INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/37

10:00 a.m., March 8, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. K. Bush
J. de Groote	H. G. Schneider
	X. Blandin
	M. B. Chatah, Temporary
	M. Sugita
G. Grosche	
J. E. Ismael	Jaafar A.
	G. D. Hodgson, Temporary
A. Kafka	H. A. Arias
H. Lundstrom	A. Lindø
	A. Abdallah
	B. Jensen
	E. M. Taha, Temporary
	J. E. Rodríguez, Temporary
J. J. Polak	
	A. V. Romuáldez
G. Salehkhou	
	A. S. Jayawardena
	V. Govindarajan, Temporary
N. Wicks	T. A. Clark
S. Zecchini	N. Coumbis
Zhang Z.	Wang E.

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

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Also Present

T. King, Europe, Middle East, and North African Regions, IBRD. Central Banking Department: T. J. T. Balino, H. Mehran. European Department: B. Rose, Deputy Director; P. C. Hole, H. B. Junz, J. Somogyi, B. W. Stanyer. Exchange and Trade Relations Department: E. H. Brau. Fiscal Affairs Department: V. Tanzi, Director. Legal Department: W. E. Holder. Research Department: T. A. Wolf. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: L. K. Doe, D. Hammann, G. E. L. Nguyen, P. Péterfalvy, T. Sirivedhin. Assistants to Executive Directors: J. R. N. Almeida, W.-R. Bengs, Chen J., G. Ercel, R. Fox, A. R. Ismael, M. Lundsager, E. Olsen, W. K. Parmena, D. J. Robinson, A. A. Scholten, Shao Z., L. Tornetta, A. H. van Ee, Wang C. Y.

1. HUNGARY - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Hungary, together with a proposed decision (SM/85/10, 1/7/85; and Sup. 1, 3/6/85). They also had before them a report on recent economic developments in Hungary (SM/85/15, 1/18/85).

Mr. de Groote made the following statement:

As the documents show, our discussion today concerns the economic situation of a country whose external balances have radically changed since it became a member of the Fund in 1982. When the Fund's membership mission was in Hungary, we all remember that the country's external balances were being dramatically affected by the debt crisis in several countries of the region. Hungary was then virtually deprived of any access to the medium-term capital markets, and short-term deposits had been abruptly withdrawn from the Hungarian banks. The country had lost some 80 percent of its reserves in gold and convertible currencies and been forced to tolerate an increasing stock of arrears vis-à-vis its trading partners, though never vis-à-vis its banking partners; the possibility of requesting a rescheduling of the debts was debated but promptly rejected by the economic policymakers. By now, as clearly shown by the capital inflows, the confidence of the capital markets in Hungary has been restored. Hungary's reserves in gold and convertible currencies are presently equal to about eight months' imports, the arrears are long forgotten, and the import regime is again back to normal. In addition, Hungary has a considerable current account surplus in convertible currencies for the second straight year, having amounted to $297 million in 1983 and $331 million in 1984.

This discussion in the Board gives me the chance to stress that the Hungarian authorities attribute these positive changes largely to their country's membership in the Fund and the World Bank, and to the assistance and encouragement that they have received from the staff and the Board in implementing their adjustment program. My Hungarian authorities have asked me to express their gratitude personally to the Managing Director for his unselfish support and timely advice during the search for a solution to the Hungarian problems. They particularly appreciate that the Fund has been considerate of Hungary's social system, and has never shown any discrimination in its approach.

The Hungarian authorities are well aware that being on the right track is not the same thing as having arrived at a safe haven. Notwithstanding Hungary's good external balances, the country's foreign debt is still too high and its structure needs further improvement. The debt service ratio is such that the country's external balances remain precarious should any kind of crisis arise.

For this reason, among others, Hungary wishes first of all to continue the adjustment efforts while accelerating the economic reform by which the country aims to transform its system of economic management into a socialist planned economy operating with market methods and market instruments. Much has been written on the Hungarian reform. At our most recent Board meetings concerning Hungary, this chair also gave a detailed exposition of the underlying concepts and main areas of application of the ongoing reform. The staff papers provide us with a fair description both of the concrete measures already taken and of those still being implemented or designed.

As to the timetable for implementing these measures, the Hungarian authorities are ready to accept the implied criticism of the staff with two qualifications. First, it is no easy task to introduce a complex of market instruments into an economy that, for nearly 40 years, has operated more or less without them. Hungary and the Hungarian economists have to relearn how the market works, and must also become familiar with a myriad of new instruments developed in modern market economies over the last few decades. Second, the market instruments have to be introduced at a time when there is a requirement for demand management measures, which unavoidably limits domestic absorption and still involves considerable social costs. This does not discourage the Hungarian policymakers from continuing with their program. However, a number of factors, including a certain reluctance by the Fund to back the Hungarian economic reform measures with a stand-by arrangement at a time when Hungary's external balances show vigorous development, make the authorities feel that they must proceed more carefully.

Even without a new stand-by arrangement, the Hungarian authorities want to use the Fund's assistance in accelerating their economic reform program and will also continue to implement demand management measures along the lines of past recommendations of the staff.

First, as far as the reform program is concerned, Hungary wants to rely on the Fund's advice in several fields. The initial steps toward the creation of a competitive banking system were taken in Hungary as of January 1, 1985, and the Hungarian authorities are now collaborating with the Fund's Central Banking Department in the preparation of proposals for the Government on the desired shape of the banking system and the necessary set of financial instruments. These proposals will include a timetable for implementing the measures. The Hungarian authorities have also applied for technical assistance in designing and introducing an adequate personal income tax system and a VAT tax system during the next two or three years. The National Bank of Hungary, together with the IMF Institute, is organizing a seminar in Budapest in March in order to make the Fund's philosophy more widely known in Hungary.

Second, on the demand management side, let me inform the Board that on January 21, some important new measures were taken. Retail prices were increased as follows: milk and dairy products, by 11-40 percent; sugar, by 16 percent; fuel and household energy, by 18-30 percent; local transport, by 55-100 percent; postage, by 84 percent; automobiles, by 3-4 percent; books, by 7 percent; theater tickets, cinema tickets, and the like, by 15 percent. In addition, certain sick leave allowances were also curtailed. Only retired persons with small pensions and families receiving allowances for children have been compensated for the price increases. The price adjustments will contribute about 3 percentage points to consumer price index for 1985, which at the present stage is expected to rise by about 7 percent for the whole year.

To summarize, Hungary considers the financial assistance and the expert advice of the Fund to be important if not decisive factors in the country's adjustment process. The country wants to continue its cooperation with the Fund, even though no stand-by arrangement is in the pipeline for the moment, by relying on the Fund's rich experience gained in various parts of the world during its decades of activity. Simultaneously, Hungary intends to continue to take an active part in the general activities of the Fund and to contribute, as its modest means permit, to the successful achievement of the important tasks of this universal financial institution.

Mr. Zhang considered that the staff in its appraisal had rightly emphasized the unusual achievements of Hungary during the period under review. In most unfavorable conditions, Hungary, as stated on page 17 of the staff report, had been able to bring about "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." The report further stated that "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." To a large extent, that success had been made possible by the economic reform, involving significant changes in planning methods, an increase in the autonomy of the state enterprises, and greatly enhanced reliance on the market mechanism. However, it should be emphasized that the reform had been proceeding within the framework of central planning and the social ownership of the predominant share of the means of production. It was virtually inconceivable that the operation of purely spontaneous market forces could by itself have resulted in such success in the absence of continuous guidance by central planning authorities, through both indirect and direct means. As could be seen from the staff report, in some instances, severe imbalances had been avoided only by the partial retention of direct controls, which had had to be temporarily and reluctantly applied in spite of the determination to continue economic reform.

The most characteristic feature of recent developments in Hungary was the skillful effort to find the most effective way of combining central planning with the greatest possible autonomy for the enterprises, Mr. Zhang continued. Within the framework of certain general legal rules and regulations, the state enterprises were to operate with increasing freedom from the directives of their supervising authorities. The objectives of the central plan were to be realized to a greater degree through the use of fiscal and financial policy measures aimed at influencing mainly the returns and costs of the enterprises and their investments. The transition to that system was obviously difficult; it involved, inter alia, introducing and developing a new entrepreneurial spirit among management and testing the effects of various measures on the working of the economy. Naturally, the process could not be expected to move in a straight line without some interruptions and modifications. Depending on both internal and external circumstances, it might become necessary to slow down, or even to reverse, some reforms for a time in order to preserve economic stability and maintain economic growth.

The staff was clearly aware of those problems, Mr. Zhang noted, in particular of the part played by certain restrictions in improving the external balance. However, certain suggestions in the staff report might create the impression that the staff was preoccupied with the further reduction of direct government regulations to an extent that overshadowed recognition of the progress already made and that diverted attention from the danger inherent in hasty and unswerving implementation of the institutional changes envisaged by the Government. For instance, in view of the clearly defined policy of the authorities and the results achieved, there seemed little point in urging the authorities "not to delay unduly... changes that are most likely to raise productivity," as the staff had done on page 19 of SM/85/10.

Some of the staff's suggestions and comments seemed to reflect a somewhat doctrinaire view rather than actual analysis of the current situation, Mr. Zhang considered. One small example was the unwarranted suggestion that the increasing share of budgetary expenditure in GDP was inconsistent with the program of decentralization. An increase in the scope of autonomous and market-influenced decisions was quite compatible with a rise in expenditure for, say, social, cultural, and health purposes, as well as for financing infrastructural work. As Table 8 in the staff report showed, subsidies and government investments were to decrease by 1.8 percent of GDP in the 1985 budget, compared with 1984, but the decrease would be more than offset by increases in expenditures on social security, health, and infrastructural financing, thereby leading to higher total expenditure in 1985.

He had similar reservations about the staff's suggestions concerning trade and exchange policies, Mr. Zhang remarked. The staff was understandably concerned with the need for further efforts to improve the balance on current account; at the same time, it suggested a further lessening of restrictions on enterprises' foreign trading rights and the establishment of a free list of imported goods for which neither a trading right nor a license would be required, the purpose being to increase competition in the Hungarian market. But under prevailing conditions, a further liberalization of imports would seriously hamper the improvement of the current account balance. The Hungarian authorities had expressed their concern in that respect by clearly stating that they recognized the need for a greater competitive impetus from a liberalized import system but considered action in that direction to be precluded in 1985 for balance of payments reasons. He wondered why the staff had questioned that statement by the authorities.

