convertible as a sign of the Hungary's commitment to a rigorous economic program and would enhance the credibility of the overall program. Poland and Yugoslavia's experience with convertibility provides support for such a course.

Before concluding, I would like to commend the Hungarian authorities for their superior debt service record. In order to maintain access to international capital, it will be important for Hungary to remain current on its debt service obligations and continue to deepen its economic reform effort. I would also like to stress that adopting policies which promote nondebt creating foreign investment will enhance Hungary's ability to grow out of its external debt problem.

In conclusion, with appropriate policies to eliminate any lingering misperceptions about Hungary in international credit markets and the rapid implementation of a comprehensive medium-term program, the present period could prove to be a watershed for the Hungarian economy. We therefore encourage the Hungarian authorities to persevere in the current stabilization program and to complete their work with the Fund on a medium-term program expeditiously.

Mr. Kyriazidis made the following statement:

The Hungarian authorities are to be commended for the persistent implementation of the 1990 program, on the basis of which the current stand-by arrangement was approved by the Board last March, although the results appear to have so far been only partially positive.

The significant improvement in the current account with the convertible area indicates that the significant tightening of monetary policy, the adjustment of the exchange rate and the measures taken to reduce exports to the member countries of the Council for Mutual Economic Assistance (CMEA) have had important beneficial effects on competitiveness and the desired reorientation of Hungary's external trade. The adverse developments in the capital account, on the other hand, as well as the implications of the debt overhang and the prospective changes in trade with the CMEA countries in the medium term, as outlined by the staff, underline the overriding and urgent need to establish and maintain the credibility of the authorities' adjustment efforts in a way that will avert in the future outflows such as those experienced in the first half of 1990 and restore the creditworthiness of Hungary with the international banking community. The task facing the Hungarian authorities is indeed daunting.

Fiscal policy is, of course, crucial. The weak performance in the fiscal sector since the beginning of 1990 as a result of some extraordinary factors as well as of the tax reform measures of 1989 has appropriately led the authorities to take corrective measures, which if I understand the staff report correctly, are expected to bring fiscal performance back on course with only minor deviations from the original targets. These corrective measures are certainly to be welcomed inasmuch as they bear testimony to the authorities' realization of the need for fiscal retrenchment and of their determination to proceed along this road.

The authorities' declared determination to pursue an active exchange rate policy is also to be welcomed in view of the overriding need to sustain the gains achieved so far and prevent losses in competitiveness that might jeopardize the process of external adjustment as the liberalization of imports progresses. However, in the light of recent price developments, some caution is required. Indeed, the maintenance of competitiveness should be the priority consideration but care should be taken not to exacerbate unnecessarily domestic inflationary pressures. I agree, therefore, with the staff's recommendation that the appropriateness of the exchange rate be reassessed on the occasion of the second review under the arrangement.

In view of the urgent need to combat inflation and restore confidence in the international financial markets, it is also important not only that the authorities maintain tight monetary and credit policies but that they be prepared, as the staff recommends, to tighten them further if the current inflationary push created by the liberalization of prices and imports and the exchange rate adjustment does not abate at the rate foreseen. In this connection, the assurances given by Mr. de Groote as to the authorities' intentions are very encouraging. In this connection, I would be interested to know also what action the authorities envisage taking, if any, in order to prevent a wage explosion that might further exacerbate inflationary pressures. The only indication in the staff paper, which is reassuring as far as it goes, is that the rise in the wage bill of large enterprises has so far been contained below the rate of inflation chiefly because of substantial labor shedding. However, the remark that unemployment has been held in check by the shortage of labor in both the service and private sectors indicates a rather tight labor market which might prove to be a propitious ground for wage increases beyond those expected by the authorities with adverse effects on the stabilization effort. Indeed, in the absence of a clear policy direction with regard to incomes, the success of the anti-inflation effort will remain uncertain.

While, at the present time, the correction of macroeconomic imbalances must out of necessity be the priority target of the Hungarian authorities, the ultimate achievement of their overall objective will depend largely on the pace of progress of structural reform in a number of strategic sectors, especially the fiscal, financial, and enterprise sectors, which will underpin the effectiveness of macroeconomic policies and enhance the supply response of the economy. We cannot but welcome, therefore, the authorities' declared intention to formulate expeditiously a comprehensive program of structural reforms that will set the foundation and the appropriate institutional framework for growth and external viability in a competitive environment. In this respect, we fully endorse the staff's recommendations as to the extent and direction of the reforms necessary although we recognize that the new Government may need some more time before it formulates and begins to implement the appropriate policies.

Hungary, at this critical stage in its adjustment and reform process, deserves strong support both from this institution and the international community at large. The firm pursuit of the reform and adjustment effort by the new democratically elected Government, in conjunction with the support provided by the Fund, the World Bank, and the European Communities is the best way to ensure that adequate support will also be forthcoming from the international banking community and private capital markets. More particularly, the expeditious elaboration of a medium-term program that can be supported by an extended arrangement might be crucial in assisting Hungary to overcome its external financing problem. Time, however, is of the essence and there is an urgency which we hope the Hungarian authorities will bear in mind.

With these remarks, I wish to express our support for the proposed decision.

Mr. Grosche said that he shared the staff's appraisal, and wished to emphasize only a few points.

The stand-by arrangement had to be seen mainly as a holding operation, Mr. Grosche noted, since Hungary was going through difficult political times--first the pending election and then the formation of a new coalition government and the formulation of new policies. Although the program was not a strong one, the outcome so far had been quite mixed. Certainly, the current account in convertible currencies had improved beyond expectations, but the inflation target for 1990 would be exceeded substantially and not only because of cuts in subsidies. What appeared to be most worrisome were the slippages in the fiscal targets--the cornerstones of the program. Also, structural reforms did not progress as fast as one would have liked. The excesses of 1989 together with the uncertainties still surrounding the policies of the new Government contributed to an unwelcome reaction by foreign creditors, whose reluctance to roll over old and extend new loans put strains on the international reserve position and would be felt in the capital accounts.

He certainly welcomed the prompt corrective measures taken by the new Government in the area of fiscal policy, which the staff believed to be sufficient to achieve the initial fiscal target for 1990, Mr. Grosche continued. But he agreed with the staff that speed was of the essence in formulating a comprehensive medium-term program of strict macroeconomic stabilization and bold structural reform. The recent agreement on land privatization was definitely an encouraging step in the right direction. As to the other measures, he could go along with what had been suggested in the staff appraisal. He hoped that agreement would be reached soon on a program that could be supported by the Fund.

A comprehensive adjustment effort should assist the authorities in safeguarding the confidence of external creditors and spontaneous access to the international financial markets, Mr. Grosche considered. The authorities would be well advised to continue with their prudent debt-servicing policy, which had served the country well. Given the already significant improvement in the external current account, the authorities should aim at an external surplus in convertible currencies for 1991, thereby avoiding further net increases in external commercial debt. His authorities acknowledged the progress that was being made in correcting the fiscal stance and in developing a comprehensive reform strategy. Therefore, they had decided recently to assist a group of German banks to put together a DM 500 million revolving credit facility to help Hungary meet its cash flow requirements over the coming year.

It should be stressed, however, that the extension of a guarantee for 90 percent of the credit line was exceptional, and given only in light of the circumstances of the country, Mr. Grosche added. Both the country and the creditors bore the responsibility for the accumulated debt, and both have to work it out--the country through the implementation of sound policies and the banks through maintaining exposure. Indeed, as the staff had so rightly put it, foreign banks had an important responsibility in maintaining exposure on the strength of evidence of firm and sustained adjustment. He supported the proposed decision.

Mr. Cirelli made the following statement:

> At the time of the stand-by arrangement's approval in March, this chair was one of those that emphasized the transitory character of the present program and advocated a strengthening of its content. It must be acknowledged, however, that the first review does not offer this opportunity. The profound political changes experienced during the past months are certainly the major cause of the maintenance of the transitory objectives set by the program. To a great extent, this outcome has been proved right as the first task of the new authorities was to stabilize the economy before engaging in a more comprehensive medium-term program. Indeed, under such circumstances, the economic outcome for the first months of the year, and in particular the current account outcome, is certainly reassuring. Furthermore, the new authorities' commitment to the program has been reaffirmed, as proved in particular by the corrective measures adopted during the spring in order to compensate for fiscal slippages. These results are commendable.
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> Nevertheless, the need for a comprehensive medium-term program of economic reform is clearly indispensable. The authorities seem to acknowledge this need, as mentioned in the staff paper, by their intention to formulate such a program. I cannot but encourage them to aim at concluding such a program which will allow the complete transformation of the economic structure toward a market-oriented one.
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> Coming back to the current situation, and turning first to macroeconomic policies, it is crucial that the authorities maintain the moderately restrictive stance of fiscal and monetary policies. Therefore, I welcome the corrective measures, most of which have already been implemented, that the new Government has undertaken to correct fiscal slippages. I note, however, that these developments will result in 1990 in higher expenditures,

notably higher subsidies, even though compensated for by higher revenues. I wonder what will be the impact of the increase in domestic interest rates on the level of these subsidies, as they represent an important weight on the budget, in particular the housing subsidies.

As concerns monetary policy, there is little to add to the report; the tightening observed since the beginning of the year was reflected in particular by a limited increase of credit to enterprises in the first quarter. I wonder, however, whether the staff does not have some evidence that this development has been offset by a growth in interenterprise credit. I also have some doubts that, given recent price developments, short-term household deposits are actually positive in real terms, an essential element for raising the level of savings that Hungary needs, being one of the most heavily indebted countries in the region.

Turning to the external sector, we previously stated in March that the present mix of moderately restrictive demand management policies and an active exchange rate policy should be modified in the future in favor of tighter internal policies in order to avoid any vicious circle between devaluation, wage increases, and inflation. I would appreciate knowing, if possible, what the contribution of recent exchange rate adjustments has been to the 19 percent price increase observed during the first months of the year. The absence of a nominal anchor in the program, contrary to programs adopted in neighboring countries, certainly makes it more difficult to stabilize inflationary expectations. It would be useful if the staff could give us some specific information on why it welcomed the pursuit of an active exchange rate policy in Hungary's case and did not favor the maintenance of the real exchange rate by tightening internal policies, which would help to dampen inflationary pressure.

The most encouraging performance since the adoption of the program was the better than expected reduction in the current account deficit in convertible currencies which partly reflected the reduction of the surplus in nonconvertible currencies. The weakness of the capital account and the resulting pressures on the external position experienced by Hungary demonstrated a posteriori the priority to be given to adjustment. This is all the more important since Hungary has succeeded so far in keeping its access to the international capital markets. This access is certainly a fundamental asset for the country, which, in the view of my authorities, should be preserved at any cost.

Regarding the trade with CMEA countries, last year the problem seemed to lie in Hungary's surplus vis-à-vis these countries. Now, it appears that the agreement with the U.S.S.R. will have far-reaching consequences. The change in the basis of trade to world prices will probably provoke an adverse change in the terms of trade for Hungary, and the previously registered surplus vis-à-vis the Union of Soviet Socialist Republics could turn to a deficit. This would certainly add to the deficit with convertible currency countries. I would be glad to know if the staff shares this view and if the need that the Board has emphasized to reduce the trade with CMEA countries is still valid.

Now that the new authorities have committed themselves to pursuing the adjustment process, the need to address structural reforms in a medium-term program has become urgent. Some encouraging developments are reported by the staff concerning the initiation of bankruptcy proceedings against a number of enterprises and the amendment to the Bankruptcy Law concerning state enterprises. It is indeed crucial that loss-making enterprises be closed in order to release more resources for profitable activities. The reinforcement of the financial constraint on the enterprise sector is also fundamental to the overall macroeconomic control.

However, there are many areas where reforms are crucially needed. These include more complete price liberalization, the solution to the issue of enterprise ownership, the implementation of a privatization program, and the reform of the financial sector. The authorities should avoid further delays in the implementation of these reforms if they want a more rapid response from the supply side of the economy and a more rapid resumption of the growth process. This should also be a positive sign for the financial markets.

Finally, contrary to other centrally planned economies, Hungary has been moved by other economic reforms over the last twenty years increasingly toward reliance on market mechanisms. Hungary should now take advantage of the new situation to deepen and strengthen economic and market structural reforms. I share the view expressed in the staff appraisal that the severity of the present situation is such that speed is of the essence. In this regard, Mr. de Groote's statement that his authorities are rightly aware of this need is very encouraging. We approve the proposed decision, including the modifications to the performance criteria, and wish the authorities well in their endeavors.

Mr. Clark made the following statement:

Developments over the past four months, since the approval of the stand-by arrangement, have been mixed. On the positive side, all the performance criteria for the first quarter of 1990 were met; progress has been made in enterprise restructuring and privatization (mainly in the form of initiating bankruptcy proceedings); the performance of the current account was unexpectedly strong; and the new Government has reaffirmed its intention to continue to pursue policies consistent with the objectives of the program--we are particularly encouraged by the priority given to containing inflation.

However, at the same time, there has been a general deterioration in economic prospects for the year from that anticipated in March. Output growth is now expected to be significantly lower; investment is forecast to remain flat; consumer prices are projected to increase more rapidly, and most disturbing, there is evidence of a general loss of confidence in Hungary's creditworthiness.

In light of these developments it is not surprising that some modifications in the performance criteria are required. Although we regret the need for such modifications, we can support them, as we are reassured that by the end of the program period, the program will be basically back on its original track. Nonetheless, there will be some loss in output which will be difficult to recapture in the immediate future. However, Hungary should not be discouraged by the fact that the cost of the transformation from a centrally planned economy to a market-oriented one is greater than originally anticipated.

