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Hungary: Request for Stand-By Arrangement—Staff Report; Staff Supplement; and Press Release on the Executive Board Discussion

In the context of the request for Stand-By Arrangement, the following documents have been released and are included in this package:

- The staff report for the Request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on October 30, 2008, 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 November 4, 2008. 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 staff supplement of November 4, 2008, on the assessment of the risks to the Fund and the Fund's liquidity position.

- A Press Release summarizing the views of the Executive Board as expressed during its November 6, 2008 discusion 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

Request for Stand-By Arrangement

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

Approved by Ajai Chopra and Adnan Mazarei

November 4, 2008

- **Stand-By Arrangement**. In the attached letter, the Hungarian authorities are requesting a 17-month, SDR 10.5 billion (€12.5 billion, US$15.7 billion, 1015 percent of quota) Stand-By Arrangement under the exceptional access policy. The request is being considered under the Emergency Financing Mechanism (EFM). An initial purchase of SDR 4.2 billion becomes available on approval of this request. In the letter, the authorities outline the rationale for adopting the economic program for which they seek Fund financial support and describe its economic policy objectives. Against the backdrop of global deleveraging, the two key objectives are (i) substantial fiscal adjustment to ensure that the government's financing needs will decline; and (ii) to maintain adequate liquidity and strong levels of capital in the banking system. The authorities' plan incorporates reductions in government expenditure, the introduction of a rules-based fiscal framework, the creation of new facilities to inject public funds into banks and to guarantee interbank borrowing, and improving liquidity management in the central bank.

- **Discussions**. During October 13−30, 2008 the staff team met with the Minister of the Economy and Development, the Governor of the central bank, the State Secretary for Finance, the Director General of the Hungarian Financial Supervisory Agency, and senior officials in these institutions, as well as representatives of financial institutions.

- **Staff**. The staff team comprised Ms. Gulde (head); Messrs. Morsink and Joshi (EUR); Mr. Debrun (FAD); Ms. Ong and Mr. Frécaut (MCM); and Ms. Barkbu (SPR). Mr. Rosenberg (Senior Resident Representative, Regional Office, Warsaw) assisted the mission. The mission cooperated closely with European Commission staff.

- **Publication**. The Hungarian authorities intend to allow the publication of the staff report.

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I. Background and Recent Economic Challenges

1. **Hungary was among the first emerging market countries to suffer from the fallout of the current global financial crisis.** As financial difficulties in advanced economies led to a decline in global liquidity and an increase in risk aversion, investors increasingly started differentiating among emerging markets. Hungary's high debt levels and significant balance sheet mismatches negatively affected investor appetite for Hungarian assets. While there was an earlier short episode of financial stress in March 2008, Hungary's financing conditions deteriorated sharply in mid-October 2008.

2. **Balance sheet vulnerabilities built up over a long period, reflecting both excessive borrowing by the Hungarian public and private sectors, and the high risk appetite of foreign investors** (Figure 1):

- *Large fiscal deficits led to rising government debt*. The general government deficit averaged more than 8 percent of GDP between 2002 and 2006, and tended to rise sharply in the run-up to parliamentary elections. As a result, general government debt amounted to 66 percent of GDP as of end-2007. In addition, the size of government is relatively large compared to other countries at similar comparable income levels.

- *Banks, including foreign-owned banks, played an important role in Hungary's increasing financial integration with the rest of Europe*. The main domestic bank accounts for 21 percent of banking system assets and the major foreign-owned banks account for another 52 percent. Starting from a low base, bank credit as a share of GDP has risen steadily, though is still low compared to advanced economies in Europe. With easy access to foreign currency-denominated funding, foreign-owned banks offered foreign currency-denominated loans, and this was copied by domestic banks. Households and many corporates found the lower interest rates on foreign currency-denominated borrowing to be attractive, even though they have no natural hedge against foreign exchange risk. Banks hedge their exposures, so their foreign exchange positions are broadly balanced, but the domestic nonfinancial sector is carrying a high degree of exchange rate risk, which could translate into credit risk for banks. Over half of bank lending to the nonfinancial sector is denominated in foreign currency (mostly euro and Swiss francs).

- *Sizeable financial inflows led over time to a high level of public and private external debt*. Hungary started the 1990s with higher external debt than neighboring countries in central and eastern Europe, reflecting a history of greater openness to the global economy. Along with the transition to a market economy and the process of accession to the European Union came substantial financial inflows that boosted productivity but also added to external liabilities. Financial inflows initially consisted mostly of foreign direct investment but—as financial and real integration with the rest of Europe deepened—shifted increasingly to debt-creating flows. External debt amounted to about 97 percent of GDP at end-2007.

3. **To reduce vulnerabilities, macroeconomic and financial policies had been strengthened since 2006.** Substantial fiscal consolidation began in mid-2006 and tax administration had improved significantly. With the fiscal deficit falling from 9¼ percent of GDP in 2006 to 5 percent of GDP in 2007, the general government debt-to-GDP ratio stabilized. Regarding monetary policy, the design and implementation of the inflation targeting framework have been in line with international best practice, and the exchange rate band was eliminated in early 2008. CPI inflation, after surging in early 2007 due to the increases in VAT rates and excise taxes associated with the fiscal consolidation, has been falling steadily (notwithstanding the rapid increases in global food and energy prices in 2008) to 5¾ percent in September 2008. In the financial sector, the authorities published guidelines on banks' risk management and consumer protection related to foreign currency loans.

4. **Reflecting the impact of fiscal consolidation on domestic demand, economic growth slowed and the current account deficit narrowed in 2007** (Figure 2). Weaker domestic demand led to some easing of pressures on resource constraints. However, credit growth remained robust, reflecting investment in export-oriented industries and some smoothing of consumption. As a result, households' debt service burden kept rising and, with most new borrowing in foreign currency, household and corporate sector net foreign currency liabilities increased. Export growth remained solid, reflecting in part exporters' ability to expand into fast-growing markets in emerging market countries. The substantial improvement in the trade surplus was partly offset by a deterioration in net income, due largely to higher earnings of export-oriented foreign-owned companies. The composition of external financing remained largely debt-creating, though this reflected in part one-off transactions related to the change in ownership of Budapest airport and share buy-backs by the state-owned oil company.

5. **Even though policies had been strengthened in recent years, the combination of Hungary's high debt levels, its role as the home country of a regionally active bank, and global deleveraging gave rise to liquidity pressures** (Figure 3). Financial markets in Hungary have come under significant stress in recent weeks, reflecting the decline in foreign investors' appetite for domestic currency-denominated assets and the rise in perceptions of counterparty risk. Banks are having difficulties rolling over maturing foreign currency swaps. Auctions of government securities have been less than fully successful and liquidity in the secondary government securities market has tightened. At the same time, government bond yields and sovereign CDS spreads have risen sharply, the stock market has fallen, and the currency has depreciated. Several banks have announced that they will slow the growth of lending, particularly foreign currency-denominated lending.

6. **The key economic challenges include the full recognition of all underlying risks and a stronger policy response.** Compared to other emerging markets, Hungary's higher "stock vulnerabilities" imply that a large amount of debt needs to be serviced and rolled over. Added risks include the large share of foreign currency lending by both domestic banks and subsidiaries of foreign parents. These exposures were hedged, but the use of foreign exchange swaps for this purpose exposed systemically important banks to significant rollover risk in the foreign exchange swap market. Past policy action has been insufficient to reduce these risks. In particular, fiscal and current account deficits of recent years did not come down sufficiently.

II. THE SBA-SUPPORTED PROGRAM

A. Overall Program Objectives

7. **The SBA-supported program is designed to strengthen Hungary's economy and thereby a foster a return of less stressed financial market conditions.** A strong emphasis on credibility reflects the nature of the crisis, and Hungary's relatively high dependence on foreign financing. Program goals also reflect the authorities' and the staff's agreement on longer-term policy priorities for Hungary. They include the need to reduce the size of the comparatively large public sector in the country, and to lower the structural risks stemming from balance sheet mismatches in Hungary's financial sector. This program is consistent with Hungary's commitments to the European Union (Box 1).

8. **The program will also reduce regional vulnerabilities and spill-over effects that could result from prolonged financial instability in Hungary.** A Hungarian financial group is active in several emerging market countries in Central and South Eastern Europe. Ensuring that this group remains strong and well capitalized will enhance credibility of its subsidiaries, and reduce the risk of instability in its host countries. In addition, banks from different euro-zone countries are active and prominent in Hungary. If unaddressed, any crisis in Hungary could have significant negative spill-over effects back to the home markets of these banks.

9. **The program is based on strong, highly visible policy measures, coupled with sizeable financial support.** Together, these two pillars are expected to stabilize expectations in key markets, thus support rollover rates, and lay the foundation for a return of investor confidence.

- ***Strong policy program***: The main pressure points in Hungary are the public finances and the banking sector. Given Hungary's large public debt, substantial fiscal adjustment is needed to provide confidence that the government's financing needs can be met in the short and medium run. At the same time, upfront bank capital enhancement is needed to ensure that banks are sufficiently strong to weather the imminent economic downturn, both in Hungary and in the region.

- ***Large external financing assistance*** is essential to minimize the risk of a run on Hungary's debt and currency markets, given the large external debt stock. With the holders of Hungarian debt being a broad and diversified group, official intervention in the form of a very substantial external financial buffer will help to shore up private investor confidence. At the same time, large private sector creditors—notably the foreign parent banks of the major banks in Hungary—have been encouraged to maintain their exposures to Hungary and have responded favorably.

Box 1: Hungary: Cooperation with the European Union

Article 119 of the Treaty Establishing the European Community requires that a non-euro area member country consult with the European Commission and the European Union's economic and financial committee (EFC) on its balance of payments needs before seeking assistance from other sources. Prior to the recent events in Hungary, no operating procedures had been developed for such interaction between the EU and the IMF. The process as developed in the case of Hungary could, however, become a reference on how to proceed should further cases of a similar nature arise—i.e., EU member states that are not participating in the ERM II mechanism. Key principles would include:

1. Early consultation and ongoing information exchange during program negotiations: Fund and Commission staff consulted each other as soon as Hungary reported difficult financial market conditions and the potential need for balance of payments support. In view of the severity and urgency of Hungary's situation, the EU agreed that consultation with the EU and IMF could be in parallel, and ensured a highly accelerated implementation of normal consultation procedures (e.g. through conference calls). An EU mission overlapped with the IMF mission in Budapest for the first few days. During the remainder of the mission both teams cooperated, and coordinated efforts to proceed at the same pace. When discussions had well advanced but before final agreement had been reached both IMF and the Presidency of the Ecofin Council and the Commission made coordinated announcements to the press on their readinness to provide support to Hungary.

2. Contribution of both institutions to financing needs. The final program package (€20 billion) contains sizeable contributions from the IMF (€12.5 billion) and the EU (€6.5 billion), as well as a contribution from the World Bank (€1 billion).

3. Joint announcement to underline broad support. Staff level agreement on the programming package and the EU agreement to participate in the support package were announced in coordinated press releases by the IMF and the EU before financial markets opened on October 29. Both institutions attended a press conference later that day organized by the authorities. The IMF and EU support will be front loaded to address the urgent balance of payments needs early under the program .

4. Consistency of program design and conditionality. Both institutions will rely on policy conditionality to support program implementation. As agreed during the initial discussions among the institutions on procedures, it is expected that the EU conditionality to be included in the EU Council decision and Memorandum of Understanding will be consistent with IMF conditionality. In addition, EC surveillance mechanisms will incorporate policy commitments made by the authorities.

5. Consultation during the program monitoring process. With staff level links firmly established, there will be regular consultation during the program period. In cases where deviations from the program trigger consultation under the IMF program, the authorities will in parallel inform the EU and both institutions will coordinate closely during the related discussions.

B. Macroeconomic Framework

10. **The Hungarian economy's response to the global deleveraging is expected to be similar to the pattern of previous capital account crises, though less severe.** There are four mitigating factors. First, unlike Asia in 1997-98, Hungary is starting from a period of low growth rather than overheating; second, EU structural funds are expected to provide a stable source of financing and to limit the fall in investment; third, the program includes assurances from foreign parent banks that they will maintain their exposures;[1] and finally, early policy action and external support will be in place at the outset, helping to head off negative feedback loops.

11. **Given the global and domestic downturn, the adjustment in 2009 will be significant** (Table 1):

- *Output* is expected to contract by about 1 percent in 2009. Already weak private consumption and investment will be negatively affected by both a sharp reduction in new bank lending and the depreciation of the exchange rate, which increases debt servicing on foreign currency denominated loans. With no fiscal space and tight financing conditions, fiscal policy will not be able to provide stimulus.

- *Inflation*, which peaked at 9 percent (year-on-year) in early 2007, currently stands at 5¾ percent. It is expected to continue its downward trend and reach 4 percent at end-2009. The opening of a large negative output gap and the decline of global food and energy prices is expected to outweigh the effect of the depreciation of the exchange rate.

- The *current account* has already been gradually narrowing in past years (Table 2). It is projected to drop by more than 4 percentage points of GDP between 2008 and 2009, mainly due to the depreciation of the real exchange rate—well within the range observed among recent capital account crisis countries—and lower growth. The process will be driven primarily by a sharp contraction of imports (which are partly upheld by imports related to investments related to EU-funds).

- The balance in the *capital and financial account* is expected to fall from a surplus of €8.2 billion in 2007 to €6.4 billion in 2008 (with a large deterioration in the last quarter) and to a deficit of €7.5 billion in 2009 (with some improvement late in the year, when markets will have regained confidence). The capital account will improve somewhat as the absorption of already committed EU funds increases. However, net portfolio flows (which include financial derivatives, notably swaps), external borrowing by the government and lending to corporates are expected to slow sharply. Foreign-owned banks, which account for some 60 percent of banks' short-term

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[1] See paragraph 24.

external debt, are cautiously assumed to roll over 80 percent of their funding from parent banks. Rollover rates for other forms of debt are assumed to be 70 percent.[2]

12. **In a difficult global environment and with low domestic demand, the economy is projected to recover only gradually.** Growth is expected to reach its estimated potential of 3 percent after 2011 (Table 3). This U-shaped adjustment pattern (rather than the V-shaped. pattern observed in previous capital account crises) reflects the simultaneous GDP slowdown in Hungary's main trading partners and the global deleveraging process, which leaves less foreign capital available to quickly return to Hungary than was the case after the Asian crisis. After contracting sharply in 2009, the current account adjusts slowly over the medium term due to sluggish response of investment, combined with a slow improvement in national savings.

C. Fiscal Policy Stance and Fiscal Framework

13. **In recent years, fiscal consolidation has been the cornerstone of the government's efforts to reduce macroeconomic vulnerabilities** (Table 4). This fiscal strategy was adopted in mid-2006 following several years of expansionary policies and high fiscal deficits. While consolidation brought the headline deficit figures down from 9¼ percent of GDP in 2006 to an expected 3.4 percent in 2008, past fiscal excesses have left Hungary vulnerable to a government funding crisis, given the large size and the maturity structure of government debt. Looking forward, the growing interest burden on outstanding debt will thus also limit the room for maneuver for further fiscal adjustment. Fiscal consolidation is also constrained by the composition of expenditures, including a comparatively high government wage bill, and a high share of pensions and social transfers.

14. **Given still high vulnerabilities, the authorities believe that further fiscal consolidation is needed for a credible medium-term policy stance** (Box 2). Foreign participants play an important role in the Hungarian treasury bill and government bond markets.[3] Funding difficulties experienced in March 2008 and more pronounced at the outset of the current crisis in October 2008, indicate that continued rollover of the large outstanding stock will require more ambitious fiscal targets to reassure markets about the solvency of the public sector. The authorities are concerned that a more accommodative stance—while politically less difficult—would put the success of the overall program at risk.

15. **The authorities' initial reaction to the crisis reflected their view that fiscal policy was insufficiently tight.** Fiscal policy for 2008 was tightened after the first signs of trouble

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[2] Capital inflows into Hungary come from a large number of sources. They include the parent banks of foreign banks, but both foreign subsidiaries and domestic bank also borrow from the a wide group of other sources, including wholesale interbank markets across Europe. The rollover rate is assumed at 80 percent for banks' short-term debt with parents; this covers about 68 percent of the total debt of banks that have foreign parents and about 40 percent of all banks' short-term debt. The rollover rate is assumed at 70 percent for all other short-term debt.

[3] Non-residents hold about 30 percent of Hungary's forint-denominated debt (about 8 percent of treasury bills and 35 percent of treasury bonds).

in the treasury bill market**.** After policy adjustment, primary government expenditures as a share of GDP are expected in 2008 to remain below the level envisaged in the budget. This will be achieved mainly by the government's recent decision not to use reserves that were built into the budget. As a result, the general government deficit is projected to fall from 4.9 percent in 2007 to 3.4 percent of GDP in 2008.

16. **In response to the further deterioration of market confidence, the program envisages a substantial revision of initial fiscal plans for 2009**. The authorities' proposals include a further tightening of the budget in an amendment to be submitted to parliament in early November (LOI ¶9). They reflect both the need to offset the revenue loss stemming from the deterioration in the economic outlook and the government's aim to reduce the borrowing requirements (Table 4). The program envisages a general government deficit of 2.5 percent of GDP in 2009, which would imply a large structural fiscal adjustment of 2½ percent of GDP (2 percentage points of GDP more than envisaged in the 2008 Article IV staff report). The program also envisages higher interest payments, reflecting mainly higher interest rates, and incorporates the financing needs in the fourth quarter of 2008 and the first quarter of 2009 connected with the bank-support package (Table 5). If there is a further deterioration in the macroeconomic outlook, staff will consult with the authorities on policy adjustments.

17. **To achieve these fiscal objectives, the authorities put emphasis on expenditure measures, consistent with their commitment to reduce the country's large public sector** (LOI ¶10). The program aims at a reduction of primary government expenditure by 2 percentage points of GDP, compared to 2008. All expenditures categories are affected, except interest payments. Measures included in the LOI are: (i) a nominal wage freeze and the elimination of the 13th monthly salary for all public sector employees (1 percent of GDP); (ii) the elimination of the 13th monthly pension for all early retirees and a cap of the 13th monthly pension to HUF 80,000 for other pensioners (0.2 percent of GDP); (iii) postponement or elimination of indexation of selected social benefits (0.2 percent of GDP); and (iv) across-the-board cuts in other spending allocations to ministries (0.5 percent of GDP). Within the capital expenditure envelope, priority will be given to investment projects cofinanced by EU structural funds (0.1 percent of GDP). On the revenue side, the authorities have already announced that tax cuts previously envisaged for 2009 will be postponed until sufficient fiscal space has been created through expenditure restraint. Under the program, the authorities will also not make any changes in the tax code that could lead to a net revenue loss.

18. **To put fiscal sustainability on a permanent footing, the government has submitted a draft fiscal responsibility law to parliament** (LOI ¶11). The law has been a contentious political issue. The authorities appear to have now assembled a parliamentary majority that would support a law with the following core elements: (i) fiscal rules on public debt (which cannot increase in real terms) and the primary balance (which cannot be negative); (ii) a strengthening of the medium-term expenditure framework (rolling three-year expenditure ceilings); and (iii) the creation of a non-partisan fiscal council to provide independent and expert scrutiny. The lack of a two-thirds majority in parliament forced the authorities to abandon initial plans to introduce stricter fiscal rules for local governments, and to enshrine an enforcement procedure in the constitution. The cost of violating the fiscal framework is therefore reputational: there is ample evidence that national fiscal rules

contributed to permanent improvements in primary balances in the European Union (see IMF Country Report No. 08/314, Chapter I).

Box 2. Fiscal Adjustment in IMF-Supported Programs in Capital Account Crises[1/]

In past capital account crises, fiscal policy aimed at striking the right balance between the needs to support macroeconomic stability and to deal with underlying vulnerabilities. This can be seen from the wide range of planned fiscal adjustments under IMF-supported programs during the crises. Specifically, planned improvements in headline fiscal balances ranged from 1 percent of GDP (Mexico, Argentina, Korea) to 5 percent of GDP in Turkey. Against this background, Hungary's program (1 percent of GDP) is at the low end of the range of planned overall balance adjustments.

That said, defining fiscal objectives consistent with medium-term debt sustainability was always an overarching concern. Targeted primary balances were accordingly set above the *medium-term* debt-stabilizing primary balances calculated on the basis of historical averages for nominal growth and interest rates—the only exception being Brazil (1999). In some cases, the urgent need to rapidly reduce public debt led to sizable margins over the debt-stabilizing balance—up to 5.7 percentage points of GDP in Turkey. Hungary's program is no exception: the required primary balance under the program is 3 percentage points of GDP higher than the *medium-term* debt-stabilizing primary balance; but it is below the *short-term* debt-stabilizing balance by 1.3 percentage point of GDP.