Furthermore, the Hungarian Government's reliance in 1985 on an increase in indirect tax rebates to assist exporters had been questioned by the staff, which, for various reasons, would prefer a change in the exchange rate, Mr. Zhang said. Irrespective of those reasons, fostering exports by tax rebates did not involve any direct increase in import prices, whereas devaluation could have a significant inflationary effect that, under present conditions, might easily upset the delicate balance of the economy with serious consequences for the future of the economic reform. More specifically, the resulting increase in prices and the decline in real wages would most likely have significant social and political consequences; the Government had suggested as much, in a statement to the effect that the scope for reducing demand had been all but used up and that the people no longer had the ability to endure real wage cuts. A similar attitude had been taken by the staff in stating that neither a further cut in enterprise investments nor one in real wages in the social sector any longer constituted a realistic policy option. Therefore, in present circumstances, a devaluation could have significant destabilizing effects on the economy. Furthermore, Hungary's significant achievements and its general compliance with the recommendations of the Fund posed the question whether the staff was not displaying a certain tendency to exaggerate the supposedly negative influence of any measure not conforming to some idealized concept of a perfectly competitive economy that was remote from reality.

On a technical point, Mr. Zhang asked what the real effective exchange rate was in Hungary, since the production cost index for exports did not necessarily reflect movements in foreign trade prices. In addition, he asked whether the staff, in advocating continued devaluations, had calculated the relevant export and import price elasticities.

With respect to the current account balance, the staff had stated on page 17 of its appraisal that "for the external position to remain viable in the period ahead, the current account surplus will, however, need to be maintained," and that in order to continue to reduce external debt, Hungary would need "...to earn a roughly undiminished current account surplus in relation to GDP for some years yet." It was not clear to him why the current size of that surplus, of about $300 million, should be elevated into an absolute target, a procedure that seemed to diverge from that normally applied by the Fund to other debtor countries.

Another general point on which he sought clarification, Mr. Zhang commented, concerned the statement by the staff in its report for the midterm review of the stand-by arrangement (EBS/84/144, 7/3/84; and Cor. 1, 7/26/84) that the authorities had advised the Fund management that they were contemplating a request for an arrangement in support of a longer supply-oriented program, a move for which the staff had also indicated general support. No mention was made in the staff report for the 1984 Article IV consultation of such a request, the emphasis having apparently shifted completely to demand management policies even though there had been no deterioration in the overall economic situation. What accounted for that change of attitude? With the deepening of the reform process in Hungary, a longer-term arrangement in support of structural adjustment would seem more appropriate at present. That the Fund's attitude had changed was confirmed by Mr. de Groote's statement that there was now "a certain reluctance by the Fund to back the Hungarian economic reform measures with a stand-by arrangement at a time when Hungary's external balances show vigorous development..." and that that, along with other factors, makes the authorities "feel that they must proceed more carefully."

In concluding, Mr. Zhang said that his remarks were not in any way intended to detract from the valuable contribution that the staff report made to the understanding of the problems faced by any centrally planned economy in the midst of economic reform.

Mr. Polak observed that Hungary had made an impressive adjustment effort in recent years and, in the process, had fully restored its international creditworthiness. The economic performance in 1985 promised to be reasonably satisfactory, although he shared some of the staff's hesitation on that score. The authorities were continuing to implement economic reforms of which they were the pioneers in Eastern Europe. Further advances were being made in enhancing the role of market forces, although the comprehensive reform discussed in the context of the 1984 stand-by arrangement appeared to have given way to a more gradual approach. The benefits of the reform, which would be derived from a greater role for market-determined prices, would thus be realized more slowly than had been hoped earlier. The reform would also enhance the capacity of the economy to adjust and would thus make demand management more effective.

In that connection, Mr. Polak recalled the active dialogue between the Fund and Hungary in 1984 on a major set of reform measures that the Fund would have been willing to support by means of a new stand-by arrangement, which regrettably was not to come to pass. It was true that, in present conditions, Hungary fortunately had no "need"--in the sense of Article V--to use Fund resources; but the lack of such a need should not stand in the way of the Fund's agreeing to a stand-by arrangement of the classical type, on the understanding that Hungary would not draw unless it developed a need.

Some of the reform measures had a severe social impact, and the authorities' desire to proceed cautiously was understandable, Mr. Polak commented. The question was whether that consideration applied to the financial system; although reforms to that system had been introduced, the bulk of bank credit was still subject to direct control by the authorities, and all interest rates continued to be fixed by the National Bank. Those rates remained low, with the yield on one-year time deposits--in which the greatest part of household savings were held--being negative in real terms at 5 percent. That negative yield seemed to have had an unfavorable effect on the growth of savings. In 1984, time deposits had increased less than in 1983, even though the rate of growth of income had increased. However, as he had said on previous occasions, Hungary was in need of a much improved system of intermediation, and the authorities should press forward with establishing it. On another aspect of reform, the much smaller reduction of price subsidies projected for 1985 than in 1984 was disappointing; price subsidies continued to constitute a large part--about 23 percent--of total government expenditure.

The external position and the exchange rate raised a sensitive and rather controversial issue, Mr. Polak noted. Hungary had succeeded in achieving a considerable surplus on current account in 1984, with a quite adequate export performance. In volume terms, exports had grown by 8 percent, accompanied however by a rather steep fall in export prices expressed in dollars. He continued to question the relevance of expressing variables in dollars rather than in, say, deutsche mark. For 1985, the authorities expected a somewhat smaller current account surplus, of anout $300 million--again, he questioned the measurement in appreciating dollars--and the staff had expressed some doubt about the attainment of a surplus of that size, which it felt was necessary. The Hungarian forecasts of convertible currency export growth (close to 4 percent in volume terms) were considered by the staff to be on the high side, and those for imports (also 4 percent) on the low side. The staff also suggested that profit margins in the export sector were under strain and seemed to question the exchange rate policy.

Some erosion in competitiveness had taken place since the devaluation of June 1984, as the staff had noted, owing in part to the excessive weight of the dollar in Hungary's currency basket, Mr. Polak went on. Inflation in 1985 was likely to exceed somewhat that in partner countries as a consequence of the further liberalization of the price system. The decision to raise again the rebate of indirect taxes for exports settled in convertible currencies--within one year after it had been lowered--indicated that the authorities were also aware of the loss of export competitiveness. He would be concerned if the authorities showed any tendency to revert to the attitude that they had taken before mid-1982, when the exchange rate had been seen primarily as an instrument to ward off inflation from abroad, with insufficient attention being given to competitiveness. It would be better to move the rate by small steps, as had been done in 1983 and 1984, than to be faced by the need for a substantial devaluation sometime in 1986.

The objective of reducing external debt by about $1 billion in the five years ahead, bringing the debt service ratio down to some 20 percent, seemed appropriate and probably attainable, Mr. Polak considered. However, by borrowing rather heavily in the last months of 1984, Hungary had actually increased its gross external debt, even expressed in dollars. Since a considerable share of the outstanding debt was denominated in currencies that had depreciated against the dollar in 1984--a fact that might usefully have been mentioned in the report on recent economic developments--the actual increase in debt was larger than a mere comparison of amounts outstanding expressed in dollars would suggest. Therefore, he would conclude with a word of caution to the authorities not to react too enthusiastically to their regained creditworthiness but to keep firmly in mind the objective of reducing external indebtedness.

Mr. Romuáldez said that he was in broad agreement with the staff appraisal of Hungary's economic situation. He therefore supported the proposed decision. In discussing the 1983 Article IV consultation with Hungary, Executive Directors had stressed the need for tightening demand management in order to achieve the current account targets for 1984, expressed concern over the bias in the adjustment strategy toward the reduction of investments, encouraged maintenance of the momentum gained toward structural reform, and underlined the role of timely exchange rate adjustments, especially in view of reductions in import restrictions.

Performance in 1984 had been largely adequate in terms of those guidelines, Mr. Romuáldez continued. Admittedly, domestic demand had not declined as much as targeted, but a relatively strong demand had been somewhat offset by a bumper wheat harvest and by stronger than expected private sector economic activity. Public finances had strengthened. Monetary policy had remained generally tight. The current account of the balance of payments in convertible currencies had continued in surplus, even if slightly below targets. Hungary's creditworthiness in international financial markets had consequently been enhanced, as evidenced by improved flows of medium-term and long-term credit on better terms. Official reserves in convertible currencies had increased to an amount equivalent to 8.2 months of end-1984 imports.

He had been glad to note that the authorities had decided to some extent to orient their system toward the market in the context of a broader program, Mr. Romuáldez said. They had put forward policy reforms designed to lessen administrative controls and enhance the efficacy of market forces in five areas: prices, wages, taxation, enterprise organization, and the financial system. Those were welcome developments, although limited in scope. The strong response by the private sector to recent moves toward liberalization should be indicative of the appropriateness of those reforms. For the sake of perspective, however, it was useful to remember that Hungary's economy remained centrally planned: the socialist sector accounted for 95.8 percent of GDP in 1983. The private sector had made inroads, slowly but consistently, with private sector activity growing from about 1.7 percent of GDP in the mid-1970s to 4.2 percent of GDP in 1983. The primary challenge for the authorities remained that of judiciously injecting meaningful measures of market orientation into economic institutions designed by central planners for a centrally planned system. With every new shift in policy, they had to face the fundamental challenges posed by the inner logic of the market to the structure of their economy and to their willingness to carry out reforms.

The objectives for 1985 of consolidating external adjustment achieved to date and reducing the level of foreign debt were appropriate, Mr. Romuâldez considered, but would require heroic efforts in the management of demand, for several reasons. First, Hungary's terms of trade were continuing to decline; second, the crop year was expected to be normal in 1985; third, fixed investment, already repressed for several years, would be allowed to rise slightly, but enough to bring about moderate increases in convertible currency imports of equipment; fourth, wages in the socialist sector would have to be raised enough to maintain real wages, which had been allowed to deteriorate in real terms during the past six years, even as private sector incomes had been rising, and by as much as 27 percent in 1984; fifth, with its high level of debt service, which had peaked in 1984 at 42 percent of goods and services, Hungary remained vulnerable to interest rate movements abroad.

For the achievement of their 1985 objective, Mr. Romuâldez continued, the authorities would have to exercise greater financial restraint than in 1984, especially in the use of extrabudgetary disbursements, which had partly accounted for overruns in the program targets in 1984. In that connection, he commended the authorities for having begun to cut down on subsidies, especially for consumer goods; they should continue on that course and act similarly on producer support subsidies. The broader approach that the authorities had taken toward reform should improve the structure of relative prices, rectify the allocation of resources, and increase factor mobility, and, along with the major restructuring of the tax reform, it should provide adequate and equitable incentives for greater efficiency and productivity.

For liberalization to be effective and for market orientation of the economy to work, increasing competition should be encouraged, particularly among enterprises, Mr. Romuâldez remarked. While competition could be useful, it again posed the problem of the inner logic of the market system in relation to the Hungarian economic system.

