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January 7, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Hungary - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Hungary. A draft decision appears on page 21.

It is proposed to bring this subject to the agenda for discussion on Monday, February 4, 1985.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Hole (ext. 8811) or Mr. Somogyi (ext. 7188).

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INTERNATIONAL MONETARY FUND

HUNGARY

Staff Report for the 1984 Article IV Consultation

Prepared by Staff Representatives for the
1984 Consultation with Hungary

Approved by L. A. Whittome and Subimal Mookerjee

January 4, 1985

I. Introduction

A staff team consisting of Messrs. Hole, Somogyi, Boote, and Stanyer (all EUR), Mr. Boonekamp (ETR), Mr. Wolf (RES), and, as secretary, Ms. Moran (EUR) held Article IV consultation discussions in Budapest during October 22-November 15, 1984. The Hungarian representatives included senior officials of the National Bank of Hungary, the Ministries of Finance and Foreign Trade, the National Planning Office, the Materials and Prices Office, the National Labor Office, the State Development Bank, and the Central Statistical Office. Mr. Whittome (EUR) joined the mission for a few days at the end of the visit, when meetings were held with the Deputy Chairman of the Council of Ministers, Mr. Marjai, the Chairman of the Economic Policy Commission of the Central Committee of the Hungarian Socialist Workers Party, Mr. Havasi, the President of the National Bank, Mr. Timar, and the First Deputy President of the National Bank, Mr. Fekete. Mr. de Groote, Executive Director for Hungary, visited Budapest during part of the mission.

Hungary became a member of the Fund on May 6, 1982 and has a quota of SDR 530.7 million. Following purchases in 1982-83 of SDR 475 million under a 13-month stand-by arrangement and SDR 72 million under the compensatory financing facility, a 12-month stand-by arrangement for SDR 425 million (80 percent of quota) was approved on January 13, 1984 (EBS/83/268, 12/16/83). All scheduled purchases have been made under this arrangement, with the second purchase proceeding after the Executive Board in May 1984 waived the nonobservance of the end-March 1984 performance criterion on the level of short-term debt in convertible currencies (EBS/84/109, 5/9/84). As of November 30, 1984, the Fund's holdings of forint subject to repurchase amounted to 183 percent of quota (170 percent of quota excluding the CFF purchase). Hungary continues to avail itself of the transitional arrangements under the provisions of Article XIV.

In the IBRD, Hungary has been judged qualified for medium-term project loans. To date, "A" loans totaling US$439.4 million have been approved for four projects in agriculture, industry, and the energy sector. In addition, in 1983 US$270 million equivalent was obtained through two cofinancing (or "B") loans involving direct IBRD participation of US$39.4 million, and in

1984 the equivalent of US$487 million has been made available through two further B loans, with IBRD participation of US$48.3 million. Implementation of the projects being financed is considered by the IBRD staff to be satisfactory. Total disbursements by the IBRD to Hungary are put at about US$110 million in 1984 and are expected to amount to some US$125 million in 1985. Recently, an IBRD mission visited Hungary to undertake an analysis of the investment system and to review sectoral investment issues and major projects; its report is scheduled to be issued in October 1985.

The Hungarian Government recently decided to join the IFC and the IDA; its membership applications are now being processed.

II. Background

A long period of excessive demand expansion, financed increasingly by foreign borrowing, culminated in 1978 in a current account deficit in convertible currencies equivalent to 7 1/2 percent of GDP and a gross external debt/GDP ratio of 46 percent. Since 1978, economic policy has been directed primarily to restoring a viable balance of payments position. Three periods of "adjustment" may be distinguished, the key elements of which are brought out in Table 1.

The first, covering 1979-80, was characterized by a sharp cutback both in an overblown investment program and in excessive stockbuilding and saw a cumulative improvement in the current account in convertible currencies of close to 6 percent of GDP. Progress then faltered in 1981, when an easing in demand management coincided with both a sharp increase in net interest payments to abroad and a weakening of creditor confidence in Eastern Europe generally (which in the case of Hungary translated into a worsening of the external capital account by more than 8 percent of GDP between 1980 and 1982). In early 1982 the loss of reserves reached massive proportions, precipitating a liquidity crisis and--with the Government's decision to eschew a rescheduling of debt--ushering in a renewed phase of concerted adjustment.

Under this third phase, which since December 1982 has been supported by stand-by arrangements with the Fund, the convertible current account moved in the first two years from a deficit of 3 1/4 percent of GDP in 1981 to a surplus of 1 1/2 percent of GDP in 1983 as the result mainly of tighter demand management, but also of increased import restrictions. Virtually all of the improvement stemmed--about equally--from a reduction in imports and a fall in international interest rates; export proceeds, by contrast, stagnated. Despite the shift into current account surplus, the external position at the end of 1983 remained tenuous, with an increase in debt service in prospect in 1984 and a still hesitant attitude by banks toward Hungary. Against this background, the authorities adopted a target surplus of US$400 million for the convertible currency current account in 1984. In order to achieve this goal, while at the same time lifting the import restrictions imposed in 1982, real domestic demand was to be reduced by 2 percent, with cuts in all items of final expenditure. In support of this program, the Fund approved a second stand-by arrangement in January 1984.

Simultaneously with the approval of the new stand-by, the Executive Board completed the 1983 Article IV consultation with Hungary. During the discussion, Directors pointed to the importance of a tightening of demand management as a necessary foundation for meeting the current account target, while expressing concern about the imbalance of an adjustment pattern focused largely on reducing investment. Directors also encouraged the authorities to maintain the momentum of their structural reform efforts and stressed the importance, particularly in a situation in which import restrictions were to be reduced, of timely exchange rate adjustments.

III. Economic Performance and Policies in 1984

The concerns voiced about prospective developments in the level and composition of demand proved well-founded. The overruns on personal income and consumption which had occurred in 1983 continued into the opening months of 1984--at a time, moreover, when export prices were developing more weakly, and international interest rates rising more rapidly, than had been allowed for in the program. In the face of these emerging trends, the authorities adopted measures in the context of the mid-term review of the stand-by (EBS/84/144, 7/3/84) to safeguard attainment of the external target. In order to bring domestic demand back in line with the program, a policy package was assembled which was designed to forestall expenditures equivalent to about 1 1/2 percent of GDP, and in June the forint was devalued by 5 percent to facilitate the required shift of resources into the external sector.

In the event, domestic demand remained resilient and for the year as a whole is estimated by the authorities to have declined only by 0.3 percent, versus 2.3 percent in the revised program (Table 3). This firmness can be attributed to two principal factors: a continued unexpectedly strong growth of activity and incomes in recently liberalized small-scale enterprises and private economic units; and some slippage in the implementation of certain policy understandings, 1/ combined with some overestimation of the demand impact of certain policy actions. However, particularly with the development of private sector activity, and with a bumper wheat harvest, real GDP is also estimated to have developed more strongly than foreseen, rising by 2.3 percent against 0.3 percent in the program. As a result, the real foreign balance on goods and services is believed to have improved by fully 2 1/2 percent of GDP as programmed, underpinning a current account surplus in convertible currencies estimated at about US$350 million 2/--slightly below the original target, but higher than

1/ Specifically, the levels of State investment, housing credits, and disbursements from the extrabudgetary Intervention Fund exceeded program understandings, while adjustments in prices through subsidy cuts and tax increases fell somewhat short of understandings.

2/ During the first three quarters of 1984, the recorded current account surplus totaled some US$100 million and was in line with the program. The fourth quarter is traditionally a relatively strong period for balance of payments performance and was forecast by officials to yield a surplus of some US$250 million.

in 1983. This consolidation of the external surplus contributed to a striking improvement in the availability of medium- and long-term foreign credits and a sizable increase in the official reserves.

All performance criteria under the stand-by, other than the end-March limit on short-term external debt, were observed through end-September (Table 2), and officials are hopeful of meeting the end-December limits. With the higher level of demand and output than foreseen, the credit program is entailing a larger increase in the velocity of money than had been assumed.

1. Demand, output and prices

All components of expenditure except fixed investment continued to grow in real terms in 1984 (Table 3). While wages in the socialist sector developed broadly as planned--declining in real terms for the fifth time in six years--other incomes increased faster than expected, paced by a growth of nearly 27 percent in net incomes from private activities. As a result, household disposable income rose by an estimated 8 3/4 percent, 1 percentage point faster than in the program (Table 4). Consumer prices, meanwhile, increased 1 percentage point less than foreseen (with the CPI up by an estimated 8 1/2 percent), due in part to delays in policy-determined increases in prices and in part to weaker than anticipated foreign prices. With the savings ratio changing little, despite an increase in deposit interest rates, private consumption increased by nearly 1 percent, against a programmed decline of 3/4 percent. Government current expenditure was likewise stronger than forecast, while stockbuilding ran substantially ahead of plan, largely as a result of the harvest. Fixed investment, by contrast, fell more than expected, to some 20 percent below its volume in 1978.

The relative firmness of demand was matched by larger supply, as the growth in agricultural output spurted to 5 1/2 percent (from 1/2 percent in 1983) and that in industrial output quickened from 1 3/4 percent to 2 1/2 percent. The labor force meanwhile continued to decline, with job vacancies exceeding the number of job seekers by a wide margin. During the year, the workweek in much of industry was cut from 42 to 40 hours. This had no discernible effect on output, underscoring the substantial underutilization of labor capacity.

