

Hungary: Second Review Under the Stand-By Arrangement, Request for Waiver of Nonobservance of Performance Criterion, and Request for Modification of Performance Criteria—Staff Report; and Press Release on the Executive Board Discussion

In the context of the second review under the Stand-By Arrangement, request for waiver of nonobservance of performance criterion, and request for modification of performance criteria for Hungary, the following documents have been released and are included in this package:

- The staff report for the Second Review Under the Stand-By Arrangement, Request for Waiver of Nonobservance of Performance Criterion, and Request for Modification of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on May 18, 2009, with the officials of Hungary on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 11, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A Press Release summarizing the views of the Executive Board as expressed during its June 23, 2009, discussion of the staff report that completed the review.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Hungary*
Technical Memorandum of Understanding*
*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

HUNGARY

**Second Review Under the Stand-By Arrangement,
Request for Waiver of Nonobservance of Performance Criterion,
and Request for Modification of Performance Criteria**

Prepared by the European Department
(In Consultation with Other Departments)

Approved by Anne-Marie Gulde and Lorenzo Giorgianni

June 11, 2009

- **Stand-By Arrangement:** a 17-month SBA in the amount of SDR 10.5 billion (1015 percent of quota) was approved by the Executive Board (Country Report No. 08/361) on November 6, 2008, and the first purchase of SDR 4.2 billion was made following the Board meeting. The second purchase of SDR 2.1 billion was made following the First Review on March 25, 2009 (Country Report No. 09/105). The third tranche, subject to the completion of this (second) review amounts to SDR 1.3 billion. The European Commission and the World Bank are also providing funds to cover the financing gap under the program.
- **Program status:** All end-March 2009 quantitative performance criteria and the continuous performance criterion on non-accumulation of external arrears were met, as well as the end-March indicative target on central government debt. The end-March structural performance criteria related to pension reform and government lending to banks were met. The structural performance criterion on amendments to the Financial Stability Act was not fully met but, on the basis of the corrective action taken, staff support the authorities' request for a waiver.
- **Discussions.** Discussions were held in Budapest during May 7–18. The mission met with Prime Minister Bajnai, Minister of Finance Oszkó, central bank Governor Simor, other senior officials, representatives of financial institutions, and academics. The staff team comprised Messrs. Morsink (head) and Wiegand, Ms. Carare (all EUR), Mses. Barkbu (SPR) and Luedersen (LEG), and Messrs. Debrun (FAD), Frécaut, and Giustiniani (both MCM). Ms. Ivaschenko (Resident Representative) assisted the mission.
- **Publication.** The Hungarian authorities have consented to the publication of the staff report.

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I. INTRODUCTION AND SUMMARY

1. **Macroeconomic and financial policies are on track.** The end-March 2009 quantitative performance criteria and indicative target, as well as the structural performance criteria related to pension reform and government lending to banks, were all met. The structural performance criterion on amendments to the Financial Stability Act was not fully met, but corrective action has been taken.
2. **However, Hungary's economic outlook has worsened due to a further deterioration of the global environment.** With exports amounting to 80 percent of GDP and the close integration of financial markets, the fall in external demand and tight external financing conditions are leading to a sharper-than-envisaged economic contraction. As a result, tax revenue will be lower and credit quality will be worse.
3. **Against this background, the policy settings under the program have been revised to strengthen fiscal sustainability and preserve financial stability:**
 - More ambitious structural spending and tax reforms are under way to strengthen fiscal sustainability, allowing the partial accommodation of automatic stabilizers and an increase in the fiscal deficit target in 2009.
 - The revised program puts additional emphasis on measures to help preserve financial stability, including careful monitoring of support for banks, strengthening bank supervision, and improving the remedial action and bank resolution frameworks.
 - Monetary and exchange rate policy will continue to target inflation over the medium term while being prepared to act as needed to mitigate risks to financial stability.
4. **The fragility of the political situation presents implementation risks.** In April, following the prime minister's replacement through a constructive motion of no confidence, a new government was formed. Parliamentary elections are scheduled for April 2010, but early elections are possible. To help foster broad-based ownership of the program, Fund staff have undertaken extensive outreach to the media and the political opposition.
5. **Fund staff have continued to cooperate closely with the staff of the European Commission (EC).** Fund and EC staff consult each other regularly regarding economic and policy developments, and field parallel missions to Hungary. The second tranche of the EU's balance of payments support (€2 billion) was disbursed in March 2009. The third disbursement (€1.5 billion) is expected in June. Fund staff have also cooperated closely with World Bank staff.

II. RECENT DEVELOPMENTS

6. **The economic downturn is sharper than envisaged at the first review, mostly due to larger-than-expected deteriorations in partner countries** (Table 1 and Figure 1):

- ***Economic activity is contracting sharply.*** Real GDP fell by 6.7 percent year-on-year in 2009Q1. The unemployment rate rose to 9.9 percent in the three months to April, compared to 7.7 percent a year ago. The fall in retail sales is still accelerating, though the sharp decline in industrial production appears to be moderating.
- ***Core CPI inflation has stabilized at about 3 percent, reflecting the offsetting effects of the large output gap and exchange rate depreciation.*** Headline CPI inflation increased to 3.8 percent in May on higher food prices. Private sector wage growth excluding bonuses was 6.5 percent y-o-y in March.
- ***The current account deficit is narrowing.*** Imports are contracting more quickly than exports. The income balance is improving due to lower profit repatriation by non-residents. Large EU transfers are contributing to a surplus on current transfers. As a result, the current account deficit is expected to narrow from 9.6 percent of GDP in 2008Q4 to 3.6 percent of GDP in 2009Q1.

7. **Financial markets remain under stress, but strains have eased since March in line with global developments** (Figure 2):

- ***The forint reached an all-time low of 317 against the Euro in March.*** In response, the central bank announced publicly that it stood ready to use the full range of monetary policy instruments at its disposal to prevent a disorderly depreciation. At the same time, the international community's readiness to provide external financing—as reflected in the G20 meeting—helped to stabilize the foreign exchange market. Since then, the forint has strengthened to about 280-290 against the Euro.
- ***Conditions in the government bond market have also improved.*** The yield on the benchmark 5-year bond fell from about 13½ percent in March to about 10 percent in May, and the CDS spread from more than 600 bps in March to about 300 bps in May. The debt management agency re-started auctions of modest amounts of government bonds in April. These auctions have been broadly successful, though demand for bonds is being supported by large bond buy-backs.
- ***Banks' FX liquidity positions have strengthened.*** Foreign parent banks have maintained exposures to their Hungarian subsidiaries. Three banks without foreign parents, among them Hungary's largest bank, have received FX loans from the government. The central bank's new 3- and 6-month FX swap facilities have helped to stabilize conditions in the FX swap market, which banks use to cover their FX funding needs. The effective Euro interest rate over euribor paid by Hungarian banks

in overnight swap transactions fell from about 300 bps in March to about zero in May.

- ***External financing was stronger than expected in 2009Q1.*** For banks, parent bank funding was stable and other net external flows were less negative than envisaged. Nonresidents' holdings of forint-denominated government securities fell in 2009Q1, though the pace of the sell-off eased. For corporations, external debt rollover was lower than projected. Overall, international reserves were well above the program floor at end-March, leading to an increase in reserve coverage to 89 percent of short-term debt.

III. POLICY DISCUSSIONS

A. Macroeconomic Framework

8. **The revised macroeconomic framework for 2009 largely reflects the impact of weaker projected growth in Hungary's main export markets (LOI ¶6-8).**

- ***Real GDP is now projected to fall by 6.7 percent,*** compared to 3.3 percent at the first review, largely due to the impact on Hungary's exports of the sharper contraction in the Euro area. Exports are now projected to fall by 15 percent, compared to 3 percent at the first review, implying much worse prospects for income and employment. Thus, weaker consumption and investment reflect primarily the downward revision to exports, as well as stricter lending criteria. The risks to the forecast remain large: prospects for recovery in Hungary's main trading partners are highly uncertain, global investor appetite for Hungarian assets remains volatile, and the severity of the credit crunch in Hungary is unclear.
- ***Credit to the economy is expected to contract in real terms in 2009*** (Table 2), reflecting weak demand, efforts by banks to reduce risk-weighted assets, and ongoing constraints on external bank funding. Broad money is projected to grow slightly more than at the time of the first review, as a less sharp drawdown of corporate deposits (in line with stronger-than-expected external financing conditions in 2009Q1), a weaker exchange rate, and higher inflation, more than offset the weaker outlook for real GDP growth.
- ***The current account deficit is expected to narrow to 4.1 percent of GDP*** in 2009 (Table 3). The size of the adjustment relative to 2008—roughly 4 percentage points of GDP—is slightly higher than at the first review. Projections for both imports and exports have been revised down since the first review.
- ***CPI inflation is projected to be higher than at the first review.*** While the output gap has widened, the larger-than-envisaged increases in VAT and excise duties have led

to an increase in projected inflation. Average inflation in 2009 is projected to be 4.5 percent, compared to 3.8 percent at the first review.

- ***The existing official support package continues to provide adequate resources to meet Hungary's external financing needs in 2009.*** Parent banks' recent confirmation of their commitments to maintain their exposures to Hungary, together with the authorities' measures to provide FX liquidity to banks, mitigate the risks to banks' external financing (Table 4). Nevertheless, given the continued fragility of global financial markets, the authorities and staff agreed to maintain cautious assumptions going forward, broadly in line with the original program projections.
- ***Official external financing provides the capacity for the authorities to mitigate downward pressure on the exchange rate.*** Available instrument include FX swaps, FX lending to banks, and intervention in the event of disorderly market conditions. In the program projections, the central bank's net foreign assets (NFA) are projected to decline gradually. Government deposits at the central bank are projected to fall, as the government uses resources from the official support package to finance the fiscal deficit, to redeem government bonds, and for bond buy-back operations.

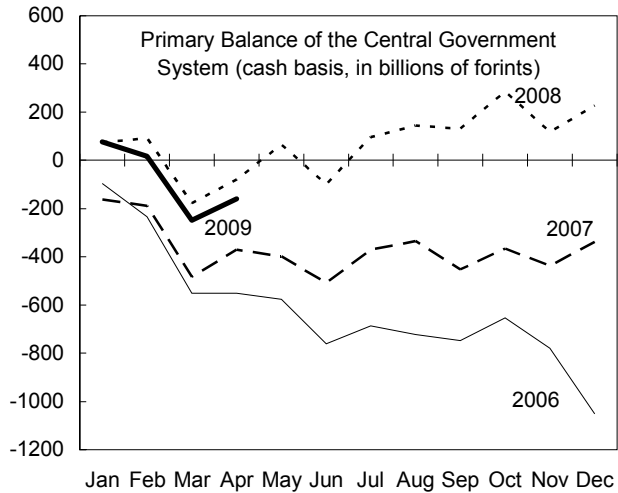
9. **The economy is expected to stabilize in 2010, but there are risks to the outlook for external financing** (Table 5). Real GDP is expected to contract by 0.9 percent in 2010, with a gradual recovery setting in only in the second half of the year. Exports should benefit from the global recovery, exchange rate depreciation, and the reduced tax wedge on labor. The moderation of global financial market stress, combined with the measures under the program to strengthen fiscal sustainability and preserve financial stability, are expected to improve financing conditions and thus support private investment. Private consumption will continue to be weighed down by losses in employment and reductions in social transfers. Regarding external financing, global financial turbulence has lasted longer than expected in November 2008, giving rise to considerable uncertainty about the resumption of private external financing flows. The financing outlook for 2010 will be revisited later this year.

10. **The program aims to ensure that government and external debt are firmly on sustainable paths** (Appendix Tables 1 and 2, and Appendix Figures 1 and 2). The government debt-to-GDP ratio is expected to peak at 80 percent at end-2010, a higher level than projected at the first review, due to higher fiscal deficits in 2009-10 (see below), lower nominal GDP, and a weaker exchange rate. Looking further ahead, the projections assume a constant structural overall surplus of about 1 percent of GDP after 2012, implying a substantial rise in the primary surplus (to about 4 percent of GDP by 2014), which is essential to reduce the public debt-to-GDP ratio under a broad range of adverse shocks. The external debt-to-GDP ratio is expected to peak at 139 percent at end-2009, a higher stock than projected at the first review, due to a weaker exchange rate and lower nominal GDP. Due to the expected improvement in the trade balance, a pick-up in growth, and a return of

non-debt creating capital inflows, external debt would gradually decline starting in 2011. The debt outlook would worsen significantly if the exchange rate was to depreciate further.

B. Fiscal Policy

11. **Fiscal performance in 2009Q1 was in line with the program** (Text Figure). The primary deficit of the central government system was 1 percent of GDP, about 0.1 percent of GDP below the program's ceiling (performance criterion). Good control over discretionary spending and delayed transfers to the state railway company (pending the signature of a public service contract) more than offset tax revenue shortfalls and pressures on mandatory expenditure (unemployment benefits and sick pay) resulting from the rapidly weakening economy.



Source: Hungarian authorities.

12. **The authorities have expanded the structural reforms initiated at the first review so as to increase medium-term budgetary savings** (LOI ¶11). Pension reform was strengthened by accelerating the increase in the statutory retirement age, broadening the conditions under which full CPI indexation of pension benefits would apply, abolishing the 13th month pension for all, and increasing pecuniary penalties for early retirement. In addition, the authorities are eliminating (instead of phasing out) subsidies to homebuyers¹ and energy subsidies, tightening eligibility of certain transfers to households, containing the growth of public sector wage bill, and encouraging efficiency gains in the delivery of public goods and services. Staff supported the authorities' approach, including the introduction of targeted support schemes to protect the poor from the abolition of selected universal transfers. However, staff expressed concern at the lack of credible strategies to support the planned savings at the local government level and in public transportation, and saw the potential for further tightening and rationalization of certain transfer schemes. Compared to the original (November 2008) program, the budgetary saving from the augmented structural reforms are expected to reach 1.4 percent of GDP in 2009 and 3.6 percent of GDP in 2010.

¹ The elimination of the small interest rate subsidy for forint-denominated borrowing on new home purchases is not expected to have any systemic impact on the banking system.

13. **The authorities have also deepened the tax reform, which—by shifting the tax burden from labor to consumption and wealth—should promote growth and thus contribute to fiscal sustainability** (LOI ¶12). In line with staff advice, the authorities plan a more ambitious reduction in the labor tax wedge than envisaged earlier this year, though staff called for a higher income tax credit and less of a decline in the top marginal tax rate to mitigate the regressivity of the reform. Revenue neutrality is expected to be preserved through a broadening of the income tax base, a larger VAT hike, and the introduction of a market-based property tax collected at the central level. Staff underlined the importance of reducing the labor tax wedge, especially on low incomes, including by reducing or eliminating the lump-sum health care contribution. The authorities explained that this contribution is a second-best instrument to collect revenue from the many workers who receive large informal payments on top of the formal minimum salary, and that retaining it would not substantially alter the impact of the tax reform on labor participation and employment.

14. **The authorities' strengthened commitment to fiscal sustainability allowed some room for automatic stabilizers to operate in 2009** (LOI ¶13 and Tables 6-7). The sharper-than-envisaged contraction in economic activity led to substantial revenue shortfalls (1.2 percent of GDP) and higher mandatory expenditure (0.2 percent of GDP). Moreover, a recent European Court of Justice (ECJ) ruling requires that the Hungarian government refund about 0.3 percent of GDP in unduly collected VAT. To minimize the adverse effect of additional fiscal adjustment on aggregate demand, staff recommended limiting spending cuts to those related to the implementation of structural reforms (0.6 percent of GDP), such as the elimination of the second installment of the 13th month pension and civil service salary. Given that the tax reform is expected to boost revenue by about 0.2 percent of GDP in 2009, the new fiscal measures offset about half of the combined effects of the automatic stabilizers and the ECJ decision. Altogether, the projected general government deficit in 2009 was revised from 2.9 percent of GDP to 3.9 percent of GDP. If economic activity contracts more than currently envisaged, the contingency reserve provides a buffer of 0.3 percent of GDP; thereafter, staff recommended fully accommodating automatic stabilizers, while the authorities said they would consider adjustments to the deficit target and the need for further measures (LOI ¶14).