Monetary policy would have to remain tight, Mr. Romuâldez stated. He agreed with the staff's caveat that the decentralization of the state enterprises and greater private sector economic activity could place increasing demands on credit from the banking system. The authorities had programmed appropriately broad money targets and net domestic credit targets for 1985 to enable them to walk the thin line between restraining the rise of banking sector credit without entirely dampening the stimulus given by the reform to independent investment decisions by enterprises and the private sector. In the context of the momentum toward decentralization and increased private sector activity, the reform making the financial system more competitive and the development of indirect instruments of control were welcome, although they had been implemented too gradually. A wider variety of credit instruments--as much within as outside the banking system--would contribute to greater intermediation and an improved allocation of financial resources.

The exchange rate needed to be monitored particularly closely, in view of the liberalization of income and investment, Mr. Romuáldez remarked. A more flexible attitude to the exchange rate would be needed, especially owing to the continuing strength of the dollar. The weight of the dollar in the currency basket to which the forint was pegged seemed greater than was warranted by U.S./Hungarian trade relations and should perhaps be reviewed.

In closing, Mr. Romuáldez remarked that it would have been helpful to examine Hungary's economic situation after having had an opportunity to look at the staff paper on the design of adjustment programs in planned economies.

Mr. Wicks noted that the Hungarian authorities had successfully completed the stand-by arrangement. While there had been slippages in a number of areas, the external position had strengthened considerably. Perhaps the most important testimony to that strengthening was the renewed willingness of commercial banks to extend medium-term and long-term credits to Hungary. He echoed Mr. Polak's plea to the authorities to exercise caution about future borrowing from the banks and to resist, where necessary, the blandishments of bankers.

Having said that, Mr. Wicks continued, he agreed with Mr. de Groote and with the Hungarian authorities that the economy had not yet arrived at a safe haven. The debt service ratio was high, and the external position remained vulnerable, as the staff's useful sensitivity analysis made clear. He asked whether the projections in Table 10 of medium-term debt were central estimates or somewhat skewed toward the optimistic. The slippage in the current account surplus in 1984 was a little disturbing, and he urged the authorities to stand ready to take prompt action if domestic demand or development appeared to threaten the target for 1985.

More generally, as he had noted when the Executive Board had discussed the Hungarian economy in the past (EBM/84/118, 8/1/84), a precondition for further effective adjustment in the Hungarian economy was a continuation and strengthening of the reform process. He therefore welcomed the measures introduced in January as one more step along the way, but he agreed with the staff that considerable scope remained for further action. The remarks by Mr. de Groote that had been quoted by Mr. Zhang had baffled him also. As Mr. Polak had already pointed out, it was a requirement of the Articles that Fund resources should be made available only when a country had a balance of payments need. It was not easy to establish such a need for Hungary, which had a current account surplus, a buoyant capital account, and reserves equal to some eight months' imports. He wondered whether Mr. de Groote's remarks meant that the staff took the view that the Articles stood in the way of a further program. Recognizing that a continuation of the reform process could initially have adverse effects on the current account, he joined Mr. Polak in asking whether a classical stand-by arrangement, under which drawings would be made only in case of need, might have been appropriate. In that connection, he would be interested in comment by the staff or by Mr. de Groote on the prospective effect on the balance of payments of the recent reforms. Finally, he inquired whether Mr. de Groote's comments suggested that the staff had concluded that, although further reforms were needed, the determination of the Hungarian authorities to go through the process of reform was flagging, so that no new program had been recommended.

On more specific points, Mr. Wicks continued, the continued slippages in private consumption and government expenditure were a little worrying. The rapid growth in aggregate private incomes of course reflected the welcome effect of the reform program in boosting small-scale enterprises and private activity in general, but it also underlined the necessity to develop new fiscal instruments. Therefore, he fully supported the authorities' emphasis on tax reform, and would in particular encourage the consideration of a personal income tax and a value-added tax. On goverment expenditure, he endorsed the staff judgment that the policy for 1985 was a little unambitious. In particular, although considerable progress had been made, subsidies remained high at over 13 percent of GDP. In addition, disbursements from the extrabudgetary Intervention Fund, which used the profits of successful enterprises to support those in difficulties, had slightly exceeded projections. Given the importance of encouraging enterprise autonomy, he hoped that that Fund would be wound down as quickly as possible.

It was important to improve the system of financial intermediation in conjunction with increasing enterprise autonomy in order to make sure that resources were channeled to the most efficient projects, Mr. Wicks said. He had been interested in the staff's remarks on the quality of Hungarian investment, and looked forward to the report of the World Bank mission on that subject. Anything more that could be said about the quality of investment would be of interest, as would information about the World Bank's future involvement with the policy of reform in Hungary, since the Fund appeared to be less involved with the reform than in the past. The measures taken in January to liberalize the choice of banking facilities--especially for small enterprises--combined with the authorities' intention to extend enterprise autonomy in that area were welcome, but for those measures to be fully effective, it might well be necessary to increase interest rates to at least real positive levels.

On external policy, although the improvement in the maturity structure of Hungary's debt was most welcome, some further lengthening would be desirable, as Mr. de Groote had observed, Mr. Wicks stated. His understanding was that a large part of Hungary's external debt was owed to preferred creditors like the World Bank and the Fund. He asked the staff to comment on that aspect of debt management. On the virtues of exchange rate action as opposed to changes in export rebates, he endorsed the staff's preference for the use of exchange rate policy and also agreed entirely with Mr. Polak's views on the subject. He had made a note of the staff's observation in SM/85/10 that "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." He would therefore be interested in comments by the staff or Mr. de Groote on whether a move toward a more trade-weighted basket might be appropriate.

Mr. Hodgson noted that the Hungarian authorities had made equally commendable progress in economic adjustment and in managing an external payments position that had appeared to be reaching a crisis point in 1982. They had been able to draw on the resources of the Fund and the World Bank and to avoid debt rescheduling through a quick and decisive adjustment in the convertible currency current account. It would have been preferable for the burden of adjustment to be more evenly spread between imports and exports, but the fact remained that adjustment had taken place. External financing was once again being made available voluntarily to Hungary, and current account surpluses in convertible currencies of about 1.5 percent of GDP had been achieved in the past two years. Those were important accomplishments.

Nevertheless, despite the progress in the external sector and the continuing reforms in the domestic economy, there were some risks in the present situation, Mr. Hodgson considered. External debt remained large, the debt service ratio was at the upper end of the manageable range, and the economy was vulnerable to external shocks. The authorities should be prepared to act quickly if any sizable slippage began to appear in the external position or if there was any deviation from the current macroeconomic plan. Such action would not necessarily call for financial assistance from the Fund; although his chair was open minded on that point, and he would listen keenly to the answers by the staff and Mr. de Groote's questions already raised by other Directors.

The recent strengthening of the external position had been achieved in conjunction with continuing, if lower, growth, Mr. Hodgson observed. However, the heavy debt burden would make current account surpluses necessary for some years to come to allow for smooth debt management. The official forecast of export growth in 1985 appeared to be on the optimistic side, while the import forecast was on the low side. The trade balance would therefore have to be closely watched for any sign of deterioration. Consideration should be given to a more active exchange rate policy as a means of encouraging hard-currency exports in place of reliance on measures such as tax rebates to exporters. However, the move to adjust the forint on a daily, rather than on a weekly, basis was welcome. The authorities should also consider liberalizing the foreign trade system more rapidly, since that could provide benefits on the export side, as well as increasing competition within domestic markets.

On the matter of economic reform in general, the authorities' domestic objectives of strengthening productivity and efficiency were clearly necessary and appropriate, Mr. Hodgson went on. Some important reforms had already been introduced, and the plans for further reforms that would realign relative prices, increase factoral mobility, and further decentralize control over economic decision making were all positive steps. He had been especially encouraged by the authorities' declared intention to introduce more competition into the financial system and to begin to reduce credit allocation by the National Bank, essential steps if enterprises were to be able to take independent investment decisions based on considerations of profitability. Presumably, interest rates would at the same time begin to play a more central role in credit allocation; he would appreciate some comment from the staff on how interest rate policy was evolving. The staff's concern about the pace of adjustment should be heeded, especially where productivity was concerned. Mr. de Groote had correctly noted that the transition to a more market-oriented system of management was not an easy one; it required learning by managers and policymakers alike. There were also costs involved in not moving quickly enough, and those costs affected both the external and the domestic sectors of the economy.

The medium-term scenario clearly indicated Hungary's vulnerability to unfavorable external developments and the need to strengthen the external position through improving the efficiency and productivity of the domestic economy, Mr. Hodgson noted. The limited technological quality of many of Hungary's manufactured goods, as well as the constraints on its ability to switch exports from the ruble area to the hard-currency area, underscored the need for quick movement on the reforms. The Hungarian authorities had already gained some experience at balancing competing economic interests, and he had confidence that they would manage the reform process effectively.

His concern with respect to macroeconomic management was that the authorities should begin to develop and use policy instruments with a view to relying increasingly upon adjustments in the policy framework rather than upon direct control to reach their goals, Mr. Hodgson commented. For instance, as the financial sector was liberalized, monetary policy could be more actively used to encourage savings and investment; he had already alluded to the role that interest rates could play in allocating credit. Demand management policy should take on a more important function in influencing the external balance if there were to be no worsening of the external situation or no slowing of the reform process, especially if national income rose more rapidly than currently expected.

Finally, Mr. Hodgson said, his chair continued to be encouraged by Hungary's commitment to reform, and hoped that other countries in similar economic circumstances were taking note of the benefits to be derived from the decentralization of decision making and increased price flexiblity.

Mr. Lindå observed that, during the program period supported by the stand-by arrangement with the Fund, Hungary had made a highly commendable adjustment effort. In response to weaker than expected economic developments abroad and to inappropriate trends in the level and composition of internal demand, supplementary measures had been taken, which had, however, no more than safeguarded the attainment of the external targets. A better result might have been expected in view of the bumper wheat harvest and would have made further adjustment efforts easier.

As shown in the staff report, much of the burden of adjustment would be shifted from demand restraint to supply-side measures, Mr. Lindå added. The change in policy emphasis deserved support, provided policies of financial restraint were continued with only moderate easing in the period ahead. Gauging the quantitative effects of supply measures, especially those of an administrative nature, was always difficult. The large uncertainties prevailing with respect to the external environment and the effects of supply-side measures inclined him to agree with the need for the safety margins incorporated in the demand estimates, and for changes in budgetary and exchange rate policies in case the economic assumptions were not realized. He had been glad to note from the staff report and from Mr. de Groote's statement that the Government would not hesitate to take the necessary corrective measures in that event.

