© 2009 International Monetary Fund

October 2009
IMF Country Report No. 09/304

Hungary: Third Review Under the Stand-By Arrangement, Requests for Extension of the Arrangement, Rephasing of Purchases, and Modification of Performance Criterion

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on September 7, 2009, with the officials of Hungary on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 16, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Press Release summarizing the views of the Executive Board as expressed during its September 25, 2009 discussion of the staff report that completed the review.

The documents listed below 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.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

HUNGARY

Third Review Under the Stand-By Arrangement, Requests for Extension of the Arrangement, Rephasing of Purchases, and Modification of Performance Criterion

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

Approved by Anne-Marie Gulde and Lorenzo Giorgianni

September 16, 2009

- **Stand-By Arrangement:** a 17-month SBA in the amount of SDR 10.5 billion (1015 percent of quota) was approved by the Executive Board (Country Report No. 08/361) on November 6, 2008, and the first purchase of SDR 4.2 billion was made following the Board meeting. The second purchase of SDR 2.1 billion was made following the First Review on March 25, 2009 (Country Report No. 09/105). The third purchase of SDR 1.3 billion was made following the Second Review on June 23, 2009 (Country Report No. 09/197). The European Commission and the World Bank are also providing funds to cover the financing gap under the program.

- **Proposed changes to SBA**: The authorities are requesting a six-month extension of the arrangement to October 5, 2010, and a rephasing of the undisbursed amounts over the remainder of the arrangement.

- **Program status**: All end-June 2009 quantitative performance criteria, the continuous performance criterion on non-accumulation of external arrears, as well as the continuous structural benchmark related to government lending to banks were met. The end-June indicative target on central government debt was not met due to technical reasons.

- **Discussions**. Discussions were held in Budapest during August 26–September 7. The mission met with Prime Minister Bajnai, Minister of Finance Oszkó, central bank Governor Simor, other senior officials, representatives of financial institutions, and academics. The staff team comprised Mr. Morsink (head), Ms. Carare, Mr. Wiegand (all EUR), Ms. Barkbu (SPR), Messrs. Debrun and Martin (both FAD) and Frécaut (MCM). Ms. Ivaschenko (Resident Representative) assisted the mission. Mr. Abel (OED) attended most of the meetings.

- **Publication**. The Hungarian authorities have consented to the publication of the staff report.

Contents Page

I. Introduction and Summary 4
II. Recent Developments....5
III. Policy Discussions 6
A. Macroeconomic Framework 6
B. Fiscal Policy 7
C. Financial Sector Policies 10
D. Monetary and Exchange Rate Policy 13
IV. Program Modalities 14
V. Staff Appraisal 15

Boxes
1. Potential Output 17
2. The Fiscal Responsibility Law as a Fiscal Anchor....18
3. Central Bank's Liquidity Facility....19
4. Stand-By Arrangement 20

Tables
1. Main Economic Indicators, 2006–10....21
2. Monetary Accounts, 2006–10....22
3. Balance of Payments, 2008–11....23
4. Indicators of External Vulnerability, 2005–09 Q2 24
5. Staff's Illustrative Medium-Term Scenario, 2006–14....25
6. Consolidated General Government, 2006–11....26
7. Borrowing Requirement of the Central Government, 2009–10....27
8. Financial Soundness Indicators for the Banking Sector, 2005–09 Q2 28
9. Program Financing, 2008 Q4 to 2010 Q3....29
10. Schedule of Reviews and Purchases....30
11. Indicators of Fund Credit, 2008–15....31

Figures
1. Recent Economic Developments....32
2. Bank Lending to Corporations and Households, 2008–09 33
3. Financial Market Developments, 2008–09....34
4. Monetary Policy Indicators, 2008–09....35

Appendix Tables
1. External Debt Sustainability Framework, 2004–14....36
2. Public Sector Debt Sustainability Framework, 2004–14....37

Appendix Figures

1. External Debt Sustainability: Bound Tests 38
2. Public Debt Sustainability: Bound Tests 39

Attachments

I Letter of Intent (LOI) 40
II. Technical Memorandum of Understanding (TMU) 52

I. Introduction and Summary

1. **Hungary's economic outlook has stabilized since the last review, reflecting in part the stabilization of the global outlook, and macroeconomic and financial policies are on track**. The end-June 2009 quantitative performance criteria, as well as the structural benchmark related to government lending to banks, were all met. The end-June indicative target on central government debt (excluding official financing) was not met for technical reasons, as market financing was used to bridge to the disbursement of the third tranche of EU balance of payments support in early July (instead of June).

2. **Against this background, the key objectives of the program remain to improve fiscal sustainability and preserve financial stability**:

- To help put government debt as a share of GDP firmly on a declining path over the medium term, the authorities are implementing comprehensive structural reforms aimed at permanently reducing government spending and bolstering potential GDP growth.
- Policies to underpin financial stability are being strengthened, including by enhancing the capability to do on-site bank inspections. Institutional arrangements will be reformed to improve the supervisory agency's independence and to give the central bank the authority to issue temporary regulations on systemic macro-prudential issues.
- The combination of improved global financial conditions and increased confidence in fiscal sustainability has created room for cautious interest rate cuts.

3. **The authorities have requested a six-month extension of the Stand-By Arrangement to cover the parliamentary elections scheduled for April 2010 and the transition to a new government** (LOI ¶3). Given the increase in international reserves, due in part to Hungary's SDR allocation of SDR 991 million (about €1,085 million), a purchase of SDR 50 million (about €55 million) is proposed following completion of this review. The remaining amount under the arrangement would be rephased in four equal disbursements of SDR 725 million (about €800 million) over the remainder of the extended arrangement.

4. **The third tranche of EU balance of payments support (€1.5 billion) was disbursed on July 6, 2009**. The remaining amount of EU balance of payments support (€1 billion) is likely to be rephased broadly in line with the SBA, with disbursements in the first three quarters of 2010. Fund staff have continued to cooperate closely with the staff of the European Commission.

5. **The World Bank is expected to approve a €1 billion Financial Sector and Macro Stability Loan on September 22, 2009**. The first tranche of €500 million would be disbursed following the approval of the loan, and the second tranche could be disbursed

in 2010H1. Fund staff are cooperating closely with Bank staff on macro-critical structural issues (Appendix II).

II. Recent Developments

6. **Economic activity contracted sharply in the first half of 2009, as expected, but there are signs that the pace of decline is easing** (Table 1 and Figure 1):

- ***Real GDP fell by 7.5 percent year-on-year in 2009Q2***. The rise in the unemployment rate, which was temporarily reversed by a public employment program for the long-term unemployment, resumed in July. The year-on-year changes in industrial production and retail sales are still very negative, but recent month-on-month changes have stabilized.

- ***Credit growth has come to a standstill, accompanied by a shift from FX to HUF lending*** (Figure 2). Bank deposits have increased, especially corporate deposits, suggesting that, for the economy as a whole, credit developments owe more to weak demand than to restrictive lending practices.

- ***CPI inflation rose to 5.0 percent in August due to the VAT hike.*** The initial impact of the VAT hike was lower than expected. Private sector wage growth excluding bonuses was 5.6 percent y-o-y in June.

- ***The current account deficit is estimated to have narrowed to 1 percent of GDP in the first half of 2009***, reflecting weak domestic demand and temporarily low gas imports due to the Russia-Ukraine dispute. Export volumes contracted sharply, due to a plunge in exports of machinery and transport equipment. The capital account is estimated to have reached a surplus of 3.3 percent of GDP, reflecting a front loading of EU structural and cohesion funds.

7. **Strains in financial markets have eased further in recent months** (Figure 3):

- ***The exchange rate has stabilized at about 270 forint per euro,*** reflecting increasing demand by nonresidents for HUF-denominated assets. Liquidity in the FX spot market has continued to improve (as indicated by lower bid-ask spreads) and exchange rate volatility has fallen further, although it remains above pre-crisis levels. Spreads and maturities in the FX swap market, which banks use to match the currency structure of their funding with that of their assets, have returned to normal.

- ***Conditions in the government bond market have improved***. The government issued a five-year €1 billion euro bond on July 17, at 395 bps above euro mid-swaps. The government debt management agency (AKK) has reduced buy-backs of HUF-denominated bonds to pre-crisis levels, and is now issuing debt at a pace that would allow the government to cover both the deficit and the roll-over need for HUF

denominated bonds for the remainder of 2009 and for 2010. In the secondary market, yields on five-year bonds have dropped to around 8 percent, down from around 10 percent in May.

- ***International reserves were above the program floor at end-June.*** Rapid current account adjustment and high EU transfers reduced the external financing requirement more than anticipated in 2009Q2. Banks saw a decline in external financing, as domestic credit institutions replaced market funding with direct FX loans from the government, and foreign parent banks repatriated some of the funds that they had injected in late 2008 and early 2009. NIR declined by €2.7 billion, of which €2.1 billion represented the FX lending to banks and another €0.4 billion was related to foreign currency debt reimbursement of the government. The July euro bond issue and the general SDR allocation brought reserve coverage to 100 percent of short-term external debt at remaining maturity at end-August.

III. Policy Discussions

A. Macroeconomic Framework

8. **The macroeconomic outlook for 2009-10 has changed only modestly since the second review, reflecting in part the stabilization of the global outlook** (LOI ¶6-8).

- ***Real GDP is still projected to fall by 6.7 percent in 2009 and 0.9 percent in 2010***. In 2009, domestic demand and imports are now projected to be slightly weaker, reflecting the outcome in the first half of 2009. In 2010, net exports are broadly unchanged, as the improvement in the global outlook is offset by a more appreciated exchange rate. Risks to the forecast are more balanced than before.
- ***Credit to the economy is expected to contract in 2009 and then start to recover in 2010*** (Table 2). The contraction in 2009 reflects weak demand for credit and restrictive lending conditions, as banks try to reduce risk-weighted assets. The trough in credit is projected to be reached in 2010Q1, in line with real GDP. A gradual recovery is expected thereafter.
- ***The current account deficit is expected to narrow sharply to 2.9 percent of GDP in 2009*** (Table 3). The size of the adjustment relative to 2008—more than 5 percentage points of GDP—is higher than at the second review. The revision is primarily determined by the slightly larger-than-expected contraction of domestic demand. In 2010, the current account deficit increases modestly to 3.3 percent of GDP, as the improvement in trade volumes is more than offset by price effects.
- ***CPI inflation is projected to rise to about 6 percent by end-2009 and then fall to below 3 percent by mid-2010***. The 2009 forecast is unchanged from the second review, as a lower-than-expected pass-through from the VAT and excise tax increases and a more appreciated exchange rate are offset by higher commodity prices and a

smaller negative output gap due to the downward revision of potential growth. The small increase in the 2010 forecast reflects the increases in excises approved since May, which will take effect in January 2010.

9. **Given more benign global financial conditions, the external financing assumptions have been revised up, but remain cautious** (Tables 3, 4 and 9). Going forward, non-residents are expected to maintain their share of HUF-denominated government bonds, and to be willing to provide much of the financing for FX bond redemptions. Corporations, for which rollover rates have exceeded 100 percent in recent months, are expected to roll over 90 percent of external debt in 2009H2, increasing to 100 percent by 2010H2. The assumptions for banks are more cautious, with 70–80 percent rollover expected in 2009H2 (in line with the original program), recovering gradually to 100 percent in 2010H2.

10. **Potential GDP growth over the medium term is now projected to be lower than at the second review** (Box 1 and Table 5). A permanent effect of the financial crisis on the price of global capital is expected to reduce investment. Risks to medium-term growth remain tilted to the downside, reflecting risks to future fiscal policy and the global recovery.

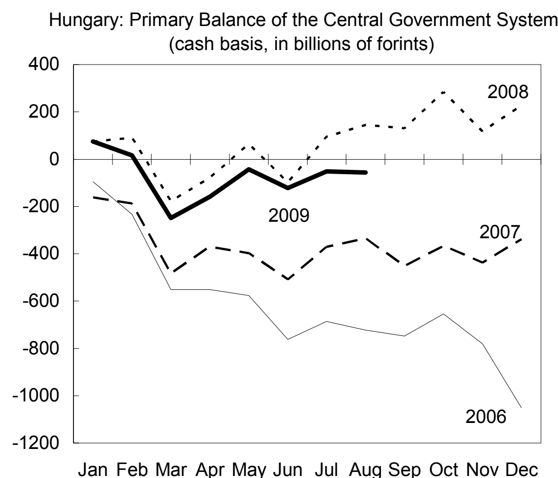
11. **The program aims to ensure that external debt is firmly on a sustainable path** (Appendix Table 1 and Figure 1). The external debt-to-GDP ratio is expected to peak at 132 percent at end-2009, lower than projected at the second review, due to a stronger exchange rate. External debt would gradually decline starting in 2011 to about 115 percent of GDP by 2014, reflecting the expected improvement in the trade balance, a pick-up in GDP growth, and a return of non-debt creating capital inflows. Notwithstanding the lower external debt-to-GDP ratio projected for 2009-10, the ratio in 2014 is about the same as at the second review, because potential GDP growth has been revised down. The debt outlook would worsen significantly if the exchange rate was to depreciate.

B. Fiscal Policy

12. **Strengthening fiscal sustainability is at the core of the program** (Table 5 and LOI ¶10). The structural general government balance is expected to improve by about 3 percentage points of GDP in 2009 and a further 0.9 percentage points of GDP in 2010. In the medium term, no further adjustment is assumed beyond a relatively small adjustment of 0.1 percentage points of GDP in 2011 to bring the headline general government deficit to below 3 percent of GDP, in line with EU commitments. The projected declines in expenditure and revenue ratios in 2011 and beyond reflect the authorities' view, which is shared by staff, that a reduction in the size of government would have a favorable impact on potential GDP growth. Decisions about spending and revenue in 2011 and beyond will be taken by the new government following the April 2010 parliamentary elections. Based on these assumptions, the government debt-to-GDP ratio is expected to peak at about 80 percent at end-2010 and then decline to about 70 percent by 2014 (Appendix Table 2 and Figure 2).

The roughly constant structural overall balance after 2011, which implies a substantial improvement in the headline overall balance as the output gap narrows, is essential to reduce the public debt-to-GDP ratio under a broad range of adverse shocks.

13. **The end-June 2009 target on the primary deficit of the central government was met, even though there were expenditure overruns in certain areas** (text chart and LOI ¶11). These overruns reflected weaknesses in expenditure control and planning (e.g., disability benefits, highway construction) and, to a lesser extent, deteriorating macroeconomic conditions (e.g., unemployment benefits, sick leave). The primary deficit target, which is calculated on a cash basis, was met because of the lagged response of receipts on EU-financed investment projects to lower-than-expected expenditure on these projects,[1] as well as relatively low CIT refunds in June.



14. **The authorities and staff agreed on the importance of limiting the general government deficit in 2009 to 3.9 percent of GDP** (Table 6 and 7). The authorities have allocated most of their contingency reserves to cover the spending overruns observed in the first half of the year. The downward revision of projected annual revenues stemming from lower car registrations, private consumption, and corporate profits, would be offset by lower interest payments and the freeze of the residual stability reserves. Risks are related to CIT collections in December (which will be the first to fully reflect the companies' financial performance in 2009) and the amount of VAT refunds related to the European Court of Justice's April 2009 ruling. On the positive side, the general government balance is positively affected by lower-than-expected capital spending at the local level.

15. **Aware of these risks, the authorities have adopted a risk management plan** (LOI ¶12). To avoid further spending overruns, controls were strengthened by setting strict limits on the use of carryover balances and by assigning to budgetary units treasurers in charge of ensuring that expenditure commitments are consistent with budget appropriations. To address other risks, the authorities intend to rely on the remaining general reserves and on identified contingency measures. Should these buffers prove insufficient to comply with the agreed fiscal targets, additional emergency measures would be implemented.

---

[1] The impact in these lags on the annual fiscal balance is projected to be limited as, over the whole of 2009, the downward revision in expected outlays on EU-financed investment projects is expected to be matched by a similar decline in EU funding.

16. **The authorities and staff agreed that the fiscal deficit target of 3.8 percent of GDP in 2010 strikes the right balance between preserving confidence in fiscal sustainability and avoiding an excessively negative impulse to economic activity.** The adoption of a budget consistent with this target will be a condition for completion of the next review. If economic and financial conditions turn out to be better than anticipated, staff recommended that the eventual overperformance be secured by freezing unallocated reserves at the end of the year, though the authorities declined to make this commitment. If economic and financial conditions turn out to be worse, staff recommended using the contingency reserve as the first line of defense and then allowing automatic stabilizers to operate fully.

17. **The authorities and staff agreed that the draft budget for 2010 is consistent with the spending cuts needed to reduce the general government deficit to 3.8 percent of GDP.** The draft budget reflects the mostly structural cuts that were agreed during the second review. Compared to the original (November 2008) program, the gross budgetary savings for 2010 alone is estimated at about 2.2 percent of GDP, including pensions (1.1 percent of GDP), reduced mandates of local governments (0.5 percent of GDP), wage and other public consumption (0.3 percent of GDP), energy and public transportation subsidies (0.2 percent of GDP), and transfers to households (0.1 percent of GDP). The envisaged decrease in farm support (0.2 percent of GDP) is subject to a ruling by the Constitutional Court, and was therefore not included in the budget. Also, the restructuring plan of the railways company still needs to be finalized (LOI ¶13). Compared to previous projections, the authorities intend to mobilize more non-tax revenues, including dividends from the state-owned companies and the proceeds of the sale of a telecommunication license, and higher interest revenues reflecting high deposits of local governments and central governments loans to banks.