15. **Looking ahead to 2010, the authorities and staff agreed that a modest reduction of the fiscal deficit as a share of GDP is needed to secure investor confidence** (LOI ¶15). On current macroeconomic projections and announced policies, staff project that additional measures amounting to about 0.5 percent of GDP are needed to reach a fiscal deficit target of 3.8 percent of GDP. The authorities said it was too early to discuss specifics at this stage of budget preparation. Staff recommended developing concrete strategies to underpin the planned efficiency gains at the local government level and the cuts in subsidies to the state-owned railway company.

16. **Institutional reforms underpinning fiscal responsibility are proceeding well** (LOI ¶16). The Fiscal Council received appropriate resources to execute its mandate, which should enhance the quality of the fiscal policy debate and budgetary forecasts. Staff called for a stronger medium-term focus of budgetary procedures. While acknowledging room for improvement, the authorities questioned the timeliness of the implied effort, citing the need to focus existing capacities on crisis management and reform implementation.

17. **Risks to the program remain elevated.** In the run-up to parliamentary elections scheduled for April 2010, political uncertainty is high. As illustrated by the parliamentary debate over the property tax, pre-election pressures could complicate the implementation of reforms. Economic risks include the macroeconomic outlook and uncertain tax compliance of credit-constrained individuals and firms (so far, although tax arrears have increased, they have been mostly related to bankrupt companies, with little evidence of weakening compliance).

C. Financial Sector Policies

18. **The banking system was resilient during the first quarter of 2009** (Table 8 and LOI ¶17). Profitability rose, as cuts in operating expenses and non-recurrent earnings compensated for higher funding costs and increased loan-loss provisions. Non-performing loans (NPLs) increased to 3.5 percent (from 3.0 percent at end-2008). The banking system's capital adequacy ratio (10.3 percent) remained well above regulatory requirements. Bank lending slowed sharply, in particular to corporations. Lending in Swiss francs—which accounts for almost 70 percent of existing household loans—came practically to a standstill.

19. **Going forward, strains on the banking system will increase as the economic downturn undermines credit quality.** While the increase in NPLs is difficult to forecast with any precision, especially given the absence of historical precedents, a tripling of NPLs by end-2009 is not unrealistic. Higher provisioning and funding costs are expected to sharply reduce profitability.

20. **In these circumstances, the possible need for additional capital cannot be ruled out.** Both the Hungarian Financial Supervision Agency (HFSA) and the central bank carry out stress tests on a regular basis. The HFSA's analysis focuses on market risk. The central bank examines the impact of macro scenarios on credit quality. Stress tests conducted by the central bank indicate that, in case of a more severe downturn (10 percent contraction), additional capital of €0.7–0.9 billion may be required to ensure that all banks meet regulatory requirements (LOI ¶20). Integration between the HFSA and central bank stress test exercises would be beneficial, as market and credit risks may reinforce each other and generate large losses.

21. **The government extended FX loans to three banks in early April to help them meet their FX funding needs without unsettling the foreign exchange market** (LOI ¶18). The loan recipients were OTP, Hungary's largest bank (€1.36 billion); FHB, a mortgage

lender (€400 million); and MFB, the state-owned development bank (€600 million).² To monitor the financial soundness and stress resilience of the banks with outstanding loans to the government, the authorities established a new subcommittee of the Financial Stability Committee, which consists of the MOF, the central bank, and the HFSA (structural performance criterion). While the work of the subcommittee started more slowly than expected, due to the change of government, the subcommittee has consulted with Fund staff (continuous structural benchmark). The compatibility of the terms of the loans with EU competition rules is being reviewed.

22. The end-March structural performance criterion concerning the Financial Stability Act was not fully met, because the draft amendments did not contain the element to specify that the share price at which shareholders of a troubled bank can sell their shares to the state will be exercised at a price as determined by an independent third party jointly selected by the central bank and the HFSA. To clarify the selection process for the auditor conducting the assessment, an amendment was submitted to parliament on May 22, 2009 requiring that the auditor appointed by the Ministry of Finance be different from the auditor previously auditing the bank. In exercising its powers, the Ministry of Finance will appoint an auditor jointly selected by the central bank and the HFSA. On the basis of the subsequent measures taken by the authorities, staff support the authorities' request for a waiver.

23. Parent bank support of the largest foreign bank subsidiaries in Hungary was recently confirmed (LOI ¶19). Following a meeting in Brussels on May 20, 2009, held in close cooperation with the European Commission (EC) and as part of the European Banking Group Coordination Initiative, the parent banks confirmed their commitments to maintain their overall exposure in Hungary and to provide additional capital for their Hungarian subsidiaries if necessary.

24. Comprehensive on-site bank inspections are under way (LOI ¶21). In recent years, the HFSA has not conducted the comprehensive on-site inspections that are needed to confirm the accuracy of banks' reported data and provide an overall view of the financial condition of diversified banking conglomerates. Given the rapid development of Hungary's banking system, including its international expansion, this had become a growing issue of concern. The HFSA is stepping up its on-site bank examination activities, with the help of the World Bank. A program to conduct comprehensive on-site inspections in all systemically important banks has been designed, with the sequencing of the inspections determined by a risk-based approach. The HFSA is also seeking close collaboration with the central bank and home- and host-country authorities in this endeavor. The first inspection started in April 2009 and the plan is to complete the inspections by the end of October. The mission stressed the urgency of completing thorough inspections of the systemically important banks.

² FHB also received a capital injection from the government of €100 million under the Financial Stability Act.

25. **In addition, the HFSA has developed an action plan to enhance its capabilities in the area of on-site bank inspections** (structural benchmark for end-May 2009). As part of the move toward a forward-looking and risk-based supervisory approach, in line with international best practices, the plan builds on the ongoing expanded inspections and incorporates them in a coherent strategy for the strengthening of the HFSA's capabilities in this field, including planning and execution procedures, a human resources plan, and a training program. The action plan is an important step in the right direction, but staff have identified significant room for further improvement, including a sharper focus on bank data accuracy, more specific intermediate objectives and actions, a more ambitious and targeted training program, and additional steps to secure continued assistance from outside sources of expertise. Given the criticality of strengthening on-site bank supervision to the success of the overall economic program, the expeditious implementation of the existing action plan and its further development will be necessary for the completion of the next (third) review.

26. **A review of the organization of financial supervision is also under way.** Notwithstanding ongoing efforts, the HFSA's effectiveness is likely to remain constrained by its lack of authority to issue regulations (as a result of constitutional impediments) and, more generally, its status as a semi-autonomous agency subordinated to the Ministry of Finance. Both the 2000 FSAP and the 2005 FSAP Update identified these as areas where Hungary was not in full compliance with the Basel Core Principles and pointed to the need for stronger supervision of large financial groups. Taking into account the lack of decisive progress on these points, the authorities asked for technical assistance to help them explore alternative institutional arrangements, including the possibility of transferring the HFSA's responsibilities to the central bank, which is independent and does have the authority to issue regulations.

27. **The remedial action and resolution regimes for banks are being strengthened** (LOI ¶22). Recent amendments to financial sector legislation have introduced stringent thresholds for the mandatory appointment of a supervisory commissioner, for example, in cases where a bank's capital position has fallen below the minimum requirement (8 percent) and cannot be restored within the time period stipulated by the authorities, or where a parent company of a bank is in a crisis situation that threatens its financial condition. More work is ongoing to refine the remedial action framework, in particular by establishing explicit powers for the removal of bank executives that are no longer meeting "fit and proper" criteria, and to provide for efficient bank resolution techniques. The authorities have formed a new subcommittee of the Financial Stability Committee to advance this work and plan to request technical assistance with the formulation of legislative proposals. Given the legal complexity in effectively limiting shareholders' governance rights during bank resolution, completion of the legislative process in this area will take longer than initially anticipated. Staff support the authorities' request to re-set the corresponding structural benchmark from end-June to end-December 2009.

28. **The government is implementing additional measures to strengthen the financial system's stress-resilience and protect households against a possible further deterioration in financial and economic conditions** (LOI ¶23). The objective is to provide incentives to reduce households' debt service burdens in episodes of systemic stress, while safeguarding credit discipline and minimizing explicit or contingent liabilities to public finances. Specifically, the authorities have submitted legislation to parliament to expand the partial mortgage debt servicing guarantee scheme for the unemployed to other debtors whose payment capacity is temporarily impaired by the financial crisis, because of either a reduction in income or an increase in debt service burden due to revaluation effects. In such cases, the lender would be asked to rephase the loan to temporarily lower the payment burden, and the government would partially guarantee the rephased portion of the loan, subject to certain restrictions. The authorities have consulted with Fund staff on the design of this scheme.

D. Monetary and Exchange Rate Policy

29. **The central bank has kept the policy rate on hold at 9.5 percent since January** (Figure 3 and LOI ¶24). This has been appropriate to help avoid a destabilizing depreciation of the exchange rate. Going forward, a further strengthening of investor confidence and a corresponding easing of financial strains would create room for interest rate cuts.

30. **Looking ahead, CPI inflation will be temporarily boosted by the increases in VAT and excise duties.** Staff therefore support the authorities' request to monitor performance under the inflation consultation mechanism by adjusting headline inflation for the technical impact of the tax hikes (3.7 percentage points), starting in September 2009 (LOI ¶25). The inflation consultation mechanism would otherwise remain unchanged.

31. **The central bank's new FX swap facilities have contributed to improving banks' FX liquidity positions** (LOI ¶26). In March, the MNB launched 3- and 6-month FX swap facilities, with a total volume of €5 billion, to provide FX liquidity for banks that are exposed to the volatile FX swap market. The use of these facilities is expected to peak at end-2009 and then to be gradually phased out during 2010. Bank interest in these facilities has been significant and strains in the FX swap market have eased. The MNB has also extended the one-week Euro/Swiss franc swap facility at least until end-July.

IV. PROGRAM MODALITIES

32. **The attached LOI describes the authorities' progress in implementing their economic program and sets out performance criteria through September 2009** (Box 1, LOI ¶2, and LOI Tables 1-3):

- ***Some modifications to the program's conditionality are proposed.*** The performance criterion on the cash primary balance of the central government system at end-June 2009 would be modified in line with the revised fiscal deficit projection for 2009. The performance criterion on net international reserves at end-June 2009 would

be adjusted upward by the higher-than-programmed end-March outcome. Starting in September 2009, the inflation consultation mechanism would be adjusted as described in ¶30. The end-June structural benchmark on legislative amendments to strengthen the remedial action and bank resolution regimes (as listed in the March 2009 LOI ¶20) would be re-set to end-December 2009.

- ***No changes are proposed to the duration of the arrangement, the level of access, or the schedule of purchases*** (Tables 9–11). The authorities and staff intend to revisit the external financing outlook for 2010–11 later in the year, and, if necessary, discuss the need for a possible extension and augmentation of the program.

Box 1. Hungary: Stand-By Arrangement

Access: SDR 10.5 billion (1015 percent of quota).

Length: 17 months (through end-March 2010).

Phasing: SDR 4.2 billion was disbursed after the Board’s approval of the arrangement on November 6, 2008, followed by another SDR 2.1 billion after the completion of the first review on March 25, 2009. The third tranche amounts to SDR 1.3 billion, and is subject to the completion of this (second) review. Subsequent disbursements are contingent upon completion of further quarterly reviews.

Conditionality

- ***Quantitative Performance Criteria***
 - A floor on the central government system primary cash balance.
 - A band around the 12-month rate of inflation of consumer prices
 - A floor on the change in net international reserves.
 - Non-accumulation of external debt arrears.
- ***Quantitative Indicative Target***
 - Ceiling on the total debt stock of the central government system.
- ***Structural Benchmarks***
 - Passage by parliament of the amendments strengthening the remedial powers of the HFSA and bank resolution regime (as listed in the March LOI ¶20). *By end-December 2009.*
 - Operation of the subcommittee described in the March LOI ¶18 as long as there is any government capital or funding support outstanding to banks, and consultation of the subcommittee with Fund staff on its work program. *Continuous.*

V. STAFF APPRAISAL

33. **Macroeconomic and financial policies are on track.** The end-March 2009 quantitative performance criteria and indicative target, as well as the structural performance criteria related to pension reform and government lending to banks, were all met. The structural performance criterion on amendments to the Financial Stability Act was not fully met, but, on the basis of corrective action taken, staff support the authorities’ request for a waiver.

34. **However, Hungary's economic outlook has worsened due to a further deterioration of the global environment.** The fall in demand for Hungary's exports and tight external financing conditions are leading to a sharper-than-previously-envisaged economic contraction. As a result, tax revenue will be lower and credit quality will be worse. Against this background, strengthened policies are critical to support external financing and economic activity in Hungary.

35. **Structural spending reforms are under way to strengthen fiscal sustainability, while allowing an increase in the headline fiscal deficit in 2009.** The government has appropriately expanded the reforms—to the pension system, social transfers, and subsidies—initiated earlier this year so as to yield permanent reductions in spending. The level of ambition of the tax reform has also been increased, with a greater shift of the tax burden from labor to consumption and wealth. Together, the structural spending reforms and the tax reform should boost labor participation and thus potential growth over the medium term. For 2009, additional fiscal measures, which are in line with these structural changes, offset about half of the increase in the fiscal deficit due to the worse macroeconomic outlook. The temporary rise in the fiscal deficit should not be detrimental to market confidence as it is accompanied by policy measures that strengthen debt sustainability and underpinned by the establishment of the fiscal council, which will provide independent scrutiny of budget preparation and execution. In the remainder of 2009, if economic activity contracts more than currently envisaged and the impact on the budget is greater than the contingency reserve, automatic stabilizers should be fully accommodated. For 2010, it is essential that the government delivers on its commitment to ensure a modest fall in the fiscal deficit.

36. **To help preserve financial stability, it is essential that the authorities implement the measures contained in the revised program.** Banks currently report adequate liquidity and capital positions, but pressures will rise as a result of higher funding costs and the impact of the economic downturn on credit quality. The government's recent FX lending to banks was motivated by banks' external funding needs and the obstacle to establishing a bank borrowing guarantee scheme posed by the sovereign's low credit rating; it is essential that the authorities carefully monitor the financial soundness of such banks so as to safeguard financial stability and minimize risks to public finances. At the same time, it is crucial that bank supervision—especially on-site inspections—be strengthened, that the bank supervisor's lack of authority to issue regulations be addressed, and that the remedial action and bank resolution frameworks be improved.

37. **Monetary and exchange rate policy will continue to target inflation over the medium term, while being prepared to act as needed to mitigate risks to financial stability.** In light of the risks associated with a sharp depreciation of the exchange rate, the policy interest rate has been appropriately kept on hold since January. Going forward, a further strengthening of investor confidence and a corresponding easing of financial strains would create room for interest rate cuts.

38. **The fragility of the political situation presents implementation risks.**

Parliamentary elections are scheduled for April 2010, but early elections are possible. To address this risk, the authorities recognize the need for continued careful program monitoring and for ongoing policy dialogue with the Fund.

39. **Implementation of policies consistent with the program provides the best chance for Hungary's economy to weather the current difficulties.** Staff support the authorities' request for completion of the second review under the Stand-By Arrangement.