According to the staff report, considerable reliance was placed on an increase in indirect tax rebates to assist exporters, Mr. Lindå noted. He agreed with the staff that the authorities should adjust the exchange rate rather than subsidize exports in that way, in order to improve the balance of payments situation. Finally, he supported the proposed decision.

Mr. Grosche remarked that he fully endorsed the staff appraisal and supported the proposed decision. The improvement in Hungary's economy since it had initiated a Fund-supported adjustment program had been impressive. Despite an increase in interest payments abroad and a net deterioration in the terms of trade, the current account in convertible currencies had again shown a sizable surplus in 1984, albeit somewhat smaller than previously expected. Real resources had been shifted into the external sector, and the reserve position had become quite comfortable. In addition, public finances had been strengthened, and real GNP growth had been above the program targets. The economy was thus in much better shape than at the time of Hungary's admission to Fund membership in May 1982. Hungary had even become independent of further financial support by the Fund, another welcome development. Like other Directors, however, he would have been ready to discuss a new stand-by arrangement, one in the true sense, that would serve as a cushion for unforeseeable repercussions of additional and bold reform steps.

It was quite clear from the staff report and from Mr. de Groote's statement that the course of reform had to be followed over the medium term, Mr. Grosche continued. Despite improvements, the external position was still vulnerable on a number of counts. External debt in convertible currencies had risen further in 1984 following substantial foreign borrowing in the fourth quarter; the debt service ratio was expected to increase in 1985 and to remain high thereafter. As the staff had pointed out, the projections for the external balance were highly sensitive to even small variations that could negatively affect the medium-term prospects. He therefore fully supported the staff's assessment that Hungary's restored creditworthiness and comfortable reserve position should by no means be allowed to lead to a relaxation in demand policies. That assessment held particularly for private consumption, which once again seemed to have overshot the targets.

The level of consumption would have to be closely watched in order to preserve sufficient resources for investment, Mr. Grosche went on. In the past, investment had had to bear the brunt of demand restraint. The fall of more than 8 percent in gross investment in 1984 had been the strongest decline since the inception of the adjustment program. Of course, a certain reduction of the investment ratio, which had been in effect before 1980, was appropriate. But that falling trend could not be continued without endangering Hungary's growth and export prospects. He shared the staff's view that further cuts in enterprise investment no longer constituted a realistic policy option. It was therefore necessary for the authorities to scrutinize the development of disposable income and current expenditures, adopting quick corrective actions when necessary.

In that connection, it was somewhat doubtful whether the new taxes on noncentrally determined wage increases were the most appropriate way to check the growth of wages, Mr. Grosche noted. He agreed with the authorities that those taxes could run counter to attempts to raise productivity by encouraging wage differentiation. He did not foresee a great threat to the inflation target if the taxes were not applied too stringently, because greater incentives would lead to additional production that would absorb the increased demand. If further action became necessary to maintain domestic absorption within program targets, he agreed with the staff that the corrective measures would have to be directed at government expenditures.

He also had some doubts about the adequacy of the easing of fiscal restraint in prospect for 1985, Mr. Grosche added. The proposed budget contained some positive elements but also others that gave rise to some concern; in particular, the prospective rise in current expenditures would entail an unwelcome increase in the relative size of the budget in the economy that might well not be considered consistent with continued adjustment. On the other hand, the envisaged further reduction of price subsidies, as well as the changes in the tax structure aimed at promoting efficient enterprises, were welcome positive features of the budget for 1985.

Again, while he welcomed the authorities' intention to continue the process of economic reform, which would include major improvements in the system of economic management, the structure of prices, and the allocation of resources, certain references in the staff report created the impression that the authorities were somewhat hesitant to implement fully the measures of reform, Mr. Grosche observed. Various exceptions and limitations had been placed on the measures planned for 1985, and the package as a whole had been scaled down from what been discussed in earlier staff reports. Therefore, he fully endorsed the staff view that there was more room to go ahead with the reform, in particular in the areas described on page 19 of SM/85/10.

Finally, Mr. Grosche noted with satisfaction that the rate for the forint against convertible currencies had recently begun to be adjusted daily, thereby eliminating the potential for broken cross-rates. However, the authorities should make more flexible use of exchange rate policy to maintain the improved external position in the period ahead. The appreciation of the real effective exchange rate at the end of 1984 was cause for some concern. A more flexible exchange rate policy would also support the reform process and should reduce the scope for granting indirect tax rebates to exporters.

Ms. Bush said that her authorities continued to be favorably impressed with Hungary's progress toward economic adjustment, both because of its specific commitment under the recently expired stand-by arrangement and because of the longer-term effort toward structural reforms. The balance of payments had been impressively strengthened. Previous reform measures and new ones introduced earlier in 1985--including those aimed at liberalizing relative prices, increasing labor mobility and greater pay differentiation, expanding decentralized decision making by enterprises, and greater reliance on indirect macroeconomic policy instruments--were all steps that should assist the authorities in promoting market methods and the use of market instruments in the economy.

The positive effects on the economy of earlier liberalization measures could already be seen in the rapid expansion of the small private sector, Ms. Bush considered. To some extent, the overshooting of the domestic demand targets for 1984 reflected those effects. But the favorable supply response, and the authorities' prompt policy reaction at midyear, had led to an acceptable outcome. The ratio of real fixed investment to GDP had apparently declined again in 1984, contributing to a 20 percent drop below the 1978 level. But the evidence of an improvement in the efficiency of investment, including the recent assessment made by the World Bank, provided an encouraging offset. In fact, the emphasis on continued improvement of the quality of investments was appropriate, especially with the expected shift toward freer and more decentralized decision making on investments by enterprises. In the latter connection, she wondered whether the largest trade enterprises would be allowed less freedom than others.

The swing from a small deficit in the state budget to a small surplus between 1983 and 1984 was another encouraging development, Ms. Bush remarked. The shift in the relative importance of expenditure constraint in 1984--as opposed to revenue increases in 1983--as the principal source of the deficit reduction was particularly welcome. However, there appeared to be little evidence that the large share of public spending was being reduced in line with the overall economic strategy of decentralization. It was nevertheless encouraging to note the new direction in tax policy toward less use of discretionary and selective taxes and toward standard, simplified statutory measures with uniform application. Moreover, the shifting of the tax burden from profits to net worth could prove useful in promoting enterprise efficiency and encouraging profitability as enterprises were permitted to retain a greater share of current earnings. However, she had some doubts about the tax on investment, which might act as a deterrent to the supply incentives needed by the Hungarian economy. While the authorities had decided that both the net worth and investment taxes were required to offset potential revenue losses from changes in the profit tax, a re-evaluation of both the investment and net worth tax might prove useful in the not too distant future. The re-evaluation should weigh the effect of those taxes on revenues, as well as the tendency that they might have to reduce supply-side incentives; that tendency was particularly important with respect to the tax on investments.

Commendable monetary restraint had been exercised in 1984, and similar restraint would be needed in 1985, Ms. Bush remarked. More important for the long run were the reforms aimed at improving the system for mobilizing and allocating financial resources. The development of improved indirect instruments of monetary control was especially important if the temptation to return to direct controls were to be resisted in the event of unexpected disturbances during the transition toward more open markets. Real positive interest rates could be another major tool.

The real effective appreciation of the exchange rate since late 1983 and the recent decision to raise the export rebate on indirect taxes rather than move the rate were disappointing developments, Ms. Bush considered. She joined the staff in encouraging the authorities to follow a more active exchange rate policy over the medium term so as to maintain relative profitability in the traded goods sector. The shift from weekly to daily rate adjustments was a small positive step.

Last but not least, the external accounts had been strengthened impressively, Ms. Bush observed. Nonetheless, the current account improvement still seemed tenuous in view of the expected revival in domestic demand, a further worsening in the terms of trade, uncertainties in export markets, and the continued dependence on trade restrictions, even with the welcome elimination of the September 1982 restrictions. Also, the much larger than expected inflow of medium-term and long-term capital in 1984, although a positive sign in terms of international creditworthiness, also added to the high foreign debt. The staff's medium-term balance of payments scenario suggested that, with the right policies and a moderately favorable world economic environment, continued current account surpluses and a reduction in foreign debt were possible. Nonetheless, a debt-to-GDP ratio of more than 32 percent and a debt service ratio of more than 26 percent--as projected for 1989--were still not altogether reassuring. She endorsed the staff's recommendation that the Hungarian economy should be opened more perceptibly to foreign competition, one means being a lessening of restrictions on enterprises' foreign trading rights.

Finally, Ms. Bush noted, the Hungarian authorities had not sought a new arrangement with the Fund. The decision seemed reasonable, given the good progress to date in effecting economic adjustment, particularly the much strengthened balance of payments. Continued pursuit of the adjustment effort and of the economic reform was in the interest of the Hungarian economy, with or without Fund financing. That seemed to be the aim of the Hungarian authorities, as outlined in Mr. de Groote's statement. In fact, the authorities had demonstrated both the will and the ability to manage their economy prudently.

Mr. Jaafar stated that he broadly concurred with the staff appraisal. He agreed with other Directors that Hungary's performance in 1984 had been remarkable; the turnaround in the external sector had been dramatic, with two successive current account surpluses and a good prospect of maintaining the surplus in 1985. The resumption of normal capital flows should be a source of satisfaction to the authorities and should serve as testimony to the return of confidence on the part of Hungary's external creditors based on the authorities' record of adjustment.

He found it equally important and relevant to mention that such performance would need to be sustained over the medium term, owing to Hungary's heavy external debt, which had triggered the economic crisis in the first place in 1982, Mr. Jaafar continued. The debt burden remained high and could be reduced only gradually, underscoring the fragility of the external position. Hungary's ability to preserve its current account surplus would determine, to a major extent, the viability of the external position. In his opinion, the staff had assigned the correct priority to preserving a tight demand management stance and on policies to promote efficiency, inter alia, in the export sector.

The export target for 1985 might be difficult to achieve, according to the staff and the authorities, Mr. Jaafar observed. It was curious that with evidence of the weakening profitability of exports--perhaps an indication of Hungary's deteriorating export competitiveness--the authorities had not opted for exchange rate action in spite of the renewed upward surge in the effective exchange rate. The recent strong appreciation of the dollar had added force to that argument lately. In that respect, and in line with Mr. Wicks's observation, he had been surprised to note that the exchange rate for the forint was linked to a currency basket in which the dollar had a heavy weight, well in excess of the relative importance of the country's trade flow with the United States. He would appreciate comment from the staff on the current effective exchange rate, which had not been appraised in the staff report.

On domestic demand policies, Mr. Jaafar noted the risks associated with the loosening of direct control over income and investment. The danger that demand would not be matched equally with supply was real for 1985 unless appropriate countermeasures were taken when demand pressures emerged. In that respect, he agreed that the target of a surplus of $300 million in the current account of the balance of payments in 1985 might not be achieved because a larger leakage into imports, as a result of the lifting of import restrictions, might reduce the surplus. The need for a more flexible exchange rate policy was therefore reinforced.