18. **Given considerable macroeconomic and execution risks, the draft 2010 budget contains higher contingency reserves, financed by lower-than-previously-expected interest payments (LOI ¶14).** In comparison to the second review, staff estimates of interest payments for 2010 have declined by about 0.2 percent of GDP, reflecting the decline in yields on government securities at all maturities, renewed access to international markets, exchange rate appreciation, and allowance for a higher share of FX-denominated debt. Staff supported the authorities' intention to use the resulting fiscal space to build additional contingency reserves (to 0.75 percent of GDP) and to plan central budgetary appropriations on the assumption of higher deficits at the local level (by 0.5 percent of GDP). The main risks to the 2010 budget arise from: spending pressures related to parliamentary (April) and local (October) elections, the inherent difficulty of accurately estimating net savings from structural measures affecting non-central entities (local governments and public enterprises),[2]

---

[2] First, accumulated deposits by local governments (close to 2 percent of GDP at end-2008), magnify the risk that expenditure overruns traditionally associated with elections exceed the historical average of 0.5 percent of GDP assumed for the preparation of the central budget. Second, expected savings from the restructuring of the transportation sector are highly uncertain. Moreover, unless efforts to restructure the railway company are intensified, there may be a need to cover the underlying operating loss of the railway company (estimated at

(continued)

and a protracted weakness in revenue collections, reflecting the impact of potentially large carryover losses on CIT and the lagged recovery in the labor market. While existing buffers seem broadly appropriate to mitigate the realization of some of these risks, a combination of them could prove hard to handle without additional measures.

19. **Looking forward, the authorities' intention to bring the deficit below 3 percent of GDP in 2011 will require further adjustment measures.** In June, Parliament voted to triple the threshold for the top PIT bracket (from HUF 5 million to 15 million), effective in 2011, leading to an expected revenue loss of 0.6 percent of GDP. It is also possible that the 2011 budget will need to cover the loss of the central bank expected in 2010.[3] Staff and the authorities agreed that additional expenditure measures should be taken to preserve the medium-term adjustment path and secure a trend decline in the debt to GDP ratio (LOI ¶15).

20. **Institutional reforms supporting fiscal responsibility are starting to bear fruit** (Box 2). The Fiscal Council is on track to be fully operational by year-end (LOI ¶16). Staff and the authorities agreed that the Council should play an increasingly important role in the budget debate as an advocate for fiscal responsibility and transparency. To that end, staff urged the authorities to quickly establish clear and transparent procedures governing the exchange of information and the policy dialogue between the Council and the government. In line with staff advice during the second review, the Ministry of Finance, the Council and the parliamentary budget committee have initiated joint work aimed at eliminating possible inconsistencies between the Fiscal Responsibility Law and existing budget procedures, and at strengthening the medium-term focus of budget preparation.

C. Financial Sector Policies

21. **The liquidity position of Hungary's banking system has improved significantly.** Deposits have increased, especially from corporations, leading to a decline in the loan-to-deposit ratio from 127.3 percent at end-March to 120.8 percent at end-June (Table 8). Liquid assets as a share of the total have increased significantly, and the FX swap market has normalized in line with global developments. As a consequence of these developments, parent banks of Hungarian subsidiaries have been able to withdraw some of the additional funding injected during the strains in October 2008 and March 2009. Short- to medium-term FX liquidity needs of three domestic credit institutions are being covered by direct loans from the government extended since April 2009.

0.3 percent of GDP) which will be financed in 2009 by remaining cash balances from past privatization revenues.

[3] Central bank losses are expected to arise from the combination of foreign currency assets, which earn a low return, and domestic currency liabilities, such as central bank bills, which pay a high interest rate. A loss is already projected for 2009, but this can be covered by existing reserves.

22. **Credit quality has begun to deteriorate.** Non-performing loans (NPLs) as a share of total loans increased from 3.0 percent at end-2008 to a still relatively modest level of 4.8 percent at end-June, with the deterioration concentrated in unsecured consumer lending and commercial real estate. As the recession has not yet fed fully fed into banks' balance sheets, NPLs are projected to peak around 10 percent in the first half of 2010.

23. **Banks' profitability and capital positions are still strong, but they are expected to deteriorate.** Return-on-assets for the banking system as a whole was 1.1 percent during the first half of 2009, only marginally below the level in 2008H1, as still-high interest margins and cuts in operating expenses compensated for the impact on profits of sharply increased loan-loss provisions. The banking system's capital adequacy ratio (CAR) stood at 12.3 percent at end-June (10.3 percent for Tier I capital), with a particularly high capital buffer for the largest domestic bank, as banks used profits to boost capital and halted the increase in risk-weighed assets. Stress tests of the central bank suggest that expected losses under the baseline macroeconomic scenario can be absorbed by banks' existing capital buffers without major difficulties. Under a more negative macroeconomic scenario, which assumes a cumulative output loss that is 5 percentage points of GDP larger than under the baseline and a sharp exchange rate depreciation, NPLs could peak between 10 and 15 percent with recapitalization needs of up to €1 billion.

24. **The authorities are taking immediate measures to enhance the financial system's stress resilience in anticipation of the expected increase of NPLs.** As an additional safeguard to banks' capital positions, the capital enhancement fund under the Financial Stability Act will be extended from end-2009 to end-2010, seeking approval from the European Commission (LOI ¶19a). The size of the fund is about 1 percent of GDP. In addition, the authorities will seek more specific agreements with the parent banks of the largest Hungarian subsidiaries following their general commitment in the context of the Bank Coordination Initiative to preserve their good financial standing (LOI ¶19b). At the same time, a subcommittee of the tripartite Financial Stability Committee (FSC), comprising members of the HFSA, the central bank, an the Ministry of Finance, continues to monitor closely and regularly the three credit institutions that have received FX loans from the government since April 2009 (LOI ¶19c), and confirmed that their liquidity and solvency situations remain strong.

25. **On-site inspections by the Hungarian Financial Supervision Authority (HFSA) are under way.** The HFSA is currently conducting broad on-site inspections of the largest banks; these are expected to be finalized by end-October (LOI ¶20a). The preliminary findings did not reveal any serious weaknesses. Additional inspections focusing on credit quality of selected banks are planned for early 2010. The completion of reports for at least three banks selected using a systemic risk based approach is a structural benchmark for March 2010. The foreign subsidiaries of Hungarian banks are being assessed through various channels. The findings of these assessments are expected to be available to the HFSA by early 2010 (LOI ¶20b).

26. **The authorities and staff agreed that a further strengthening of bank supervision is needed.** Although much progress has been made in recent months, the on-site inspections of domestic banks and reviews of foreign subsidiaries still leave significant room for improvement. As for domestic inspections, sampling methods for loan portfolio examinations require additional fine-tuning, so that the findings can be credibly extrapolated to the overall portfolio. The verification of data accuracy needs to be expanded so that overall financial statements adjusted by the inspection teams can be prepared. The assessments of the foreign subsidiaries of Hungarian banks (which are currently being carried out for the first time) cannot yet be synchronized, because new procedures involving a number of outside contributors had to be negotiated and then implemented. In addition, the HFSA's capability to vet the consolidation procedures applied by complex financial groups needs to be further developed, so that the HFSA will become able to form an authoritative opinion on the overall condition of the concerned groups. The HFSA will address these areas for development in the next cycle of on-site domestic inspections and reviews of foreign subsidiaries (LOI ¶20d).

27. **The HFSA has started to implement its May 2009 Action Plan while preparing an enhanced version** (LOI ¶20c). In addition to improvements for domestic on-site inspections and reviews of foreign subsidiaries, the enhanced Action Plan also includes a substantially strengthened training program, far larger in volume and better targeted to foster specialized expertise accumulation, through the definition of professional development paths, alternating field assignments and courses delivered by practitioners. The HFSA also has the intention of rapidly acquiring senior expertise in areas where its competencies are currently incomplete, including accounting according to IFRS standards, and plans on expanded reliance on outside sources of expertise.

28. **The organization of financial regulation and supervision is being overhauled to increase its effectiveness** (LOI ¶21). Starting from one of the two options proposed by a July 2009 IMF technical assistance mission, the authorities have decided to upgrade the HFSA to the status of an autonomous organization with the ability to issue regulations, ending its status as a semi-autonomous agency reporting to the Ministry of Finance. Its organizational structure will be overhauled, with its Chairman, who will be appointed by the President of the Republic and report once a year to Parliament, given the operational and strategic responsibility for all its activities. The authorities have also decided that the central bank will obtain the power to issue temporary regulations on macro-prudential issues of systemic importance. The tripartite Financial Stability Committee will be replaced by a more powerful Financial Stability Council, which will assess the stability of the different components of the financial system and monitor the activities of the HFSA as regards the enforcement of laws and regulations from the point of view of financial stability. The submission of legislation to overhaul the organization of financial supervision is a structural benchmark for October 15, 2009. Giving the HFSA the authority to issue regulations would require a constitutional change; if this is not forthcoming, the authorities will consider moving financial sector supervision to the central bank.

29. **Work is under way to improve the remedial action and bank resolution framework** (LOI ¶19d). Recent amendments to financial sector legislation have already provided for a stronger role of the supervisory commissioner. A subcommittee of the FSC has made further-ranging proposals for more refined triggers for remedial actions by the HFSA and a more comprehensive range of bank resolution techniques, including purchase-and-assumption transactions and bridge banks. The legal and constitutional feasibility of these proposals is currently being analyzed by the government, with support from IMF technical assistance.

30. **In addition, the government is pursuing various initiatives to strengthen the stress-resilience of households and corporations** (LOI ¶19e). A partial mortgage guarantee scheme for debtors whose debt-service-to-income burden has increased sharply has recently been approved by the European Commission. The government is also working on extending schemes to partially cross-guarantee loans to funding-constrained small- and medium-sized enterprises.[4] Hungary's corporate bankruptcy regime was strengthened recently, with a view to providing stronger incentives for over-extended debtors to initiate appropriate action at an earlier stage, e.g., seek an orderly debt rescheduling instead of liquidation of the company.

D. Monetary and Exchange Rate Policy

31. **Monetary policy has started to ease, as the reduction in financial market strains has lessened concerns about excessive exchange rate volatility** (Figure 4). After remaining unchanged for six months, the policy interest rate was cut in July and August by a total of 150 bps to 8.0 percent, which implies a real policy rate of about 5 percent (excluding the temporary impact of the increases in the VAT rate and excise duties on inflation). Looking forward, to the extent that risks to financial stability continue to diminish, macroeconomic considerations will become more important in policy rate decisions. Low underlying inflation, a large output gap, and a flat yield curve suggest that the policy rate should eventually settle at a lower level, but the decline should be gradual, commensurate with improvements in investor confidence. With only one-third of loans denominated in domestic currency, policy rates have a modest influence on overall lending conditions.

32. **Demand for the central bank's liquidity facilities has moderated recently, in line with the improvement in financial market sentiment** (Box 3). The scaling back of extraordinary liquidity injections is welcome, but maintaining the facilities is essential as long as there is a risk that financial strains may return.

---

[4] The fiscal impact of such guarantees would be less than ½ percent of GDP even in an adverse scenario.

IV. Program Modalities

33. **The attached LOI describes the authorities' progress in implementing their economic program and sets out performance criteria through December 2009** (Box 4, LOI ¶2, and LOI Tables 1–3):

- ***The performance criterion on net international reserves would be modified .*** The end-September 2009 criterion would be adjusted upward following the higher-than-programmed end-June outcome and improved external financing conditions.

- ***Two new structural benchmarks are proposed***. The authorities are committed to submit legislation to parliament on a major overhaul of legal and organizational framework for financial supervision and regulation by October 15, 2009. Moreover, the HFSA intends to complete thematic inspections focusing on credit risk and the quality of the loan portfolio for at least three banks, selected using a systemic risk-based approach, by end-March 2010.

34. **The authorities request a six-month extension of the arrangement** (LOI ¶3). Given the uncertainty about prospects for global financial conditions, it is proposed to extend the SBA to October 5, 2010, to cover the election period and the transition to a new government.

35. **The authorities also request a rephasing of the undisbursed amounts to cover the balance of payments need over the remainder of the extended period** (Tables 9–11). The external financing need arising from the current account deficit and maturing external obligations is expected to be partly offset by capital transfers from the EU, foreign direct investment, foreign financing of the government, banks, and corporates, and official financing from the EU and the World Bank. The proposed rephasing of purchases would allow the central bank to maintain reserves at about 90 percent of short-term external debt at remaining maturity. Taking into account the SDR allocations of SDR 991 million in August and September 2009, it is proposed to rephase the undisbursed amount under the arrangement with a disbursement of SDR 50 million following completion of this (third) review and four equal disbursements of SDR 725 million over the remainder of the extended arrangement. The authorities have indicated their intention to continue drawing under the arrangement. While Hungary's capacity to repay the Fund is expected to be strong, continued high government and external debt pose important risks. Performance under the program has been strong and the external position has improved more quickly than originally anticipated. The program aims at strengthening fiscal sustainability and preserving financial stability, in order to mitigate risks to the Fund.

36. **Fund financing addresses multiple financing needs in Hungary**. The purchase from the Fund that would be made available at the completion of this (third) review would be deposited at the central bank and its domestic counterpart used to increase the government's

cash reserves, to preserve confidence in the government's ability to meet its liquidity needs. The November 2008 and March 2009 purchases were also directed to the government, and were used for different purposes, including the bank support package, lending to domestic credit institutions to help them meet FX funding needs, and the government's financing need as non-residents reduced their holdings of domestic currency government bonds. The June 2009 purchase was channeled to the central bank.

V. Staff Appraisal

37. **Macroeconomic and financial policies are on track**. The June 2009 quantitative performance criteria, as well as the structural benchmark related to government lending to banks, were all met. The June indicative target on central government debt (excluding official financing) was not met, as market financing was used to bridge to the disbursement of the third tranche of EU balance of payments support in early July (instead of June).

38. **Hungary's economic outlook has stabilized since the last review, reflecting in part the stabilization of the global outlook**. Real GDP is contracting sharply this year and is expected to fall further in 2010. The current account deficit is narrowing quickly this year. Inflation is expected to rise temporarily through early 2010 due to the increases in the VAT rate and excise duties, and then fall to below the central bank's inflation target by mid-2010. Against this background, the key objectives of the program remain to improve fiscal sustainability and preserve financial stability.

39. **The government should be prepared to take additional measures, if necessary, to underline its commitment to fiscal sustainability**. The authorities' plan to manage the risks to the 2009 target is appropriate, but the realization of large negative shocks to revenues or further expenditure slippages would require a quick and forceful response. The 2010 budget credibly reflects structural spending cuts decided in June, but strict expenditure control and a cautious use of contingency buffers will be essential to manage risks. Concrete measures backing planned savings in local governments and in public transportation have been identified and incorporated into the budget. The budget is premised on reasonable assumptions and includes larger contingency reserves than in the past. However, risks remain and, if combined, could rapidly exhaust planned buffers. In particular, the implementation of adjustment measures in non-central institutions (local governments and public transportation) is subject to large uncertainty. To mitigate the resulting risk to program targets, recent initiatives to strengthen expenditure controls should be continued, and reserves should only be used when offsets cannot be found within existing appropriations.

40. **It is essential that the authorities continue to implement measures to preserve financial stability**. Banks currently have adequate liquidity and capital positions, but pressures on capital will rise due to the impact of the economic downturn on credit quality, and liquidity remains vulnerable to changes in Hungary's external financing conditions. The authorities should continue to carefully monitor the financial soundness of credit institutions

that have received FX loans from the government, so as to safeguard financial stability and minimize risks to public finances. The HFSA has stepped up its on-site inspections, and should conduct follow-up inspections on capital adequacy and credit quality. At the same time, it is important to reform institutional arrangements to improve the HFSA's independence, to enhance the remedial action and resolution frameworks, and to give the central bank the authority to issue temporary regulations on systemic macro-prudential issues.

41. **Monetary and exchange rate policy will continue to target inflation over the medium term, while taking into account risks to financial stability**. The combination of improved global financial conditions and increased confidence in fiscal sustainability created room for interest rate cuts in recent months. Going forward, continued fiscal consolidation and stable external financing conditions would allow for further cautious interest rate cuts.

42. **Implementation of policies consistent with the program remains essential to strengthen macroeconomic stability and provide the basis for strong, sustainable growth over the medium term**. The authorities have requested a six-month extension of the Stand-By Arrangement to cover the parliamentary elections scheduled for April 2010 and the transition to a new government. Staff support the authorities' requests for completion of the third review, extension of the arrangement, and rephasing of the purchases, as well as the modification of the NIR performance criterion.