The impact of fiscal adjustment on market confidence was also an important concern in IMF-supported programs, particularly in countries exposed to a funding crisis because unfavorable debt dynamics (high real interest rates, low growth, large stock of outstanding liabilities) or short maturity structure. The extent to which fiscal adjustment actually helped bolster confidence is difficult to assess (many other contemporaneous factors were at play) and varied across countries. However, the evidence suggests that fiscal adjustment has been instrumental in reversing capital flows in countries with well-identified public sector vulnerabilities or fiscal credibility issues (Brazil, Turkey, and to a lesser extent, Argentina and Mexico). In contrast, fiscal adjustment in Asia—where fiscal vulnerability was low—did not seem to have any short-term impact on capital flows.

In emerging market countries with debt overhangs, the "Keynesian" effect of fiscal adjustment is likely to be outweighed by "non-Keynesian" effects related to expectations and credibility.[2/] Non-Keynesian effects have to do with the offsetting response of private saving to policy-related changes in public saving. In particular, if fiscal adjustment credibly signals improved public sector solvency, a fiscal contraction could turn out to be expansionary, as private consumption rises based on the view that future tax hikes will be smaller than previously envisaged.

1/ Ghosh, A. and others, 2002, *IMF-Supported Programs in Capital Account Crises*, IMF Occasional Paper No. 210

2/ *World Economic Outlook* October 2008.

D. Financial Sector and Financial Markets

19. **Hungarian domestic banks have entered this period of market stress with strong solvency positions.** While solvency is still robust, liquidity pressures have emerged, in part driven by developments in the largest Hungarian bank's foreign subsidiaries. As a result, liquidity pressures were strongest for domestic banks, which also lack the support and added credibility of a strong parent. To mitigate heightened risk perceptions, the government announced a blanket guarantee of all banks' deposits on October 8. To further buttress credibility and ensure soundness of all banks operating in Hungary, the program includes a strong bank-support package. As an additional aim, the measures will also ensure that the main domestic bank can continue to be a responsible parent of its foreign bank subsidiaries in the region. The package was designed by the authorities in consultation with the mission and is in line with other recent initiatives in Europe (Box 3). Submission of the necessary legislation by November 10, 2008 will be a structural performance criterion (LOI ¶15).

20. **The banking sector package contains provisions for added capital and funds a guarantee fund for interbank lending** (LOI ¶15). Total funding of HUF 600 billion (2.2 percent of GDP) will be divided evenly between the Capital Base Enhancement Fund and the Refinancing Guarantee Fund. These Funds will be available to all private Hungarian banks of systemic importance with own funds above HUF 200 billion (0.73 percent of GDP). This in practice covers the three largest banks. The other 33 banks in the system, most of which are small and thus pose low systemic risk, are protected through the blanket guarantee of deposits by the government and the widened access to central bank refinancing through recently introduced liquidity facilities. Any amount not utilized in the Capital Base Enhancement Fund by end-January 2009 will be transferred to the Refinancing Guarantee Fund.

21. **The Capital Base Enhancement Fund has been sized to bring the eligible banks' capital adequacy ratio (CAR) up to 14 percent**. The two largest banks had CARs of just below 10 percent as of end-June 2008 and will be eligible for capital increases of around HUF 200 billion and HUF 100 billion, respectively.[4] Given the current exceptional level of uncertainty, capitalizing banks to this high degree is aimed at allowing them to withstand even a severe deterioration in the quality of their loan portfolio. Basic stress testing by staff indicates that, starting from a CAR of 14 percent, the largest domestic bank would be able to preserve a CAR of above 8 percent in the event of combined losses of 5 percent on HUF loans, 10 percent on foreign currency loans, and 10 percent on foreign subsidiaries' assets. The Capital Fund will acquire preference shares that will pay a dividend based on the cost for the government plus a margin of 2 percentage points, which will increase by one percentage point annually from 2011. Safeguard measures will complete the capital increases. Banks will have the option to repurchase these preference shares whenever compatible with maintaining a strong capital position.

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[4] For the largest bank, the ratio of equity to assets is higher than its CAR, because of the deduction from its regulatory capital of its participation in its banking subsidiaries.

Box 3. Europe: Cross-Country Comparisons of Financial Stability Measures

Hungary's financial stability measures to strengthen confidence in its banking sector are broadly in line with those in the major EU countries. The support package for the banking system—an integral part of the Program—comprises capital injections and bank guarantees by the government. The former is similar to that of the United Kingdom's in that additional capitalization is not aimed at distressed or troubled banks only. The bank guarantee scheme is different as it requires banks' qualification for capital injection as a pre-condition for the guarantee.

Other recent stability measures include enhancements to the deposit insurance and central bank lending schemes. The recent augmentation of deposit insurance coverage is consistent with EU agreements; in addition, the government has pledged a blanket guarantee for all deposits. In the event that systemic liquidity measures are required, the MNB noted that it has various tools that could be employed; however, it has not publicized them for moral hazard reasons. Foreign exchange liquidity is the key focus, and a foreign exchange swap facility has been established.

Box Table. Europe: Government Programs to Support Financial Stability in Selected Countries

Germany	France	Italy	United Kingdom	Hungary proposal
Capital Injection				
* Financial market stabilization fund may recapitalize banks up to €80 billkion using e.g. preferential shares. * Drawing capital from the fund possible until December 2009.	* A second funding vehicle, with funds of €40 billion will be established to inject capital into distressed financial firms.	* The government will intervene through direct recapitalisation or purchase of preferred assets, if a private bank is in trouble on a case-by-case basis. * No initial ceiling disclosed.	* Eligible banks must raise £25 billion in Tier 1 capital. The government has a facility to make Tier 1 capital available, in preference shares or PIBS. * Pref. shares purchased by the govt will pay a fixed 12% coupon and are not redeemable for 5 years.	* A HUF300 billion Capital Base Enhancement Fund will be established to provide further capital buffers for all private Hungarian banks with regulatory capital above HUF200 billion as of end-June 2008 (Eligible Banks). * Eligible Banks will have to apply for the support to MNB by January 31, 2009; any amount not utilized in the Capital Base Enhancement Fund will be transferred to the Refinancing Guarantee Fund. * The capital enhancement will take place in the form of Preference Shares that are senior to all other categories of shares in the payout of dividends; the return on the investment value of the Preference Shares is the 12-month treasury bill yield, plus a margin of 2 percentage points, which will increase by one percentage point annually from 2011.
Guarantees				
* Financial market stabilization fund will make guarantees up to €400 billion available for newly issued refinancing instruments with maturity up to 36 months. * Fee for guarantees >2%. * Valid until December 2009. * Government provision for defaults of 5% of the guarantee amount (€20 billion).	* The government pledged a €320 billion fund for newly issued bank debt issued before December 2009 and maturity up to 5 years. * Solvent banks will obtain financing in exchange for assets that cannot be repo'ed with the ECB.	* Announced a €20-30 billion emergency stabilisation fund to provide loans to banks to ease liquidity stresses. * Direct guarantee by the state of new liabilities until December 2009 and for maturities <= 5 years.	* Government will guarantee new debt issuance in £, $, €, with maturity up to 36 months. * To qualify for this support, the relevant institution must raise Tier 1 capital by the amount and in the form the government considers appropriate whether by government subscription or other sources. * Fee: per annum rate of 50 basis points + 100% of institution's median CDS between October 2007–08 (indicative median = 84 basis points).	* A special Guarantee Fund, which can be utilized from October 30, 2008 to December 31, 2009, will be established to secure the financing of Eligible Banks who have applied for and obtained support under the Capital Base Enhancement Fund. * The Guarantee Fund will be capitalized at HUF300 billion to guarantee new interbank loans and the issuance of new wholesale securities with maturities > 3 months and < 5 years. * The pre-funded guarantee will be provided against a fee not to exceed 4% per annum.
Deposit Protection				
Government guarantees all private savings accounts	€ 70,000	€ 103,000	£50,000	Increased from HUF6 million to HUF13 million (in line with EU agreements); pledged to provide a blanket guarantee on all deposits.
Central Bank Lending Schemes				
* As of October 15, 2008, increased haircuts on collateral: flat 12% haircut on all ABS with an additional 5% valuation markdown for ABS marked to model, versus previous rule of 2-18% range. * As of the procedure settled on October 15, 2008, regular MROs carried out via a fixed rate tender procedure, with full allotment at the interest rate on the main refinancing operation (currently 3.25%), at least until January 20, 2009. * ECB reduced as of October 9 the corridor of standing facilities from 200 basis points to 100 basis points around interest rate of MRO at least until January 20, 2009, i.e., marginal lending rate currently set at 3.75% and deposit rate currently set at 2.75%. * ECB will conduct 7-, 28- and 84-day U.S. dollar funding at fixed rate for full allotment, at least until January 2009. * As of October 15, 2008 and until end 2009, Expansion of eligible assets as collateral for credit operations to include: debt instruments denominated in currencies other than €, $,£ or yen, if issued within the euro area; euro-denominated syndicated credit claims governed by UK law; all CDs which are traded on non-regulated markets, subordinated debt with an acceptable guarantee; the credit threshold for marketable and non-marketable assets will be lowered from A- to BBB-, except for ABS.			* £200bn will be made available to banks under the SLS, which is extended to January 30, 2009. * BoE will conduct 7-, 28- and 84-day U.S. dollar funding at fixed rate for full allotment. * Extended range of eligible collateral: incl. AAA rated ABS of certain corporate and consumer loans.	* Established a foreign exchange swap facility, which is supported by a repo facility with the ECB amounting to €5 billion. * Created two new facilities to inject forint liquidity into the banking system: a two-week refinancing window at a fixed price and six-month tender with no fixed price. * Expansion of liquidity toolkit will be effected as needed, including expanding the definition of the useable collateral put up by financial institutions to obtain access to the MNB's facilities.

22. **The Guarantee Fund is meant to bring comfort to the providers of wholesale funding and secure the refinancing of the eligible banks.** Its endowment of HUF

300 billion (1.1 percent of GDP) will be invested in euro denominated government bonds of Euro area countries and managed by the MNB. Open for new transactions until end-2009, it will guarantee the rollover of loans and wholesale debt securities with an initial maturity of more than 3 months and up to 5 years, against a fee and with appropriate safeguards.

23. **Important further initiatives are underway to improve the resilience of the banking sector.** The government is seeking an agreement with commercial banks to mitigate the balance sheet risks of households from their exposure to foreign currency loans, and to put in place a private debt resolution strategy in the event that asset quality deteriorates significantly (LOI ¶13). The authorities are also stepping up efforts to strengthen the HFSA's and MNB's capacity to assess and address solvency and liquidity concerns in banks in a timely manner, and to ensure that the economy's access to banking functions is preserved at all times. A mechanism to grant the HFSA the necessary remedial powers for accelerated resolution of any failed bank will be submitted to parliament by end-December 2008 (structural benchmark) (LOI ¶15). These reforms will also facilitate quicker payout to insured depositors in case of need. Financial sector regulation and supervision will be further strengthened through the introduction of a positive credit registry for households; introduction of maximum loan-to-value ratio requirements for new mortgage loans, and close monitoring of foreign exchange exposures, among other measures.

24. **Foreign-owned banks are expected to remain strong players in Hungary.** Unlike in most capital account crises, foreign banks' exposure is to a significant extent to their subsidiaries. These subsidiaries represent a sizeable and strategic investment of the parent banks in "brick and mortar" and in the human capital of their employees. These subsidiaries have also been a major source of growth and profits for the parents. Given their long-term interest in Hungary as a market place, parent banks of all foreign subsidiaries have issued statements of support to Hungary, in which they affirm their willingness to support their clients forint and foreign exchange needs. Yet in line with a more difficult economic environment in Hungary and some foreign parents' own funding issues, some decline in lending in Hungary may be expected. As part of the program, stocks and flows of net foreign assets, as well as foreign exchange swap positions, will be monitored on a daily basis.

E. Monetary and Exchange Rate Policy

25. **Monetary policy will aim at gradually bringing inflation back to the official target by early 2010**. The exchange rate band was removed in early 2008, allowing the MNB to exclusively focus on its inflation target of 3 percent. Under the program, progress towards this goal will be monitored using a standard consultation clause. Monetary policy was tightened in the first half of 2008 in response to a rise in underlying inflationary pressures and again on October 22, when the MNB hiked the policy rate by 300 basis points to fend off a potentially destabilizing swing of the exchange rate. Looking forward, the MNB will continue to set the policy interest rate so as to bring inflation back to target at the two-year horizon (quantitative performance criterion, LOI ¶18). The MNB's efforts to reduce inflation should be supported by an agreement between the government and social partners to restrain nominal wage growth. With the risk that global deleveraging may continue to put downward pressure on the exchange rate (which could have inflationary consequences), monetary policy will need to remain vigilant and premature easing will be avoided.

Consistent with its inflation-targeting mandate, the MNB generally refrains from intervening on the foreign exchange market, except to stabilize disorderly market conditions.

26. **The MNB will ensure that the facilities created to manage domestic currency liquidity are managed well within the inflation targeting framework.** The MNB's liquidity-enhancing measures are solely intended to improve liquidity in various market segments, not to influence prices (including bond yields), which should remain fully market-determined. It should stand ready to further expand its toolkit as needed, including by modifying the Central Bank Act to simplify and expand the use of the collateral put up by financial institutions to obtain access to its facilities.

III. Program Modalities

A. Access

27. **Hungary has very large balance of payments financing needs through end-2009** (Table 6). The gross financing requirement is the sum of the current account deficit, obligations maturing during the program and the needed increase in gross reserves to cover about 80 percent of short-term debt at remaining maturity. Although the current account deficit is projected to decline to 2 percent of GDP in 2009, gross external financing requirements are still projected at about €39 billion through end-2009. Much of this financing is expected to be covered through foreign direct investment, net positive capital transfers with the European Union, portfolio flows, and bank and corporate foreign financing, leaving a €20 billion financing gap. Commitments by the European Union (€6.5 billion) and the World Bank (€1 billion) will lower the financing gap. Absent such financing, gross reserves would deteriorate substantially. Staff projects that gross reserves would fall to about €7.8 billion at end-2009, which would cover only 30 percent of short-term debt by remaining maturity, well below a desirable minimum.[5]

[5] At the end of the second quarter of 2008, reserve coverage was 72 percent of short-term debt by remaining maturity.

Box 4. Hungary: Exceptional Access Criteria

Staff's assessment is that Hungary meets all four criteria for exceptional access. The total access under the SBA would equal SDR 10.5 billion (€ 12.5 billion, 1015 percent of quota), and both the cumulative and annual access limits under the program would exceed the normal access limits, requiring an evaluation of the case for exceptional access based on the four substantive criteria under the exceptional access framework:

- **Criterion 1—Exceptional balance of payments pressure in the capital account resulting in a need for Fund financing that cannot be met within normal limits.** The combination of global deleveraging and Hungary's high vulnerabilities has increased capital outflows, as illustrated by the recent depreciation of the forint. The sharp increase in sovereign spreads and a number of less than fully successful government securities auctions indicate restricted market access.
- **Criterion 2—Sustainable debt position.** As the imminent economic slowdown will significantly reduce the growth of government revenue and higher interest rates will increase debt service payments, public debt sustainability hinges on further fiscal consolidation to keep the projected government debt-to-GDP ratio (66 percent of GDP at end-2007) firmly on a downward path, as illustrated in the baseline scenario (Table 8, Figure 5). However, staff's analysis, which includes stress tests and alternative scenarios, shows that Hungary's public debt outlook is vulnerable to shocks and underlines the fact that Hungary's debt outlook is critically dependent on a policy change. Under the baseline scenario, external debt as a share of GDP is projected to increase initially, from 97 percent of GDP at end-2007 to 116 percent of GDP at end-2009), given a projected substantial real depreciation in 2008–09 (Table 9, Figure 6). External debt would then come down as the exchange rate appreciates somewhat and less available external financing reduces the nominal amount of the debt. Stress test shows that the external debt outlook worsens significantly if the depreciation turns out to be larger than projected in the baseline scenario. By maintaining investor confidence, a strong economic program would help prevent a sharper and more long-lasting exchange rate depreciation, which would otherwise hurt external debt sustainability.
- **Criterion 3—Good prospects of regaining access to private capital markets.** Given the increased fragility of global investor confidence, Hungary's access to private capital markets has deteriorated. How quickly access improves depends on both developments in global markets and the strength of policy measures to ensure that macroeconomic and financial policies remain anchored. Hungary has a strong track record in servicing its external debt even in periods of acute balance of payments stress. In staff's view, Hungary's access to private financial markets will very likely be restored.
- **Criterion 4—The policy program provides a reasonably strong prospect of success, including not only Hungary's adjustment plans but also its institutional and political capacity to deliver that adjustment**. Hungary's track record of sound macroeconomic policy implementation over the past two years and robust institutions would underpin the proposed program. With political agreement reached on the economic program, staff believes the program has good prospects for implementation.

28. **To help contain the reserve decline, exceptional access in the amount of €12.5 billion (SDR 10.5 billion, 1015 percent of quota) will be needed**.[6] Of this, it is proposed that up to €5 billion be disbursed up front (Table 7). Staff assesses that Hungary meets the four criteria for exceptional access (see Box 4). Staff considers that SBA terms are appropriate given the uncertainty surrounding the speed with which investors will return, which itself depends the speed of re-establishment of normal conditions in global financial markets, and the associated risk that the balance of payments difficulties may require a longer time to resolve than the SRF maturity. [7]

B. Capacity to Repay the Fund and Risks to the Program

29. **Hungary's capacity to repay the Fund is expected to be strong, although continued high public sector and external debt are important risks**. By the end of the arrangement, Fund exposure is projected to be about 10 percent of GDP and 53.5 percent of gross reserves (Tables 8–9). Public sector and external debt are expected to remain elevated over the program period, with public sector projected at 66 percent of GDP and external debt at 105 percent of GDP at end-2010 (Tables 10–11, Figures 5–6). However, Hungary's excellent record of timely servicing its obligations and the likely improvement in global financing conditions in coming years provide assurances that Hungary will be in a position to discharge its obligations to the Fund in a timely manner.

30. **Notwithstanding the strength of the authorities' policy commitments, Hungary's capacity to repay the Fund could be impaired if significant downside risks materialize** (Table 12). Risks include accelerated capital outflows, which would lead to exchange rate overshooting and a sharper GDP growth slowdown than currently envisaged. Sharper than expected exchange rate adjustment would also imply additional pressures on household and corporate borrower's balance sheets, with attendant risks to the health of the banking sector. While the government is seeking an agreement with banks on reducing balance sheet risks to borrowers (LOI ¶13), agreement on the proposed measures has not been reached and failure to do so would be a further risk to the program. Also, while the assumed rollover rates are, in the view of the authorities, highly conservative, the program would be at risk if they should fall significantly or over a prolonged period under the assumed levels. Finally, the government does not have a majority in parliament. Much effort has been made to build broad political consensus and the authorities have the declared buy-in of a sufficient number of opposition parliamentarians, but under this constellation political risk remains a concern. In sum, the proposed arrangement with Hungary entails significant risks to the Fund.

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[6] As required under the exceptional access framework, a separate supplement accompanying this report assesses the impact of the new arrangement on Fund finances.

[7] There is a presumption under the exceptional access framework that the SRF reserves should be used to provide exceptional access in a capital account crisis. However, the SRF is intended for capital account crisis where an early correction of the balance of payment problem is expected.

31. **Several additional clauses have been included into the program to mitigate some of the above risks to the Fund.** The duration and phasing of the program intend to capture the macroeconomic framework and budget for 2010. In addition, upfront policy action aims at locking in fiscal performance (notably the submission of the Fiscal Responsibility Law) and conditionality (see below) aims to ensure sufficient strengthening of the banking sector (through providing a framework for additional capital and guarantees for interbank lending). Finally, daily monitoring of bank's foreign assets, liabilities, and swap positions should help to ensure that early policy discussions take place in case of emerging pressures under the program.

C. Program Monitoring and Conditionality

32. **The SBA will run over 17 months from November 2008 to March 2010** (Box 5). Size and timing of the disbursements should ensure that the program is able to support to Hungary's economic policies during the current period of global deleveraging. Given the high access level, and extraordinary uncertainty surrounding projections at the moment, staff will consult with the authorities on evolving risks and agree on policy adjustments needed to achieve the goals of the program, in line with the procedures under the EFM.