The correct fiscal stance to promote efficiency in production and discourage wage increases had been taken, Mr. Jaafar observed. Rapid progress toward the relaxation of price controls might entail risks in the short term, but such flexibility was essential if the market were to function properly. He therefore encouraged the continuation of that policy, together with the reduction of subsidies and the provision of incentives to investment. At the same time, more could be done on the revenue side, in the form of taxation, to improve the overall budget balance. As it stood, there was a good chance that expenditures might outstrip the target in the program for 1985. He welcomed the long-term objective of simplifying the tax system, by way of introducing a personal income tax and other taxes, and registered his support for technical assistance to Hungary in laying the groundwork for establishing a comprehensive tax system.

The authorities' nonaccommodative monetary policy was appropriate, Mr. Jaafar considered. It would be helpful if the effort to improve financial intermediation could be accelerated so as to enhance the scope for increased savings, although he recognized the difficulties inherent in adapting market-economy instruments to a centrally planned economy.

Finally, Mr. Jaafar encouraged the authorities to make continued progress, under the economic reforms, toward injecting more flexibility and incentive into the economy.

Mr. Blandin considered that the 1984 Article IV consultation with Hungary provided an appropriate opportunity to take stock of the authorities' policies after almost three years of Fund membership and on the expiration of the stand-by arrangement. Considerable ground had been covered since 1982. In 1981, the country had experienced a liquidity crisis, with a massive loss of reserves and a deficit on convertible current account of more than 3 percent of GDP. Major corrective measures had been implemented, with the support of two stand-by arrangements and a compensatory financing drawing. All the performance criteria under the stand-by arrangement had been met, with the exception of a marginal deviation from the monetary target. More generally, the authorities' success had been most evident on the external side, with the restoration of a current account surplus, the elimination of arrears, and the replenishment of international reserves up to eight months' convertible currency imports. That progress had not been achieved at the expense of economic growth, which had increased by 3 percent in real terms in 1984, or at the expense of household incomes. Once again, it had been proved that a program supported by the Fund was not necessarily conducive to recession; the action by the Fund and the World Bank had been a determining factor in sustaining the authorities' adjustment efforts.

However, it was hard to avoid the impression of a somewhat incomplete process of adjustment and reform, Mr. Blandin commented. In particular, it would be interesting to discuss the factors underlying the noticeable slowdown in the reform, to which Mr. de Groote had made reference in noting that "a number of factors make the authorities feel that they must proceed more carefully." The apparent replacement of the comprehensive reform envisaged in the 1984 program by a more gradual reform, as Mr. Polak had observed, also called for further explanation. Mention had been made by Mr. de Groote of "a certain reluctance by the Fund to back the Hungarian economic reform measures with a stand-by arrangement at a time when Hungary's external balances show vigorous development." Like other Directors, he awaited with interest the response to the points made, by Mr. Wicks in particular, on that statement.

The gains achieved in several fields had to be consolidated, Mr. Blandin noted. External debt was one among various major constraints. In that connection, he recalled the statement by his chair in August that "if the reforms in the areas of prices, wages, the decision-making process, the tax and financial systems, are not carried through with energy and determination, the recovery will remain fragile, and to preserve it Hungary will continue to suffer unnecessary costs" (EBM/84/118, 8/1/84). That statement was more relevant than ever. As stressed by the staff, the objective of a $300 million surplus in the current account in 1985 seemed ambitious, given the uncertainties in the international environment; it would require at least the pursuit of a strict budgetary and monetary policy, on which the staff had made broadly appropriate recommendations.

The advantage of adjusting the exchange rate had to be assessed carefully in view of the conclusion in the departmental memorandum on the role of exchange rates in economic stabilization and structural adjustment in four planned economies (DM/85/4, 1/28/85), Mr. Blandin continued. It was stated in that memorandum that the exchange rate would be a more effective policy instrument only if imports were further liberalized together with tighter financial discipline. In that respect, he particularly welcomed the announcement in paragraph 6 of Supplement 1 to the staff report of the abolition of various restrictions.

The upturn in agricultural output, after the severe drought of 1983, was gratifying, Mr. Blandin remarked. The staff seemed a little concerned by the reduction of the investment ratio; although the trend was a matter of concern, the ratio of fixed capital formation to GDP, at 24.5 percent in 1983, still appeared high by international standards. As Ms. Bush had noted, the problem was more qualitative than quantitative; as pointed out by the staff, an effort should be made to improve the efficiency of investment outlays. In that field, the expertise of the World Bank should be called upon to a greater extent. The fundamental issue of structural reform was indeed a subject for sensitive debate in a planned economy that, as Mr. de Groote had recalled, had been functioning for nearly 40 years. However, he joined other Directors in urging the authorities not to delay unduly reforms that were aimed at raising productivity, especially in the four directions designated by the staff as requiring priority attention.

He himself would emphasize reform of the tax and financial systems, a field in which the Fund's technical assistance was most welcome. In his opening statement at EBM/84/118, on August 1, 1984, Mr. de Groote had emphasized the future introduction of "a new comprehensive tax system, based on taxation of value added and personal income." Thus, he would appreciate comments on the timetable for the implementation of that reform. As to the reform of the financial intermediation system, his wish was that the Hungarians would display the same skill in the domestic market that they were demonstrating in international banking.

To conclude, Mr. Blandin noted that the progress made by the Hungarian authorities in such a short time had resulted from the increased flexibility of the economic mechanism, without a need for debt rescheduling, thereby allowing for continued growth. Given the burden of indebtedness, the economy remained vulnerable to external changes, and close cooperation with the Fund was required not only to bring the economy into a safe harbor, but to bring it in on the right course.

Mr. Zecchini observed that in the past two years, a period covered by programs under two stand-by arrangements with the Fund, the improvements in Hungary's economy had been noticeable, mainly in the external and foreign reserve positions, thereby increasing the country's credit standing in international financial markets. It was remarkable that those improvements had been achieved in a context of rising real national income and moderate rates of inflation.

Although those achievements might lead the authorities to believe that they had acquired ample room for sustaining a more rapid pace of economic growth, it seemed to him that Hungary still had to come to grips with structural adjustment problems, Mr. Zecchini continued. The adjustments had to be aimed at enhancing the efficiency of the economic system, while preserving both a viable balance of payments position and a high degree of domestic price stability. Conflicts might arise, at least in the short term, if rapid growth, structural adjustment, external equilibrium, and price stability were to be pursued simultaneously. In particular, the reduction of price subsidies, together with an easing of the rules governing price determination, might create tension in the price structure, which, if not offset by reductions in other prices, would give rise to additional inflationary pressures. Furthermore, domestic demand might increase to excess, owing both to reform of the wage system with its expansionary effects on disposable income and to greater freedom for enterprises to take investment decisions without government guidance.

All those undesirable repercussions on prices and the external balance might in turn lead the authorities to draw the wrong conclusion, reversing their present course of action, Mr. Zecchini commented. In his opinion, there was practically no alternative to that course to guarantee the development of the economy. Therefore, it was of the utmost importance to monitor closely the expansion of domestic demand so that it could be adjusted to the pace of the needed structural reforms and their consequences.

On the reform in the allocation of labor and the organization of enterprises, Mr. Zecchini mentioned that many indicators pointed to the need for a reallocation of human resources in the economy. He referred specifically to the continuous decline in the labor force, alongside the substantial underutilization of labor capacity cited on page 4 of SM/85/10, and the fact that some job vacancies could not be filled. Thus, in some areas the availability of appropriate labor appeared to be a bottleneck preventing a supply response to growing domestic demand. Greater job mobility was needed, together with labor-saving production processes. More intensive and efficient use of available human resources was being sought through reforms intended to link wages more directly to productivity. However, the measures being considered appeared insufficient to achieve the goal, and the taxes recently introduced were offsetting the incentives set for greater wage differentiation. Highly progressive taxes would be levied on enterprises according to the remuneration of individual workers or the average increase in the wage bill. Those taxes would penalize enterprises and sectors in which productivity increased coupled with rising wages. Moreover, an additional tax of 150 percent would be paid by enterprises on wage increases in excess of the rise in value added; the latter tax, by de facto limiting incentives to productivity growth, would greatly slow adjustments in relative wages. A flat-rate tax on enterprises' wage bills would seem more appropriate because it would discourage labor hoarding, thereby promoting greater mobility of labor while not having the undesirable effects that he had mentioned. However, he recognized that some kind of wage control should be maintained in order to avoid inflationary pressures.

As for the reorganization of the enterprise system, Mr. Zecchini remarked, the three guidelines reported on page 12 of the staff report seemed appropriate, and he encouraged the authorities to implement them. Even though it was difficult to reach a judgment on the appropriate speed with which such reforms should be carried out, it was evident that those guidelines were so closely interconnected that simultaneous action on several fronts would be necessary to obtain satisfactory results. The greater independence of enterprises from government control was welcome since it seemed to be a necessary condition for fostering competition and increasing the efficiency of the economic system. Those objectives suggested that it would also be advisable to consider the economic convenience of dismantling conglomerates. Individual incentive schemes could be extended simultaneously, for instance, by linking as planned the wages of managers to the economic performance of the enterprise and by giving managers greater decision-making responsibilities. In addition, a reduction in financial aid from the Government to weaker enterprises and the application of the new law on the liquidation of insolvent enterprises should foster a more efficient allocation of resources.

Great caution was still called for in the management of the country's external policies, Mr. Zecchini stated. Even though gross reserves in convertible currencies had reached a comfortable level and the medium-term outlook depicted in Table 10 of the staff report seemed viable, he shared the staff's concerns about the optimistic assumptions underlying those projections. The balance of payments performance would be highly sensitive to changes in interest rates and in the terms of trade. Furthermore, there was the possibility, stated in the staff report, of some changes in the pattern of trade with partners in the Council for Mutual Economic Assistance (CMEA) that might negatively affect Hungary's external position. However, he did not fully agree with the staff's suggestion that the authorities should depreciate the exchange rate rather than increase tax rebates to exporters. Despite the increase in those rebates from 2 percent to 7 percent on January 1, 1985, they were still on average insufficient to cover the indirect taxes paid on exports. The increase in the rebates therefore seemed justified.

Less justified in the present period was the need to depreciate the exchange rate, as suggested by the staff, Mr. Zecchini concluded. Hungary currently had a surplus in the current account and in the overall balance of payments, and there was no clear evidence at present that the exchange rate was significantly overvalued. Furthermore, a depreciation would increase the domestic price of imports unduly, and since those prices also served as a ceiling for certain domestic producer prices, they would trigger additional inflationary pressures. A wrong signal might be sent as a result because, in order to improve competitiveness, it was essential to increase the cost-effectiveness of domestic enterprises, to contain producer prices, and to implement the structural reforms that had already begun or were being considered.