2. Balance of payments and external debt

The strengthening in the balance of payments continued in 1984 when the current account surplus in convertible currencies is estimated to have risen to US$349 million (1.7 percent of GDP) from US$297 million (1.4 percent of GDP) in 1983. While the improvement entirely reflected an enlargement of the trade surplus, the picture suggested by Table 5 exaggerates the contribution from lower imports. This is because Hungary ran up sizable debit balances above agreed swing limits on its nonruble bilateral payments agreements, settlement of which--made in convertible currencies--appears as an invisible payment (under "other current receipts, net"), rather than as a trade debit. But for an unanticipated upturn in the middle quarters of the year in interest rates on international markets, which added US$50 million to the net investment income deficit, the estimated current account outturn would have corresponded virtually exactly to the program target.

Analysis of trade developments in Hungary is severely limited by the inclusion in the published statistics of energy re-exports and associated imports, the values of which are not separately identified but which are thought to have fluctuated considerably since late 1982. Excluding all trade in energy products, the volume of exports settled in currencies other than rubles in the first three quarters of 1984 was nearly 8 percent higher than in the corresponding period of 1983. This compared with an estimated growth in non-oil imports in partner countries of 5 percent and was achieved despite (i) a worsening of the liquidity problems of developing countries, which constitute an important market for Hungarian exports; (ii) a high dependence on food exports, which are subject to stiff protective barriers in the industrial countries; and (iii) an appreciation of the forint vis-à-vis the currencies of Western Europe--Hungary's main nonruble market--consequent on the strengthening of the U.S. dollar and its sizable weight in the exchange rate basket. The strong growth in volume was, however, associated with a further sharp fall in export prices (of 6 1/2 percent in U.S. dollar terms, following 9 1/2 percent in 1983), suggesting a straining of profit margins. The growth in the volume of nonenergy imports also quickened in the first three quarters of 1984 (to 6 1/2 percent, from 3 percent in 1983), due primarily to the easing of import restrictions and in part to the firming of total demand, and import prices fell, but by significantly less than export prices.

With the further strengthening in the external current balance, the attitude toward Hungary in financial markets, which had begun to improve in 1983, became markedly positive in 1984. This was evidenced by a surge in gross medium- and long-term capital inflows, which for the year as a whole are estimated to have totalled at least US$2.1 billion (US$0.8 billion more than foreseen at the mid-term review). While the average interest rate on new credits rose in line with developments in the markets, the country-specific terms of borrowing improved, with lower spreads and commitment fees and longer maturities and grace periods. The borrowing facilitated the repayment of short-term liabilities, thereby helping to lengthen the average maturity of the debt. It also served, together with purchases of US$436 million from the Fund, to buttress the convertible currency reserves, which are expected to have reached the equivalent of at least 8 months of imports at end-1984, against 5 1/2 months of imports one year earlier.

External debt in convertible currencies remained unchanged over the first nine months of 1984, but with substantial foreign borrowing in the fourth quarter is estimated to have reached at least US$8.5 billion (42 percent of GDP) at the end of the year (Table 6). With the contemporaneous buildup in the reserves, net external debt is estimated to have fallen (to 30 percent of GDP) over the course of the year. As the result of higher-than-expected interest rates, gross debt service payments in convertible currencies absorbed some 42 percent of receipts from export of goods and services, 1/ against 39 percent in the program.

Reversing the trend of previous years, the deficit on the current account in nonconvertible currencies is estimated to have narrowed in 1984, although by less than previously forecast (Table 7). The latter deviation is attributable in part to an increase in the deficit on trade within agreed swing limits under nonruble bilateral agreements. Exports and imports both fell substantially in relation to 1983 and were also weaker than foreseen at the time of the mid-year review.

3. External policies

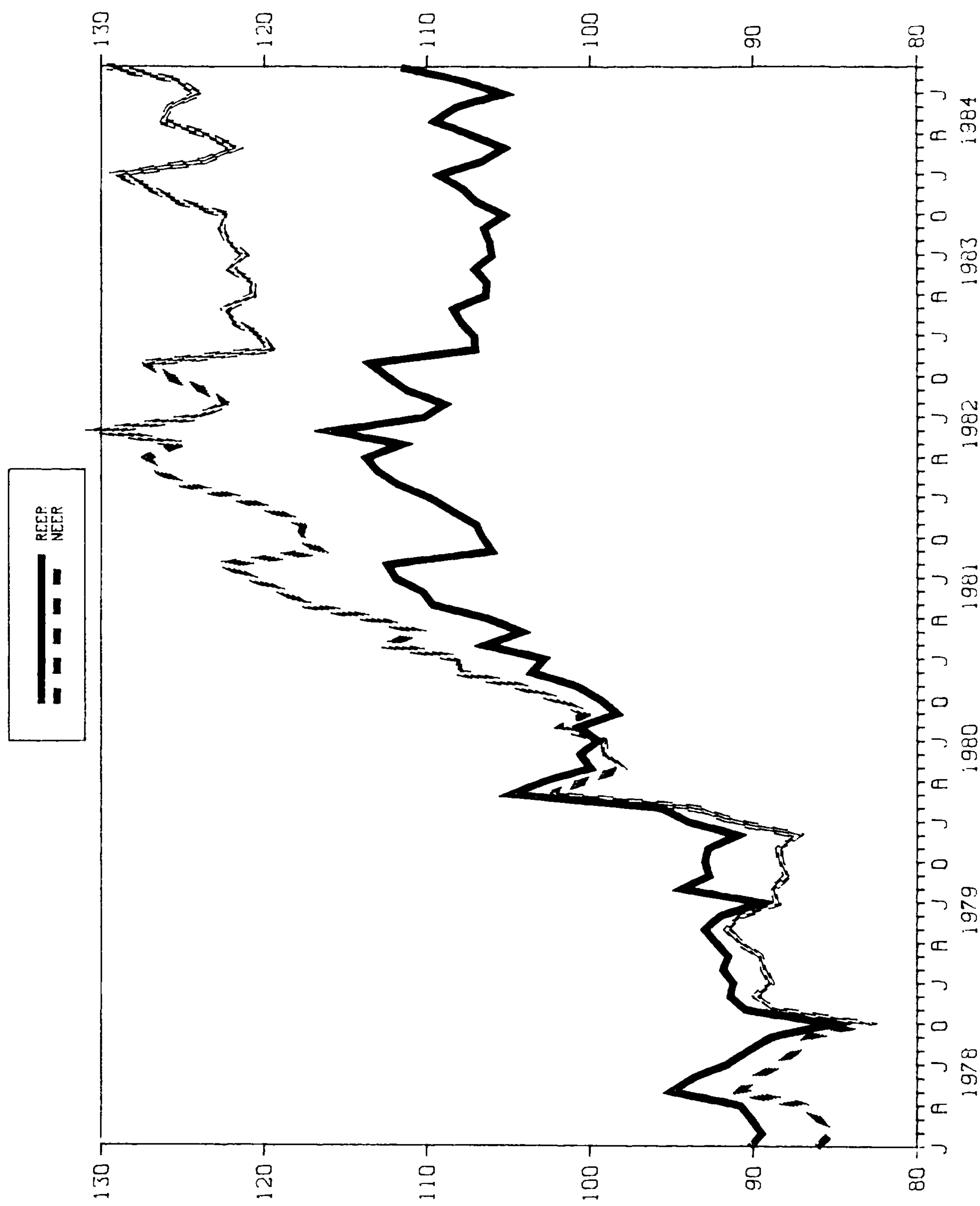
A basic principle of exchange rate policy over the past 15 years has been to adjust the exchange rate to limit the influence of foreign inflation on domestic prices. Other considerations, including the need to maintain adequate profit levels in the production of exports, have also been taken into account and in recent years have assumed increasing importance. Thus, after appreciating fairly steadily in the period to mid-1982, between June 1982 and December 1983 the forint was devalued by 20 percent against the basket of convertible currencies to which it is pegged. Further devaluations, of 3 percent and 5 percent, respectively, followed in February and June 1984. However, the effects on enterprise profitability of the February step were largely nullified by a simultaneous 3 percentage point reduction in the rebate of indirect taxes on exports settled in convertible currencies. Similarly, the impact of the 5 percent devaluation in June was rapidly eroded by the strong appreciation of the U.S. dollar, which carries a weight in the currency basket well in excess of the relative importance of Hungarian-U.S. trade flows. By September 1984, the index of the (trade-weighted) real effective exchange rate was 6 percent below its peak in June 1982, but 4 percent higher than in September 1983 (Chart).

In conformity with policy undertakings under the stand-by arrangement, during the course of 1984 the authorities eliminated the import restrictions that had been introduced as a stopgap in September 1982. In addition, the authorities have stated that the import licensing system is being implemented in practice in a way which does not involve a restriction on payments and transfers for current international transactions.

In 1984, Hungary terminated its bilateral payments agreement with Brazil and reached agreement to terminate the bilateral agreement with Finland early in 1985. At end-1984 Hungary maintained bilateral payments agreements with ten Fund members and a number of non-Fund members. Its exchange system also continued to give rise to a multiple currency

1/ If the ratio were adjusted (i) to allow for interest earnings on the reserves in the numerator and (ii) to include in the denominator the value of exports made in nonconvertible currency to secure oil imports from the CMEA, it would be 33 percent.

HUNGARY
REAL AND NOMINAL EFFECTIVE EXCHANGE RATES
(1980 = 100)



practice in the form of significant differences between the implied and the explicit exchange rates between the forint and the national currencies of other CMEA countries which are also Fund members. In addition, to the extent that a quota on imports of consumer goods operates through the licensing system, an exchange restriction subject to Fund jurisdiction is involved. In their present form, these various restrictions are treated as transitional arrangements under the provisions of Article XIV and do not require Executive Board approval.