33. **Program performance will be monitored by quarterly reviews.** The first review under the program will be set for February 2009, based on end-December targets. Given the need to respond quickly to rapid changes in financial markets, besides quarterly reviews, conditionality focuses on measures critical for addressing the problems faced by Hungary. Limited structural conditionality is appropriate, given ongoing reform efforts in key institutional areas, and the progress over the past years.[8] In addition to standard performance criteria on exchange measures, the program includes four quantitative performance criteria: (i) a floor on the central government primary cash balance,[9] (ii) a consultation band on 12-month rate of inflation of consumer prices, and (iii) a continuous criterion on non-accumulation of external arrears. There is also an indicative target (ceiling) on the central government debt. Submission of the bank-support package law to parliament is a structural performance criterion for early November 2008. In addition, passage of the fiscal responsibility law and submission to parliament of a law granting the Hungarian Financial Supervisory Authority (HFSA) special remedial powers to accelerate the resolution of any failed bank are structural benchmarks.

34. **Staff have initiated a first-time safeguards assessment of the MNB, which will need to be completed no later than the first review under the SBA.** Audited financial statements are published on the central bank's website and the staff's preliminary findings indicate that the MNB's external audit and financial reporting practices comply with

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[8] In the past year Hungary improved its ranking in the "doing business indicators" from rank 50 to rank 41. The country has also taken action to implement recommendations of the 2005 FSAP and the 2006 Fiscal ROSC.

[9] The targeting of the primary balance also requires a careful monitoring of interest payments.

international standards. Staff has requested the documentation necessary to complete the assessment and has held initial discussions with the central bank's external auditors.

Box 5. Hungary: Stand-By Arrangement

Access: SDR 10.5 billion.

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

Phasing: SDR 4.2 billion will be made available upon the Board's approval of the arrangement to address the large balance of payments need in the fourth quarter of 2008 and to replenish reserves. The eight subsequent tranches will equal SDR 6.3 billion. The next two tranches could be made available in February and May 2009, and quarterly thereafter.

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 Performance Criterion***
  - Submission to parliament of a draft support package for domestic banks and request of initiation of extraordinary procedures for early passage. *By November 10, 2008*.

- ***Structural Benchmarks***
  - Passage of the fiscal responsibility law. *By end-December 2008.*
  - Submission to parliament of a draft law granting the HFSA special remedial powers to accelerate the resolution of any failed bank. *By end-December 2008*.

IV. Staff Appraisal

35. **Hungary's successful macroeconomic adjustment has been disrupted by the global financial crisis.** Over the past two years, fiscal adjustment had brought down headline deficits, and—in the context of the EU convergence plan—further reductions were programmed. The introduction of a floating exchange rate regime in early 2008 removed potential conflicts between monetary and exchange rate policies in an inflation targeting environment. With the onset of the global financial crisis, the fiscal adjustment plans as set out proved no longer sufficient. Several less-than-fully successful government securities auctions and a sharp depreciation of the exchange rate signaled a fall in investor confidence, which prompted a review by the authorities of areas for reform needs.

36. **Regaining credibility requires both financing and a high degree of policy discipline.** Hungary's goal is to exit as soon as possible from the current episode of financial stress and continue focusing on medium term structural development and growth goals, including accession to the euro. In the context of global financial market difficulties, changing expectations will, however, only be possible if markets are convinced that a financing crisis has been averted, both in the immediate and medium runs. A large financing package can provide reassurance that short term obligations can be met without resorting to unsustainable or damaging policies. Equally important though are strong policies—both in the fiscal and financial sector—that ensure that stocks of debt and the burden of debt service will go down over the medium term.

37. **The authorities' program—which is supported by the proposed SBA—delivers a strong policy anchor, but risks remain.** Under the program, the path of fiscal adjustment has been accelerated, liquidity provision to financial markets is being strengthened, and a system is being put in place to ensure that high levels of capital of the banking system are maintained. The program also includes elements to strengthen financial sector surveillance. Together, these measures address the areas that have proven to be among the most serious vulnerabilities in the crisis, and should therefore go far in turning around market expectations. Yet risks to the program remain, including a more serious economic deterioration than underlying the macroeconomic framework projections, a slower recovery of global financial markets, and lack of necessary political support for key measures. To minimize risks, the authorities recognize the need for continued and careful program monitoring and for ongoing policy dialogue with the Fund, and are committed to make policy adjustments that may become necessary.

38. **To support the fiscal policy package, a broad political consensus around medium-term goals is needed.** The authorities' program aims for consistency among the current measures and the established longer term reform needs. Most important in this regard is the decision not only to contain overall spending but to uphold the goal of reducing the (comparatively large) size of the government sector in Hungary. Adjustment therefore includes a broad set of expenditure cuts, including in wages and pensions. These measures are unavoidably painful, yet—by bringing Hungary closer to wage and pension levels in neighboring countries, and by allowing for a more growth oriented and sustainable level of total spending—will have important longer term benefits. It remains critical to engage the public on these issues and build consensus on the importance of retaining the reform momentum.

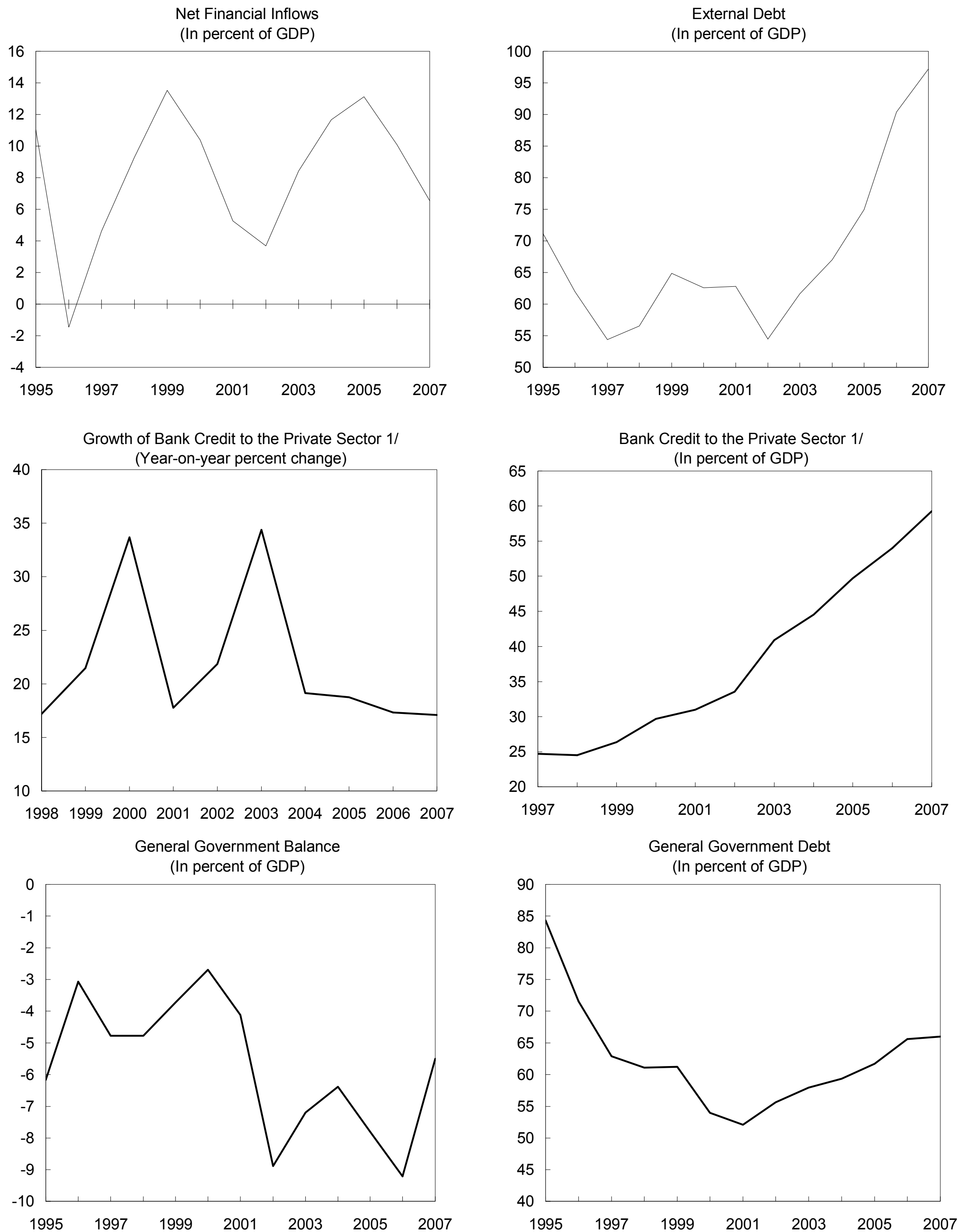
39. **The banking measures should help support the strength of the banking system and ensure access to liquidity.** Hungary's banking sector includes subsidiaries of foreign banks and domestic banks, one of which has subsidiaries in a number of neighboring countries. In light of the global financial crisis, many advanced countries have taken pre-emptive measures to shore up bank capital and other steps to support their banking systems. Hungary's banking sector package will re-establish a level playing field, in ensuring that key banks, including domestic banks, have access to a well-defined capital support framework. Supporting improvements in supervision and central bank liquidity management will also

help to enhance the stability of the banking sector and support its continued access to global financial markets.

40. **Other macroeconomic policies need to remain prudent to support overall policy package.** Hungary has a successful track record of implementing an inflation targeting framework. Under the program, keeping inflation low and predictable will support exchange rate stability and be critical for the sustainability of the reform package.

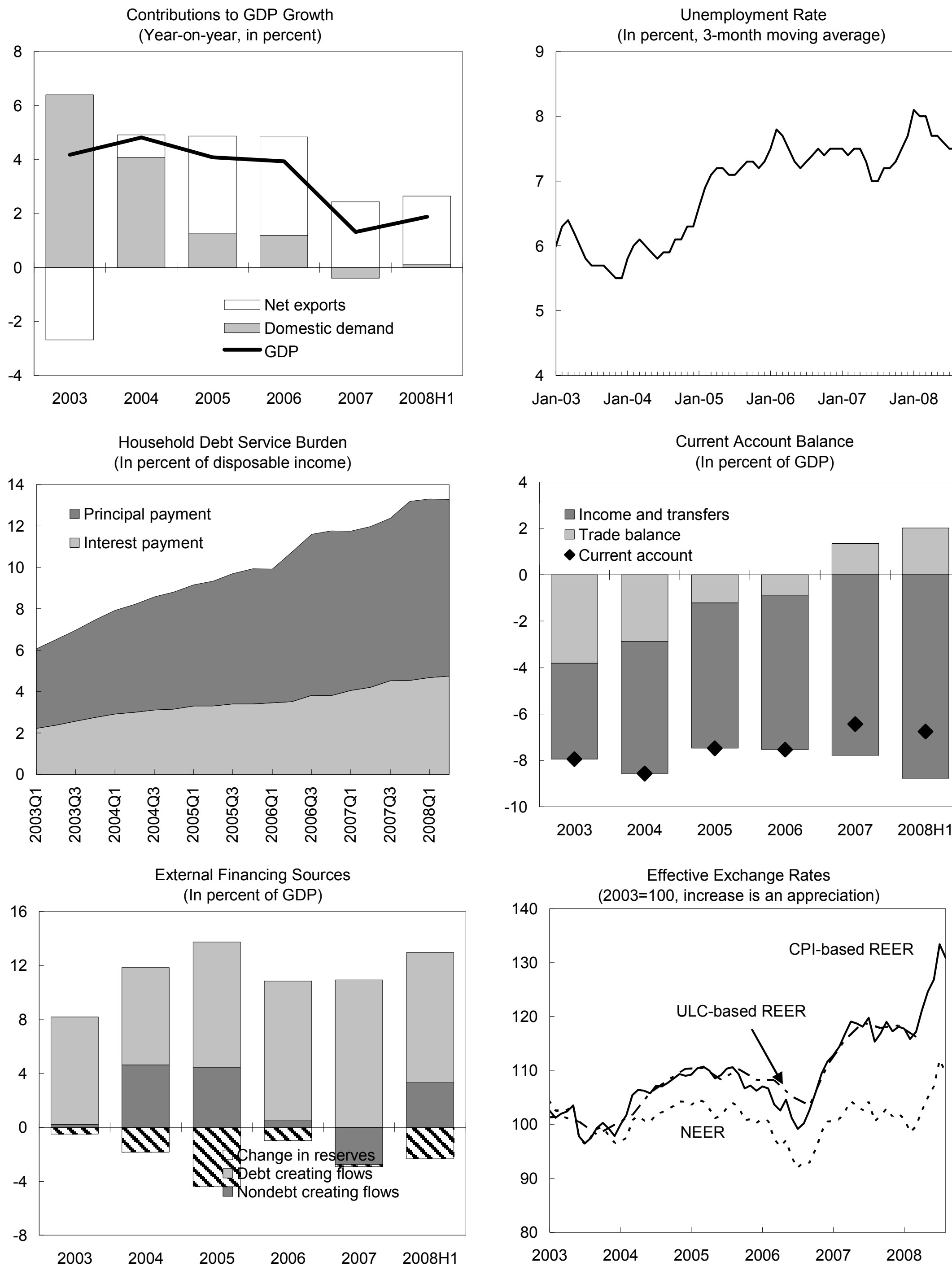
41. **With the consistent implementation of the program, staff expects that the Hungarian economy will weather the current difficulties.** Staff supports the authorities request for a 17-month SBA arrangement.

Figure 1. Hungary: Vulnerabilities, 1995–2007



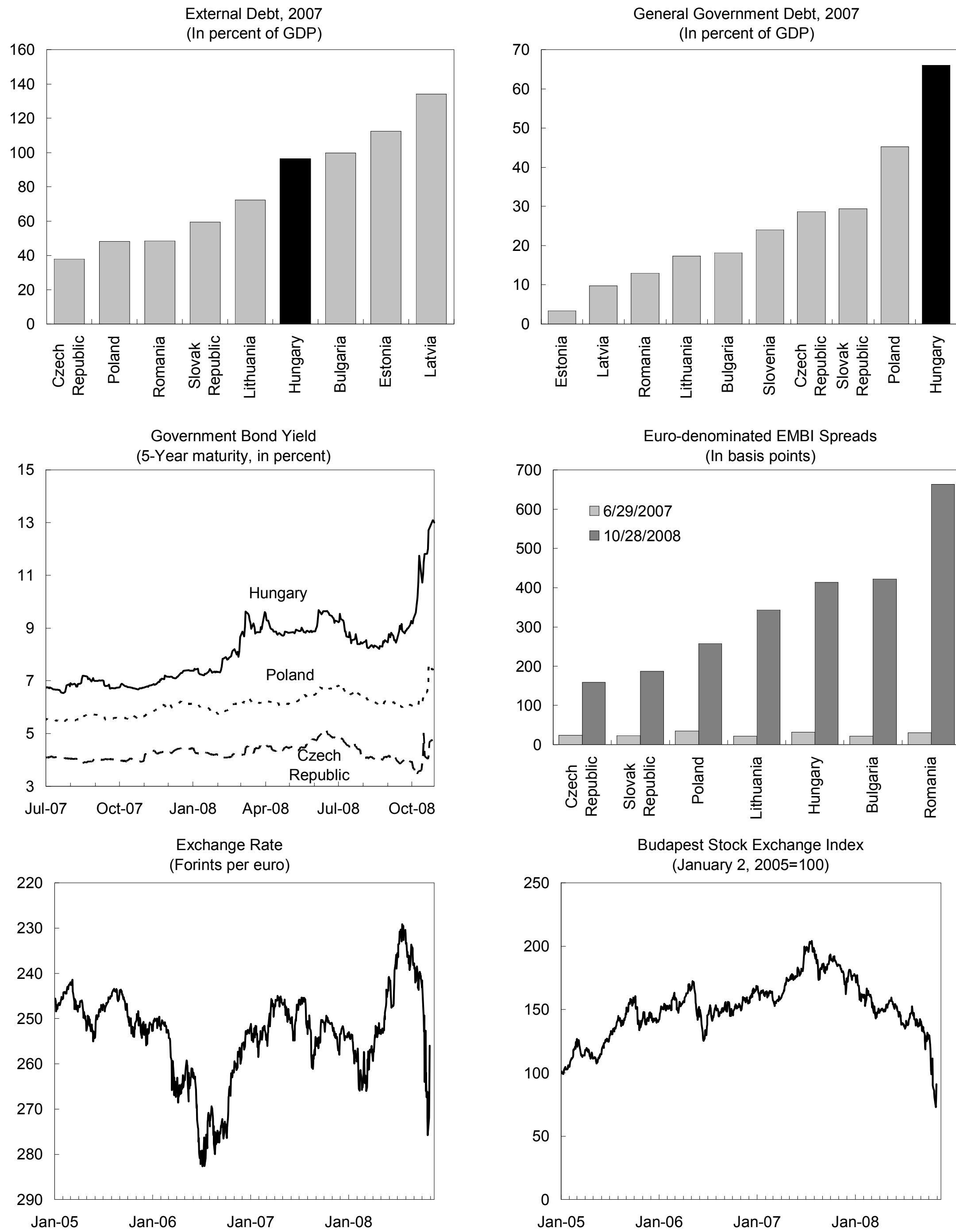
Sources: Hungarian Ministry of Finance; Magyar Nemzeti Bank; and IMF staff calculations.
1/ Consolidated loans of MFIs to non-government residents.

Figure 2. Hungary: Recent Macroeconomic Developments, 2003–08



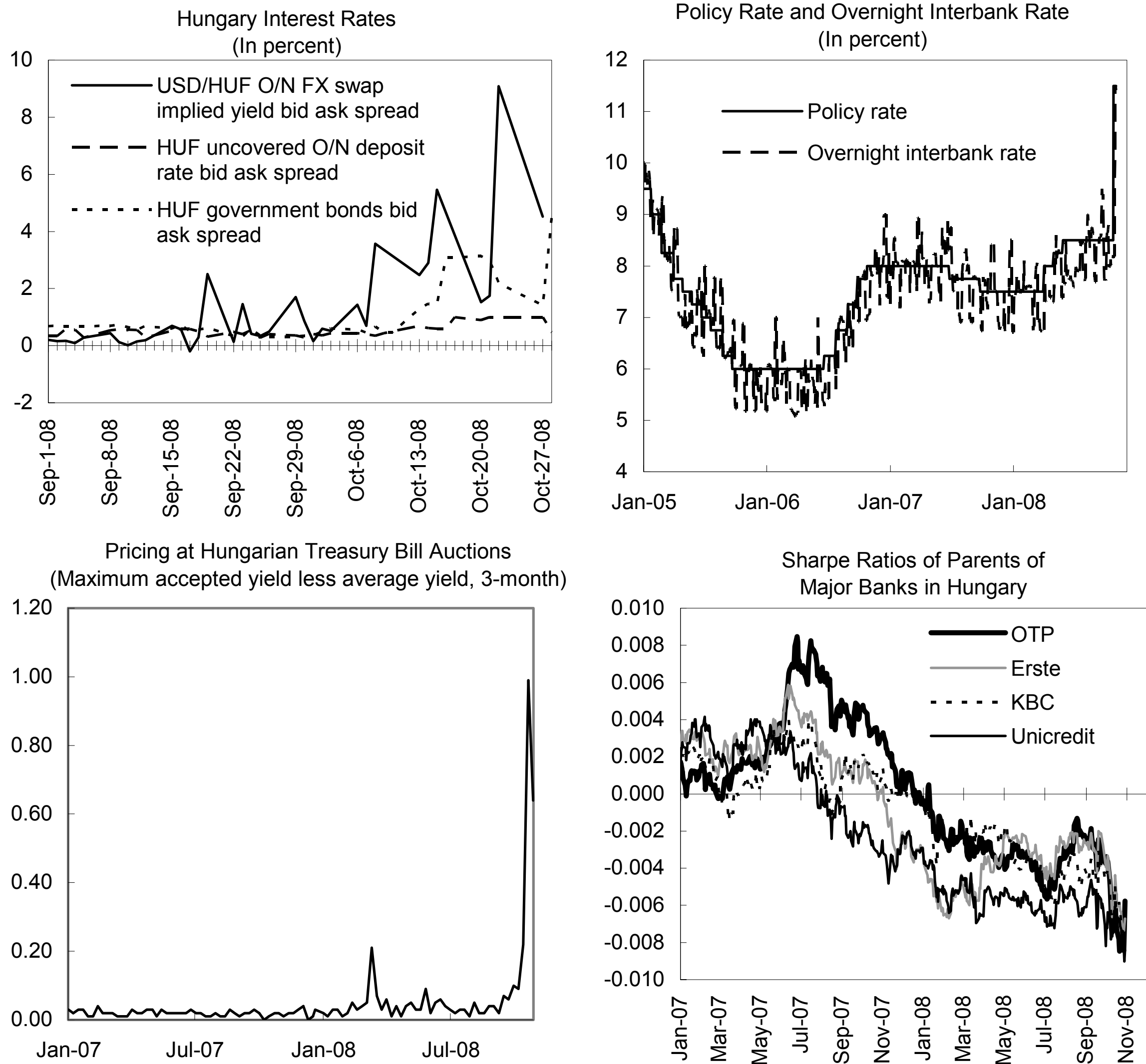
Sources: Magyar Nemzeti Bank; European Commission; and Hungarian Statistical Office.