Mr. Govindarajan said that he could generally agree with the staff assessment of recent economic developments in Hungary, with which the authorities also apparently were in agreement. The commendable success of the authorities in turning around their external account since 1978 was the result of courageous and pragmatic measures adopted in the framework of two programs under stand-by arrangements. The achievement was all the more commendable since it had coincided with a period during which Hungary had embarked on what might be called cautious experimentation with new policies, especially on the structural side of the economy. The authorities considered that the positive changes in the external sector were largely attributable to their membership in the Fund and the World Bank and the assistance received from both institutions; it was clear that the authorities attached great importance to the continued provision of such assistance and advice in future in the achievement of their objectives.

He agreed with the authorities' assessment that the gains in correcting the external imbalances needed to be further consolidated and the external debt contained at a reasonable level, Mr. Govindarajan continued. To that end, it was necessary for the adjustment to continue and for the economic reform process to be accelerated. The scope for reducing demand in order to achieve the external objectives having been substantially used up, the stage seemed to have been reached at which demand management could work only against the background of a reform of the regulatory system. The measures outlined in the staff report as being part of the economic reform were indeed bold and wide ranging, affecting almost all areas of economic regulation such as prices, wages, taxation, enterprise organization, and the financial system. While some steps had already been taken to initiate the process, further steps in the direction indicated by the staff were necessary, as the authorities seemed to recognize. The question remaining was the speed at which the thorough-growing economic reforms contemplated by the authorities should be carried out and what assistance the Fund could provide in their timely implementation.

The reform process outlined by the authorities was well designed and needed to be put into effect without delay, as the staff had noted, Mr. Govindarajan continued. At the same time, as Mr. de Groote had indicated, Hungary faced the constraints inherent in introducing a measure of market forces into an economy that had been more or less regulated for 40 years, by no means an easy or simple task. The implementation of the reform would be experimental for some time to come; without an assurance of assistance, should the contemplated changes create imbalances in the shorter term, it would not be possible to speed up the reform. In those circumstances, he saw considerable merit in the Hungarian authorities' request for a further stand-by arrangement, which could have several beneficial results. First, the authorities would be able to move with confidence and the necessary speed to carry out the economic reform. Second, the Fund would have an opportunity to provide periodic advice on the evolution of the reform so that timely, corrective action could be taken, if necessary. Third, Hungary would retain its hard-won creditworthiness in commercial markets, thereby obtaining assurance of smooth flows of commercial lending of the order envisaged in the medium-term outlook. Fourth, the mutual trust and cooperation between the Fund and Hungary would be furthered.

Hungary's track record of cooperation with the Fund in the short span of its membership had been excellent, and its request for a new stand-by arrangement should be considered with the same understanding that the Fund had exhibited so far, Mr. Govindarajan considered. A classical stand-by arrangement including in its ambit the elements of the envisaged economic reform would probably be appropriate and acceptable to the authorities. Although Hungary did not currently have an external imbalance, its external accounts could again swing into deficit if it continued to implement the reforms with speed but without adequate support. Experience showed that agreement on a program with the Fund at an early stage had been beneficial by achieving external balance without undue dislocations in the economy of the member and had also helped the Fund fulfill the role assigned to it under the Articles of Agreement. In the recent past, positive consideration had also been given to the possibility of catalytic programs, especially for major borrowers. Against that background, he considered that the Fund could start a dialogue with the Hungarian authorities on a new stand-by arrangement, should it be requested, thereby helping the member to achieve its objectives of economic reform and adjustment. If the present satisfactory external situation continued, Hungary might not even have to draw under the arrangements.

Mr. Salehkhou noted that since the 1983 Article IV consultation, and as evidenced in the midterm review of the stand-by arrangement in 1984, Hungary had continued to take a number of adjustment measures aimed at restoring a viable balance of payments position following the excessive expansion of demand in the 1970s, financed primarily by foreign borrowing. In January 1984, the Executive Board had approved a 12-month stand-by arrangement for SDR 425 million to enable Hungary to continue the process of improving the position of the convertible currency account that had started in 1983. Hungary's progress had been achieved in the face of several handicaps, among them a sizable increase in interest payments to foreign creditors and a net deterioration in the terms of trade. The effort undertaken involved a shift of real resources into the external sector estimated at 16 percent of GDP. More precisely, the improvement reflected positive changes in the trade balance against a background of a widening deficit on current services and transfers.

At the end of 1982, when the program under the first stand-by arrangement had been launched, Mr. Salehkhou recalled, gross international reserves in convertible currencies had been reduced to $1.1 billion, equivalent to 3.2 months of imports, compared with 4.5 months on average during 1979-81. By contrast, and after the introduction of Fund-recommended adjustment, gross official reserves in convertible currencies had increased to $1.8 billion in September 1984, equivalent to 5.9 months of convertible currency imports, reflecting to a large extent net new borrowings and reduced imports. Under the Fund-supported program, the current account had shifted from a deficit of 3.25 percent of GDP in 1981 to a surplus of 1.5 percent in 1983. That shift had, however, entailed major restrictions on imports, whereas export proceeds had remained stagnant, despite successive devaluations. Two factors accounted for that shortcoming. First, Hungary's balance of trade was heavily dependent on food exports, which often encountered stiff protectionist measures in industrial countries. Second, Hungary's foreign trade remained a state monopoly, reserved to state enterprises. At the end of 1983, despite a current account surplus, the external position had remained weak, with an increase in debt service.

Confronted by those realities, the Hungarian authorities had adopted a target in 1984 of a surplus of $400 million for the convertible currency account, and they had set out to reduce real domestic demand while loosening the tight restrictions imposed on imports since 1982, Mr. Salehkhou noted. To safeguard the attainment of that target--and in the light of the weak development of exports and the rise in international interest rates--the authorities had reduced expenditures by 1 1/2 percent of GDP and devalued the forint by 5 percent. But domestic demand had remained resilient due to strong private economic activity, with private consumption having increased by 1 percent against an expected fall of 0.75 percent in 1984. As it turned out, the surplus had been $350 million, below the target but higher than in 1983. The strengthening of the current account position in convertible currencies had improved reserves and opened the door for a surge in medium-term and long-term capital inflows because it had enhanced the credit rating of Hungary. The new borrowing had helped to repay short-term liabilities and lengthen the average maturity of debt, at the same time bolstering convertible currency reserves, which were estimated to have jumped from 5.9 months of imports to 8 months of imports by end-1984.

Despite the evident improvement in the convertible currency account, a number of weak points remained in the external sector as well as in the public finances of the foreign trade enterprises, Mr. Salehkhou said. Because of high international interest rates, gross debt service payments in convertible currencies amounted to 42 percent of receipts from exports of goods and services in contrast to the objective of 39 percent, compared with 34.2 percent in 1983. Total external debt in convertible currencies had been estimated at $8.5 billion or 42 percent of GDP in 1984. One of Hungary's major priorities should therefore probably be to direct close attention to the level of foreign debt because the improvement in the reserve position had stemmed from an increase in borrowed resources and the outlook for further growth in export proceeds was apparently reaching its upper limit at the same time that the compression of imports was perhaps tending toward its lower limit. The servicing of the debt would therefore continue to burden the Hungarian economy for several years.

It was therefore necessary to contemplate new measures, in collaboration with the Fund, in the years ahead, Mr. Salehkhou considered, measures that did not necessarily rely on wage restraint and declining investment. After all, there was a limit to such an approach if the potential for growth was not to be compromised. The measures should, however, improve productivity, and strengthen and expand the scope of decentralized decision making by state enterprises so as to allow them greater flexibility in the allocation of resources, product selection, and price determination. At the same time, a judicious use of taxation could favor efficient enterprises and penalize those requiring more inputs. Furthermore, foreign competition could be introduced to improve the quality of exportable products and to lead to greater technological sophistication. While monetary and fiscal policies should be in line with the adjustment process, the authorities should remain vigilant not to accommodate higher domestic absorption by recourse to the banking system while they allowed a moderate increase in credit to enterprises. Finally, he supported the proposed decision.

The staff representative from the European Department noted that the staff, like the Hungarian authorities, was aware of the importance of the reform process as a means of reconciling the need to reduce external debt with an improvement in living standards over the years ahead. In referring to the rising share of budget expenditure in GDP, the staff had been concerned more about the continued sizable intermediary role played by the budget, including the diversion of fund to inefficient enterprises, than about expenditure on social, cultural, and health expenditures.

The liberalization of imports was seen by the staff as a prerequisite for the efficient functioning of a liberalized economy as small as that of Hungary, the staff representative noted. Of course, import liberalization would hamper attainment of the external target unless imports were priced more realistically as the system was opened up. As to whether devaluation would have destabilizing effects in present circumstances, the staff had advocated the pursuit of an active exchange rate policy under which a series of small adjustments of the rates would be made, rather than a single large adjustment, in order to mitigate shocks to the economy. It was worth emphasizing that adverse consequences for the economy could not be excluded if the present balance of payments position could not be sustained or if living standards had to be cut back in order to meet the balance of payments target.

The Hungarian authorities sensed the strain on their competitive position in export markets, the staff representative continued, less perhaps because of the evidence offered by indicators of effective exchange rates than because of the need to cut export prices to maintain shares. For the same reason, Hungary's export prices were also unlikely to rise significantly in 1985, in contrast with the expectations of similar countries. A second indicator was the perceived need to increase the rate of rebate of indirect taxation for exporters. The indirect taxation in question largely consisted of levies on raw material and energy imports from the CMEA area aimed precisely at bringing the prices of such inputs up to world levels. In a sense, at the same time as relative prices were being adjusted to international levels, the impact on management decisions was being diluted. A third indicator was the relatively weak demand in Hungary for export-promoting credits, even though they were subsidized.

Responding to a number of technical questions on the exchange rate, the staff representative said that prices in Hungary increasingly reflected true costs, and the effective exchange rate was becoming a more meaningful measure. Only rough estimates of the relevant elasticities of exports and imports were available, particularly in view of the structural changes in the Hungarian economy in recent years. In general, the staff would tend to the view that the demand-reducing effect of an exchange rate devaluation would be larger in current circumstances than the expenditure-switching effect. However, export elasticities were not thought to be unnegligible, especially if an exchange rate change were backed by a policy of domestic demand restraint. To his knowledge, the authorities probably would not move toward a more trade-weighted exchange rate basket at present, given expected movements in exchange rates.