Box 1. Potential Output

Staff have revised down their estimates of potential output. At the 2008 Article IV consultation (prior to the crisis), potential output was expected to grow by about 3¼ percent in the medium term. Since then, estimates of potential output growth have been revised down (text figure). Staff's latest estimates of potential output growth suggest the following key points (text table):

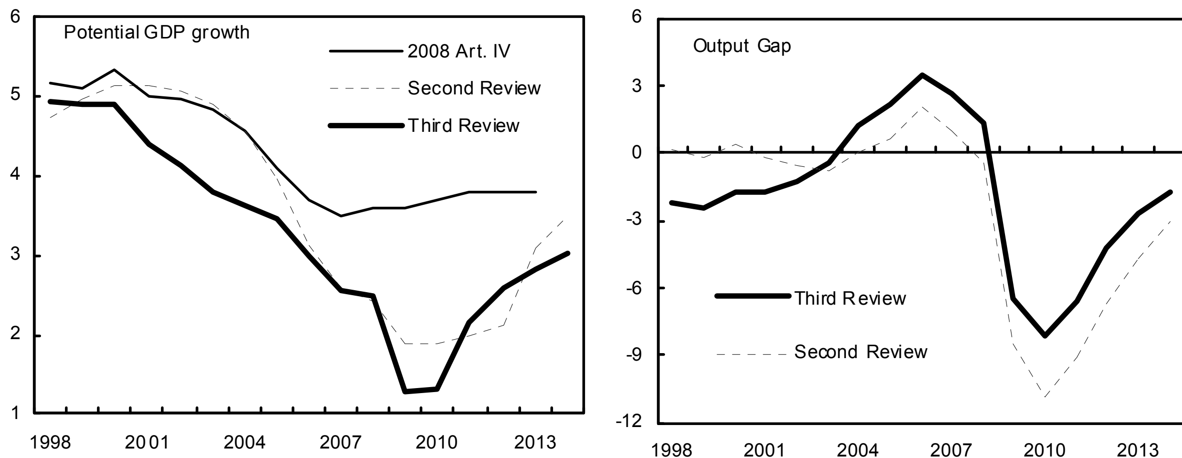
- *lower potential growth rates for 2002–07*, reflecting the view that rapid actual growth during this period partly reflected overheating;
- *lower potential growth rate for 2014*, reflecting the view that risk appetite and thus capital accumulation will be lower;
- *larger positive output gap for 2002–07 and a smaller negative gap for 2008–14*.

Potential Output Growth

	1996-01	2002-07	2008-10	2011-13	2014
Potential GDP Growth (Second Review)	4.2	3.5	1.6	1.9	3.0
Potential GDP Growth (Third Review)	4.1	2.9	1.2	2.0	2.5
of which					
Capital Stock	1.9	1.6	0.7	1.2	1.4
Total Hours Worked	0.4	-0.1	-0.3	0.0	0.2
Total Factor Productivity	1.9	1.5	0.8	0.8	0.9

Source: IMF staff calculations.

Estimates of Potential Output Growth and Output Gap



Source: IMF staff estimates.

Box 2. The Fiscal Responsibility Law as a Fiscal Anchor

Hungary adopted a Fiscal Responsibility Law (FRL) in November 2008 aimed at ensuring long-term debt sustainability and broadly balanced budgets for the central government system (general government excluding subnational entities). The law—whose adoption was part of the program's structural conditionality—introduces *numerical rules* consistent with a decline in the public debt to GDP ratio over the medium term; it amends *budgetary procedures* to enhance fiscal discipline and transparency (fiscal impact assessment of new legislations, pay-go principle, medium-term budgetary planning); and it mandates a new non-partisan agency (the Fiscal Council) to *monitor compliance* with the rules, to facilitate their enforcement (scoring of new legislation) and to provide independent macroeconomic and budgetary forecasts. Through its broader advisory role, the Fiscal Council is also likely to play an important role in the public debate about fiscal policy.

Starting with the preparation of the 2012 budget, the primary balance will be subject to a floor which (i) must be positive, and (ii) is consistent with a decline of the public debt in real terms—in general a stricter requirement than a decline in the debt to GDP ratio. In the meantime, the 2010 and 2011 budgets are subject to two (transitory) numerical constraints: (i) the Maastricht deficit indicator (general government deficit in percent of GDP) must be lower than the year before, and (ii) real primary expenditure must grow by less than half the real GDP growth rate. In current circumstances, the first requirement is the binding constraint.

The authorities' fiscal targets for 2010-11 are consistent with the transitory numerical rules and sticking to current plans should enhance the credibility of the permanent rules. Empirical evidence on the link between the government bond yields and the degree of constraint associated with fiscal policy rules indeed suggests that a good record of fiscal performance is important for the rule to enhance fiscal credibility (lower interest rates). Compliance with the rule can lower interest rates over and above the impact of actual fiscal performance, because a credible fiscal rule provides reliable information about future fiscal policy, which is in turn reflected in the pricing of government bonds ("The Credibility Effect of Numerical Fiscal Rules: An Empirical Investigation," in Hungary—Selected Issues, IMF Country Report, No. 08/314, September 2008). This provides an additional incentive for the government to stick to the rule.

Overall, the FRL provides an adequate framework to support immediate adjustment needs and to encourage future governments to address long-term challenges, including the rationalization of social security, the reduction in the overall tax burden, and the need to improve expenditure efficiency at the subnational level. Given Hungary's long history of strong electoral budget cycles, the rules-based fiscal framework will face its first major test over the coming year. Sticking to the planned consolidation path would send a strong signal that a fiscal anchor now exists in Hungary.

Box 3. Central Bank's Liquidity Facilities

The central bank's standard mode of operation prior to the financial crisis was to absorb excess liquidity with its central bank bill. In October 2008, when acute liquidity strains emerged—reflected among other things in a sharp increase in overnight deposits at the central bank—the central bank started to *inject* liquidity in both forint and in foreign currency, and created several new facilities to this effect.

- Instruments to inject forint liquidity include 2-week and 6-month lending facilities. The central bank also established a facility to purchase government bonds from primary dealers, but this facility was closed in December 2008.

- As regards foreign currency liquidity, the central bank set up an emergency overnight FX swap facility in October 2008. In March 2009, it was complemented by two longer-term facilities with maturities of 3 and 6 months, respectively. Banks had to prequalify for the competitively priced 6-month facility by making certain commitments, including maintenance of their corporate loan portfolio. The 3-month facility is free of such restrictions, but is priced 50 bps above the 6-month facility. The longer-term facilities are scheduled to be phased out during 2010.

Demand for the central bank's new facilities has been strong during episodes of intense financial stress, notably in October-November 2008 and in March 2009. More recently, demand has fallen, reflecting the easing of financial strains and banks' lower funding needs due to the slowdown in credit growth. The only facility whose outstanding volume has not declined in recent months is the 6-month FX swap facility. However, even the use of this facility has remained below expectations, with about one third of the amounts allotted to banks drawn. Interest in the 3-month FX swap facility has also diminished.

Box 4. Hungary: Stand-By Arrangement

Access: SDR 10.5 billion (1,015 percent of quota).

Length: Initially 17 months from November 6, 2008. Proposed extension by 6 months to October 5, 2010.

Phasing: SDR 4.2 billion was disbursed after the Board's approval of the arrangement on November 6, 2008, followed by SDR 2.1 billion after the completion of the first review on March 25, 2009 and SDR 1.3 billion after the completion of the second review on June 23, 2009. Under the proposed re-phasing, SDR 50 million would be available following the completion of this (third) review. The remaining amount under the arrangement would be rephased in four equal disbursements of SDR 725 million over the remainder of the extended arrangement.

Conditionality

- ***Quantitative Performance Criteria***
  - A floor on the central government system primary cash balance.
  - A band around the 12-month rate of inflation of consumer prices
  - A floor on the change in net international reserves.
  - Non-accumulation of external debt arrears.

- ***Quantitative Indicative Target***
  - Ceiling on the total debt stock of the central government system.

- ***Structural Benchmarks***
  - Submitting legislation to parliament that (i) upgrades the HFSA's legal status to an autonomous organization, (ii) grants the MNB the authority to issue temporary regulations on macro-prudential issues of systemic importance, and (iii) establishes the Financial Stability Council. *By October 15, 2009.*
  - Passage by parliament of the amendments strengthening the remedial powers of the HFSA and bank resolution regime (as listed in the March LOI ¶20). *By end-December 2009*.
  - Completion of reports on thematic inspections focusing on credit risk and the quality of the loan portfolio for at least 3 banks, selected using a systemic risk-based approach. *By end-March 2010.*
  - Operation of the subcommittee described in the March LOI ¶18 as long as there is any government capital or funding support outstanding to banks, and consultation of the subcommittee with Fund staff on its work program. *Continuous*.

Table 1. Hungary: Main Economic Indicators, 2006–10

	2006	2007	2008	2009		2010	
				2nd Rev.	3rd Rev.	2nd Rev.	3rd Rev.
Real economy (change in percent)							
Real GDP	3.9	1.2	0.6	-6.7	-6.7	-0.9	-0.9
Total domestic demand 1/	1.1	-1.9	0.3	-8.0	-8.6	-2.0	-1.9
Private consumption	1.9	-1.4	0.1	-6.6	-6.8	-2.6	-2.4
Gross fixed investment	-3.6	1.8	-2.6	-10.3	-9.3	0.8	0.8
Foreign balance 1/	2.7	3.1	0.3	1.3	1.9	1.1	1.0
Exports	18.4	16.4	4.8	-15.1	-15.1	3.0	2.6
Imports	15.0	13.4	4.7	-16.7	-17.2	2.1	1.8
CPI (end year)	6.5	7.4	3.5	6.4	6.1	1.6	2.4
CPI (average)	3.9	7.9	6.1	4.5	4.5	3.8	4.1
Unemployment rate (average, in percent)	7.5	7.4	7.8	10.5	9.9	11.2	10.7
Gross domestic investment (percent of GDP) 2/	24.3	23.8	23.7	22.5	20.9	22.9	21.7
Gross national saving (percent of GDP, from BOP)	16.7	17.3	15.3	18.4	18.0	18.8	18.5
General government (percent of GDP), ESA-95 basis 3/							
Overall balance	-9.3	-4.9	-3.4	-3.9	-3.9	-3.8	-3.8
Primary balance	-5.4	-0.9	0.8	1.0	0.5	0.9	0.7
Debt	65.6	65.9	72.6	77.4	78.8	80.4	79.9
Money and credit (end-of-period, percent change)							
Broad money	13.6	11.0	9.2	4.5	3.4	3.2	5.1
Credit to the economy, flow-based	17.3	15.9	10.6	-1.5	-1.2	1.3	1.4
Interest rates (percent)							
T-bill (90-day, average)	7.0	7.6	8.9	...	...	...	...
Government bond yield (5-year, average)	7.4	7.0	9.3	...	...	...	...
Balance of payments							
Goods and services trade balance (percent of GDP)	-0.9	1.4	0.9	4.3	4.7	4.4	4.4
Current account (percent of GDP)	-7.6	-6.5	-8.4	-4.1	-2.9	-4.0	-3.3
Reserves (in billions of euros)	16.4	16.4	24.0	23.9	27.5	20.4	28.5
Gross external debt (percent of GDP) 4/	90.5	96.9	114.1	138.8	132.3	136.7	130.0
Exchange rate							
Exchange regime			Floating				
Present rate (Sept 14, 2009)			Ft 188.90 = US$1; Ft. 274.81 = €1				
Nominal effective rate (2000=100)	94.1	100.2	101.3	...	…		…
Real effective rate, CPI basis (2000=100)	95.8	107.5	111.5	...	…		…
Quota at the Fund			SDR 1038.4 million				

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

1/ Contribution to growth. Calculated using 2000 prices. It includes inventories.
2/ Includes change in inventories.
3/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments.
4/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.

Table 2. Hungary: Monetary Accounts, 2006-10

	2006	2007	2008		2009					2010	
			Sept.	Dec.	March	June	Sept.	Dec.		2nd Rev.	3rd Rev.
					Est.		Proj.	2nd Rev.	3rd Rev.		
	(in billions of forints, unless otherwise specified)										
Monetary Survey											
Net foreign assets	-83	-952	-1577	-1487	-631	-546	-175	-922	-14	-1812	1365
Net domestic assets	12809	15078	16230	16908	16543	16354	15852	17042	16000	18449	15396
Domestic credit	16190	18907	20523	21481	22122	21379	20636	21396	20471	22383	19479
Net claims on government	3026	3270	3299	2952	1897	3058	2801	2137	2678	2870	1436
Credit to the economy	13165	15637	17224	18529	20224	18322	17835	19259	17793	19513	18043
Other items, net	-3381	-3829	-4292	-4573	-5578	-5025	-4784	-4353	-4471	-3934	-4083
Broad money	12727	14126	14653	15422	15913	15774	15643	16120	15952	16637	16762
Currency in circulation	1838	2068	2009	2137	2205	2090	2020	2308	2066	2481	2240
Total deposits	10075	10869	11444	12114	12387	12348	12226	12386	12446	12510	12883
Domestic currency deposits	7827	8704	8656	9737	9690	9494	9446	10024	9645	10159	9990
Foreign currency deposits	2248	2165	2788	2377	2696	2855	2780	2362	2801	2351	2893
Short-term securities	35	200	152	313	412	413	456	547	456	647	556
Money market instruments	779	990	1048	858	909	924	942	879	984	999	1082
Accounts of the Magyar Nemzeti Bank (MNB)											
Net foreign assets 1/	3838	3941	4046	5988	8139	6326	6692	6828	6354	4948	6657
Net domestic assets	-1404	-1150	-1397	-3383	-5522	-3788	-4044	-3981	-3712	-1884	-3847
Net domestic credit	-1369	-1138	-1561	-3193	-4627	-3548	-4124	-3503	-3857	-1418	-4031
Net claims on government	-141	-108	-281	-1286	-2447	-664	-1129	-1361	-965	-1361	-1073
Claims on government	233	147	147	360	360	360	360	314	360	314	360
Liabilities to government 2/	373	255	428	1646	2807	1024	1489	1675	1325	1675	1433
Net claims on the economy	-5	0	0	0	0	0	0	0	0	0	0
Net claims on banks	-1223	-1029	-1280	-1907	-2179	-2884	-2995	-2142	-2892	-57	-2958
Other items, net	-34	-12	164	-190	-895	-240	80	-478	145	-466	184
Base money	2434	2791	2648	2605	2617	2538	2648	2847	2642	3064	2810
Currency in circulation	1838	2068	2009	2137	2205	2090	2020	2308	2066	2481	2240
Cash in bank vaults	130	134	140	171	156	176	279	181	228	200	206
Banks' reserves	466	589	500	296	257	272	349	358	348	383	364
Required reserves	615	682	751	322	343	344	349	358	348	383	364
Excess reserves	-149	-92	-252	-26	-86	-72	0	0	0	0	0
Other Monetary and Financial Institutions											
Net foreign assets	-3920	-4892	-5623	-7475	-8770	-6872	-6866	-7751	-6368	-6760	-5292
Net domestic assets	14809	16951	18267	20759	22478	20556	20490	21563	20254	20916	19813
Domestic credit	17554	20045	22084	24674	26748	24927	24760	24899	24328	23801	23510
Net claims on government	3166	3378	3580	4238	4345	3722	3930	3498	3643	4231	2508
Credit to the economy	13165	15637	17224	18529	20224	18322	17835	19259	17793	19513	18043
Net claims on the central bank	1223	1029	1280	1907	2179	2884	2995	2142	2892	57	2958
Banks' reserves and overnight deposits	838	1062	798	296	257	272	349	358	348	383	364
Other items, net	-3584	-4156	-4615	-4211	-4527	-4643	-4619	-3694	-4421	-3268	-4060
Banks' liabilities	10888	12058	12644	13285	13708	13685	13623	13812	13886	14156	14521
Total deposits	10075	10869	11444	12114	12387	12348	12226	12386	12446	12510	12883
Demand deposits	3995	4280	4107	4023	4114	4101	4060	4114	4134	4155	4279
Time deposits	6080	6589	7337	8090	8273	8247	8165	8272	8312	8355	8604
Short-term securities	35	200	152	313	412	413	456	547	456	647	556
Money market instruments	779	990	1048	858	909	924	942	879	984	999	1082
***Memorandum items*:**	(y-o-y percentage change)										
Base money	10.7	14.7	2.7	-6.7	4.8	1.0	0.0	9.3	1.4	7.6	6.4
Broad money	13.6	11.0	8.3	9.2	8.4	11.5	6.8	4.5	3.4	3.2	5.1
Credit to the economy	16.7	18.8	16.1	18.5	10.3	11.8	3.5	3.9	-4.0	1.3	1.4
Credit to the economy, flow-based 3/	17.3	15.9	15.3	10.6	6.6	4.2	-0.5	-1.5	-1.2	1.3	1.4
	(in percent)										
Foreign currency loans to total loans	47.9	56.4	58.7	64.7	68.2	64.1	63.5	67.5	63.8	67.4	64.4
Foreign currency deposits to total deposits	22.3	19.9	24.4	19.6	21.8	23.1	22.7	19.1	22.5	18.8	22.5
	(in billions of forints)										
Net international reserves	4000	4051	4157	4908	6275	4773	5126	3775	4573	1753	4229
plus IMF disbursement to the government 4/	0	0	0	1215	2129	1875	1888	3340	2103	3481	2750
minus other non-reserve liabilities (net)	162	110	112	135	264	322	322	286	322	286	322
= net foreign assets of the central bank	3838	3941	4046	5988	8139	6326	6692	6828	6354	4948	6657

Sources: Magyar Nemzeti Bank and IMF staff calculation.