With regard to the specific modifications of the performance criteria, we have no difficulty with the proposed change to the net bank credit to the state budget, as the consolidated deficit for the year remains unchanged. We welcome the additional revenue measures and reduction in expenditures aimed at offsetting the shortfall in revenues in the first quarter. We only wish to caution the authorities that they should be prepared to take additional action if they find that these measures are insufficient.

Although there could be room for concern about the higher than expected increase in consumer prices, credit conditions are now much tighter than originally envisaged, and economic activity considerably weaker. Therefore, we agree with the revised net domestic assets target, which will allow for only a gradual reversal of the large underexpansion of net domestic assets in the first quarter.

However, we do have some concerns with regard to the third modification, the change in the net international reserve target. Our concern is not with its downward revision, which basically reflects unforeseen developments since March, but rather with the ability of the authorities to meet even this more modest target.

Given the loss of confidence in Hungary's creditworthiness earlier this year, we question the soundness of the assumption of a strong recovery in medium- and long-term borrowing in the second half of the year, together with some reflow of short-term capital. Creditors may continue to be hesitant to provide new financing in the face of Hungary's large external debt, and unsustainable and growing debt-servicing ratio, which this year is estimated at about 50 percent. On a per capita basis, Hungary is already the most highly indebted country in Eastern Europe. Moreover, if other uncertainties are taken into consideration--not only those relating to the difficulties of the transition to a market economy and changes in the trading arrangement with Hungary's main trading partner, the Union of Soviet Socialist Republics, but, as well, those uncertainties relating to becoming a democratic society--those funds that are still available could dry up rather quickly. We welcome the authorities' reaffirmation of the priority they attribute to the uninterrupted servicing of their external debt. However, given the factors noted above, it may be difficult for Hungary to maintain access to private capital markets, even if there is a strong adjustment program in place, unless it is perceived that the debt-servicing situation is sustainable. Perhaps the staff could comment on the conditions that will be necessary to ensure the validity of this key assumption.

Finally, the staff paper provides limited information about the progress that is being made in structural reforms. Rapid progress in this area is key to the successful transformation to a market-oriented economy, although we realize that with the recent elections, it would have been difficult to make major advances in the past four months. However, we hope that the authorities will now rapidly formulate and begin to implement a structural reform program. Not only is this the main hope for Hungary to grow out of its debt problem, it is also Hungary's best chance to safeguard its recent advances toward a democratic society.

Mr. Iqbal made the following statement:

Notwithstanding its modest objectives and generally vague policy commitments, the Hungarian program has so far been characterized by mixed results. Inflation has picked up, the budget has come under renewed pressure, and the performance of the external capital account in convertible currencies is weaker than expected. I recognize the steps taken by the authorities to offset emerging weaknesses, particularly in the fiscal area, as being in the right direction. However, the present policy package can, at best, be viewed as a holding action which should be followed by a stronger, comprehensive, and long-lasting program aimed at a fundamental structural transformation of the economy.

This chair noted the modestness of planned actions when the arrangement was discussed in March 1990. On the basis of information contained in the staff paper, our views remain unchanged. Consideration should have been given to rephasing purchases with, perhaps, a shortening of the stand-by period, pending the formulation of the planned comprehensive program. Now that the elections are over, it is time to address the underlying problems in a more durable fashion. I am happy to note from Mr. de Groote's statement that the authorities are cognizant of the required changes.

Clearly, the evolution of four important areas will have to be closely monitored and addressed decisively, even if the modest planned objectives are to be realized. These include: persistent inflation; fiscal weaknesses; the seeming difficulties in strengthening the convertible currency capital accounts, and accumulating reserves; and state enterprise reforms, including the pace of privatization. The comprehensive program following the end of the current arrangement should be directed toward correcting these weaknesses.

First, despite the planned additional official actions, the fiscal objective for 1990 appears optimistic. The turnaround from a deficit in 1989 to a surplus in 1990 may require stronger expenditure controls and revenue generation than experienced hitherto. It should be recognized that the proposed modifications to ceilings on credit to the Government sector are not a solution to the underlying further weakening of the fiscal system.

Second, in the presence of large external debt service obligations, a durable recovery in the external payments position cannot be realistically expected without a drastic restructuring of the economy and redirection of economic relations. While foreign financial institutions and investors have a role to play, they cannot be expected to take on additional exposure without fundamental changes in the structure and profitability of the economy. Hence, the need for a more durable plan of action than that subsumed in the current arrangement. This does not mean that the authorities should pursue a more active exchange rate policy. Instead, a more fundamental structural reorientation is called for. In this context, the estimated large net outflow of short-term capital in convertible currency in 1990 highlights the limited nature of official policy action on the external front. I am happy to note that the revised program focuses more realistically on the pace of the shift from inconvertible to convertible currency surpluses.

Third, exchange rate policy in Hungary continues to play catch-up with domestic inflation relative to that of its trading partners. This stance, among other factors, may have weakened policy restraint on domestic inflation and weakened official resolve to correct inflationary pressures through a correction of domestic financial policies. It would have been more helpful, as suggested by this chair during the Board's discussion in March, if some sort of exchange rate anchoring had been practiced, so as to force action where needed, that is, on the domestic front.

To sum up, the current program should be viewed as a short-term palliative providing time for the authorities to undertake fundamental economic restructuring and redirection of international economic relations. This is a long-term process and it is to be hoped that the new program, perhaps under the extended Fund facility, will be more substantive than the current endeavor.

Finally, I am willing to go along with the proposed modifications and hope for a more comprehensive effort in the future.

Mrs. Sirivedhin said that her chair could endorse the proposed decision, including the proposed modifications of performance criteria. She was glad to note that all performance criteria under the current stand-by arrangement for end-March 1990 were fully observed, and was encouraged by the new Government's firm intention to continue implementing policies consistent with the objectives of the program. The recent introduction of measures to prevent slippages in the fiscal area indeed demonstrated its commitment to keep the program on track. The Fund's continued support was of critical importance for the success of Hungary's adjustment program, especially at the difficult juncture of transition toward a more market-based economy. The success of the program would no doubt provide a solid foundation for the implementation of Hungary's medium-term economic and structural reform which was under preparation.

Insofar as Hungary's economic performance was concerned, it was regrettable that the overall outcome had been less favorable than projected, Mrs. Sirivedhin went on. To a certain extent, that seemed to reflect the adverse effects of the ongoing economic transformation and policy changes on output, inflation, and the external position. For instance, while output had been adversely affected by efforts to reduce the current account surplus in nonconvertible currencies, inflation had become more difficult to contain as a result of price liberalization.

As for the external position, it was indeed unfortunate that a substantial improvement in the current account deficit in convertible currencies--one of the major objectives of the program--had been more than offset by the deterioration in the capital account, Mrs. Sirivedhin said. Thus, instead of improving as projected under the program, the foreign exchange position had weakened considerably during the first two quarters of 1990.

The new Government's prompt response to strengthen the program was therefore welcome, especially the introduction of a number of important measures to improve both sides of the budgetary position and increase interest rates, Mrs. Sirivedhin commented. Those measures, together with the reaffirmation of priority on external debt service payments, should enhance the credibility of the program, thereby improving prospects for the remainder of the program.

While she generally concurred with the staff's assessment and policy recommendations, like Mr. Clark, she was not quite as optimistic as the staff about the improvement expected in the capital account in convertible currencies for the rest of the year, Mrs. Sirivedhin concluded. The amount of net disbursements and capital inflows projected seemed substantial, and she wondered whether one could expect such a large turnaround in the space of the next few months. Therefore, it might perhaps be more prudent for the authorities to develop alternative policy actions in advance, to be used if the outcome proves to be less favorable than expected. In that connection, she agreed that exchange rates vis-à-vis convertible currencies needed to be kept under close review.

Mr. Wright made the following statement:

> The staff report and earlier speakers have referred to rather mixed progress: disappointing on the fiscal side, a worrying stagnation in output growth, but a better than expected export performance.
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> The emergence of revenue shortfalls and expenditure overruns in the early months of the year shows that fiscal adjustment, which has long been the Achilles heel of Hungarian programs, remains a problem. But the prompt and decisive corrective action the authorities have taken is both encouraging and, of course, essential if financial support is to continue to be forthcoming. I particularly welcome the decision of the Hungarian authorities to lower subsidies as part of the package of remedial measures.
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> I note that the fiscal measures proposed are expected to offset earlier sources of slippage and higher planned expenditures to deliver a budget surplus at least as large as that originally projected for the year as a whole. As other speakers have noted, such an outcome will clearly require the new measures to be strictly adhered to and any further slippages to be addressed without delay. Perhaps the staff could comment on the likely impact of the 30 percent reduction in Soviet oil shipments to Hungary which will affect both the convertible currency current account and the budget balance. Perhaps staff would also comment on whether there is likely to be an additional impact on domestic inflation, which is already uncomfortably high.

The second area of concern is the stagnation in output growth, notwithstanding the fact that the most recently published statistics do not fully capture activity in the private sector. As in Poland, it may well be that Hungary's state-dominated and monopolistic industrial sector is responding to the adjustment program by cutting output and raising prices. Even if this is not the whole story, I agree with other speakers that rapid reform of the supply side of the economy in the form of radical structural and institutional change remains a high priority. Once structural reforms have been introduced, output should begin to pick up. And, in this area, the World Bank's recently approved structural adjustment loan will clearly have a central role to play.

The strong surge in export in the first half of the year, particularly in the agricultural sector, has been a welcome development. As the staff notes, this partly reflects the carryover of exports from the previous year by enterprises seeking to take advantage of the lower rate of tax on profits introduced at the beginning of 1990. But it also reflects gains in competitiveness from the flexible exchange rate policy and a successful switching of production from domestic and ruble markets, which bodes well for the longer term.

One of several benefits of the better than expected current outturn is, of course, that it helps the authorities in their objective of avoiding a debt rescheduling which might damage their creditworthiness. The Hungarian authorities will need to continue to press hard in seeking new money from the commercial banks to supplement that from official lenders which would bring further relief to the external position.

As I said at the outset, Hungary's progress under the stand-by arrangement has been mixed. And the agenda ahead, particularly in the area of structural reform, remains daunting. However, all the performance criteria for the first review were observed and I can accept the proposed modifications, given that it remains the authorities' firm intention to stick to their original budgetary targets for 1990 as a whole. This they must do to preserve the credibility of their other adjustment policies and to pave the way for a comprehensive medium-term program supported by an extended Fund arrangement by the end of the year.

Mr. Ichikawa stated at the outset that he welcomed the new Administration's reaffirmation to maintain the adjustment effort under the stand-by program. Nevertheless, as elaborated in the staff report, there remained much uncertainty ahead, some of which reflected the unsatisfactory policy performance, particularly in the fiscal area, in the first few months of 1990. The authorities should therefore endeavor to maintain and enhance the adjustment momentum in order to ensure more reliable growth over the transitional period of economic restructuring. At the same time, like other speakers, he stressed the importance of formulating a comprehensive medium-term program at an early stage.

He was in broad agreement with the staff appraisal, Mr. Ichikawa continued. On fiscal performance, he had noted with concern that the fiscal target for the first quarter was met only because of the postponement of expenditure to the second quarter. Underlying revenue shortfall was a source of concern and pointed to the need to reassess the whole revenue projection. He welcomed the authorities' commitment to corrective measures. Nevertheless, while the revised program projected good revenue performance in anticipation of the pickup in economic growth in the latter half of 1990, a prudent fiscal stance was still warranted.

The response of the real sector of the economy was somewhat disappointing, Mr. Ichikawa added. Economic activity was sluggish owing to the sharp reduction in ruble exports, while inflation, as his chair had noted with concern at the previous Board discussion in March, running higher than programmed. However, he reiterated his authorities' emphasis on structural adjustment measures to deal with those difficulties.

An expansionary fiscal and monetary stance, in current circumstances, would slow the momentum of adjustment and could undermine the credibility of the Hungarian economy in foreign investors' eyes, Mr. Ichikawa observed. In that regard, his chair was somewhat concerned about the mixed performance of enterprise reform and privatization. While the authorities' efforts to formulate a comprehensive structural reform plan were welcome, the study should not delay the implementation of ongoing reforms, in view of the need to support financial adjustment.

It was unfortunate that the reduction in ruble exports and lower than anticipated capital inflow had offset the favorable growth in exports with the convertible currency area, Mr. Ichikawa concluded. That being said, the competitiveness of the economy should be further enhanced in order to allow a further and rapid transfer from ruble to convertible currency exports. Also, as the staff had emphasized, the authorities should focus on financial stability in order to attract medium- and long-term foreign capital inflow and to maintain Hungary's access to the international financial market. At the same time, the authorities should continue to monitor the monetary effect of the ruble trade surplus. He supported the proposed decision.

Mr. Ghasimi noted that the performance of the Hungarian economy since the beginning of 1990 had been somewhat mixed. Indeed, while a remarkable improvement had been achieved in the current account, food prices had risen, and deviations from the foreign reserve target had occurred. Under those circumstances, the envisaged improvement of domestic production and the reduction of the fiscal deficit had made the management of the economy a rather difficult task for the new authorities, a task which they were firmly determined to tackle properly. In fact, upon assuming office, they had rightly envisaged embarking on a far-reaching medium-term adjustment program aimed at addressing the deep-seated economic difficulties. In addition, the authorities had adopted a set of immediate and appropriate measures to pursue the objectives of the economic program for 1990.

Given the new political conditions, and in order to allow the authorities to evaluate thoroughly the economic situation, so essential for preparing a well-designed program, he shared the staff's view concerning the time needed to accomplish such a task, Mr. Ghasimi stated. Therefore, he supported the authorities' request for the modification of the performance criteria.

It was indeed encouraging to note that the authorities had given the highest priority to dealing with the expected sharp fiscal slippages by the end of the present year because of their possible large adverse impact on the confidence of foreign creditors in the Hungarian economy, Mr. Ghasimi added. In that respect, the measures undertaken so far to reduce certain subsidies and other expenditures as well as to increase tax revenue were very encouraging.