Figure 3. Hungary: Recent Financial Market Developments, 2005–08



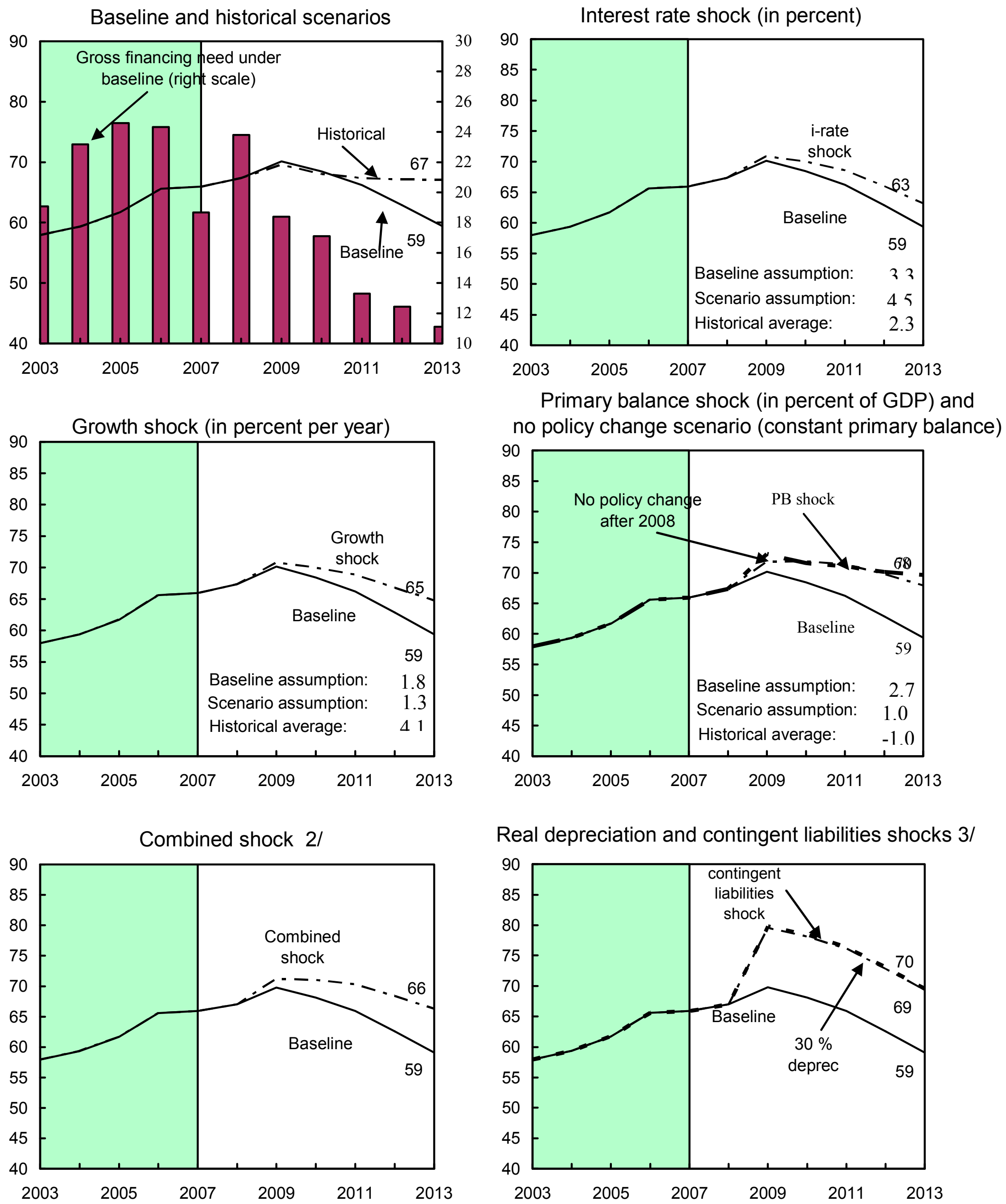
Sources: Bloomberg; Haver DLX; and Eurostat.

Figure 4. Hungary: Recent Pressures on Financial Markets



Sources: Hungarian Debt Management Agency (AKK), and IMF staff calculations.

Figure 5. Hungary: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



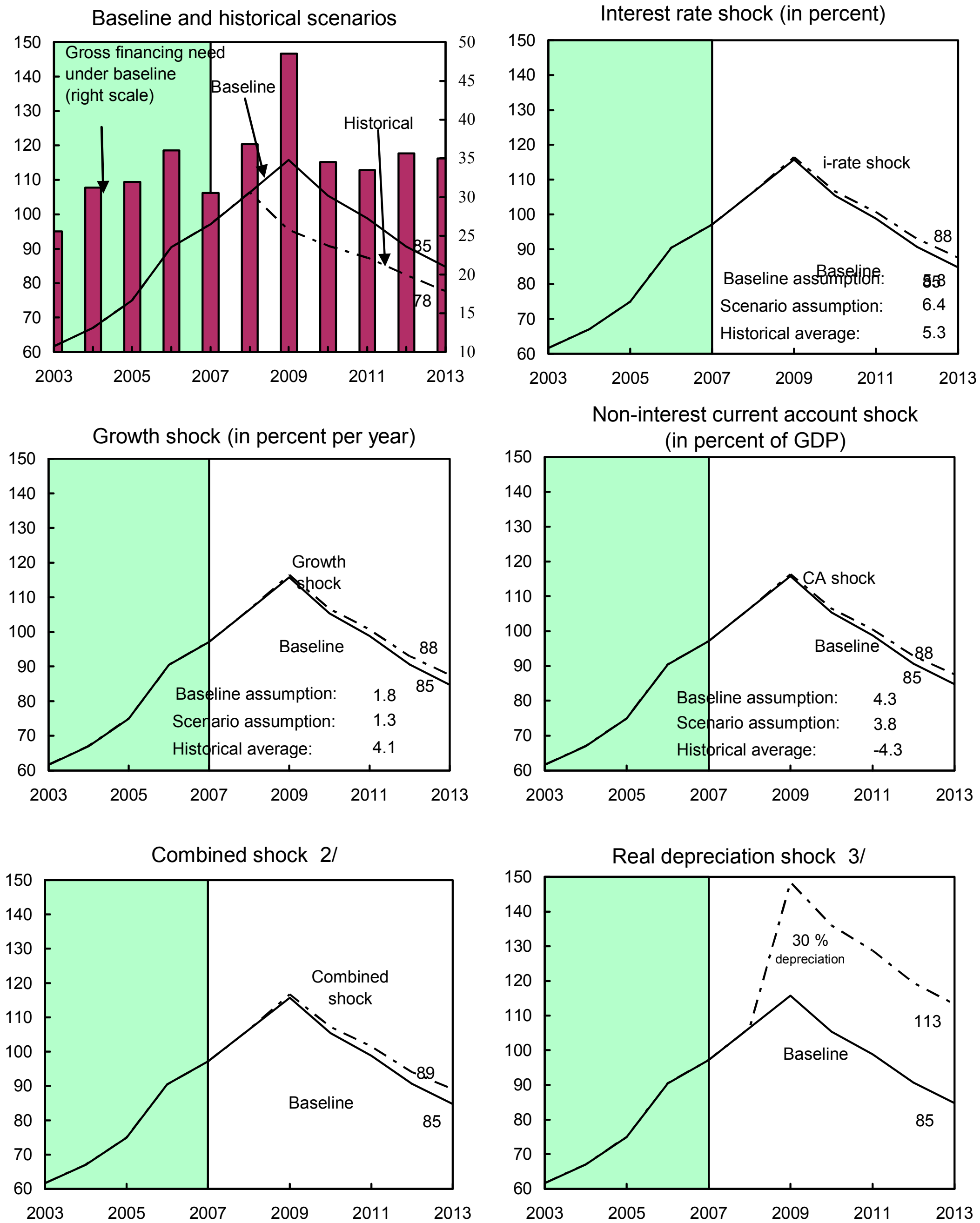
Sources: International Monetary Fund, country desk data, and staff estimates.

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).

Figure 6. 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.

Table 1. Hungary: Main Economic Indicators, 2005–09

	2005	2006	2007	2008	2009
				Proj.	
Real economy (change in percent)					
Real GDP	4.1	3.9	1.1	1.8	-1.0
Private consumption	3.6	1.9	-1.9	0.9	-3.9
Gross fixed investment	5.3	-2.5	0.1	1.0	-0.9
Exports	11.5	19.0	14.2	7.6	2.1
Imports	6.8	14.7	12.0	8.1	0.7
CPI (end year)	3.3	6.5	7.4	5.1	4.2
CPI (average)	3.6	3.9	7.9	6.3	4.5
Unemployment rate (average, in percent)	7.2	7.5	7.4	7.8	8.5
Gross domestic investment (percent of GDP) 1/	23.6	23.1	23.0	22.8	20.0
Gross national saving (percent of GDP, from BOP)	16.1	15.6	16.6	16.5	18.0
General government (percent of GDP), ESA-95 basis 2/					
Overall balance	-7.8	-9.3	-4.9	-3.4	-2.5
Primary balance	-3.7	-5.4	-0.9	0.6	1.9
Debt	61.6	65.5	65.8	67.4	70.1
Money and credit (end-of-period, percent change)					
M3	14.6	13.8	11.0	4.1	1.3
Credit to nongovernment	18.9	17.1	17.3	7.2	-6.2
Interest rates (percent)					
T-bill (90-day, average)	6.8	7.0	7.6	...	...
Government bond yield (5-year, average)	8.0	6.9	7.0	...	...
Balance of payments					
Goods and services trade balance (percent of GDP)	-1.2	-0.9	1.4	1.8	7.5
Current account (percent of GDP)	-7.5	-7.5	-6.4	-6.2	-2.0
Reserves (in billions of euros)	15.7	16.4	16.4	19.5	19.8
Gross external debt (percent of GDP) 3/	75.0	90.4	97.2	106.4	115.8
Exchange rate					
Exchange regime	Floating				
Present rate (October 31, 2008)	Ft 204.85 = US$1; Ft. 261.10 = €1				
Nominal effective rate (2000=100)	111.6	105.1	111.8	…	…
Real effective rate, CPI basis (2000=100)	132.6	127.0	142.5	…	…
Quota at the Fund	SDR 1038.4 million				

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and IMF staff estimates.
1/ Includes change in inventories.
2/ 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.
3/ Including inter-company loans, and nonresident holdings of forint-denominated assets.

Table 2. Hungary: Balance of Payments, 2007–11
(In millions of euros)

	2007	2008			2009					2010	2011
		Sep.	Dec.	Year	Mar.	Jun.	Sep.	Dec.	Year		
		Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current Account	**-6,510**	**-1,934**	**-1,214**	**-6,632**	**-581**	**-396**	**-543**	**-395**	**-1,915**	**-1,611**	**-1,144**
Goods and service, net	1,370	25	895	1,956	1,473	1,982	1,796	2,021	7,272	8,541	9,707
Exports	80,824	20,093	21,560	85,209	19,761	21,428	21,967	23,549	86,704	90,179	96,854
Imports	-79,454	-20,068	-20,666	-83,253	-18,288	-19,446	-20,171	-21,529	-79,433	-81,638	-87,146
Income, net	-7,386	-1,726	-2,169	-7,810	-1,922	-2,246	-2,207	-2,283	-8,657	-9,568	-10,227
Current transfers, net	-494	-233	61	-778	-132	-132	-132	-132	-529	-584	-625
Capital Account	**1,139**	**167**	**302**	**1,384**	**402**	**451**	**443**	**490**	**1,785**	**1729**	**1780**
Net capital transfers from the EU	1,220	168	302	1,387	406	451	451	496	1,803	1729.01	1779.85
Financial Account	**7,100**	**2,637**	**-3,362**	**5,049**	**-3,434**	**-2,504**	**-1,788**	**-1,668**	**-9,393**	**1849**	**3009**
Direct investment, net	1,608	-1,083	-163	985	181	-195	362	228	577	596	623
Direct Investment Abroad	-2,765	-1,178	-778	-1,651	-242	-421	-62	-329	-1,054	-1029	-1051
In Hungary	4,373	95	615	2,636	424	226	424	557	1,631	1625	1675
Portfolio investment, net	-789	2,325	-1,449	2,072	-1,964	-993	-1,013	-690	-4,660	-130	68
Assets	2,491	2,427	1,042	4,850	819	286	250	216	1,570	-937	-916
Equity	-1,885	-432	-51	-1,718	-52	-52	-53	-54	-211	-215	-224
Debt securities	4,376	2,859	1,093	6,568	871	338	302	270	1,781	-721	-693
Liabilities	-3,280	-103	-2,491	-2,777	-2,783	-1,278	-1,263	-906	-6,231	806	985
Equity	-3,635	811	217	1,519	222	228	233	240	923	-596	-572
Debt securities	355	-913	-2,708	-4,296	-3,005	-1,506	-1,496	-1,146	-7,154	1402	1556
Other investment	6,281	1,395	-1,750	1,992	-1,651	-1,316	-1,137	-1,206	-5,310	1383	2318
Assets	-3,326	-1,601	-288	-4,374	-294	-299	-305	-311	-1,209	-2319	-1798
o/w: short-term assets	-618	-700	-139	-1,554	-142	-144	-147	-150	-583	-1384	-1121
Liabilities	9,606	2,996	-1,462	6,366	-1,357	-1,017	-832	-895	-4,101	3703	4116
o/w short-term liabilities	4,350	-409	-1,225	-258	-1,080	-847	-737	-646	-3,310	1148	1382
Net errors and omissions	-1,595	-1,097	-657	-3,751	-657	-657	-657	-657	-2,626	-1313	-657
Overall Balance	**134**	**-227**	**-4,930**	**-3,950**	**-4,270**	**-3,105**	**-2,545**	**-2,229**	**-12,148**	**654**	**2988**
Prospective Financing	**...**	**...**	**2,000**	**2,000**	**2,500**	**2,000**	**1,000**	**0**	**5,500**	**0**	**0**
European Union	...	...	2,000	2,000	2,000	1,500	1,000	0	4,500	**0**	**0**
World Bank					500	500			1,000	0	0
Bank Guarantee Fund	...	...	-1,034	-1,034	...	...	...	...	...	...	...
Net International Reserves (increase -)	**-134**	**227**	**3,965**	**2,984**	**1,770**	**1,105**	**1,545**	**2,229**	**6,648**	**-654**	**-2988**
Gross Reserves	-134	227	-2,070	-3,050	-730	-395	45	729	-352	-1154	-2988
Reserve Liabilities	0	0	6,034	6,034	2,500	1,500	1,500	1,500	7,000	500	0
Bank Guarantee Fund	0	0	1,034	1,034	0	0	0	0	0	0	0
Prospective Fund credits	0	0	5,000	5,000	2,500	1,500	1,500	1,500	7,000	500	0
Current account (in percent of GDP)	-6.4	-6.8	-4.6	-6.2	-2.8	-1.7	-2.2	-1.4	-2.0	-1.5	-1.0
Gross external debt (in percent of GDP)	97.2	101.0	106.4	106.4	118.3	118.6	118.4	115.8	115.8	105.4	98.8
Gross official reserves	16,385	17,409	19,479	19,479	20,209	20,604	20,559	19,830	19,830	20484	23472
In percent of short-term debt at remaining maturity	86.6	62.3	67.2	67.2	70.6	77.6	76.8	79.5	79.5	80.1	79.9

Sources: Hungarian authorities and IMF staff projections.

Table 3. Hungary: Staff's Illustrative Medium-Term Scenario, 2005–11

	2005	2006	2007	2008	2009	2010	2011
				Projections			
	(In percent, unless otherwise indicated)						
Real GDP growth	4.1	3.9	1.1	1.8	-1.0	0.6	1.9
Nominal GDP, forint billions	22,042	23,795	25,419	27,220	28,154	29,168	30,673
Inflation (CPI; year average basis)	3.6	3.9	7.9	6.3	4.5	4.1	3.2
Inflation (CPI; end-year basis)	3.3	6.5	7.4	5.1	4.2	3.6	3.0
	(Annual percentage change, constant prices)						
Domestic demand	0.5	0.3	-1.4	2.2	-2.9	-0.6	1.3
Consumption	3.2	2.4	-2.1	0.5	-3.5	0.4	0.9
Gross fixed capital formation	5.3	-2.5	0.1	1.0	-0.9	1.9	5.0
Exports of GNFS	11.5	19.0	14.2	7.6	2.1	3.9	4.6
Imports of GNFS	6.8	14.7	12.0	8.1	0.7	3.1	4.3
	(In percent of GDP, unless otherwise indicated)						
External current account balance	-7.5	-7.5	-6.4	-6.2	-2.0	-1.5	-1.0
Gross national saving	16.1	15.6	16.6	16.5	18.0	17.0	17.6
Gross national investment 1/	23.6	23.1	23.0	22.8	20.0	18.5	18.6
Capital account, net	0.8	0.6	1.1	1.3	1.8	1.6	1.5
Financial account, net	12.9	10.3	7.0	4.8	-9.7	1.7	2.6
Gross external debt 2/	75.0	90.4	97.2	106.4	115.8	105.4	98.8
General government (ESA-95)							
Revenue, primary	41.9	42.3	44.6	45.0	44.3	44.5	44.8
Expenditure, primary	45.9	47.9	45.8	44.7	42.6	42.2	41.9
Primary balance	-3.7	-5.4	-0.9	0.6	1.9	2.6	3.2
General government balance (incl. costs of pension reform)	-7.8	-9.3	-4.9	-3.4	-2.5	-2.0	-1.5
Net interest	3.9	3.7	3.8	3.7	4.2	3.9	4.3
General government debt	61.6	65.5	65.8	67.4	70.1	68.4	66.2
Memorandum items							
Output gap	0.8	1.5	0.1	-0.9	-4.4	-6.4	-7.3
Potential GDP growth	3.6	3.2	2.8	2.8	2.5	2.6	2.8
Structural general government balance	-8.0	-9.8	-5.0	-3.2	-1.2	-0.1	0.7
Structural primary balance	-4.2	-6.1	-1.2	0.6	3.0	3.9	5.1

Sources: Hungarian authorities; and IMF staff projections.
1/ Includes change in inventories.
2/ Includes intercompany loans.
3/ Consistent with the balance of payments data (not necessarily with the national accounts data).

