INTERNATIONAL MONETARY FUND

Staff Country Reports

December 2009
IMF Country Report No. 09/330

Hungary: Fourth Review Under the Stand-By Arrangement, and Request for Modification of Performance Criteria

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 November 16, 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 December 4, 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 December 18, 2009 discussion of the staff report that completed the review.

- A staff statement.

The document(s) 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.

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INTERNATIONAL MONETARY FUND

HUNGARY

Fourth Review Under the Stand-By Arrangement, and Request for Modification of Performance Criteria

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

Approved by Anne-Marie Gulde and Lorenzo Giorgianni

December 4, 2009

- **Stand-By Arrangement**: a 17-month SBA in the amount of SDR 10.5 billion (1015 percent of quota) and the first purchase of SDR 4.2 billion were approved on November 6, 2008. The second purchase of SDR 2.1 billion was made following the First Review on March 25, 2009. The third purchase of SDR 1.3 billion was made following the Second Review on June 23, 2009. At the Third Review, on September 25, 2009, the arrangement was extended to October 5, 2010, the undisbursed amounts were rephased over the remainder of the arrangement, and the fourth purchase of SDR 50 million was made. The European Commission and the World Bank are also providing funds to cover the financing need under the program.
- **Program status**: All end-September 2009 quantitative performance criteria, the continuous performance criterion on non-accumulation of external arrears, the indicative target on central government debt, as well as the continuous structural benchmark related to government lending to banks, were met. Inflation in September breached the lower inner band of the inflation consultation mechanism and the central bank had a discussion with Fund staff. The structural benchmark on submission of legislation on strengthening the institutional framework for bank supervision was met with only a minor delay.
- **Disbursement**: The authorities do not intend to draw the amount that would be made available upon completion of this review (SDR 725 million, about €780 million).
- **Discussions**: Discussions were held in Budapest during November 4-16, 2009. The mission met with Prime Minister Bajnai, Minister of Finance Oszkó, Minister of Justice Draskovics, central bank Governor Simor, HFSA Chairman Farkas, other senior officials, representatives of financial institutions, and academics. The staff team comprised Mr. Morsink (head), Ms. Carare, Mr. Wiegand, Ms. Popescu (all EUR), Ms. Barkbu (SPR), Mr. Frécaut (MCM), Ms. Luedersen (LEG), and Mr. Martin (FAD). Ms. Ivaschenko (Resident Representative) assisted the mission. Mr. Abel (OED) attended most of the meetings. Teams from the EC, ECB, and the World Bank joined.
- **Publication**: The 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 8
C. Financial Sector Policies 11
D. Monetary and Exchange Rate Policy 14
IV. Program Modalities 15
V. Staff Appraisal 16

Tables
1. Main Economic Indicators, 2006–10....................21
2. Monetary Accounts 2006–10 22
3. Balance of Payment, 2008–11 23
4. Program Financing, 2008 Q4 to 2010 Q3 24
5. Indicators of External Vulnerability, 2005–09 Q3 25
6. Staff's Illustrative Medium-Term Scenario, 2006–14....................26
7. Consolidated General Government, 2008–11 27
8 Borrowing Requirement of the Central Government 2009–10....................28
9. Financial Soundness Indicators for the Banking Sector, 2005–09 Q3 29
10. Schedule of Reviews and Purchases 30
11. Indicators of Fund Credit, 2008–16 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

Boxes
1. Hungary's Fiscal Adjustment in Perspective 18
2. Foreign Currency Lending in Hungary....................19
3. Hungary: Stand-By Arrangement 20

Appendix Tables
1. External Debt Sustainability Framework, 2004–14....................36
2. Public Sector Debt Sustainability Framework, 2004-14....................38

Appendix Figures
1. External Debt Sustainability: Bound Tests 37
2. Public Debt sustainability: Bound Tests 39

Attachments

I. Letter of Intent (LOI) 40
II. Technical Memorandum of Understanding (TMU)..51

I. Introduction and Summary

1. **Important progress has been made in strengthening policies that underpin fiscal sustainability and financial stability since the SBA was approved in November 2008** (Informational Annex, Appendix I). Government spending has been reduced in a durable way, while allowing the fiscal deficit to increase in 2009 to avoid exacerbating the economic contraction. In the financial sector, bank supervision and the remedial action framework have been enhanced. By better anchoring market expectations and creating room for a cautious reduction in the policy interest rate, these measures have allowed Hungary to take full advantage of the ongoing stabilization in global financial conditions.

2. **Macroeconomic and financial policies remain on track**. All September 2009 quantitative performance criteria, the continuous performance criterion on non-accumulation of external arrears, the indicative target on central government debt, as well as the continuous structural benchmark related to government lending to banks, were met. Inflation in September breached the lower inner band of the inflation consultation mechanism and the central bank had a discussion with Fund staff. The structural benchmark on submission of legislation to parliament on strengthening the institutional framework for bank supervision was met with only a minor delay. The government is committed to preparing a business plan for the state-owned railway company (MAV) consistent with the planned savings in the 2010 budget by December 7, 2009 (prior action) and to finishing the technical work on draft legislation to strengthen the bank resolution framework by December 11, 2009 (prior action).

3. **Reflecting the consistent implementation of economic policies and the reduction in global financial strains, the authorities do not intend to draw the amount that would be made available upon completion of this review** (SDR 725 million, about €780 million). The availability of Fund resources would help to provide insurance against the impact of any unforeseen deterioration in external financing conditions. The authorities have also indicated that they will not request the release of EU balance of payments assistance upon completion of this review. The outstanding undrawn amount (of up to €1 billion) would remain available and could be disbursed as needs arise, subject to policy conditionality as usual. The World Bank approved a €1 billion Financial Sector and Macro Stability Loan on September 22, 2009, but the loan documents have not yet been signed. Fund staff are cooperating closely with Bank staff on macro-critical structural issues (Informational Annex, Appendix II).

4. **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, strict expenditure control and cautious use of contingency reserves will be needed in 2010, and further measures will be required in 2011.

- To help preserve financial stability, the proposed reform of the institutional arrangements for bank supervision and the proposed strengthening of the bank resolution framework need to be adopted.

- The combination of improved global financial conditions and increased confidence in fiscal sustainability should create room for further cautious interest rate cuts.

5. **Parliamentary elections are expected in April 2010**. The parliamentary session before the elections is expected to be very short.

II. Recent Developments

6. **Economic activity continued to contract sharply in the third quarter of 2009, though there are signs that the pace of decline is easing** (Table 1 and Figure 1):

- ***Real GDP fell by 7.2 percent year-on-year in 2009Q3***. The unemployment rate increased from 9.6 percent in 2009Q2 to 10.3 percent in 2009Q3. The weak labor market, as well as the increase in VAT rate in July 2009, dampened retail sales. Recent data on exports and industrial production suggest that the pace of economic contraction is slowing, as in many other emerging economies in the region.

- ***Credit continued to stagnate*** (Figure 2). Outstanding loans to corporations fell by 4 percent since the beginning of the year, while loans to households have been stable, with a shift in new lending from foreign currency to domestic currency.

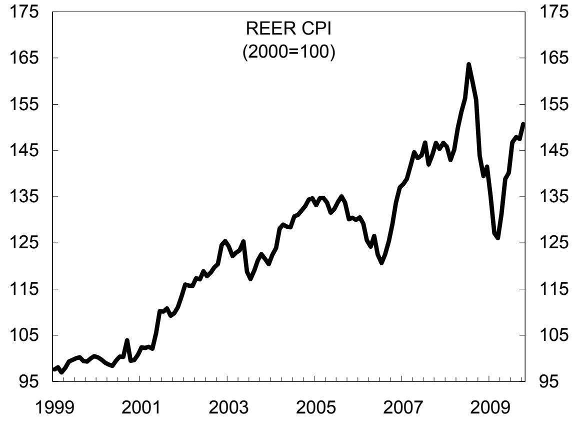
- ***CPI inflation moderated to 4.7 percent in October***, due mostly to lower food price inflation. Private sector wage growth excluding bonuses declined to 4.1 percent y-o-y in September.