As to the external sector, he noted that in light of the implementation of a sound exchange rate policy since late 1989, the external competitiveness of the economies has improved substantially, Mr. Ghasimi said. In that connection, the authorities' intention to remain committed to a flexible exchange rate within their medium-term economic strategy was highly commendable.

In conclusion, as noted by the staff in its report, the availability of external financial resources in a timely and sufficient manner will definitely play a crucial role in the successful implementation of the economic reforms in Hungary, Mr. Ghasimi concluded. To that end, it was expected that, along with the official creditors, other creditors would respond favorably to the financial needs of the Hungarian adjustment efforts.

Mr. Thorláksson said that in view of the political circumstances in Hungary earlier in the year, there were reasons to be relatively content with the performance of the economy under the stand-by program since March of 1990. The economy had, by and large, performed as projected and in some areas significantly better than programmed. However, the rate of inflation and weakness of the capital account were clearly matters for concern. The unsatisfactory results in those two areas could be traced back to inadequate fiscal policy and insufficient access to international capital markets. This chair, among others, had been concerned about both these features at the time the stand-by arrangement was approved.

It was encouraging to learn that the Hungarian authorities had already adopted measures that the staff believed to be sufficient to ensure that the original fiscal targets of the program were reached by the end of 1990, Mr. Thorláksson observed. That course of action and a continued strict credit policy--including enforced financial discipline of the enterprises--should contribute significantly to price stabilization and prevent cost increases from undermining competitiveness and weakening the trade balance.

Access to international capital markets depended largely on the credibility of a viable economic policy, Mr. Thorláksson noted. In that context, the structural reforms played a crucial role in promoting an effective supply response to generate exports and foreign direct investment in Hungary. He completely agreed with the staff that in formulating and implementing further structural policies, speed was of the essence. The external debt and the future prospects for debt service were the most serious problems facing the Hungarian authorities. The projections of an increase in external debt in the coming years were very disturbing, and every effort should be made to contain that increase. In view of the uncertain effects of the dismantling of the current basis of trade with the CMEA partners, it seemed important that the authorities pursue policies geared to achieving a larger than currently projected surplus of convertible currencies in the trade balance.

Finally, the Union of Soviet Socialist Republics had recently decided to reduce oil exports to neighboring countries, Mr. Thorláksson noted. Furthermore, it would require payment in convertible currencies. Like Mr. Wright, he would appreciate a staff comment on the probable effects of that move on the Hungarian economic program.

He endorsed the proposed modification of the performance criteria.

Mr. Kwon made the following statement:

> When the Board considered Hungary's request for a stand-by arrangement in March, some question was posed as to whether it would be appropriate to approve the program a few weeks before the election. Nevertheless, the program was approved on the understanding that a critical review would be more appropriate during the first review, at which time the new authorities would be in charge and a longer-term outlook could be discussed. In that light, the review paper before the Board, proposing the modification of performance criteria for the remaining quarters, seems to suggest that the performance so far has been mixed. While it is regrettable that the comprehensive medium-term program which was expected to be incorporated in the review paper has yet to be formulated and that the Board's first review is taking place somewhat later than envisaged, I am pleased to note that substantial progress has been achieved in correcting imbalances in some areas, including the current account in convertible currencies.
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> Moreover, many uncertainties that were present at the time of the Board's approval of the current program appear to have passed.

I welcome the indication that the new Hungarian authorities have found it wise to continue to implement policies consistent with the 1990 program objectives, and that they are in the process of formulating a more comprehensive medium-term economic program in close cooperation with the Fund. Like previous speakers, however, I would like to stress that the time has come for the authorities to speed up the formulation of a far-reaching medium-term program and its implementation. It is indeed encouraging that the authorities' adherence to prudent financial policies has resulted in the stabilization of economic activity and the formation of favorable expectations, as well as substantial improvement in the current account balance.

It is clear, however, that more needs to be done, in both the areas of macroeconomic and structural reforms. On these, I can fully endorse the staff views, with the emphasis on tighter financial policies through greater fiscal efforts and with early progress on structural reforms designed to allow a faster pace of transition to a market-oriented economic system. I am therefore encouraged to note that the authorities have demonstrated their readiness to adopt corrective measures to ensure that the break from past inefficient policies is maintained. In this regard, the authorities' revenue-raising measures and the lowering of subsidies and transfers should be regarded as first steps toward future fiscal reforms. These reforms should, of course, be accompanied by continued flexibility of exchange and interest rates as well as tighter credit policy to deal with the much higher than expected rate of inflation.

On structural reform, I should emphasize the importance of trade liberalization and capital market reform which can go a long way in addressing the problem of capital flight. Indeed, it is important that the authorities re-establish their credibility in order to reverse the outflow of financial resources, which resulted in a deterioration in the external position despite significant improvement in the current account. In this regard, I agree with the staff that the Government's reaffirmation of uninterrupted servicing of external debt, coupled with the strict implementation of policies designed to underpin the more ambitious current account target, offers the best prospect of restoring confidence of the financial markets. I can also endorse the view that foreign bank creditors have an important responsibility to maintain exposure on the strength of evidence of firm and sustained adjustment.

In conclusion, the proposed modification of the performance criteria for the remaining period appears to be inevitable and also entirely appropriate under the present circumstances, and I can therefore support the proposed decision.

Mr. Dai made the following statement:

In view of developments in the implementation of the policy program in the past few months, I agree with the Hungarian authorities that the first priority of economic policy should be to curb inflation and to continue tight financial policies. The tasks facing the authorities are complex. First, how can they bring down price inflation on the one hand and, in the meantime, accelerate price liberalization and the liberalization of convertible currency imports without upward pressures on prices, on the other? In the process of price liberalization, the increase in price levels is inevitable. Part of the increase is of an adjustment nature. The programmed target of the inflation rate should take this factor into account and allow for a reasonable element of an upward price adjustment. However, what is most important in addressing inflation is to maintain an appropriate balance between aggregate demand and supply. We note that both consumption and investment have been revised downward, which implies that the authorities are tightening efforts to contain domestic demand. Nevertheless, I wonder whether the expected larger budget deficits and monetary financing could have a counteractive effect.

Second, how can the authorities strengthen Hungary's weak fiscal position while economic activity continues to be sluggish? It is noted that the main element of revenue weakness in the first quarter has been sharply lower corporate profit taxes, including dividends from the state-owned enterprises. These revenue losses were related to the weaker performance of economic activity. It is now envisaged that there will be a decline in GDP of around 2 percent for the year. I wonder whether the objective of a substantial increase in revenue could be successfully achieved in conditions of a depressed level of production. Perhaps more emphasis should be placed on the expenditure side. While further tightening the financing policies, care needs to be taken to avoid undesirable effects on the supply response. Moreover, in the course of enterprise restructuring, including the diversion of export markets, some depressive effects on output and employment may be inevitable. However, caution must be exercised in the event of prolonged stagnation in productive activity as it could be counterproductive to the process of structural reform.

Third, how can the authorities tide over the great risk to Hungary in the external payments position in the face of difficult access to the international capital markets? On the one hand, it is so crucial for Hungary to grow out of its external debt problem because external debt and debt service obligations have reached such a high level; on the other hand, in order to attack its external payments difficulties, Hungary has to continue to rely upon larger external borrowing. This dilemma may not be eliminated in the foreseeable future. During the discussion on the request for a stand-by arrangement by the Hungarian authorities in March, we expressed our concern that the outlook for the balance of payments appeared very uncertain--in particular, the unassured response of the commercial lenders would also complicate the external position of Hungary in 1990, when substantial financial resources would be needed to accomplish the authorities' adjustment commitments. This concern remains valid in view of the intensified difficulties in raising medium- and long-term capital in recent months. It seems that more time is needed before the Fund's catalytic role can come fully into play and the confidence of financial markets can be restored. Therefore, more reliance on foreign financing has to be placed on official resources--bilateral and multilateral. I am not sure if external financing is already assured for the remainder of the year, which could have a significant impact on program implementation.

In conclusion, as I emphasized before, the accomplishment of the adjustment and reform program in Hungary requires strong and sustained support from the international community, of which the Fund's continued assistance is indispensable. I can agree with the proposed decision.

Mr. Posthumus made the following statement:

The medium-term tasks facing the Hungarian authorities are indeed daunting, in particular because the stabilization objectives have not yet been reached. The fiscal targets certainly have become more difficult to attain, and I am concerned about this. Inflation in 1990 may be in the order of 20-25 percent, higher than originally foreseen, and requiring tight financial policies. The priority given to curbing inflation is therefore right. However, the staff notes that tight financial policies initially had a greater impact on the external balance than on inflation. Growth, estimated to be negative in 1990, was lower than anticipated. Continued tight financial policies might continue to result in economic stagnation rather than in lowering inflation, and not only initially. This underlines the urgency of structural reforms, but does not necessarily mean that these reforms will be effective in the short run, so that an environment of stagflation is possible.

In view of the primacy of external adjustment, a deterioration of the competitive position must be prevented, calling for a so-called active exchange rate policy. The staff indicates that the level of the real exchange rate at the moment is appropriate, as well as the peg to the basket of foreign currencies. Is this a basket of hard currencies? Continuing inflation requires continuing depreciation, which may feed inflation, a familiar process. Is there no way to break this process?

It is clear that the structural reforms have to be carried through, and I think we can conclude that the authorities are indeed moving in this direction, but I cannot judge whether they go far enough. The status of enterprises, both legally and in practice, is apparently not yet adjusted to a market economy environment.

I can approve the program but the uncertainties about appropriate parallelism between the stabilization measures and the structural measures are so great that it is almost impossible to be reasonably confident that the specific performance criteria can be adhered to.

Against this background, we should not be surprised when the external debt obligations of Hungary cannot really be met all the time. But debt service ratios of about 50 percent seem unsustainable, even in the absence of such serious structural problems. It may well be that scheduled repurchases from the Fund in 1991-95 are only a small portion of total debt service, an argument that holds, of course, for every separate creditor. And it means, notwithstanding our preferred creditor status and in light of the Fund's role, that caution regarding access will be necessary when future Fund programs are contemplated. I approve the proposed decisions.

Mr. Arora commented that in guarded words, Mr. de Groote had laid out the dilemmas of a relatively small economy in transition from the status of central planning to market-oriented status. Mr. de Groote had also made a quite striking remark, in mentioning that the reaction of the financial markets to the Hungarian adjustment program could throw in doubt the value and meaning of Fund-monitored programs. Indeed, it was paradoxical that under central planning, with varying degrees of control but a largely controlled economy, financial markets had been ready to lend considerable sums to Hungary. Just when Hungary was undertaking structural reform, the markets became cautious. The situation was a paradoxical one because the fundamental indicators showed that except for one of the past four years, GDP had virtually not grown, and in fact had declined. The fiscal deficits, at from 0.1 percent to 3.2 percent of GDP, were not a cause for concern. Domestic savings were at a high level, and the investment/savings balance was not really the cause of Hungary's trouble. The cause for worry was to be found in the debt overhang and the capital account. Therefore, Hungary did indeed face a dilemma.

Certainly, Hungary needed to undertake the systemic reform to which Directors had drawn attention, Mr. Arora remarked. But systemic reform in the existing external environment put the entire social fabric at risk. Therefore, as Mr. Posthumus had rightly pointed out, there was a risk of economic stagnation in Hungary, and the question was whether, with a change in the political system, the population would stand for it. The duty of the international community was thus quite clear. Hungary had actually observed the performance criteria and he could go along with the proposed decision on their modification. But the longer-term implications of developments during the period under review were of concern; if they were not viewed from a wider perspective, the process of reform in Hungary might be stifled. Consequently, as Mr. Grosche had correctly pointed out, the commercial banks and the authorities in Hungary had to get together with the multilateral institutions and agree on a reform package that would give them enough time to adjust to the emerging realities.

In that context, Mr. Posthumus and Mr. Cirelli had expressed some doubts about the exchange rate policy and the need for an anchor, Mr. Arora noted. The problem was that in the short run, to prescribe for Hungary the kind of adjustment that Latin American countries had followed, namely, to run an external current account surplus, was not possible without an active exchange rate policy. And that, of course, had implications for inflation. Such a prescription could prove erroneous. Fresh thinking was needed on reform in relatively small economies like that of Hungary and other countries in Eastern Europe, but also in a massive economy like that of the Union of Soviet Socialist Republics when it turned to market-oriented reform.

Mr. Fernández Ordóñez said that he agreed with the staff appraisal and supported the proposed decision. Developments in Hungary since the Board's meeting in March had been mixed. The current account had performed better than expected; in the view of the authorities, the current account deficit could be $150 million lower in 1990 than had been expected three months before. Nevertheless, other developments and the revised projections were not so encouraging. The weakness in the capital account, the faster increase in consumer prices, lower public revenue, and higher public expenditure were matters of concern. He welcomed the intentions of the authorities to commit themselves to maintaining tight financial policies, but as his chair had stated in March, his authorities attached the greatest importance to the implementation of a medium-term structural program. It was gratifying to note that the authorities were working in that direction.

Conscious as he was of the difficulties of the authorities' task, he joined others in offering two pieces of advice to the Hungarian authorities, Mr. Fernández Ordóñez said. First, they should not delay the implementation of the medium-term structural program, which would be crucial in promoting a quick supply response. Second, although the decision of the Government not to interrupt the service of external debt was welcome, the authorities should take into account the experience of other countries and realize that policy could be very costly and completely useless as a means of restoring the confidence of the markets if it was not accompanied by sound economic policies. It was a necessary condition but not a sufficient one.