Table 4. Hungary: Consolidated General Government, 2006–11 1/
(In percent of GDP, unless otherwise indicated)

	2006	2007	2008	2009		2010	2011
			Est.	Budget	Program Proj.	Staff proj.	
Total revenues	42.6	44.9	45.3	45.6	44.6	44.8	45.1
Current revenues and current transfers (incl. grants)	41.7	44.0	44.1	44.0	43.0	43.2	43.5
Tax revenues	37.0	39.5	39.8	39.9	38.7	38.8	39.1
Taxes on income, profits and capital gains	9.4	10.2	10.5	10.8	10.2	10.3	10.4
Personal income tax	6.7	7.1	7.4	7.8	7.2	7.3	7.4
Corporate income tax	2.3	2.8	2.7	2.7	2.6	2.6	2.7
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	13.8	13.8	13.5	13.5	13.6
Taxes on goods and services	15.0	15.6	15.5	15.3	15.0	15.0	15.0
VAT	7.4	7.8	7.7	7.6	7.4	7.4	7.5
Other (incl. excises and import taxes)	7.5	7.9	7.8	7.8	7.5	7.5	7.5
Current non-tax revenues	4.0	3.8	3.6	3.4	3.6	3.7	3.7
Of which : interest	0.3	0.3	0.3	0.2	0.3	0.3	0.3
Current transfers (incl. grants)	0.8	0.6	0.7	0.7	0.7	0.7	0.7
Capital revenues and capital transfers (incl. grants)	0.9	0.9	1.2	1.6	1.6	1.6	1.6
Memorandum item: subnational governments own revenues	6.3	5.9	...	...	...	...	...
Total expenditures	51.9	49.8	48.7	48.5	47.1	46.8	46.6
Current expenditures and current transfers	45.7	44.3	44.0	44.0	42.6	42.3	42.2
Compensation of employees 2/	12.1	11.5	11.3	11.8	10.3	10.2	10.1
Goods and services	7.0	6.7	6.6	6.4	6.5	6.4	6.3
Interest payments	4.0	4.0	4.0	4.2	4.5	4.6	4.6
Subsidies	1.4	1.4	1.4	1.4	1.4	1.3	1.3
Current transfers to households	18.5	18.1	18.3	18.2	18.0	17.9	17.9
Social security	13.4	13.5	...	...	...	...	...
Of which : labor market fund (mostly unemployment benefits)	0.4	0.4	...	...	...	...	...
Other	5.0	4.6	...	...	...	...	...
Other current transfers	2.7	2.6	2.5	2.0	2.0	1.9	1.9
Capital expenditures	4.3	3.6	3.1	3.0	3.0	2.9	2.9
Capital transfers	1.9	1.9	1.5	1.5	1.5	1.5	1.5
Other net expenditure	...	...	...	...	...	...	...
Memorandum item: subnational governments total expenditure	12.8	11.6	...	...	...	...	...
General government balance 3/	-9.3	-4.9	-3.4	-2.9	-2.5	-2.0	-1.5
Primary balance	-5.4	-0.9	0.6	1.3	1.9	2.6	3.2
Memorandum items:							
Primary expenditure	47.9	45.8	44.7	44.3	42.6	42.2	41.9
Output gap (in percent of potential GDP)	1.5	0.1	-0.9	-2.5	-4.4	-6.4	-7.3
Cyclically-adjusted overall balance (CAB, in percent of potential GDP)	-10.1	-5.0	-3.0	-1.7	-0.5	1.0	2.0
Change in CAB (y-o-y)	-1.9	5.1	2.0	1.3	2.5	1.5	0.9
One-off items (net)	-3.3	-1.0	0.1	0.0	0.0	0.0	0.0
Structural balance	-6.8	-4.0	-3.1	-1.7	-0.5	1.0	2.0
Change in SB (y-o-y)	...	2.8	0.9	1.4	2.6	1.5	0.9
Gross public debt (Maastricht definition)	65.5	65.8	...	...	...	...	...
Real GDP growth (in percent, y-o-y, not seasonally adjusted)	3.9	1.1	1.8	1.2	-1.0	0.6	1.9

Sources: Hungarian authorities; and IMF staff estimates.
1/ Data are classified following the ESA'95 methodology, as reported to the European Commission.
2/ Including social security contributions.
3/ For 2009, the aggregate overall balance of local governments (cash basis) is expected to be around HUF 135 billion (slightly less than 0.5 percent of GDP). Over the last 10 years, local government finances have exhibited relatively small deficits or surpluses.

Table 5. Hungary. Borrowing Requirement of the Central Government System, 2008–09
(In billion of forints)

	2008					2009				
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year
Net borrowing requirement 1/	510.0	209.8	6.5	802.6	1,528.9	586.8	137.3	-94.6	39.4	668.9
Redemptions										
In Hungarian forints	1,262.4	1,517.8	1,578.7	1,555.4	5,914.3	1,299.4	2,112.6	2,085.0	1,651.0	7,148.1
In foreign currency (euro)	5.5	141.8	8.4	5.3	161.0	166.6	121.4	8.7	6.0	302.6
Gross borrowing requirement	1,777.9	1,869.4	1,593.6	2,363.2	7,604.2	2,052.7	2,371.3	1,999.1	1,696.5	8,119.6
Actual and planned financing										
Gross issuance (actual and planned)										
In Hungarian forints	1,600.7	1,514.5	1,533.2	1,632.8	6,281.1	1,894.3	2,017.3	2,091.8	1,849.3	7,852.7
In foreign currency	72.5	426.4	10.7	293.2	802.7	0.0	450.0	0.0	274.0	724.0
Drawing on deposits with banking system	104.8	-71.5	49.7	437.3	520.3	158.4	-96.0	-92.6	-426.9	-457.0
Constrained borrowing										
Gross issuance 2/										
In Hungarian forints	1,600.7	1,514.5	1,533.2	1,170.5	5,818.8	1,099.5	1,898.9	1,989.0	1,739.9	6,727.3
In foreign currency 3/	72.5	426.4	10.7	560.0	1,069.6	981.6	600.0	280.0	0.0	1,861.6
Drawing on deposits with banking system	104.8	-71.5	49.7	632.7	715.8	-28.4	-127.6	-269.9	-43.4	-469.3

Sources: Hungarian authorities; and IMF staff estimates.
1/ Overall budget balance of the central government system (cash basis) and costs of banking sector rescue package.
2/ No issuance in foreign currency, no net domestic currency issuance, rollover of maturing debt of 75 percent (08Q4 and 09Q1), 85 percent in 08Q2, 95 percent in 09Q3 and 105 percent in 09Q4.
3/ Includes identified multilateral assistance from the EU and the World Bank.

Table 6. Hungary: Program Financing, 2008-09
(In millions of euros)

	2008	2009				2008-09
	Dec.	Mar.	Jun.	Sep.	Dec.	Total
	Proj.	Projection				Projection
Total financing requirements	**-6,267**	**-4,671**	**-3,556**	**-2,988**	**-2,719**	**-20,201**
Current account deficit	-1,214	-581	-396	-543	-395	-3,128
Financial account outflows	-3,362	-3,434	-2,504	-1,788	-1,668	-12,755
Direct investment, net	-163	181	-195	362	228	414
Portfolio investment, government net 1/	-159	-1,031	-840	-959	-718	-3,706
Portfolio investment, private net 2/	-1,291	-933	-153	-54	27	-2,404
of which, financial derivatives 3/	-2,484	-1,910	-603	-475	-366	-5,838
Other investment	-1,750	-1,651	-1,316	-1,137	-1,206	-7,060
Bank Guarantee Fund	-1,034	0	0	0	0	-1,034
Net errors and omissions	-657	-657	-657	-657	-657	-3,283
Total financing sources	**233**	**2,171**	**2,056**	**1,488**	**1,219**	**7,166**
Capital account inflows	302	402	451	443	490	2,088
Net capital transfers from the EU	302	406	451	451	496	2,105
Prospective Financing	2,000	2,500	2,000	1,000	0	7,500
European Union	2,000	2,000	1,500	1,000	0	6,500
World Bank		500	500			1,000
Change in gross reserves	-2,070	-730	-395	45	729	-2,421
Financing gap	**-6,034**	**-2,500**	**-1,500**	**-1,500**	**-1,500**	**-13,034**
Bank Guarantee Fund (reserves liability)	1,034	0	0	0	0	1,034
Prospective Fund credits 4/	5,000	2,500	1,500	1,500	1,500	12,000

Sources: Hungarian authorities; and IMF staff projections.
1/ Financing difficulties are expected to persist through 2009, with no FX issuance.
Non-residents share of forint-denominated securities is projected to fall from 38 to 30 percent.
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.
4/ A €500 million Fund disbursement is projected for the first quarter of 2010, bringing total prospective Fund credit to €12.5 billion.

Table 7. 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
February 15, 2009	2,107.5	203.0	First review and end-December 2008 performance criteria
May 15, 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**	**1014.8**	

Source: IMF staff estimates.

Table 8. Hungary. Indicators of Fund Credit, 2008-15
(In millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015
Existing Fund credit	-	-	-	-	-	-	-	-
Stock 1/	-	-	-	-	-	-	-	-
Obligations	-	-	-	-	-	-	-	-
Proposed Stand-By Arrangement								
Disbursement	4,215	5,901	421	-	-	-	-	-
Stock 1/	4,215	10,116	10,537	10,537	7,165	1,949	53	-
Obligations	21	355	539	542	3,858	5,461	1,934	53
Repurchase 2/	-	-	-	-	3,372	5,216	1,897	53
Charges	21	355	539	542	486	244	37	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	4.2	10.8	10.2	9.5	6.0	1.5	0.0	-
In percent of exports of goods and services	5.2	12.2	12.2	11.3	7.2	1.8	0.0	-
In percent of gross reserves	22.7	53.2	53.5	46.7	27.6	6.8	0.2	-
Obligations to the Fund from existing and prospective Fund arrangements								
In percent of quota	2.0	34.2	51.9	52.2	371.5	525.9	186.2	5.1
In percent of GDP	0.0	0.4	0.5	0.5	3.2	4.3	1.4	0.0
In percent of exports of goods and services	0.0	0.4	0.6	0.6	3.9	5.1	1.7	0.0
In percent of gross reserves	0.1	1.9	2.7	2.4	14.8	19.0	6.5	0.2

Source: IMF Staff estimates.
1/ End of period.
2/ Repayment schedule based on repurchase obligations.

Table 9. Hungary: Proposed Access, 2008-2010

		High-Access Cases 1/				Normal Access Cases			
	Proposed Arrangement	Proposed Arrangement (Percentile)	20th Percentile (Ratio)	80th Percentile (Ratio)	Average (Ratio)	Proposed Arrangement (Percentile)	20th Percentile (Ratio)	80th Percentile (Ratio)	Average (Ratio)
Access									
In millions of SDRs	10,537	60.7	2,462	14,233	8,847	100	36	409	359
Average annual access	716	100	119	355	248	100	20	50	39
Total access in percent of: 2/									
Actual quota	1,015	89	279	781	600	100	30	75	62
Gross domestic product	11.8	88	2.8	8.3	6.5	100	0.7	2.7	1.8
Gross international reserves	64	59	27	115	96	88	5	41	41
Exports of goods and nonfactor services	17	32	11.3	46.3	34.9	93	1.9	7.0	5.5
Imports of goods and nonfactor services	15	26	12.8	63.6	35.9	95	1.6	6.4	4.8
Total debt stock									
Of which: Public	31	88	6	18	16	...	...	...	...
External	11	52	5	15	12	93	2	6	4
Short-term	75	81	19	56	55	...	...	...	...
M2	25	80	5	27	30	93	1	12	102

Source: Executive Board documents, MONA database, and Fund staff estimates.

1/ High access cases include all available data at approval and on augmentation for the 25 requests to the Board since 1994 which involved the use of the exceptional circumstances clause or SRF resources. Exceptional access augmentations are counted as separate observations. For the purpose of measuring access as a ratio of different metrics, access includes augmentations and previously approved and drawn amounts.

2/ The data used to calculate ratios is the actual value for the year prior to approval for public and short-term debt, and the projection at the time of program approval for the year in which the program was approved for all other variables.

Table 10. Hungary: Public Sector Debt Sustainability Framework, 2003-13
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Debt-stabilizing primary balance 10/
Baseline: Public sector debt 1/	58.0	59.4	61.7	65.6	65.9	**67.4**	**70.1**	**68.4**	**66.2**	**62.9**	**59.4**	**0.0**
o/w foreign-currency denominated	14.1	15.3	17.4	18.5	18.5	18.5	18.9	19.3	19.4	19.1	18.7	
Change in public sector debt	2.4	1.4	2.3	3.9	0.3	1.5	2.8	-1.7	-2.2	-3.3	-3.5	
Identified debt-creating flows (4+7+12)	0.8	-1.2	5.1	1.8	-1.1	1.3	0.2	-0.3	-1.7	-3.3	-3.7	
Primary deficit	3.1	2.0	3.7	5.4	0.9	-0.6	-1.8	-2.2	-2.8	-3.2	-3.6	
Revenue and grants	41.9	42.6	42.2	42.6	44.9	45.3	44.1	44.2	44.5	43.7	42.8	
Primary (noninterest) expenditure	45.0	44.5	45.9	47.9	45.8	44.7	42.3	41.9	41.7	40.5	39.2	
Automatic debt dynamics 2/	-2.1	-2.4	3.4	-2.3	-1.9	-0.4	2.0	1.9	1.0	-0.1	-0.1	
Contribution from interest rate/growth differential 3/	-1.1	-0.6	0.6	-0.6	-0.1	-0.4	2.0	1.9	1.0	-0.1	-0.1	
Of which contribution from real interest rate	1.0	2.0	2.8	1.7	0.5	0.7	1.3	2.3	2.3	2.2	2.2	
Of which contribution from real GDP growth	-2.1	-2.6	-2.3	-2.2	-0.7	-1.1	0.7	-0.4	-1.2	-2.3	-2.3	
Contribution from exchange rate depreciation 4/	-1.0	-1.8	2.8	-1.7	-1.8	...	...	...	...	...	...	
Other identified debt-creating flows	-0.2	-0.8	-1.9	-1.2	0.0	2.2	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-0.2	-0.8	-1.9	-1.2	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	2.2	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	1.6	2.6	-2.8	2.1	1.4	0.2	2.6	-1.4	-0.5	0.0	0.2	
Public sector debt-to-revenue ratio 1/	138.3	139.5	146.3	154.1	146.9	148.9	159.0	154.9	148.8	143.9	138.7	
Gross financing need 6/	19.1	23.2	24.6	24.3	18.7	23.8	18.4	17.1	13.3	12.4	11.1	
in billions of U.S. dollars	16.1	23.7	27.2	27.5	25.9	38.5	26.9	27.7	23.2	23.3	22.2	
Scenario with key variables at their historical averages 7/						**67.4**	**69.6**	**68.0**	**67.4**	**67.1**	**67.1**	**-1.1**
Scenario with no policy change (constant primary balance) in 2008-2013						**67.4**	**73.1**	**71.6**	**71.1**	**70.2**	**69.7**	**0.0**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.2	4.8	4.1	3.9	1.1	1.8	-1.0	0.6	1.9	3.8	4.0	
Average nominal interest rate on public debt (in percent) 9/	8.1	8.3	7.4	6.9	6.6	6.5	6.5	6.4	6.8	6.9	7.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.3	3.9	5.2	3.1	0.9	1.3	2.0	3.4	3.6	3.7	3.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	8.3	15.3	-15.6	11.5	11.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	5.8	4.4	2.2	3.9	5.7	5.2	4.5	3.0	3.2	3.2	3.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.7	3.7	7.2	8.7	-3.5	-0.6	-6.4	-0.2	1.4	0.8	0.8	
Primary deficit	3.1	2.0	3.7	5.4	0.9	-0.6	-1.8	-2.2	-2.8	-3.2	-3.6	

1/ General government gross debt.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ 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 $\alpha\varepsilon(1+r)$.
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/ The scenario assumes structural balances of -2.5 percent of GDP in 2009, -1.5 in 2010, and -0.5 over 2011-13.
9/ Derived as nominal interest expenditure divided by previous period debt stock.
10/ 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.

Table 11. Hungary: External Debt Sustainability Framework, 2003-13
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Debt-stabilizing non-interest current account 6/
Baseline: External debt	61.6	67.0	75.0	90.4	97.2	**106.4**	**115.8**	**105.4**	**98.8**	**90.6**	**84.8**	**0.1**
Change in external debt	7.1	5.4	8.0	15.5	6.7	9.3	9.3	-10.4	-6.6	-8.2	-5.9	
Identified external debt-creating flows (4+8+9)	2.6	-2.6	-2.1	0.8	-6.5	0.7	8.3	0.1	-2.5	-3.8	-3.0	
Current account deficit, excluding interest payments	5.7	5.8	4.6	4.4	2.8	1.0	-3.3	-3.8	-4.5	-4.7	-5.2	
Deficit in balance of goods and services	3.8	2.7	1.2	0.9	-1.4	-1.8	-7.5	-7.9	-8.4	-8.3	-8.3	
Exports	61.5	65.0	67.5	76.6	79.9	80.3	89.2	83.9	84.3	84.2	84.8	
Imports	65.3	67.7	68.8	77.5	78.6	78.5	81.7	76.0	75.9	75.9	76.5	
Net non-debt creating capital inflows (negative)	-1.9	-5.4	-5.0	-4.4	-4.3	-3.8	5.1	-0.8	-1.7	-1.4	-0.8	
Automatic debt dynamics 1/	-1.3	-3.0	-1.7	0.8	-5.0	3.5	6.5	4.7	3.7	2.4	3.0	
Contribution from nominal interest rate	2.3	2.6	2.9	3.2	3.7	5.2	5.3	5.3	5.5	5.9	6.4	
Contribution from real GDP growth	-2.2	-2.7	-2.5	-2.9	-0.9	-1.7	1.2	-0.6	-1.9	-3.5	-3.4	
Contribution from price and exchange rate changes 2/	-1.4	-2.9	-2.1	0.5	-7.8	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	4.5	8.0	10.1	14.7	13.2	8.6	1.0	-10.5	-4.0	-4.4	-2.9	
External debt-to-exports ratio (in percent)	100.1	103.1	111.0	118.0	121.6	132.6	129.9	125.6	117.2	107.7	100.0	
Gross external financing need (in billions of euros) 4/	19.1	25.7	28.4	32.4	30.9	39.1	47.2	37.1	38.5	43.9	45.7	
in percent of GDP	25.6	31.2	32.0	36.0	30.5	36.8	48.5	34.5	33.5	35.6	35.0	
Scenario with key variables at their historical averages 5/						**106.4**	**95.3**	**90.8**	**87.4**	**82.3**	**77.6**	**-8.3**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.2	4.8	4.1	3.9	1.1	1.8	-1.0	0.6	1.9	3.8	4.0	
GDP deflator in euros (change in percent)	1.4	5.1	3.7	-2.5	11.1	3.1	-7.4	9.9	4.9	3.4	2.0	
Nominal external interest rate (in percent)	4.4	4.7	4.7	4.3	4.5	5.6	4.6	5.1	5.6	6.4	7.5	
Growth of exports (euro terms, in percent)	3.3	16.3	12.2	15.0	17.1	5.4	1.8	4.0	7.4	7.2	6.8	
Growth of imports (euro terms, in percent)	5.9	14.1	9.7	14.2	13.8	4.8	-4.6	2.8	6.7	7.4	6.9	
Current account balance, excluding interest payments	-5.7	-5.8	-4.6	-4.4	-2.8	-1.0	3.3	3.8	4.5	4.7	5.2	
Net non-debt creating capital inflows	1.9	5.4	5.0	4.4	4.3	3.8	-5.1	0.8	1.7	1.4	0.8	

1/ 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.

2/ 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).

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

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

5/ 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.

6/ 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.

Table 12. Hungary. Indicators of External Vulnerability, 2005-08

	2005	2006	2007	2008 Proj.
Financial Indicators				
M3, end-of-period, percent change	14.6	13.8	11.0	4.1
Private sector credit, percentage change	18.9	17.1	17.3	7.2
T-bill , 90-day, average, in percent	6.8	7.0	7.6	..
Government bond yield, 5-year, average, in percent	8.0	6.9	7.0	..
Share of foreign currency liabilities in total liabilities	34.4	39.3	42.4	42.0
Share of foreign currency loans in total credit to:				
Corporates	21.8	20.3	20.9	19.5
Households	9.5	14.8	19.3	23.0
Other loans	18.8	19.1	22.5	23.5
Non-performing loans to gross loans	2.5	2.5	2.4	2.8
External Indicators				
Exports of goods and services, annual percentage change	12.9	15.0	17.1	5.4
Imports of goods and services, annual percentage change	10.0	14.2	13.8	4.8
Real effective exchange rate, percentage change, + = appreciation	2.0	-4.4	12.7	..
Current account balance, in percent of GDP	-7.5	-7.5	-6.4	-6.2
Capital and financial account, in percent of GDP	0.8	0.6	1.1	1.3
Financial account, in percent of GDP	12.9	10.3	7.0	4.8
Net foreign direct investment, in percent of GDP	5.0	3.2	1.6	0.9
Gross official reserves, in billions of euros	15,721	16,397	16,385	19,479
In months of imports	2.7	2.5	2.4	2.9
In percent of short-term debt at remaining maturity	108.3	116.2	86.6	67.2
Total external debt, in billions of euros	66,608	81,428	98,266	112,951
In percent of GDP	75.0	90.4	97.2	106.4
Short-term debt at remaining maturity	14,514	14,115	18,914	28,979
Financial Market Indicators				
Stock market index, local currency, average 2/	19,233	22,674	26,364	13,399
EMBI Global bonds spread, average 2/	54.5	72.6	79.0	498.0
CDS spread, 5-year, average 2/	19.0	35.0	29.0	420.0

Source: Hungarian authorities; and staff estimates.

1/ 2008 data refers to observation as of end-September 2008.
2/ Observation in 2008 refers to average from January 1, 2008 to October 31, 2008.

ATTACHMENT I. HUNGARY: LETTER OF INTENT

Budapest, November 4, 2008

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

Dear Mr. Strauss-Kahn:

1. Financial market stress in Hungary has intensified in past weeks as a result of events in global financial markets. In response, the government and the central bank of Hungary (Magyar Nemzeti Bank, MNB) have developed a comprehensive strategy to firmly anchor macroeconomic policies and reduce financial market stress. We request that the Fund support our program through a Stand-By Arrangement (SBA) for a period of 17 months in the amount of SDR10.5 billion (€12.5 billion). This arrangement, in conjunction with support of €6.5 billion under the EU's balance of payment financing facility and other multilateral and bilateral commitments, will signal the international community's support for our policies.