Table 1. Hungary: Main Economic Indicators, 2005–10

	2005	2006	2007	2008	2009		2010
					1 st Rev.	2 nd Rev.	Prog.
Real economy (change in percent)							
Real GDP	4.0	4.0	1.1	0.5	-3.3	-6.7	-0.9
Total domestic demand 1/	0.5	1.3	-1.8	-0.4	-4.5	-8.0	-2.0
Private consumption	3.6	1.9	-1.8	-0.1	-3.8	-6.6	-2.6
Gross fixed investment	8.0	-5.7	1.5	-2.6	-5.0	-10.3	0.8
Foreign balance 1/	3.5	2.7	2.9	0.8	1.1	1.3	1.1
Exports	11.5	18.4	15.9	4.6	-3.2	-15.1	3.0
Imports	6.9	15.0	13.1	4.0	-4.3	-16.7	2.1
CPI (end year)	3.3	6.5	7.4	3.5	4.3	6.4	1.6
CPI (average)	3.6	3.9	7.9	6.1	3.8	4.5	3.8
Unemployment rate (average, in percent)	7.2	7.5	7.4	7.8	8.9	10.5	11.2
Gross domestic investment (percent of GDP) 2/	24.2	24.3	23.7	23.1	19.4	22.5	22.9
Gross national saving (percent of GDP, from BOP)	16.7	16.7	17.2	14.6	15.4	18.4	18.8
General government (percent of GDP), ESA-95 basis 3/							
Overall balance	-7.8	-9.3	-4.9	-3.3	-2.9	-3.9	-3.8
Primary balance	-3.7	-5.4	-0.9	0.7	1.5	1.0	0.9
Debt	61.8	65.6	65.9	72.8	75.9	77.4	80.4
Money and credit (end-of-period, percent change)							
Broad money	14.5	13.6	11.0	9.2	2.2	4.5	3.2
Credit to the economy, flow-based	15.4	17.3	15.9	10.6	-0.7	-1.5	1.3
Interest rates (percent)							
T-bill (90-day, average)	6.7	7.0	7.6	8.9	...	...	...
Government bond yield (5-year, average)	6.8	7.4	7.0	9.3	...	...	...
Balance of payments							
Goods and services trade balance (percent of GDP)	-1.2	-0.9	1.4	0.9	4.9	4.3	4.4
Current account (percent of GDP)	-7.5	-7.5	-6.5	-8.4	-3.9	-4.1	-4.0
Reserves (in billions of euros)	15.7	16.4	16.4	24.0	22.4	23.9	20.4
Gross external debt (percent of GDP) 4/	75.1	90.5	97.2	119.8	131.1	138.8	136.7
Exchange rate							
Exchange regime					Floating		
Present rate (June 10, 2009)					Ft 197.21 = US\$1; Ft. 278.79 = €1		
Nominal effective rate (2000=100)	111.6	105.1	111.8	113.1	...	...	...
Real effective rate, CPI basis (2000=100)	132.8	127.2	142.7	148.0	...	...	...
Quota at the Fund							
					SDR 1038.4 million		

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and IMF staff estimates.

1/ Contribution to growth. Calculated using 2000 prices.

2/ Includes change in inventories.

3/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments, as well as motorway investments previously expected to be recorded off-budget in 2006-07.

4/ Excluding Special Purpose Enterprises. Including inter-company loans and non-residents holdings of forint-denominated assets.

Table 2. Hungary: Monetary Accounts, 2005–10

	2005	2006	2007	2008		2009				2010
				Sept.	Dec.	March	June	Sept.	Dec.	
				Est.							Prog.		Prog.
(in billions of forints, unless otherwise specified)										
Monetary Survey										
Net foreign assets	375	-83	-952	-1577	-1487	-634	-981	-1004	-922	-1812
Net domestic assets	10830	12809	15078	16230	16908	16545	16689	16912	17042	18449
Domestic credit	13711	16190	18907	20523	21481	22122	21632	21218	21396	22383
Net claims on government	2426	3026	3270	3299	2952	1897	2236	1884	2137	2870
Credit to the economy	11285	13165	15637	17224	18529	20225	19396	19334	19259	19513
Other items, net	-2881	-3381	-3829	-4292	-4573	-5577	-4943	-4306	-4353	-3934
Broad money	11204	12727	14126	14653	15422	15911	15708	15908	16120	16637
Currency in circulation	1600	1838	2068	2009	2137	2205	2207	2222	2308	2481
Total deposits	9053	10075	10869	11444	12114	12386	12211	12330	12386	12510
Domestic currency deposits	7664	7827	8704	8656	9737	9686	9728	9910	10024	10159
Foreign currency deposits	1388	2248	2165	2788	2377	2700	2483	2421	2362	2351
Short-term securities	56	35	200	152	313	412	457	502	547	647
Money market instruments	495	779	990	1048	858	909	834	853	879	999
Accounts of the Magyar Nemzeti Bank (MNB)										
Net foreign assets 1/	3673	3838	3941	4046	5988	8139	7214	6979	6828	4948
Net domestic assets	-1473	-1404	-1150	-1397	-3383	-5522	-4481	-4191	-3981	-1884
Net domestic credit	-1360	-1369	-1138	-1561	-3370	-4627	-3674	-3752	-3503	-1418
Net claims on government	-37	-141	-108	-281	-1286	-2447	-1551	-1647	-1361	-1361
Claims on government	247	233	147	147	360	360	366	314	314	314
Liabilities to government 2/	284	373	255	428	1646	2807	1917	1961	1675	1675
Net claims on the economy	-5	-5	0	0	0	0	0	0	0	0
Net claims on banks	-1318	-1223	-1029	-1280	-2084	-2179	-2123	-2105	-2142	-57
Other items, net	-113	-34	-12	164	-14	-895	-808	-438	-478	-466
Base money	2199	2434	2791	2648	2605	2617	2733	2789	2847	3064
Currency in circulation	1600	1838	2068	2009	2137	2205	2207	2222	2308	2481
Cash in bank vaults	114	130	134	140	171	156	161	205	181	200
Banks' reserves	485	466	589	500	296	257	364	361	358	383
Required reserves	526	615	682	751	322	343	364	361	358	383
Excess reserves	-40	-149	-92	-252	-26	-86	0	0	0	0
Other Monetary and Financial Institutions										
Net foreign assets	-3298	-3920	-4892	-5623	-7475	-8773	-8195	-7984	-7751	-6760
Net domestic assets	12902	14809	16951	18267	20759	22480	21696	21669	21563	20916
Domestic credit	15066	17554	20045	22084	24851	26749	25306	24970	24899	23801
Net claims on government	2463	3166	3378	3580	4238	4345	3787	3531	3498	4231
Credit to the economy	11285	13165	15637	17224	18529	20225	19396	19334	19259	19513
Net claims on the central bank	1318	1223	1029	1280	2084	2179	2123	2105	2142	57
Banks' reserves and overnight deposits	750	838	1062	798	296	257	364	361	358	383
Other items, net	-2914	-3584	-4156	-4615	-4387	-4526	-3974	-3663	-3694	-3268
Banks' liabilities	9604	10888	12058	12644	13285	13706	13501	13685	13812	14156
Total deposits	9053	10075	10869	11444	12114	12386	12211	12330	12386	12510
Demand deposits	3589	3995	4280	4107	4023	4114	4055	4095	4114	4155
Time deposits	5464	6080	6589	7337	8090	8272	8155	8235	8272	8355
Short-term securities	56	35	200	152	313	412	457	502	547	647
Money market instruments	495	779	990	1048	858	909	834	853	879	999
Memorandum items:										
	(y-o-y percentage change)									
Base money	9.4	10.7	14.7	2.7	-6.7	4.8	9.8	5.3	9.3	7.6
Broad money	14.5	13.6	11.0	8.3	9.2	8.4	10.9	8.6	4.5	3.2
Credit to the economy	18.9	16.7	18.8	16.1	18.5	10.3	11.8	8.7	3.9	1.3
Credit to the economy, flow-based 3/	15.4	17.3	15.9	15.3	10.6	6.7	3.7	-0.9	-1.5	1.3
	(in percent)									
Foreign currency loans to total loans	45.2	47.9	56.4	58.7	64.7	68.2	66.5	66.9	67.5	67.4
Foreign currency deposits to total deposits	15.3	22.3	19.9	24.4	19.6	21.8	20.3	19.6	19.1	18.8
	(in billions of forints)									
Net international reserves	3762	4000	4051	4157	4908	6275	5033	4361	3775	1753
plus IMF disbursement to the government 4/	0	0	0	0	1215	2129	2468	2904	3340	3481
minus other non-reserve liabilities (net)	89	162	110	112	135	264	286	286	286	286
= net foreign assets of the central bank	3673	3838	3941	4046	5988	8139	7214	6979	6828	4948

Sources: Magyar Nemzeti Bank and IMF staff calculation.

1/ Includes anticipated disbursement of the first IMF tranche under the SBA to the government, as well as disbursements of EU and WB funds.

2/ Includes built-up of government deposits commensurate with the disbursement of the first IMF tranche, EU and WB funds; as well as the use of deposits to finance the government's net borrowing requirements.

3/ Controls for fluctuations in the exchange rate.

4/ The first two IMF tranches were disbursed to the government, who deposited the funds with the MNB and converted them into forint. As a result, IMF disbursements were recorded as a foreign asset but domestic liability of the MNB. The future tranches are also assumed to be disbursed to the government.

Table 3. Hungary: Balance of Payments, 2007-11 1/
(in millions of euros)

	2007	2008	2009						2010	2011		
			Mar		Jun		Sep				Dec	
			Est.	Prog.	Prog.	Prog.	Prog.	1 st Rev.			2 nd Rev.	Prog.
Current Account	-6,602	-8,902	-757	-902	-913	-1,001	-3,623	-3,557	-3,506	-3,286		
Goods and service, net	1,370	997	657	1,036	1,026	1,010	4,499	3,744	3,844	3,778		
Exports	80,824	85,994	16,552	17,651	18,215	19,385	81,041	71,819	75,761	81,275		
Imports	-79,454	-84,997	-15,896	-16,615	-17,190	-18,375	-76,542	-68,075	-71,917	-77,498		
Income, net	-7,477	-8,585	-1,460	-1,760	-1,760	-1,833	-7,628	-6,813	-6,859	-6,545		
Current transfers, net	-494	-1,313	46	-178	-178	-178	-494	-488	-491	-518		
Capital Account	1,139	1,121	863	326	326	326	1,648	1,840	1,764	1,584		
Net capital transfers from the EU	1,220	1,129	868	336	336	336	1,679	1,875	1,764	1,584		
Financial Account	7,192	10,643	-961	-1,810	-1,700	-1,524	-7,370	-5,995	-1,995	2,452		
Direct investment, net	1,700	3,254	-115	230	476	468	747	1,059	1,216	1,279		
Direct Investment Abroad	-2,729	-1,151	-257	-86	-32	-170	-725	-545	-546	-567		
In Hungary	4,429	4,405	142	316	508	639	1,472	1,604	1,762	1,846		
Portfolio investment, net	-789	-3,077	-2,824	-199	-643	-220	-999	-3,886	-1,262	1,004		
Assets	2,491	5,389	1,026	283	315	297	1,283	1,921	1,893	1,865		
Equity	-1,885	-2,153	-55	-76	-26	-27	-257	-184	-104	-107		
Debt securities	4,376	7,542	1,081	359	341	324	1,540	2,105	1,997	1,972		
Liabilities	-3,280	-8,466	-3,850	-482	-958	-516	-2,283	-5,807	-3,155	-861		
Equity	-3,635	-260	-32	34	34	36	875	72	-145	356		
Debt securities	355	-8,206	-3,818	-517	-993	-552	-3,158	-5,879	-3,010	-1,217		
Other investment	6,280	10,465	1,979	-1,841	-1,533	-1,773	-7,117	-3,168	-1,948	168		
Assets	-3,326	-1,367	332	173	169	239	-725	913	437	-567		
o/w: short-term assets	-618	1,728	-29	115	111	182	-253	379	316	-350		
Liabilities	9,606	11,832	1,647	-2,014	-1,702	-2,012	-6,392	-4,081	-2,385	736		
o/w short-term liabilities	4,350	2,477	1,106	-1,432	-1,306	-1,193	-4,091	-2,826	-1,401	1,328		
Net errors and omissions	-1,595	-2,382	319	-647	-647	-647	-2,588	-1,622	-811	-406		
Overall Balance	134	479	-536	-3,033	-2,934	-2,847	-11,933	-9,334	-4,548	345		
Program financing		2,000	2,000	1,500	500	1,000	5,500	5,000	500	0		
European Union		2,000	2,000	1,500	0	1,000	4,500	4,500	0	0		
World Bank		0	0	0	500	0	1,000	500	500	0		
Others		0	0	0	0	0	0	0	0	0		
Bank Guarantee Fund 2/		0	0	-2,060	0	-300	-2,069	-2,360				
Net International Reserves (increase -)	-134	-2,479	-1,464	3,593	2,434	2,147	8,501	6,694	4,048	-345		
Gross Reserves	-134	-7,403	-3,811	2,185	1,026	739	1,639	123	3,579	-345		
Reserve Liabilities	0	4,923	2,347	1,408	1,408	1,408	6,863	6,571	469	0		
Fund disbursements	0	4,923	2,347	1,408	1,408	1,408	6,863	6,571	469	0		
Current account (in percent of GDP)	-6.5	-8.4	-3.6	-4.2	-4.3	-4.3	-3.9	-4.1	-4.0	-3.6		
Gross external debt (in percent of GDP)	97.2	119.8	143.5	142.4	140.2	138.8	131.1	138.8	136.7	132.6		
Gross official reserves	16,385	24,040	27,890	25,704	24,678	23,940	22,401	23,940	20,361	20,706		
In percent of short-term debt at remaining maturity	88.9	85.0	89.3	79.9	77.1	80.5	80.3	80.5	79.1	69.5		

Sources: Hungarian authorities and staff projections.

1/ Excluding Special Purpose Enterprises.

2/ Including direct FX lending to banks.

Table 4. Hungary: Indicators of External Vulnerability, 2005–08

	2005	2006	2007	2008 Est.
Financial Indicators				
M3, end-of-period, percent change	14.5	13.6	11.0	9.2
Private sector credit, percentage change	15.4	17.3	15.9	10.6
T-bill , 90-day, average, in percent	6.7	7.0	7.6	8.9
Government bond yield, 5-year, average, in percent	6.8	7.4	7.0	9.3
Share of foreign currency liabilities in total liabilities	34.4	39.3	42.4	45.6
Share of foreign currency loans in total credit to:				
Corporates	47.7	47.1	52.6	60.3
Households	32.6	46.8	59.0	70.7
Other loans	75.2	75.4	81.7	87.2
Non-performing loans to gross loans 1/	2.5	2.5	2.5	3.0
External Indicators				
Exports of goods and services, annual percentage change	12.9	15.0	17.1	6.4
Imports of goods and services, annual percentage change	10.0	14.2	13.8	7.0
Real effective exchange rate, percentage change, + = appreciation	2.0	-4.8	12.6	4.2
Current account balance, in percent of GDP	-7.5	-7.5	-6.5	-8.4
Capital and financial account, in percent of GDP	0.8	0.6	1.1	1.1
Financial account, in percent of GDP	13.0	10.3	7.1	10.1
Net foreign direct investment, in percent of GDP	5.0	3.2	1.7	3.1
Gross official reserves, in millions of euros	15,721	16,397	16,385	24,040
In months of imports	2.7	2.5	2.3	4.2
In percent of short-term debt at remaining maturity	112.2	123.6	88.9	85.0
Total external debt, in millions of euros	66,608	81,428	98,266	126,190
In percent of GDP	75.1	90.5	97.2	119.8
Short-term debt at remaining maturity, in millions of euros	14,012	13,270	18,428	28,280
Financial Market Indicators				
Stock market index, local currency, end-of-period	20,785	24,844	26,236	12,242
EMBI Global bonds spread, end-of-period	74.0	58.0	84.0	504.0
CDS spread, 5-year, end-of-period	26.5	21.0	48.5	430.2

Source: Hungarian authorities; and staff estimates.

1/ Non-performing loans are defined as loans past due more than 90 days.