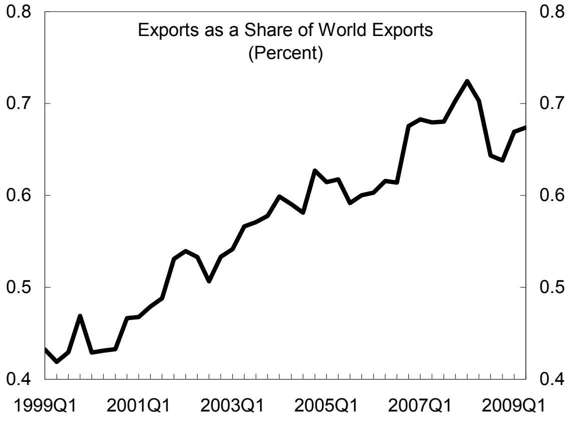
- ***Preliminary trade data suggests that the current account could register a surplus of about 2 percent of GDP in 2009Q3***. Exports benefited from a growth rebound in the euro area, while imports contracted further in line with weak domestic demand. Outflows of investment income fell in line with declining corporate profits.

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

- ***The exchange rate has remained roughly stable at about 265-275 forint per euro.*** Support for the currency has come in particular from non-residents taking long positions in the FX swap market to benefit from high domestic interest rates. Liquidity in the FX spot market has improved further (as indicated by lower bid-ask spreads) and exchange rate volatility has fallen to about pre-crisis levels.

- ***The CPI-based real effective exchange rate is about 8 percent below its July 2008 peak***, though it has appreciated by 20 percent since March 2009. At its current level, the exchange rate is roughly in line with fundamentals as estimated by the CGER exercise. Hungary's share of world exports has risen recently, as the global cycle in investment goods and consumer durables has turned up.





- ***Conditions in the government bond market have improved further***. The government debt management agency (AKK) continues to issue 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 since September by another percentage point to around 7 percent, amid solid demand from domestic institutional investors, partly reflecting recent regulatory changes to pension funds' asset allocations in favor of local assets.

- ***Net international reserves increased by €2.8 billion in 2009Q3, more than expected, due to the improvements in the trade balance and external financing conditions.*** The use of the central bank's FX swap facility was less than programmed. Banks' net external financing improved in 2009Q3, but is estimated to have still been negative. While foreign parent banks continued to repatriate some of the funds that they had injected in late 2008 and early 2009, their financing remained stable in September and October. Banks benefited from net inflows related to valuation gains on financial derivatives, partly as a result of exchange rate appreciation. The government received net financing through the euro bond issuance (€1 billion) and EU balance of payments support (€1.5 billion). Non-residents purchased domestic-currency government securities on a net basis (€0.6 billion).

III. Policy Discussions

A. Macroeconomic Framework

8. **The macroeconomic outlook for 2010 has improved modestly since the Third Review, reflecting the nascent recovery in the euro area** (LOI ¶s 7–10).

- ***The pace of economic contraction is expected to ease from 6.7 percent in 2009 to 0.6 percent in 2010***. In 2009, an earlier-than-expected pick-up in exports is offset by weaker domestic demand, including de-stocking. In 2010, real GDP growth has been revised up by ¼ percentage point, reflecting stronger export growth and the reduction in domestic interest rates. Risks to the forecast are balanced.

- ***Credit to the economy is expected to bottom out in the first quarter of 2010*** (Table 2). During the remainder of 2009, credit is projected to contract mildly owing to weak demand and tight lending conditions. In 2010, a gradual recovery is expected in line with the strengthening of domestic demand.

- ***CPI inflation is projected to rise above 5 percent by end-2009 and then fall to below 3 percent by mid-2010.*** Higher commodity prices, especially for energy, are expected to raise inflation in the very near term. In 2010, following the initial boost to inflation from the excise tax increases that take effect in January, the large output gap and weak labor market will put downward pressure on inflation.

- ***The current account deficit is expected to narrow sharply to 0.5 percent of GDP in 2009 and then widen modestly to 1.5 percent of GDP in 2010*** (Table 3). The size of the adjustment in 2009—almost 7 percentage points of GDP—is larger than expected at the Third Review.[1] In 2010, the widening of the current account deficit is due mostly to a deterioration in the investment income balance.

9. **The improvement in external financing conditions is expected to persist, but vulnerabilities remain** (Tables 4–5). Going forward, the current account deficit is fully offset by EU capital transfers, implying a lower external financing need than anticipated at the Third Review. Moreover, 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. Rollover rates for parent banks of Hungarian subsidiaries have been revised upward, in line with their commitments in the context of the European Bank Coordination Initiative (EBCI). Nevertheless, the gross external financing requirement (the sum of the current account deficit and debt amortization) in 2010 remains elevated due to the high level and short maturity of external debt. The increase in reserves over the past year, together with the available financing from the Fund, the EU and the World Bank, help provide a buffer against a deterioration in external financing conditions.

10. **Over the medium term, economic growth is projected to recover** (Table 6). The global recovery and a lower tax wedge on labor are projected to boost export growth. Domestic currency interest rates should continue to decline owing to fiscal consolidation,

[1] Revised balance of payments data show a current account deficit at 7.2 percent of GDP in 2008, compared to 8.4 percent in the preliminary data. Downward revisions were due to new data on corporate sector reinvested earnings from FDI in the income balance (0.8 percent of GDP) and accrual accounting of EU transfers, in line with Eurostat guidelines (0.6 percent of GDP).

thus supporting domestic demand. Risks to medium-term growth remain tilted to the downside, reflecting risks to fiscal policy and the global recovery.

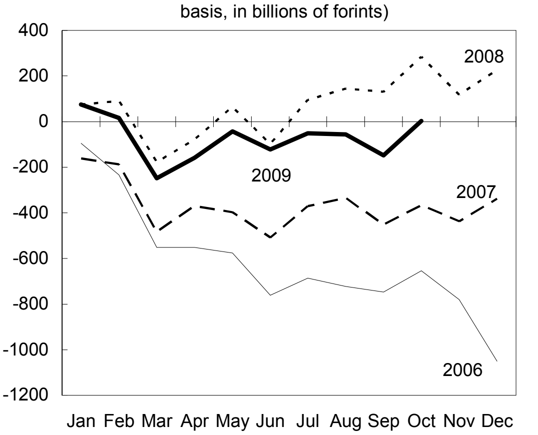
11. **Reflecting the adjustment of the current account and the projected rebound in growth, the external debt-to-GDP ratio is expected to peak at 137 percent in 2009 and then fall gradually to 112 percent in 2014**. The peak is about 4 percentage points of GDP higher than expected at the Third Review, reflecting a methodological change in recording EU transfers, revisions to debt data, and more optimistic rollover assumptions going forward. The projection is highly sensitive to assumptions about the future path of the exchange rate (Appendix, Table 1 and Figure 1).

B. Fiscal Policy

12. **Strengthening fiscal sustainability remains at the core of the program** (Box 1 and LOI ¶11). The structural general government balance is expected to improve by about 3 percentage points of GDP in 2009, a further 1 percentage point of GDP in 2010, and a further 0.1 percentage point of GDP in 2011, in line with the EU commitment to bring the headline general government deficit to below 3 percent of GDP by 2011. Beyond that, no further adjustment is assumed over the medium term. 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-September 2009 target on the primary cash balance of the central government was met** (text chart and LOI ¶12). In 2009Q3, higher-than-projected spending by line ministries and on housing subsidies was offset by lower-than-expected spending in other areas (including in the social security and labor market funds) as well as by higher-than-projected revenue, especially VAT and personal income tax. Local governments registered a small surplus in the first nine months of 2009, as expected.

Hungary: Primary Balance of the Central Government System (cash basis, in billions of forints)



14. **The authorities and staff agreed on the importance of limiting the general government deficit to 3.9 percent of GDP in 2009** (Tables 7-8 and LOI ¶13). The target remains appropriate given the largely unchanged macroeconomic outlook and the need to strengthen fiscal sustainability. Compared to the Third Review, projected spending by line ministries and on unemployment benefits and health care is higher, and corporate tax revenue

is lower (text table). These effects are offset by higher-than-projected excise revenue resulting from advance purchases of stamps by tobacco companies (ahead of the increase in excise duties in January) and dividend receipts from state-owned enterprises, as well as the saving of the pension contingency reserve and interest payments.[2] Tax compliance does not appear to have deteriorated significantly over the past year. Important downside risks relate to revenues from personal income tax and social security contributions in the fourth quarter, and to corporate tax receipts in December (which will be the first to fully reflect companies' financial performance in 2009). The authorities propose to adjust down the end-December 2009 performance criterion on the central government's cumulative cash primary balance to account for part of the macro-related revenue shortfalls and higher spending on unemployment benefits. The target for the general government deficit in 2009 is unchanged, as the deterioration in the primary balance is offset by lower interest expenditure.