2. We have discussed with IMF staff our economic program, which is outlined below. Our main objectives are to (i) reduce the government's financing needs and improve long-term fiscal sustainability, (ii) maintain adequate capitalization of the domestic banks and liquidity in domestic financial markets, and (iii) underpin confidence and secure adequate external financing. The government is in the process of considering additional steps to improve the competitive position of the economy, which are fully consistent with the program.

3. The program will be monitored through quantitative performance criteria and indicative targets, structural performance criteria and structural benchmarks, and regular reviews. Table 1 below sets out specific quarterly targets that are to be observed under the SBA for the cash central government primary balance, CPI inflation, and net international reserves, as well as an indicative ceiling on the overall stock of central government debt. We have already submitted to parliament an amended fiscal responsibility law before consideration of our program by the IMF's Executive Board. A support package for domestic banks will be submitted to parliament before November 10, 2008. We will also present to parliament a law to strengthen the emergency powers of the Hungarian Financial Supervision Authority (HFSA) and pass the fiscal responsibility law by end-2008. The first review of the program will take place by February 15, 2009 and the second review by May 15, 2009. We

believe that the policies set forth 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 the achievement of its objectives.

Recent economic performance and macroeconomic framework for 2008–09

4. Macroeconomic policies have shown important results in recent years. The fiscal consolidation that began two years ago has narrowed the general government deficit from 9¼ percent of GDP in 2006 to a projected 3.4 percent of GDP in 2008 (ESA95 classification). For 2008, the projected outcome is markedly better than planned in the budget. Reflecting fiscal consolidation, the current account deficit has narrowed to a projected 6¼ percent of GDP in 2008. Monetary policy has been focused on achieving the 3 percent inflation target at the two years horizon, and the removal of the exchange rate band earlier this year has removed a potential conflict between monetary policy objectives. Inflation has fallen from 9 percent in early 2007 (when it was temporarily boosted by increases in indirect taxes associated with the fiscal consolidation) to 5¾ percent in September 2008 despite significant commodity price shocks, and is projected to fall further in 2009, although the recent depreciation of the forint may slow the decline. GDP growth is expected to recover to just under 2 percent on an annual basis in 2008, following a temporary slowdown associated with the introduction of our fiscal adjustment program in 2006.

5. In recent weeks, financial stress has increased sharply, mainly due to external factors. Investors' extreme risk aversion, which spilled over from difficulties in global financial markets, has negatively affected the foreign exchange, government securities, and equity markets in Hungary. The effect in Hungary may have been more pronounced than elsewhere in the region because underlying stock vulnerabilities (public and external debt) are still high, and financial markets are developed and deeply integrated with EU markets.

6. The outlook for 2009 is exceptionally uncertain, as it depends on global events and, crucially, on the extent to which investor confidence in Hungary can be maintained. In our baseline scenario, global financial market stress will gradually abate, which over time will reduce pressures in financial markets in Hungary. However, the global deleveraging that is already under way will reduce net capital inflows, which in turn will sharply slow credit growth in Hungary. The acceleration of our fiscal consolidation strategy will also dampen domestic demand. Export growth will be restrained by the economic slowdown among our main trading partners. As a result, output will likely fall by around 1 percent, CPI inflation will decline to about 4 percent at year-end, and the current account deficit will narrow to some 2 percent of GDP. The risks to the baseline scenario are mostly on the downside, reflecting uncertainty about the speed with which financial markets will stabilize and the depth of the global economic slowdown.

7. Gross external financing needs will decline over the course of 2009, due to the smaller fiscal and current account deficits, and will be partly covered by EU structural funds (a stable source of inflows) and already committed foreign direct investment inflows. We cautiously assume net outflows from the non-financial private sector and a reduction in the government's net issuance of external debt. Foreign banks, however, are expected to largely maintain their exposure in Hungary (see below). At the same time, we aim to gradually increase the MNB's foreign reserves as a precaution against unexpected outflows. The resulting external financing need of some €20 billion can be covered by drawing on resources from the IMF, support under the EU's balance of payment facility and other official creditors. Any additional support from other international financial institutions will be used to further augment our foreign reserves.

Fiscal Policy

8. Fiscal consolidation in recent years has been the cornerstone of the government's efforts to reduce macroeconomic vulnerabilities. As a share of GDP, primary government expenditures in 2008 will be reduced to below the level envisaged in the budget. This will be achieved mainly by not using contingency reserves. As a result, the general government deficit is projected to fall to 3.4 percent of GDP (or 2.9 percent of GDP, adjusted for the EU's Excessive Deficit Procedure purposes).

9. The 2009 budget will be amended to reflect the deterioration in the economic outlook and to further reduce the government's borrowing requirement. The revised budget envisages a general government deficit of 2½ percent of GDP, which implies a structural fiscal adjustment of about 2½ percent of GDP. Revenues, which are difficult to project precisely in the present environment, are expected to decline somewhat as a percentage of GDP, reflecting the slower growth of the tax base and the effect of the spending measures outlined below. The tax cuts previously envisaged for 2009 will be cancelled and we will not make any changes in the tax code that could lead to lower net revenues.

10. The necessary adjustment will focus on the expenditure side, which seems consistent with the need to reduce Hungary's comparatively large public sector as a share of GDP. Specifically, primary government expenditure (which excludes interest payments) will be reduced by 2 percentage points of GDP compared to 2008. This will be achieved by (i) keeping nominal wages in the public sector constant throughout 2009, (ii) eliminating the 13th monthly salary for all public servants, (iii) capping the 13th monthly pension payment for pensioners at HUF 80,000 and eliminating the 13th monthly pension payment for all early retirees, (iv) postponing the indexation of selected social benefits, and (v) trimming operating expenditure allocations to all ministries across the board. Within the government's expenditure envelope, we will give priority to investment projects cofinanced by EU funds and programs designed to support small and medium-sized enterprises. In case of need, the

government will take corrective measures to prevent the accumulation of spending arrears. The program will be primarily monitored through the primary cash balance of the central government including social security and other extrabudgetary funds (a quarterly performance criterion). We will consult IMF staff on adjustments to the primary balance target and on eventual corrective measures in the event of a larger-than-expected shortfall in government financing, the level of public debt exceeding its indicative target path by more than 300 billion HUF, or a further significant deterioration of the macroeconomic outlook. We will also follow closely developments in local government finances and will consult IMF staff on possible corrective measures in case the aggregate deficit of local governments exceeds expectations.

11. The government is committed to maintaining fiscal discipline in the long-term, recognizing that this is a key element in retaining investor confidence. We therefore intend to continue budget consolidation in the 2010 budget—to be discussed with IMF staff as part of the program—and beyond; new medium-term fiscal targets will be contained in the forthcoming convergence program and our medium-term fiscal framework. To put fiscal sustainability on a permanent footing, we have already submitted to parliament a draft fiscal responsibility law, which establishes fiscal rules on public debt and primary deficit, strengthens the medium-term expenditure framework (rolling three-year expenditure ceilings) and creates a fiscal council to provide independent and expert scrutiny. We plan to enact this law by end-December 2008 (a structural benchmark).

Financial Sector Policies

12. The Hungarian banking system complies with regulatory capital requirements and has been profitable. Liquidity risk has recently increased due to the drop in global risk appetite which has increased banks' funding costs and shortened maturities. However, most of the external funding comes from parent banks in the euro area, which now have access to liquidity through ECB facilities and which have pledged their continuous support of their subsidiaries in Hungary, as reaffirmed in the joint statement of MNB and leading banks in Hungary of October 17, 2008. The MNB and the HFSA will monitor this commitment closely, and provide summary information on a daily basis to IMF staff. Domestic funding has not shown any signs of stress and any stress would be contained by the liquidity facilities mentioned below. In addition, the government has not only increased the level of deposit insurance coverage of retail deposits from HUF 6 million to HUF 13 million (in line with EU agreements) but also pledged to provide a blanket guarantee on all deposits. The government stands ready to take further measures to ensure the stability of bank funding, if needed.

13. The government is seeking an agreement with commercial banks to mitigate the balance sheet risks of households from their exposure to foreign currency loans, and to put in place a private debt resolution strategy. The proposed agreement would consist of three

components: (i) at the request of the debtor, the banks will allow the duration of the loan to be extended with fixed monthly installments; (ii) debtors who deem that exchange rate fluctuations carry excessive risks will be allowed to convert their foreign currency-based loan to a forint loan, without extra charges; and (iii) in the event that a debtor is unable to service the existing loan, the banks will be amenable to transitionally reducing the installments at the request of the debtor. If these strategies prove to be ineffective, additional resolution mechanisms will be considered.

14. The continuity of access to banking functions needs to be preserved at all times. In this context, we will step up our efforts to strengthen the HFSA's and MNB's capacity to assess and address solvency and liquidity concerns in banks in a timely manner. A mechanism for early remedial actions, including well-defined triggers and emergency powers for the HFSA, will be submitted to parliament by end-December 2008 (structural benchmark). We will also improve the efficiency of the bank resolution regime to facilitate paying out quickly to depositors in case of need.

15. We have developed, in consultation with IMF staff, a comprehensive package of support measures available to all qualified domestic banks, to buttress their credibility and confirm our commitment to preserving their key role in the Hungarian economy. The domestic banks have entered this period of market stress with strong solvency positions, which they have been able to preserve so far in spite of the severity of the turmoil. We are nevertheless in the process of providing a support package in line with best practices, ensuring a level playing field within the EU. The banking sector package contains provisions for added capital and funds a guarantee fund for interbank lending. Funding will be divided as follows: Total funding of HUF 600 billion will be divided evenly between the Capital Base Enhancement Fund and a and the Refinancing Guarantee Fund. The Package is available to private Hungarian banks of systemic importance. The Capital Base Enhancement Fund has been sized to bring the eligible banks' capital adequacy ratio (CAR) up to 14 percent. The Guarantee Fund is meant to bring comfort to the providers of wholesale funding and secure the refinancing of the eligible banks. Its endowment of HUF 300 billion will be invested in euro denominated government bonds of Euro area countries and managed by the MNB. Open for new transactions until end-2009, it will guarantee the rollover of loans and wholesale debt securities with an initial maturity of more than 3 months and up to 5 years, against a fee and with appropriate safeguards. This package should also ensure that the domestic banks remain capable of playing a responsible role vis-à-vis their foreign subsidiaries. We will submit a bill to this effect to parliament by November 10 and request an extraordinary procedure to pass the bill as soon as possible (structural performance criterion). We will monitor carefully the impact of a possible deterioration of borrowers' capacity to repay their loans as the economy slows. Recent pressures on banks' funding are being addressed by their management in close coordination with the HFSA and MNB. We welcome the involvement of EBRD in further strengthening the Hungarian banking system.

16. Over the period covered by the program, financial sector regulation and supervision will be further strengthened. Measures include (i) introduction of a positive credit registry for households, (ii) modification of the Central Bank Act to allow the MNB to request individual but unidentifiable data to adequately analyze credit risk, (iii) enhanced regulation of insurance and credit brokers and their products, (iv) introduction of maximum loan-to-value ratio requirements for new mortgage loans, and (v) close monitoring of banks' foreign exchange exposures. Given the importance of Hungary as a home and host country to foreign banks, we are strengthening communication with financial authorities in home and host countries regarding risk assessments and liquidity contingency plans.

Monetary and Exchange Rate Policy

17. The exchange rate band was removed in early 2008, moving Hungary to a floating exchange rate regime. Monetary policy is now able to focus exclusively on the inflation target, with exchange rate movements factored into the setting of the policy interest rate to the extent that they affect the outlook for inflation. In addition, the elimination of the exchange rate band has largely removed the possibility of a one-way bet against the forint in a period of financial market turmoil.

18. The MNB is determined to gradually bring inflation down to the official target of 3 percent. Under the program, progress towards this goal will be monitored using a standard consultation clause (see Appendix). Monetary policy was tightened in the first half of 2008 in response to a rise in underlying inflationary pressures and again recently to fend off a potentially destabilizing swing of the exchange rate. Looking forward, the projected economic slowdown in Hungary and the rest of the world will likely put downward pressure on inflation, but a further depreciation of the exchange rate could boost inflation. Therefore, even though underlying inflationary pressures appear to be easing, interest rate policy will remain vigilant. Monetary policy does not respond to short-term fluctuations of the exchange rate unless there is evidence that it may affect the long-term inflation outlook. The MNB's intervention policy will be applied consistently with the target for net international reserves under the program. Our efforts to reduce inflation will be supported by the government's intention to facilitate an agreement among social partners to restrain nominal wage growth.

19. Over the past couple weeks, in response to increased stress in domestic financial markets, we have taken a number of measures to improve liquidity. The MNB has established a foreign exchange swap facility, which is supported by a repo facility with the ECB amounting to €5 bn. We have also established an auction facility to purchase government bonds from market makers of these securities, which is intended to improve liquidity in the secondary market. The MNB has also created two new facilities to inject forint liquidity into the banking system: a two-week refinancing window at a fixed price and six-month tender with no fixed price. All of these measures are intended to improve liquidity in various market

segments, not to influence prices (including bond yields), which should remain fully market-determined. The MNB stands ready to further expand its toolkit as needed.

János Veres /s/ Minister of Finance	András Simor /s/ Governor of the MNB

Attachments

Table 1. Hungary: Quantitative Program Targets

	2008		2009		
				Program projections	
	end-Sep	end-Dec	End-Mar	End-Jun	End-Sep
	Actual	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/	130.3	215	-280	-55	255
2. Cumulative change in net international reserves (floor, in millions of euros) 2/ 3/	15,890.7	...	...	...	...
II. Continuous Performance Criterion					
3. Non-accumulation of external debt arrears	…	0	0	0	0
III. Inflation Consultation					
4. 12-month rate of inflation in consumer prices 4/					
Outer band (upper limit)	...	7.1	6.8	6.5	6.3
Inner band (upper limit)	...	6.1	5.8	5.5	5.3
Central point	5.7	5.1	4.8	4.5	4.3
Inner band (lower limit)	...	4.1	3.8	3.5	3.3
Outer band (lower limit)	...	3.1	2.8	2.5	2.3
IV. Indicative Target					
5. Ceiling on the total debt stock of the central government system (in billions of forints) 5/	15,973	16,320	16,650	16,850	16,860

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

2/ The end-September 2008 NIR figure is a stock. The cumulative change in NIR for subsequent quarters is from September 2008.

3/ NIR stock is adjusted upward (downward) for any increase (decrease) in the amount of actual disbursement compared to program disbursements (see TMU).

4/ 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.

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

Table 2. Hungary: Proposed Structural Conditionality Under the Program for 2008

	Measure	Conditionality [1/]	Timing
1	Submission to parliament of draft support package for domestic banks and request initiation of extraordinary procedure for early passage (¶ 15)	SPC	November 10, 2008
2	Passage of the draft fiscal responsibility law (¶ 11)	SB	end-December 2008
3	Submission to parliament of a law granting the HFSA special remedial powers to accelerate the resolution of any failed bank (¶ 14)	SB	end-December 2008

1/ SB = structural benchmarks, SPC = structural performance criterion

ATTACHMENT II. HUNGARY: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

November 4, 2008

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. As is standard under all Fund arrangements, we will consult with the Fund before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the Fund with the necessary information for program monitoring.

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.[10]

Central Government System

3. **Definition**: The central government system (CGS) is defined to include the central government (state budget), extrabudgetary funds, and social security funds. In case the government establishes new extrabudgetary 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-September 2008	15,890.7
Floor on cumulative change in net international reserves from end-September 2008:	
End-December 2008 (performance critierion)	...
End-March 2009 (performance criterion)	...
End-June 2009 (indicative target)	...
End-September 2009 (indicative target)	...

[10] 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 with maturity of less than one year. 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), banks foreign currency deposits against reserve requirements, and all credit outstanding from the Fund.

7. NIR targets will also 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.

External Program Disbursements (Baseline Projection)

Cumulative flows from end-September 2008:	(In millions of euros)
End-December 2008 (program projection)	2,000
End-March 2009 (program projection)	4,500
End-June 2009 (program projection)	6,500
End-September 2009 program projection)	7,500

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

8. **The quarterly consultation bands for the 12-month rate of inflation in consumer prices** (as measured by the headline consumer price index (CPI) published by the Hungarian Central Statistical Office), are specified below. Projected CPI for end-December 2008 and end-March 2009 are performance criteria, while those for end-June 2009 and end-September 2009 are indicative targets.

	December 2008	March 2009	June 2009	September 2009
Outer band (upper limit)	7.1	6.8	6.5	6.3
Inner band (upper limit)	6.1	5.8	5.5	5.3
Central point	5.1	4.8	4.5	4.3
Inner band (lower limit)	4.1	3.8	3.5	3.3
Outer band (lower limit)	3.1	2.8	2.5	2.3

9. Projected CPI inflation 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 outer bands, and our policy response. In this vein, should the observed year-on-year rate of CPI inflation fall outside the outer bands specified above, the authorities will complete a consultation with the Fund on their proposed policy response before requesting further purchases under the program. In addition, the MNB will conduct discussions with the Fund staff should the observed year-on-year rate of CPI inflation fall outside the inner bands specified for the end of each quarter in the table above.

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

	(In billions of forints)
End-of-the-year primary balance:	
End-December 2008 (performance criterion)	215
Cumulative primary balance from January 1, 2009:	
End-March 2009 (performance criterion)	-280
End-June 2009 (indicative target)	-55
End-September 2009 (indicative target)	255

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, reconcilialition between reported transfers and reported revenues from other CGS entities will be required before compliance with the CGS primary balance ceiling can be assessed.

12. For the purpose of the program, the primary expenditure of the CGS excludes any cash payment related to bank recapitalization (to establish the Capital Enhancement Fund) 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 mark-to-market deposits at or placed by the Hungarian Debt Management Agency (ÁKK).[11] 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-September 2008 (actual)	15,973
End-December 2008 (indicative ceiling)	16,320
End-March 2009 (indicative ceiling)	16,650
End-June 2009 (indicative ceiling)	16,850
End-September 2009 (indicative ceiling)	16,860

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 two weeks of the end of each quarter.

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

[11] 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.

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 government budget and financing plans.

Net EU Transfers (Baseline Projection)

Baseline projections:	(In billions of forints)
End-December 2008 (program projection)	-269.32
End-March 2009 (program projection)	334.43
End-June 2009 (program projection)	25.39
End-September 2009 program projection)	1.01

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-December 2008 (program projection)	162.00
End-March 2009 (program projection)	287.01
End-June 2009 (program projection)	405.24
End-September 2009 program projection)	305.11

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

Request for Stand-By Arrangement—Informational Annex

Prepared by the European Department

November 4, 2008

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APPENDIX I. HUNGARY: FUND RELATIONS

(As of September 30, 2008)

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	964.57	92.89
Reserve position in Fund	73.83	7.11

III. **SDR Department**

	SDR Million	Allocation
Holdings	60.28	N/A

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	3/15/96	2/14/98	264.18	0.00
Stand-by	9/15/93	12/14/94	340.00	56.70
EFF	2/20/91	9/15/93	1,114.00	557.24

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

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

VIII. **Article IV Consultations**:

Hungary is on a 12-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 other mission documents 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

X. **Regional Resident Representative for Central And Eastern Europe:**

Mr. Christoph Rosenberg, Senior Regional Resident Representative for central and eastern Europe, took up his duties in Warsaw in February 2005.

APPENDIX II. HUNGARY—STATISTICAL ISSUES

1. Data provision is adequate for surveillance. Significant progress has been made in improving the coverage, periodicity, and other aspects of quality of the economic and financial statistics. Most data quality issues noted in the data module of the 2001 Report on the Observance of Standards and Codes (ROSC) have been satisfactorily addressed, but some are pending.[12]

2. Hungary subscribes to the Special Data Dissemination Standard (SDDS), and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (http://dsbb.imf.org). Hungary meets the SDDS specifications for the coverage, periodicity, and timeliness of the data, and for the dissemination of advance release calendars.

A. Real Sector Statistics

3. To implement Eurostat regulations, the Hungarian Central Statistical Office (HCSO) started to use chain-linked volume measures of GDP from the third quarter of 2006 and made corresponding backward calculations to the year 2001. Quarterly GDP is estimated using the production and expenditure approach. A first preliminary estimate of GDP volume indices is released 45 days after the reference period. Detailed estimates are released 70 days after the end of the reference period. Prior to the introduction of chain-linked estimates, GDP volume indices based on the production approach were compiled at constant prices of 2000. Since the third quarter of 2006, the HCSO has also been compiling current price estimations. In addition, as of September 2006, the HCSO introduced direct output volume measurement for some government services (education and healthcare). Furthermore, the HCSO refined its method to indirectly measure financial intermediation services by introducing two separate reference rates for transactions in local and in foreign currencies. Also, the HCSO started to include illegal activities into the national accounts.