Table 5. Hungary: Staffs Illustrative Medium-Term Scenario, 2005-11

	2005	2006	2007	2008	2009	2010	2011
	Program						
	(In percent, unless otherwise indicated)						
Real GDP growth	4.0	4.0	1.1	0.5	-6.7	-0.9	3.2
Nominal GDP, forint billions	21,997	23,785	25,419	26,470	25,914	26,210	27,631
Inflation (CPI; year average basis)	3.6	3.9	7.9	6.1	4.5	3.8	2.8
Inflation (CPI; end-year basis)	3.3	6.5	7.4	3.5	6.4	1.6	3.0
	(Annual percentage change, constant prices)						
Domestic demand	0.5	1.3	-1.8	-0.4	-8.3	-2.2	2.4
Total consumption	3.1	2.4	-1.8	-0.4	-6.1	-2.5	1.0
Gross fixed capital formation	8.0	-5.7	1.5	-2.6	-10.3	0.8	6.0
Exports of GNFS	11.5	18.4	15.9	4.6	-15.1	3.0	4.6
Imports of GNFS	6.9	15.0	13.1	4.0	-16.7	2.1	4.0
	(In percent of GDP, unless otherwise indicated)						
External current account balance	-7.5	-7.5	-6.5	-8.4	-4.1	-4.0	-3.6
Gross national saving	16.7	16.7	17.2	14.6	18.4	18.8	19.9
Gross national investment 1/	24.2	24.3	23.7	23.1	22.5	22.9	23.5
Capital account, net	0.8	0.6	1.1	1.1	2.1	2.0	1.7
Financial account, net	13.0	10.3	7.1	10.1	-6.9	-2.3	2.7
Net international investment position	28.5	33.0	40.8	47.1	49.4	50.5	50.5
Gross external debt 2/	75.1	90.5	97.2	119.8	138.8	136.7	132.6
General government (ESA-95)							
Revenue, total	42.3	42.6	44.9	46.3	46.8	46.4	46.3
Expenditure, primary	46.0	48.0	45.8	45.5	45.8	45.5	44.4
Primary balance	-3.7	-5.4	-0.9	0.7	1.0	0.9	2.0
General government balance (including the costs of pension reform)	-7.8	-9.3	-4.9	-3.3	-3.9	-3.8	-2.9
Net interest	3.9	3.7	3.8	3.8	4.6	4.5	4.5
General government debt	61.8	65.6	65.9	72.8	77.4	80.4	79.1
Memorandum items							
Output gap	0.6	2.0	1.0	-0.4	-8.5	-10.8	-9.1
Potential GDP growth	3.5	2.6	2.1	1.9	1.4	1.4	1.5
Structural general government balance	-8.1	-7.1	-4.5	-3.4	0.4	1.6	1.6
Structural primary balance	-4.3	-3.4	-0.7	0.4	5.0	6.1	6.1

Sources: Hungarian authorities; and staff estimates.

1/ Includes change in inventories.

2/ Includes intercompany loans.

Table 6. Hungary: Consolidated General Government, 2006–11 1/
(In percent of GDP, unless otherwise indicated)

	2006	2007	2008	2009		2010	2011
				1 st Rev.	2 nd Rev.	Prog.	Prog.
Total revenues	42.6	44.9	46.3	46.5	46.8	46.4	46.3
Current revenues and current transfers (incl. grants)	41.7	44.0	45.3	44.8	45.1	44.1	43.9
Tax revenues	37.0	39.5	40.8	40.4	40.6	39.8	39.7
Taxes on income, profits and capital gains	9.4	10.2	10.8	10.5	10.6	9.6	10.0
Personal income tax	6.7	7.1	7.6	7.4	7.4	6.4	6.7
Corporate income tax	2.3	2.8	2.8	2.7	2.8	2.8	2.8
Other (incl. wealth, capital, and property taxes)	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Taxes on payroll and workforce and Social Security contributions	12.6	13.6	14.1	13.7	13.9	12.9	12.6
Taxes on goods and services	15.0	15.6	15.9	16.1	16.2	17.2	17.0
VAT	7.4	7.8	7.9	8.2	8.2	9.1	8.9
Other (incl. excises and duties)	7.5	7.9	8.0	7.9	8.0	8.2	8.1
Current non-tax revenues	4.0	3.8	3.9	3.9	3.9	3.6	3.5
Of which: interest	0.3	0.3	0.3	0.2	0.3	0.2	0.3
Current transfers (incl. grants)	0.8	0.6	0.5	0.6	0.6	0.7	0.7
Capital revenues and capital transfers (incl. grants)	0.9	0.9	1.0	1.7	1.7	2.3	2.5
<i>Memorandum item: subnational governments own revenues</i>	6.3	5.9	-	-	-	-	-
Total expenditures	51.9	49.8	49.6	49.3	50.7	50.0	49.1
Current expenditures and current transfers	45.7	44.3	44.6	44.5	45.6	44.3	43.0
Compensation of employees 2/	12.1	11.5	11.7	11.3	11.4	11.0	10.4
Goods and services	7.0	6.7	6.6	6.5	6.6	6.6	6.4
Interest payments	4.0	4.0	4.1	4.3	4.9	4.7	4.9
Subsidies	1.4	1.4	1.2	0.8	1.1	0.9	0.9
Current transfers to households	18.5	18.1	18.8	19.1	19.3	18.5	17.9
Social security	13.5	13.5	14.5	14.8	14.9	15.1	14.7
Of which unemployment benefits	0.4	0.4	0.4	0.4	0.5	0.5	0.4
Other	5.0	4.6	4.3	4.3	4.3	3.4	3.2
Other current transfers	2.7	2.6	2.3	2.4	2.3	2.5	2.5
Capital expenditures	4.3	3.6	2.9	3.2	3.3	3.7	3.8
Capital transfers	1.9	1.9	2.1	1.7	1.7	2.0	2.3
Other net expenditure	-	-	-	-	0.1	0.2	0.2
<i>Memorandum item: subnational governments total expenditure</i>	12.8	11.6	-	-	-	-	-
General government balance	-9.3	-4.9	-3.3	-2.9	-3.9	-3.8	-2.9
Primary balance	-5.4	-0.9	0.7	1.5	1.0	0.9	2.0
Memorandum items:							
Primary expenditure	48.0	45.8	45.5	45.0	45.8	45.3	44.2
Output gap (in percent of potential GDP)	2.0	1.0	-0.4	-5.8	-8.5	-10.8	-9.1
Cyclically-adjusted overall balance (CAB, in percent of potential GDP)	-10.4	-5.4	-3.1	0.0	0.4	1.6	1.6
Change in CAB	-2.2	4.9	2.3	3.3	3.6	1.2	0.0
One-off items (net)	-3.3	-1.0	0.2	0.0	0.0	0.0	0.0
Structural balance	-7.1	-4.5	-3.4	0.0	0.4	1.6	1.6
Change in the structural balance	-	2.6	1.1	3.5	3.8	1.2	0.0
Gross public debt	65.6	65.8	72.8	75.9	77.4	80.4	79.1
Real GDP growth (in percent)	4.0	1.1	0.5	-3.3	-6.7	-0.9	3.2
In nominal terms (HUF billions)							
Total revenue	10,133	11,411	12,243	12,381	12,139	12,155	12,806
Of which tax revenues	8,797	10,043	10,812	10,752	10,520	10,422	10,959
Total expenditure	12,350	12,666	13,129	13,141	13,143	13,152	13,607
Of which primary expenditure	11,409	11,638	12,051	11,992	11,872	11,919	12,264
Primary balance	-1,276	-227	192	389	268	236	543
Overall balance	-2,217	-1,256	-886	-759	-1,004	-997	-801

Sources: Hungarian authorities; and staff estimates.

1/ Data are classified following the ESA'95 methodology, as reported to the European Commission.

2/ Including social security contributions.

Table 7. Hungary: Borrowing Requirement of the Central Government, 2008-09
(in billion of forints)

	2008		2009				
	Q4	Year	Q1	Q2	Q3	Q4	Year
Net borrowing requirement 1/	776.1	1,507.1	566.0	195.6	237.1	-87.5	911.2
Redemptions							
In Hungarian forints	1,414.1	5,773.0	1,052.9	2,078.1	1,743.3	1,463.2	6,337.5
In foreign currency (euro)	8.4	164.1	152.5	121.3	9.3	6.5	289.7
Gross borrowing requirement	2,198.6	7,444.2	1,771.4	2,395.1	1,989.7	1,382.2	7,538.4
Actual and planned financing							
Gross issuance (actual and planned) 2/ 3/							
In Hungarian forints	1,175.2	5,823.5	994.4	1,641.7	2,203.5	1,346.7	6,186.3
In foreign currency	1,872.3	2,381.9	1,244.8	0.0	0.0	0.0	1,244.8
Drawing on deposits with banking system	-848.9	-761.2	-467.7	753.4	-213.8	35.6	107.4

1/ Overall budget balance of the central government system (cash basis) and costs of banking sector rescue package.

2/ Gross issuance in Hungarian forints include amounts that will be swapped to Hungarian forints from EU and IMF disbursements.

3/ Includes disbursements from the EU and the IMF in 2008Q4 and 2009Q1.

Table 8. Hungary: Financial Soundness Indicators for the Banking Sector, 2005–09
(In percent unless otherwise indicated, end of period)

	2005	2006	2007	2008	2009Q1 1/
Capital adequacy					
Regulatory capital to risk-weighted assets	11.6	11.0	10.4	11.1	10.3
Capital (net worth) to assets	8.2	8.3	8.2	8.0	7.3
Asset composition and quality					
Annual growth of bank loans	19.8	18.4	22.1	20.9	21.3
Sectoral distribution of bank loans (in percent of total)					
Corporates	45.7	43.2	39.8	35.3	35.1
o/w in foreign currency	21.8	20.3	20.9	21.3	23.0
Households	29.2	31.5	32.7	36.0	35.2
o/w in foreign currency	9.5	14.8	19.3	25.4	25.9
Other loans	25.0	25.3	27.5	28.7	29.7
o/w in foreign currency	18.8	19.1	22.5	25.0	26.4
Financial institutions	12.3	11.3	10.7	9.5	10.6
Central government	0.6	0.5	0.5	0.2	0.2
Nonresidents	5.1	6.2	9.1	12.2	12.9
Other	7.0	7.2	7.2	6.8	5.9
Denomination of FX loans to corporates					
EUR	74.80	70.7	67.8	67.1	70.5
USD	5.70	4.7	5.1	4.2	3.7
CHF	19.30	24.6	26.7	28.5	25.8
Other	0.20	0.0	0.4	0.1	0.0
NPLs to gross loans 2/	2.5	2.5	2.5	3.0	3.5
Provisions to NPLs	54.4	53.9	58.1	59.6	53.3
NPLs net of provisions to capital	9.0	9.2	8.4	10.5	16.7
Earnings and profitability					
ROA (after tax)	2.0	1.8	1.4	1.1	1.6
ROE (after tax)	24.7	24.0	18.1	11.6	20.2
Net interest income to gross income	64.4	64.7	61.3	56.0	50.2
Noninterest expenses to gross income	48.6	48.7	50.2	50.4	39.2
Personnel expenses to noninterest expenses	47.2	48.3	48.9	49.4	49.8
Trading and fee income to total income	33.8	32.3	36.1	30.7	37.6
Spread between loan and deposit rates	3.7	3.5	3.2	2.6	2.2
Liquidity					
Liquid assets to total assets	21.0	20.0	16.4	15.6	14.6
Liquid assets to short term liabilities	35.7	36.8	30.5	31.5	31.0
Loans to deposits	107.7	109.9	121.6	125.1	127.4
FX liabilities(own capital is excluded) to total liabilities (own capital is excluded)	34.4	39.3	42.4	45.6	47.6
Sensitivity to market risk					
Net open position in FX to capital	3.5	7.2	6.0	13.7	14.1

Source: Magyar Nemzeti Bank.

1/ Preliminary.

2/ Non-performing loans (NPLs) are defined as loans past due more than 90 days.

Table 9. Hungary: Program Financing, 2008-09
(in millions of euros)

	2008		2009			2008-09	
	Dec	Mar	Jun	Sep	Dec	Total	
	Est.		Prog.			1 st Rev. Prog.	2 nd Rev. Prog.
Total financing requirements	-669	-1,399	-5,419	-3,260	-3,472	-15,750	-14,219
Current account deficit	-2,584	-757	-902	-913	-1,001	-5,870	-6,157
Financial account outflows	2,561	-961	-1,810	-1,700	-1,524	-4,645	-3,434
Direct investment, net	1,494	-115	230	476	468	2,289	2,553
Portfolio investment, government net 1/	-2,874	-508	-396	-851	-438	-3,745	-5,067
Portfolio investment, private net 2/	-2,692	-2,316	197	208	218	-3,421	-4,386
of which, financial derivatives 3/	-1,157	-1,441	-282	19	35	-1,919	-2,827
Other investment	6,633	1,979	-1,841	-1,533	-1,773	231	3,465
Bank Guarantee Fund	0	0	-2,060	0	-300	-2,069	-2,360
Net errors and omissions	-646	319	-647	-647	-647	-3,166	-2,268
Total financing sources	-4,254	-948	4,011	1,852	2,064	1,895	2,724
Capital account inflows	67	863	326	326	326	1,716	1,907
Net capital transfers from the EU	68	868	336	336	336	1,716	1,943
Program Financing	2,000	2,000	1,500	500	1,000	7,500	7,000
European Union	2,000	2,000	1,500	0	1,000	6,500	6,500
World Bank	0	0	0	500	0	1,000	500
Change in gross reserves	-6,322	-3,811	2,185	1,026	739	-7,321	-6,182
Financing need	-4,923	-2,347	-1,408	-1,408	-1,408	-13,855	-11,494
Fund credits	4,923	2,347	1,408	1,408	1,108	11,786	11,194

Sources: Hungarian authorities and staff projections.

1/ Financing difficulties are expected to persist through 2009, with no FX issuance.

2/ Banks with foreign parent banks are expected to roll over 80 percent of short-term debt, and others 70 percent. As a result, short-term financing for banks will be negative in 2009 (following years of large build-up of debt).

3/ 80 percent of FX swaps are expected to be rolled over, recovering to 90 percent in second half of 2009.

Table 10. Hungary: Schedule of Reviews and Purchases

Date	Amount of Purchase		Conditions
	Millions of SDRs	Percent of Quota	
November 6, 2008	4,215.0	405.9	Approval of arrangement
March 25, 2009	2,107.5	203.0	First review and end-December 2008 performance criteria
June 22, 2009	1,264.5	121.8	Second review and end-March 2009 performance criteria
August 15, 2009	1,264.5	121.8	Third review and end-June 2009 performance criteria
November 15, 2009	1,264.5	121.8	Fourth review and end-September 2009 performance criteria
February 15, 2010	421.5	40.6	Fifth review and end-December 2009 performance criteria
Total	10,537.5	1,014.8	

Source: IMF staff estimates.