Changes in the 2009 Fiscal Projections Since the Third Review
(Central governement, cash basis; in percent of GDP)

	Macro-Related	Non Macro-Related	Total
Change in the underlying primary balance (1)	-0.30	0.01	-0.29
Revenue	-0.28	0.15	-0.12
Spending	0.03	0.14	0.16
Use of contingency reserves identified at the Third Review (2)			0.15
Saving of the pension contingency reserve			0.07
Dividends from state-owned enterprises			0.08
Change in primary balance (3) = (1) - (2)			-0.14
Change in interest payments (4)			-0.11
Change in overall balance (5) = (3) - (4)			-0.03

Source: IMF staff estimates.

15. **The 2010 budget adopted by parliament is consistent with the agreed target and reflects the full implementation of previously agreed structural reforms** (LOI ¶14). A modest reduction of the general government deficit to 3.8 percent of GDP in 2010 is needed to preserve a credible commitment to debt sustainability, while avoiding an excessively negative impulse to economic activity. As envisaged at the time of the Third Review, part of the specific reserves were allocated to finance higher spending on healthcare, higher spending by local governments on school meals and education, and a reduction in the VAT on district heating. The remaining specific reserves contributed to increase the stability reserve, bringing overall budgetary reserves to 0.8 percent of GDP. As the envisaged decrease in farm support remains subject to a ruling by the Constitutional Court, it has not been included in the budget and will be saved if the Court rules in favor of the government.

16. **While the adopted budget provides for substantial reserves, meeting the fiscal objectives for 2010 will require strict expenditure control** (LOI ¶15). Considerable macroeconomic and execution risks surround the budget projections for 2010. Two types of risks are so significant that they are reflected in staff's baseline scenario: (i) lower-than-projected revenue due to the stock building of excise stamps in 2009 and the continuation of

[2] A higher-than-projected VAT refund (related to the ECJ ruling) to the state-owned railway company, MAV, is offset by a lower-than-projected subsidy to MAV.

weakness in the gambling tax and corporate tax; (ii) higher-than-projected subsidies to the public transport system, as the impact of the envisaged reforms is uncertain and may be insufficient to improve the sector's profitability. Taking these factors into account, the remaining budgetary reserves would amount to about 0.5 percent of GDP. While this level appears broadly adequate to cover other risks, the authorities and staff agreed that strict expenditure control will be essential to meet the 2010 fiscal objectives. In this regard, the authorities pointed to two factors underpinning spending discipline: (i) the appointment of treasurers in the line ministries; and (ii) clarity on appropriations from the beginning of the year (in contrast to 2009, when line ministries had to implement cuts during the course of the year).

17. **The authorities said they would intensify their efforts aimed at restructuring the public transport system** (LOI ¶14). The government will prepare a business plan for the state-owned railway company (MAV) consistent with the planned savings in the 2010 budget by December 7, 2009 (prior action) and announce decisions on fares and subsidies for the entire public transport system by December 15, 2009. While the envisaged reforms are expected to generate some savings in the short-term, the authorities need to tackle more forcefully the structural inefficiencies affecting the sector's profitability. Absent such structural reforms, the situation of the sector will continue to represent a significant drain on government finances, complicating fiscal consolidation efforts.

18. **The authorities and staff agreed that, if economic and financial conditions turn out to be better than anticipated, any extra revenues should be saved.** Such savings would help limit the necessary adjustment in spending that is likely to be necessary to bring the overall deficit of the general government below 3 percent of GDP in 2011.

19. **Looking forward, the authorities' intention to bring the deficit below 3 percent of GDP in 2011 will require further measures** (LOI ¶16). While the improvement in the structural general government balance needed to reach this objective is small, the authorities will have to offset the fiscal impact of the increase in the threshold for the top PIT bracket that will take effect in 2011 (projected to be 0.6 percent of GDP), the budgetary effect of the central bank's loss expected in 2010 (projected to be 0.3 percent of GDP), and the projected weak growth of some of the tax bases (such as private consumption) relative to GDP. The authorities and staff agreed that additional expenditure measures, which could amount to about 1¼ percent of GDP, should be envisaged to preserve the medium-term adjustment path and secure a trend decline in the debt to GDP ratio. To identify such measures, the authorities indicated that they will review possible expenditure rationalization reforms aimed at improving the efficiency of public service delivery.

20. **Further progress has been made in implementing the institutional reforms under the Fiscal Responsibility Law** (LOI ¶17). The Fiscal Council has started playing its role of advocate for fiscal responsibility and transparency, including through a thorough review of the 2010 budget submitted to parliament. The government has taken on board most of the

Fiscal Council's recommendations and intends to work closely with the Council to adequately implement the others. The Ministry of Finance has completed, in consultation with the Fiscal Council and the parliament budgetary committee, a review of the inconsistencies between the Fiscal Responsibility Law and existing budget procedures, and has started addressing the identified inconsistencies. It also intends to take steps to improve budgetary procedures with a focus on medium-term budget planning and management.

C. Financial Sector Policies

21. **Continued profitability has allowed banks to further increase capital buffers** (Table 9 and LOI ¶s18-19). Return-on-equity for the banking system as a whole in the first nine months of the year was 14.8 percent, down slightly from the mid-year result (15.3 percent). While loan-loss provisions have increased further, interest margins have remained robust and banks have cut operating costs. Profits have also been boosted by one-off events, such as gains on banks' holdings of government bonds and profits made from asset sales. Non-performing loans (NPLs) as a share of total loans stood at 5.9 percent at end-September, compared to 5.1 percent at end-June and 3.5 percent at end-March. The deterioration remains concentrated in unsecured consumer lending and commercial real estate. The banking system's capital adequacy ratio (CAR) increased further to 13.1 percent at end-September from 12.3 percent at end-June, owing mostly to retained earnings that have been added to the capital base, with a particularly high capital buffer for the largest domestic bank.

22. **Going forward, bank profitability is projected to weaken, as loan-loss provisions increase further and interest margins narrow**. The central bank projects that NPLs will peak at 9-10 percent during the course of 2010. For most banks, loan loss provisions are expected to reduce profits but not capital levels. Updated stress tests conducted by the central bank suggest no significant recapitalization needs for the banking system under the macroeconomic baseline scenario, and needs of €400–600 million under a downside scenario.

23. **Banks' liquidity positions have improved further.** While corporate deposits fell somewhat in the third quarter, following a strong increase in the first half of the year, household deposits have continued to increase. Moreover, parent bank funding to Hungarian subsidiaries stabilized in September and October, following several months of withdrawal of emergency liquidity that parent banks had injected during the turbulent period in late 2008 and early 2009. Liquid assets as a share of total assets have increased to 21.5 percent at end-September, up from 14.6 percent at end-2008. The improved liquidity position has allowed the largest domestic bank to repay in early November half of the FX-denominated government loan (€0.7 billion) that it had received in the second quarter.

24. **The authorities have secured specific commitments from the parent banks of Hungary's six largest subsidiaries in the context of the EBCI** (LOI ¶20). A follow-up

meeting was held in Brussels on November 19 to add specificity to the general commitments made in May. Some limited flexibility was introduced as regards the stability of parents' exposure, with a minimum level of 95 percent of that prevailing at end-September 2008 (just before the initiation of program discussions), which provides appropriate assurances given improved yet still fragile external financing conditions. A specific reporting format to monitor groups' global exposure to Hungary was discussed and approved. The authorities are now expecting to receive individual letters confirming the banks' commitments by end-December 2009.

25. Banking supervision capacity continues to increase, with priority given to on-site inspections of large banks (LOI ¶21). The implementation of the Hungarian Financial Supervisory Authority's (HFSA) Action Plan to develop its capabilities in the field of banking supervision is on track. Together with a substantially expanded training program, a key component of this plan consists in wide coverage on-site inspections of the domestic operations of the eight large banks. Six of these inspections were finalized by the originally envisaged end-October deadline, one was completed in November, and the final inspection is projected to be finalized in early 2010. Some inspections were extended to permit more in-depth investigations, leading, in a few cases, to requests for sizeable additional provisions, which however do not threaten the adequacy of the capital positions of the concerned banks. Moreover, the reviews of the foreign subsidiaries of Hungarian banks are progressing as scheduled. At the domestic level, the preparations by the HFSA of the next cycle of on-site controls, including inspections of credit quality for selected banks in early 2010, are progressing satisfactorily. The objective to complete the reports on these inspections for three banks in the first quarter (structural benchmark for end-March 2010) is within reach.