He would be interested in the answer of the staff to the question posed by Mr. Posthumus and Mr. Cirelli, Mr. Fernández Ordóñez noted.

The historic changes taking place in Eastern Europe needed to be buttressed by one successful experience to encourage the authorities of other countries to persevere in introducing free market policies, Mr. Fernández Ordóñez concluded. Hungary, which had been the pioneer in introducing that kind of reform, even under the previous regime, was probably the best prepared to reap an early harvest, and he wished the authorities the very best in their efforts.

The staff representative from the European Department noted that Mr. Kyriazidis had asked what measures might be considered to prevent a wage explosion. There was currently a tax-based incomes policy, which had some effect, but if there were significant price increases, the question was whether the necessary response of enterprises, out of concern for profitability, would be sufficient to prevent excessive wage increases in the context of a reform program. That difficult question would have to be looked into. However, the staff paper issued in 1989 (Economic Reform in Hungary since 1968, SM/89/203, 10/5/89) which had reviewed Hungary's reform experience since 1968, showed that wage policy had been changed back and forth during that period, to public resentment. Some important ideas that had been put forward to prevent such a wage explosion were at various stages of consideration, and the authorities would look at them carefully, in formulating their program and in discussions with the staff, but it was too soon to elaborate on the details.

As to whether financial policies would not continue to have more of an impact on growth and the balance of payments than on inflation, the staff representative added, the staff had relatively little experience in gauging the market response to financial policies because the market had been undergoing a process of progressive liberalization. Inflation had been higher than the Hungarian authorities had hoped during the first half of the year; it was coming down, but not as fast as one would like. Over time, as indicated in the staff paper, the experience of other countries at least suggested that tighter financial policies would have the desired impact on inflation.

Higher interest rates definitely affected the cost of subsidies, the staff representative said. For instance, they were responsible for part of the increase in housing subsidies shown in the budget, although the National Savings Bank had absorbed part of the increase in interest rates by reducing its profits. There did not appear to have been a further increase in inter-enterprise credits in the first part of the year to offset the lower rate of increase in credit from the banking system. While the data was not as readily available as it used to be, the information given to the staff by officials of the National Bank as well as by representatives of commercial banks was that, during the first quarter of the year, there had in fact probably been a decline in interenterprise credits rather than a continuation of the increase which had been observed in the previous two years.

On exchange rate policy and the extent to which the impact of the exchange rate change in 1990 had contributed to inflation, the staff representative noted that in the past, the authorities had looked at a transmission coefficient of 0.4, so that, with a 16 percent depreciation, the CPI would increase by 6 percentage points. Whether that mechanical relationship still pertained in a free-market environment was an open question. But the exchange rate changes definitely had contributed to inflation because of their impact on expectations and perceptions.

As to why the staff welcomed a flexible exchange rate policy, rather than a fixed rate which could lower the risk of a vicious circle of depreciation and inflation, the staff representative observed that an essential element to the success of the reform program would be an appropriate change in relative prices domestically, which would be consistent with the restructuring and with the liberalization of trade. In theory, that change in relative prices could be achieved through a greater tightening of demand management policies, and a lower level of domestic demand. In practice, however, in 1990, not only in Hungary, but also in some other neighboring countries, prices had proved to be stickier than had been hoped, so that exclusive reliance on demand management policies to effect the change in relative prices, could require substantial slack.

How to avoid that vicious circle of depreciation and inflation had been discussed to some extent at the Board's previous meeting on Hungary, the staff representative recalled. The Government had made it very clear that lowering inflation was a key priority, and that it was willing, at least to some no doubt limited extent, to sacrifice growth to achieve that result. If there was to be a change in relative prices--an issue that the staff would in fact be discussing in the near future with the Government--it would be better, in his view, to have it early on followed by policies which would make it possible to keep the exchange rate more stable and to bring down the rate of inflation subsequently. The strategy remained to be examined more fully by the Government, as well as discussed with the staff. Information for the month of May, which was not reflected in the staff report, indicated a further slowdown in the rate of inflation, which needed to fall a lot more, however, the staff representative added. The information for June did not indicate clearly whether or not there had been a further slowdown compared with the month of May.

The arrangement reached with the Union of Soviet Socialist Republics for the conversion of accumulated balances did not mean that Hungary should strive to increase the volume of its trade across the board with the Union of Soviet Socialist Republics, the staff representative explained. Trade that was profitable should be maintained and expanded. No one would advise people in Hungary or any of the other East European countries not to trade with the Union of Soviet Socialist Republics, if it was a profitable market, because the trade would simply be taken over by other countries. The staff's concern in 1989 had been the severe effects on liquidity of the large surplus, which had immediately been reflected in larger deficits of the balance of payments on current account in convertible currencies. A repetition of that outcome had to be prevented. In a sense, it was a trade-off between the gain from accumulating balances which could be converted to finance future deficits and achieving the target of the balance of payments in convertible currencies. The need to withdraw credit from other sectors in case of continued large surpluses in CMEA trade also raised the question of whether that reallocation of resources was consistent with the restructuring that needed to take place, in particular as many of the enterprises that traditionally had been trading with the CMEA area were those in most need of restructuring. Inevitably, there was also uncertainty concerning the use of larger accumulated surpluses and over what period of time.

The outlook for the capital account in the second half of 1990, and how certain the inflows of foreign capital were, had been a matter for consideration since the beginning of the year, the staff representative added. As far as private capital was concerned, there had been successful bond issues in European markets. For the remainder of the year, the realization of the assumptions underlying the projected balance of payments depended greatly on success in issuing further bonds, which would make it possible to rebuild reserves. As Mr. de Groote had indicated, the performance of the current account balance during the second quarter of the year was another favorable element. There would also be an issue in the Eurodollar market under the World Bank's enhanced cofinancing operation, and the Japanese credit rating agency had reconfirmed the rating of Hungary for issues in Japan. Those issues were being prepared; it had not been possible to proceed with them in the first half of the year because Hungary's previous borrowing authority had been exhausted, and the credit rating therefore needed to be renewed.

Although a number of uncertainties remained, on the basis of the plans that were currently being pursued, the staff hoped that the borrowing program would be achieved, the staff representative said. In the short term, the staff hoped that the pressure on the reserve position would have been reduced, through the BIS operation, as well as the German Government's guarantee to which Mr. Grosche had referred and which had been signed and made available.

The Government had reaffirmed the objective of stopping the growth of external debt, the staff representative stated, which was an absolutely essential objective. The Government also needed to proceed strongly to achieve the fiscal and external objectives set for the current year and convince creditors that it would put in place a strong structural reform program which would hopefully be supported, as it had been to an unexpected degree so far in 1990, through inflows of foreign direct investment and also a strong growth of exports. Of course, there was no certainty when one was operating in free markets; indeed, in 1982, when Hungary had faced an even more difficult situation, it had taken 12 to 18 months before the banks had re-entered the market. So far in 1990, Hungary had been able to rely to a large degree on bond issues, and of course, official support. It was the firm intention of the Government, as some speakers had observed, to continue to service its debt normally.

As to whether lower exports of oil from the Union of Soviet Socialist Republics to Hungary would have an impact on the budget, the current account, and inflation, and thus any implications for the objectives laid out in the staff paper, the staff representative explained that the Union of Soviet Socialist Republics had exported less oil than planned to Hungary during the first half of the year, as reflected in the current account deficit, and in the budget. The initial assumption that there would be some reversal of that shortfall for the remainder of the year would not be realized, at least for the third quarter. The cost for the budget in the third quarter would be about Ft 3-4 billion, and for the current account in convertible currencies, about $50 million. The Union of Soviet Socialist Republics had promised to increase deliveries in the fourth quarter. The impact on both the budget and the current account, so far, were within the reserve margins that he had mentioned earlier, so that for the time being, there should be no serious difficulties. As far as inflation was concerned, the cost fell on the budget because enterprises were already being charged world market prices, even for oil imported from the CMEA area.

Mr. de Groote made the following concluding remarks:

The Board has again examined Hungary's situation and made a number of analytically profound and stimulating suggestions which I will not fail to transmit to my Hungarian authorities. These suggestions will obviously represent an important input to their ongoing reflections on the outline of a program of systemic reform.

Let me take as a starting point the question raised by Mr. Posthumus and Mr. Arora, which was also approached by Mr. Dai and Mr. Cirelli from a different direction: is it really necessary to continue a deflationary program, since there is a risk that its main goal of producing balance of payments surpluses might be accompanied by side effects such as output stagnation and inflationary pressures whose impact would be compounded by the flexible exchange rate policy? I would like to propose three elements of an answer to this question: first, in terms of the magnitude and nature of the ongoing adjustment; second, in terms of the relative priorities of balance of payments versus income objectives; and third, in terms of the degree of reliance on foreign funding needed to obtain a more effective adjustment in the future.

Most Executive Directors are of the view that the results so far have been mixed; and also, as Mr. Clark has put it, that "the cost of the transformation was greater than originally expected." Is this really so? The income losses will most probably total from 1 percent to 2 percent of GDP over the whole of 1990, and as I mentioned in my opening statement, the inflation incorporates a large component of systemic price adjustment reflecting the elimination of subsidies. It does not seem correct to characterize such a situation as one of "stagflation." And are these consequences really so severe when viewed against the background of the fundamental political and economic changes going on since the beginning of the year? Can a country really be expected to step across to a democratic electoral and organizational system, and eliminate a heavy overhang of subsidies, without incurring some costs in terms of incomes and prices? My Hungarian authorities do not think so, and would therefore agree with my colleagues that the results had indeed to be mixed, but I very much doubt that they really expected a better outcome under the circumstances. Comparisons with the costs of transition incurred by the other countries of the Eastern Bloc is rather instructive on this point.

What about the trade-off between balance of payments and income objectives? On this point, I would like to stress that my Hungarian authorities would readily agree with Mr. Dawson and Mr. Grosche, that absolute priority must go now to the attainment of a balance of payments surplus, given the country's high level of indebtedness and the indispensable role of external financing in the success of the upcoming systemic program. It seems unavoidable that this choice of priorities would entail a moderate slowing of income growth, perhaps even a slight reduction in income, and that some price effects will by necessity accompany the elimination of subsidies needed for an improved resource allocation leading to a better current account position. These are not too high a price to pay for restoring the country's external position, on which everything else, and in particular future growth, so crucially depends. The period during which a less than optimum income performance must be accepted for the sake of achieving, in the first phase, the balance of payments objective will be kept very brief, since it is precisely the purpose of the structural adjustment program to rapidly elicit supply effects that will restore appropriate growth conditions.

This brings me to my third question: can Hungary grow out of debt and attain a viable balance of payments position without having to rely on additional external resources? No doubt some measures can be taken at home that will contribute to a favorable outcome--I am referring particularly to Mr. Dawson's suggestion that an increase in interest rates and full liberalization of the use of deposits in foreign currencies would facilitate the repatriation of externally held balances sometimes estimated to total as much as $2-3 billion. But these and other internal measures presently under consideration obviously cannot provide the flow of financing needed to allow systemic change to proceed rapidly, and thus enable Hungary to grow out of debt. We therefore can all agree with Mr. Grosche that the international lending community, which has allowed Hungary's debt to become what it is, has a responsibility to continue its support as long as the country is implementing a successful and fundamental program under the Fund's guidance. Any other course would bring into serious question the Fund's catalytic role, and the role of the banks themselves, in financing the processes of balance of payments adjustment and systemic change.

Several colleagues have mentioned, and I acknowledge, that time is needed to restore a country's spontaneous access to the markets, even under conditions of satisfactory performance. The staff representative has cited some precedents from Hungary's experience with previous programs; I could also cite Turkey's case, where despite a fundamental reform program and a strikingly successful outcome, about two years were needed for the country to restore its credibility vis-à-vis its lenders. That Turkey was only enabled to get through this period by the assistance of friendly countries and the support of the international financial organizations also indicates what effort will be needed from friendly countries, from the EEC, from the World Bank, and from ourselves, before Hungary can reach a sustainable balance of payments position. Obviously, external assistance will only materialize, as was particularly stressed by Mr. Clark and Mr. Iqbal, if Hungary can produce a convincing medium-term balance of payments forecast reflecting the results that the adopted policies will produce. And of course, the great uncertainties about Hungary's future trade with the Union of Soviet Socialist Republics will require these forecasts to consider a set of alternative assumptions reflecting possible further deterioration in Hungary's terms of trade with that country and suitable policies for responding to that possibility.

I would now like to give my reactions on three important topics raised by members of the Board which will be central considerations in the design of the structural adjustment program of systemic reform: inflation and incomes policies, the ownership issue, and convertibility and trade with the Union of Soviet Socialist Republics.

On inflation, I have already stressed that the demand element in the price movement seems rather limited, most of the increases being due to subsidy elimination. Mr. Dawson has observed on this point that the recent increase in the public sector wage bill may have strengthened inflationary pressures. In fact, this increase has only partly offset increases in the cost of living experienced by public sector employees due to elimination of the subsidy on housing credits and rents. During the whole of the reform period, the public sector is expected to contribute to the adjustment by a moderate decline in real income. Mr. Kyriazidis has addressed the same issue by asking how the present wage explosion could be moderated. Is labor shedding the only available corrective? True enough, the rising unemployment that can be expected from the rehabilitation of some state enterprises and the dismantling of others will exert a moderating influence for a number of years on the level of real wages. However, since a high percentage of the newly unemployed work force seems to have been easily absorbed up to now by the rapidly growing sector of small- and medium-scale enterprises, it might make sense to give incomes policy a decisive role in the program for systemic reform; indeed, a durable transfer of resources to the balance of payments sector will be possible only as long as nominal wages do not fully catch up with the price increases that are bound to result from the elimination of subsidies.