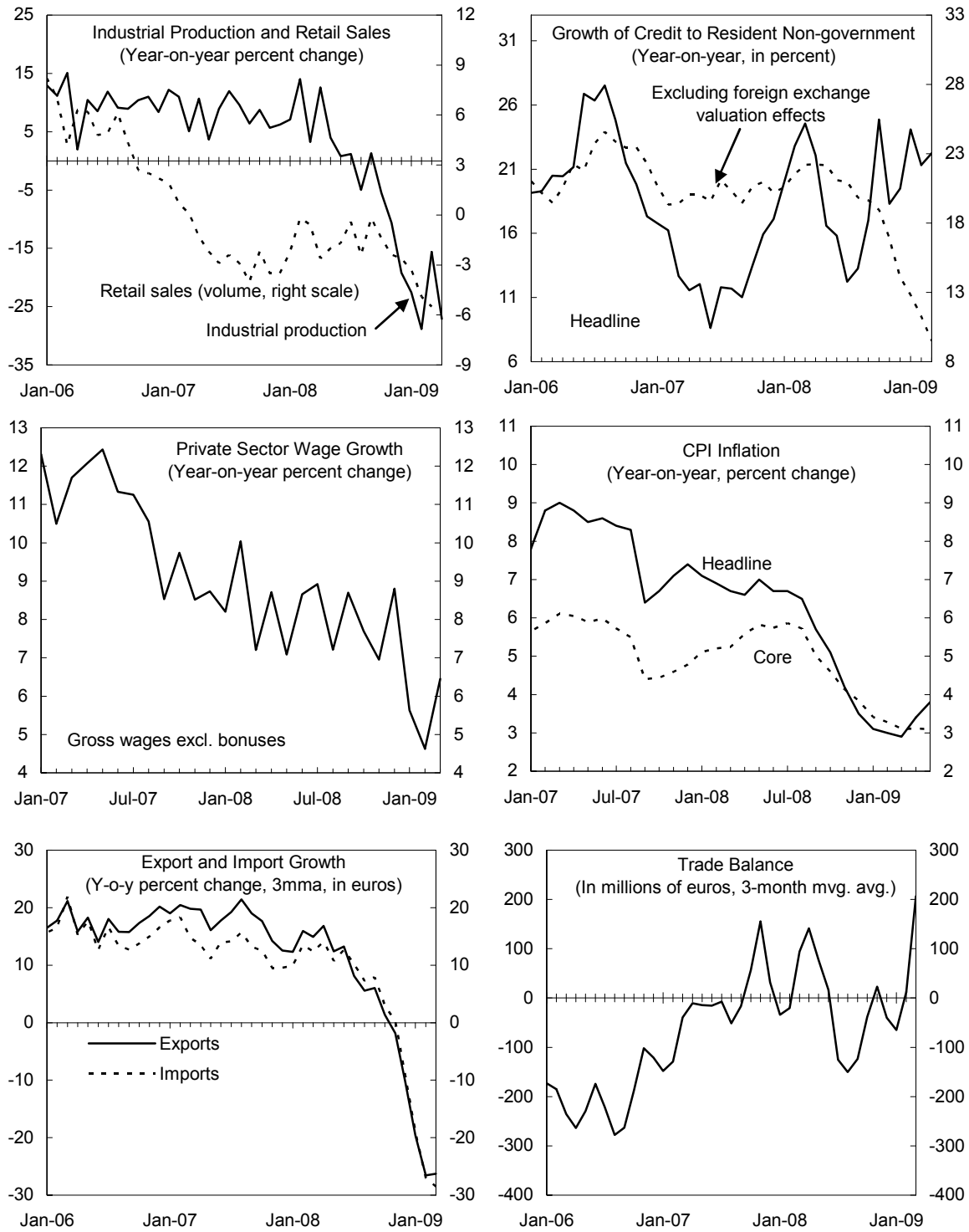
Table 11. Hungary. Indicators of Fund Credit, 2008-15
(In millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015
Existing and prospective Fund credit								
Disbursement	4,215	5,901	422	-	-	-	-	-
Stock 1/	4,215	10,116	10,538	10,538	7,166	1,949	53	-
Obligations	21	224	305	311	3,652	5,357	1,915	53
Repurchase	-	-	-	-	3,372	5,216	1,897	53
Charges	21	224	305	311	280	140	19	0
Stock of existing and prospective Fund credit								
In percent of quota	405.9	974.2	1014.8	1014.8	690.1	187.7	5.1	-
In percent of GDP	4.3	13.2	13.6	12.8	8.2	2.1	0.1	-
In percent of exports of goods and services	5.3	16.0	15.7	14.6	9.1	2.2	0.1	-
In percent of gross reserves	18.8	47.9	58.2	57.2	32.2	7.5	0.2	-
Obligations to the Fund from existing and prospective Fund arrangements								
In percent of quota	2.0	21.6	29.3	29.9	351.7	515.8	184.4	5.1
In percent of GDP	0.0	0.3	0.4	0.4	4.2	5.7	1.9	0.0
In percent of exports of goods and services	0.0	0.4	0.5	0.4	4.6	6.1	2.0	0.0
In percent of gross reserves	0.1	1.1	1.7	1.7	16.4	20.7	6.5	0.2

Source: IMF staff estimates.

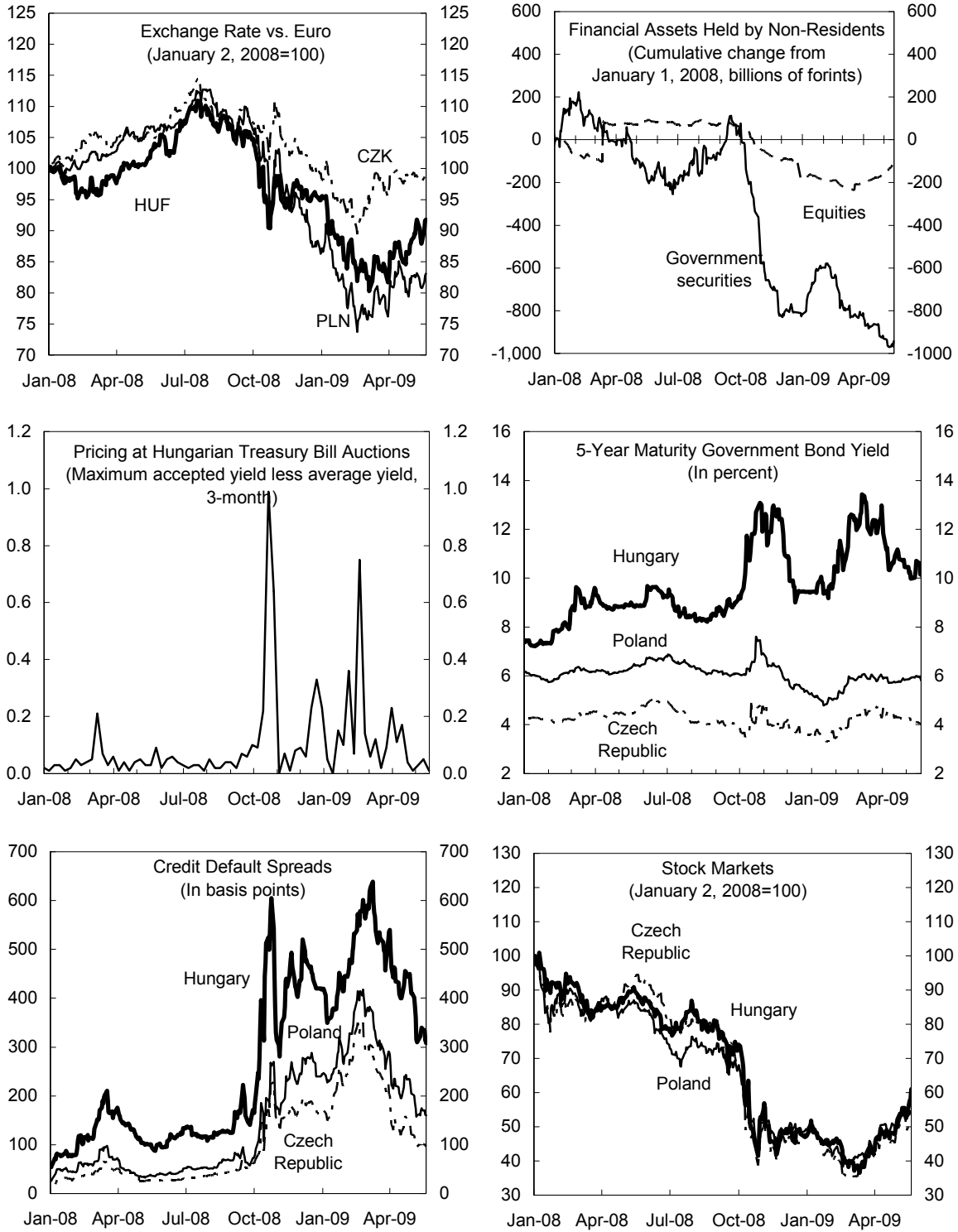
1/ End of period.

Figure 1. Hungary: Recent Economic Developments



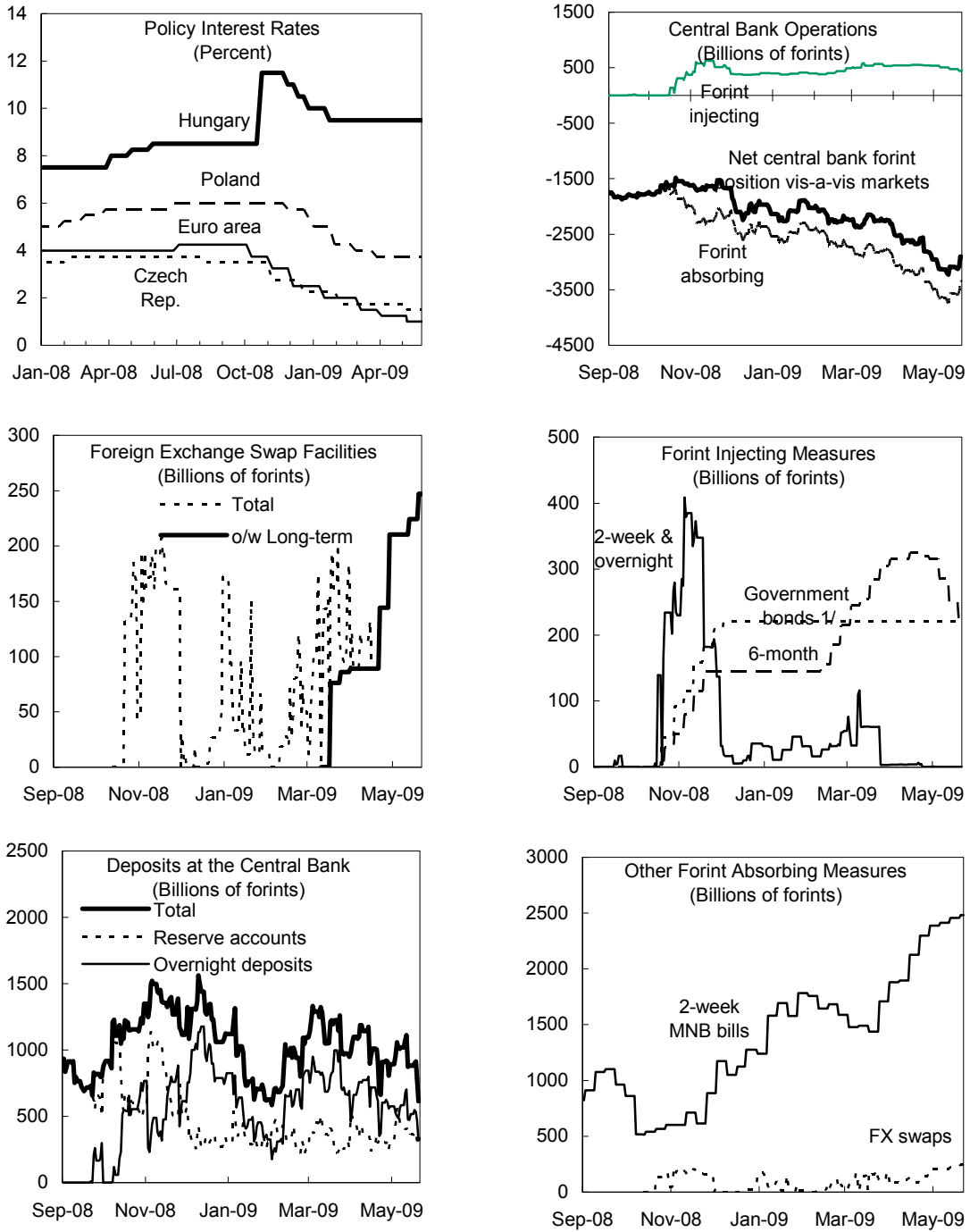
Sources: Hungarian Statistical Office; and IMF staff calculations.

Figure 2. Hungary: Financial Market Developments, 2008-09



Sources: National authorities; Bloomberg; and AKK.

Figure 3. Hungary: Monetary Policy Indicators, 2008-09



Sources: Hungarian authorities; and IMF staff calculations.
 1/ Facility to purchase government bonds from primary dealers.

Appendix Table 1. Hungary: Public Sector Debt Sustainability Framework, 2004-14
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing primary balance 9/
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	
Baseline: Public sector debt 1/	59.4	61.8	65.6	65.9	72.8	77.4	80.4	79.1	76.1	71.8	66.9	
o/w foreign-currency denominated	15.3	17.4	18.5	18.5	26.5	32.2	31.7	30.0	28.0	25.9	24.1	-1.1
Change in public sector debt	1.4	2.4	3.8	0.3	6.9	4.6	2.9	-1.2	-3.1	-4.3	-4.9	
Identified debt-creating flows (4+7+12)	-1.2	5.2	1.7	-1.1	3.3	5.4	2.9	-1.2	-3.1	-4.3	-4.9	
Primary deficit	2.0	3.7	5.4	0.9	-0.7	-1.0	-0.9	-2.0	-2.6	-3.3	-3.9	
Revenue and grants	42.6	42.3	42.6	44.9	46.3	46.8	46.4	46.3	46.1	45.9	45.6	
Primary (noninterest) expenditure	44.6	46.0	48.0	45.8	45.5	45.8	45.5	44.4	43.5	42.5	41.7	
Automatic debt dynamics 2/	-2.4	3.4	-2.4	-2.0	4.0	6.5	3.8	0.7	-0.5	-0.9	-1.0	
Contribution from interest rate/growth differential 3/	-0.6	0.6	-0.7	-0.2	1.5	6.5	3.8	0.7	-0.5	-0.9	-1.0	
Of which contribution from real interest rate	2.0	2.9	1.6	0.5	1.8	1.5	3.1	3.2	2.5	2.3	2.1	
Of which contribution from real GDP growth	-2.6	-2.3	-2.3	-0.7	-0.3	5.0	0.7	-2.4	-3.0	-3.3	-3.1	
Contribution from exchange rate depreciation 4/	-1.8	2.8	-1.7	-1.8	2.6	...	...	...	...	...	...
Other identified debt-creating flows	-0.8	-2.0	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-0.8	-2.0	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	2.6	-2.8	2.1	1.4	3.6	-0.8	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	139.5	146.3	154.1	146.9	157.4	165.3	173.3	170.7	165.0	156.6	146.6	
Gross financing need 6/	23.2	24.6	24.3	18.7	34.8	19.5	22.8	30.1	23.0	16.6	17.4	
in billions of U.S. dollars	23.7	27.2	27.5	25.9	53.9	23.2	27.4	38.5	31.5	24.6	27.8	
Scenario with key variables at their historical averages 7/						77.4	77.7	77.9	78.1	78.3	78.4	-1.1
Scenario with no policy change (constant primary balance) in 2009-2014						77.4	85.4	87.8	86.7	84.5	82.3	-1.3
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.8	4.0	4.0	1.1	0.5	-6.7	-0.9	3.2	4.0	4.6	4.7	
Average nominal interest rate on public debt (in percent) 8/	8.3	7.4	6.9	6.6	6.4	6.6	6.1	6.4	6.3	6.2	6.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.9	5.2	3.0	0.9	2.8	1.7	4.1	4.2	3.5	3.4	3.3	
Nominal appreciation (increase in US dollar value of local currency, in percent)	15.3	-15.6	11.5	11.0	-12.0	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	4.4	2.2	3.9	5.7	3.6	4.9	2.1	2.2	2.8	2.8	2.8	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.7	7.2	8.6	-3.5	-0.1	-6.1	-1.6	0.7	1.9	2.2	2.7	
Primary deficit	2.0	3.7	5.4	0.9	-0.7	-1.0	-0.9	-2.0	-2.6	-3.3	-3.9	

1/ General government gross debt.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\epsilon(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ϵ = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\epsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Appendix Table 2. Hungary: External Debt Sustainability Framework, 2004-14
(In percent of GDP, unless otherwise indicated) 1/

	Actual					Projections						Debt-stabilizing non-interest current account 7/ -5.4
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	
Baseline: External debt	67.0	75.1	90.5	97.2	119.8	138.8	136.7	132.6	127.0	118.6	116.0	
Change in external debt	12.5	8.1	15.4	6.7	22.6	19.0	-2.0	-4.2	-5.6	-8.3	-2.6	
Identified external debt-creating flows (4+8+9)	-5.2	2.4	9.2	4.5	9.5	17.5	5.2	-2.1	-5.8	-5.9	-5.3	
Current account deficit, excluding interest payments	5.8	4.6	4.4	2.9	3.1	-2.4	-3.0	-3.0	-3.0	-3.1	-3.0	
Deficit in balance of goods and services	2.7	1.2	0.9	-1.4	-0.9	-4.3	-4.4	-4.1	-3.7	-3.4	-3.1	
Exports	65.0	67.7	76.7	79.9	81.6	82.8	86.7	88.2	90.2	93.3	96.4	
Imports	67.7	68.9	77.6	78.6	80.7	78.4	82.3	84.1	86.5	89.9	93.3	
Net non-debt creating capital inflows (negative)	-5.4	-0.6	4.1	6.9	4.9	3.7	0.0	-1.5	-4.3	-3.9	-3.4	
Automatic debt dynamics 1/	-5.5	-1.6	0.8	-5.3	1.5	16.2	8.2	2.4	1.5	1.1	1.2	
Contribution from nominal interest rate	2.6	2.9	3.2	3.7	5.4	6.5	7.0	6.5	6.5	6.5	6.3	
Contribution from real GDP growth	-4.3	-2.4	-3.0	-0.9	-0.4	9.7	1.3	-4.2	-5.0	-5.4	-5.2	
Contribution from price and exchange rate changes 2/	-3.8	-2.1	0.6	-8.1	-3.4	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	17.7	5.8	6.1	2.2	13.2	1.5	-7.3	-2.1	0.2	-2.4	2.6	
External debt-to-exports ratio (in percent)	103.1	111.0	118.0	121.6	146.7	167.7	157.7	150.2	140.7	127.2	120.4	
Gross external financing need (in billions of euros) 4/	23.6	28.4	32.4	31.0	41.4	56.3	48.6	43.6	49.1	56.6	57.7	
in percent of GDP	28.6	32.0	36.0	30.6	39.3	64.8	55.6	47.4	49.9	53.5	50.6	
Scenario with key variables at their historical averages 5/						138.8	130.5	128.0	128.1	125.8	127.5	-7.2
Key Macroeconomic Assumptions Underlying Baseline 6/												
Real GDP growth (in percent)	9.2	3.9	4.0	1.1	0.5	-6.7	-0.9	3.2	4.0	4.6	4.7	
GDP deflator in euros (change in percent)	6.6	3.7	-2.5	11.2	3.7	-11.7	1.6	2.2	2.8	2.8	2.8	
Nominal external interest rate (in percent)	5.6	4.7	4.3	4.5	5.7	4.5	5.1	5.0	5.2	5.5	5.8	
Growth of exports (euro terms, in percent)	20.2	12.2	15.0	17.1	6.4	-16.5	5.5	7.3	9.3	11.2	11.2	
Growth of imports (euro terms, in percent)	20.8	9.7	14.2	13.8	7.0	-19.9	5.6	7.8	9.9	11.7	11.8	
Current account balance, excluding interest payments	-5.8	-4.6	-4.4	-2.9	-3.1	2.4	3.0	3.0	3.0	3.1	3.0	
Net non-debt creating capital inflows	5.4	0.6	-4.1	-6.9	-4.9	-3.7	0.0	1.5	4.3	3.9	3.4	