26. Significant progress is expected to be made on strengthening the institutional framework for financial supervision (LOI ¶22). Legislation was submitted to parliament on October 22 (slightly beyond the deadline of the structural benchmark of October 15) to upgrade the HFSA to an autonomous organization (from an agency subordinated to the Ministry of Finance) with the ability to issue regulations, grant the central bank the authority to issue temporary regulations on macro-prudential issues, and establish a Financial Stability Council (FSC). Some aspects of the legislative package have been modified in the process of consultation with parliament. In particular, while the HFSA is expected to be upgraded to an autonomous institution that is accountable to parliament and controls its budget and human resources, there was insufficient political support to give the HFSA the right to issue binding regulations, which would have required a constitutional change and therefore a two-thirds majority in parliament. However, both the FSC and the MNB are expected to obtain the right to propose regulations to the government on a "comply or explain" basis, i.e., the government is obliged either to adopt the proposal within 15 days, or elaborate in public on why it disagrees. Moreover, the HFSA—rather than the MNB—is expected to be granted the right to issue binding temporary resolutions in case of imminent risks to the financial system. Although this represents a second-best outcome, the reform would still amount to a significant strengthening of the effectiveness and independence of financial supervision. This legislation is expected to be enacted by December 15, 2009. Staff will take up the issue of granting the HFSA the power to issue binding regulations with the next government.

27. **The subcommittee of the Financial Stability Committee that monitors the three credit institutions that received FX loans from the government continues its work**. It meets regularly to discuss, among other things, the outcome of on-site inspections, the central bank's stress tests, and banks' financial results. The subcommittee also met with Fund staff to consult on its work program (continuous structural benchmark). Moreover, the capital enhancement fund under the December 2008 Financial Stability Act was extended from end-2009 to end-2010. The size of the fund is about 1 percent of GDP.

28. **The government is developing regulations to reduce risks related to lending to households in foreign currency** (LOI ¶23). FX loans are a key macro-financial vulnerability during the crisis (Box 2). While large-scale defaults on these loans have been avoided, this has come at the expense of a pro-cyclical increase in the policy interest rate to prevent an excess depreciation of the exchange rate. The regulations are expected to prescribe lower loan-to-value ratios for FX loans than for forint loans, and changes to banks' scoring systems for the approval of household loans, which imply lower monthly installments for FX loans than for forint loans to reflect the impact of exchange rate volatility on households' payment capacity while avoiding an unnecessarily large dampening of credit growth during the recovery. Although it will likely be several years before the flow of new lending has a significant impact on the currency composition of the outstanding stock of household loans, the regulations are helpful to prevent a further built-up of balance sheet vulnerabilities and to protect households with limited stress absorbing capacity.

29. **Material but not yet sufficient progress has been achieved to strengthen the remedial action and resolution regime for banks** (LOI ¶24). As part of a comprehensive package of financial sector reform measures, and in addition to legislative changes already made earlier this year (including stronger legal protection for the supervisory commissioner), the authorities submitted to parliament on October 22 a set of amendments to the Law on Credit Institutions and Financial Enterprises that are expected to be passed by December 15, 2009 (structural benchmark for end-December 2009). These amendments will establish a stronger regime for the removal of bank executives that no longer meet "fit and proper" criteria, stipulate an additional mandatory threshold for the appointment of a supervisory commissioner (capital adequacy falling below 4 percent), and clearly state that only the HFSA has the power to initiate bank liquidation proceedings. However, in the area of refining and complementing the powers for the use of specific bank resolution techniques progress has been slower than expected, owing to the complexity of the technical work and an overcrowded legislative agenda.

30. **The authorities have affirmed their commitment to develop still-missing elements of the remedial action and resolution regime for banks** (LOI ¶s 4 and 24). The authorities will complete by December 11, 2009 the remaining technical work—including a

full legislative proposal and a presentation note—on broadening the available bank resolution techniques that would facilitate the timely and efficient resolution of a problem bank, consistent with their prior commitments contained in paragraph 20 (iii) of the March 2009 Letter of Intent (prior action). They will then finish all necessary consultation and approval processes and submit the proposed legislation to parliament by February 12, 2010 (structural benchmark). Although parliament will likely not vote on this legislation before the elections, the completion of such a comprehensive proposal will be a major step towards strengthening the bank resolution regime. Staff will press this issue with the new government after the elections.

D. Monetary and Exchange Rate Policy

31. Monetary policy has eased further, in line with the continued reduction in financial strains (Figure 4 and LOI ¶25). Since July, the MNB has cut the key policy rate by a total of 300 bps to 6.5 percent. Excluding the temporary impact of the July increases in VAT and excise duties on inflation, this implies a real policy rate of slightly below 4.5 percent. Low underlying inflation, the large output gap, and a flat yield curve point to substantial room to cut policy rates further should the relaxation in financial strains persist. Markets expect the policy rate to drop to around 6 percent in early 2010. Given the still-large interest rate differential to the euro, however, the immediate impact of further cuts in the policy rate on demand for credit is expected to be limited.

32. The central bank had discussions with Fund staff on the breach of the lower inner band of the inflation consultation mechanism (ICM) (LOI ¶26). Consumer price inflation stood at 4.9 percent at end-September, equivalent to 1.2 percent once inflation is adjusted for the estimated technical impact of the VAT and excise duty increases in July (3.7 percent)—far lower than the central bank's midpoint inflation target (3.0 percent). However, this under-shooting does not relate to excessively low underlying inflation, but to an actual pass-through of the increases in indirect taxes that was more than a full percentage point lower than the estimated technical impact. For the period ahead, the adjustor under the ICM has been modified accordingly (LOI ¶26 and TMU).

33. Demand for the central bank's medium-term FX swap facilities picked up in recent weeks, but total amounts drawn under the FX swap facilities (€1.2 billion in early December) remain far below amounts available (about €4.5 billion), reflecting the return to normal of spreads and maturities in the FX swap market. The amounts available under the medium-term swap facilities will peak at end-year, and will then gradually fall over the course of 2010. Demand for forint-denominated liquidity instruments has remained low.

34. Looking forward, the authorities and staff discussed possible policy responses in the event of a resurgence of large capital inflows. If the exchange rate comes under strong and sustained upward pressure, the authorities and staff agreed on the importance of an appropriate policy mix within the inflation targeting framework, including, if needed, interest rate cuts and a consistent communication policy. FX intervention could be used in the event of excessive exchange rate volatility (LOI ¶27).

IV. Program Modalities

35. The attached LOI describes the authorities' progress in implementing their economic program and sets out performance criteria and structural conditionality through March 2010 (Box 3, LOI ¶s 2-4, LOI Tables 1-3, and TMU ¶s 7-8):

- ***The performance criteria on net international reserves and primary cash balance for end-December 2009 would be modified.*** Net international reserves would be adjusted upward to lock in higher than anticipated reserves at end-September 2009, and expected improved external financing conditions going forward. The central government's cumulative cash primary balance would be adjusted down to account for part of the macro-related revenues shortfalls and higher spending on unemployment benefits.

- ***The adjustors for performance criterion on net international reserves and the inflation consultation mechanism would also be modified***. The performance criterion for net international reserves would be adjusted upward for program disbursements in 2010 from the EU and the World Bank (TMU ¶7). The adjustor under the inflation consultation mechanism would be modified in line with estimated actual pass-through (TMU ¶8).

- ***A prior action is introduced to support the credibility of the 2010 budget with regard to the planned reduction in the subsidy to the state-owned railway company (MAV).***

- ***A prior action and a structural benchmark for February 12, 2010 are introduced to address delays in preparing legislation to broaden the available techniques in the bank resolution regime***. The end-December 2009 structural benchmark on the remedial action and bank resolution regime would be modified to exclude the broadening of the available techniques in the bank resolution regime.

36. The authorities have indicated their intention not to draw the amount that would be made available upon completion of this review (Tables 10-11, LOI ¶6). The authorities have also indicated that they will not request the release of EU balance of payments assistance upon completion of this review. The government's external financing conditions have improved, as evidenced by the successful euro bond issuance in July 2009. The government is able to cover its domestic currency financing need in the domestic market. Gross official reserves increased from €17.4 billion at end-September 2008 to €30.6 billion at end-September 2009. However, the gross external financing need remains elevated due to the high level and short maturity of external debt. Available official financing from the Fund, the EU and the World Bank will help insulate Hungary from potential external shocks throughout the program period.

V. Staff Appraisal

37. **Important progress has been made in strengthening policies that underpin fiscal sustainability and financial stability since the SBA was approved in November 2008**. Government spending has been reduced in a durable way, while allowing the fiscal deficit to increase in 2009 to avoid exacerbating the economic contraction. In the financial sector, bank supervision and the remedial action framework have been enhanced. By better anchoring market expectations and creating room for a cautious reduction in the policy interest rate, these measures have allowed Hungary to take full advantage of the ongoing stabilization in global financial conditions.