On the ownership issue, I have noted the view of Executive Directors that market mechanisms cannot fully come into play unless private ownership has been established throughout the productive sector. Mr. Grosche was right in welcoming the privatization of land, as were the other members of the Board, in particular Mr. Cirelli, who advocated more active implementation of the bankruptcy law.

On convertibility, several colleagues wonder whether the present exchange rate can be regarded as an equilibrium rate, and Mr. Kyriazidis suggests that during our further reviews of the stand-by arrangement we should examine the appropriateness of the rate. Mr. Cirelli has raised a fundamental issue by questioning the validity of a policy of constant downward adjustments of the exchange rate as opposed to a policy that would maintain the exchange rate constant in real terms. The staff representative has answered this question by indicating that such adjustments of the exchange rate are necessary to elicit a movement of productive resources toward those sectors that have comparative advantages in terms of more favorable relative prices. This line of reasoning should be complemented by the following considerations: the movement of resources will only respond to exchange rate inducements if the transmission mechanism for exchange rate adjustments is working satisfactorily. As Mr. Cirelli implicitly hinted, this may not yet be fully true. Progress in the direction of privatization and the establishment of a market whose effective functioning at all levels exists in the real world and not merely on paper or in a legal decree, seems to be a prerequisite of a fully effective policy of exchange rate adjustment.

Concerning trade with the Union of Soviet Socialist Republics, some of my colleagues have suggested that it might be advisable for Hungary to accumulate surpluses vis-à-vis that country, now that it has declared that it will settle all its current deficits in convertible currencies. I would again like to complement what has been said by the staff representative by reminding the Board that the problem might just cut the other way, since the Union of Soviet Socialist Republics will henceforth ask Hungary to pay for its energy imports in convertible currency at market prices, without any certainty that corresponding imports will take place from Hungary nor, if they take place, without any certainty that the Union of Soviet Socialist Republics will agree to pay world prices for commodities it has been accustomed to purchase under exceptionally favorable, in many cases, leonine conditions. But, even if we disregard this most important risk for Hungary's future current account position, does it really make sense for any creditor now to increase his claims on the Union of Soviet Socialist Republics, even if it has announced that such claims will be fully paid in U.S. dollars? For many observers, it is difficult to see how the Union of Soviet Socialist Republics can now settle all its debts immediately in U.S. dollars when it was formerly unable to do so under more auspicious circumstances.

In ending, let me express my confidence in the possibility that we will quickly see a fundamental reform program set into operation. All members of the Board have stressed that success will crucially depend on the prompt implementation of a comprehensive program, all the elements of which should avoid undue gradualism. All of you agreed with the principal agenda items that my authorities and the staff intend to consider: elimination of subsidies, acceleration of the privatization process, full modernization of the financial and banking sector, and full convertibility of the currency. Beyond all technicalities, I am convinced for two reasons that we can have full confidence in Hungary's power to realize this ambitious goal. First, the process of economic reform began in Hungary years ago, at a time when it was difficult and even dangerous to pursue it. Thanks to this early start, Hungary possesses a much stronger real basis for a market economy than exists in other countries, where economic reform could only begin once the past started to crumble with Budapest's decision not to close its borders with the West. Hungary was in the vanguard of change, and like all pioneers, its people prize the more highly and guard the more jealously their achievement of a strong basis for further progress. Which brings me to my second reason: during my visits to Budapest I have detected not a single trace of complacency with the progress achieved so far. That progress, won painfully by long effort under adverse circumstances, has brought Hungary to the point where the full rewards of those years of effort and courage are finally visible. Now that the final exertions can be made under conditions of freedom, by Hungarians in full possession of their land and national identity, there are none who believe the continued effort to be too strenuous, who wish to delay the final stages, or who are willing to stop here and be content with the incomplete rewards already won.

The Executive Board then took the following decision:

1. Hungary has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Hungary (EBS/90/32, Sup. 1) and paragraph 12 of the letter dated February 13, 1990 from the President of the National Bank and the Minister of Finance of Hungary, in order to review the implementation of the policies and measures described in the letter dated February 13, 1990 and the attached table.

2. The letter, with attached table, dated July 6, 1990 from the President of the National Bank and the Minister of Finance of Hungary shall be annexed to the stand-by arrangement for Hungary, and the letter of February 13, 1990 with the table attached thereto shall be read as modified and supplemented by the letter of July 6, 1990 with the table attached thereto.

3. Accordingly, the limits specified in paragraph 4(a)(1), (a)(2), and (b)(4) of the stand-by arrangement shall be modified as indicated in Table 1 attached to the letter of July 6, 1990.

4. Paragraph 4(c) of the stand-by arrangement shall be amended to read as follows:

> during any period after May 30, 1990 or November 29, 1990, respectively, until the review contemplated in paragraph 12 of the annexed letter has been completed; or

5. The Fund decides that the first review contemplated in paragraph 4(c) of the arrangement is completed, and that Hungary may proceed to purchase the equivalent of SDR 31.84 million under the stand-by arrangement for Hungary notwithstanding that the data as of June 30, 1990 for the performance criteria specified in paragraph 4(a) of the arrangement are not yet available.

Decision No. 9511-(90/123), adopted
July 27, 1990

The General Counsel pointed out that the purpose of the decision was to release the second purchase under the stand-by arrangement for Hungary. It so happened that the review that had taken place was being completed after June 30, 1990, the date as of which the performance criteria for that purchase would be relevant. Therefore, he proposed that in order to release the second purchase, and while the data as of end-June were not yet available, paragraph 5 of the proposed decision be amended to read: "The Fund decides that the first review contemplated in paragraph 4(c) of the arrangement is completed, and that Hungary may proceed to purchase the equivalent of SDR 31.84 million under the stand-by arrangement for Hungary notwithstanding that the data as of June 30, 1990 for the performance criteria specified in paragraph 4(a) of the arrangement are not yet available."

2. AFGHANISTAN - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Afghanistan (SM/90/131, 7/3/90, and Sup. 1, 7/23/90). They also had before them a report on recent economic developments in Afghanistan (SM/90/140, 7/13/90).

Mr. Ghasimi made the following statement:

> I would like to convey my Afghan authorities' appreciation to the staff for the 1990 Article IV consultation discussions with Afghanistan, which took place, after a hiatus of four years, in a frank and highly cooperative and constructive manner.
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> For more than a decade, the economy of Afghanistan weathered a number of adverse shocks and had to shoulder the burden of a devastating and protracted internecine conflict that entailed a tragic cost in human life, enormous damage to the infrastructure and productive assets, and widespread disruption to the economy. Notwithstanding the continued difficult security situation, the authorities initiated a number of economic reforms that are expected to be reinforced as a result of the ongoing constitutional reforms. The economic reforms encompass wide-ranging decentralization and liberalization measures aimed at reorienting the economy and moving toward a new market-oriented development strategy. The authorities continue to emphasize the removal of price controls, the enhancement of the role of the private sector in all areas of the economy, and deregulation of the financial system.
>
> During the last decade, the Afghan economy suffered from the continued difficult internal security situation and the associated problems. Following the second brief recovery since 1980 of output in 1986/87, net material product (NMP) contracted by an annual average of 8 percent during the three years ending

1989/90. Agricultural output, which accounts for a major share of NMP, declined by almost half since the late 1970s. Indeed, the internal security conditions, which were reflected in shortages of necessary inputs and constraints on transportation and marketing, as well as a locust attack and crop disease, all profoundly aggravated conditions in the agricultural sector and resulted in a sharp downturn in the output growth of this sector by 19 percent in 1987/88, which was followed by further declines of 7 percent in 1988/89 and 3 percent in 1989/90. Though the security situation continues to remain uncertain, the authorities envisage a consolidation of the process of national reconciliation while simultaneously strengthening the implementation of the necessary macroeconomic and structural policies with a view to normalizing the economy and bringing about a sharp recovery of output (12.4 percent) in 1990/91. Meanwhile, the prospect for the return of farmers to their land and the restoration of land to their original owners are encouraging signs in the authorities' attempts to ease tensions in the agricultural sector and raise the rate of growth to 7 percent in this sector.

In recent years, fiscal developments have been characterized by large military expenditures, the provision of public employment to returning refugees, and the assumption of huge social expenditures for war victims and their families. In the meantime, fiscal revenues plummeted owing mainly to shortfalls in a number of tax revenues, especially import taxes, and to the cessation of income originating from natural gas sales. Government revenues further deteriorated as a result of the weakened financial position of a number of public enterprises, which, in turn, reflected a notable decline of transfers to the budget. Consequently, the overall fiscal deficit widened during the last few years and amounted to 25 percent of NMP in 1988/89. In such circumstances, the uncertain trend of external assistance obliged the authorities to finance the deficit through frequent and large recourse to the domestic banking system. Naturally, the resulting rapid expansion of government net indebtedness to the banking system emerged as the major contributing factor to the growth of liquidity, as net foreign assets of the banking system showed little change. Therefore, the authorities were left with no choice but to accept the challenging task of coping with the heavy burden of inflationary pressures in the economy. It can hardly be denied that, unless substantial revenue-generating measures are realized in the near future, any foreseeable potential savings from the improvement in the security situation would have to significantly outweigh the aggregate cost of national reconstruction and resettlement of the refugees, if the fiscal deficit and its associated problems are not to overpower the Afghan economy in the future.

Preliminary data for the year 1989/90 indicate that the budget deficit narrowed to 12 percent of NMP owing to the success of efforts to contain extrabudgetary outlays. With regard to the current fiscal year 1990/91, the authorities plan to further strengthen budget monitoring and control procedures and to attain a total expenditure of Af 159 billion which, in nominal terms, is slightly below last year's figure. On the revenue side, despite the obstacles in strengthening tax collection and improving tax administration, the authorities have identified a number of revenue-generating measures in the 1990/91 budget. In this connection, taxes on corporate income were revised from 20 percent to 25 percent, and sales taxes were increased from 2 percent to 2.5 percent. In the same period, government revenues are contemplated to increase by 10 percent and amount to Af 53 billion. Indeed, this projected increase seems realistic as a number of the measures in the budget are supplemented by an extensive revision of the tariff structure (introduced in September 1989) and the resumption of natural gas exports. Taking into consideration all of these developments, the overall government deficit is foreseen to decline by about 7 percent in 1990/91.

While the authorities are encouraged by recent improvements in the budget, they are by no means complacent about the enormous weaknesses therein, and the magnitude of the challenges that lie ahead. The authorities are, in fact, fully cognizant of the dangers posed by the growing pressures of domestic demand that emanate from the heavy reliance on the banking system to finance the budget deficit and the associated consequences for domestic inflation. In fact, their desire to restrain the budget deficit and contain demand pressures should be considered as the cardinal reason for their adherence to strengthening macroeconomic policies and pursuing structural reforms, as well as gradually initiating market-oriented policies.

As to developments in money and credit, it should be emphasized that the mounting challenges faced by the private sector in recent years have markedly limited the ability of this sector to absorb bank credit. Consequently, banks' claims on the private sector did not register any increase in real terms during 1987/88-1989/90. In the same period, claims on the official entities and public enterprises also diminished sharply as the proceeds of the sale of commodities, provided through bilateral aid, permitted repayments of some of their previous loans from the central bank. The authorities are very concerned with the financial and physical crowding out of the nongovernment sector, which they are determined to address in a practical manner through the implementation of the necessary economic policies.

It is recognized that the operation of a healthy and efficient banking system is indispensable for achieving financial stability and realizing further improvement in resource allocation. To this end, the authorities are endeavoring to introduce a number of banking reforms by March 1991. These reforms will embrace a number of wide-ranging measures involving the privatization of banks, a revision of the Investment Law to allow foreign ownership of banks, and the accommodation of more flexibility in the use of market forces to determine interest rates.

On the external side, a sharp curtailment of the two main sources of foreign exchange earnings, namely, external assistance from bilateral sources and export receipts, dominated recent developments. Under these circumstances, imports were severely cut back from $1.3 billion in 1986/87 to $0.7 billion in 1989/90, which in turn exacerbated domestic inflationary pressures. Meanwhile, the consolidation of the market-oriented process is bolstering the establishment of economic links with the rest of the world and promoting a move toward multilateral trade transactions. This trend has been accompanied by courageous measures, launched in 1989, to liberalize and rationalize the exchange and trade system as part of a broader package of deregulation of the pricing system. The commercial exchange rate, which is maintained at a level close to the rate in the bazaar, is now applied to 90 percent of all transactions in convertible currency. Also, almost all of the restrictions on imports have been dismantled. The authorities have indicated their intention to further pursue these reform measures and to take the necessary steps to complete the exchange rate unification as soon as practical. Furthermore, they are cognizant of the fact that, unless budgetary deficits are properly contained under the liberalized trade and exchange system, the demand pressures will adversely influence the exchange rate and accentuate the prevailing domestic inflationary pressures, which are already a matter of serious concern and one that warrant continued vigilance.

The authorities have recognized the importance of structural reforms and the advantages of efficient utilization of scarce resources. Since 1988/89, they have opted for indicative planning with emphasis on the elimination of distortions in microeconomic prices and incentives, the promotion of privatization, and the decentralization of decision making in public enterprises. In fact, a number of incentives have already been introduced to improve the environment for private sector activity. The number of private businesses has been increasing, mostly in the last four years, from 170 in 1978/79 to 420 in 1989/90. The authorities aim to proceed first with the privatization of a number of smaller public enterprises and later with the sale of assets of larger enterprises. For the remaining enterprises in the public sector, the plan is to improve their operations by increasing their autonomy and decision-making powers. In this connection, with the dismantling of the Department of Price Control in the Ministry of Planning in 1987/88, public enterprises now have full autonomy in production, investment, marketing, and pricing decisions. However, statutory minimum wages, which are applicable to all enterprises, are set by the Government. Furthermore, the Law for Domestic and Foreign Investment was revised in 1987/88 to provide a more conducive climate for investment. Consideration is also being given to a further revision of this Law, in order to permit foreign ownership of up to 100 percent and to extend the period of tax exemption from five years to six years and eventually to ten years.