4. The consumer price index (CPI) is compiled as an annual chained Laspeyres index using for weights the expenditure patterns of two years prior to the current period. The computation of imputed rent for owner-occupied housing is based on the average price changes of different repair items and does not cover all elements of costs to the user.

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[12] The original 2001 ROSC Data Module and updates are available on the IMF internet web site. The latest update is *Hungary: Report on the Observance of Standards and Codes—Data Module, 2004 Update* (July 2004).

B. External Sector Statistics

5. In 2005, the Magyar Nemzeti Bank (MNB) launched a project to set up a new data collection system for balance of payments (BOP) and international investment position (IIP) statistics, with a view to replace the international transaction reporting system (ITRS) with direct reporting (DR) of respondents. This change in data collection system became effective in January 2008. The move from ITRS to DR is in line with the recent trends concerning BOP data collection systems in other EU Member States. Under the new system, resident economic entities report directly their transactions and positions vis-à-vis nonresident entities.

6. The extent of cooperation between the HCSO and the MNB in the production of external statistics—the "Rest of the World" in the National Accounts framework on the one hand, and the BOP and IIP on the other hand—has also been significantly enhanced. In addition to data sharing already existing—data on trade in goods (since 2003), on FDI (since 2004), on travel and business services (since 2005), and on other services such as transportation, insurance, financial and government services (since 2006) —cooperation has been extended to new areas of non-financial accounts (such as compensation of employees and EU transfers). Nevertheless, the full responsibility for the compilation and publication of BOP and IIP statistics still rests with the MNB.

7. Furthermore, the MNB changed the reporting of stock and flow data of special-purpose entities (SPEs) as of January 1, 2006. According to the international statistical standards, an offshore firm is resident of the country in which it is registered. The off-shore status of SPEs ceased to exist on December 31, 2005, and from January 2006, the MNB has been compiling the BOP including data on SPEs. Nevertheless, the MNB continues to treat the statistics that exclude the flow and stock data of SPEs as readily interpretable in economic terms. In defining the range of SPEs, the MNB cooperates with the HCSO.

8. The HCSO, the MNB and the Ministry of Finance are presently looking into addressing the high level of errors and omissions in the BOP. Within the General Framework of Cooperation between the HCSO and the MNB, effective since 2002, a joint task force was established in the 2007 annual work program to investigate possible flaws in the Foreign Trade Statistics (FTS) data. Issues under investigation include:

- the possibly wrong attribution in FTS of Hungarian residence to foreign, nonresident companies importing and exporting goods to/from Hungary with a Hungarian VAT number; and
- possible VAT fraud (so-called "carousel fraud"), which has also led to underestimation of goods imports in other EU countries (e.g., the UK).

9. With regard to the "VAT resident issue," the task force has explored its possible impact on trade in goods data according to the National Accounts and BOP concept versus the FTS concept. The final conclusion and decision of the interested parties in February 2008

was to address this issue by revising the trade data back to 2004 in both NA and BOP statistics in a concerted way in September 2008. In implementing this, the Eurostat's relevant future recommendations, if any, will be respected.

10. As for the second (VAT fraud) issue, HCSO and MNB first have to agree on a proposal to redesign the information system of tax and customs authorities to facilitate better

provision of necessary details on explored frauds that can be used to compile the NA and BOP statistics. This task has been put on the agenda in the HCSO-MNB 2008 work program.

C. Monetary and Financial Statistics

11. Starting with the release of data for January 2003, the MNB has been compiling and publishing data based on a new methodology consistent with the European Central Bank's framework for monetary statistics using the national residency approach. In addition to the central bank and credit institutions, monetary statistics now also cover money market funds.

12. The Hungarian authorities have reported that they have addressed all recommendations in the area of monetary and financial statistics made in the context of the 2001 data ROSC report. Following Statistics Department (STA) recommendation that securities on the balance sheets of depository corporations be valued at market prices, the authorities have pursued improvement. From 2004, depository corporations were encouraged to use market valuation for securities in their trading portfolio. From 2005, this requirement was made compulsory for those depository corporations that are listed on the stock exchange.

D. Government Finance Statistics (GFS)

13. In January 2004, STA conducted a substantive update of the GFS dataset using the July 2003 Data Quality Assessment Framework. The mission reported that, overall, significant progress has been made in addressing the shortcomings of budget execution data and GFS identified in the 2001 ROSC Data Module. These improvements relate mainly to institutional coverage of general government, consolidation of data and reconciliation of deficit and financing. However, plans to report monthly expenditures classified on an economic basis have yet to come to fruition.

14. The latest data reported for publication in the 2007 GFS Yearbook are for 2006. These data now cover the operations of the consolidated central government and consolidated general government sectors, as well as their corresponding subsectors. The data for 2000 onwards have been compiled on an accrual basis and reported in the Government Finance Statistics Manual 2001 format.

Hungary: Table of Common Indicators Required for Surveillance
As of October 28, 2008

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality Accuracy and reliability[9]
Exchange Rates	10/28/2008	10/28/2008	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sep 2008	10/20/2008	M	M	M		
Reserve/Base Money	Sep 2008	10/13/2008	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	Sep 2008	10/13/2008	M	M	M		
Central Bank Balance Sheet	Sep 2008	10/13/2008	M	M	M		
Consolidated Balance Sheet of the Banking System	Aug 2008	9/30/2008	M	M	M		
Interest Rates[2]	Sep 2008	10/3/2008	M	M	M		
Consumer Price Index	Sep 2008	10/14/2008	M	M	M	O,O,O,O	O,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2007	4/1/2008	A	A	A	O,LNO,LO,O	LO,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Aug 2008	10/21/2008	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4 2007	4/1/2008	Q	Q	Q		
External Current Account Balance	Q2 2008	9/30/2008	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NA
Exports and Imports of Goods and Services	Q2 2008	9/30/2008	Q	Q	Q		
GDP/GNP	Q2 2008	9/5/2008	Q	Q	Q	O,O,O,LO	O,LO,O,O,NA
Gross External Debt	Q2 2008	9/30/2008	Q	Q	Q		
International investment Position[6]	Q2 2008	9/30/2008					

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC and Substantive Update published in May 2001 and July 2004, respectively, and based on the findings of the respective missions that took place during January 2001 and January 2004 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

Hungary—Assessment of the Risks to the Fund and the Fund's Liquidity Position

Prepared by the Finance and Strategy, Policy, and Review Departments

In consultation with other Departments

Approved by Andrew Tweedie and Adnan Mazarei

November 4, 2008

1. This note assesses the risks to the Fund arising from the proposed Stand-By Arrangement (SBA) with Hungary and its effects on the Fund's liquidity, in accordance with the policy on exceptional access.[1] [2] The authorities are requesting a 17-month SBA with access of SDR 10.5 billion (1,015 percent of quota). Proposed access is front-loaded, with SDR 4.2 billion (406 percent of quota) available upon approval, and SDR 2.1 billion (203 percent of quota) available in February 2009 (Table 1). The remaining access is phased in three quarterly purchases of SDR 1.3 billion (122 percent of quota), and a final purchase of SDR 0.4 billion (41 percent of quota) scheduled for February 2010.

Table 1. Hungary: Proposed SBA–Access and Phasing

		Purchases		
			Percent of quota	
Availability	Date 1/	SDR mn	Annual	Cumulative
2008	November (Approval)	4,215.0	405.9	405.9
2009	February	2,107.5	203.0	608.9
	May	1,264.5	121.8	730.6
	August	1,264.5	121.8	852.4
	November	1,264.5	121.8	974.2
2010	February	421.5	40.6	1,014.8
	Total	10,537.5	1,014.8	1,014.8

Source: Finance Department.

1/ Starting from February 2009, purchases will depend on the completion of a review.

[1] See *Access Policy in Capital Account Crises—Modifications to the Supplemental Reserve Facility and Follow-Up Issues Related to Exceptional Access Policy* (available at http://www.imf.org/external/np/tre/access/2003/pdf/011403.pdf).

[2] The analysis in this supplement is based on information on Fund arrangements as of end-September 2008. Except where specifically noted, it does not take into account the effects of other arrangements that may be put forward for the consideration of the Board in the near term.

I. Background

2. **Hungary has had an extensive financial relationship with the Fund since becoming a member in May 1982, but it has not borrowed from the Fund since 1993.** Purchases from the General Resources Account (GRA) were made under five SBAs, one extended arrangement, and three uses of the Compensatory Financing Facility during 1982 to 1993 (Table 2). Hungary's last arrangement with the Fund was its sixth SBA expiring in February 1998, and no purchases were made under this arrangement which was entered into on a precautionary basis. Total Fund credit to Hungary peaked at SDR 972 million in 1984-85, fell to SDR 174 million in 1990, rose again to SDR 908 million in 1993, and declined thereafter until full repayment in 1998 (Figure 1).

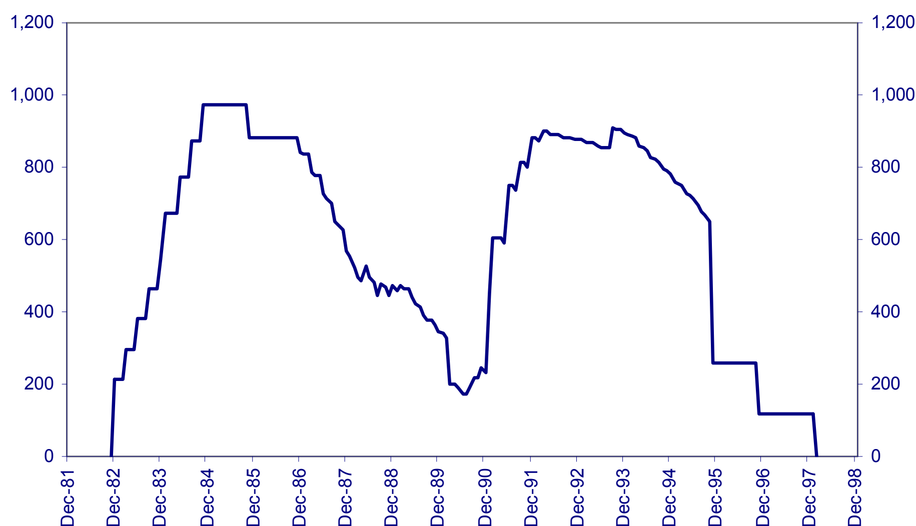
Table 2. Hungary: Actual and Projected Use of Fund Resources, 1982–2015
(In millions of SDRs)

Year		Type of Facility	Date of Arrangement 1/	Date of Expiration or Cancellation	Amount Approved	Amount Drawn	Purchases	Repurchases 2/	Fund Exposure 3/
1982		SBA, CFF	8-Dec-1982	7-Jan-1984	547.0	547.0	214.5	0.0	214.5
1983							332.5	0.0	547.0
1984		SBA	13-Jan-1984	12-Jan-1985	425.0	425.0	425.0	0.0	972.0
1985							0.0	88.3	883.7
1986							0.0	41.0	842.7
1987							0.0	272.9	569.9
1988		SBA	16-May-1988	30-Jun-1989	265.4	215.4	165.4	263.9	471.3
1989							50.0	174.2	347.1
1990		SBA	14-Mar-1990	19-Feb-1991	159.2	127.4	127.4	242.8	231.7
1991		EFF, CFF	20-Feb-1991	15-Sep-1993	1,340.2	783.4	703.8	55.3	880.2
1992		CFF	26-Mar-1992	26-Mar-1992	38.8	38.8	118.4	122.8	875.8
1993		SBA	15-Sep-1993	14-Dec-1994	340.0	56.7	56.7	36.2	896.3
1994							0.0	114.7	781.6
1995							0.0	522.9	258.7
1996		SBA	15-Mar-1996	14-Feb-1998	264.2	0.0	0.0	140.0	118.7
1997							0.0	0.0	118.7
1998							0.0	118.7	0.0
…									
…									
2008	4/	SBA	6-Nov-2008		*10,537.5*		*4,215.0*	--	*4,215.0*
2009	4/						*5,901.0*	--	*10,116.0*
2010	4/						*421.5*	--	*10,537.5*
2011	4/						--	--	*10,537.5*
2012	4/						--	*3,372.0*	*7,165.5*
2013	4/						--	*5,216.1*	*1,949.4*
2014	4/						--	*1,896.8*	*52.7*
2015	4/						--	*52.7*	*0.0*

Source: Finance Department.

1/ Includes purchases under the Compensatory Financing Facility.
2/ Projected repurchases follow obligations schedule.
3/ As of end-December, unless otherwise indicated.
4/ Figures under the proposed program in italics.

Figure 1. Hungary: IMF Credit Outstanding, 1981-1998
(In millions of SDRs)



Source: IFS.

3. **Notwithstanding the significant progress in fiscal consolidation achieved in recent years, the current global financial crisis has hit Hungary particularly hard**. This reflects the significant vulnerabilities arising from Hungary's high public debt and large external debt and debt service requirements. As of end-2007, Hungary's public debt was about 66 percent of GDP, which ranks highest among the emerging market members of the European Union (see Figure 3 of the staff report). Total external debt is projected to be 106 percent of GDP at end-2008 (Table 3), which is higher than all but one of the five recent exceptional access cases (Table 4).[3] [4] Given the size and maturity structure of external debt, total external debt service in 2008 is estimated at 28 percent of GDP (€ 29 billion), with public debt accounting for about one-sixth of external debt service. As discussed in the staff report, these high public and external debt burdens have increased the impact of global develeraging on Hungary, and especially on the Hungarian banking system.

[3] Hungary's external debt includes intercompany loans for FDI, which are projected to account for 20 percent of total external debt at end-2008. Public external debt comprises foreign-currency and domestic-currency denominated debt to non-residents, with foreign-currency denominated debt projected to represent 18.5 percent of GDP at end-2008, equivalent to one-half of total public external debt.

[4] The exceptional access cases used as comparators in this paper are five of the six arrangements approved since the exceptional access procedures were put in place (Argentina, Brazil, Georgia, Turkey, and Uruguay). The 2008 extended arrangement for Liberia also involved exceptional access. However, this arrangement was different from other exceptional access cases since, in this case, exceptional access was granted in the context of Liberia's clearance of arrears to the Fund.

Table 3. Hungary: External Debt, 2005–2008

		2005	2006	2007	2008 1/
		(In millions of euros)			
Total External Debt		66,608	81,428	98,266	112,951
of which:	Public	26,440	30,376	33,415	39,894
	Private	40,168	51,052	64,851	73,057
Net External Debt		30,372	38,280	48,756	54,696
		(In percent of GDP)			
Total External Debt		75.0	90.4	97.2	106.4
of which:	Public	29.8	33.7	33.0	37.6
	Private	45.2	56.7	64.1	68.8
Net External Debt		34.2	42.5	48.2	51.5

Sources: Hungarian authorities and IMF staff estimates.

1/ Projected to end-2008.

Table 4. Debt Ratios in Recent Exceptional Access Cases 1/
(In percent of GDP)

	Total External Debt	Public External Debt	Debt to IMF
Argentina (2003)	129.0	82.5	12.2
Brazil (2003)	38.6	21.5	5.1
Turkey (2005)	35.0	17.8	3.0
Uruguay (2005)	82.0	60.8	13.8
Georgia (2008) 2/	34.6	21.0	2.8
Hungary (2008) 3/	*106.4*	*37.6*	*4.2*

Sources: Board Documents and IMF staff estimates.

1/ Ratios for the year indicated in parenthesis. Year in parenthesis corresponds to the year of approval of the last IMF arrangement with each country.
2/ Projected for end-2008, including PRGF resources.
3/ Projected for end-2008, assuming first drawing under proposed SBA.

II. THE NEW SBA—RISKS AND IMPACT ON FUND FINANCES

A. Risks to the Fund

4. **Hungary's proposed access is relatively high and front-loaded compared with recent exceptional access cases.**[5] Hungary's outstanding use of the Fund's GRA resources would reach 406 percent of quota upon approval, and continue to rise to 1015 percent of quota in February 2010. Relative to quota, the peak exposure to Hungary would exceed all recent exceptional access cases aside from Turkey (Figure 2, panel A). While Hungary's proposed access level lies between those proposed for Iceland and Ukraine, Hungary's access is more front-loaded (Figure 2, panel B).

5. **If the proposed SBA is drawn in full, Hungary's total outstanding use of Fund resources will represent 10 percent of GDP.** Access under the proposed SBA is much greater than Hungary's previous exposures to the Fund (Table 2). From its first purchase, Hungary's outstanding use of Fund resources would be 4.2 percent of GDP, higher than the comparable ratios for all the current large users of Fund resources as of end-September 2008, except for Liberia (Table 5). Hungary's outstanding use of Fund resources in terms of GDP would reach about 10 percent upon completion of the arrangement in early 2010 (Table 6), roughly in the middle of recent exceptional access cases (Table 4).

6. The Fund will account for a significant share of Hungary's public external debt and debt service if the proposed SBA is fully drawn. By end-2008, Hungary's outstanding use of Fund resources would account for 11 percent of public external debt, rising to 22 percent by end-2009 (Table 6). Given Hungary's already large debt service burden, payments to the Fund would put further strains on its external debt servicing capacity, with projected service under the proposed SBA peaking in 2013 at SDR 5.5 billion, accounting for 34 percent of public external debt service (5 percent of exports of goods and services).[6]

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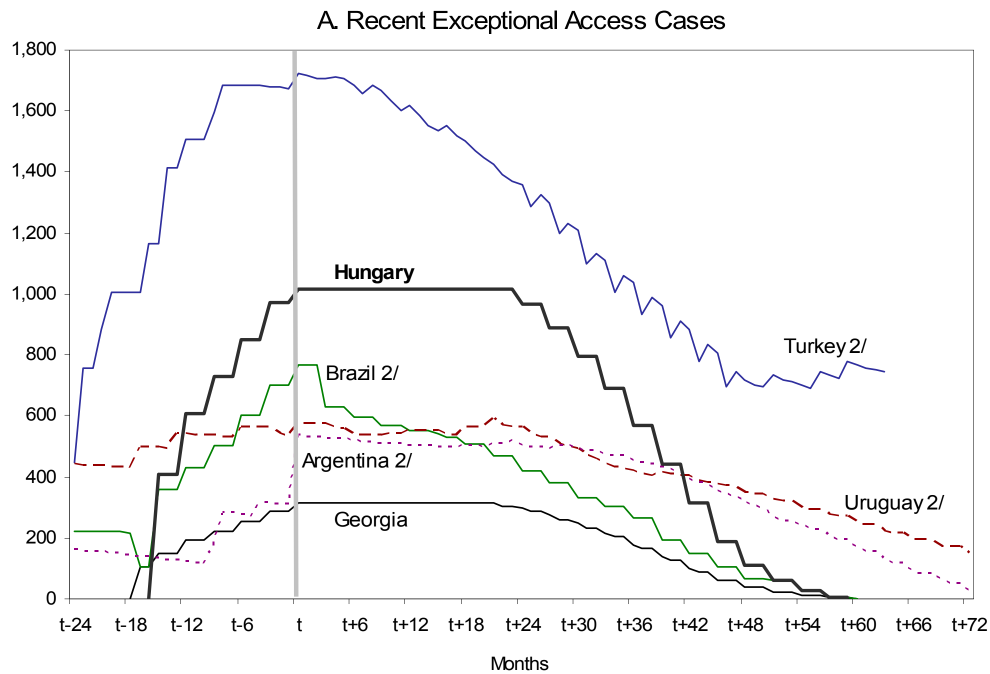
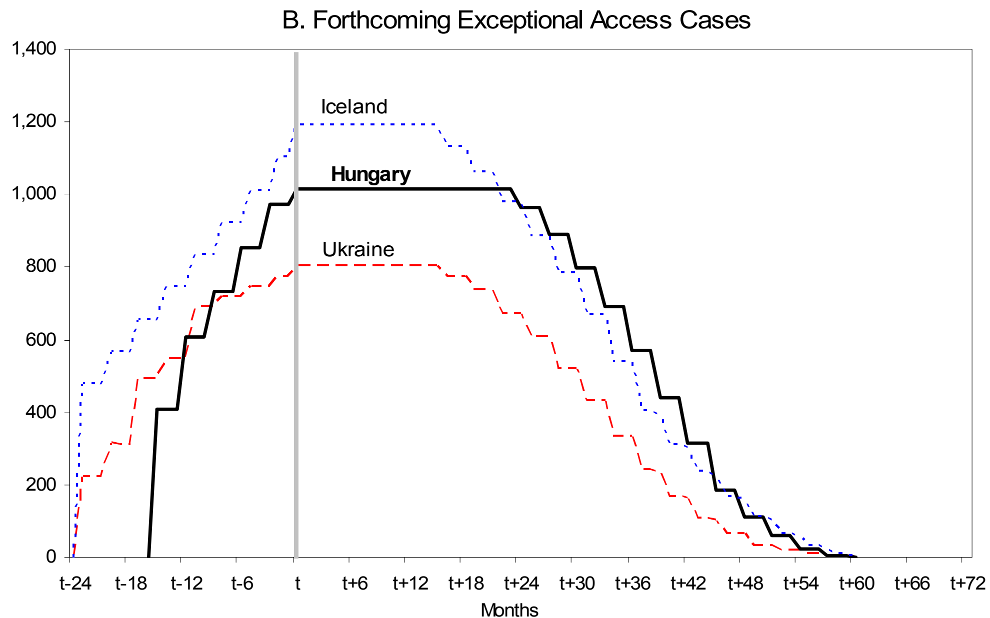
[5] Currency holdings resulting from scheduled purchases under the proposed SBA would be subject to level-based surcharges of 100 basis points over the basic rate of charge (adjusted for burden sharing) on credit outstanding exceeding 200 of percent of quota, and surcharges of 200 basis points on credit outstanding exceeding 300 percent of quota, from the approval of the arrangement until October 2013.