4. Public finances

The program of demand restraint underpinning the continued improvement in the external balance was reflected in a further strengthening in the public finances in 1984. From a deficit of Ft 1.7 billion (0.2 percent of GDP) in 1983, the budget is estimated to have swung--exactly as programmed--into a surplus of Ft 17.9 billion (1.9 percent of GDP) in 1984. If allowance is made for the accumulation of unspent balances in the State Lending Fund (included in the Budget) and in the extrabudgetary Intervention Fund, the "adjusted fiscal balance" strengthened rather more, by the equivalent of 2 1/2 percent of GDP for the second consecutive year (Table 8). The substantial confiscations of enterprises' retained profits in 1983 and early 1984 that formed the main resources of these Funds served directly to drain away an accumulated overhang of enterprise liquidity and to contain enterprise-decided investment.

In contrast to 1983, when revenues rose sharply, the improvement in the budget in 1984 rested primarily on a curtailment of expenditures, which were reduced by 3 1/2 percent of GDP. The bulk of the reduction fell on subsidies. In spite of some slippage from the program--mainly on production subsidies and turnover tax refunds, but also on price supports--total outlays on subsidies were cut by 3 percent of GDP, with a particularly sharp reduction in consumer price supports. In relation to GDP, expenditures also fell for State investment, as well as for "health, defense and other" purposes. Social security expenditures, by contrast, rose as expected in real terms, mainly for demographic reasons. This was more than offset, however, by a 10 percent increase in the rate of enterprise contributions, and in fact the deficit of the social security system (2 1/4 percent of GDP in 1983) was virtually eliminated. All other revenue categories declined in relation to GDP.

Disbursements from the State Lending Fund in 1984 were linked to an IBRD project and limited to Ft 1 billion. The balance of the resources channelled to this Fund and shown as expenditure in Table 8--i.e., Ft 11.4 billion--was frozen at the National Bank. Expenditures of the extrabudgetary Intervention Fund meanwhile totalled Ft 8.5 billion (1 percent of GDP), or slightly more than projected. Outlays from this Fund were directed mainly to providing temporary support to enterprises facing low export prices.

5. Money and credit

During 1984 monetary conditions remained generally tight. While the faster-than-projected growth in demand was associated with some easing of policies, the year-on-year expansion of both gross domestic credit and broad money slowed further in the first nine months of the year, to rates (4.9 percent and 4.2 percent, respectively) which were substantially below the estimated increase (7.8 percent for 1984 as a whole) in nominal GDP (Table 9).

In the period through September 1984, all credit limits under the stand-by--which were designed to target a current account outturn in convertible currencies fairly directly--were observed and the external balance was on target. As to the broader credit aggregates, net domestic credit of the banking system--the key indicative target--increased somewhat faster than projected. While banks' claims on government and enterprises were lower than planned, credit to households was significantly above target and enterprises' balances in frozen reserve funds lagged expectations. All of the overrun spilled into the nonconvertible balance of payments, leaving broad money below program projections. However, as within-quarter levels of working capital credits to enterprises exceeded end-quarter levels by an unusually large margin, the underlying levels of NDC and M2 were higher than suggested by the end-quarter data, and the increase in the velocity of M2 correspondingly less.

Like 1983, the first nine months of 1984 were characterized by a marked decline in enterprise holdings of financial assets (which fell from 23 percent of GDP at end-1982 to 13 percent at end-September 1984) and continued real growth in household monetary assets (reflecting the expansion of the private sector and the increasing monetization of the rural economy). By early 1984, the reduction in enterprise liquidity was beginning to cause some deterioration in payments discipline and an increase in involuntary interenterprise lending. This prompted a number of policy modifications, including a relaxation of import predepositing requirements, which appear to have alleviated the situation.

IV. Policies for the Period Ahead

The authorities consider the most important task in the period ahead to be to consolidate the external adjustment achieved to date and reduce the level of foreign debt. This reflects a recognition that the recent strengthening in the external liquidity position has come largely from borrowed resources, that the level of debt remains uncomfortably high, and that despite the current lengthening in the average maturity of the debt, its servicing will continue to pose a substantial burden for several years yet.

The authorities also consider, however, that the scope for reducing demand in order to achieve the external objectives has been all but used up. In this connection, they are particularly concerned both that the major burden of the recent cutbacks has been borne by the efficient enterprises, and about the implications of the declining trend of investment for export competitiveness and the economy's growth potential. They also perceive an exhaustion of the population's tolerance of real wage cuts. In 1985, it is believed that the compression of fixed investment and of real wages in the socialist sector can and should be halted, and that convertible currency imports can begin to grow moderately. It is well recognized, however, that in the period ahead it will be difficult to provide for a reasonable improvement in living standards and, at the same time, for a meaningful reduction in external indebtedness unless the economy's productivity and efficiency is improved. Accordingly, beginning in January 1985 and continuing over the next few years, important further changes are to be made in the system of economic management, the broad objectives of which will be: (i) to improve the structure of relative prices and the allocation of resources; (ii) to increase factor mobility; (iii) to expand the scope for decentralized decisionmaking; and--as an essential corollary--(iv) to fashion and rely on macroeconomic policy instruments to guide the economy.

A major precondition for the success of the envisaged structural reform measures will be the maintenance of balanced conditions in domestic markets. In line with this, financial policies in 1985 are to continue to exercise restraint--albeit with some moderate easing from the tight policy stance in 1984--and while real wages and real investment outlays are not to be cut further, they are also not to increase. A continued growth of private sector incomes and social benefits is still expected to lead to a small rise in private consumption, but domestic expenditure is not expected to grow by more than 1 percent (Table 3). Output growth, which is expected to benefit from the reform measures but to be weakened by the assumed return of a normal crop year, is forecast to be in the range of 2-2 1/2 percent, permitting a further shift of resources (of at least 1 percentage point of real GDP) into the external sector.

1. Economic reforms

In 1968 a process of reform was initiated in the system of economic management in Hungary which was partly reversed in the mid-1970s but then renewed after 1978. The general thrust has been to reduce administrative directives to enterprises and increase the role of market forces. In 1985 a new advance in this process is being launched which it is intended to build on over the next few years. The steps being taken from January 1 range broadly across the system of economic regulation. They also include safeguards to ensure that the further moves away from direct control do not put economic stability at risk and that they are compatible with an inflation limit for 1985 of no more than 7 percent, which is deemed necessary to avoid an awakening of inflationary expectations. The principal measures fall in five main areas:

a. Prices

The package of changes in this area has three principal ingredients: (i) an easing of the rules governing price determination for enterprises operating under sufficiently competitive conditions, which is designed to impart greater flexibility to prices; (ii) further cuts in price subsidies, designed to promote a more rational structure of relative prices; and (iii) a streamlining of the previously numerous rates of turnover taxation, designed to improve the usefulness of this tax as a general policy instrument.

With the underlying rate of consumer price inflation put at about 4 percent in 1985, the above-mentioned changes have been constrained to result in price increases of no more than 3 percentage points, consistent with the inflation target. Virtually all of the "room" is to be taken by cuts in subsidies, with budgetary outlays on consumer price subsidies to be reduced by 16 percent (and on producer subsidies by 9 percent). The weighted effective rate of turnover tax, by contrast, is to decline slightly. The relaxation of the rules governing price determination is expected to allow enterprises accounting for 40 percent of manufacturing output to set prices freely, subject only to the condition that import prices not be exceeded. This is estimated to lead to an additional increase in producer prices of about 1/2 percent in 1985.

b. Wages

Changes being made in the wages field in 1985 are aimed at raising labor productivity. Thus, the regulations governing wage determination in the competitive sector are being modified to make wage increases more directly a function of profits and to facilitate a widening of pay differentials. In addition, a 10 percent tax, to be paid out of profits, is being introduced on the wage bill of enterprises. Further, the system of managerial remuneration is being overhauled to link salaries, too, more directly to profits.

Given the target for inflation, and thus the permissible growth in wage incomes, the noncentrally-determined wage schemes will continue to feature a highly progressive tax (paid by the enterprises) on either individual earnings or the average increase in the wage bill. In addition, a new virtually prohibitive tax (150 percent) is to be applied in 1985 to wage increases in excess of the rise in value added. The authorities consider that without such safeguards, there would be insufficient resistance to destabilizing wage awards, especially with the move to greater enterprise autonomy (see below). They recognize that such taxation inevitably constrains wage differentiation and thus runs counter to the attempts to raise productivity, but they do not expect it to blunt such efforts entirely. Thus, average wage increases in 1985 are expected to range from 10-11 percent under the most liberal scheme (estimated to cover 25 percent of the labor force outside agriculture and government) to 2-3 percent under the most rigorous centrally-determined scheme (20 percent of the labor force).

c. Taxation

A major restructuring of the tax system was introduced on January 1, 1985, the aim of which is to tax profits (and thus the efficient enterprises) less, while taxing the use of factors of production more. Toward the former end, the 40 percent tax on depreciation allowances and the practice of confiscating a portion of retained profits--both of which weighed disproportionately on profitable enterprises--have been abolished and the effective rate of profit tax reduced slightly (a larger reduction is planned for 1986). Toward the latter end, and in order to offset the foregoing revenue loss, new taxes have been introduced on investment outlays and enterprise net worth, as well as on the wage bill.