38. **Macroeconomic and financial policies are on track**. All end-September 2009 quantitative performance criteria, the continuous performance criterion on non-accumulation of external arrears, the indicative target on central government debt, as well as the continuous structural benchmark related to government lending to banks, were all met. Inflation in September breached the lower inner band of the inflation consultation mechanism and the central bank had a discussion with Fund staff. The structural benchmark on submission of legislation to parliament on strengthening the institutional framework for bank supervision was met with only a minor delay.

39. **Hungary's economic outlook has improved modestly since the last review, reflecting in part the nascent recovery in the euro area**. Real GDP is contracting sharply this year and is expected to fall a little 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.

40. **The government should be prepared to take additional measures, if necessary, to underline its commitment to fiscal sustainability**. 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. 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. At the same time, the authorities need to strengthen their efforts to restructure the public transport system.

41. It is essential that the authorities continue to implement measures to preserve financial stability. In the banking system, funding levels have remained stable and capital levels are well above regulatory requirements, but pressures on capital will rise due to the impact of the economic downturn on credit quality. 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 introduce regulation to reduce risks related to lending to households in foreign currency, to implement the proposed reform of the institutional arrangements for bank supervision, and to develop a concrete proposal for strengthening the bank resolution framework. These actions would imply material but not yet sufficient progress in financial sector reforms. The need for the HFSA to have the authority to issue regulations, as well as parliamentary adoption of the proposal to strengthen the bank resolution framework, will have to be taken up with the new government after the elections.

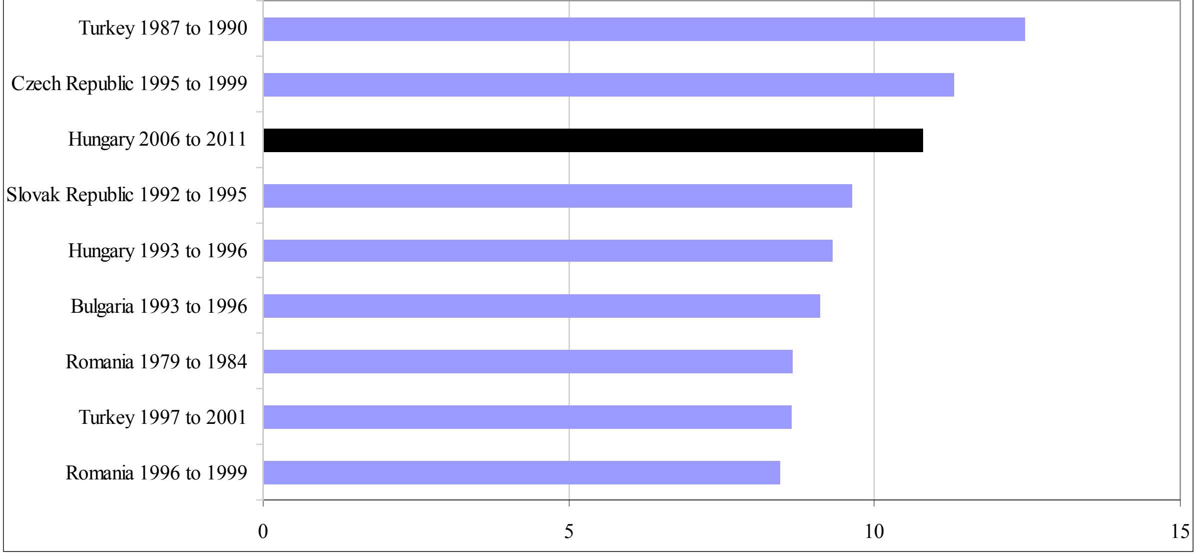
42. Monetary and exchange rate policy will continue to target inflation over the medium term, while taking into account risks to financial stability. The combination of improved global financial conditions and increased confidence in fiscal sustainability created room for interest rate cuts in recent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

43. 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. Staff support the authorities' requests for completion of the fourth review and the modification of the central government primary cash balance and NIR performance criteria.

Box 1. Hungary's Fiscal Adjustment in Perspective

Hungary's ongoing fiscal consolidation is large by regional historical standards. The general government's structural primary balance, which improved from a deficit of 6.0 of GDP in 2006 to a surplus of 0.5 percent of GDP in 2008, is expected to improve further to 4.7 percent of GDP in 2011. This assumes as-yet unidentified spending measures of about 1½ percent of GDP in 2011 to offset the expected revenue loss associated with the planned reduction in personal income taxes, the projected loss of the central bank in 2010, and a tax base that is expected to be less dynamic than GDP. As projected, Hungary's fiscal consolidation effort between 2006–11, by delivering an increase in the structural primary balance of close to 11 percent of GDP, would fall among the largest observed in emerging Europe in recent decades (see text figure).

Figure. Episodes of Large Fiscal Consolidation in Emerging Europe
(change in the structural primary balance, in percent of GDP)



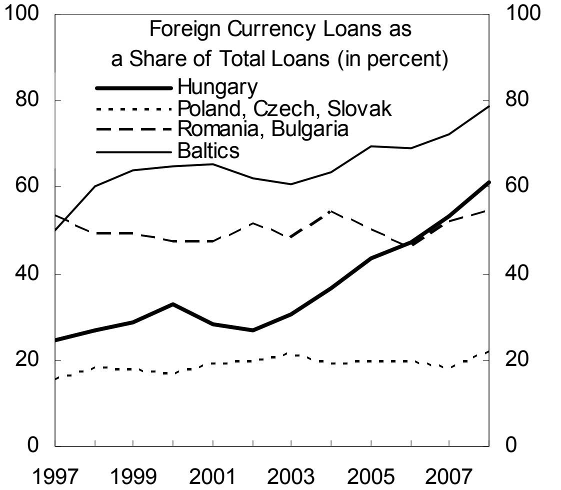
The focus on expenditure reforms should contribute to the sustainability of the current consolidation effort. The composition of consolidations is a crucial determinant of their success. Sustained adjustments episodes have tended to rely mainly on spending reductions.[1/] Revenue-based adjustments have a greater risk of reversal, especially in countries like Hungary with a high revenue-to-GDP ratio. Overall, Hungary's fiscal consolidation is focused on spending reforms, with the bulk of the adjustment expected to come from a reduction of the structural primary spending-to-potential GDP ratio from 49 percent in 2006 to 40 percent in 2011.

If implemented as planned, the ongoing fiscal consolidation will go a long way to putting Hungary on a sustainable path. As reflected in the public sector debt sustainability framework, the envisaged fiscal path should allow a significant reduction in the government debt-to-GDP ratio starting in 2011. Assuming continued fiscal discipline, Hungary's government debt is projected to be brought back below 60 percent of GDP within 10 years.

1/ "Experience with Large Fiscal Adjustments", Occasional Paper No. 246, 2006.

Box 2: Foreign Currency Lending in Hungary

A key macro-financial vulnerability of Hungary is FX lending to unhedged borrowers. The main factors driving FX lending have been cross-border financial integration and the large interest differential between the forint and funding currencies such as the euro and the Swiss Franc (see Box 3 of the October 2009 Regional Economic Outlook for Europe). In Hungary, the increase in FX lending after 2003 reflected in part the abolition of a subsidy on forint-denominated household loans. At end-2008, the share of FX loans in Hungary was the highest among the EU New Member States outside the Baltics.



The sharp depreciation of the forint between October 2008 and March 2009 raised concerns about the ability of borrowers to service their FX loans and, consequently, the quality of banks' loans portfolios. To prevent an excessive and possibly destabilizing depreciation, the central bank kept the policy interest rate higher than it otherwise would have been, easing only in July 2009 after financial markets strains had lessened markedly.

Preliminary analysis shows that debt service on FX loans has remained manageable for most borrowers. For example, the monthly payment burden on a variable rate 10-year Swiss Franc mortgage loan contracted in 2005 remained below or roughly equal to the payment on a comparable forint denominated mortgage, even at the height of exchange rate pressures in March 2009. Low euro and Swiss franc interest rates helped to keep debt service manageable. However, the successful interest rate defense needs to be weighed against the economic costs of tighter-than-otherwise monetary policy and the possible future costs from encouraging risky behavior from borrowers and lenders (moral hazard).

The recent relative shift to forint lending (see Figure 2)—amid very weak overall demand for credit—reflects in part banks' efforts to reduce currency mismatch and rely more on domestic currency funding. Going forward, the attractiveness of forint lending will depend on a continued narrowing of the interest differential between the forint and foreign currencies, which will require the steadfast implementation of fiscal consolidation.