Finally, in order to maintain and further strengthen the momentum of the ongoing economic reforms, the Afghan authorities are looking forward to further cooperation with the Fund in connection with the discussions on an arrangement under the structural adjustment facility. In this connection, they intend to collaborate fully and consult closely with the Fund in the period ahead. The authorities hope that the Executive Board will give its support and sympathetic consideration to their request as soon as circumstances permit. Afghanistan has remained current on all its external financial obligations, including repayments to the World Bank. The authorities hope that relations with the World Bank will be revived as soon as possible in order to expedite the realization of Afghanistan's deserving request and much-needed financial support.

Mr. Dawson made the following statement:

Over a decade of war has caused severe damage to Afghanistan's infrastructure as well as serious distortions to its economy. Official estimates of war damage to infrastructure and productive assets equal one half the level of national output. Until domestic security problems are settled, it will be difficult to improve the economic situation. Nonetheless, it is important for authorities to move forward on needed economic adjustments and reforms. We are pleased to hear that the authorities are in the process of transforming the economic system through a strategy based on decentralization, privatization, and market-related reforms. However, the success of these efforts to create a new economic structure will be dependent on their taking simultaneously a highly disciplined approach to domestic financial management.

An improved budgetary situation is a matter of urgency. The deterioration of recent years must be reversed to minimize upward pressure on prices and to avoid serious consequences for the balance of payments. Strict attention should be paid to both revenues and expenditures. We are encouraged that the Afghan authorities recognize the need to reinforce budget monitoring and control procedures and that measures are being implemented to accomplish this. However, we are disappointed that with the recent escalation in government expenditures, this goal will not be in sight soon enough. Revenues should be enhanced through linking taxes more closely to incomes, prices, and the value of goods and services, and by selling off public enterprises.

Owing to the high degree of monetization of the budget deficit, getting the fiscal accounts under control is the first step to cutting inflation and to stabilizing the financial accounts sufficiently to allow recourse to monetary policy as needed. We strongly encourage the rapid liberalization of interest rates, and hope that the introduction of real positive interest rates is also in the plans.

The movement to begin privatization of small public enterprises and banks in the near future is important. We would be interested in hearing further details on intermediate and future steps. Afghanistan faces an interesting dilemma in the existence of an efficient, if underdeveloped, parallel market economy in the money bazaars. One step that would work toward melding the two would be to remove the remaining restrictions in the foreign exchange market and to fully liberalize financial institutions by permitting full banking operations in any market. Although it is likely that data are impossible to come by, it would be interesting to have more details on the financial workings of the money bazaar system.

We strongly urge the authorities to supplement the introduction of new regulations that would allow 100 percent foreign participation in domestic industry with other steps, such as the removal of the requirement that foreign employees convert 60 percent of their foreign currency salaries into Afghanis at the official or any rate. Nonetheless, while these steps to attract foreign investment are moves in the right direction, investment is unlikely to flourish until the economic and security environment is stable.

On the external accounts, we strongly support the authorities' intention to move toward multilateral rather than bilateral trade. We commend them for the liberalization in the exchange and trade system that has taken place over the past year. However, we would join the staff in not approving at this time the multiple currency practices subject to approval under Article VIII. We underscore the importance the staff places on a solid data base for sound policy and strongly encourage the Afghan authorities to agree to the staff's suggestion of technical assistance for its improvement.

In summary, we find the Afghan movement toward introducing market-oriented reforms to be encouraging. We hope that the authorities will remain in close contact with the Fund. We concur with the staff that there are a number of problems that remain to be solved before the Fund could give serious consideration to financial assistance through the SAF, as the Afghan authorities have suggested.

Mr. Goos said that he endorsed the staff appraisal. He certainly also welcomed, like Mr. Dawson, the new orientation of the authorities' economic and financial policies and the desire to cooperate closely with the Fund in seeking a solution to the existing severe imbalances in the Afghan economy. The new policy orientation, if properly reinforced in accordance with the staff's recommendations, was undoubtedly worthy of the Fund's support. But he agreed with the staff and Mr. Dawson that the unsettled political circumstances and the security situation were serious obstacles to be removed before the Fund's financial assistance could be justified. One would also expect the authorities to strengthen substantially their administrative capacity and the statistical data base as prerequisites for the Fund's financial involvement. He supported the proposed decision.

Mr. Arora observed that Afghanistan was a poor and landlocked country, so that it had disadvantages and disincentives. In the past decade, it had been the victim of long political instability and civil strife, which had dislocated the economic infrastructure. There had been natural disasters also. All that had led the authorities to cut down development expenditure. Economic, fiscal, and balance of payments considerations had led to the compression of imports, which also affected the industrial base and growth prospects; the country had lost cumulatively nearly one fourth in terms of net material product during the past two to three years alone. With the manifold increase in security expenditures, the overall fiscal deficit had reached large proportions in 1988-89, and although it might have come down in 1989/90, was still too large for comfort. As had been pointed out by the staff, the deficit had been financed largely through recourse to borrowings from the central bank, adding to the liquidity growth in the process.

The consequences in terms of high inflation and the further pressure on the balance of payments had all been detailed in the staff report, Mr. Arora noted. What was important was that, as the staff had noted, the authorities had started moving toward decentralization or toward a more market-oriented development strategy and policy. That approach had begun to yield results, particularly in agriculture and in the area of some small- and medium-sized enterprises.

The challenges before the authorities were daunting, Mr. Arora considered. External assistance could be expected to decline, and as the security situation improved and the political solution came nearer, such tasks as reconstructing the infrastructure and resettling refugees would place enormous burdens on the Afghan authorities. They would be called upon to observe financial discipline; they would also be called upon to initiate systemic and fundamental economic reform to enable Afghanistan to take advantage of its undoubtedly important and extensive natural resources. Therefore, the outlook, though uncertain, pointed in the direction of the Afghan authorities taking full advantage of the advice given to them by multilateral agencies in terms of improving the growth environment. In that context, he strongly supported the suggestion made by Mr. Ghasimi in his statement that the Fund should think in terms of assistance under the structural adjustment facility for Afghanistan. Important steps remained to be taken. Certainly, the security and political situation had to be resolved, but the initial moves had begun, and in time, Afghanistan could receive such assistance from the Fund.

In its appraisal, the staff had suggested that the allocation of credit should be based on economic returns rather than being determined administratively, Mr. Arora observed. While that was indisputable as a general proposition, in the context of the renewal of infrastructure a great deal of investment would have to be channelled into those activities which might not have the kind of high economic returns that the staff might have in mind. Therefore, perhaps that type of recommendation should be modified in Afghanistan's situation.

Another question concerned the possible impact on the investment climate of the recent increase in corporate income and sales taxes, Mr. Arora noted.

On the exchange rate, he went along with the staff view that a move toward a new unified rate was desirable, Mr. Arora concluded. It would be easier for Afghanistan to take advantage of the new situation ahead if the exchange rate reflected economic realities. But for the time being, to be more flexible, the dual rate could serve the purpose that it had been serving so far of allowing Afghanistan to make the necessary adjustment.

The staff representative from the Middle Eastern Department said that the authorities had indicated their intention to start the process of privatization in the not too distant future, beginning with some of the smaller public entities and then moving on to the commercial banks before eventually privatizing the larger public entities. Their intention was apparently to carry the process forward as far as they could and to privatize as many public organizations as possible.

As for the money bazaar, the staff had little information on the system, which operated as a free market and without legal restrictions, the staff representative observed. The money dealers engaged not only in foreign exchange transactions but also in domestic lending operations and deposit taking. The authorities provided information to the staff on the exchange rate in the free market on a weekly basis, but little or no other information. As noted in the staff report, the free market exchange rate was being used as the guide for setting the official "commercial" exchange rate that now governed most transactions through the official market.

Mr. Ghasimi said that his first point was to emphasize that, of course, in assessing the current economic situation in Afghanistan, it had to be borne in mind that the country was coping with a protracted war, which, among other things, had disrupted the normal functioning of the economy. Furthermore, after a number of years of interruptions in the normal process of a regular Article IV consultation, the fact that the 1990 Article IV consultation with Afghanistan was about to be concluded should in itself constitute an achievement that would help the authorities in consolidating the process of economic reform which they had initiated in recent years.

Second, the authorities were aware that unless new revenue-generating methods were envisaged, and unless expenditures were controlled, any savings envisaged as a result of improvement in the security situation should really outweigh substantially the aggregate cost of national reconstruction and resettlement of refugees if the budget deficit and its associated problems were not to overwhelm the Afghan economy, Mr. Ghasimi stated.

Finally, in order to maintain the momentum of the ongoing economic measures, the authorities were looking forward to closer and better association with the Fund in the near future in connection with an arrangement under the structural adjustment facility. They hoped that the Executive Board would give its sympathetic consideration and its support to such a request whenever circumstances permitted. The authorities considered the role of the World Bank to be important in the preparation of a policy framework paper and they looked forward also to a better relationship with the World Bank, which would naturally expedite and facilitate the realization of their deserving financial request.

The Acting Chairman made the following summing up:

Directors welcomed the resumption of Article IV consultation discussions with Afghanistan and endorsed the thrust of the appraisal in the staff report.

Directors recognized that security problems continued to have a major impact on economic developments and prospects in Afghanistan and had contributed to the serious deterioration in economic and financial performance over the past three years. In the context of a sharp contraction of real output and a marked reduction in external economic assistance, large and rising budget deficits were seen as fueling high inflation and leading to a serious deterioration in the external position.

The authorities were commended for the market-based structural reforms that were currently under way, despite the difficult circumstances. In particular, Directors welcomed the steps taken toward decentralization and liberalization in all areas of the economy, noting that considerable progress had already been realized in increasing the autonomy of public enterprises, in reducing price rigidities and controls, and in setting the stage for full participation by the private sector in the economy. Directors welcomed the considerable progress toward liberalizing and unifying the exchange system and urged the Afghan authorities to complete the process of exchange rate unification.

Directors encouraged the authorities to press on with their reform program in order to lay the basis for a resumption of sustainable growth. While recognizing that an enduring economic recovery would require a lasting improvement in security conditions, Directors stressed that realization of the full benefits and potential of the present reforms also depended upon the restoration of more stable domestic financial conditions. In this regard, Directors warned that the mounting fiscal imbalances and the associated severe inflationary pressures in the economy called for urgent corrective action, which would have to include measures to increase revenues as well as to contain expenditures. The reduction of the large budget deficit was seen as a precondition for the restoration of financial discipline and monetary control.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Afghanistan's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1990 Article XIV consultation with Afghanistan, in the light of the 1990 Article IV consultation with Afghanistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Afghanistan continues to retain multiple currency practices and exchange restrictions that are subject to Fund approval under Article VIII, Sections 2(a) and 3, except that Afghanistan also maintains restrictions on invisible payments in accordance with Article XIV, Section 2. The Fund welcomes the important progress that has been achieved in the past year toward unifying

the exchange system and liberalizing restrictions, and hopes that the authorities will be able to take further action to consolidate these reforms at an early date.

Decision No. 9512-(90/123), adopted
July 27, 1990

3. HONDURAS - REQUEST FOR STAND-BY ARRANGEMENT AND EXCHANGE SYSTEM

The Executive Directors considered a staff paper on a request by Honduras for a 12-month stand-by arrangement in an amount equivalent to SDR 30.5 million (EBS/90/124, Sup. 1, 7/10/90; and Sup. 2, 7/23/90).

Mrs. Filardo made the following statement:

Honduras has been one of the most challenging cases in my constituency, since it was one of the 11 countries on the list of members with overdue obligations to the Fund. This situation coincided with the enhancement of the intensified collaborative approach and the long discussions regarding the strengthening of the arrears strategy in the context of the quota increase. Some members in my constituency were particularly concerned and my authorities made strenuous efforts to organize a group that could support the efforts initiated by the new Government. The new Honduran Administration, immediately after taking office on January 28, 1990, launched a comprehensive growth-oriented adjustment program for the period 1990-92, with the collaboration of the World Bank, the Fund, and the Inter-American Development Bank (IDB), with the purpose of correcting internal and external disequilibria and re-establishing its creditworthiness in the financial markets. The task was not easy, given that Honduras' debt is mainly concentrated in multilateral institutions and that the largest portion of arrears was incurred with the World Bank, IDB, and bilateral creditors. Also, except for the traditional donor--the United States--the possibility of finding new donors is very difficult, as has been demonstrated in other cases. In addition, loans or bridges are very difficult to obtain from any source. In the case of the multilateral institutions, the Fund has been particularly cautious in increasing its exposure, given the risk involved in the operation. Management is recommending only a 45 percent access to Fund resources and has persuaded the authorities to enter into a 12-month stand-by arrangement. During our long discussions on the rights approach, I was of the view that in spite of the fact that we were trying to solve Honduras' problem without accessing the new facility, that did not mean that Honduras did not require special treatment, both regarding access and a medium-term program. My authorities are aware of the risk involved but, so far, they have demonstrated their willingness to implement a strong program and are ready and committed to make the necessary corrections if deviations occur.

My Honduran authorities would like to express their appreciation to the Fund staff for its supportive and constructive advice on the design of the program. Also, they wish to convey their deep gratitude to the U.S. and Venezuelan Governments for their support and leadership in putting together the bridge loan needed for the clearance of arrears with the multilateral institutions. My authorities are convinced that without the cooperation of these countries and the financial assistance provided by them and by the Governments of Japan and Mexico, they would not have been able to conclude the final deal. My Honduran authorities are very grateful to all of them.