The Hungarian representatives noted that while the shift in the incidence of taxation would favor efficient enterprises relative to the less efficient, there would be no reduction in the overall absorption of enterprise resources by the budget in 1985, given the need to contain investment. To that extent, and taking into account the uncertainties created in the short-run by the many changes in taxes, the supply response in 1985 is expected to be limited. It is also likely to be dampened by the legislation of a large number of exceptions to the main tax rates. Officials considered these to be transitional in nature. They saw the changes being introduced in 1985 as a first step in a long process of replacing the discretionary and selective methods of taxation of the past several years by a more normative and simplified tax structure based on statutory rules and with uniform application across enterprises. Key elements of the system in the next few years are expected to be a personal income tax and, possibly, a value-added tax. Introduction of the former, in addition to strengthening the presently limited armory of general policy instruments, is seen as affording an effective way of meeting the pressing social need to tax incomes from private sector activities more equitably without curbing the vitality of such activity, as well as permitting a desired reduction in the overall tax burden on enterprises. The authorities have indicated that they will shortly request technical assistance from the Fund in this area, as well as in the area of establishing--at a later date--a VAT.

d. Enterprise organization

Three interlinked intiatives are being made in this area, the impact of which while potentially far-reaching is likely to come through only over a period of several years. First, the independence of enterprises from their supervisory ministries is to be increased. Except in the largest state enterprises, all operating decisions, including investment decisions, will devolve to the enterprises, where the right to appoint senior management and to take strategic policy decisions is to be exercised by boards involving worker representation. The changes, which are to be introduced gradually over a two-year period, are based on the successful experience of self-management in the agricultural cooperatives. Second, competition is to be strengthened by an accelerated dismantling of conglomerates and the removal of restrictions on the freedom of enterprises to choose what to produce. Third, a new law on the liquidation of insolvent enterprises is to be enacted which will provide for bankruptcy proceedings through the courts.

e. Financial system

With greater decentralization of decision making in the rest of the economy, increased attention is being given to improving the system of mobilizing and allocating financial resources while maintaining effective monetary control. To this end, a number of changes are being implemented in early 1985, and in the latter part of January a staff mission will visit Budapest to provide technical advice on the further development of financial instruments and the future evolution of the financial system.

The declared intention of the authorities is to introduce more competition into the banking system and to move toward indirect instruments of control. In 1985 the central banking and credit departments of the National Bank are being notionally separated. More substantively, a number of small new banks have been established, enterprises given the right to maintain time deposits with and seek investment credits from any bank, and the various restrictions previously limiting competition in the provision of banking facilities to households lifted. While the vast bulk of bank credit will continue to be subject to direct control and all interest rates other than on interenterprise and interbank transactions will continue to be fixed by the National Bank, first steps are being made away from credit ceilings for part of the banking system to controlling the refinancing provided by the central bank. To promote intermediation outside the banking system, commercial bills have been introduced and all regulations previously restricting other forms of interenterprise capital transfers removed.

2. Financial policies

The 1985 budget incorporates, as noted, important changes in the structure of taxation, the incentive effects of which are difficult to estimate. As to its implications for demand, the unweighted budget surplus is projected to diminish to 0.7 percent of GDP, from an estimated

1.9 percent of GDP in 1984. This easing of restraint is expected to derive equally from the revenue and expenditure sides. The projected decline in the revenue/GDP ratio is concentrated in the household sector, where the simplification of consumer turnover tax rates is expected to be accompanied by a fall in real receipts. In part, this reflects the priority attached, within a given inflation target, to reducing price subsidies, which are budgeted to fall by a further 1 1/2 percent of GDP. Investment expenditures are also to continue to fall in real terms, but an increase of nearly 2 percent of GDP is budgeted in health, defense and other expenditures (made up of significant increases in several sub-categories of expenditure), and as a result the relative size of the budget in the economy is forecast to increase.

A key role for credit policy in 1985 is to ensure that any tendency for the various changes in the economic management system to lead to higher-than-planned levels of domestic absorption is not accommodated by the banking system. With enterprise liquidity judged to be appropriately tight, an increase in broad money during 1985 of about 7 1/2 percent--or marginally less than the projected growth in nominal GDP--is being tentatively targeted. Within this, net domestic credit is to rise by 2 1/2-3 percent, consistently with the overall balance of payments objective. (During 1984, M2 and NDC are provisionally projected to have increased by about 5 percent and 1 1/2-2 percent, respectively.) The credit plan for 1985 provides for a further sizable rise in subsidized housing credit to individuals, in line with the Government's social and demographic policy objectives. In view of this and of the projected reduction in the budget surplus, only a moderate increase is planned in credit to enterprises.

3. Investment policy

Against the background both of a sharp reduction in the fixed investment ratio since 1978 (from 34 to 22 1/2 percent of GDP), and of the prospect that, at least over the next few years, the task of reducing the external debt is likely to leave little room for investment to rise much in real terms, the quality of investment has begun to come under increasing scrutiny. Officials generally consider that the cutback since 1978 has been accompanied by a discernible improvement in quality as the share of investment under the control of enterprises has risen and certain large State projects have been cancelled. This view is on balance borne out in the preliminary findings of the recent IBRD mission, which considers that the process of project selection and evaluation, the project implementation record, and the quality of recent projects have all improved. Reflecting this, incremental capital output ratios are beginning to fall, although they remain high by international standards even when adjusted for reductions in the rate of capacity utilization in recent years.

In order to raise the efficiency of investment further, the Government intends in the near term to postpone infrastructural investments in order to allow for some growth in investment in the productive sectors. Within the latter, the responsibility for investment selection is to be transferred increasingly to enterprise management, which it is expected will raise the productivity of capital. In the transitional period immediately ahead, when responsibility for investment decisions will be mixed, emphasis is to be given to small investments of a modernizing nature with relatively quick yields. This approach is in line with the priorities identified by the IBRD in its lending program for Hungary.

4. Energy policy

Largely as a result of increases in the late 1970s in the producer prices of energy--to levels approximating those in world markets--domestic consumption of energy has remained essentially unchanged since 1978, while real GDP has increased by a cumulative 11 percent. The high dependence of the economy on imported energy has also declined as domestic coal resources have been tapped more intensively and a first nuclear power station brought on stream. Current policy seeks to contain the growth of energy consumption through further improvements in the efficiency of energy use, to sustain import substitution, and to hold energy sector investment at present levels for the remainder of the decade so as to create the room needed for the expansion first of productive investment by enterprises and later of infrastructural investment.

5. External policy

High priority is to be given in the period ahead to reducing the external debt and lengthening its maturity. Toward the latter end, the authorities intend to be increasingly selective in drawing both on short-term lines of credit and on medium-term credit offers with relatively short maturities. Toward the former end, and against the background of a weakening in relative export profitability during 1984, the rate at which indirect taxes on exports settled in convertible currencies is refunded was raised on January 1, 1985 from 2 percent to 7 percent. The Hungarian representatives said that this course had been preferred in light of the tight target for inflation and observed that the higher rate of refund would still not cover the implicit average rate of indirect taxation in export costs. They emphasized that exchange rate policy would continue to be guided by the need to ensure that exports and import substitutes remained sufficiently competitive to meet the current account target.

Also with effect from January 1, 1985, the National Bank began adjusting the exchange rate for the forint against convertible currencies on a daily basis, rather than once per week as before. The new system eliminates the potential for broken cross rates inherent in the previous quotation practice.

Foreign trade in Hungary remains a state monopoly and may be effected only by authorized enterprises. Parallel to the moves to deregulate domestic enterprise activity, an additional 32 enterprises were granted foreign trading rights as of January 1, 1985, bringing the total number of enterprises with such rights to 250, against 211 at end-1983. The Hungarian representatives said that they fully recognized the need for a greater competitive impetus from a more liberalized import system but considered action in this direction to be precluded in 1985 by the balance of payments constraint.

V. Outlook

1. 1985

The macroeconomic program for 1985 is designed, as noted, to shift real resources equivalent to at least 1 percent of GDP into the external sector. Part of this shift is needed to meet a further expected deterioration in the nonruble terms of trade (of about 1 percent). The remainder is to be applied to reducing short-term debt to the nonconvertible currency area, the current account balance with which is projected to move into a surplus of US$85 million from a deficit of US$125 million in 1984. The current account surplus in convertible currencies, meanwhile, is forecast to decline slightly, to about US$300 million (1 1/2 percent of GDP). With the resumption of growth in domestic demand and with the return to the import system obtaining before September 1982, the volume of nonruble imports is projected to rise by close to 4 percent. While the volume of nonruble exports is forecast to increase at a similar rate, a relatively larger proportion of this growth is expected to represent shipments under bilateral agreements; in convertible currencies, accordingly, the real trade balance is projected to weaken. No difficulties are foreseen on the capital account, and officials do not expect any reduction in foreign reserves in 1985.

Officials noted that, given the changes being implemented in the economic management system, the forecasts for 1985 were subject to wider margins of error than usual. The greatest perceived risk was that wages or investment would overshoot plan targets. To some degree an overrun in one would, however, be at the expense of the other and--with the new taxes on wages and investment--to the benefit of the budget. Even so, safety margins had been incorporated into the demand estimates. Similarly, the impact of the reform in inducing a faster growth of output in 1985 had been estimated conservatively, at about 1/2 percent of GDP. This impetus was expected to derive primarily from additional savings in intermediate inputs, higher labor productivity, and stronger manufactured exports as the more efficient enterprises were allowed greater scope to expand. Officials indicated that the Government would not hesitate to take corrective action if during the course of the year the projected supply surplus was not materializing.