1/ Excluding Special Purpose Enterprises

2/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in euro terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

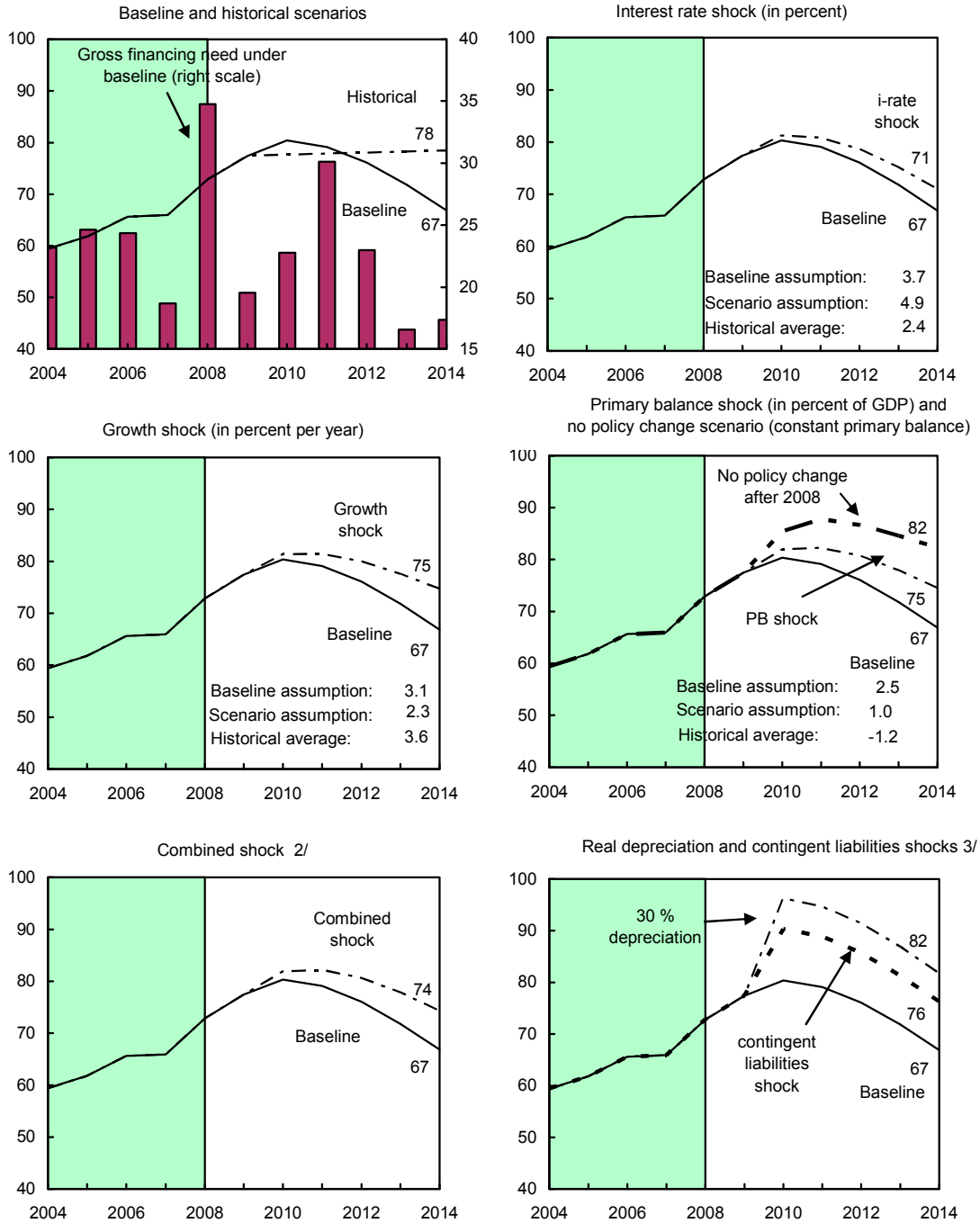
4/ For projection, line includes the impact of price and exchange rate changes.

5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Appendix Figure 1. Hungary: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



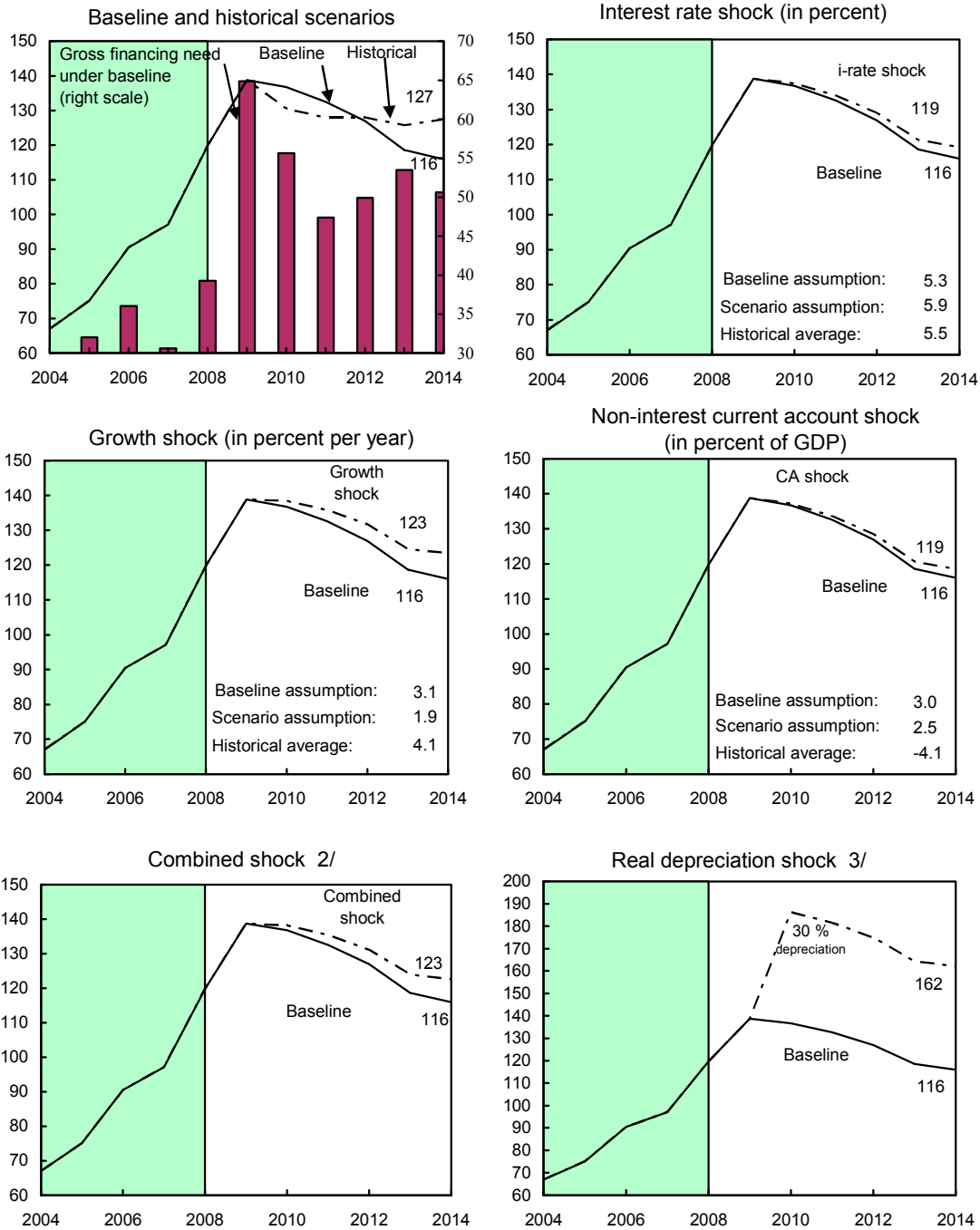
Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix Figure 2. Hungary: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2009.

ATTACHMENT I. LETTER OF INTENT (LOI)

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC, 20431
U.S.A.

Budapest, June 11, 2009

Dear Mr. Strauss-Kahn:

1. Hungary is experiencing one of the harshest recessions since the country's transition to a market economy. The external environment has deteriorated further, triggering a sharp reduction in global trade and investment flows that is particularly detrimental to a small, open economy like Hungary. Financial strains have remained severe, some recent easing notwithstanding, and another round of stress in global financial markets cannot be ruled out. Weak external demand and tight global financing conditions are likely to remain significant drags on the Hungarian economy in 2009 and 2010.

2. Notwithstanding the challenging external environment, implementation of the IMF-supported program has continued to be strong (Tables 1 and 2):

- *Quantitative performance criteria and inflation consultation mechanism.* All quantitative performance criteria for end-March 2009 and the continuous performance criterion on non-accumulation of external arrears have been met, as well as the end-March 2009 indicative target on central government debt. Inflation was within the inner band of the inflation consultation mechanism.
- *Structural performance criteria.* The end-March 2009 structural performance criteria on pension reform (paragraph 11a) and on the establishment of a subcommittee of the Financial Stability Committee to monitor the financial soundness and stress-resilience of banks that receive capital or refinancing support from the government (paragraph 18, second bullet) were met. The end-March structural performance criterion on amendments to the Financial Stability Act was not met with respect to one amendment, as, in our view, the existing legal framework is already consistent with the objectives that were meant to be achieved by this amendment. Moreover, corrective action is being taken to provide further legal clarification (paragraph 18, first bullet).
- *Structural benchmarks.* The continuous structural benchmark that the sub-committee mentioned above remains operational and consults with Fund staff on its work program has also been met. The end-May structural benchmark on the development of an action plan by the Hungarian Financial Supervision Agency (HFSA) to

strengthen its operational capabilities in the field of on-site bank examinations (paragraph 21) has been met.

3. In view of this performance, we request completion of the second review under the Stand-By Arrangement. On the basis of the corrective measures being taken and the additional explanations given in this Letter, we request a waiver for the end-March 2009 structural performance criteria on submitting to parliament amendments to the Financial Stability Act.
4. In view of the worsening of the macroeconomic outlook and its impact on the public finances, we request a modification of the end-June 2009 performance criterion on the cash primary balance of the central government system, in line with the revised deficit target for 2009. We also request a modification to the performance criterion on net international reserves at end-June 2009 to lock in the overperformance at end-March 2009, which will further reduce Hungary's vulnerability to a deterioration in external financing conditions. Finally, we request that, for the purpose of monitoring performance under the inflation consultation mechanism, consumer price index (CPI) inflation be adjusted to reflect the impact of the VAT and excise tax increases, starting in September 2009. Quantitative and structural performance criteria through end-September 2009 are set out in Tables 2 and 3, as well as in the Technical Memorandum of Understanding attached to this letter. The third review of the program is scheduled to take place after August 14, 2009, and the fourth review after November 14, 2009.
5. We believe that the policies set forth in the letters of November 4, 2008; March 12, 2009; and in this letter are adequate to achieve the objectives of our economic program, but the Government stands ready to take additional measures as appropriate to ensure achievement of its objectives. As is standard under all IMF arrangements, we will consult with the IMF before modifying measures contained in this letter or adopting new measures that would deviate from the goals of the program, and provide the IMF with the necessary information for program monitoring.

Macroeconomic Framework for 2009 and 2010

6. The growth outlook for 2009 and 2010 has deteriorated further. The collapse in global trade has sharply reduced the demand for Hungarian exports. Domestic demand is suffering from the loss in employment—due in part to a drastic fall in industrial production—stricter lending criteria and the impact of the needed fiscal adjustment. Going forward, both external and domestic demand are projected to recover only slowly, as the global economy remains weak and financing conditions tight, with little room for positive impulses from macroeconomic policies. In 2009, GDP is now expected to contract by 6.7 percent, double the projected rate at the time of the first review. In line with this projection, first quarter GDP was 6.7 percent lower compared to a year ago. In 2010, GDP is expected to contract by another 0.9 percent, with a gradual recovery setting in only in the second half of the year.

7. Consumer price inflation is projected to increase to 4.5 percent in 2009 (annual average), due mainly to a five percentage points VAT hike in July 2009, and delayed pass-through of the currency depreciation experienced during the first quarter. At the same time, the large output gap will mitigate price pressures. Average inflation is projected to be 3.8 percent in 2010, and should return to the central bank's midpoint inflation target of 3 percent in 2011.

8. The trade balance is improving, in line with a current account adjustment of more than 4 percentage points of GDP that is expected to play out over the course of 2009 and 2010. Although exports and imports have continued to decline, the pace of the export contraction appears to have moderated, leading to a trade balance surplus of 2.9 percent of GDP in the first quarter of 2009. Going forward, imports are expected to continue to fall as domestic demand contracts. Exports, while suffering from very low demand in trading partner countries, are expected to benefit from the exchange rate depreciation, and—starting from 2010—a reduced tax wedge on labor. On this basis, the current account deficit is expected to narrow to 4.1 percent in 2009 and to 4.0 percent in 2010.

9. The existing official financing package continues to provide adequate support for 2009. Funding of parent banks to their Hungarian subsidiaries has remained roughly stable. Non-residents holdings of government bonds have continued to fall, although the pace of the sell-off has declined. Given the continued fragility of the global financial outlook, the larger than originally programmed reserves buffer can help improve confidence in the strength of Hungary's external position. However, Hungary's high debt rollover needs combined with the fragility of global financial conditions suggests an external financing need in 2009 broadly in line with original program projections. We intend to revisit the external financing outlook for 2010–11 later in the year, and, if necessary, discuss the need for a possible extension of the program.

Fiscal Policy and Structural Fiscal Reforms

10. In the face of substantial tax revenue losses caused by worsening macroeconomic conditions, a central objective of the program is to contain the government's financing need in the short term and to substantially reduce it over the medium term. To anchor market expectations, stabilize financial conditions, and provide room for lower interest rates, we are implementing comprehensive structural reforms aimed at permanently reducing public expenditure—through entitlement and public service reforms—and bolstering potential growth—through tax reforms. The resulting improvement in the structural fiscal balance will put the public debt-to-GDP ratio firmly on a declining path, gradually creating the fiscal space needed to ease the excessive tax burden.