[6] The figures on debt service used in this report correspond to the schedule on an obligations basis, in line with the guidelines stipulated in Review of Fund Facilities—Proposed Decisions and Implementation Guidelines (available at http://www.imf.org/external/np/pdr/fac/2000/02). Under the obligations schedule, the first repurchase is scheduled to take place in February 2012, 3¼ years after the first purchase under the arrangement. Under the policy on time-based repurchase expectations, there is an expectation that repurchases of holdings resulting from purchases in the credit tranches and the EFF, including under exceptional access, will adhere to the expectations schedule, and an extension from the expectations to the obligations schedule would require a decision by the Executive Board.

Figure 2. Fund Credit Outstanding in the GRA around Peak Borrowing 1/
(in percent of quota)





Source: IFS, Finance Department, and IMF staff estimates.

1/ Peak borrowing is defined as the highest level of credit outstanding for a member, in percent of quota. Month t represents the month of the highest historical credit outstanding (in percent of quota). For Argentina, t is September 2001; for Brazil, September 2003; for Turkey, April 2003; and for Uruguay, August 2004. For Georgia, t would be reached in February 2010. For the countries in Panel B, t would be reached in February 2010 in the case of Hungary, and October 2010 in the cases of Iceland and Ukraine. For comparability, projected repurchases are assumed to be on an obligations basis.

2/ Projected repurchases (on an obligation basis) as of May 2005. Schedules do not show large early repurchases made by Argentina, Brazil, and Uruguay in 2005-06.

Table 5. Fund GRA Exposures

		In Percent of			
				Total GRA Credit	
	SDR Millions	Quota	GDP 3/	As of end-Sep. 2008	After approval of arrangements in panel B 4/
A. Top five borrowers as of end-September 2008					
Turkey 1/	5,898.7	495.1	1.2	77.9	38.4
Dominican Republic 1/	350.2	160.0	1.2	4.6	2.3
Liberia 1/	342.8	265.3	59.4	4.5	2.2
Sudan 1/	220.9	130.2	0.6	2.9	1.4
Georgia 1/	161.7	107.6	2.0	2.1	1.1
B. Forthcoming exceptional access cases					
Iceland 2/	560.0	476.2	5.1	…	3.6
Hungary 2/	4,215.0	405.9	4.2	…	27.5
Ukraine 2/	3,073.1	224.0	2.6	1.0	20.0

Sources: Finance Department and IMF staff estimates.

1/ Fund credit outstanding as of September 30, 2008.

2/ Fund credit outstanding after the first purchases of the proposed SBA. For Ukraine, includes credit outstanding as of end-September 2008.

3/ Staff projections to end-2008.

4/ Numerator is Fund credit outstanding as of end-September 2008 for countries in panel A, and Fund credit outstanding as of end-September 2008 plus the first purchase under the proposed SBA for countries in panel B. Denominator is the sum of total Fund GRA credit outstanding as of end-September 2008 and the first purchases of the three proposed arrangements in panel B.

7. Moreover, there are considerable risks to Hungary's capacity to repay the Fund. The main risks would include:

- **Accelerated capital outflows.** The program is based on certain rollover rates for the funding of foreign-owned banks and for other debts—including those of domestic banks—which, if not realized, could lead to exchange rate overshooting, exacerbating pressures on households, corporates, and banks, and causing a sharper-than-envisaged slowdown in growth. The resulting deterioration in private sector balance sheets would undermine prospects for rebuilding foreign reserves.

- **The process of global deleveraging.** It is very difficult to predict the impact of current developments in international financial markets on investors' exposure to emerging markets in the medium-term. The depth and pace of recovery from global deleveraging will have a bearing on Hungary's ability to mobilize resources from international capital markets.

- **Inadequate program implementation.** Notwithstanding the recent progress in fiscal consolidation and the improvement in the external current account, it will be challenging to sustain the envisaged fiscal adjustment in the context of a sharp slowing in growth and given the government's lack of a parliamentary majority.

Table 6. Hungary—Impact on GRA Finances

(in millions of SDRs, at end of period unless otherwise noted)

	2008	2009	2010	2011	2012	2013	2014	2015
Exposure								
Fund GRA credit outstanding to Hungary 1/	4,215.0	10,116.0	10,537.5	10,537.5	7,165.5	1,949.4	52.7	0.0
Fund GRA credit outstanding to Hungary (percent of quota) 1/	405.9	974.2	1,014.8	1,014.8	690.1	187.7	5.1	0.0
Fund GRA credit outstanding to Hungary (percent of total GRA credit outstanding) 2/	27.5	…	…	…	…	…	…	…
Fund GRA credit outstanding to five largest debtors (percent of total GRA credit outstanding) 2/	91.9	…	…	…	…	…	…	…
Liquidity								
One-year Forward Commitment Capacity (FCC) 3/	127,615.8	…	…	…	…	…	…	…
Hungary's impact on FCC 4/	(10,537.5)	…	…	…	…	…	…	…
Prudential measures								
Fund GRA credit outstanding to Hungary (percent of current precautionary balances) 5/	60.7	…	…	…	…	…	…	…
Debt and Debt Service Ratios 6/								
Hungary's GRA credit outstanding (percent of total public external debt)	11.1	21.8	21.0	20.1	14.6	4.4	0.1	0.0
Hungary's GRA credit outstanding (percent of GDP)	4.2	10.8	10.2	9.5	6.0	1.5	0.0	0.0
Hungary's GRA credit outstanding (percent of gross international reserves)	22.7	53.2	53.5	46.7	27.6	6.8	0.2	0.0
Hungary's GRA debt service to the Fund (percent of exports of goods and services)	0.0	0.4	0.6	0.6	3.9	5.1	1.7	0.0
Hungary's GRA debt service to the Fund (percent of total public external debt service)	0.4	5.0	7.4	6.3	26.8	33.7	14.0	0.5
Memorandum items								
Fund's precautionary balances 5/	6,938.6	…	…	…	…	…	…	…
Fund's residual burden sharing capacity 7/	110.0	…	…	…	…	…	…	…
Projected payment of charges to the Fund on GRA credit outstanding	21.1	355.0	538.5	542.4	486.0	244.5	36.8	0.5
Projected debt service payments to the Fund on GRA credit outstanding	21.1	355.0	538.5	542.4	3,858.0	5,460.5	1,933.5	53.2

Sources: Hungarian authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

1/ Repurchases follow obligations schedule.
2/ Reflects Fund credit outstanding as of September 30, 2008, plus first purchases by Hungary, Iceland, and Ukraine.
3/ As of September 30, 2008. The Forward Commitment Capacity is a measure of the resources available for new financial commitments in the coming year, equal to usable resources plus repurchases one-year forward minus the prudential balance.
4/ A single country's negative impact on the FCC is defined as the country's sum of Fund credit and undrawn commitments minus repurchases one-year forward. It does not incorporate the possibility that Hungary would not remain the Financial Transactions Plan.
5/ As of end-April 2008.
6/ Staff projections for total public external debt, GDP, gross international reserves, and exports of goods and services, as used in the staff report that requests the proposed SBA.
7/ Estimated based on end-September data and taking into account the first purchases of Hungary, Iceland and Ukraine under their proposed programs. Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate. Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being utilized to offset deferred charges and takes into account the loss in capacity due to nonpayment of burden sharing adjustments by members in arrears.

B. Impact on Fund Finances

8. The proposed arrangement would have a significant impact on the Fund's liquidity.[7] The proposed SBA would reduce the one-year forward commitment capacity (FCC) by SDR 10.5 billion, about 8 percent of the FCC of SDR 127.6 billion as of end-September (Table 6).[8] Moreover, in light of the sharp weakening in Hungary's external position, it would be proposed that Hungary be excluded from the forthcoming Financial Transactions Plan. Hungary's exclusion would have the effect of reducing the FCC by an additional SDR 0.8 billion.

9. **Hungary may become the second largest exposure in the Fund's lending portfolio.** Assuming that first purchases are also made under the proposed arrangements for Iceland and Ukraine, Hungary's share of total Fund credit outstanding would be about 27 percent, second only to Turkey (Table 5). The share of total credit extended to the top-five borrowers was 92 percent as of end-September 2008, and this measure of portfolio concentration would be almost unchanged following the first purchases under these proposed arrangements (Table 6). Nonetheless, the concentration of the Fund's lending portfolio could change significantly if additional arrangements are approved.

10. **Potential GRA exposure to Hungary would also be high relative to the Fund's precautionary balances.** After the first purchase, GRA credit to Hungary would be equivalent to 61 percent the Fund's precautionary balances as of end-April 2008 (Table 6), and this exposure would rise to about 150 percent of current precautionary balances if the proposed SBA is fully drawn.

11. **If Hungary were to incur arrears on the charges accruing on its GRA obligations the Fund's burden-sharing capacity could be exceeded.**[9] Charges on Hungary's GRA obligations are projected at SDR 355 million in 2009, well in excess of estimates of the Fund's residual burden-sharing capacity assuming that first purchases are also made under

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[7] Indicators of Fund liquidity, adequacy of reserves, and impact on the burden-sharing mechanism are likely to change in light of some potentially large arrangements already agreed or under negotiation.

[8] The FCC is the principal measure of Fund liquidity. The (one-year) FCC indicates the amount of quota-based, nonconcessional resources available for new lending over the next 12 months. Following the creation of the Short-term Liquidity Facility (SLF), the calculation of the FCC will exclude repurchases falling due under the SLF—see A New Facility for Market Access Countries—The Short-term Liquidity Facility—Proposed Decision (available at http://www.imf.org/external/np/pp/eng/2008/102708.pdf).

[9] Under the burden-sharing mechanism, the financial consequences for the Fund arising from overdue financial obligations are shared between creditors and debtors through a decrease in the rate of remuneration and an increase in the rate of charge, respectively. The mechanism is used to accumulate precautionary balances in the special contingent account (SCA-1) and to compensate the Fund for a loss in income when debtors do not pay charges. The Executive Board has set a floor for remuneration at 85 percent of the SDR interest rate. No corresponding ceiling applies to the rate of charge. The adjustment for the SCA-1 was suspended, effective November 1, 2006, by the Executive Board (Decision No. 13858-(07/1), adopted January 3, 2007).

the proposed arrangements for Iceland and Ukraine (Table 6). However, the impact on the Fund's burden sharing capacity of potential overdue charges on outstanding purchases from this arrangement would decline if the Fund's loan portfolio were to expand.

III. ASSESSMENT

12. **The proposed arrangement with Hungary entails significant financial risks to the Fund.** Access proposed under the arrangement aims to strengthen confidence in Hungary's ability to address the present environment of global deleveraging by bolstering its reserve position and thereby providing breathing space for the macroeconomic adjustment envisaged under the program to take hold and minimizing the risk of a run on Hungary's debt and currency markets. However, the proposed access represents a significant share of the Fund's liquidity, is at the high end of recent exceptional access cases, and is relatively front-loaded. A range of factors may impair Hungary's capacity to repay the Fund, including the potential for accelerated capital outflows in case of lower-than-expected rollover rates on external obligations, while challenges in program implementation could undermine the rebuilding of investor confidence. Hungary may also face difficulties in repaying the Fund on account of potential difficulties in securing adequate capital market access, against the background of Hungary's already high debt burden and the possibility that the pace of recovery from global deleveraging will be gradual, although such difficulties may be moderated by the continuing integration of Hungary's economy into the European Union. The Hungarian authorities' resolve to adhere to the policies contemplated in the proposed arrangement, their commitment to maintaining fiscal discipline in the long-term, and their readiness to take additional measures as appropriate to ensure the achievement of the objectives of their economic program, are key to mitigating these risks and safeguarding Fund resources.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

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FOR IMMEDIATE RELEASE
November 6, 2008

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves €12.3 Billion Stand-By Arrangement for Hungary

The Executive Board of the International Monetary Fund (IMF) today approved a 17-month SDR 10.5 billion (about €12.3 billion or US$15.7 billion) Stand-By Arrangement for Hungary to avert a deepening of financial market pressures. The approval makes SDR 4.2 billion (about €4.9 billion or US$6.3 billion) immediately available and the remainder will be available in five installments subject to quarterly reviews. The Stand-By Arrangement entails exceptional access to IMF resources, amounting to 1,015 percent of Hungary's quota, and was approved under the Fund's fast-track Emergency Financing Mechanism procedures.

The IMF arrangement is designed to facilitate the rapid reduction of financial market stress in Hungary, while supporting the country's longer-run economic goals by creating conditions necessary to facilitate appropriate reforms in government finances and in the banking sector. Specifically, the IMF-supported economic program is based on two key objectives: to implement a substantial fiscal adjustment to ensure that the government's debt-financing needs will decline; and to maintain adequate liquidity and strong levels of capital in the banking system.

The recent international financial turmoil has increased the rollover risk of Hungary's external debt. The IMF's financial support, combined with the commitments by the European Union (€6.5 billion or about US$8.4 billion) and the World Bank (€1 billion or about US$1.3 billion), which total €20 billion (about US$25.8 billion) in financial support, will provide Hungary with the amount of reserves that is sufficient to meet its external obligations, even in extreme market circumstances.

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

"Hungary's successful macroeconomic adjustment in recent years has been disrupted by the global financial crisis. Over the past two years, fiscal consolidation has sharply reduced the

fiscal deficit. The introduction of a floating exchange rate regime in early 2008 removed potential conflicts between monetary and exchange rate policies in an inflation targeting environment.

"However, with the decline in global liquidity and increase in risk aversion, financial markets in Hungary came under intense pressure, given Hungary's high debt levels and significant balance sheet mismatches. Several government bond auctions failed, liquidity in the secondary bond market dried up, and bond yields rose sharply. At the same time, the stock market fell and the currency depreciated.

"Reducing financial market stress will require both a high degree of policy discipline and large external financing. The authorities' comprehensive set of policy measures, supported by the 17-month Stand-By Arrangement under the Fund's exceptional access policy, is designed to strengthen Hungary's economy and thereby foster a reduction in financial market stress. The path of fiscal adjustment has been accelerated, liquidity provision to financial markets is being enhanced, a system is being put in place to ensure that high levels of capital in the banking system are maintained, and financial sector surveillance is being strengthened. These measures address Hungary's most important vulnerabilities and should therefore underpin an improvement in investor confidence. Most important, the combination of accelerated fiscal adjustment and the introduction of a rules-based fiscal framework will help persuade investors that the government's short- and medium-term financing needs are being addressed.

"In the context of global financial market turmoil, the restoration of investor confidence requires not only a strong economic program, but also large external financing support. Support from the international community will provide reassurance that Hungary's external obligations can be met. Against this background, the joint financial assistance being provided by the IMF, the European Union, and the World Bank sends a strong signal of the international community's confidence that, with the consistent implementation of the program, Hungary will weather the current difficulties."

ANNEX

Recent Economic Developments

Hungary was among the first emerging market countries to suffer from the fallout of the current global financial crisis. As financial difficulties in advanced economies led to a decline in global liquidity and an increase in risk aversion, investors increasingly started differentiating among emerging markets. Hungary's high external debt levels, which amounted to 97 percent of GDP at end-2007, and significant balance sheet mismatches, negatively affected investor appetite for Hungarian assets. Even though macroeconomic and financial policies had been strengthened since 2006, with substantial fiscal consolidation and tax administration improvements, Hungary was hit hard by the global deleveraging. Financial markets in Hungary have come under significant stress in recent weeks, reflecting the rise in perceptions of counterparty risk.

Program Summary

Growth is expected to contract in 2009 to -1 percent from around 1¾ percent in 2008. Already weak private consumption and investment will be negatively affected by a sharp reduction in new bank lending. Inflation, which peaked at 9 percent in early 2007, is projected to continue a downward trend and reach 4 percent at end-2009. In a difficult global environment and with low domestic demand, the economy is projected to recover only gradually due to the fact that the slowdown is simultaneously occurring in Hungary's main trading partners and the global deleveraging process that will leave less foreign capital available to quickly return to Hungary. Growth is not expected to reach its estimated potential of 3 percent until after 2011.

The authorities' economic program is designed to foster a rapid return of less stressed financial market conditions, while supporting longer-run structural goals. The main pressure points in Hungary are in public finances and the banking sector. In response, the program is based on the following key elements:

- **Given Hungary's large public debt, substantial fiscal adjustment is required** to provide confidence that the government's financing need can be met in the short and medium run. The program envisages a large structural fiscal adjustment of 2½ percent of GDP with emphasis on expenditure measures, consistent with the need to reduce the country's large public sector. To put fiscal sustainability on a permanent footing, a rules-based fiscal framework will also be introduced. To mitigate social impacts, low-income pensioners will be exempt from the elimination of pension bonuses.

- **Upfront bank capital enhancement is needed** to ensure that banks are sufficiently strong to weather the imminent economic downturn, both in Hungary and in the region. The banking sector support package in the program contains provisions for

added capital and resources to finance a guarantee fund for interbank lending to establish a level-laying field for the Hungarian banks in an international environment where their competitors already have access to similar guarantees.

- **Large external financing assistance is needed to support Hungary's return to normal international funding**. In addition to the IMF, contributions are being received from both the EU and the World Bank.

Hungary joined the IMF on May 6, 1982; its quota is SDR 1,038.4 million (about €1,212.9 million or US$1,548.8 million), and it has no outstanding use of IMF credits.

Hungary: Main Economic Indicators, 2005–09

	2005	2006	2007	2008	2009
				Proj.	
Real economy (change in percent)					
Real GDP	4.1	3.9	1.1	1.8	-1.0
CPI (end year)	3.3	6.5	7.4	5.1	4.2
CPI (average)	3.6	3.9	7.9	6.3	4.5
Unemployment rate (average, in percent)	7.2	7.5	7.4	7.8	8.5
Gross domestic investment (percent of GDP) 1/	23.6	23.1	23.0	22.8	20.0
Gross national saving (percent of GDP, from BOP)	16.1	15.6	16.6	16.5	18.0
General government (percent of GDP), ESA-95 basis 2/					
Overall balance	-7.8	-9.3	-4.9	-3.4	-2.5
Primary balance	-3.7	-5.4	-0.9	0.6	1.9
Debt	61.6	65.5	65.8	67.4	70.1
Money and credit (end-of-period, percent change)					
M3	14.6	13.8	11.0	4.1	1.3
Credit to nongovernment	18.9	17.1	17.3	7.2	-6.2
Interest rates (percent)					
T-bill (90-day, average)	6.8	7.0	7.6	...	...
Government bond yield (5-year, average)	8.0	6.9	7.0	...	...
Balance of payments					
Goods and services trade balance (percent of GDP)	-1.2	-0.9	1.4	1.8	7.5
Current account (percent of GDP)	-7.5	-7.5	-6.4	-6.2	-2.0
Reserves (in billions of euros)	15.7	16.4	16.4	19.5	19.8
Gross external debt (percent of GDP) 3/	75.0	90.4	97.2	106.4	115.8
Exchange rate					
Exchange regime	Floating				
Present rate (November 6, 2008)	Ft 202.3 = US$1; Ft. 261.4 = €1				
Nominal effective rate (2000=100)	111.6	105.1	111.8	…	…
Real effective rate, CPI basis (2000=100)	132.6	127.0	142.5	…	…
Quota at the Fund	SDR 1038.4 million				

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and IMF staff estimates.
1/ Includes change in inventories.
2/ 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.
3/ Including inter-company loans, and nonresident holdings of forint-denominated assets.