With regard to the balance of payments, officials agreed that, given the conditions in Hungary's main export markets and the limited technological quality of many of its manufactured goods, the projected growth in nonruble exports would not be easily achieved. They did not, however, foresee any significant diversion of nonruble exportables to the ruble area in 1985, both because goods sold in the two areas were not readily substitutable and because ample capacity was thought to exist to permit a stronger export performance to the ruble area. The need to increase ruble exports could, however, be expected to require more imported inputs from the convertible currency area. Given also the release of some pent-up demand for imported machinery with the easing of import restrictions, officials agreed that the ability to hold imports to the level forecast would hinge crucially on the success of the reform measures in inducing enterprises to economize further on their use of energy and raw materials.

2. Medium-term

Over the medium term, the authorities believe that the current account surplus in convertible currencies can be increased gradually to about US$0.5 billion in 1989. Taking account of the bunching of medium- and long-term maturities in 1985 and 1986, and assuming the maintenance of gross borrowing at US$1.35 billion beyond 1985, it would be possible thereby to maintain an adequate level of reserves while achieving a reduction in the gross external debt of about US$1.0 billion between end-1984 and end-1989. Concurrently, the debt service ratio would begin to decline after 1985, reaching about 26 percent in 1989 (Table 10).

Key assumptions underlying the projections are: (i) increases in export and import prices for nonruble trade of 4 percent a year for 1986 and beyond, after increases of 1 1/4 percent and 2 1/4 percent, respectively, in 1985; (ii) an average annual rate of increase of non-oil imports by trade partners of some 3 percent in volume; (iii) an average interest rate on the external debt in convertible currencies of 10.5 percent in 1985, and 10 percent thereafter; and (iv) the maintenance of adequate incentives to ensure the share of exportables in domestic production. Import projections are estimated to be consistent with rates of GDP growth of about 2 1/2 percent per year.

Two particular areas of uncertainty should be noted. First, projections for the external balance in convertible currencies are highly sensitive to assumptions for the terms of trade and for interest rates on international capital markets. If export prices for 1986 and beyond were to be 1 percent lower than assumed, then the 1989 current account surplus would be in the order of US$250 million and the gross external debt would be reduced only by some US$0.5 billion over the five-year period (assuming the reserves increased as shown in Table 10). If, in addition, market interest rates were 1 percent higher than assumed, the current account surplus in 1989 would be below US$150 million and level of external debt at end-1989 not appreciably different from that at end-1984.

Second, negotiations are to be completed during 1985 on the intra-CMEA trade plan for 1986-90. Three aspects, in particular, of the future pattern of Hungary's trade with its CMEA partners will have a bearing on its convertible currency trade balance. The first concerns the availability and prices of energy and raw materials from the CMEA area. If supplies should decline or expand less fast than needed for domestic production, more imports would be needed from the convertible currency area. The second concerns the quality of the goods that Hungary will need to export to its CMEA partners in exchange for imports of energy and raw materials. If this should be raised significantly, as was foreshadowed at the June 1984 economic summit of the CMEA, there could--at least in the short run--be a diversion of convertible currency exportables to the nonconvertible area. The third, which is akin to the second, concerns the outlook for exports to the CMEA area which are settled in convertible currencies. Such exports are estimated to have accounted for about 15-20 percent of Hungary's total convertible currency exports in recent years. A reduction in this trade could--again at least in the short run--be expected to have an adverse impact on the convertible currency balance.

VI. Staff Appraisal

The progress made by Hungary in recent years in the direction of economic adjustment was sustained in 1984, when a higher current account surplus in convertible currencies is estimated to have been achieved at a faster rate of output growth. The estimated increase in the external surplus brought the improvement from 1978 in the convertible current account/GDP ratio to more than 9 percentage points. Achieved in the face of a sizable increase in interest payments to abroad and of a net deterioration in the terms of trade, this entailed a shift of real resources into the external sector equivalent to fully 16 percentage points of GDP--a striking degree of adjustment by any standard. Significantly, and in contrast to the record in many other countries, this adjustment was also achieved in conjunction with a positive and steady growth in output. In the process, Hungary successfully weathered the liquidity crisis of 1982 without recourse to a rescheduling of debt--and in so doing helped reverse a weakening of creditor confidence in Eastern Europe generally--and subsequently enjoyed an improving credit standing in international financial markets. During 1984, consolidation of the current account position was accompanied by a substantial increase in medium- and long-term capital inflows which permitted a sharp rise in the reserves to a high level by international standards. By January 1985, Hungary was thereby well placed to forego further Fund assistance on the expiration of its second stand-by arrangement.

For the external position to remain viable in the period ahead, the current account surplus will, however, need to be maintained. Despite the strengthening in the current account, net external debt in convertible currencies at the end of 1984 is estimated to have remained equivalent to about 30 percent of GDP (only 3 percentage points less than at end-1978). More pointedly, the gross convertible currency debt service ratio is estimated to have risen to 42 percent of exports of goods and services in 1984, as the result primarily of the onset of a hump in the debt repayment schedule, and is expected to remain high over the next few years. In this respect the economy remains vulnerable to a change in conditions on international capital markets. It would thus be unfortunate if the current ease of borrowing and comfortable reserve position were to foster a belief that there is more room to maneuver on domestic demand policies. There is a need, rather, to guard against Hungary's becoming locked into a high debt situation--which could result if demand policies were shaded on the side of ease, if the impetus given to convertible currency exports by current reforms of the economic mechanism should prove disappointing, and if substantially more convertible currency exports were to be required to secure essential raw material and energy imports. All this underscores the need not to relent on reducing the debt, but to earn a roughly undiminished current account surplus in relation to GDP for some years yet.

In this connection, it needs to be borne in mind that further cuts in enterprise investment (particularly through the confiscation of retained profits) and further reductions in real wages in the socialist sector--which have been major components of demand management packages in recent years--no longer constitute a realistic policy option. Sustaining the balance of payments position from now on will require both the development and active use of new policy instruments to maintain control over disposable incomes and aggregate expenditure, as well as the more urgent promotion, on the supply side, of greater efficiency and productivity in the economy.

This, the authorities recognize. For 1985 they have targeted a current account surplus in convertible currencies of some US$300 million (1 1/2 percent of GDP)--only slightly below 1984's estimated outturn. For the medium term, they have launched an advance in their ongoing economic reform process, designed to enhance the possibility of achieving the requisite external surplus while permitting a reasonable rate of economic growth.

Attainment of a US$300 million surplus in 1985 may not prove easy on present policies. Indications are that the official forecast for exports is toward the upper end of the plausible range, and that for imports toward the lower end. There is also obviously some risk--notwithstanding the safeguards built into the steps toward greater economic liberalization--that the loosening of direct controls over incomes and investment in 1985 could lead to an overrun on domestic absorption which would not be matched by larger supply. In these circumstances, the authorities will need to remain vigilant to any deviations from the macroeconomic plan, and to stand ready to take corrective action as necessary.

If action should be needed, a second look might appropriately be taken at budgetary (particularly expenditure) policy, as well as external policies. The proposed budget for 1985, while providing for an important qualitative change in the structure of taxation, is quantitatively unambitious: the budget surplus is projected to decline and--paradoxically at a time of moves in the direction of economic decentralization--the intermediary role of the Government is set to increase, with a rise in the share of expenditure to GDP. External policies, meanwhile, rely importantly in 1985 on an increase in indirect tax rebates to assist exporters. The staff questions the preference for this measure over a change in the exchange rate, both because of its implicit subsidization of imports and in light of the renewed appreciation of the real effective exchange rate over the past year.

The new advance in 1985 in improving the economic management system is timely. Its aims--of reducing administrative interference and enhancing the role of market forces so as to increase efficiency and the ability of the economy to adjust--go to the heart of weaknesses in the economic mechanism and can only be endorsed. Toward these ends potentially important steps are being taken toward liberalizing prices, raising the cost of labor, widening pay differentials, reducing administrative constraints on enterprises, and taxing the use of resources more and profits less. For 1985, however, these measures are subject to various exceptions and constraints--not least, the self-imposed limit on price increases, which fundamentally circumscribes the scope for restructuring relative prices and liberalizing the wage system--and the package as a whole has been scaled down from what was discussed in earlier staff reports. In view of this, the initial impetus to greater efficiency, exports and output is likely to be moderate.

The staff appreciates that the reform process will need to be spread over time but would urge the authorities not to delay unduly those changes that are most likely to raise productivity. In addition to easing the constraints surrounding the January 1985 initiatives as expeditiously as possible, there are four areas that would seem to warrant priority attention in the next round. The first, and most fundamental, is to increase competition. This is a prerequisite for the efficient functioning of a liberalized system. Since Hungary's small economy cannot generate sufficient competitive forces across all, or even most, product categories, there is a need to open up the economy more perceptibly to foreign competition. Toward this end, restrictions on enterprises' foreign trading rights should be lessened further and, more importantly, a free list of imported goods should be established for which neither a trading right nor a license would be required. In turn, imports would need to be priced more appropriately.

The second area for attention would be to promote enterprise financial responsibility more actively. A good litmus test of progress here would be a reduction in the size of the budget, as well as, more particularly, in the scale of discretionary extrabudgetary support for financially-troubled enterprises. The third is to improve the system of financial intermediation so as to mobilize and allocate financial resources more effectively. The fourth is to broaden the range and effectiveness of fiscal and credit policy instruments. This is required not only in view of the expenditure overruns of the past two years and the heavy reliance that has been placed on cutting back on investment, but also to counter--without resort to administrative interference--the new risks that changes in behavioral relationships and a loosening of direct controls might entail for domestic absorption. The progressive removal of restraints on internal price formation would also seem to require a considerably more flexible use of the exchange rate than heretofore if the relative profitability of the traded goods sector is to be maintained.