1/ Includes disbursements of IMF tranches under the SBA to the government, as well as disbursements of EU and WB funds.

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

3/ Controls for fluctuations in the exchange rate.

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

Table 3. Hungary: Balance of Payments, 2008-11 1/

(in millions of euros)

	2008	2009						2010						2011
		Mar	Jun	Sep	Dec			Mar	Jun	Sep	Dec			
	Est	Est	Proj.	Proj.	Proj.	2nd Rev.	3rd Rev.	Proj.	Proj.	Proj.	Proj.	2nd Rev.	3rd Rev.	Proj.
Current Account	**-8,903**	**-591**	**198**	**-1,286**	**-1,016**	**-3,557**	**-2,706**	**-620**	**-925**	**-794**	**-828**	**-3,506**	**-3,167**	**-3,414**
Goods and service, net	997	822	1,841	652	946	3,744	4,267	1,064	1,189	930	1,025	3,844	4,209	3,666
Exports	85,994	16,396	17,573	17,398	18,764	71,819	69,080	17,241	17,840	17,733	18,431	75,761	71,245	75,603
Imports	-84,997	-15,574	-15,731	-16,746	-17,818	-68,075	-64,813	-16,177	-16,651	-16,803	-17,405	-71,917	-67,036	-71,937
Income, net	-8,586	-1,471	-1,465	-1,760	-1,783	-6,813	-6,480	-1,547	-1,977	-1,587	-1,717	-6,859	-6,827	-6,503
Current transfers, net	-1,313	58	-178	-178	-178	-488	-476	-137	-137	-137	-137	-491	-549	-578
Capital Account	**1,121**	**863**	**571**	**204**	**204**	**1,840**	**1,841**	**452**	**452**	**452**	**452**	**1,764**	**1,807**	**1,746**
Net capital transfers from the EU	1,129	858	581	214	214	1,875	1,866	452	452	452	452	1,764	1,807	1,746
Financial Account	**10,415**	**-672**	**-3,357**	**411**	**-1,256**	**-5,995**	**-4,874**	**-586**	**44**	**-710**	**408**	**-1,995**	**-843**	**989**
Direct investment, net	3,201	262	-13	277	316	1,059	841	276	154	272	212	1,216	913	967
Direct Investment Abroad	-1,163	-274	-277	-237	-298	-545	-1,085	-297	-23	-361	-564	-546	-1,244	-1,291
In Hungary	4,364	536	263	514	614	1,604	1,926	572	176	633	776	1,762	2,157	2,258
Portfolio investment, net	-3,115	-3,060	-1,219	1,516	3	-3,886	-2,760	179	802	-760	419	-1,262	641	-40
Assets	5,351	555	1,196	-104	-112	1,921	1,535	-118	-125	-83	-87	1,893	-412	-370
Equity	-2,191	-380	-192	-149	-155	-184	-876	-161	-166	-123	-126	-104	-576	-103
Debt securities	7,542	935	1,388	45	43	2,105	2,411	42	41	40	39	1,997	163	-267
Liabilities	-8,466	-3,615	-2,415	1,620	115	-5,807	-4,295	297	927	-677	506	-3,155	1,053	330
Equity	-260	134	640	138	236	72	1,148	113	116	356	383	-145	967	382
Debt securities	-8,206	-3,749	-3,055	1,482	-121	-5,879	-5,443	184	811	-1,033	123	-3,010	86	-52
Other investment	10,329	2,126	-2,125	-1,382	-1,575	-3,168	-2,956	-1,040	-912	-222	-223	-1,948	-2,397	62
Assets	-1,732	-325	-1,036	-280	-149	913	-1,790	-152	-156	-134	-136	437	-579	-728
o/w: short-term assets	1,359	-658	-1,220	-158	-113	379	-2,149	-116	-119	-96	-99	316	-430	-513
Liabilities	12,062	2,450	-1,089	-1,101	-1,426	-4,081	-1,166	-888	-756	-88	-87	-2,385	-1,818	791
o/w short-term liabilities	2,480	1,268	-1,007	-876	-824	-2,826	-1,439	-449	-435	-6	-5	-1,401	-894	1,446
Net errors and omissions	-2,154	-136	-70	-173	-173	-1,622	-552	-173	-173	-173	-173	-811	-691	-346
Overall Balance	**480**	**-536**	**-2,658**	**-845**	**-2,241**	**-9,334**	**-6,292**	**-927**	**-602**	**-1,224**	**-141**	**-4,548**	**-2,894**	**-1,024**
Program financing	**2,000**	**2,000**	**0**	**1,500**	**500**	**5,000**	**4,000**	**300**	**800**	**400**	**0**	**500**	**1,500**	**0**
European Union	2,000	2,000	0	1,500	0	4,500	3,500	300	300	400	0	0	1,000	0
World Bank	0	0	0	0	500	500	500	0	500	0	0	500	500	0
Others	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Projected Direct Lending to Banks					-300	-2,360	-300							
Net International Reserves (increase -)	**-2,480**	**-1,464**	**2,658**	**-655**	**2,041**	**6,694**	**2,592**	**627**	**-198**	**824**	**141**	**4,048**	**1,394**	**1,024**
Gross Reserves	-7,403	-3,831	1,270	-1,792	1,249	123	-3,093	-165	-990	33	141	3,579	-982	1,024
Reserve Liabilities	4,923	2,368	1,389	1,137	792	6,571	5,685	792	792	792	0	469	2,375	0
Fund disbursements	4,923	2,368	1,389	55	792	6,571	4,603	792	792	792	0	469	2,375	0
SDR allocation	0	0	0	1,082	0	0	1,082	0	0	0	0	0	0	
Current account (in percent of GDP)	-8.4	-2.9	0.8	-5.5	-4.3	-4.1	-2.9	-3.0	-3.7	-3.2	-3.2	-4.0	-3.3	-3.4
Gross external debt (in percent of GDP)	114.1	136.7	133.2	133.9	132.3	138.8	132.3	132.8	134.7	134.9	130.0	136.7	130.0	122.3
Gross official reserves	24,040	27,890	26,950	28,742	27,493	23,940	27,493	27,658	28,648	28,616	28,475	20,361	28,475	27,450
In percent of short-term debt at remaining maturity	86.7	94.5	94.1	96.6	94.9	80.5	94.9	91.1	90.0	89.5	87.2	79.1	87.2	96.0

Sources: Hungarian authorities and staff projections.

1/ Excluding Special Purpose Entities.

Table 4. Hungary: Indicators of External Vulnerability, 2005-09 Q2

	2005	2006	2007	2008	June 2009 Est. 1/
Financial Indicators					
M3, end-of-period, percent change	14.5	13.6	11.0	9.2	11.5
Private sector credit, percentage change	15.4	17.3	15.9	10.6	4.2
T-bill, 90-day, average, in percent	6.7	7.0	7.6	8.9	9.6
Government bond yield, 5-year, average, in percent	6.8	7.4	7.0	9.3	11.0
Share of foreign currency liabilities in total liabilities	34.4	39.3	42.4	45.6	71.6
Share of foreign currency loans in total credit to:					
Corporates	47.7	47.1	52.6	60.3	61.1
Households	32.6	46.8	59.0	70.7	70.4
Other loans	75.2	75.4	81.7	87.2	86.2
Non-performing loans to gross loans 2/	2.5	2.5	2.5	3.0	4.8
External Indicators					
Exports of goods and services, annual percentage change	12.9	15.0	17.1	6.4	-21.8
Imports of goods and services, annual percentage change	10.0	14.2	13.8	7.0	-28.7
Real effective exchange rate, percentage change, + = appreciation	2.0	-4.8	12.6	4.3	-10.4
Current account balance, in percent of GDP	-7.5	-7.6	-6.5	-8.4	0.8
Capital and financial account, in percent of GDP	0.8	0.6	1.1	1.1	-11.6
Financial account, in percent of GDP	13.0	10.3	7.1	9.8	-14.0
Net foreign direct investment, in percent of GDP	5.0	3.2	1.7	3.0	-0.1
Gross official reserves, in millions of euros	15,721	16,397	16,385	24,040	26,950
In months of imports	2.7	2.5	2.3	4.5	4.8
In percent of short-term debt at remaining maturity	112.2	123.6	88.9	86.7	94.1
Total external debt, in millions of euros	88,665	89,966	101,386	105,951	122,236
In percent of GDP	75.1	90.5	96.9	114.1	133.2
Short-term debt at remaining maturity	14,012	13,270	18,428	27,740	28,632
Financial Market Indicators					
Stock market index, local currency, end-of-period	20,785	24,844	26,236	12,242	15,783
EMBI Global bonds spread, end-of-period	74.0	58.0	84.0	504.0	373.0
CDS spread, 5-year, end-of-period	26.5	21.0	48.5	430.2	357.3

Source: Hungarian authorities; and staff estimates.

1/ External indicators for June 2009 refer to 2009 Q2.
2/ Non-performing loans (NPLs) are defined as loans classified as substandard, doubtful, and bad.

Table 5. Hungary: Staff's Illustrative Medium-Term Scenario, 2006-14

	2006	2007	2008	2009	2010	2011	2012	2013	2014
					Program				
				(In percent, unless otherwise indicated)					
Real GDP growth	3.9	1.2	0.6	-6.7	-0.9	3.2	4.5	4.0	3.5
Nominal GDP, forint billions	23,775	25,479	26,621	25,793	26,300	27,684	29,504	31,295	33,023
Inflation (CPI; year average basis)	3.9	7.9	6.1	4.5	4.1	2.5	3.0	3.0	3.0
Inflation (CPI; end-year basis)	6.5	7.4	3.5	6.1	2.4	2.7	3.0	3.0	3.0
				(Annual percentage change, constant prices)					
Domestic demand	1.1	-1.9	0.3	-8.9	-2.0	2.4	3.3	3.4	3.2
Total consumption	2.2	-1.9	-0.2	-6.1	-2.3	2.0	2.7	2.8	2.7
Gross fixed capital formation	-3.6	1.8	-2.6	-9.3	0.8	3.0	5.0	5.0	5.0
Exports of GNFS	18.4	16.4	4.8	-15.1	2.6	4.6	6.0	6.0	6.0
Imports of GNFS	15.0	13.4	4.7	-17.2	1.8	4.0	5.1	5.6	6.0
				(In percent of GDP, unless otherwise indicated)					
External current account balance	-7.6	-6.5	-8.4	-2.9	-3.3	-3.4	-3.4	-3.5	-3.4
Gross national saving	16.7	17.3	15.3	18.0	18.5	18.4	18.2	17.8	17.5
Gross national investment 1/	24.3	23.8	23.7	20.9	21.7	21.8	21.6	21.3	21.0
Capital account, net	0.6	1.1	1.1	2.0	1.9	1.7	1.8	1.8	1.6
Financial account, net	10.3	7.1	9.8	-5.3	-0.9	1.0	4.0	5.9	4.4
Net international investment position	-105.6	-101.5	-99.5	-115.7	-114.0	-108.3	-106.7	-107.9	-108.0
Gross external debt 2/	90.5	96.9	114.1	132.3	130.0	122.3	119.4	117.3	115.0
General government (ESA-95)									
Revenue, total	42.6	44.8	46.2	46.2	45.6	44.6	44.3	44.1	43.9
Expenditure, primary	48.0	45.7	45.4	45.6	44.9	42.8	41.8	41.0	40.4
Primary balance	-5.4	-0.9	0.8	0.5	0.7	1.9	2.5	3.1	3.5
General government balance (including the costs of pension reform)	-9.3	-4.9	-3.4	-3.9	-3.8	-2.8	-2.1	-1.3	-0.6
Net interest	3.7	3.8	3.8	4.1	4.1	4.4	4.3	4.1	3.9
General government debt	65.6	65.9	72.6	78.8	79.9	78.7	76.0	72.9	69.7
Memorandum items									
Output gap	3.6	2.7	1.3	-6.2	-7.8	-6.4	-4.2	-2.6	-1.7
Potential GDP growth	2.5	2.1	2.0	0.8	0.8	1.7	2.1	2.4	2.5
Structural general government balance	-10.4	-5.3	-3.7	-0.7	0.2	0.3	0.3	0.3	0.3
Structural primary balance	-6.7	-1.5	0.0	3.3	4.3	4.6	4.6	4.4	4.2

Sources: Hungarian authorities; and staff estimates.

1/ Includes change in inventories.
2/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.

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

	2006	2007	2008	2009		2010		2011
				2nd Rev.	3rd Rev.	2nd Rev.	3rd Rev.	Staff. proj.
Total revenues	42.6	44.8	46.2	46.8	46.2	46.4	45.6	44.6
Current revenues and current transfers (incl. grants)	41.8	43.9	45.2	45.1	44.6	44.1	44.4	42.9
Tax revenues	37.0	39.4	40.1	40.6	39.8	39.8	39.4	38.7
Taxes on income, profits and capital gains	9.4	10.2	10.6	10.6	10.4	9.6	10.0	9.7
Personal income tax	6.7	7.0	7.6	7.4	7.6	6.4	7.1	6.7
Corporate income tax	2.3	2.7	2.6	2.8	2.4	2.8	2.4	2.4
Other (incl. wealth, capital, and property taxes)	0.4	0.4	0.4	0.4	0.4	0.4	0.6	0.6
Taxes on payroll and workforce and Social Security contributions	12.6	13.6	13.8	13.9	13.5	12.9	12.3	12.1
Taxes on goods and services	15.0	15.6	15.6	16.2	15.9	17.2	17.1	17.0
VAT	7.4	7.8	7.6	8.2	8.0	9.1	8.9	8.8
Other (incl. excises and duties)	7.5	7.8	8.0	8.0	7.9	8.2	8.2	8.1
Current non-tax revenues	4.0	3.8	4.1	3.9	4.1	3.6	4.0	3.5
Of which: interest	0.3	0.3	0.4	0.3	0.4	0.2	0.4	0.3
Current transfers (incl. grants)	0.8	0.6	1.0	0.6	0.7	0.7	1.0	0.6
Capital revenues and capital transfers (incl. grants)	0.9	0.9	1.0	1.7	1.5	2.3	1.2	1.7
Memorandum item: subnational governments own revenues	6.3	5.9	6.3	-	-	-	-	-
Total expenditures	51.9	49.7	49.6	50.7	50.1	50.2	49.4	47.4
Current expenditures and current transfers	45.7	44.2	45.3	45.6	45.9	44.3	45.3	43.1
Compensation of employees 2/	12.2	11.5	11.5	11.4	11.5	11.0	10.9	10.6
Goods and services	7.0	6.6	7.0	6.6	7.0	6.6	6.8	6.4
Interest payments	4.0	4.0	4.2	4.9	4.4	4.7	4.4	4.6
Subsidies	1.4	1.4	1.0	1.1	0.9	0.9	0.9	0.6
Current transfers to households	18.5	18.1	18.6	19.3	19.5	18.5	19.0	18.1
Social security	13.5	13.4	14.2	14.9	15.2	15.1	14.8	14.3
Of which unemployment benefits	0.4	0.4	0.4	0.5	0.6	0.5	0.5	0.6
Other	5.0	4.6	4.4	4.3	4.4	3.4	4.2	3.9
Other current transfers	2.7	2.6	3.0	2.3	2.4	2.5	3.4	2.8
Capital expenditures	4.3	3.6	2.7	3.3	2.9	3.7	2.5	2.8
Capital transfers	1.9	1.9	1.5	1.7	1.4	2.0	1.5	1.4
Other net expenditure	-	-	0.0	0.1	0.0	0.2	0.0	0.0
Memorandum item: subnational governments total expenditure	12.8	11.6	11.5	-	-	-	-	-
General government balance	-9.3	-4.9	-3.4	-3.9	-3.9	-3.8	-3.8	-2.8
Primary balance	-5.4	-0.9	0.8	1.0	0.5	0.9	0.7	1.9
Memorandum items:								
Primary expenditure	48.0	45.7	45.4	45.8	45.6	45.3	44.9	42.8
Output gap (in percent of potential GDP)	3.6	2.7	1.3	-8.5	-6.2	-10.8	-7.8	-6.4
Cyclically-adjusted overall balance (CAB, in percent of potential GDP)	-11.2	-6.3	-4.0	0.4	-0.8	1.6	0.1	0.3
Change in CAB	-2.3	4.9	2.3	3.6	3.3	1.2	0.9	0.2
One-off items (net)	-0.8	-1.0	-0.3	0.0	0.0	0.0	-0.1	0.0
Structural balance	-10.4	-5.3	-3.7	0.4	-0.7	1.6	0.2	0.3
Change in the structural balance	-1.1	5.1	1.6	3.8	3.0	1.2	0.9	0.1
Gross public debt	65.6	65.7	72.6	77.4	78.8	80.4	79.9	78.7
Real GDP growth (in percent)	3.9	1.2	0.6	-6.7	-6.7	-0.9	-0.9	3.2
In nominal terms (HUF billions)								
Total revenue	10,133	11,411	12,296	12,139	11,913	12,155	11,995	12,356
Of which tax revenues	8,797	10,043	10,662	10,520	10,257	10,422	10,365	10,714
Total expenditure	12,350	12,666	13,191	13,143	12,916	13,152	12,985	13,118
Of which primary expenditure	11,409	11,638	12,076	11,872	11,774	11,919	11,815	11,839
Primary balance	-1,276	-227	220	268	140	236	180	517
Overall balance	-2,217	-1,256	-895	-1,004	-1,003	-997	-990	-763

Sources: Hungarian authorities; and staff estimates.