11. Our commitment to fiscal sustainability rests on a substantial augmentation of the structural reform package announced in February (March 2009 LOI para. 15), focusing savings on untargeted transfers and inefficient subsidies. The government is committed to preserving social safety nets and income support for the poor in a way that does not affect the budget balance. The key new (or amended) measures are as follows:

- *Pension reforms.* First, the new indexation formula for pension benefits gives a greater weight to CPI than initially envisaged by linking lower CPI weight to higher GDP growth (1% point shift in each band). Second, the 13th month pension has been abolished for all and replaced by a pension premium conditional on expected real GDP growth being above 3.5 percent. Third, we accelerated the planned increase in the statutory retirement age to 65 (by half a year annually from 2012, with consideration for gender and age). Fourth, early retirement more than 2 years before the statutory age is prohibited for female and male employees born after 1958 and 1954 respectively. To further discourage early retirement, we accelerated the introduction of a penalty (“malus”) system by which pension benefits are reduced proportionally to the remaining time to reach the statutory age. These reforms were approved by Parliament on May 11, 2009. The original pension reform bill, which was submitted to Parliament in March 2009 in line with the structural performance criterion, was amended in order to make way for the more ambitious reforms.
- *Wage moderation in the civil service.* The overall wage bill of the public sector will not increase in nominal terms over the next 2 years. This reflects (i) the abolition of the 13th month salary, (ii) the non-indexation to inflation in 2009 and 2010, and (iii) lower remunerations for management staff. Savings from the reduction in employers’ social security contributions will be fully preserved. Salaries will be adjusted to protect the purchasing power of income at the lower end of the scale. We envisage the introduction of a top-up payment contingent on expected real GDP growth.
- *Better targeted and more efficient transfers.* The cash support system for the first years of parenthood will be limited to 2 years. The maximum eligibility age for child support will be reduced by 3 years, to 20 years of age. These changes were enacted by Parliament on May 25, 2009.
- *Reduction in inefficient subsidies.* As part of the 2010 budget, all energy subsidies will be abolished. National farm support will be decreased by an additional HUF 45 billion on an accrual basis. The interest subsidy on forint-denominated mortgages and the universal housing subsidy will be abolished for all home purchases. The changes to housing subsidies were implemented by government decree on May 27, 2009.
- *More focused and more efficient delivery of public goods and services.* We will reduce local government mandates and encourage efficiency gains in line with an overall savings of at least HUF 120 billion in 2010. The budgetary costs of railway transportation will be reduced by mandating cuts in operating expenses of the state railway company MAV-start, and by reviewing price subsidies (tighter eligibility). By the time we submit the 2010 budget to Parliament, we will identify measures consistent with a HUF 40 billion reduction in public transportation subsidies, notably in the MAV-start appropriation. We will fully reflect these

savings in the 2010 public service contract to be signed with MAV-start by the end of the year.

12. Revenue-neutral tax reforms aimed at reducing the tax wedge on labor and bolstering potential growth remain a key priority. We will submit amendments to the tax package described in the March 2009 LOI (para. 16). Specifically:

- *Labor taxes.* As of January 2010, we will further reduce the tax wedge. Personal income tax will be calculated on a “supergross” basis (including employers’ social security contributions), but the top marginal tax rate will be reduced; the threshold for the top tax bracket will be increased; the tax rate for the lower tax bracket will be lowered, while the tax credit for wage earners will guarantee a declining tax burden for low-income employees.
- *Consumption and wealth taxes.* Effective July 1, 2009, the standard VAT rate will be increased by 5 percentage points to 25 percent, while a new reduced 18 percent rate will apply for certain basic dairy and bakery products and district heating. Effective January 1, 2010, the rehabilitation contribution paid by employers will be increased. A new value-based property tax will be introduced and will be collected centrally. Finally, the general transaction tax rate will be reduced and selected preferential regimes will be abolished.

Given the exceptional uncertainty related to the estimated revenue impact of these measures, we are committed to make all necessary adjustments that would be required to preserve the revenue neutrality of the package.

13. In 2009, lower-than-expected nominal GDP growth will reduce tax revenues and raise mandatory spending, including on unemployment benefits and other social safety nets. In 2009Q1, the primary balance of the central government system was above the end-March program floor (performance criterion), as good control over discretionary spending and delayed transfers to MAV-start (pending the signature of a public service contract) more than offset emerging tax revenue shortfalls and pressures on mandatory expenditure. Looking ahead, on unchanged policies, we would have expected a revenue shortfall of about HUF 320 billion, higher mandatory expenditure of about HUF 40 billion, and a loss of HUF 60 billion related to the recent European Court of Justice ruling on VAT refunds, relative to the estimates at the time of the First Review. Fully offsetting the deficit-increasing impact of the recession would have required emergency (temporary) measures with large adverse demand effects and would have undermined the focus on structural reforms. Therefore, we have identified partial offsets of about HUF 170 billion that are largely related to our augmented reform package: (i) the elimination of the second installment of the 13th month pension and the postponement of the 2009 pension correction until 2010; (ii) a reduction in the wage bonus of senior civil servants; (iii) a nominal freeze in family allowances; (iv) a decrease in the replacement rate for sick leave benefits from 70 to 60 percent of the salary; (v) efficiency gains in vocational training programs; and (vi) the freezing of the positive balance of the research and development fund. In addition, the tax

reforms described above are expected to increase revenue in 2009 by about HUF 50 billion. This implies a revised ceiling for the general government deficit of 3.9 percent of GDP, compared to an original ceiling of 2.9 percent. Program floors for the primary cash balance of the central government system (performance criterion) have been adjusted in line with the new budgetary projections.

14. We do not envisage further adjustment measures this year. Any additional revenue shortfall or mandatory expenditure overrun unambiguously related to macroeconomic conditions will be accommodated by the contingency reserve of 0.3 percent of GDP. Should the latter prove insufficient, we will consider adjustments to the 2009 targets and the need for further measures. Conversely, should the ongoing recession prove milder than currently anticipated, we will not ease our saving plans or allow for additional tax relief.

15. Looking forward to 2010, we are committed to submit a budget consistent with a reduction of the fiscal deficit in proportion of GDP, and will assess the eventual need for additional measures as the uncertainty about the economic outlook dissipates. For 2011, we firmly intend to bring the deficit below 3 percent of GDP.

16. Institutional reforms underpinning fiscal responsibility are proceeding well. First, we have secured a budget appropriation commensurate to the mandate of the Fiscal Council. The Council's secretariat—including about 40 professional staff—should be fully operational by year-end. Second, we will conduct a thorough review of our budgetary procedures, in consultation with the Fiscal Council and the relevant parliamentary committees, to identify weaknesses and possible inconsistencies with the Fiscal Responsibility Law (FRL), including the need for a stronger medium term focus of budget management.

Financial Sector Policies

17. The banking system has remained stable. Profitability at the end of the first quarter of 2009 was still high, with return on assets of 1.1 percent on a 12-month basis. Lower operating expenses and non-recurring earnings compensated for lower net interest income and increased provisioning. Domestic and external funding of the banking system has continued to be stable, as has lending to the Hungarian economy. The banking system's capital buffer remains solid, with a capital adequacy ratio of 10.3 percent, and the share of non-performing loans, though growing, continues to be moderate. Going forward, however, higher funding costs and more provisioning as a result of the recession's impact on non-performing loans are expected to weigh on banks' profitability and capital adequacy.

18. We are completing the support measures for the banking sector that we started to put in place in late 2008:

- We amended the Financial Stability Act in March 2009 by extending the availability of the capital enhancement component through end-2009 and by clarifying the law with respect to the thresholds concerning a severe deterioration in the financial condition of banks (March 2009 LOI para 18). In March 2009, we did not amend the

Act regarding the procedure to determine the price at which the shareholders of a troubled bank can sell their share to the state, because §18(1) of the Act already specifies that, if the Hungarian State increases the capital of a bank ex officio, it will exercise the rights of the general meeting of the bank (from the entry into force of the Government Decree). As the selection of the auditor is one of the rights of the general meeting, this right will be exercised on behalf of the state by the Minister of Finance. In this situation, in exercising its powers, the Minister of Finance will appoint an independent auditor selected jointly by the central bank and the HFSA, and direct the auditor to determine the value of the bank on the basis of its current and prospective financial conditions. On May 22, 2009 we have submitted to parliament an amendment to the Financial Stability Act to ensure that it is clear that the auditor under §16(3) of the Financial Stability Act is different from any auditor that conducted the audit during the two previous years under Act CXII of 1996 on Credit Institutions.

- The government has extended direct loans in foreign currencies to three banks for a total of € 2.4 billion. One of the banks has also received a capital injection from the government of € 100 million under the Financial Stability Act. In March 2009, we appointed the members and thus established a sub-committee of the Financial Stability Committee to monitor the financial soundness and stress-resilience of any bank that receive capital or funding support from the government (structural performance criterion for end-March 2009). The subcommittee held its first official meeting on May 12, 2009. It consulted Fund staff on its work program for the first time on May 15, 2009 (continuous structural benchmark).

19. We have also taken steps to further secure the support provided by the parent banks of the largest foreign bank subsidiaries in Hungary. On May 20, 2009, we held discussions with the subsidiaries' parent banks in Brussels, in close cooperation with the Fund and the European Commission (EC), and as part of the European Banking Group Coordination Initiative. In their concluding statement, the parent banks confirmed their commitments to maintain their overall exposure in Hungary, and to provide additional capital for their Hungarian subsidiaries should the need arise.

20. To assess the banking sector's shock-absorbing capacity, the Hungarian National Bank (MNB) conducts macro stress-tests on a regular basis. The results of the most recent exercise, published in the April 2009 Financial Stability Report, indicate that under a severe recession scenario a capital injection of € 0.7–0.9 billion might be required to ensure that all banks meet regulatory requirements. We will conduct further credit, market, and liquidity risk stress testing exercises in collaboration with Fund staff. These will take into account the methodology that Fund staff is developing for a common region-wide stress testing exercise to assess the level of financial sector stress in countries in emerging Europe. The results will be discussed with banks to assess any need for further strengthening current capital and liquidity buffers.

21. The HFSA needs to further step up its on-site bank examination activities and capabilities, given the development of Hungary's banking system, including its international expansion. To address this, the HFSA has started comprehensive on-site inspections of the largest banks, with the assistance of the World Bank, and the sequencing of inspections will be determined using a risk-based approach. The HFSA will seek close collaboration with the MNB and home-and host-country authorities. The HFSA has also developed an action plan to strengthen its operational capabilities in the field of on-site bank examinations (structural benchmark for end-May 2009). Its implementation will proceed expeditiously, as part of the move toward a forward-looking and risk-based supervisory approach, in line with international best practice. Moreover, the plan will be continuously reviewed and upgraded to ensure its effectiveness. We will also reconsider the current organization of the supervision of the financial institutions to check if it is still the most suitable for Hungary, and have requested technical assistance from the IMF in this regard.

22. We amended the Law on Credit Institutions and Financial Enterprises and other financial sector legislation to strengthen the remedial powers of the HFSA in March 2009. These amendments establish higher thresholds for the appointment of the supervisory commissioner, including on a mandatory basis, and incorporate broader powers such as regarding the disposal of bank assets. Also, limits are set on the possible personal civil liability of the supervisory commissioner, and some clarification is provided on the role of HFSA in the initiation of bank liquidation proceedings. These amendments are a first step in the implementation of the measures contemplated under the program's structural benchmark for end-June 2009. However, the task of building a more robust bank resolution regime has proven more challenging than expected. We have therefore formed another subcommittee of the Financial Stability Committee (comprised of representatives from the Ministry of Finance, HFSA, and MNB) to identify the key areas in need of strengthening in the current framework. The subcommittee will prepare a work program and formulate reform proposals, including more refined triggers for remedial actions by the HFSA and a more comprehensive range of bank resolution techniques, which may include purchase-and-assumption transactions and bridge banks, and may come with temporary limitations of shareholders' rights. The subcommittee's work program will be ready by end-June 2009. Moreover, we are seeking technical assistance to assist in the formulation of the legislative proposals. As we envisage passage by parliament by the end of the year (as described in the March 2009 LOI ¶20), we request that the structural benchmark be re-set to end-December 2009.

23. We are considering additional measures to strengthen the financial system's stress-resilience and protect households against a possible further deterioration in financial and economic conditions. The measures aim at providing incentives to reduce households' debt payment burden in episodes of systemic stress, while safeguarding credit discipline and minimizing explicit or contingent liabilities to the public finances. Specifically, we have submitted to parliament a proposal to expand the existing partial household debt servicing guarantee. We are also working on measures to limit the financial and social consequences of foreclosures should there be a substantial increase in mortgage defaults. We will evaluate any such schemes under various macroeconomic assumptions—including scenarios that

substantially deviate from the baseline under the program—and will consult with IMF staff on their design prior to a possible submission to parliament.

Monetary and Exchange Rate Policy

24. The MNB remains committed to the inflation target of 3 percent over the medium term, while acting as needed to mitigate risks to financial stability. The MNB's key policy rate has been kept on hold since January 2009, with a view to avoiding excessive exchange rate volatility. Room to cut interest rates would emerge in case of a further strengthening of investor confidence and corresponding easing of financial strains.

25. Looking forward, CPI inflation will temporarily be boosted by the implementation in July 2009 of VAT and excise tax hikes (paragraph 7). Therefore, starting end-September, under the inflation consultation mechanism (ICM), we will monitor the headline CPI adjusted by 3.7 percentage points to account for the estimated technical effect of these tax increases (Table 2), starting in September 2009. The central point of the ICM remains at 3 percent, at the central bank's inflation target, and both bands of the ICM also remain unchanged.

26. In March the MNB introduced euro-liquidity swap tenders at 3 and 6-month maturities, thus further expanding its toolkit to adequately provide the economy with liquidity. Demand for these facilities has been relatively strong, and their inception has coincided with a marked improvement of conditions in the foreign exchange swap market, thus facilitating banks' efforts to match the currency structure of their funding with that of their assets.

27. A key objective of the government's economic program remains to gradually build up an adequate level of international reserves. The target for net international reserves (NIR) under the program is designed to meet this objective, while allowing room for stabilizing market conditions in a fragile external environment. The government will refrain from issuing short-term debt for the purpose of meeting the NIR target.

/s/
Péter Oszkó
Minister of Finance

/s/
András Simor
Governor of the MNB

Attachments

Table 1. Hungary: Program Monitoring

Measure	
Quantitative Performance Criteria	<u>March 2009</u>
1 Floor on the cash primary balance of the central government system	Observed
2 Floor on net international reserves	Observed
Continuous Performance Criteria	
Non-accumulation of external debt arrears	Observed
Inflation Consultation Clause	
Inner band	Observed
Outer band	Observed
Indicative Target	
Ceiling on total debt stock of the central government system	Observed
Structural Performance Criteria	
1 Submission to Parliament of all legislative changes required to implement the measures on pension reform described in paragraph 15a of the March 2009 Letter of Intent by end-March 2009	Observed
2 Submission to Parliament of amendments to the Financial Stability Act as listed in Paragraph 18 of the march 2009 Letter of Intent by end-March 2009	Partially observed, corrective action taken
3 Establishment of a new sub-committee of the tripartite Financial Stability Committee to monitor the financial soundness and stress-resilience of banks that receive capital or refinancing support from the government by end-March 2009	Observed
Structural Benchmarks	
1 Operation of the new sub-committee described in Paragraph 18 of the March 2009 Letter of Intent as long as there is any government capital or funding support outstanding to banks, and consultation of the sub-committee with Fund staff on its work program (continuous)	Observed
2 Development of an action plan to strengthen the operational capabilities of the HFSA in the field of on-site bank examinations (by end-May 2009).	Observed

Table 2. Hungary: Quantitative Program Targets

	2008			2009			Prog. proj.	
	end-Sep	end-Dec		end-Mar		End-Jun	End-Sep	End-Dec
	Actual	Prog.	Outcome	Prog.	Outcome	Prog.	Prog.	
I. Quantitative Performance Criteria								
1. Overall floor on the cumulative cash primary balance of the central government system (floor, in billions of forints) 1/	130	215	226	-280	-248	-155	-160	240
2. Cumulative change in net international reserves (floor, in millions of euros) 2/	17,096	...	+1,398	...	+1,464	...	...	...
II. Continuous Performance Criterion								
3. Non-accumulation of external debt arrears	n.a.	0	0	0	0	0	0	0
III. Inflation Consultation								
4. 12-month rate of inflation in consumer prices 3/								
Outer band (upper limit)		7.1		5.0		5.0	5.0	5.0
Inner band (upper limit)		6.1		4.0		4.0	4.0	4.0
Central point	5.7	5.1	3.5	3.0	2.9	3.0	3.0	3.0
Inner band (lower limit)		4.1		2.0		2.0	2.0	2.0
Outer band (lower limit)		3.1		1.0		1.0	1.0	1.0
III. Indicative Target								
5. Ceiling on the total debt stock of the central government system (in billions of forints) 4/ 5/	15,973	16,230	15,925	16,281	15,936	15,074	15,057	15,037

1/ Cumulative flows from the beginning of the calendar year.