Box 3. Hungary: Stand-By Arrangement

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

Length: 23 months from November 6, 2008 (extended from 17 months at the Third Review).

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. Access was rephased, and SDR 50 million was disbursed at the completion of the Third Review. The availability of the fifth tranche (SDR 725.1 million) is subject to the completion of this (Fourth) Review. The authorities have indicated their intention not to draw this amount. The availability of the remaining amounts (SDR 2,175 million) is contingent upon completion of further quarterly reviews.

Conditionality

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

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

- ***Prior Actions***
  - Prepare a business plan for the state-owned railway company (MAV) consistent with the planned savings in the 2010 budget. *By December 7, 2009*.
  - Complete the remaining technical work—including a full legislative proposal and a presentation note—on broadening the available bank resolution techniques, consistent with paragraph 20 (iii) in the March 2009 LOI. *By December 11, 2009.*

- ***Structural Benchmarks***
  - Operation of the subcommittee described in the March 2009 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*.
  - Passage by parliament of the amendments strengthening the remedial powers of the HFSA as listed in paragraph 20 (i), (ii), and (iv) of the March 2009 LOI . *By end-December 2009*.
  - Submission to parliament of the amendments strengthening the bank resolution regime as listed in paragraph 20 (iii) of the March 2009 LOI. *By February 12, 2010.*
  - 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.*

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

	2006	2007	2008	2009		2010	
				3nd Rev.	4th Rev.	3nd Rev.	4th Rev.
Real economy (change in percent)							
Real GDP	4.0	1.0	0.6	-6.7	-6.7	-0.9	-0.6
Total domestic demand 1/	0.9	-2.1	0.6	-8.6	-11.2	-1.9	-1.8
Private consumption	1.9	-1.6	-0.6	-6.8	-6.8	-2.4	-2.3
Gross fixed investment	-3.6	1.6	0.4	-9.3	-8.3	0.8	1.0
Foreign balance 1/	3.1	3.1	0.0	1.9	4.5	1.0	1.2
Exports	18.6	16.2	5.6	-15.1	-12.3	2.6	3.6
Imports	14.8	13.3	5.7	-17.2	-16.5	1.8	2.7
CPI (end year)	6.5	7.4	3.5	6.1	5.2	2.4	2.5
CPI (average)	3.9	7.9	6.1	4.5	4.2	4.1	3.9
Unemployment rate (average, in percent)	7.5	7.4	7.8	9.9	10.0	10.7	10.9
Gross domestic investment (percent of GDP) 2/	24.0	23.5	23.4	20.9	19.3	21.7	20.0
Gross national saving (percent of GDP, from BOP)	16.5	16.7	16.2	18.0	18.8	18.5	18.5
General government (percent of GDP), ESA-95 basis 3/							
Overall balance	-9.3	-4.9	-3.7	-3.9	-3.9	-3.8	-3.8
Primary balance	-5.4	-0.9	0.4	0.5	0.4	0.7	0.7
Debt	65.6	65.7	72.9	78.8	78.7	79.9	80.2
Money and credit (end-of-period, percent change)							
Broad money	13.6	11.0	9.2	3.4	3.6	5.1	4.3
Credit to the economy, flow-based	17.3	15.9	10.6	-1.2	-1.4	1.4	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	1.2	0.7	4.7	5.6	4.4	5.6
Current account (percent of GDP)	-7.5	-6.8	-7.2	-2.9	-0.5	-3.3	-1.5
Reserves (in billions of euros)	16.4	16.4	24.0	27.5	29.7	28.5	32.5
Gross external debt (percent of GDP) 4/	91.0	98.1	115.3	132.3	136.6	130.0	131.7
Exchange rate							
Exchange regime							
Present rate (Nov 30, 2009)							
Nominal effective rate (2005=100)	94.1	100.6	100.7	...	…	…	…
Real effective rate, CPI basis (2005=100)	95.8	108.5	112.1	...	…	…	…
Quota at the Fund							

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

1/ Contribution to growth. Calculated using 2000 prices. It includes change in 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, 2006-2010

	2006	2007	2008		2009					2010	
			Sept.	Dec.	March	June Est.	Sept.	Dec. 3rd Rev.	Dec. 4th Rev.	3rd Rev.	4th Rev.
	(in billions of forints, unless otherwise specified)										
Monetary Survey											
Net foreign assets	-83	-952	-1577	-1487	-631	-502	372	-14	564	1365	735
Net domestic assets	12809	15078	16230	16908	16543	16317	15395	16000	15414	15396	15924
Domestic credit	16190	18907	20523	21481	22122	21378	20650	20471	20722	19479	21292
Net claims on government	3026	3270	3299	2952	1897	3058	2641	2678	2837	1436	3153
Credit to the economy	13165	15637	17224	18529	20224	18321	18009	17793	17885	18043	18139
Other items, net	-3381	-3829	-4292	-4573	-5578	-5061	-5255	-4471	-5308	-4083	-5368
Broad money	12727	14126	14653	15422	15913	15815	15708	15952	15978	16762	16658
Currency in circulation	1838	2068	2009	2137	2205	2090	2002	2066	2046	2240	2109
Total deposits	10075	10869	11444	12114	12387	12389	12263	12446	12504	12883	13006
Domestic currency deposits	7827	8704	8656	9737	9690	9527	9552	9645	9781	9990	10204
Foreign currency deposits	2248	2165	2788	2377	2696	2862	2711	2801	2723	2893	2802
Short-term securities	35	200	152	313	412	413	433	456	433	556	433
Money market instruments	779	990	1048	858	909	923	1009	984	995	1082	1111
Accounts of the Magyar Nemzeti Bank (MNB)											
Net foreign assets 1/	3838	3941	4046	5988	8139	6355	6993	6354	6680	6657	6308
Net domestic assets	-1404	-1150	-1397	-3383	-5522	-3852	-4449	-3712	-4113	-3847	-3665
Net domestic credit	-1369	-1138	-1561	-3193	-4627	-3582	-4081	-3857	-3722	-4031	-3273
Net claims on government	-141	-108	-281	-1286	-2447	-664	-830	-965	-644	-1073	-227
Claims on government	233	147	147	360	360	360	310	360	310	360	310
Liabilities to government 2/	373	255	428	1646	2807	1024	1140	1325	954	1433	536
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	-2918	-3251	-2892	-3078	-2958	-3047
Other items, net	-34	-12	164	-190	-895	-270	-368	145	-391	184	-392
Base money	2434	2791	2648	2605	2617	2504	2544	2642	2566	2810	2643
Currency in circulation	1838	2068	2009	2137	2205	2090	2002	2066	2046	2240	2109
Cash in bank vaults	130	134	140	171	156	142	207	228	171	206	172
Banks' reserves	466	589	500	296	257	272	335	348	349	364	362
Required reserves	615	682	751	322	343	344	331	348	349	364	362
Excess reserves	-149	-92	-252	-26	-86	-72	4	0	0	0	0
Other Monetary and Financial Institutions											
Net foreign assets	-3920	-4892	-5623	-7475	-8770	-6857	-6620	-6368	-6116	-5292	-5573
Net domestic assets	14809	16951	18267	20759	22478	20582	20326	20254	20047	19813	20123
Domestic credit	17554	20045	22084	24674	26748	24960	24731	24328	24444	23510	24565
Net claims on government	3166	3378	3580	4238	4345	3722	3471	3643	3481	2508	3379
Credit to the economy	13165	15637	17224	18529	20224	18321	18009	17793	17885	18043	18139
Net claims on the central bank	1223	1029	1280	1907	2179	2918	3251	2892	3078	2958	3047
Banks' reserves and overnight deposits	838	1062	798	296	257	272	335	348	349	364	362
Other items, net	-3584	-4156	-4615	-4211	-4527	-4650	-4740	-4421	-4746	-4060	-4804
Banks' liabilities	10888	12058	12644	13285	13708	13725	13705	13886	13932	14521	14550
Total deposits	10075	10869	11444	12114	12387	12389	12263	12446	12504	12883	13006
Demand deposits	3995	4280	4107	4023	4114	4115	4073	4134	4153	4279	4319
Time deposits	6080	6589	7337	8090	8273	8274	8190	8312	8351	8604	8686
Short-term securities	35	200	152	313	412	413	433	456	433	556	433
Money market instruments	779	990	1048	858	909	923	1009	984	995	1082	1111
***Memorandum items*:**	(y-o-y percentage change)										
Base money	10.7	14.7	2.7	-6.7	4.8	1.0	-4.0	1.4	-1.5	6.4	3.0
Broad money	13.6	11.0	8.3	9.2	8.4	11.6	7.2	3.4	3.6	5.1	4.3
Credit to the economy	16.7	18.8	16.1	18.5	10.3	11.8	4.6	-4.0	-3.5	1.4	1.4
Credit to the economy, flow-based 3/	17.3	15.9	15.3	10.6	6.6	4.2	-0.7	-1.2	-1.4	1.4	1.4
	(in percent)										
Foreign currency loans to total loans	47.9	56.4	58.7	64.7	68.2	64.1	63.1	63.8	63.0	64.4	63.3
Foreign currency deposits to total deposits	22.3	19.9	24.4	19.6	21.8	23.1	22.1	22.5	21.8	22.5	21.5
	(in billions of forints)										
Net international reserves	4000	4051	4157	4908	6275	4740	5409	4573	5106	4229	5235
plus IMF disbursement to the government 4/	0	0	0	1215	2129	1875	1876	2103	1864	2750	1864
minus other non-reserve liabilities (net)	162	110	112	135	264	260	292	322	290	322	791
= net foreign assets of the central bank	3838	3941	4046	5988	8139	6355	6993	6354	6680	6657	6308

Sources: Magyar Nemzeti Bank and IMF staff calculation.