1/ Data are classified following the ESA'95 methodology, as reported to the European Commission.
2/ Including social security contributions.

Table 7. Hungary: Borrowing Requirement of the Central Government, 2009-10
(in billion of forints)

	2009					2010				
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year
Net borrowing requirement 1/	566.0	218.6	253.1	-75.9	961.8	523.8	218.2	217.4	-88.9	870.6
Redemptions										
In Hungarian forints	1,052.2	2,037.8	1,750.3	1,497.6	6,337.9	899.2	1,431.4	1,416.7	1,580.7	5,327.9
In foreign currency (euro)	152.4	119.0	9.7	5.9	287.0	10.2	8.2	341.3	11.1	370.8
Gross borrowing requirement	1,770.7	2,375.4	2,013.1	1,427.6	7,586.7	1,433.2	1,657.8	1,975.4	1,502.8	6,569.3
Actual and planned financing										
Gross issuance (actual and planned)										
In Hungarian forints	993.8	1,273.0	1,650.1	1,333.5	5,250.3	1,261.4	1,447.2	1,621.4	1,528.8	5,858.8
In foreign currency	1,244.0	0.0	678.9	150.9	2,073.8	0.0	569.6	0.0	0.0	569.6
Drawing on deposits with banking system	-467.1	1,102.4	-315.9	-56.7	262.7	171.8	-359.0	354.0	-26.0	140.8

1/ Overall budget balance of the central government system (cash basis).

Table 8. Hungary: Financial Soundness Indicators for the Banking Sector, 2005–09 Q2
(In percent unless otherwise indicated, end of period)

	2005	2006	2007	2008	2009Q1	2009Q2
Capital adequacy						
Regulatory capital to risk-weighted assets	11.6	11.0	10.4	11.2	10.3	12.3
Capital (net worth) to assets	8.2	8.3	8.2	8.0	7.3	8.1
Asset composition and quality						
Annual growth of bank loans	19.8	18.4	22.1	20.9	21.3	11.0
Sectoral distribution of bank loans (in percent of total)						
Corporates	45.7	43.2	39.8	35.3	35.1	35.6
o/w in foreign currency	21.8	20.3	20.9	21.3	23.0	21.8
Households	29.2	31.5	32.7	36.0	35.2	35.9
o/w in foreign currency	9.5	14.8	19.3	25.4	25.9	25.2
Other loans	25.0	25.3	27.5	28.7	29.7	28.5
o/w in foreign currency	18.8	19.1	22.5	25.0	26.4	24.6
Financial institutions	12.3	11.3	10.7	9.5	10.7	9.9
Central government	0.6	0.5	0.5	0.2	0.2	0.4
Nonresidents	5.1	6.2	9.1	12.2	12.9	12.1
Other	7.0	7.2	7.2	6.8	5.9	6.1
Denomination of FX loans to corporates						
EUR	74.7	70.8	67.6	66.9	70.2	72.3
USD	5.7	4.6	4.9	4.1	3.6	3.3
CHF	19.2	24.4	26.4	27.8	25.2	23.5
Other	0.4	0.2	1.0	1.1	1.0	0.8
NPLs to gross loans 1/	2.5	2.5	2.5	3.0	3.7	4.8
Provisions to NPLs	54.4	53.9	58.1	59.6	54.1	52.6
NPLs net of provisions to capital	9.0	9.2	8.4	11.1	16.3	18.7
Earnings and profitability						
ROA (after tax)	1.4	1.5	1.2	0.8	1.3	1.1
ROE (after tax)	24.5	23.8	18.4	11.6	18.3	15.3
Net interest income to gross income	64.4	64.7	61.3	56.0	50.3	54.7
Noninterest expenses to gross income	48.6	48.7	50.2	50.4	39.3	40.7
Personnel expenses to noninterest expenses	47.2	48.3	48.9	49.4	49.8	48.8
Trading and fee income to total income	33.8	32.3	36.1	30.7	37.5	38.3
Spread between loan and deposit rates	3.7	3.5	3.2	2.6	2.2	2.4
Liquidity						
Liquid assets to total assets	21.0	20.0	16.4	15.6	14.6	19.4
Liquid assets to short term liabilities	35.7	36.8	30.5	31.4	29.9	39.8
Loans to deposits	107.7	109.9	121.6	125.1	127.3	120.8
FX liabilities(own capital is excluded) to total liabilities (own capital is excluded)	34.4	39.3	42.4	45.6	47.6	46.5
Sensitivity to market risk						
Net open position in FX to capital	3.5	7.2	6.0	13.7	14.1	18.1

Source: Magyar Nemzeti Bank.

1/ Non-performing loans (NPLs) are defined as loans classified as substandard, doubtful, and bad.

Table 9. Hungary: Program Financing, 2008 Q4 to 2010 Q3

(in millions of euros)

	2008	2009				2010			Total
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	
	Est	Est		Proj.			Proj.		Proj.
Total financing requirements	**-669**	**-1,399**	**-3,229**	**-1,048**	**-2,744**	**-1,378**	**-1,053**	**-1,676**	**-13,197**
Current account deficit	-2,583	-591	198	-1,286	-1,016	-620	-925	-794	-7,615
Financial account outflows	2,145	-672	-3,357	411	-1,256	-586	44	-710	-3,980
Direct investment, net	1,492	262	-13	277	316	276	154	272	3,035
Portfolio investment, government net	-4,347	-2,561	-1,911	1,560	-46	326	950	-908	-6,937
Portfolio investment, private net 1/	-1,257	-499	692	-44	50	-147	-148	148	-1,205
of which, financial derivatives 2/	-1,157	-1,452	767	0	0	0	0	0	-1,841
Other investment	6,257	2,126	-2,125	-1,382	-1,575	-1,040	-912	-222	1,127
Bank Guarantee Fund	0	0	0	0	-300	0	0	0	-300
Net errors and omissions	-231	-136	-70	-173	-173	-173	-173	-173	-1,301
Total financing sources	**-4,255**	**-968**	**1,840**	**-89**	**1,953**	**586**	**262**	**884**	**213**
Capital account inflows	67	863	571	204	204	452	452	452	3,263
Net capital transfers from the EU	68	858	581	214	214	452	452	452	3,289
Program Financing	2,000	2,000	0	1,500	500	300	800	400	7,500
European Union	2,000	2,000	0	1,500	0	300	300	400	6,500
World Bank	0	0	0	0	500	0	500	0	1,000
Change in gross reserves	-6,322	-3,831	1,270	-1,792	1,249	-165	-990	33	-10,550
Financing need	**-4,923**	**-2,368**	**-1,389**	**-1,137**	**-792**	**-792**	**-792**	**-792**	**-12,984**
Fund credits	4,923	2,368	1,389	55	792	792	792	792	12,984
SDR allocation	0	0	0	1,082	0	0	0	0	0

Sources: Hungarian authorities and staff projections.

1/ During the second half of 2009, banks with foreign parent banks are expected to roll over 80 percent of short-term debt, and others 70 percent, recovering gradually to 100 percent in the second half of 2010.
2/ Assumes zero net flows from financial derivatives.

Table 10. Hungary: Schedule of Reviews and Purchases

	Original Schedule		**Proposed New Schedule**		
	Amount of Purchase		Amount of Purchase		
Date	Millions of SDRs	Percent of Quota	Millions of SDRs	Percent of Quota	Conditions
November 6, 2008	4,215.0	405.9	4,215.0	405.9	Approval of arrangement
March 25, 2009	2,107.5	203.0	2,107.5	203.0	First review and end-December 2008 performance criteria
June 23, 2009	1,264.5	121.8	1,264.5	121.8	Second review and end-March 2009 performance criteria
September 25, 2009	1,264.5	121.8	50.0	4.8	Third review and end-June 2009 performance criteria
November 15, 2009	1,264.5	121.8	725.1	69.8	Fourth review and end-September 2009 performance criteria
February 15, 2010	421.5	40.6	725.1	69.8	Fifth review and end-December 2009 performance criteria
May 15, 2010			725.1	69.8	Sixth review and end-March 2010 performance criteria
August 15, 2010			725.2	69.8	Seventh review and end-June 2010 performance criteria
Total	**10,537.5**	**1,014.8**	**10,537.5**	**1,014.8**	

Source: IMF staff estimates.

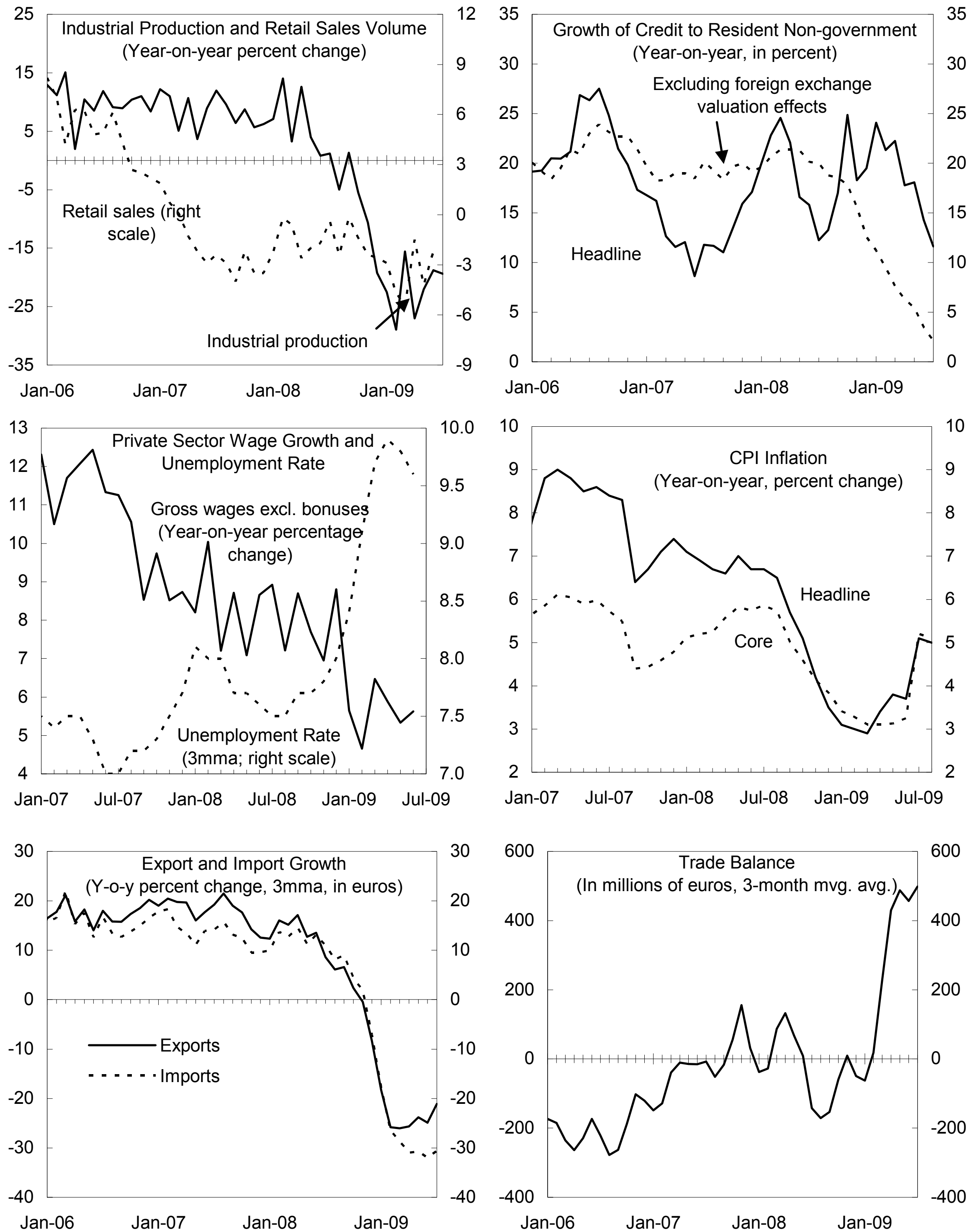
Table 11. Hungary. Indicators of Fund Credit, 2008-15
(In millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015
Existing and prospective Fund credit								
Disbursement 1/	4,215	4,147	2,175	-	-	-	-	-
Stock 2/	4,215	8,362	10,538	10,538	7,317	2,592	544	-
Obligations	21	224	248	288	3,492	4,893	2,077	549
Repurchase	-	-	-	-	3,220	4,725	2,049	544
Charges 3/	21	224	248	288	272	168	28	5
Stock of existing and prospective Fund credit								
In percent of quota	405.9	805.3	1014.8	1014.8	704.7	249.7	52.4	-
In percent of GDP	4.3	10.2	12.1	11.4	7.4	2.5	0.5	-
In percent of exports of goods and services	5.3	13.6	16.4	15.4	9.9	3.3	0.6	-
In percent of gross reserves	18.8	34.1	41.0	42.4	26.9	8.2	1.6	-
Obligations to the Fund from existing and prospective Fund arrangements								
In percent of quota	2.0	21.6	23.9	27.7	336.3	471.2	200.0	52.8
In percent of GDP	0.0	0.3	0.3	0.3	3.6	4.7	1.9	0.5
In percent of exports of goods and services	0.0	0.4	0.4	0.4	4.7	6.1	2.4	0.6
In percent of gross reserves	0.1	0.9	1.0	1.2	12.9	15.5	6.0	1.5

Source: IMF staff estimates.

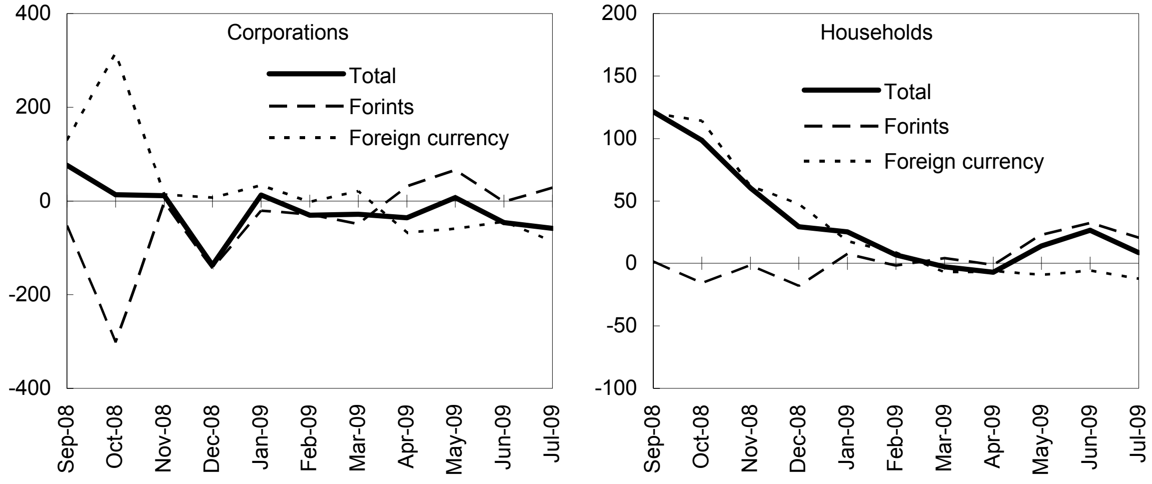
1/ Calculated based on proposed extension and rephasing of purchases.
2/ End of period.
3/ New schedule of surcharges.