2/ The end-September 2008 NIR figure is a stock. The change in NIR for December is from September 2008, the cumulative changes for 2009 are from December 2008.

3/ The inner band for consultation is +/-1 percentage points around the central point, and the outer band is +/-2 percentage points around the central point. Starting end-September 2009, under the inflation consultation mechanism, we will monitor the headline CPI adjusted by 3.7 percentage points to account for the estimated technical effect if increases in VAT and excise taxes (see TMU).

4/ Foreign-currency denominated debt calculated at program exchange rates.

5/ These are the indicative target ceilings adjusted for EU transfers and other items described in the TMU. Before adjustment, these ceilings were 16,320 for end-December 2008 and 15,872 for end-March 2009.

Table 3. Hungary: Structural Conditionality

Measure	
Structural Benchmark	
1 Operation of the new sub-committee described in Paragraph 18 of the March 2009 Letter of Intent as long as there is any government capital or funding support outstanding to banks, and consultation of the sub-committee with Fund staff on its work program	Continuous
2 Passage by parliament of the amendments strengthening the remedial powers of the HFSA and bank resolution regime as listed in paragraph 20 of the March 2009 Letter of Intent	By end-December 2009

ATTACHMENT II. TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

June 11, 2009

1. This Technical Memorandum of Understanding (TMU) defines the variables subject to quantitative targets (performance criteria and indicative targets), specified in the Letter of Intent (LOI). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets. Reference to “days” in this TMU should be understood to mean “business days in Budapest”.
2. The exchange rates for the purposes of the program of the Hungarian forint (HUF) to the Euro is set at HUF 243.17 = €1, to the U.S. dollar at HUF 169.15 = \$1, and to the Swiss franc at HUF 154.01 = CHF 1, the rates as shown on the Hungarian central bank’s (Magyar Nemzeti Bank, MNB) website as of September 30, 2008.¹

Central Government System

3. **Definition:** The central government system (CGS) is defined to include the central government (state budget), extra budgetary funds, and social security funds. In case the government establishes new extra budgetary funds, they will be consolidated within the central government system.

Quantitative Performance Criteria, Indicative Ceiling, and Continuous Performance Criteria: Definitions and Reporting Standards

A. Floor on the Net International Reserves of the MNB

	(In millions of Euros)
Outstanding stock:	
End-December 2008	18,493.8
Floor on cumulative change in net international reserves from end-December 2008:	
End- March 2009 (actual)	1,464
End-June 2009 (performance criterion)	...
End-September 2009 (performance criterion)	...
End-December 2009 (indicative target)	...

¹ These exchange rates were derived from the file posted on the MNB website at <http://english.mnb.hu/Resource.aspx?ResourceID=mnbarfolyamfile&f=0>.

4. **Net international reserves (NIR)** of the central bank of Hungary (MNB) are defined as the Euro value of gross foreign assets of the MNB minus gross foreign liabilities of the MNB with maturity of less than one year and all of the government's credit outstanding from the Fund. Non-Euro denominated foreign assets and liabilities will be converted into Euro at the program exchange rates. Data will be provided by the MNB to the Fund with a lag of not more than five days past the test date.

5. **Gross foreign assets** are defined consistently with SDDS as readily available claims on nonresidents denominated in foreign convertible currencies. They include the MNB's holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country's reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered, claims on residents, claims in foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options), precious metals other than gold, assets in nonconvertible currencies, and illiquid assets.

6. **Gross foreign liabilities** are defined consistently with SDDS as all foreign exchange liabilities to residents and nonresidents, including commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options), and banks foreign currency deposits against reserve requirements. Government foreign exchange deposits and forward liabilities arising from swap arrangements with the MNB are not treated as foreign liability of the MNB.

7. NIR targets will be adjusted upward (downward) by the surplus (shortfall) in program disbursements relative to the baseline projection. Program disbursements are defined as external disbursements from official creditors that are usable for the financing of the overall central government budget. In the case that Hungary participates in any SDR allocation between March 31, 2009, and the test date, the NIR target will be adjusted upward by 100 percent of the equivalent of the amount of the cumulative additional SDR allocation up to the test date, measured at program exchange rates.

External Program Disbursements (Baseline Projection)

Cumulative flows from end-December 2008:	(In millions of Euros)
End-March 2009	2,000
End-June 2009 (program projection)	3,500
End-September 2009 (program projection)	4,000
End-December 2009 (program projection)	5,000

B. Consultation Mechanism on the 12-month Rate of Inflation

8. **The quarterly consultation band for the 12-month rate of inflation in consumer prices** is based on the measure of the headline consumer price index (CPI) published by the Hungarian Central Statistical Office. Consistent with the headline CPI inflation target of the MNB, the central point for end-quarter inflation will be 3 percent, with lower and upper bands around each target of ± 1 and ± 2 , respectively. The targets for end-June 2009 and end-September 2009 are performance criteria, while the one for end-December 2009 is an indicative target. For the purpose of monitoring performance under the inflation consultation mechanism, CPI inflation will be adjusted by 3.7 percentage points, which is equal to the estimated technical impact of the VAT increase (3.4 percentage points) and the excise tax increase (0.3 percentage points), starting in September 2009. This has been calculated by applying the relevant tax increases to the applicable products in the consumer price index basket.

9. **The CPI inflation consultation band will be an important part of each review under the arrangement.** In line with our accountability principles, we are committed to report to the public the reasons for any breach of the inner band and our policy response. In this vein, the MNB will conduct discussions with the Fund staff should the observed year-on-year rate of CPI inflation fall outside the inner band. In addition, should the observed year-on-year rate of CPI inflation fall outside the outer band specified above, the authorities will complete a consultation with the Fund on their proposed policy response before requesting further purchases under the program.

C. Floor on the Cash Primary Balance of the Central Government System

	(In billions of forints)
Cumulative primary balance from January 1, 2009:	
End-June 2009 (performance criterion)	-155
End-September 2009 (performance criterion)	-160
End-December 2009 (indicative target)	240

10. The primary balance of a budgetary institution is defined as the difference between total revenues and non-interest expenditures of that institution.

11. The floor on the primary balance of the CGS will be monitored from above the line on a cash basis. It is understood that transfers among entities of the CGS are mutually consistent; hence, the difference between the simple sum of revenues and the simple sum of primary expenditures across all CGS entities yields the consolidated CGS balance. Should discrepancies arise, reconciliation between reported transfers and reported revenues from other CGS entities will be required before compliance with the CGS primary balance ceiling

can be assessed. Data will be provided by the Ministry of Finance to the IMF with a lag of no more than seven days past the test date.

12. For the purpose of the program, the primary expenditure of the CGS excludes any cash payment related to bank recapitalization and to transfers to the Bank Guarantee Fund.

13. Net lending of any component of the CGS will be considered as a non-interest expenditure item, whereas negative net lending of any component of the CGS will be considered as a revenue item.

D. Indicative Ceiling on Overall Stock of Debt of the Central Government System

14. The ceiling on the overall stock of the debt, as outlined below, shall apply to the HUF value of total stock of debt contracted by the central government system. Excluded from this indicative ceiling are credits from the IMF, external program financing, normal trade-related credits, reserve and long-term liabilities of the MNB, and the absolute net value of mark-to-market deposits of the Hungarian Debt Management Agency (ÁKK).¹ Liabilities related to the bank support package are not included. All stated benchmarks of ÁKK in terms of public debt management will be maintained as much as possible, depending on market conditions and the possible use of IMF credit.

Outstanding stock:	(In billions of forints)
End-December 2008 (actual)	15,925
End-March 2009 (actual)	15,936
End-June 2009 (indicative ceiling)	15,074
End-September 2009 (indicative ceiling)	15,057
End-December 2009 (program projection)	15,037

15. Data on the total stock of debt of the central government system will be provided to the IMF by ÁKK on a quarterly basis within 10 days of the end of each quarter.

16. The program exchange rate will apply to all non-HUF denominated debt.

17. The indicative ceiling will also be adjusted upward (downward) by the shortfall (surplus) in net EU transfers relative to the baseline projection which forms the basis of the

¹ According to ÁKK's benchmarks, foreign currency debt should be kept wholly in Euro denomination and the interest rate composition is also fixed. To meet this benchmark while issuing debt in non-Euro currency—such as the U.S. dollar, Japanese Yen, and the Pound Sterling—ÁKK uses cross-currency and interest rate swaps. To limit counterparty risks in such transactions, ÁKK places (or accepts) cash deposits as collaterals. Any such deposit thus increases public debt for reasons autonomous to the government's financing plans. For this reason, these mark-to-market operations are excluded from the indicative ceiling.

government budget and financing plans. The term “net EU transfers” refers to the net effect of pre- and post-financing of certain EU transfers, which are excluded from the public deficit but included in the public debt.

Net EU Transfers (Baseline Projection)

Baseline projections:	(In billions of forints)
End-June 2009 (program projection)	76
End-September 2009 (program projection)	-49
End-December 2009 (program projection)	-248

18. The indicative ceiling will also be adjusted upward (downward) for an increase (decrease) of the ÁKK’s cash reserves (built for liquidity management purposes) in the Single Treasury Account held at the MNB relative to the baseline projection.

Cash reserves at the Single Treasury Account (Baseline Projection)

Baseline projections:	(In billions of forints)
End-June 2009 (program projection)	437
End-September 2009 (program projection)	606
End-December 2009 (program projection)	184

E. Continuous Performance Criteria on Non-accumulation of External Debt Payments Arrears by the Central Government System

19. The central government system will accumulate no new external debt arrears during the program period. For the purposes of this performance criterion, an external debt payment arrear will be defined as a payment by the central government system, which has not been made within seven days after falling due.

20. The stock of external arrears of the central government system will be calculated based on the schedule of external payments obligations reported by the ÁKK. Data on external arrears will be reconciled with the relevant creditors, and any necessary adjustments will be incorporated in these targets as they occur.

21. The performance criterion will apply on a continuous basis. The ÁKK will provide the final data on the stock of the central government system external arrears to the Fund, with a lag of not more than seven days after the test date. This performance criterion does not cover trade credits.

INTERNATIONAL MONETARY FUND

HUNGARY

**Second Review Under the Stand-By-Arrangement, Request for Waiver of
Nonobservance of Performance Criterion, and Request for Modification of
Performance Criteria—Informational Annex**

Prepared by the European Department

June 11, 2009

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APPENDIX I HUNGARY: FUND RELATIONS
(As of May 31, 2009)

I. **Membership Status:** Joined on May 6, 1982; Article VIII.

II. General Resources Account:		SDR Million	Percent of Quota
Quota		1,038.40	100.00
Fund holdings of currency		7,287.07	701.76
Reserve position in Fund		73.83	7.11

III. SDR Department	SDR Million	Allocation
Holdings	1.78	N/A

IV. Outstanding Purchases and Loans:		SDR Million	Percent of Quota
Stand-By Arrangements		6,322.50	608.87

V. Financial Arrangements:			Amount Approved	Amount Drawn
	Approval Date	Expiration Date	(SDR Million)	(SDR Million)
Stand-by	11/6/08	4/5/10	10,537.50	6,322.50
Stand-by	3/15/96	2/14/98	264.18	0.00
Stand-by	9/15/93	12/14/94	340.00	56.70

VI. **Projected Obligations to Fund:** (SDR million; based on existing use of resources and present holdings of SDRs)

			Forthcoming		
	2009	2010	2011	2012	2013
Principal				2,897.81	3,161.25
Charges/Interest	84.23	167.47	167.47	137.50	43.76
Total	84.23	167.47	167.47	3,035.31	3,205.01

VII. **Exchange Rate Arrangement:**

The Hungarian forint is freely floating, effective February 26, 2008.

VIII. **Article IV Consultations:**

Hungary is on a 24-month consultation cycle. The last Article IV Board discussion took place on September 17, 2008. The associated Executive Board assessment is available at <http://www.imf.org/external/np/sec/pn/2008/pn08124.htm> and the staff report and selected

issues papers at <http://www.imf.org/external/pubs/cat/longres.cfm?sk=22374.0> and <http://www.imf.org/external/pubs/cat/longres.cfm?sk=22375.0>. Hungary has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions on the making of payments and transfers on current international transactions except for those maintained solely for the preservation of national or international security and that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

IX. Technical Assistance:

Year	Department.	Purpose	Date
1995	FAD	Tax administration	February
1995	FAD	Treasury	February
1995	FAD	Treasury	May
1995	FAD	Treasury	November
1995	FAD	Debt management	November
1995	MAE	Central bank internal auditing	November
1995	MAE	Monetary analysis and research	December
1996	FAD	Tax policy	May
1996	MAE	Central bank accounts	September
1996	FAD	Subsidies	November
1997	FAD	Subsidies follow-up	May
2000	MAE	FSAP	February
2000	FAD	Tax legislation	June
2000	STA	Money and banking statistics	October
2000	FAD	Tax legislation follow-up	November
2002	FAD	Expenditure rationalization	November
2004	STA	ROSC update of the fiscal sector	January
2005	MFD	FSAP update	February
2005	FAD	Tax policy and administration	October
2006	FAD	Fiscal ROSC	May
2006	FAD	Public-private partnership	September
2007	FAD	Tax policy	April
2007	FAD	Public financial management	June
2007	FAD	Tax administration	October
2008	FAD	Pension reform	May
2008	FAD	Tax administration	October
2009	FAD	Tax administration	March

X. Resident Representative:

Ms. Iryna Ivaschenko assumed her duties on May 1, 2009.



Press Release No.09/231
FOR IMMEDIATE RELEASE
June 23, 2009

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Second Review Under Stand-By Arrangement with Hungary and Approves €1.4 Billion Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the second review of Hungary's economic performance under a program supported by a 17-month Stand-By Arrangement (SBA). The completion of the review enables the immediate disbursement of SDR 1.26 billion (about €1.4 billion or US\$1.9 billion), bringing total disbursements under the program to SDR 7.58 billion (about €8.4 billion or US\$11.7 billion).

The SBA was approved on November 6, 2008 (see [Press Release No. 08/275](#)) for SDR 10.53 billion (about €11.7 billion or US\$16.2 billion). The arrangement entails exceptional access to IMF resources, amounting to 1,015 percent of Hungary's quota.

Following the Executive Board's discussion on Hungary, Mr. John Lipsky, First Deputy Managing Director and Acting Chair, stated:

“Weaker than expected external demand and tighter external financing conditions exacerbated the recession in Hungary. In these circumstances, policy settings have been revised to strengthen fiscal sustainability and preserve financial stability. More ambitious structural spending and tax reforms are under way to strengthen fiscal sustainability, allowing the partial accommodation of automatic stabilizers and an increase in the fiscal deficit target in 2009. The authorities’ commitment to the firm and timely implementation of appropriate policies is reassuring.

“Fiscal sustainability is being strengthened through structural spending reforms, while allowing an increase in the fiscal deficit in 2009, owing to the partial operation of automatic fiscal stabilizers. The permanent budgetary savings from expanded reforms to the pension system, social transfers, and subsidies are encouraging. These reforms, together with tax reform that will shift the tax burden from labor to consumption and wealth should boost labor participation and potential growth over the medium-term.

“The prompt implementation of the authorities’ revised program to preserve financial stability, including the careful monitoring of banks that receive government financial support and strengthening bank supervision, are important steps. It is recommended that the

authorities explore institutional arrangements that would provide the financial supervisory agency with the necessary regulatory powers, and that remedial action and bank resolution frameworks be quickly strengthened.

“Monetary and exchange rate policy will continue to target inflation over the medium term, while being prepared to act as needed to mitigate risks to financial stability and avoid risks to destabilizing the exchange rate. Looking ahead, a further strengthening of investor confidence and a corresponding easing of financial strains would create room for interest rate cuts,” Mr. Lipsky stated.