1/ Includes disbursements of IMF, EU and WB funds to the government.

2/ Includes built-up of government deposits commensurate with the disbursement of IMF, 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 and the fourth tranch 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.

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	Est	Proj.	Proj.	3rd Rev.	4th Rev.	Proj.	Proj.	Proj.	Proj.	3rd Rev.	4th Rev.	Proj.
Current Account	**-7,591**	**-562**	**476**	**443**	**-787**	**-2,706**	**-430**	**-176**	**-467**	**-444**	**-414**	**-3,167**	**-1,500**	**-3,309**
Goods and service, net	780	843	1,815	1,736	791	4,267	5,184	1,365	1,409	1,292	1,402	4,209	5,468	4,378
Exports	86,390	16,575	17,513	17,609	18,864	69,080	70,561	17,587	18,292	18,620	19,134	71,245	73,633	78,821
Imports	-85,610	-15,732	-15,699	-15,873	-18,073	-64,813	-65,376	-16,222	-16,883	-17,328	-17,732	-67,036	-68,165	-74,443
Income, net	-7,697	-1,257	-1,469	-1,313	-1,328	-6,480	-5,368	-1,391	-1,726	-1,587	-1,666	-6,827	-6,371	-7,058
Current transfers, net	-674	-147	130	20	-250	-476	-247	-149	-149	-149	-149	-549	-598	-629
Capital Account	**1,034**	**300**	**415**	**306**	**505**	**1,841**	**1,526**	**461**	**455**	**467**	**469**	**1,807**	**1,853**	**1,910**
Net capital transfers from the EU	937	295	417	316	515	1,866	1,543	461	455	467	469	1,807	1,853	2,123
Financial Account	**9,629**	**-138**	**-3,439**	**598**	**-962**	**-4,874**	**-3,942**	**-761**	**140**	**-994**	**229**	**-843**	**-1,386**	**740**
Direct investment, net	2,499	31	-872	-105	4	841	-942	-44	162	-163	-150	913	-194	202
Direct Investment Abroad	-568	-164	-472	-76	-123	-1,085	-835	-170	133	-315	-340	-1,244	-692	-719
In Hungary	3,067	195	-400	-29	127	1,926	-107	127	29	152	191	2,157	498	921
Portfolio investment, net	-3,174	-2,918	-531	2,425	353	-2,760	-671	221	788	-652	555	641	912	398
Assets	5,351	784	1,725	1,182	-96	1,535	3,596	-98	-100	-45	-46	-412	-290	-332
Equity	-2,191	-390	183	-307	-109	-876	-623	-111	-113	-58	-59	-576	-341	-117
Debt securities	7,542	1,175	1,542	1,489	13	2,411	4,219	13	13	13	13	163	51	-216
Liabilities	-8,525	-3,702	-2,256	1,243	448	-4,295	-4,267	319	889	-607	601	1,053	1,202	730
Equity	-260	135	628	-5	291	1,148	1,049	140	143	440	473	967	1,196	490
Debt securities	-8,265	-3,838	-2,883	1,248	157	-5,443	-5,316	180	746	-1,047	128	86	7	240
Other investment	10,304	2,748	-2,037	-1,722	-1,319	-2,956	-2,329	-939	-810	-178	-177	-2,397	-2,104	140
Assets	-1,818	51	-1,160	731	-71	-1,790	-449	-72	-74	-48	-49	-579	-243	-688
o/w: short-term assets	1,274	-282	-1,342	715	-37	-2,149	-946	-38	-39	-13	-14	-430	-104	-486
Liabilities	12,121	2,697	-877	-2,453	-1,248	-1,166	-1,880	-866	-736	-130	-128	-1,818	-1,861	828
o/w short-term liabilities	2,506	1,501	-795	-1,439	-663	-1,439	-1,397	-422	-411	-43	-42	-894	-918	1,477
Net errors and omissions	-2,593	-137	-110	-79	-109	-552	-434	-109	-109	-109	-109	-691	-434	-217
Overall Balance	**479**	**-536**	**-2,658**	**1,269**	**-1,353**	**-6,292**	**-3,280**	**-584**	**20**	**-1,079**	**176**	**-2,894**	**-1,468**	**-875**
Program financing 2/	**2,000**	**2,000**	**0**	**1,500**	**0**	**4,000**	**3,500**	**800**	**300**	**900**	**0**	**1,500**	**2,000**	**0**
European Union	2,000	2,000	0	1,500	0	3,500	3,500	300	300	400	0	1,000	1,000	0
World Bank	0	0	0	0	0	500	0	500	0	500	0	500	1,000	0
Others	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Projected Net Direct Lending to Banks					400	-300	400							
Net International Reserves (increase -)	**-2,479**	**-1,464**	**2,658**	**-2,769**	**953**	**2,592**	**-620**	**-216**	**-320**	**179**	**-176**	**1,394**	**-532**	**875**
Gross Reserves	-7,402	-3,831	1,270	-3,888	953	-3,093	-5,496	-995	-1,099	-601	-176	-982	-2,871	875
Reserve Liabilities	4,923	2,368	1,389	1,120	0	5,685	4,876	779	779	780	0	2,375	2,339	0
Fund disbursements 2/	4,923	2,368	1,389	54	0	4,603	3,811	779	779	780	0	2,375	2,339	0
SDR allocation	0	0	0	1,065	0	1,082	1,065	0	0	0	0	0	0	0
Current account (in percent of GDP)	-7.2	-2.5	2.0	1.8	-3.8	-2.9	-0.5	-0.8	-1.8	-1.6	-1.6	-3.3	-1.5	-3.2
Gross external debt (in percent of GDP)	115.3	137.0	138.5	138.3	136.6	132.3	136.6	135.9	135.9	135.5	131.7	130.0	131.7	120.9
Gross official reserves	24,040	27,890	26,950	30,603	29,650	27,493	29,650	30,645	31,745	32,346	32,521	28,475	32,521	31,646
In percent of short-term debt at remaining maturity 3/	72.3	79.5	77.2	86.3	85.1	94.9	85.1	82.2	81.7	82.8	81.5	79.1	81.5	90.3

Sources: Hungarian authorities and staff projections.

1/ Excluding Special Purpose Entities.
2/ Shows new available official financing from March 2010 to program expiration in October 2010.
3/ The short-term debt at remaining maturity includes an estimate of intercompany loans falling due in the short-term.

Table 4. 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	**-1,341**	**-836**	**-3,074**	**963**	**-1,457**	**-1,045**	**-435**	**-1,546**	**-8,773**
Current account deficit	-2,268	-562	476	443	-787	-176	-467	-444	-3,784
Financial account outflows	992	-138	-3,439	598	-962	-761	140	-994	-4,563
Direct investment, net	1,310	31	-872	-105	4	-44	162	-163	324
Portfolio investment, government net 1/	-4,407	-2,483	-255	1,766	236	322	886	-923	-4,858
Portfolio investment, private net 2/	-1,256	-435	-276	659	117	-101	-97	270	-1,119
of which, financial derivatives 3/	-1,157	-1,335	766	543	0	0	0	0	-1,183
Other investment	5,346	2,748	-2,037	-1,722	-1,319	-939	-810	-178	1,089
Bank Guarantee Fund	0	0	0	0	400	0	0	0	400
Net errors and omissions	-66	-137	-110	-79	-109	-109	-109	-109	-826
Total financing sources	**-3,582**	**-1,531**	**1,685**	**-2,082**	**1,457**	**266**	**-344**	**766**	**-3,365**
Capital account inflows	739	300	415	306	505	461	455	467	3,649
Net capital transfers from the EU	660	295	417	316	515	461	455	467	3,586
Program Financing	2,000	2,000	0	1,500	0	800	300	900	7,500
European Union	2,000	2,000	0	1,500	0	300	300	400	6,500
World Bank	0	0	0	0	0	500	0	500	1,000
Change in gross reserves	-6,321	-3,831	1,270	-3,888	953	-995	-1,099	-601	-14,514
Financing need	**-4,923**	**-2,368**	**-1,389**	**-1,120**	**0**	**-779**	**-779**	**-780**	**-12,138**
Fund credits	4,923	2,368	1,389	54	0	779	779	780	11,072
SDR allocation	0	0	0	1,065	0	0	0	0	1,065

Sources: Hungarian authorities and staff projections.