As a result of the continued precarious political environment of the Central American region, deterioration in the terms of trade, adverse weather conditions, failure in the timely implementation of domestic policies, and the sharp reduction in foreign aid, the Honduran economy continued to deteriorate during 1989. Real GDP growth declined from 4.7 percent in 1988 to 2.1 percent in 1989, as a result of the deceleration in the rate of growth of almost all the sectors of economic activity. Inflation, which was maintained at a rate of 3-4 percent during the period 1984-88, accelerated to 9.8 percent in 1989; the balance of payments current account deficit increased from 5.1 percent of GDP in 1988 to 5.6 percent of GDP in 1989 and net international reserves were almost exhausted. External arrears continued to accumulate and Honduras was declared ineligible to use Fund resources in November 1989.

As Honduras mainly depends on the export of a few primary products, whose prices have continuously deteriorated, and on the financial assistance of friendly governments that declined sharply during the last few years, it experienced external shocks on all fronts after more than forty years of economic stability and growth. The decline in fiscal revenues and the lack of adjustment when the shock occurred seriously affected the overall nonfinancial public sector deficit. In addition, the shift in the financing of the public deficit from external to internal resources put additional pressures on domestic prices and aggravated the balance of payments disequilibrium.

As noted already, upon taking office on January 28, 1990, the Government of President Callejas embarked on a strong, comprehensive adjustment program and structural change aimed at re-establishing internal and external equilibrium, integrating the

Honduran economy with the rest of the world, and providing incentives for job creation through private sector investment.

The program comprises actions toward a comprehensive fiscal reform to increase public sector savings and the improvement of the efficiency of the public sector investment program, as well as a provision for a social emergency plan to assist the low-income groups that could be most greatly affected by adjustment. It also contemplates credit restraint and exchange and trade reforms.

In the fiscal area, the program envisages a reduction of the combined deficit of the public sector of 2.3 percent of GDP, as a result of the reduction of the overall deficit of the Central Government from 8.8 percent of GDP in 1989 to 5.2 percent of GDP in 1990 and a surplus of 1.4 percent of GDP in the rest of the nonfinancial public sector. To obtain these results, the Government has embarked upon the strongest comprehensive fiscal reform in order to increase revenue and streamline outlays: sales tax rates were increased from 5 percent to 7 percent, with a charge of 10 percent on alcoholic beverages and cigarettes; the implicit exchange rate subsidy and excise taxes on petroleum imports were eliminated and replaced with an ad valorem tax; the corporate income tax structure was changed from a range of 3-40 percent to a two-bracket scale of 15 percent and 35 percent, while larger firms (with profits above L 500,000) will be subject to an additional surcharge ranging from 10 percent to 15 percent. Notwithstanding the bias introduced by export taxes, the authorities have introduced them on a temporary basis and it will be phased out by December 1991. In addition, cuts are envisaged on government expenditures, specifically on purchases of goods and services and on the public sector wage bill. To complement the reform, measures to enhance the tax administration have been undertaken, and a revision and increase in public utility tariffs will be put into effect in the near future.

Monetary policy will be consistent with the objective of increasing net international reserves; net domestic assets of the Central Bank will increase by a very small amount and there will be no credit increase from the banking system to the public sector.

In relation to the exchange rate system, my authorities consider that one of the most important steps with regard to policy implementation was the modification of the exchange system. Effective March 12, 1990, the exchange rate, which has been pegged to the U.S. dollar since 1919 at a rate of L2=$1, was modified according to the evolution of the parallel market rate. As it is the authorities' intention to maintain a real effective exchange rate for the lempira, on May 24 a further modification was made, setting the lempira at a reference rate of L4.20 per U.S. dollar, against the L4.00 per U.S. dollar established at the time of the exchange reform. Commercial banks are allowed to conduct foreign exchange transactions within a margin of 2 1/2 percent on either side of the reference rate, which is to be revised periodically by the Central Bank. The reform included the elimination of the CETRA scheme and the shift of all transactions, except central government debt service and external debt conversion, to the interbank market.

Consistent with the exchange reform, on March 2, 1990 the Honduran Congress approved legislation providing for a general revision of the tariff system that commits the Government to a major reduction in average effective protection rates until 1992. Under these modifications, nominal tariffs will vary between 2 percent and 40 percent--against 0 and 90 in the old import tariff--and by the end of 1992 dispersion on nominal rates will range between 5 percent and 20 percent. Moreover, most additional surcharges (accounting for about 35 percent) were eliminated.

Due to the impact that an adjustment program has on the low-income groups, my authorities consider it instrumental to introduce a social safety net in the economic program. Thus they have incorporated immediate measures needed to alleviate the temporary hardships being faced by the poorest sector of the population. To this end, a Fondo Hondureño de Inversión Social (FHIS) or Honduran Fund of Social Investment was created on a temporary basis, with the aim of assisting unemployed and displaced workers to obtain jobs in small-scale industrial enterprises and to provide temporary jobs in public works. Along with this Fund, a targeted subsidy was created to cover the increase in the prices of public transportation and of some basic commodities that were previously imported at the official exchange rate. Moreover, a food stamp program was established providing for a grant of L 20 per month for poor families.

Since the program was launched, notwithstanding that all performance criteria for the end of June were observed, neither fiscal revenues nor foreign exchange sales by exporters to the Central Bank were as expected under the program; therefore, the authorities have undertaken new measures to make the necessary corrections:

On June 27, the Central Bank decided to increase its purchases of foreign exchange to a level adequate to reach the agreed target. The purchases are being financed with the proceeds of the weekly auctions of bonds, recently established by the Central Bank.

The shortfalls in central government revenues were largely offset by the decline in public spending. Since at present it appears that a shortfall in revenues will reach 14 percent, the authorities are to implement new administrative measures allowing up front payment of export taxes. Also, a 10 percent selective consumption duty is to be approved by the Congress and is expected to be in effect in early August; the 10 percent increase in wages originally envisaged in the program is to be postponed to 1991; additional savings are to be achieved due to the slower pace of project implementation.

Even though great efforts have been made to solve the arrears problem with the multilateral institutions and there is a great commitment on the part of my authorities to implement any additional measures to ensure the adequate implementation of the strong and far-reaching economic adjustment program, the medium-term outlook, as envisaged by the staff in EBS/90/124, Supplement 1, presents serious uncertainties and risks. As mentioned before, Honduras' external position strongly relies on the behavior of the external prices of coffee and bananas as well as the availability of foreign financial assistance. Without the necessary financial assistance, the Government's courageous efforts will be derailed. In their view, the clearance of arrears is the very first step in the hazardous process of stabilization in order to reach sustainable economic growth. Thus, for a permanent solution to its arrears problem, for re-establishing its creditworthiness and for placing the economy on a sustainable path, they expect to receive the continuous and timely support of the international community. In the end, all of us are embarked on a long and difficult journey toward the internal and external viability of the country and the solution of the arrears problem with multilateral institutions.

Mr. Piantini made the following statement:

The new Honduran authorities are fully committed to do away with the inefficiencies that have plagued the economy for a long time. To tackle those problems which are reflected in macroeconomic disequilibrium and structural rigidities, the authorities have launched a far-reaching structural adjustment program which vigorously pursues sustained economic growth and restoration of normal relations with external creditors and donors. In this respect, we welcome the recent simultaneous clearing of arrears to the international financial institutions. As Mrs. Filardo stressed in her opening statement, the timely and substantive support given by some countries in her constituency and others made this clearing possible, demonstrating their commitment to strengthen the intensified collaborative approach. This action has paved the way for the implementation of the program, and the Honduran authorities are requesting the Board's approval of a stand-by arrangement to support this program, which we fully endorse.

The program appropriately focuses on three fundamental elements. First, to reduce sharply the domestic financing requirements of the public sector by 90 percent, to 0.5 percent of GDP. Second, to increase private savings through the introduction of greater flexibility in the interest rate structure; and, third, to foster export growth and eliminate relative price distortions by reforming the exchange and trade systems.

In the crucial fiscal sector, the authorities are acting through both revenue measures and expenditure restraint to improve the fiscal balance. On the revenue front, the program envisages an increase in central government revenue by 4.5 percent of GDP. This increase would reflect the effect of the exchange rate adjustment on import duty collections, and an increase in the sales tax, as well as a temporary export tax to capture some of the windfall profits from the large currency depreciation. Additionally, the authorities are undertaking reforms to streamline the tax system and to improve tax collections. Other revenue measures also include an increase in employee contributions to the social security system and adjustments in public sector prices and tariffs in line with inflation. On the expenditure side, an important example of the authorities' seriousness is their courageous action to restrain expenditures, including a reduction in capital expenditures, laying off of public workers in excess of the number that had been envisaged, and the postponement to 1991 of the 10 percent increase in wages for most workers whose wages have been frozen since 1986, to offset an unforeseen revenue shortfall that threatened the fiscal performance. In that respect, we welcome the additional fiscal measures to reinforce the program, but we encourage the authorities to find alternative sources of revenue to replace the temporary export taxes, as this could undermine the success of the program.

We also welcome the special attention given to social expenditures, including targeted subsidies to cushion the effects of adjustment on the more vulnerable members of the society. Regarding the public enterprises, we welcome the new steps taken by the authorities to speed up the divestment program by privatizing five additional enterprises, and we encourage them to continue this program and to open the basic utilities to private sector participation.

The pursuit of a cautious monetary policy will be essential to meet inflation and reserve targets. Avoidance of any increase in credit from the banking system to the public sector will be the key element of the stabilization effort. The program envisages that credit to the private sector will rise by 23 percent in line with the growth of nominal GDP. To avoid a credit relaxation, any subsidized rediscount facility should be eliminated, and reserve requirements should be enforced. We welcome the introduction by the Central Bank of an auction system for government bonds that could enhance the development of a capital market. We encourage the authorities to introduce a market-determined interest rate to raise savings and to achieve a better mobilization of financial resources.

Regarding income policies, a prudent wage policy will be fundamental to meet the inflation target and to enhance export competitiveness.

In the external sector, the courageous reforms introduced by the authorities have resulted in a decline in the real effective exchange rate to its lowest level since the 1970s and narrowed the spread between the official and parallel exchange rates from 25 percent at the beginning of the program to 5 percent in June. Under the new system, the Central Bank sets a reference rate in the interbank market and allows the banks to effect transactions within a margin of 2 1/2 percent on either side of this rate, which is adjusted periodically based on the weighted average rates of actual transactions. Nevertheless, this system introduces a weak element to the program by allowing the Central Government to transact its debt service payments at the previous exchange rate. We encourage the authorities to eliminate quickly this element. The comprehensive trade reforms call also for an appropriate exchange rate policy to achieve the balance of payments objectives. In addition, the trade restriction in the form of import licensing should be removed.

The medium-term projections show the vulnerability of the Honduran economy to external shocks as well as a financial gap in the order of $100-200 million a year in the period 1991-95. This gap will have to be closed through debt relief and concessional resources. Thus, these projections reinforce the need for Honduras to pursue without hesitation a continued stabilization program and to deepen structural reforms in order to foster and diversify exports as well as the continued need for financial support from the international community.

Mr. Dawson made the following statement:

In a few short months, the new Honduran authorities have implemented an impressive economic reform program, including:

a sharp reduction in the deficit of the public sector and a restrained monetary policy to combat inflation; a reform of the exchange system, including a devaluation of more than 100 percent; a restructuring of the economy, including strengthening of the financial position of public enterprises, an accelerated program of privatization, and liberalization of the trading system; and normalization of financial relations with the international financial institutions.

The measures which the authorities have already taken on their own represent a classic Fund adjustment program and go far beyond the traditional prior actions usually sought from members. The seal of approval which the stand-by arrangement will provide, as well as the additional measures provided in the program, will help consolidate the progress achieved and extend and broaden the reform effort.

The economy is projected to achieve no growth this year as the authorities pursue tight macroeconomic policies. The very substantial reduction in the fiscal deficit projected in the program, roughly 25 percent as a share of GDP, compares favorably with other countries, developed or developing. However, the sharp increase in revenue provided in the program relies heavily on the spillover effects of the exchange rate depreciation, especially the temporary windfall tax on exports. We welcome the indication in the staff supplement that additional fiscal measures are being taken to ensure that the ambitious fiscal targets in the program are achieved. They clearly demonstrate the authorities' commitment to the program. Nevertheless, the shortfalls in revenue experienced in the first half of the year highlight the need to develop alternative, more permanent sources of revenue.

The improved fiscal position will permit a much tighter monetary policy, including virtual elimination of bank financing of the budget deficit. It will be important to sustain restrained financial policies to ensure that the one-time increase in prices due to devaluation and public sector price reforms do not trigger a wage-price spiral. In this regard, the increases in interest rates and reform of the government bond market should produce positive real rates of interest as inflation pressures subside, but we would join the staff in urging early elimination of remaining interest rate ceilings.

The achievement of a unified exchange rate at competitive levels is critical to the success of the program. The substantial devaluation earlier in the year and the Government's tight financial policies have closed the gap between the parallel and official rates. We share the staff's disappointment that foreign exchange gains have not been larger, which may reflect continuing confidence problems. In this regard, the authorities' willingness to increase foreign exchange purchases, to sterilize the liquidity effects through open market operations, and to raise interest rates further will help to achieve the balance of payments and reserve objectives of the program. However, there may well be a need for additional action, particularly on the fiscal front, if further exchange rate and interest rate pressures are to be avoided.

With regard to structural policies, we welcome the adoption of more market-oriented pricing of the public utilities and would urge the authorities to accelerate the privatization process as much as possible. The trade reform program should also help to open the economy to market forces and make it more competitive. In this regard, we would urge the authorities to move ahead expeditiously to permit increased foreign investment, possibly in connection with the recent U.S. Latin American initiative.