The staff welcomes the termination in 1984 of the bilateral payments agreement with Brazil and the intention to terminate the agreement with Finland in early 1985. It also welcomes the change, with effect from January 1, 1985, to adjusting the exchange rate for the forint on a daily basis, which eliminates the potential for broken cross rates inherent in the previous quotation practice. In addition, the staff notes that the import licensing system is being implemented in practice in a way which does not involve a payments restriction.

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

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Hungary's exchange measures subject to Article VIII, sections 2 and 3, and in concluding the 1984 Article XIV consultation with Hungary, in the light of the 1984 Article IV consultation with Hungary conducted under Decision No. 5394-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Hungary maintains restrictions on payments and transfers for current international transactions and a multiple currency practice in accordance with Article XIV. The Fund encourages Hungary to pursue policies that would permit their elimination. In particular, the Fund encourages Hungary to take early steps to eliminate its bilateral payments agreements with Fund members. In this respect, the Fund notes with satisfaction the intention of the Hungarian authorities to terminate the bilateral payments arrangement with a Fund member. The Fund also welcomes the change in the method of setting the exchange rate of the forint against convertible currencies, which eliminates a practice that has given rise to broken cross rates in the past.

Table 1. Hungary: Selected Elements of External Adjustment

	Cumulative Change in Percent or (*) Percentage Points			
	1978 to 1980	1980 to 1981	1981 to 1983	1983 to 1984
Real domestic expenditure	-4.8	1.4	-1.8	-0.3
Total consumption	(3.0)	(2.9)	(1.8)	(0.9)
Total investment	(-19.5)	(-2.2)	(-10.9)	(-3.7)
Real GDP	1.6	2.9	3.5	2.3
Real foreign balance on goods and services/GDP*	6.9	1.5	5.2	2.5
Terms of nonruble trade	0.4	2.2	-3.5	-2.8
Net investment income/GDP*	-0.3	-3.0	1.7	-0.4
Nonconvertible currency current balance/GDP* (improvement, -)	0.2	-0.2	0.5	-0.6
Current account in convertible currencies/GDP* (improvement, +)	5.8	-1.5	4.6	0.3
Exports 1/	53.1	0.3	-0.6	2.2
Imports 1/	15.2	-3.4	-10.5	-6.4

	Ratios, in Percent; Convertible Currency Accounts Only					
	1978	1980	1981	1982	1983	1984
Current account/GDP	-7.5	-1.7	-3.2	-0.4	1.4	1.7
Capital account/GDP	10.3	3.6	0.9	-4.6	0.7	-0.7
Medium- and long-term	(6.4)	(3.0)	(2.3)	(-0.1)	(--)	(2.1)
Short-term	(3.9)	(0.6)	(-1.4)	(-4.5)	(0.7)	(-2.8)
Gross debt/GDP	45.7	41.0	38.3	33.3	39.3	42
Net debt/GDP 2/	32.7	30.0	29.5	28.0	30.4	30
Gross reserves/imports	54.0	53.3	45.2	30.0	46.9	68
Debt service/exports of goods and services	...	29.7	33.7	32.7	34.2	42

Source: Information provided by the Hungarian authorities.

1/ In convertible currencies; U.S. dollar value terms.
2/ Net debt equals gross debt less gross reserves (gold valued at US$226 per ounce).

Table 2. Hungary: Quantitative Performance Criteria under 1984 Stand-By Arrangement

	Actual	Actual	Limit	Actual	Limit	Actual	Limit	Limit
	December 31, 1983	March 31, 1984		June 30, 1984		September 30, 1984		December 31, 1984
				(In billions of forint)				
Net domestic assets of National Bank of Hungary	261.7	261.4	262.0	262.4	262.5	264.0	264.0	260.0
Net bank credit to the State, under the understanding that no borrowing from the State Insurance Company will occur in 1984	28.9	22.5	22.5	19.8	19.8	16.3	16.4	11.0
Credit granted by State Development Bank	148.0	149.9	150.0	153.3	154.5	157.2	157.2	164.0
				(In millions of U.S. dollars)				
Net foreign liabilities in convertible currencies of specialized financial institutions	1,088	1,122	1,130	1,047	1,085	1,054.9	1,055	1,055
New long-term foreign debt in convertible currencies by nonbank borrowers	1.4	--	26.3	—	...	—	...	25.0
Total short-term debt in convertible currencies	2,123	1,680	1,350 1/	1,389	1,500	1,445.5	1,550	1,600

Sources: EBS/83/268 (12/16/83); Letter of Intent of May 18, 1984, and data provided by Hungarian authorities.

1/ Limit waived by Executive Board on May 14, 1984 (EBS/84/109, 5/9/84).

Table 3. Hungary: Demand and Supply

	In Billions of Forint at Current Prices 1984	(Percentage Change in Volume) 1983	Revised Program 1/ 1984	Estimated Cutturn 1984	Official Forecast 2/ 1985
Consumer expenditure	599.7	0.5	-0.7	0.9	1.2
Government current expenditure	93.0	1.3	-3.0	0.4	2.6
Gross fixed investment 3/	217.0	-3.8	-7.7	-8.4	0.4
State investment	77.5	(-2.5)	(-9.3)	(-8.4)	(-2.0)
Enterprise investment	105.5	(-4.9)	(-8.1)	(-9.7)	(-0.2)
Investment of population	43.0	(10.6)	(8.6)	(8.0)	(5.6)
Stockbuilding 4/	22.1	-1.1	0.4	1.2	-0.1
Domestic demand	931.8	-1.7	-2.3	-0.3	1.0
Exports of goods and services	404.1	6.7	6.0	6.8	5.1
Imports of goods and services	-369.9	0.9	0.4	0.7	3.2
GDP	966.0	0.7	0.3	2.3	2.0
Plan reserve	--	...	...	...	0.6 4/
GDP, including plan reserve	966.0	0.7	0.3	2.3	2.6
Memorandum items:					
Contribution to real GDP growth of change in real foreign balance 4/		2.4	2.4	2.6	1.1
Change in GDP deflator (in percent)		5.0	5.6	5.3	6.1

Source: Information provided by the Hungarian authorities.

1/ All references in tables to "Revised Program" are to estimates agreed at time of mid-term review of 1984 stand-by arrangement (EBS/84/144, 7/3/84).

2/ Excluding investment reserve of Ft 3 billion, not included in investment chapter of Plan.

3/ Components somewhat exceed total because adjustments for leads and lags, taxes, etc., not allocated. Percentage change data for state and enterprise investment deflated by price deflator for socialist sector investment.

4/ In percentage points.

Table 4. Hungary: Household Incomes, Consumption and Savings

	In Billions of Forint (Estimate) 1984	(Percentage Change) 1983	Revised Program 1984	Estimated Outturn 1984	Official Forecast 1985
Wages in socialist sector	329.2	4.8	4.7	4.9	6.9
Receipts from private activities 1/	70.9	31.1	18.3	26.6	18.3
Total labor income	400.1	8.1	6.7	8.2	8.9
Taxes, etc.	-28.7	16.7	...	17.1	16.4
Social benefits	125.6	9.2	...	12.3	9.1
Other money income, plus benefits and income in kind	141.5	7.9	...	8.3	6.5
Disposable income	638.5	7.9	7.7	8.7	8.1
Consumption	599.7	7.0	7.9	8.8	7.9
Savings	38.8				
Housing	(33.5)				
Financial savings	(5.3)				
Memorandum items:					
Consumption deflator (percent change)		6.5	8.7	7.8	6.5
Real consumption (percent change)		0.5	-0.7	0.9	1.2
CPI (percent change)		7.3	9.4	8.5	7.0
Savings ratio (in percent of disposable income)		6.2	5.7	6.1	6.3
Of which: Financial savings		1.3	0.7	0.8	0.9

Source: Information provided by the Hungarian authorities.

1/ Net of production costs.

Table 5. Hungary: Balance of Payments in Convertible Currencies

(In millions of U.S. dollars)

	1982	1983	1984 Revised Program	1984 Estimated Outturn	1985 Forecast
Exports	4,876	4,847	4,994	4,956	5,013
Imports	-4,110	-3,970	-3,916	-3,715	-4,083
Trade balance	766	877	1,078	1,241	930
Freight and insurance (net)	-220	-175	-193	-168	-201
Travel (net)	176	165	180	190	191
Investment income (net)	-976	-662	-671	-722	-712
Government expenditure (net)	-45	-39	-47	-41	-43
Other current receipts (net)	146	77	-12	-207	54
Unrequited transfers (net)	61	54	65	66	75
Current balance	-92	297	400	349	294
Medium- and long-term capital					
Assets 1/	-192	-65	-100	-88	-100
Liabilities	174	60	-309	503	-414
Inflows	(1,068)	(1,276)	(1,226)	(2,069)	(1,286)
Outflows	(-894)	(-1,216)	(-1,535)	(-1,566)	(-1,700)
Short-term capital					
Assets 1/	-161	-239	-80	-143	-80
Liabilities 2/	-883	393	-487	-416	300
Overall balance	-1,154	446	-576	205	--
Monetary movements					
Monetary gold (increase -)	383	-368	49	70	--
Foreign exchange (increase -)	536	-430	77	-711	--
Use of Fund resources 3/	235	352	450	436	--
Memorandum item:					
Gross international reserves in convertible curencies (end-year) 4/	1,112	1,573	...	2,274	...