Figure 1. Hungary: Recent Economic Developments



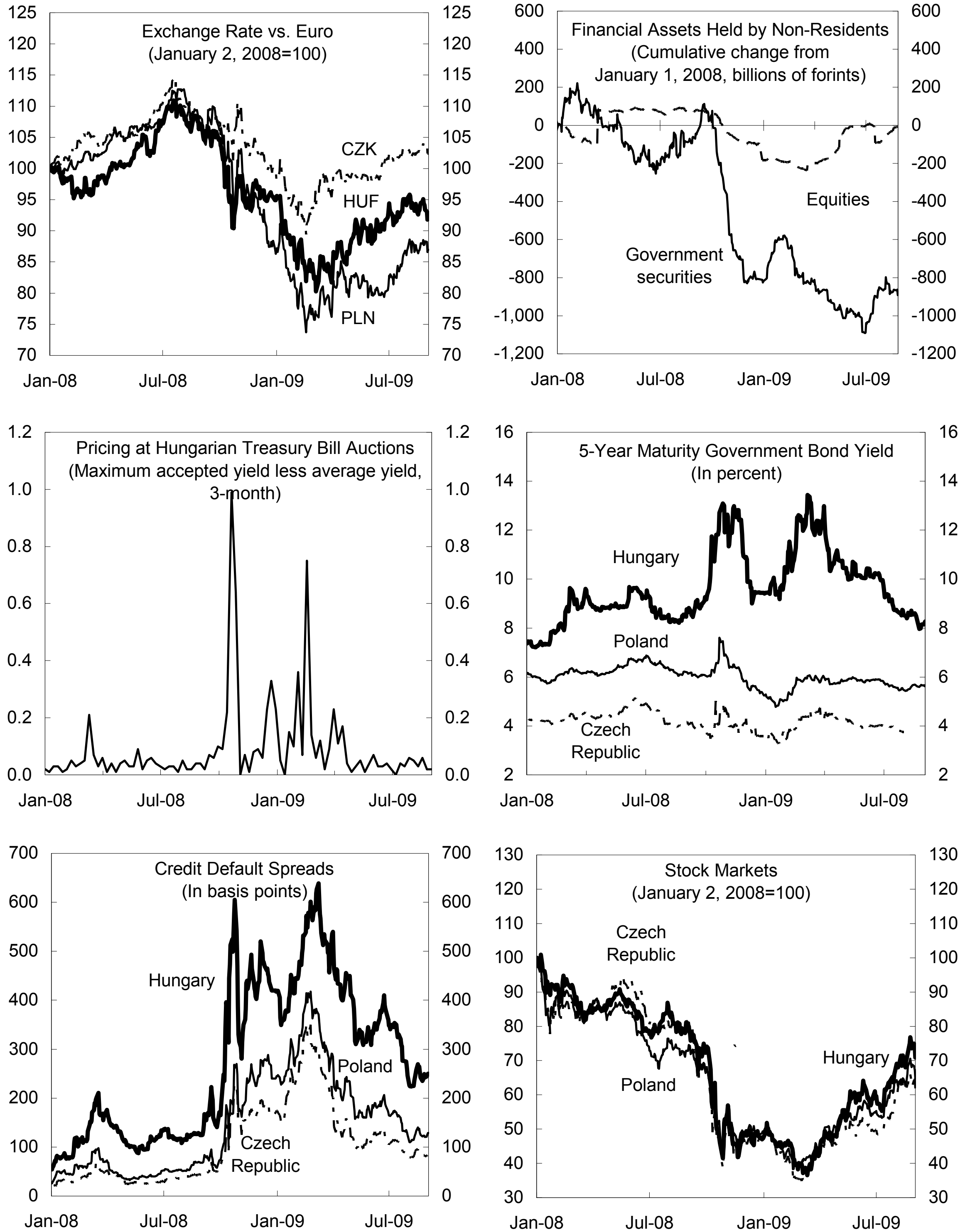
Sources: Hungarian Statistical Office; and IMF staff calculations.

Figure 2. Hungary: Bank Lending to Corporations and Households, 2008-09
(Billions of forints, flows)



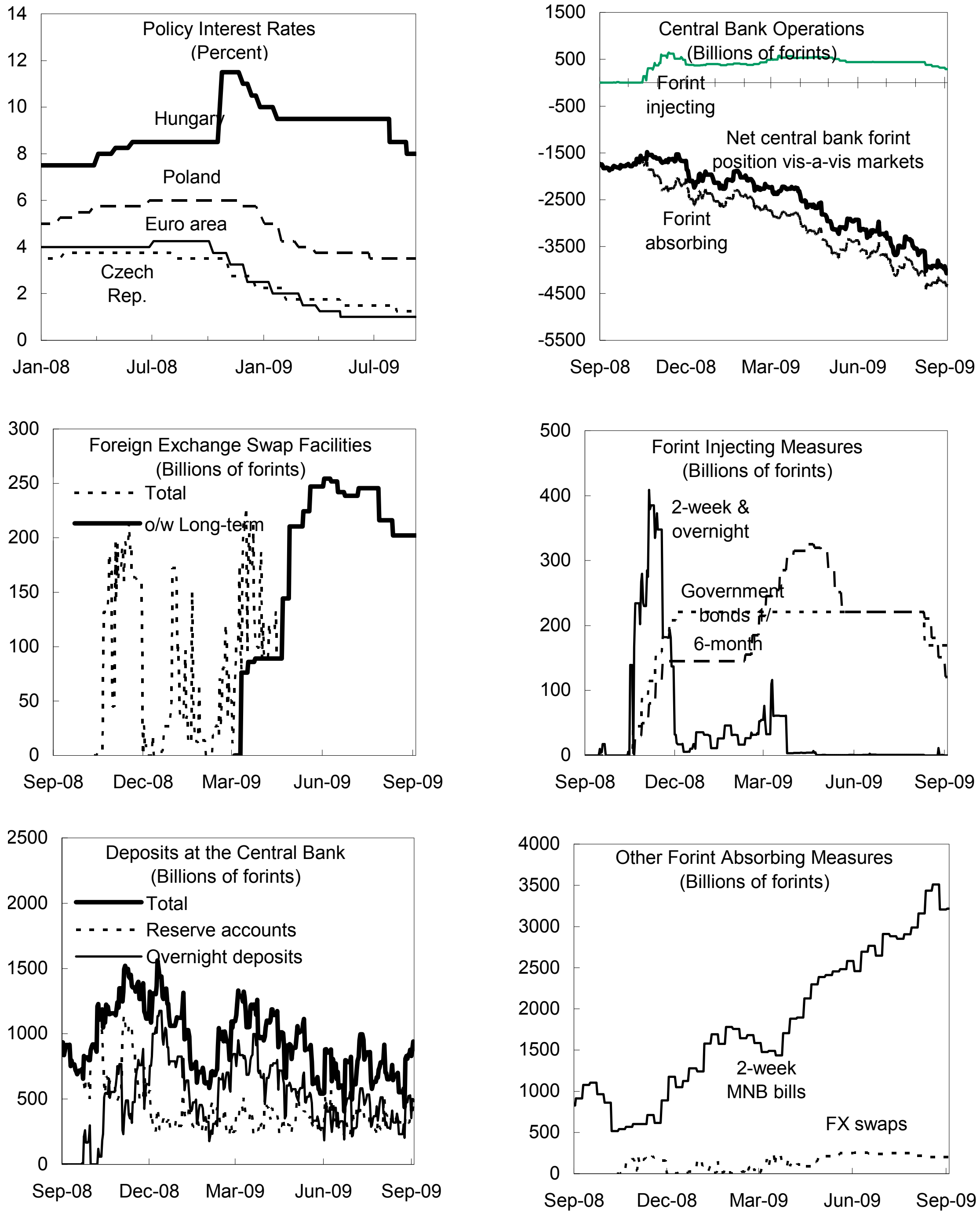
Source: Magyar Nemzeti Bank.

Figure 3. Hungary: Financial Market Developments, 2008-09



Sources: National authorities; Bloomberg; and AKK.

Figure 4. Hungary: Monetary Policy Indicators, 2008-09



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

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

	Actual					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	**Debt-stabilizing non-interest current account 7/**
Baseline: External debt	67.0	75.1	90.5	96.9	114.1	**132.3**	**130.0**	**122.3**	**119.4**	**117.3**	**115.0**	**0.8**
Change in external debt	12.5	8.1	15.4	6.4	17.2	18.3	-2.4	-7.7	-2.9	-2.1	-2.3	
Identified external debt-creating flows (4+8+9)	-5.2	-1.3	2.9	1.1	5.8	12.3	5.1	0.2	0.1	0.9	1.6	
Current account deficit, excluding interest payments	5.8	4.6	4.4	2.9	3.0	-3.2	-3.0	-2.0	-1.7	-1.6	-1.5	
Deficit in balance of goods and services	2.7	1.2	0.9	-1.4	-0.9	-4.7	-4.4	-3.6	-3.1	-2.7	-2.3	
Exports	65.0	67.7	76.7	79.7	81.2	75.3	73.7	74.3	75.5	76.7	78.9	
Imports	67.7	68.9	77.6	78.4	80.2	70.6	69.4	70.7	72.4	74.0	76.5	
Net non-debt creating capital inflows (negative)	-5.4	-4.3	-2.3	3.8	1.5	0.5	0.8	0.9	1.9	1.9	2.0	
Automatic debt dynamics 1/	-5.5	-1.6	0.8	-5.5	1.2	15.0	7.4	1.4	0.0	0.5	1.0	
Contribution from nominal interest rate	2.6	2.9	3.2	3.7	5.4	6.2	6.3	5.4	5.2	5.0	4.9	
Contribution from real GDP growth	-4.3	-2.4	-2.9	-1.0	-0.6	8.9	1.1	-4.0	-5.2	-4.5	-3.9	
Contribution from price and exchange rate changes 2/	-3.8	-2.2	0.5	-8.2	-3.6	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	17.7	9.5	12.5	5.3	11.4	6.0	-7.5	-7.9	-3.0	-3.0	-3.9	
External debt-to-exports ratio (in percent)	103.1	111.0	118.0	121.6	140.5	175.7	176.3	164.5	158.0	153.0	145.8	
Gross external financing need (in billions of euros) 4/	19.0	21.1	21.9	20.4	34.7	37.5	33.9	36.6	33.4	37.8	40.0	
in percent of GDP	23.1	23.7	24.3	20.1	32.7	40.9	35.0	36.0	30.8	32.8	32.9	
Scenario with key variables at their historical averages 5/						**132.3**	**127.6**	**117.8**	**112.8**	**108.0**	**102.6**	**-7.8**
Key Macroeconomic Assumptions Underlying Baseline 6/												
Real GDP growth (in percent)	9.2	3.9	3.9	1.2	0.6	-6.7	-0.9	3.2	4.5	4.0	3.5	
GDP deflator in euros (change in percent)	6.6	3.7	-2.3	11.3	3.9	-7.2	6.3	2.0	1.9	2.0	2.0	
Nominal external interest rate (in percent)	5.6	4.7	4.3	4.5	5.8	4.7	5.0	4.4	4.5	4.5	4.4	
Growth of exports (euro terms, in percent)	20.2	12.2	15.0	17.1	6.4	-19.7	3.1	6.1	8.3	7.7	8.6	
Growth of imports (euro terms, in percent)	20.8	9.7	14.2	13.8	7.0	-23.7	3.4	7.3	9.1	8.4	9.1	
Current account balance, excluding interest payments	-5.8	-4.6	-4.4	-2.9	-3.0	3.2	3.0	2.0	1.7	1.6	1.5	
Net non-debt creating capital inflows	5.4	4.3	2.3	-3.8	-1.5	-0.5	-0.8	-0.9	-1.9	-1.9	-2.0	

1/ Excluding Special Purpose Entities.

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

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

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

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

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

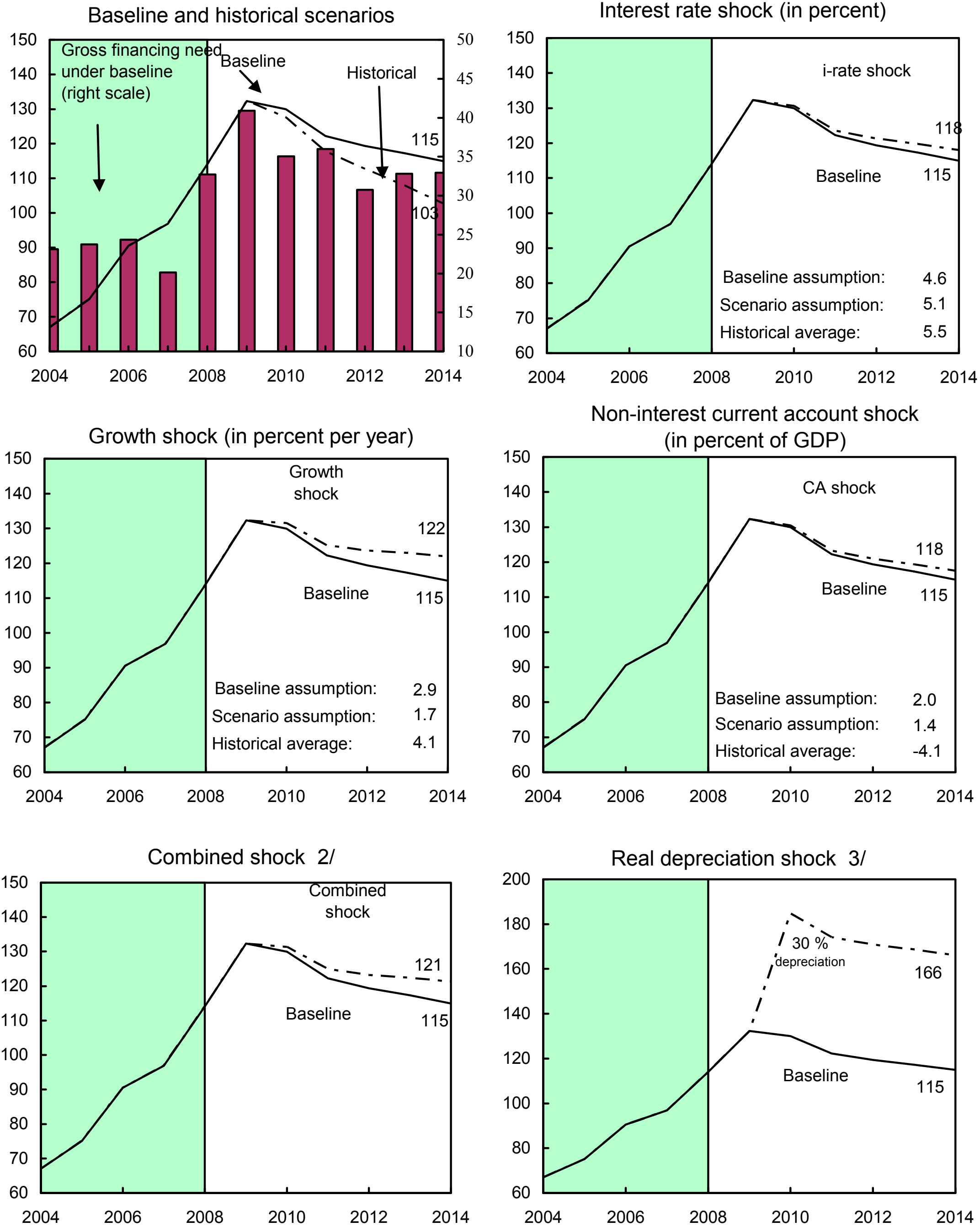
7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels

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

	Actual					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	**Debt-stabilizing primary balance 10/**
Baseline: Public sector debt 1/	59.4	61.8	65.6	65.9	72.6	**78.8**	**79.9**	**78.7**	**76.0**	**72.9**	**69.7**	**0.2**
o/w foreign-currency denominated	15.3	17.4	18.5	18.5	26.4	33.7	34.1	28.6	26.7	24.8	23.1	
Change in public sector debt	1.4	2.4	3.8	0.3	6.7	6.2	1.1	-1.2	-2.8	-3.1	-3.2	
Identified debt-creating flows (4+7+12)	-1.2	5.2	1.7	-1.1	2.9	6.2	2.2	-1.2	-2.8	-3.1	-3.2	
Primary deficit	2.0	3.7	5.4	0.9	-0.8	-0.5	-0.7	-1.8	-2.5	-3.1	-3.5	
Revenue and grants	42.6	42.3	42.6	44.9	46.2	46.2	45.6	44.6	44.4	44.1	44.0	
Primary (noninterest) expenditure	44.6	46.0	48.0	45.8	45.4	45.7	44.9	42.8	41.8	41.0	40.4	
Automatic debt dynamics 2/	-2.4	3.4	-2.4	-2.0	3.8	6.8	2.9	0.7	-0.3	0.0	0.4	
Contribution from interest rate/growth differential 3/	-0.6	0.6	-0.7	-0.2	1.2	6.8	2.9	0.7	-0.3	0.0	0.4	
Of which contribution from real interest rate	2.0	2.9	1.6	0.5	1.6	1.7	2.3	3.1	3.1	2.9	2.8	
Of which contribution from real GDP growth	-2.6	-2.3	-2.3	-0.7	-0.4	5.0	0.7	-2.4	-3.4	-2.9	-2.4	
Contribution from exchange rate depreciation 4/	-1.8	2.8	-1.7	-1.8	2.6	...	...	...	...	...	...	
Other identified debt-creating flows	-0.8	-2.0	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-0.8	-2.0	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	2.6	-2.8	2.1	1.4	3.7	0.0	-1.1	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	139.5	146.3	154.1	146.9	157.1	170.6	175.2	176.4	171.2	165.1	158.5	
Gross financing need 6/	23.2	24.6	24.3	18.7	26.5	19.3	12.5	26.7	22.7	18.5	19.2	
in billions of U.S. dollars	23.7	27.2	27.5	25.9	41.4	24.0	16.5	37.3	33.9	29.2	31.9	
Scenario with key variables at their historical averages 7/						**78.8**	**77.9**	**78.0**	**78.2**	**78.4**	**78.5**	**-1.1**
Scenario with no policy change (constant primary balance) in 2009-2014						**78.8**	**81.9**	**85.0**	**84.7**	**84.3**	**84.4**	**0.5**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.8	4.0	4.0	1.1	0.6	-6.7	-0.9	3.2	4.5	4.0	3.5	
Average nominal interest rate on public debt (in percent) 9/	8.3	7.4	6.9	6.6	6.7	5.9	5.8	6.1	6.2	6.1	6.0	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.9	5.2	3.0	0.9	2.5	2.0	2.9	4.1	4.3	4.2	4.1	
Nominal appreciation (increase in US dollar value of local currency, in percent)	15.3	-15.6	11.5	11.0	-12.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	4.4	2.2	3.9	5.7	4.1	3.9	2.9	1.9	2.0	1.9	2.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.7	7.2	8.6	-3.5	-0.4	-6.1	-2.5	-1.7	2.2	2.0	2.1	
Primary deficit	2.0	3.7	5.4	0.9	-0.8	-0.5	-0.7	-1.8	-2.5	-3.1	-3.5	
Memorandum item												
Growth of real public debt	6.2	7.0	7.8	0.0	11.4	-1.9	1.4	0.6	-0.2	-1.2	-2.0	