Reform of the financial system had tended to lag, the staff representative noted, although the authorities had begun to give thought to the course that they should follow and were in fact making up for lost time rather rapidly. A technical assistance mission from the Central Banking Department had recently visited Budapest and had been asked to submit to the authorities the main lines of its recommendations on the structure of such a reform and the instruments of monetary policy, for presentation by the authorities to the Congress of the Hungarian Socialist Workers' Party, which was to meet at the end of March. The details of the reform might be decided later in 1985.

Interest rate policy had also been the focus of some attention by the technical assistance mission, the staff representative commented. The authorities' thinking had been evolving, and it had been accepted that there should be flexibility in the interest rates charged to different enterprises according to their creditworthiness. It was also becoming increasingly accepted that interest rate policy itself should be more flexible. In the household sector, some interest rate adjustments had been made over the period covered by the two stand-by arrangements. The subsequent response to the adjustment in longer-term deposits had not reflected solely a reshuffling of savings deposits. However, the major deposit interest rate on one-year time deposits remained unchanged at 5 percent, well below the rate of inflation. In conjunction with highly subsidized housing credits, it was severely limiting the financial savings of households, which were negligible.

Regarding the fiscal package in the reform program, the staff representative observed that the investment tax should be seen as part of the overall package. It was designed partly to encourage efficiency in investment but mainly to restrain investment in the enterprise sector as a whole. The staff viewed the investment tax as a major improvement over the past practice of arbitrarily confiscating profits retained by enterprises or taxing depreciation allowances. Enterprises would be more likely to respond rationally and with greater predictability to such a tax.

Under the further fiscal reform to be explored with the help of the Fiscal Affairs Department, the intention was to introduce two main taxes, the staff representative said. The first was expected to be a personal income tax. The infrastructure to apply that tax had to be established, as there was no concept of withholding taxes in Hungary. It would take more time to put the second main tax into place, namely, the value-added tax (VAT). The streamlining of the previously large number of rates of turnover tax, which had been reduced from about 80 to 4, would help to advance the move toward a value-added tax, which of itself would not be a complex tax to administer. However, a VAT would entail substantial changes in relative prices that would affect different segments of the population quite differently; it would therefore be more difficult to introduce.

It had been suggested by the staff that the current account surplus should remain undiminished in the period ahead for two reasons, the staff representative explained. First, Hungary's credit standing had been improved considerably by its ability to achieve a current account surplus in the past two years. There was inevitably a risk that if the surplus began to tail away, the attitude of bankers might change. The second point was that, given the substantial debt service burden to be met in the next few years, attainment of anything much less than a current account surplus of the order achieved in 1984 could result in the re-emergence of a nonviable balance of payments position. The relevant arithmetic was set out in the medium-term scenario in Table 10 of the staff report, which had been drawn up in cooperation with the Hungarian authorities. The assumptions had been shaded on the conservative side, compared to those in the World Economic Outlook, specifically, with respect to prices, growth in markets, and interest rates. An important assumption was that Hungary would be able to undertake gross borrowing of roughly $1.25 billion a year throughout the period. The ability to maintain the present current account surplus would be an important factor in that respect. A large unknown was how relations with the CMEA area would develop over the period ahead. Negotiations on the intra-CMEA trade plan for 1986-90 were taking place in 1985. It was already clear, however, that the supply of energy by the Union of Soviet Socialist Republics (U.S.S.R.) to Hungary, as to other members of the CMEA, would essentially be frozen at the 1985 level and that those members would be required to supply better-quality goods to the U.S.S.R. over the second half of the decade.

With regard to the composition of external debt, the staff representative noted that, by the end of 1984, approximately 11 percent of total debt in convertible currencies had been owed to the Fund, 3 percent directly to the World Bank, and 8 percent to commercial banks under cofinancing arrangements with the World Bank. The combined level of the two latter components was under discussion in the Bank.

The concept of the economic reform in Hungary continued to have the full endorsement of the staff, the staff representative commented. The overriding consideration for not offering Fund support in the form of a new stand-by arrangement in 1985 had been the absence of a balance of payments need in two senses. First, in the broad sense, the overall balance of payments was in surplus. Hungary had a current account surplus, and was readily able to borrow on the market, so that its reserves were high and increasing. In the fourth quarter of 1984, as had been brought out in the supplement to SM/85/10, the ability of Hungary to tap international markets had strengthened further. For 1984 as a whole, medium-term and long-term borrowing would be more than double the amount of roughly $1.25 billion, assumed at midyear in the program. The inflow of capital had not only taken the form of bank credit; the authorities had been able to move also into the bond market. Second, in the more narrow sense, the balance of payments had not appeared to be exposed to a substantial foreign exchange risk, because the authorities were taking a careful approach in the reform measures that they were implementing in 1985. The staff did not think that that careful approach represented any fundamental change in the authorities' commitment to persevering with the reform. Rather, when the time had come to move from designing a coherent framework for advancing the reform process to implement laws and specifying concrete measures, additional considerations had inevitably come to the fore. In concept, the reform process remained a comprehensive one, but it would be carried out gradually. After long discussions with the authorities, it had been considered that it would not be feasible in the time period within view for the authorities to accelerate the reform and simultaneously to flank it with the stronger policy measures that would then be needed to secure the balance of payments target. It had therefore not been clear that Fund assistance could, in the circumstances, be truly classical, or, in other words, provide assurance against totally unexpected balance of payments risks. It was true that Fund support could be catalytic; on the other hand, the Hungarian authorities also recognized the advantages--from the standpoint of the capital markets--of being able to detach themselves from Fund support.

The Fund intended to remain abreast of developments in Hungary, the staff representative stated, and the authorities had expressed interest in holding the 1985 Article IV consultation earlier, if necessary, at which time the situation could be reassessed in light of the Congress of the Party later in March. The World Bank also intended to explore possibilities of assisting Hungary on various areas of the reform.

In response to further questions by Mr. Zhang, the staff representative from the European Department explained that while a small shortfall from the current account surplus in convertible currencies targeted for 1985 would likely be inconsequential, a more significant shortfall--say, of $100-200 million--could affect the way in which commercial banks viewed the country's external performance. The more substantive point was that if Hungary were to be able to reduce its debt over a reasonable time, as the authorities wished, there was little, if any, room for reduction in the current account surplus in the period immediately ahead. The more the surplus fell below $300 million, the higher the debt and the debt service ratio would remain, and the greater the problem would be of returning to a stable trend of growth in the future.

The staff representative from the Exchange and Trade Relations Department stated that the Fund had not applied unusual criteria in its attitude toward a stand-by arrangement for Hungary. The member's balance of payments position in 1984, measured by the surplus on both the current account and the overall balance, was strong. Given the pace of the reform effort, the same held true for the period immediately ahead. Hungary's gross reserves were also rather high. The Fund's attitude to a stand-by arrangement for Hungary was, therefore, not an exception from its normal policy.

Ms. Bush commented that she did not want to leave the impression that her authorities did not endorse the tax reforms announced by the Hungarian authorities. Certainly, net worth and investment taxes were greatly preferable to the confiscation of profits and would add both predictability and fairness to the tax system. The reduced profits tax should also encourage enterprise efficiency and profitability. Her point with respect to the investment tax was that any possible disincentive effects beyond the near term should be evaluated, especially in view of the need for supply incentives in the economy. She recognized that any revisions in the tax would have to be weighed against the revenue effects.

Mr. de Groote observed that Executive Directors had again examined with great attention the evolution of the Hungarian economy and had made most useful remarks on the dual objectives pursued by the authorities, namely, the restoration of a current account position compatible with debt repayment obligations and the needed reform of the economic system through more effective resource allocation mechanisms. Hungary had been successful on both counts, but the need to adjust the balance on current account had called for the imposition of import restrictions, drastic reductions in investment, confiscation of the profits of enterprises, and direct action aimed at a reduction of wage income, measures that of necessity went in the opposite direction to what the liberalization of the economy would have required.

The need to choose continuously between the objective of fundamental reform and the objective of balance of payments adjustment had been at the center of the debate on economic issues in Hungary since 1978, as well as having been central to the authorities' dialogue with the Fund, Mr. de Groote continued. In Hungary, the debate had been especially intense recently during preparations for the Five-Year Congress of the Hungarian Socialist Workers' Party, which would take place at the end of March. All levels and segments of the political and economic decision-making process had taken an active part in preparing for the Congress. Although a great variety of options would be submitted for decision by the Congress, it could already be said, on the basis of preparatory work, that the passage to a system regulated by market mechanisms was envisaged as being subject to the constraints set by the balance of payments and indebtedness situation. External debt in convertible currencies would have to be brought down from the present 40 percent of GDP to about 30 percent before the end of the 1980s. Therefore, a surplus on current transactions in convertible currencies, year after year, would be one of the main policy determinants for the period ahead.

Accordingly, his Hungarian authorities saw no contradiction between the structural reform that the Congress would undoubtedly endorse and the need to achieve a surplus on the current account, Mr. de Groote said. As had been observed by several Executive Directors, on the occasion of the reviews of the two stand-by arrangements, as well at the present meeting, the methods currently used for controlling demand had been exploited to the limit. Confiscation of profits was delaying the development of a market-oriented economy; direct intervention in wages ran counter to the enhancement of labor mobility and to the differentiation of remuneration based on productivity; reductions in investment in order to control overall demand unfavorably affected future prospects for output and exports; the ebullient surge of consumption--largely a result of the rapidly growing contribution of autonomous enterprises, as Ms. Bush had observed--was hard to channel in the absence of appropriate transmission mechanisms for regulating demand. Only the introduction of macroeconomic regulating mechanisms would make it possible to achieve the balance of payments targets, together with improved conditions for income and export growth. The point had been made aptly by Mr. Polak that the benefits of the reform were not limited to a greater role for market-determined prices but that they would also enhance the adjustment capacity of the economy, thereby making demand management more effective. Reform and adjustment were inseparable: the free price setting, which was already effective for about 45 percent of manufactured production, had to be extended further. Financial surpluses would have to be rechanneled through an effective intermediation mechanism. The financing of the budget should be based partly on the direct taxation of individual income and partly on a VAT-type taxation for productive activities. Wages should be responsive to the requirements of labor mobility and differentiation. All those objectives would most certainly become the officially accepted working principles of the Hungarian economy after the Party Congress. It was a momentous decision, and not only from an economic standpoint.

The determination of the Hungarian authorities to enact those measures, on the basis of a strong political consensus, had been made particularly apparent in the correspondence between the Managing Director and the Vice Prime Minister responsible for Economic Affairs, who had played a decisive role in establishing Hungary's relationship with the Fund, Mr. de Groote recalled. The viewpoint of the Hungarian authorities had also been made abundantly clear to the Managing Director during his conversations with the Secretary of the Central Committee of the Party, who had demonstrated convincingly--and more effectively than economists expert in the functioning of a market economy--the impracticability of economic dirigism, based on his own direct experience and knowledge gained over his career, which he had begun as a worker, before climbing through all the different echelons of responsibility.