Source: National Bank of Hungary.

1/ Nonreserve assets; mostly export financing.
2/ Includes errors and omissions.
3/ Includes drawing of SDR 72 million under CFF in December 1982.
4/ Gold valued at SDR 35 per ounce.

Table 6. Hungary: Selected External Debt Data

	1981	1982	1983	1984 1/	September 1984
A. Total foreign debt					
	(In millions of U.S. dollars; end-period)				
In convertible currencies	8,699	7,715	8,257	8,534	8,255
In nonconvertible currencies	1,327	1,274	1,367	...	1,465
B. Debt in convertible currencies					
	(In percent of total)				(In millions of U.S. dollars)
By original maturity					
Short-term	33	23	26	18	1,445
Medium- and long-term	67	77	74	82	6,810
By type					
Financial loans 2/	93	86	81	81	6,707
Trade-related credits	5	9	14	13	1,102
Other	2	5	5	6	446
	(In percent)				
Interest rates					
Average rate on stock of debt outstanding 3/	14.0	12.8	10.3	10 1/2-11	
Average rate on loans contracted in year 4/	13.1	9.5	10.6	11	
	(In years)				
Average maturity of loans contracted in year 4/	6.1	4.7	6.4	6 1/2-7	
	(In percent)				
Gross debt/GDP	38.3	33.3	39.3	42	
Net debt/GDP 5/	29.5	28.0	30.4	30	
Debt service/exports of goods and services	33.7	32.7	34.2	42	

Source: National Bank of Hungary.

1/ Data on original maturity and type refer to end-September 1984; all other data are official estimates of the end-year or full year position.
2/ Includes Fund credit.
3/ Includes short-term debt.
4/ Medium- and long-term debt only.
5/ Gross debt less gross convertible currency reserves/GDP; gold holdings valued at US$226 per ounce.

Table 7. Hungary: Balance of Payments in Nonconvertible Currencies

(In millions of U.S. dollars)

	1982	1983	Revised Program 1984	Estimated Outturn 1984	Forecast 1985
Exports	4,207	4,031	4,216	3,861	4,047
Imports	-4,465	-4,482	-4,342	-4,267	-3,936
Trade balance	-258	-451	-126	-406	111
Freight and insurance (net)	-91	-71	-101	-99	-99
Travel (net)	81	95	104	101	112
Investment income (net)	14	-4	20	-23	-25
Government expenditure (net)	3	7	2	-2	--
Other current receipts (net)	28	161	88	302	-16
Unrequited transfers (net)	2	3	2	2	2
Current balance	-221	-261	-51	-125	85
Medium- and long-term capital					
Assets 1/	12	-15	-9	23	3
Liabilities	87	94	25	-5	3
Inflows	(133)	(133)	(...)	(...)	(25)
Outflows	(-46)	(-39)	(...)	(...)	(22)
Short-term capital					
Assets 1/	128	-27	--	--	-2
Liabilities 2/	32	190	35	78	-81
Overall balance	38	-19	--	-29	8

Source: National Bank of Hungary.

1/ Nonreserve assets; mostly export financing.
2/ Includes errors and omissions.

Table 8. Hungary: Summary Budget Transactions

	In Billions of Forint Estimated 1984	(In percent of GDP) 1/ 1982	1983	Revised Program 1984	Estimated Outturn 1984	Proposed Budget 1985
Expenditures	553.1	58.7	60.9	56.7	57.3	57.7
Investment	58.1	6.3	6.4	5.8	6.0	5.6
Subsidies	144.1	17.3	18.1	14.3	14.9	13.5
Consumer price subsidies	(51.5)	(7.6)	(7.4)	(5.3)	(5.3)	(4.2)
Producer price subsidies	(25.1)	(3.2)	(3.2)	(2.5)	(2.6)	(2.2)
Social security	120.6	11.6	12.0	12.4	12.5	12.6
Health, defense, other	217.9	23.6	23.4	22.8	22.6	24.4
State Lending Fund	12.4	--	1.1	1.4	1.3	1.6
Revenues	571.0	57.3	60.7	58.6	59.1	58.5
Wage tax and other social security contributions	119.3	8.8	9.6	12.0	12.3	15.2 2/
Profit taxes	139.5	13.3	14.6	14.0	14.4	12.5 2/
Production and capital taxes	28.6	3.0	3.3	3.0	3.0	5.2
Indirect taxes	195.7	22.6	22.8	20.3	20.3	19.3
Confiscated funds	8.2	--	1.1	0.9	0.8	--
Other	79.7	9.6	9.3	8.4	8.3	6.3
Budget balance	17.9	-1.4	-0.2	1.9	1.9	0.7
Memorandum item:						
Adjusted fiscal balance 3/	33.3	-1.4	0.9	3.4	3.4	2.2

Source: Ministry of Finance; National Planning Office; and staff estimates.

1/ For 1985, GDP figure excludes all plan reserves.
2/ With the changes in wage taxes proposed for 1985, a tax on wage increases previously included in profits taxes, is now classified as a wage tax.
3/ Budget balance plus unspent funds in the State Lending Fund (included in the Budget) and the Intervention Fund (extrabudgetary).

Table 9. Hungary: Selected Monetary and Credit Developments

	In Billions of Forint				Percentage Change Over 12 Months	
			Program	Outturn		
	December 1982	December 1983	September 1984		December 1983	September 1984
National Bank of Hungary						
Net domestic assets	251.3	261.7	264.0	264.0	4.1	4.6
Net foreign liabilities in convertible currencies 1/	164.0	163.8	160.5	159.0	-0.1	0.4
Currency in circulation	87.3	97.9	103.5	105.0	12.1	11.5
Banking System						
Net foreign assets 2/	-275.7	-276.0	-277.1	-283.0	-0.1	-0.2
Convertible currencies	-269.2	-262.6	-258.0	-256.7	...	...
Nonconvertible currencies	-6.5	-13.4	-19.1	-26.3	...	...
Net domestic credit	663.3	680.9	683.5	687.9	2.7	3.3
Claims on budget	29.3	28.9	16.4	16.3	...	...
Claims on enterprises	534.1	551.0	575.3	573.1	3.2	4.4
Claims on households	133.6	154.3	172.3	176.0	15.5	17.1
Less: reserve funds, other items, etc.	-33.7	-53.3	-80.5	-77.5	...	...
Broad money (M2)	387.6	404.9	406.4	404.9	4.5	4.2
Money	183.0	190.2	188.9	182.6	3.9	4.0
Quasi-money	204.6	214.7	217.5	222.3	4.9	4.4

	1982	1983	Program 1984	Estimate 1984
Income velocity of M2 3/	2.25	2.26	2.29	2.32
M2 held by households	3.43	3.25	3.15	3.18
M2 held by enterprises	6.58	7.43	8.36	8.53

Source: National Bank of Hungary.

1/ Valued at constant (June 1982) exchange rates.
2/ Valued at program exchange rates.
3/ GDP divided by average of end-quarter stock of M2.

Table 10. Hungary: Medium-Term Debt Analysis in Convertible Currencies, 1983-1989

(In millions of U.S. dollars)

	1983	1984	1985	1986	1987	1988	1989
Debt service payments							
Payments on existing debt 1/							
Interest 2/	753	793	648	463	327	230	179
Amortization	1,216	1,566	1,598	1,496	1,225	701	326
Of which: IMF	(--)	(--)	(--)	(136)	(269)	(191)	(106)
Payments on new borrowings							
Interest	--	95	242	360	463	533	572
Amortization 3/	--	--	102	239	398	923	975
Of which: IMF	(--)	(--)	(--)	(--)	(7)	(76)	(69)
Total	1,969	2,454	2,590	2,558	2,413	2,387	2,052
Total debt service payments/ exports of goods and services	34.2	42.0	43.3	39.4	35.0	32.5	26.2
Balance of payments							
Exports of goods and services	5,749	5,849	5,981	6,493	6,899	7,344	7,838
Imports of goods and services	5,452	5,500	5,687	6,130	6,485	6,864	7,302
Of which:							
Interest payments	(753)	(888)	(890)	(823)	(790)	(763)	(751)
Current account	297	349	294	363	414	480	536
Capital account	149	-144	-294	-449	-217	-247	-36
Of which: Gross borrowing	(1,276)	(2,069)	(1,286)	(1,250)	(1,250)	(1,250)	(1,250)
IMF (net)	352	436	--	-136	-276	-267	-175
Gross reserves: 4/							
(Months of imports)	5.6	8.2	7.4	6.1	5.5	5.0	5.4
(Percent of short-term debt)	87.8	158.3	133.3	115.7	106.3	100.0	109.7
Memorandum items:							
Debt outstanding (end-period)	8,256	8,534	8,420	8,035	7,762	7,488	7,537
Of which: IMF	(573)	(972)	(972)	(836)	(560)	(293)	(118)
Debt/GDP (in percent)	39.2	42.4	39.9	37.2	35.0	33.0	32.4

Sources: National Bank of Hungary; and staff estimates.

1/ Debt outstanding at end-June 1984.
2/ Includes interest on short-term debt. Assumed interest rate: 11.0 percent in 1984; 10.5 percent in 1985; 10.0 percent thereafter.
3/ Average maturity: six years, including one-year grace period.
4/ Gold valued at US$226 per ounce.