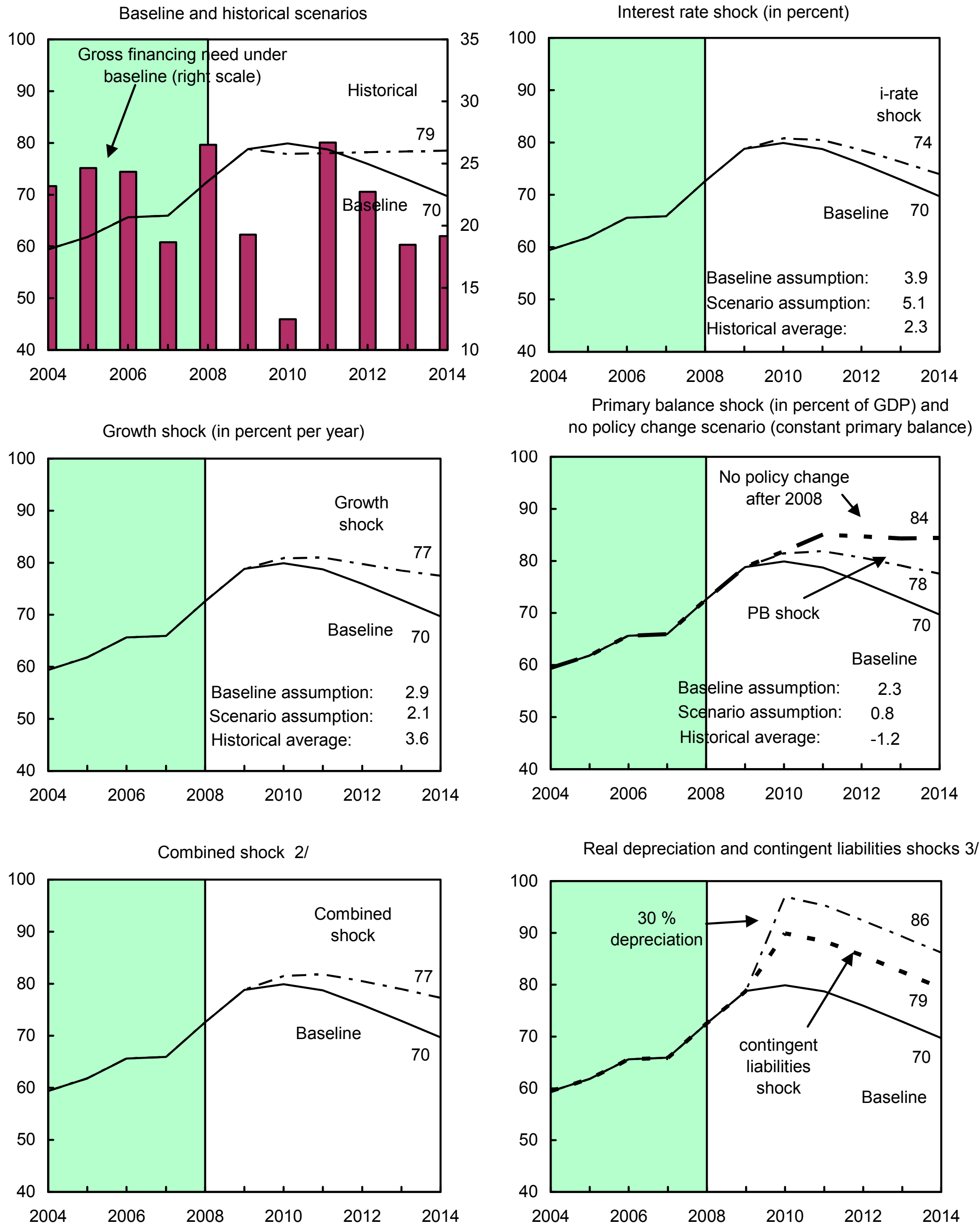
1/ General government gross debt.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange 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.

Appendix Figure 1. 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 2010.

Appendix Figure 2. 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).

ATTACHMENT I. LETTER OF INTENT (LOI)

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

Budapest, September 16, 2009

Dear Mr. Strauss-Kahn:

1. Hungary's economy is in the midst of a severe recession, reflecting in part the global financial crisis and the ensuing economic downturn. Economic activity contracted by 7.5 percent (y-o-y) in the second quarter of this year, and unemployment increased to close to 10 percent in the period of May-July. However, concurrent indicators suggest that the pace of the contraction is slowing. The turning point in activity is expected for the first quarter of 2010. External financial strains have eased significantly, allowing the government to issue a five-year €1 billion euro bond in July.

2. In spite of the challenging environment, the implementation of our economic program has remained in line with our commitments under the stand-by arrangement (Tables 1 and 2):

- All quantitative performance criteria for end-June 2009 have been met. Moreover, inflation at end-June was within the inner bands of the inflation consultation band. However, the indicative target on central government debt (which excludes program financing from the EU) was not met, as the government's borrowing from the market increased temporarily, reflecting that the disbursement of the third tranche of the EU balance of payments support originally scheduled for end-June did not occur until July 6.

- In line with the continuous structural benchmark, the Financial Stability sub-committee that monitors the financial soundness and stress-resilience of banks that receive capital or refinancing support from the government remains operational and is consulting with Fund staff on its work program (paragraph 19).

3. In view of this performance, we request completion of the third review under the Stand-By Arrangement. Given the still considerable uncertainty about prospects for global financial conditions, we also request a six-month extension of the Stand-By Arrangement (SBA) to October 5, 2010. The extended program will cover the election period and the transition to a new government. Economic policies during the extended period will continue to be in line with the objectives of our economic program. Given the improvement in official

international reserves, due in part to the SDR allocation,[1] we request a disbursement of SDR 50 million following completion of the third review. We also request that the remaining amount under the SBA (SDR 2,901 million) be re-phased in four equal disbursements over the remainder of the extended program.

4. We request that the performance criteria on net international reserves be modified to lock in the increase in reserves at end-September 2009. Quantitative performance criteria through end-December 2009 are set out in Table 2 and the Technical Memorandum of Understanding, both attached to this letter. Structural benchmarks are set out in Table 3. The fourth review of the program will take place after November 15, 2009 and the fifth review after February 15, 2010.

5. We believe that the policies set forth in the letters of November 4, 2008; March 12, 2009; June 11, 2009, and in this letter are adequate to achieve the objectives of our economic program, but the Government stands ready to take additional measures as appropriate to ensure achievement of its objectives. As is standard under all IMF arrangements, we will consult with the IMF before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the IMF with the necessary information for program monitoring.

Macroeconomic Framework for 2009 and 2010

6. The economy has largely evolved as anticipated at the time of the second review. The real GDP decline by 7.5 percent (y-o-y) in the second quarter was in line with expectations. The "Pathway to Work" program—a scheme to provide working opportunities to long-term unemployed—has temporarily slowed the increase in unemployment, but weak retail sales, due especially to a decline in car sales, point to a slightly larger contraction in real private consumption. Domestic lending conditions remain tight, as lower borrowing rates are offset by more restrictive lending policies. Exports are likely to pick up going forward, but a recovery in domestic demand is expected to get under way only in the second half of next year. Overall, real GDP is expected to contract by 6.7 percent this year and by another 0.9 percent in 2010, projections that are unchanged compared to the second review.

7. Consumer price inflation is projected at 4.5 percent for 2009, unchanged from the second review. The initial impact on inflation from the VAT increase in July was less than expected and the exchange rate appreciated somewhat. However, these effects are balanced by slightly higher commodities prices and a smaller output gap due to the downward revision of potential growth. In 2010, average inflation is projected to be 4.1 percent after taking into

[1] Hungary received allocations of SDR 770 million on August 28, 2009, and SDR 221 million on September 9, 2009. These allocations relate to the IMF's general allocation of US$ 250 billion, and a special one-time allocation of SDR 21.5 billion under the fourth amendment of the IMF's articles of agreement, respectively.

account increases in excise duties that were approved in mid-May 2009 and will come into effect on January 1, 2010.

8. The current account deficit is expected to narrow to 2.9 percent of GDP in 2009, from 8.4 percent in 2008, somewhat more than anticipated at the second review and reflecting the slightly larger contraction of domestic demand. For 2010, the current account deficit is projected to widen modestly. While export volumes are expected to pick up due to increased demand from trading partner countries, and import volume growth is projected to be weak, the combined effect of these factors is expected to be offset by a deterioration in the terms of trade due to higher oil prices, and a more appreciated real exchange rate relative to the first half of 2009.

9. External financing conditions have improved in line with global developments, allowing the government to issue a five-year €1 billion euro bond in July. Moreover, non-residents have increased their holdings of government bonds over the past months. Pressures in the FX swap market have dissipated, the exchange rate has appreciated to levels of around 270 forint against the euro, compared to 317 forint at the height of financial markets strains in March, and exchange rate volatility has fallen. Banks experienced net negative financial outflows in the second quarter of 2009, in part because parent banks of Hungarian subsidiaries repatriated some of the emergency liquidity provided in Q4 2008. Going forward, the lower current account deficit is expected to reduce Hungary's external financing need. The higher-than-anticipated build-up in international reserves provides a considerable buffer against shocks to external financing, allowing the remaining disbursements under the SBA to be re-phased over an extended period until October 2010.

Fiscal Policy and Structural Fiscal Reforms

10. A core objective of the program is to buttress our commitment to sustainable public finances by containing the government's short-term financing need and credibly reducing it over the medium term. To this end, we adopted in June and started to implement a comprehensive package of entitlement, public service, and tax reforms (June Letter of Intent, paragraphs 11 and 12) aimed at permanently reducing public expenditure and stimulating potential growth. By better anchoring market expectations and creating room for a cautious reduction in policy interest rates, these measures have allowed Hungary to take full advantage of the ongoing stabilization of global financial conditions. Over the medium term, the combination of higher growth, lower interest rates, and stronger structural budget balances will put the public debt-to-GDP ratio firmly on a declining path, while gradually making space for easing the excessive tax burden.

11. In the first half of 2009, the primary balance of the central government system was above the program floor (performance criterion), as spending overruns by the central budgetary institutions and higher-than-expected mandatory expenditures were temporarily offset by lower-than-expected outlays on EU-financed investment projects. As EU funding

will automatically adjust to expected expenditures in the second half of the year, we have allocated HUF 50 billion from the stability reserve and HUF 13 billion from the general reserve to cover the afore-mentioned spending overruns. On the revenue side, tax collections reflected the continued contraction in economic activity, with higher-than-expected shortfalls in CIT and car taxes, leading us to freeze the remaining HUF 28 billion of the stability reserve.

12. Looking forward, we are fully committed to the general government deficit ceiling of 3.9 percent of GDP (Maastricht definition) in 2009. While the end-September primary balance floor is expected to be met (quantitative performance criterion), the end-December target will be adjusted downward to account for lower-than-expected interest payments. As the end-2009 fiscal targets remain subject to macroeconomic and execution risks, we have developed a three-pronged risk management plan. First, to avoid further spending overruns, controls were strengthened: carryover balances have been made subject to binding floors; and by virtue of a new government decree adopted on August 26, the Prime Minister appointed Treasurers in budgetary units. Acting under the authority of the Finance Minister, Treasurers will report spending commitments that could be untimely or inconsistent with the unit's tasks, resulting in delays or cancellation of such spending commitments. The second line of defense consists of remaining buffers, including in central government reserves and identified emergency measures amounting to about HUF 50 billion. Third, we are fully committed to taking additional measures in case the program targets are at risk.

13. We have submitted to Parliament the draft budget for 2010, reflecting in full the structural reforms announced in our June Letter of Intent (paragraphs 11 and 12). In line with the terms of the Fiscal Responsibility Law and of our commitment under the EU Excessive Deficit Procedure, the draft budget provides for a modest reduction of the overall deficit from 3.9 to 3.8 percent of GDP (Maastricht definition). To meet this target, and as envisaged at the time of the second review, we have specified concrete measures to reduce local government mandates and encourage efficiency gains with a view to generate net savings of about HUF 80 billion for the general government. Additional savings of about HUF 40 billion will come from lower education expenditures due to demographic trends, increases in selected fees, and adjustments to certain subsidies. The draft budget also reflects HUF 40 billion in savings in the public transport system. These will be achieved by eliminating redundancies between railway and long-distance bus lines, restructuring the railway company MAV, better targeting price subsidies, and improving procurement procedures and corporate governance. These measures should also generate substantial savings over the medium term. The draft budget does not account for the planned decrease in the national farm support (June Letter of Intent, paragraph 11), pending a ruling of the Constitutional Court. On the revenue side, the new value-based property tax voted by Parliament was more limited than envisaged at the time of the second review. The resulting revenue loss was offset with higher excise duties. The draft budget is premised on conservative tax revenue projections, and on higher non-tax revenues, owing mainly to the sale of a new broadband license, higher interest revenues, and additional dividends from state-owned enterprises.

14. In view of the risks surrounding the 2010 deficit target, the draft budget contains appropriate buffers. In addition to risks to the macroeconomic outlook, the structural nature of many underlying measures implies that their exact financial impact is difficult to estimate, and that their timely execution can be challenged by unexpected hurdles. Moreover, local elections scheduled for October 2010 create potentially significant spending pressures beyond our control. To mitigate those downside risks, the draft central budget is built on the likely need to offset a large increase in local government deficits (by 0.5 percent of GDP), and contains adequate reserves (0.75 percent of GDP) that can cover macroeconomic and execution risks.

15. We re-affirm our intention to bring the 2011 overall deficit of the general government below 3 percent of GDP, as required under the EU Excessive Deficit Procedure. To offset the revenue loss from the planned increase that year in the top PIT bracket, additional permanent expenditure cuts will be considered.

16. Building institutions that promote fiscal discipline is an essential part of our program. The Fiscal Council's secretariat is now recruiting highly-qualified professionals for its economics and budget departments, and we expect it to be fully operational by year-end (June Letter of Intent, paragraph 16). The Council has already published an assessment of fiscal risks, and is expected to issue an analysis of the 2010 budget, including a review of the macroeconomic forecasts underlying it. We will establish clear and transparent procedures governing the exchange of information and the policy dialogue between the Council and the government. Work has started with the Council and the parliamentary budget committee to identify possible inconsistencies between the Fiscal Responsibility Law and existing budget procedures, including ways to strengthen the medium-term focus of budget preparation. We will publish the results of this review by end-October.

Financial Sector Policies

17. The banking system has remained profitable and adequately funded during the first half of 2009. Return on equity was 15.3 percent, compared to 17.1 percent in the first half of 2008, as robust interest rate margins and cuts in operating expenses mostly compensated for the negative impact on profits from sharply increased loan loss provisions. The banking system's capital adequacy ratio rose to 12.3 percent at end-June 2009, compared to 10.3 percent at end-March. The banking system's funding situation has also improved. Deposits from residents have increased, especially from corporations, counterbalancing the decrease in funding from parent banks to their Hungarian subsidiaries in recent months (paragraph 9). Credit to the economy has contracted, especially to the corporate sector, albeit at a relatively modest pace (2.7 percent between end-2008 and July 2009) and reflecting in part a lack of demand. Non-performing loans (including problem, sub-standard and bad) have increased to 4.8 percent at end-June, compared to 3.0 percent at end-2008.

18. Significant challenges for the banking system lie ahead, but they appear manageable. Profitability is projected to decline sharply during the remainder of this year, as banks further step up provisioning and interest margins narrow. Non-performing loans could peak at around 10 percent in the first half of 2010. Stress tests conducted by the central bank, consistent also with the IMF-coordinated regional initiative, suggest that under the baseline macroeconomic scenario, the capital buffer of the banking system as a whole would remain adequate, but modest capitalization needs would emerge in individual banks in 2010.