The staff's medium-term scenario indicates that Honduras' external position will remain tight and extremely vulnerable to developments in its principal export markets. While the increase in official reserves will provide a necessary cushion, additional external support will be required in the form of debt rescheduling and reduction. We understand that the Paris Club will be considering a request by Honduras for debt rescheduling in September, which should close the financing gap that now exists. It is our hope that Honduras will receive the same consideration shown other arrears countries in light of its substantial home grown effort to deal with the country's economic problems.

In conclusion, Honduras has acted courageously to get its economic house in order and to set the stage for improved economic performance in the 1990s. The bulk of the adjustment program has been in place for several months and the authorities have moved quickly to implement additional actions as necessary to keep it on track. The arrears to the Fund and other international financial institutions have been cleared in record time without the formation of a support group. The amount of resources being provided by the Fund is modest and IMF exposure will actually decline. In these circumstances, we believe that the proposed program warrants our support.

Mr. Feldman made the following statement:

After experiencing a relatively satisfactory economic performance, characterized by low inflation and a stable, albeit low growth rate, the economic situation of Honduras deteriorated in

1989. Economic growth slowed down, inflation doubled, and a marked widening in internal and external imbalances became evident.

Although the widening public deficit was a major factor in explaining these trends, in particular the shift in the financing of the deficit from external to domestic sources, the problem was compounded by the deterioration in the external position of Honduras, as the price of major exportables fell and the accumulation of arrears with practically all creditors brought about a disruption in the country's relations with the international community.

In this regard, the strenuous efforts of the new Government to clear arrears with the international financial institutions, and thereby regain eligibility to get access to new resources, is a much welcome step. Mrs. Filardo has made explicit the enormity of the task carried out as well as the support provided by major creditor countries. The decision to request the stand-by arrangement for 12 months is also positive and deserves our strong support. I share Mrs. Filardo's concern about the level of access to Fund resources, because one could argue that, had Honduras entered the rights approach, the Fund would have accepted, overall, a larger exposure for Honduras.

Having said this, and since the program as well as economic developments in Honduras are well described in the staff paper, I can limit my comments to some brief observations and questions.

Fiscal policies, including the additional measures recently taken, seem to provide reasonable reassurances that the fiscal objectives will be met. On public enterprises, I would like to ask whether recent political events in Central America could not allow a more positive reassessment of the economic feasibility of the El Cajón hydroelectrical project.

On monetary policy, the staff indicates that the Central Bank currently operates a number of subsidized rediscount lines, mostly under agreements with international lending agencies. These lines will soon be phased out, but in any case, it is difficult to understand the rationale for interest subsidization when what is actually required is to match the demand for maturity transformation, given the absence of long-term financial instruments.

Turning to the inflation rate estimated for 1990, the staff paper indicates that a rate of no more than 25 percent on a year-on-year basis or 38 percent on year-end is expected for 1990. Several factors would tend to suggest that these estimates could be on the optimistic side. First, the full impact of the recent devaluation on prices might not have fully materialized so far; second, the elimination of the CETRA system could have some additional lagged effect on prices of tradable goods; and third, the corrective price increases that are projected, particularly large adjustments in several public services, are all factors that would put upward pressure on the rate of inflation. Perhaps some recent estimates covering the first six months of 1990 could help to confirm the return or some convergence to the projected trend.

On the issue of external financing, I agree with Mrs. Filardo that clearance of arrears has been just a first step and that the efforts of the Honduran authorities would have to be complemented by timely and adequate availability of foreign assistance. Given Honduras' vulnerability to the oscillation in the price of a few export commodities, I feel the need to repeat the question recently raised in the case of Morocco, namely, why is it that Honduras has not considered any kind of contingency mechanism within or independently from the compensatory and contingency financing facility? I would also appreciate any information about the progress already achieved, if any, in the negotiations with commercial banks, given the fact that the program assumes that an agreement would be reached by the end of 1990.

Finally, let me welcome the prompt reaction of the Honduran authorities for the adoption of corrective measures to reinforce the program, as presented in the supplementary staff paper. The postponement of the salary increase until 1990 will obviously imply a further decline in real wages, but this decision demonstrates the bold determination of the authorities to sustain the adjustment efforts. On the other hand, I regret that no other option than cutting spending under the social safety net could be found, given the high priority that the authorities had assigned to the objective of alleviating the costs of adjustment to the poorest groups of society. I had understood that available administrative capacity was in itself a constraint to these expenditures.

Mr. Wright made the following statement:

This is a crucial juncture for Honduras. For a number of years, economic management has been weak, and problems have mounted. Honduras has a track record of running up substantial arrears with its creditors, including the Fund. These have eroded confidence and constrained dialogue on policy measures. The new Government is trying to make a decisive break with the policies of the last two years. They have cleared arrears to the Fund and to other multilateral institutions. They have also made a commitment to undertake fundamental economic reforms and have taken some significant actions already.

Nevertheless, as the supplement to the staff report makes clear, adjustment has already run into difficulties. The staff papers also leave no room for doubt about the magnitude of the problems that Honduras faces. The prospects for medium-term viability seem particularly uncertain. This program also has implications for the Fund's policies on arrears and on financing assurances. It needs particularly careful examination. I would like first to look at the details of the program.

The centerpiece of the program is an improvement in the public finances. The first priority is clearly to increase revenue. The authorities have taken a number of important measures which I welcome, including increases in public utility tariffs and reforms to the system of direct taxation. However, I am more doubtful about the introduction of a temporary export tax. Given Honduras' precarious external position, any measure that reduces incentives for exporters must be questionable. The supplement to the staff report indicates, in fact, that the export tax has not been particularly effective as a revenue measure, and has caused a number of exporters to shift transactions to the parallel market. This in turn must have exacerbated the authorities' problems in acquiring foreign exchange. I would therefore urge the authorities to explore alternatives to this tax as soon as possible.

Given the difficulties that the authorities have encountered in rasing revenue, their decision to postpone the planned increase in wages for government employees until next year is understandable. The judgment about whether, in the present strained climate in labor relations, this might not precipitate industrial action with further detrimental effects on revenue, however, must be a fine one. I note that some progress has been made in reducing the numbers of public sector employees and wonder whether further saving could be achieved here. I welcome the authorities' plans to institute a social safety net. It is regrettable that plans for this have had to be modified in the light of difficulties in implementing other fiscal measures and limits on administrative capacity. I hope that this is a problem that can be addressed over the longer term.

The authorities are clearly moving in the right direction on monetary policy, although they could probably go somewhat further. Despite the further tightening of monetary conditions in July, deposit rates seem likely to remain well below the actual and expected rate of inflation this year. Since in the long run the prospects for Honduras depend on the mobilization of private sector savings, and given the pressing need to increase the repatriation of export earnings, this is a problem that needs to be addressed with some urgency.

Turning to the exchange rate system, the devaluation of the lempira in March was an essential step and long overdue. However, the current system seems to be an uneasy compromise between a fixed and floating exchange rate which must be very difficult to administer. The level of reserves is very low, and the authorities are currently buying foreign exchange in the market.

Given the acute shortage of reserves, and the private sector's apparent distrust of the official exchange market, it seems doubtful whether the authorities can maintain this system for very long. Nor does a return to a credible fixed exchange rate seem feasible in the near term. Moving to a floating rate may therefore be more logical but would need to be done in conjunction with monetary and fiscal policies sufficiently strong to prevent the onset of an inflationary spiral.

The measures planned by the authorities are clearly moves in the right direction. However, Honduras' prospects for the medium term remain very uncertain. The staff's medium-term scenario shows financing gaps extending well into the future, and it is far from clear how these will be filled. Even in the first year, the financing gap can only be filled with the aid of an exceptionally generous rescheduling from the Paris Club, and with a substantial contribution from the commercial banks. Nothing in the paper indicates that this contribution will be in the form of an agreed rescheduling, or the disbursement of new money. The implication at the moment therefore seems to be that the program can only be financed by arrears to commercial creditors. This may be unavoidable in present circumstances but I do not find this conclusion particularly comfortable. It is clearly at odds with the Fund's agreed position on financing assurances, which is that there should only be lending into a financing gap when negotiations with the commercial banks have begun, and when there is a prospect that agreement can be reached within a reasonable period of time. In this case, negotiations have not even begun.

There is also the question of how this program fits in with the Board's policy on arrears cases. Honduras has been more or less continuously in arrears since 1987, and these were only cleared at the end of last month. I confess to being uneasy about Fund disbursements beginning so soon after the clearance of arrears in the absence of a clear track record of adjustment and with the financing doubts to which I have referred. There might well therefore have been a case for a Fund-monitored program before disbursements began. Nevertheless, in view of the evident commitment of the authorities to the fundamental reform of their economy, and the fact that this is a new Government, with a clear desire to make a fresh start, I think we should give Honduras the benefit of the doubt, and I am willing to go along with the proposed stand-by arrangement.

Mr. Goos made the following statement:

I too welcome the clearance of Honduras' arrears to the Fund and the adoption of the adjustment program before us. This program--including the important measures already taken--represents a commendable effort and a most promising break with the past, but it raises a number of issues.

First of all, I think it is fair to say that the Board's approval of the program would constitute quite an exceptional vote of confidence in the authorities' ability to follow through. After all, under the intensified collaborative approach, countries with protracted arrears are normally expected to establish a convincing track record prior to the resumption of Fund lending. And one could argue that the application of this safeguard for the Fund's resources and the eventual success of the adjustment effort would be particularly justified in the case before us considering that a similar effort to clear Honduras' arrears to the Fund in 1988 had failed shortly thereafter. Nobody would be well served if, owing to an unproven capacity of the authorities to live up to their policy commitments, we were to see a repetition of this previous failure. In such an event, the damage inflicted on Honduras' external financial relations would be enormous, if not irreparable, at least in the foreseeable future, so it appears that the authorities carry an exceptional responsibility for the success of the ongoing stabilization effort.

I would agree that this concern has been somewhat alleviated by the fact that we are dealing with a new Government that has demonstrated its willingness to promptly adopt additional measures in order to keep their program on track. But frankly speaking, however successful this test of cooperation might have been, the need for corrective action so early in the program period might have cast some doubts on the credibility of the authorities' adjustment strategy. One therefore would have wished this strategy to be based on more solid and sustainable assumptions. I have in mind, of course, the substantial revenue shortfalls that have already occurred and the fact that the budget is being based on a number of temporary measures which remain to be consolidated. There was also the concern mentioned by Mr. Feldman about the possibility of delaying the adjustment of wages until 1991, considering that wages had not been adjusted since 1986.

Moreover, I feel that the credibility of the program could have been enhanced if it had provided for an immediate liberalization of interest rates. The provision of sufficiently remunerative financial returns is undoubtedly of particular importance at a time of rapidly increasing inflation in order to stimulate private sector savings which--according to program assumptions--seem to be on the decline. In addition, remunerative interest rates could also be expected to help eliminate the worrisome discount for the lempira in the parallel market and resolve the problem of only partial repatriation of export earnings. Against this background, while welcoming the recent increase in interest rates on government bonds as a step in the right direction, I would encourage the authorities to eliminate the existing interest rate ceilings without delay as a clear demonstration of their commitment to a market-determined policy approach. At any rate, such a move would be clearly preferable to the intention to increase fines and penalties for the underinvoicing of exports and for delays in the repatriation of export earnings which are likely to undermine the trust in the authorities' adjustment strategy and introduce new distortions.

The desirability of a more forceful approach toward adjustment and reform in the areas I have just mentioned is being underlined by two other considerations, namely, first by what I feel are rather unsubstantiated expectations that the external financing gap will be closed by the end of this year and, second, the lack of medium-term viability of the balance of payments. At the risk of sounding somewhat outmoded, I think it is appropriate to recall that these shortcomings are incompatible with established Fund policies. This is all the more serious in a situation where a country has to restore its external credit standing after a period of protracted arrears and hence in a situation where expected capital flows are subject to particular uncertainties. I therefore found it quite surprising that the deviations from fundamental principles of Fund policy were not given more attention in the staff report. Further clarification by the staff of these issues would certainly be most helpful--not least to dispel the suspicion that we are being asked to support an exercise aimed in the first instance and, so to speak, at any cost, at the most rapid clearance of existing arrears. This suspicion is incidentally reinforced by the fact that the funding to be provided under the proposed arrangement would imply the complete refinancing not only of the previous stock of overdue repurchase obligations but also of a substantial share of the interest arrears.

To conclude, for the reasons just mentioned, it is only with considerable reservations that I lend my support to the proposed arrangement. In doing so, I appreciate the enormous difficulties faced by the authorities in fleshing out within a matter of months a radical departure from previous policies; seen from that perspective, they have indeed made an impressive and commendable start. Nevertheless, I would hope that in their forthcoming review discussions with the staff the authorities will strive to strengthen their adjustment policies so as to create the basis for a favorable and swift response of external creditors and donors to the country's financing needs and to achieve medium-term viability in the external accounts. Achievement of these tasks could probably be facilitated if the authorities imbedded their stabilization efforts in a credible medium-term framework of adjustment and reform.

With these remarks, I can support the staff appraisal and the proposed decisions.

The Executive Directors agreed to continue the discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/122 (7/25/90) and EBM/90/123 (7/27/90).

4. ANNUAL REPORT, 1990 - TRANSMITTAL TO BOARD OF GOVERNORS

The Executive Board approves the transmittal of the 1990 Annual Report to the Board of Governors under cover of the letter set forth in EBD/90/75, Supplement 1 (7/23/90).

Adopted July 26, 1990

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/90/196 (7/24/90) and EBAP/90/199 (7/25/90) and by an Advisor to Executive Director as set forth in EBAP/90/199 (7/25/90) is approved.

APPROVED: July 12, 1991

LEO VAN HOUTVEN
Secretary