Hungary--Fund Relations

(As of November 30, 1984)

I. Membership Status

(a) Date of membership:	May 6, 1982
(b) Status:	Article XIV

(A) Financial Relations

II. General Department (General Resources Account)

	(Millions of SDRs)	(Percent of quota)
(a) Quota	530.7	
(b) Total Fund holdings of currency	1,502.7	283.2
(c) Fund credit	972.0	183.2
Of which:		
Under tranche policies 1/	900.0	169.6
CFF	72.0	13.6
(d) Reserve tranche position	--	

III. Stand-By

(i) Twelve month stand-by arrangement in the amount of SDR 425 million, approved on January 13, 1984, completed as planned.

(ii) Thirteen-month stand-by arrangement in the amount of SDR 475.0 million, approved on December 8, 1982; completed as planned.

IV. SDR Department

(a) Net cumulative allocation: --

(b) Holdings: SDR 0.02 million

1/ Ordinary and enlarged access resources.

(B) Nonfinancial Relations

V. (a) Exchange Rate Arrangement: The exchange rate of Hungary's currency, the forint, vis-à-vis the currencies of countries other than members of the Council of Mutual Economic Assistance, the People's Socialist Republic of Albania, and the Democratic People's Republic of Korea is linked to a weighted basket of nine currencies.

As of November 30, 1984 the representative rate was Ft 50.42 per U.S. dollar.

(b) Unapproved exchange practices subject to Article VIII, Sections 2 and 3: see text of decision below.

VI. Last Article IV consultation was discussed by the Board on January 13, 1984 when a stand-by arrangement was also discussed and approved. The mid-term review of that program was discussed by the Board on August 1, 1984. Hungary is on a 12-month consultation cycle. The following decision was taken by the Board on January 13, 1984:

1. The Fund takes this decision relating to Hungary's exchange measures subject to Article VIII, sections 2 and 3, and in concluding the 1983 Article XIV consultation with Hungary, in the light of the 1983 Article IV consultation with Hungary conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Hungary maintains restrictions on payments and transfers for current international transactions (as described in EBS/83/268, 12/16/83). With respect to the tighter import licensing and import quotas introduced in September 1982, the Fund urges their elimination at an early date. In the meantime, in the circumstances of Hungary, the Fund grants approval of these restrictions until June 30, 1984, or the completion of the review under the stand-by arrangement, whichever is earlier. For those restrictions maintained under Article XIV, the Fund encourages Hungary to pursue policies that would permit their elimination. In particular, the Fund encourages Hungary to take early steps to eliminate its bilateral payments agreements with Fund members. In this respect, the Fund welcomes the modification of the bilateral agreement with Brazil.

VII. Technical Assistance

(a) Central Banking Department

A Fund staff team will visit Budapest in January 1985 to provide the Hungarian authorities with technical advice on the development of the instruments for an effective monetary and credit policy under a restructured banking system.

(b) Fiscal Affairs Department

The Hungarian authorities have requested technical assistance to advise on tax matters.

Hungary: Use of Fund Credit, December 1983 to November 1984

	12/31/83	1/31/84	5/31/84	8/15/84	11/15/84
			(In millions of SDRs)		
Purchases under stand-by arrangement	83.2	127.5	99.2	99.2	99.2
Ordinary resources	37.8	63.8	49.6	49.6	49.6
Borrowed resources	45.4	63.8	49.6	49.6	49.6
Total Fund credit outstanding (end of period)	547.0	674.5	773.7	872.9	972.0
Under tranche policies 1/	475.0	602.5	701.7	800.8	900.0
Under special facilities 2/	72.0	72.0	72.0	72.0	72.0
			(In percent of quota)		
Purchases under stand-by arrangement	15.7	24.0	18.7	18.7	18.7
Total Fund credit outstanding (end of period)	103.1	127.1	145.8	164.5	183.2
Under tranche policies	89.5	113.5	132.2	150.9	169.6
Under special facilities	13.6	13.6	13.6	13.6	13.6

Source: IMF Treasurer's Department.

1/ Ordinary and enlarged access resources.
2/ Compensatory financing facility.

Hungary - Statistical Issues

1. Coverage, Currentness, and Reporting of Data in IFS

		Latest Data in December 1984 IFS
Real Sector	- National Accounts	1983
	- Prices	September 1984
	- Production	September 1984
	- Employment	September 1984
	- Earnings	September 1984
Government Finance	- Deficit/Surplus	Q2 1984
	- Financing	Q2 1984
	- Debt	n.a.
Monetary Accounts	- Central Bank	June 1984
	- Deposit Money Banks	September 1984
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Values	September 1984
	- Merchandise Trade: Prices	Q2 1984
	- Balance of Payments 1/	Q2 1984
	- International Reserves	September 1984
	- Exchange Rates	October 1984

During the past year, the reporting of data for inclusion in IFS has been timely.

2. Outstanding Statistics Issues

a. Government finance

No monthly data are available as yet. However, the authorities hope to begin producing them on a regular basis by 1986.

b. Monetary accounts

Hungary is planning to reform the structure of its financial system. Beginning January 1985 the commercial banking operations of the National Bank would be performed by a separate department. This would be the first step in the process of establishing independent financial institutions, perhaps as "Business Banks." Meanwhile, the National Bank has already started to change its accounting procedures so as to ensure continuity in the production of monetary data. In this connection, the Hungarian representatives attending the recent Annual Meeting proposed that a money

1/ There are two presentations, one for transactions in all currencies and another for transactions in convertible currencies only.

and banking expert visit the Bank once the new accounts for January 1985 become available. They indicated that February or March 1985 would perhaps be the appropriate time for this visit. During the visit the necessary changes in the country's IFS page would be discussed and a short seminar on the draft Guide to Money and Banking Statistics in IFS would also be conducted. As a result a technical assistance mission is now scheduled to visit Budapest in March 1985.

c. Balance of payments

The statistical problems that exist in balance of payments statistics will be taken up during a technical assistance visit which is scheduled for April 1985.

Hungary: Selected Economic and Financial Indicators, 1982-85

	1982	1983	1984 Revised Program	1984 Estimated Outturn	1985 Official Projection
			(Annual percentage changes, unless otherwise specified)		
National income and prices					
GDP at constant prices	2.8	0.7	0.3	2.3	2.0-2.6
GDP deflator	5.7	5.0	5.6	5.3	6.1
Consumer prices	6.9	7.3	9.4	8.5	7.0
External sector (on the basis of U.S. dollars) 1/					
Exports, f.o.b.	2.2	0.3	-3.8	-2.7	5.4
Imports, c.i.f.	-8.8	-1.3	-8.1	-5.6	6.0
Export volume	10.7	10.8	-1.4	3.4	4.2
Import volume	-2.3	6.4	-9.4	-2.4	3.7
Terms of trade (deterioration -)	-1.1	-2.4	-3.8	-2.8	-1.0
Nominal effective exchange rate (depreciation -)	7.4	-2.0	-2.4	...	...
Real effective exchange rate (depreciation -)	3.6	-4.2	-2.7	...	...
Government budget					
Revenue	2.8	12.1	3.9	4.9	7.1
Expenditures	3.3	9.7	0.3	1.3	9.1
Money and credit					
Net domestic credit 2/	1.8	2.7	1.0	1.8	2.8
Domestic credit	6.1	5.3	4.4	4.6	5.6
Government	52.6	-1.4	-61.9	-61.9	-70.9
Enterprise and households, etc.	4.8	5.6	7.1	7.3	6.8
Money and quasi-money	6.4	4.5	3.8	5.0	7.4
Velocity (GDP relative to M1) 3/	4.6	5.11	5.06	5.21	5.10
Interest rate (annual rate, two-year term deposit)	5.0	5.0	6.0	6.0	6.0
Domestic credit as a share of M2 4/	11.0	9.6	8.0	8.3	10.2
			(In percent of GDP)		
Central Government fiscal balance 5/	-1.4	0.9	3.4	3.4	2.2
Overall public sector balance 6/	-1.6	0.8	3.5	3.5	2.2
Domestic bank financing	1.4	-1.0	-3.5	-3.5	-2.2
Gross domestic investment 7/	28.7	26.6	24.7	24.8	24.6
Gross domestic savings	29.5	28.5	27.7	28.3	28.6
External current account balance, including grants 1/	-0.3	1.5	1.9	1.7	1.4
External debt 1/	34.9	38.7	34.1	37.6	35.9
Inclusive of use of Fund credit	36.0	41.5	39.2	42.4	40.6
Debt service ratio (in percent of exports of goods, services and private transfers) 1/	32.7	34.2	39.2	42.4	40.6
Interest payments (in percent of exports of goods, services and private transfers) 1/	17.4	13.1	13.3	15.2	14.9
			(In millions of SDRs, unless otherwise specified)		
Overall balance of payments 8/	-961	477	-567	205	--
Gross official reserves (months of imports) 9/	3.6	5.6	5.4	8.2	7.4
External payments arrears	--	--	--	--	--

Sources: Central Statistical Office, Statistical Yearbook; data provided by the Hungarian authorities; and staff estimates.

1/ Nonruble transactions for trade and convertible currencies for current account, debt, debt service payments, and reserves. Trade figures are not adjusted for re-exports.
2/ Excluding valuation effects.
3/ Using quarterly average money stocks.
4/ Percentage contribution to M2 growth.
5/ Budget balance plus unspent funds in the State Lending Fund and the Intervention Fund.
6/ Fiscal balance plus local authorities' net borrowing from National Savings Bank.
7/ Including stockbuilding.
8/ In convertible currency.
9/ Gold is valued at the price of US$226 per ounce.