19. To further prepare for these challenges, we are pursuing the following initiatives.

a. We will extend the capital enhancement scheme under the financial stability act until end-2010, and seek EC approval. The amount available remains unchanged at HUF 270 billion. We plan to submit legislation to parliament by end-October 2009.

b. We will seek a more specific agreement with the parent banks of the largest Hungarian subsidiaries following-up on their general commitment given in Brussels on May 20 to maintain appropriate funding for their subsidiaries and preserve their good financial standing.

c. A subcommittee of the Financial Stability Committee (FSC), consisting of members of the Hungarian National Bank (MNB), the Hungarian Financial Supervisory Authority (HFSA), and the Ministry of Finance, continues to monitor closely the liquidity and solvency situation of banks that received foreign exchange loans from the government in April 2009. The subcommittee meets regularly and consults with IMF staff on its work program (continuous structural benchmark)

d. We are further strengthening the legal framework for remedial action and bank resolution. A subcommittee of the FSC has developed proposals to temporarily restrict ownership rights of distressed banks, ease the transfer of deposits and split problematic banks of systemic importance, institute a bridge bank, and facilitate preventive intervention by the HFSA. Based on these proposals, the Ministry of Finance is evaluating legal options for draft legislation, with technical assistance of the IMF and consistent with the EU's legislative framework. Passage by parliament of such legislation is a structural benchmark for end-December 2009.

e. We are developing schemes to strengthen the stress-resilience of the household and corporate sectors against the expected further deterioration in economic conditions. In June 2009, parliament enacted the extension of a partial household debt servicing guarantee scheme, which was approved by the European Commission (EC) on July 13. For rephased mortgages of households whose debt-service-to-income ratio has increased by at least 25 percent, the government offers a guarantee of 80 percent of the rephased portion of the loan. The scheme contains safeguards aimed at preserving credit discipline and limiting potential fiscal costs, including limits on initial indebtedness and the size of the loan. Also in June, a reform of the corporate bankruptcy legislation was enacted that

provides tools and incentives for restructuring debts of a bankrupt corporation, rather than entering into liquidation. Moreover, the government is promoting schemes to encourage bank lending to small and medium-sized enterprises, including through partial cross-guarantees of default insurance on such loans.

20. In parallel with these initiatives, the HFSA has stepped up its efforts in the area of on-site inspection of banks' domestic activities (in line with the action plan from May 2009), initiated an inspection process for their foreign subsidiaries, and prepared an enhanced version of its action plan.

a. Broad on-site inspections of five major banks—the largest bank and four subsidiaries of foreign parent banks—have been completed. Inspections reports are being prepared and discussed with the affected banks. Two additional major banks will be inspected by end-October. Focused follow-up inspections on capital adequacy are scheduled for fall 2009. In early 2010, the HFSA will conduct thematic inspections focusing on credit risk and the quality of the loan portfolio of selected large banks. The completion of reports on these thematic inspections for at least 3 banks, selected with a systemic risk-based approach, is a structural benchmark for end-March 2010.

b. The HFSA has developed a work agenda to assess the foreign subsidiaries of Hungary's banks, starting with the largest, which is active in eight countries in the region. For the three subsidiaries in EU-countries, the host countries' supervisors are carrying out inspections in cooperation with the HFSA. For the five subsidiaries in non-EU countries, the HFSA is procuring the services of external auditing firms that will perform the assessments. The findings of all these assessments are expected to be available to the HFSA by March 2010.

c. The enhanced HFSA action plan contains—in addition to the expanded inspection schedule and a stronger focus on data accuracy—an extensive training program, far larger in volume and better targeted to foster specialized expertise accumulation, through the definition of professional development paths, alternating field assignments, and courses delivered by practitioners. The HFSA also has the intention of rapidly acquiring senior expertise in areas where the HFSA's competencies are currently incomplete, including accounting according to IFRS standards.

d. Further activities to enhance the HFSA's capacities include a stronger focus on the preparation of financial statements adjusted by the inspection team. Sampling methods for loan portfolio examinations will also be improved. Assessments of the foreign subsidiaries of Hungarian banks will be synchronized, and the capacity of HFSA staff to vet the consolidation process be improved, so that they will become able to monitor and form an opinion on the overall condition of major banking groups.

21. We have initiated a major overhaul of legal and organizational framework for financial supervision and regulation, in line with recommendations of an IMF technical

assistance mission from July 2009. Some changes require constitutional amendments and therefore a two-thirds majority in parliament. In case the constitutional amendment will fail, we will consider making the MNB responsible for financial sector supervision.

a. We will upgrade the HFSA to an autonomous organization with the ability to issue regulations, ending its status as a semi-autonomous agency ("government office") reporting to the Ministry of Finance. The organizational structure of the HFSA will be overhauled to eliminate unclear and at times overlapping responsibilities and lines of reporting. Specifically, the supervisory board of the HFSA will be abolished, and the Chairman of the HFSA will be given the operational and strategic responsibility for all activities of the HFSA. The Chairman will be appointed by the President of the Republic of Hungary and report once a year to the legislature.

b. The MNB will obtain the authority to issue temporary regulations on macro-prudential issues of systemic importance. In parallel with issuing the regulation, the Governor of the MNB can propose, on a "comply or explain" basis, legislative action to the government or the HFSA, depending on the legal responsibility in the specific case under consideration.

c. The tripartite Financial Stability Committee will be replaced by a Financial Stability Council. The Council will comprise the Chairman of the HFSA, the Governor of the MNB, the Minister of Finance, and three additional members, one each appointed by the . Chairman of the HFSA, the Governor of the MNB, and the Minister of Finance. The Council's tasks include assessing the stability of different parts of the financial system based on the analyses of the HFSA and the central bank, and monitoring the activities of the HFSA as regards the enforcement of laws and regulations from the point of view of financial stability. Moreover, the Council can request, on a "comply or explain" basis, that the HFSA or the government takes regulatory or legal action.

Submitting legislation to parliament that (i) upgrades the HFSA's legal status to an autonomous organization, (ii) grants the MNB the authority to issue temporary regulations on macro-prudential issues of systemic importance, and (iii) establishes the Financial Stability Council is a structural benchmark for October 15, 2009.

Monetary and Exchange Rate Policy

22. The MNB remains committed to the inflation target of 3 percent over the medium term, while acting as needed to mitigate risks to financial stability. Since July 28, the MNB has cut the key policy rate by a total of 150 bps to 8.0 percent, in line with the strengthening of investor confidence and the associated easing of external financing conditions. The rate cuts followed a period of 6 months during which the MNB kept the policy rate on hold at a relatively elevated level, reflecting concerns about the volatile market environment. With consumer price inflation projected to fall below the MNB's central target of 3 percent once the transitory impact of the recent VAT and excise tax increases evaporates, there is room for

further cuts in policy rates should recent improvements in market sentiment prove sustainable.

23. For the purpose of monitoring inflation under the inflation consultation mechanism (ICM), headline CPI is adjusted for the estimated technical effect of the recent increases in VAT and excise duties (Table 2), starting in September 2009. The central point of the ICM remains at 3 percent—the central bank's inflation target—and both bands of the ICM also remain unchanged.

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

/s/	/s/
Peter Oszkó	András Simor
Minister of Finance	Governor of the MNB

Attachments

Table 1. Hungary: Program Monitoring

	Measure	
Quantitative Performance Criteria		Jun-09
1	Floor on the cash primary balance of the central government system	Observed
2	Floor on net international reserves	Observed
Continuous Performance Criteria		
	Non-accumulation of external debt arrears	Observed
Inflation Consultation Clause		
	Inner band	Observed
	Outer band	Observed
Indicative Target		
	Ceiling on total debt stock of the central government system	Not observed
Structural Benchmark		
	Operation of the new sub-committee described in Paragraph 18 of the March 2009 Letter of Intent as long as there is any government capital or funding support outstanding to banks, and consultation of the sub-committee with Fund staff on its work program (continuous)	Observed

Table 2. Hungary: Quantitative Program Targets

	2008			2009						2010	
	end-Sep	end-Dec		end-Mar		end-Jun		end-Sep	end-Dec	end-Mar	end-Jun
	Actual	Prog.	Outcome	Prog.	Outcome	Prog.	Outcome	Prog.		Proj.	
I. Quantitative Performance Criteria											
1. Overall floor on the cumulative cash primary balance of the central government system (floor, in billions of forints) 1/	130	215	226	-280	-248	-155	-123	-160	220	-205	-110
2. Cumulative change in net international reserves (floor, in millions of euros) 2/	17,096	-6,465	+1,398	-4,451	+1,464	-4,629	-1,195	-3,540	-5,581	-6,207	-6,009
II. Continuous Performance Criterion											
3. Non-accumulation of external debt arrears	…	0	0	0	0	0	0	0	0	0	0
III. Inflation Consultation											
4. 12-month rate of inflation in consumer prices 3/											
Outer band (upper limit)	...	7.1	...	5.0	...	5.0		5.0	5.0	5.0	5.0
Inner band (upper limit)	...	6.1	...	4.0	...	4.0		4.0	4.0	4.0	4.0
Central point	5.7	5.1	3.5	3.0	2.9	3.0	3.7	3.0	3.0	3.0	3.0
Inner band (lower limit)	...	4.1	...	2.0	...	2.0		2.0	2.0	2.0	2.0
Outer band (lower limit)	...	3.1	...	1.0	...	1.0		1.0	1.0	1.0	1.0
III. Indicative Target											
5. Ceiling on the total debt stock of the central government system (in billions of forints) 4/ 5/	15,973	16,230	15,925	16,281	15,936	15,100	15,162	15,070	15,170	15,340	15,590

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

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

3/ The inner band for consultation is +/-1 percentage points around the central point, and the outer band is +/-2 percentage points around the central point. Starting end-September 2009, under the inflation consultation mechanism, we will monitor the headline CPI adjusted by 3.7 percentage points in 2009 and 4.1 percentage points in 2010 to account for the estimated technical effect of increases in VAT and excise taxes (see TMU).

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

5/ These are the indicative target ceilings adjusted for EU transfers and other items described in the TMU. Before adjustment, these ceilings were 16,320 for end-December 2008, 15,872 for end-March 2009 and 15,074 for end-June.

Table 3. Hungary: Structural Conditionality

	Measure	
Structural Benchmarks		
1	Operation of the new sub-committee of the tripartite Financial Stability committee as long as there is any government capital or funding support outstanding to banks, and consultation of the sub-committee with Fund staff on its work program	Continuous
2	Submitting legislation to parliament that (i) upgrades the HFSA's legal status to an autonomous organization, (ii) grants the MNB the authority to issue temporary regulations on macro-prudential issues of systemic importance, and (iii) establishes the Financial Stability Council	By October 15, 2009
3	Passage by parliament of the amendments strengthening the remedial powers of the HFSA and bank resolution regime as listed in paragraph 20 of the March 2009 Letter of Intent	By end-December 2009
4	Completion of reports on thematic inspections focusing on credit risk and the quality of the loan portfolio for at least 3 banks, selected with a systemic risk-based approach	By end-March 2010

ATTACHMENT II. TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

September 16, 2009

1. This Technical Memorandum of Understanding (TMU) defines the variables subject to quantitative targets (performance criteria and indicative targets), specified in the Letter of Intent (LOI). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets. Reference to "days" in this TMU should be understood to mean "business days in Budapest".

2. The exchange rates for the purposes of the program of the Hungarian forint (HUF) to the euro is set at HUF 243.17 = €1, to the U.S. dollar at HUF 169.15 = $1, and to the Swiss franc at HUF 154.01 = CHF 1, the rates as shown on the Hungarian central bank's (Magyar Nemzeti Bank, MNB) website as of September 30, 2008.[1]

Central Government System

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

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

A. Floor on the Net International Reserves of the MNB[2]

	(In millions of euros)
Outstanding stock:	
End-December 2008	18,493.8
Floor on cumulative change in net international reserves from end-December 2008:	
End- March 2009 (actual)	1,464
End-June 2009 (actual)	-1,195
End-September 2009 (performance criterion)	-3,540
End-December 2009 (performance criterion)	-5,581
End-March 2010 (indicative target)	-6,207
End-June 2010 (indicative target)	-6,009

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

[2] Several items, such as the foreign currency receipts from EU and World Bank disbursements, EU transfers, and foreign exchange market financing of the government, increase the central bank's capacity for intervention under the NIR target, in addition to the decline in NIR.

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

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

6. **Gross foreign liabilities** are defined consistently with SDDS as all foreign exchange liabilities of the MNB to residents and nonresidents, including commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options), and banks foreign currency deposits against reserve requirements. Hungary's SDR allocation is treated as a foreign liability of the MNB.[3] Government foreign exchange deposits and forward liabilities arising from swap arrangements with the MNB are not treated as foreign liability of the MNB.

7. NIR targets will be adjusted upward (downward) by the surplus (shortfall) in program disbursements relative to the baseline projection. Program disbursements are defined as external disbursements from official creditors that are usable for the financing of the overall central government budget. NIR will not be affected by the SDR allocations received by Hungary in September and expected in October 2009, as the central bank's reserves assets and its liabilities to the SDR department will increase at the same time.

External Program Disbursements (Baseline Projection)

Cumulative flows from end-December 2008:	(In millions of euros)
End-March 2009	2,000
End-June 2009	2,000
End-September 2009 (program projection)	3,500
End-December 2009 (program projection)	4,000
End-March 2010 (program projection)	4,300
End-June 2010 (program projection)	4,600

[3] As a consequence, NIR will not be affected by the SDR allocations received by Hungary on August 29 and September 9, as gross foreign assets and liabilities will increase at the same time by the same amount.

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

8. **The quarterly consultation band for the 12-month rate of inflation in consumer prices** is based on the measure of the headline consumer price index (CPI) published by the Hungarian Central Statistical Office. Consistent with the headline CPI inflation target of the MNB, the central point for end-quarter inflation will be 3 percent, with lower and upper bands around each target of ±1 and ±2, respectively. The targets for end-September 2009 and end-December 2009 are performance criteria, while the one for end-March 2010 is an indicative target. For the purpose of monitoring performance under the inflation consultation mechanism, CPI inflation will be adjusted by 3.7 percentage points in 2009, and 4.1 percentage points in 2010, which is equal to the estimated technical impact of the VAT increase (3.4 percentage points) and the excise tax increases (0.3 percentage points in 2009 and 0.7 percentage points in 2010), starting in September 2009. This has been calculated by applying the relevant tax increases to the applicable products in the consumer price index basket.

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

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

	(In billions of forints)
Cumulative primary balance from January 1, 2009:	
End-September 2009 (performance criterion)	-160
End-December 2009 (performance criterion)	220
End-March 2010 (indicative target)	-205
End-June 2010 (indicative target)	-110

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

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

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

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

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

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

14. The ceiling on the overall stock of the debt, as outlined below, shall apply to the HUF value of total stock of debt contracted by the central government system. Excluded from this indicative ceiling are credits from the IMF, external program financing, normal trade-related credits, reserve and long-term liabilities of the MNB, and the absolute net value of mark-to-market deposits of the Hungarian Debt Management Agency (ÁKK).[4] Liabilities related to the bank support package are not included. All stated benchmarks of ÁKK in terms of public debt management will be maintained as much as possible, depending on market conditions and the possible use of IMF credit.

Outstanding stock:	(In billions of forints)
End-December 2008 (actual)	15,925
End-March 2009 (actual)	15,936
End-June 2009 (actual)	15,162
End-September 2009 (indicative ceiling)	15,070
End-December 2009 (indicative ceiling)	15,170
End-March 2010 (program projection)	15,340
End-June 2010 (program projection)	15,590

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

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

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

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

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

Net EU Transfers (Baseline Projection)

Baseline projections:	(In billions of forints)
End-September 2009 (program projection)	-11
End-December 2009 (program projection)	-152
End-March 2010 (program projection)	218
End-June 2010 (program projection)	31

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-September 2009 (program projection)	269
End-December 2009 (program projection)	160
End-March 2010 (program projection)	320
End-June 2010 (program projection)	721

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 EXTERNAL RELATIONS DEPARTMENT

Press Release No. 09/331
FOR IMMEDIATE RELEASE
September 25, 2009

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Third Review Under Hungary's Stand-By Arrangement, Extends the Arrangement, and Approves €53.7 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the third review of Hungary's economic performance under a program supported by a Stand-By Arrangement (SBA). The Board also extended the SBA by six months to October 5, 2010 to support the country's economic program during the election and transition period to a new government, and approved the rephasing of the undisbursed amounts over the remainder of the arrangement. The completion of the third review enables the immediate release of SDR 50 million (about €53.7 million or US$79.3 million), bringing total disbursements under the program to SDR 7.64 billion (about €8.20 billion or US$12.12 billion).

In completing the review, the Board also approved a modification of the performance criterion on net international reserves given improved external financing conditions.

The SBA was approved on November 6, 2008 (see Press Release No. 08/275) for SDR 10.54 billion (about €11.32 billion or US$16.72 billion). The arrangement entails exceptional access to IMF resources, amounting to 1,015 percent of Hungary's quota.

Following the Executive Board's discussion on Hungary, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, said:

"Macroeconomic and financial policies in Hungary are on track. Continued implementation of policies consistent with the program remains essential to strengthen macroeconomic stability and provide the basis for strong, sustainable growth over the medium term.

"Fiscal sustainability is being strengthened through structural spending reforms to the pension system, social transfers, and subsidies. At the same time, tax reform is shifting the tax burden from labor to consumption and wealth, which should boost labor participation and

potential growth over the medium term. The full implementation of these comprehensive structural reforms is essential to put government debt as a share of GDP firmly on a declining path.

"Financial stability is being maintained through a further strengthening of the capability to do on-site bank inspections, institutional reform to improve the supervisory agency's independence and strengthen the central bank's authority on macro-prudential issues, and the careful monitoring of banks that have received government financial support.

"Monetary and exchange rate policy will continue to target inflation over the medium term, while the authorities will remain prepared to act as needed to mitigate risks to financial stability. The combination of improved global financial conditions and increased confidence in fiscal sustainability has created room for cautious interest rate cuts," Mr. Kato stated.