During the transition to the full establishment of market mechanisms, it should not be excluded that the liberalization of incomes, the increase in investment, the further liberalization of imports, and the greater autonomy of enterprises in general might have effects on import demand that were difficult to forecast with precision, Mr. de Groote went on. Previous experience offered no guide to the possible reaction of the fundamental magnitudes of the Hungarian economy to a completely new environment. Admittedly, it was not the Fund's role to support the transition to a market economy as such, but it would be very much the role of the Fund to help a country deal with the balance of payments effects entailed by such a transition. He had therefore noted with great interest that several Directors shared his view, as they had already during previous discussions in the Board on Hungary. It seemed to have been recognized that the Fund had a role to play not in financing systemic changes as such but in financing their balance of payments consequences.

There were two different ways of looking at the future role of the Fund in Hungary, in the absence of a stand-by arrangement, Mr. de Groote mentioned. The staff representative had commented that there had been no change in attitude on the part of the staff, and that Hungary's reserves were, in any case, at a level that would make it difficult to justify a classical stand-by arrangement. The staff might well have felt that the reform process had not yet gone far enough at the conclusion of the previous stand-by arrangement to justify the continuation of such Fund assistance. The Hungarian authorities on the other hand would submit that the movement toward reform would have been faster if the Fund had adopted a more activist attitude and helped them in formulating certain stages of the reform. Those two approaches to a complex and evolving situation raised an interesting question of principle: should the Fund make its assistance available, on a contingency basis, when a country first started taking measures that would most probably have balance of payments effects, or should the Fund wait until such effects had actually materialized?

Some of the misunderstandings that had arisen in the course of the negotiations, none of them serious enough to threaten the good relations between Hungary and the Fund, might have been due to uncertainties about the acceptability of the notion of a precautionary or contingency stand-by arrangement, which could have been accompanied by a commitment not to draw on the Fund's resources unless unforeseeable circumstances materialized, Mr. de Groote stated. It was his understanding that that type of stand-by arrangement would still have been of the classical type, since it would have aimed at correcting the balance of payments effects of measures in line with Fund recommendations. Another cause of those misunderstandings might have been the excessive proportion of the staff's time that was unavoidably taken up by detailed discussions on the elaboration and operation of demand-management mechanisms in the absence of a clear knowledge of how those mechanisms would work in an economy like Hungary's. A painstaking effort was needed to devise adjustment policy instruments in a country where the action of traditional macroeconomic mechanisms would not yet be fully operational, and such time-consuming efforts provided little opportunity for involvement in the more fundamental aspects of the envisaged reform.

The Hungarian economy remained a planned economy, as Mr. Zhang had rightly stressed, and it would continue to be subject to government guidance and direction, Mr. de Groote remarked. Mr. Zhang was also right to point out that there was no contradiction per se between movement toward the use of market-economy mechanisms on the one hand, and the possible increase of government expenditure in total expenditure or the maintenance of a large publicly owned sector on the other hand. The fact that only 5 percent of output resulted from the activity of private enterprises had led Mr. Romuâldez to conclude that very limited use was being made of market mechanisms. A sharp distinction had to be drawn between the operation of market mechanisms and the ownership of enterprises. If he was correct, about 50 percent of total production was subject to market pricing mechanisms. Market mechanisms rather than planning directives also governed about 80 percent of the allocation of factors of production among enterprises.

His Hungarian authorities welcomed the criticisms and suggestions of Executive Directors, Mr. de Groote noted, because most of them were consistent with their objectives under the framework of the reform. He agreed with Mr. Zecchini that greater flexibility in the labor market was necessary to reallocate the labor force among productive uses. He also agreed with the observations by Mr. Zecchini and Mr. Grosche on the taxation of wages, and by Ms. Bush on the taxation of investment. It was obvious that the taxation of wages constituted in itself an obstacle to the adjustment in relative wages, and that the taxation of investment could be seen as a deterrent to investment and as an obstacle to the realization of supply-side effects. Admittedly, those were second-best solutions, in the absence of an overall reform of the taxation system, which was gaining speed. His Hungarian authorities were grateful for the effective assistance by the Fund's Fiscal Affairs Department in that connection.

As Mr. Polak had reiterated, appropriate financial intermediation mechanisms would have to be designed, Mr. de Groote continued, and, as Mr. Hodgson and Mr. Jaafar had argued, more active use of monetary policy would encourage saving and investment. On the exchange rate, his Hungarian authorities did not intend to resort, as on some occasions in the past, to exchange rate appreciation in order to control price developments. On the contrary, they recognized that, within appropriate limits, consumer prices had to increase if consumption were to be controlled, and that the exchange rate had to serve the purpose of promoting correct price relationships between domestic products and imports. Nor would the practice of increasing tax rebates on exports become a permanent alternative to exchange rate adjustment. That technique had been used in present circumstances, based on the understandable desire to limit the already considerable increase of consumer prices, especially following the Government's decision to raise the prices of household fuel in the middle of one of the most severe winters that Hungary had ever known. The authorities recognized that the exchange rate had to play an active role in achieving an internationally compatible level of prices.

As for the possibility of establishing a trade-weighted basket for determining the exchange rate of the forint, Mr. de Groote observed, it was the firm intention of the Hungarian authorities to establish, in due time, the convertibility of the currency. Trade weights would then seem of less direct relevance than the place of different currencies in Hungary's external payments. In that respect, the role of the U.S. dollar was surely not limited to bilateral trade relationships between the United States and Hungary.

In closing, Mr. de Groote expressed agreement with those Directors who had drawn attention to the major contribution that Hungary's membership in the Fund had made to the success of the recovery program. The Fund's catalytic role had accelerated the dual process of adjustment and reform. Hungary would shortly become a member of the International Finance Corporation and of the International Development Association. Membership in the IFC demonstrated Hungary's desire to increase the role of the private sector. Membership in the IDA showed that Hungary did not view its cooperation with the Bretton Woods institutions as a one-way street: just as it had been assisted, Hungary wished itself to assist wherever it could make an active contribution to achieving better conditions of life in the lowest-income countries.

The Chairman made the following summing up:

Executive Directors warmly commended the Hungarian authorities on the progress made in strengthening the balance of payments over the past several years. They especially welcomed the impressive results achieved since 1982, under stabilization policies supported by two stand-by arrangements, and praised Hungary's record of cooperation with the Fund during that period. Speakers generally commented on the role played by a marked tightening of fiscal and credit policies in restraining demand and the vitality of a newly liberalized private sector in sustaining output. In the process, Hungary had successfully come through an external liquidity crisis and had brought about a major shift of resources into the external sector--equivalent to some 16 percent of GDP since 1978--while maintaining a positive rate of economic growth.

Directors welcomed the fact that the further improvement in the current account in convertible currencies in 1984 had been accompanied both by a faster rate of output growth and by a full restoration of creditworthiness and access to international capital markets. The latter had permitted foreign exchange reserves to increase to a comfortable level. They regarded the external adjustment that had been accomplished with Fund support as a very important achievement.

Directors also noted, however, the high level of Hungary's external debt and the expectation that the debt service ratio would remain sizable over the next few years, cautioning that that left the economy vulnerable to adverse developments in capital markets, the world economy, or the terms of trade. Directors thus urged the authorities to continue their efforts to reduce the external debt.

Most Directors emphasized the need to keep demand management policies sufficiently tight and to be particularly watchful for possible overshooting of private consumption. General support was expressed for pressing ahead with economic reforms designed to improve the efficiency and adaptability of the economy. In that context, several speakers noted that singling out investment and wages in the socialist sector for purposes of restraining demand no longer constituted a viable policy option. In the circumstances, the broadening of demand management policy instruments and the promotion of a greater supply response took on added urgency.

With respect to the outlook for 1985, a number of Directors were concerned that the current account surplus could again fall short of the official target, viewed by the staff as the minimum required. They stressed the need for the authorities to stand ready to take corrective action, particularly to reduce budgetary expenditure. Several Directors shared the staff view that the 1985 budget could be more ambitious and they drew attention to the continued very high level of budget subsidies.

With regard to exchange rate policy, a few Directors noted their concern about the potential inflationary impact of depreciation. A number of Directors, however, believed that a loss of competitiveness was currently taking place, and they saw the reintroduction of export tax rebates as an undesirable move. They stressed the need for Hungary to remain competitive and urged the authorities to pursue a flexible exchange rate policy to that end.

Directors welcomed the new advance launched in 1985 toward improving the economic management system, particularly the initiatives taken to liberalize prices, widen pay differentials, reduce administrative directives to enterprises, and tax the use of resources more and profits less. While it was recognized that the reform process would need to be implemented gradually, a number of speakers encouraged the authorities not to weaken in their resolve in carrying through the necessary reforms as quickly as possible, so that the contribution of reform to greater efficiency could be fully realized. Directors stressed, however, that such reforms should be accompanied by the introduction of effective instruments for the regulation of demand.

Directors also underscored the importance of opening up the economy more to foreign competition as a prerequisite for the efficient functioning of a liberalized economic system. In addition, they stressed the need to scale down resource transfers through the budget from profitable to inefficient enterprises, to build on steps already being taken to raise labor productivity and allocate labor resources more efficiently, and to improve the system of financial intermediation so as to mobilize and allocate financial resources more effectively. In this last connection, several speakers saw evidence that a more active use of the interest rate policy would effectively assist in increasing the financial savings of households. Also, several Directors warmly supported the authorities' use of technical advice from the Fund in establishing a competitive banking system and developing effective monetary policy instruments as well as in restructuring the tax system.

It was clear from the discussion that Hungary attached great importance, in the process of the fundamental reform and adjustment of its economy, to its membership in the Fund and the World Bank. Hungary had made remarkable progress toward overcoming its balance of payments problem in recent years, and, as had also been clearly indicated by Directors, the Fund would continue to remain appropriately responsive in further assisting Hungary in that process of adjustment and reform.

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

The Executive Board then took the following decision:

1. The Fund takes this decision 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. 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 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 announced termination of 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.

Decision No. 7923-(85/37), adopted
March 8, 1985

2. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Lindå on completion of his service as Alternate Executive Director.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/36 (3/6/85) and EBM/85/37 (3/8/85).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/105 and 84/106 are approved. (EBD/85/61, 2/28/85)

Adopted March 6, 1985

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/32, Supplement 1 (3/5/85), EBAP/85/54 (3/5/85), and EBAP/85/55 (3/6/85) is approved.

APPROVED: December 17, 1985

LEO VAN HOUTVEN
Secretary