1/ Assumes FX issuance in 2010 Q2.

2/ During the fourth quarter of 2009, banks with foreign parent banks are expected to roll over 95 percent of short-term debt, and others 70 percent, recovering gradually to 100 percent in the second half of 2010.

3/ Assumes no net gains from financial derivatives.

Table 5. Hungary: Indicators of External Vulnerability, 2005–09

	2005	2006	2007	2008	Sept 2009 Est. 1/
Financial Indicators					
M3, end-of-period, percent change	14.5	13.6	11.0	9.2	7.2
Private sector credit, percentage change	15.4	17.3	15.9	10.6	4.6
T-bill, 90-day, average, in percent	6.7	7.0	7.6	8.9	7.2
Government bond yield, 5-year, average, in percent	6.8	7.4	7.0	9.3	8.0
Share of foreign currency liabilities in total liabilities	34.4	39.3	42.4	45.6	45.9
Share of foreign currency loans in total credit to:					
Corporates	47.7	47.1	52.6	60.3	59.8
Households	32.6	46.8	59.0	70.7	69.5
Other loans	75.2	75.4	81.7	87.2	86.3
Non-performing loans to gross loans 2/	2.3	2.6	2.3	3.0	5.9
External Indicators					
Exports of goods and services, annual percentage change	12.9	15.4	16.6	7.0	-20.8
Imports of goods and services, annual percentage change	10.0	14.7	13.5	7.7	-28.4
Real effective exchange rate, percentage change, + = appreciation	2.0	-4.8	12.6	4.3	..
Current account balance, in percent of GDP	-7.2	-7.5	-6.8	-7.2	1.8
Capital and financial account, in percent of GDP	0.7	0.7	0.7	1.0	3.7
Financial account, in percent of GDP	12.8	10.1	7.8	9.1	2.4
Net foreign direct investment, in percent of GDP	5.0	3.1	1.6	2.4	-0.4
Gross official reserves, in millions of euros	15,721	16,397	16,385	24,040	30,603
In months of imports	2.7	2.5	2.3	4.4	5.4
In percent of short-term debt at remaining maturity	112.2	123.6	88.9	72.3	86.3
Total external debt, including SPEs, in percent of GDP 3/	..	105.6	113.9	144.6	..
Total external debt, excluding SPEs, in percent of GDP	75.6	91.0	98.1	115.3	138.3
Of which:					
Direct investment intercompany loans	11.9	16.4	18.8	22.0	27.3
General government	29.1	33.2	33.5	36.2	48.1
Of which: non-residents holdings of local currency government bonds	11.5	13.0	12.8	8.1	9.8
Central bank	1.2	1.1	0.6	1.1	3.5
Banks	21.5	27.5	30.5	40.4	41.3
Non-financial institutions	11.9	12.8	14.6	15.5	18.1
Short-term debt at remaining maturity 4/	14,012	13,270	18,428	33,244	35,441
Financial Market Indicators					
Stock market index, local currency, end-of-period	20,785	24,844	26,236	12,242	20,226
EMBI Global bonds spread, end-of-period	74.0	58.0	84.0	504.0	231.0
CDS spread, 5-year, end-of-period	26.5	21.0	48.5	430.2	215.0

Source: Hungarian authorities; and staff estimates.

1/ External indicators for September 2009 refer to 2009 Q3.
2/ Non-performing loans are defined as corporate, household, interbank, foreign and other loans that are past due for more than 90 days.
3/ Special Purpose Entities are defined as resident corporations of non-resident owners, which perform a passive, financial intermediary function between their non-resident partners. SPEs have a marginal impact on the domestic economy, and their transactions have negligible net impact on the balance of payments (an enterprise that has a non-negligible net impact on the balance of payments is removed from the list of SPEs). Foreign assets and liabilities of SPEs are largely matched, and loans are considered as FDI in accordance with international statistical standards. Data for SPEs are not available prior to 2006.
4/ Includes an estimate of intercompany loans falling due in the short-term.

Table 6. Hungary: Staff's Illustrative Medium-Term Scenario, 2006–14

	2006	2007	2008	2009	2010	2011	2012	2013	2014
				Program					
Real GDP growth	4.0	1.0	0.6	-6.7	-0.6	3.2	4.5	4.0	3.5
Nominal GDP, forint billions	23,755	25,408	26,543	25,696	26,196	27,552	29,362	31,144	32,877
Inflation (CPI; year average basis)	3.9	7.9	6.1	4.2	3.9	2.5	3.0	3.0	3.0
Inflation (CPI; end-year basis)	6.5	7.4	3.5	5.2	2.5	2.7	3.0	3.0	3.0
Domestic demand	0.9	-2.1	0.7	-11.7	-2.0	4.6	3.3	3.3	3.3
Total consumption	2.3	-2.0	-0.6	-6.1	-2.1	0.2	2.6	2.8	2.7
Gross fixed capital formation	-3.6	1.6	0.4	-8.3	1.0	2.8	5.0	5.0	5.0
Exports of GNFS	18.6	16.2	5.6	-12.3	3.6	4.5	6.0	6.0	6.0
Imports of GNFS	14.8	13.3	5.7	-16.5	2.7	5.7	5.1	5.6	6.0
External current account balance	-7.5	-6.8	-7.2	-0.5	-1.5	-3.2	-3.4	-3.5	-3.5
Gross national saving	16.8	17.1	16.5	18.8	18.5	19.4	19.1	18.6	18.3
Gross national investment 1/	24.3	23.8	23.7	19.3	20.0	22.6	22.4	22.1	21.8
Capital account, net	0.7	0.7	1.0	1.7	1.9	1.9	1.8	1.8	1.6
Financial account, net	10.1	7.8	9.1	-4.3	-1.4	0.7	3.9	6.0	1.5
Net international investment position	-105.6	-101.5	-99.8	-116.5	-114.0	-108.8	-107.6	-108.9	-109.0
Gross external debt 2/	91.0	98.1	115.3	136.6	131.7	120.9	116.8	114.3	111.6
General government (ESA-95)									
Revenue, total	42.6	44.8	45.5	46.2	45.5	44.6	44.4	44.3	44.4
Expenditure, primary	48.0	45.7	45.1	45.8	44.8	42.9	41.9	41.2	40.8
Primary balance	-5.4	-0.9	0.4	0.4	0.7	1.8	2.6	3.2	3.6
General government balance (including the costs of pension reform)	-9.3	-4.9	-3.7	-3.9	-3.8	-2.8	-1.7	-0.9	-0.3
Net interest	3.7	3.8	3.7	4.0	4.1	4.3	4.0	3.9	3.7
General government debt	65.6	65.7	72.9	78.7	80.2	79.0	75.9	72.4	68.9
Memorandum items									
Output gap	3.6	2.7	1.3	-6.2	-7.5	-6.2	-4.0	-2.4	-1.4
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	-10.3	-5.3	-4.1	-0.9	0.1	0.2	0.2	0.2	0.2
Structural primary balance	-6.6	-1.5	-0.4	3.1	4.3	4.5	4.2	4.0	3.9

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

	2006	2007	2008	2009		2010		2011
				3rd Rev.	4th Rev.	3rd Rev.	4th Rev.	Staff. proj.
Total revenues	42.6	44.8	45.5	46.2	46.2	45.6	45.5	44.6
Current revenues and current transfers (incl. grants)	41.8	43.9	44.9	44.6	44.9	44.4	44.2	43.0
Tax revenues	37.0	39.4	40.1	39.8	39.8	39.4	39.3	38.5
Taxes on income, profits and capital gains	9.4	10.2	10.6	10.4	10.2	10.0	10.1	9.7
Personal income tax	6.7	7.0	7.7	7.6	7.6	7.1	7.1	6.7
Corporate income tax	2.3	2.7	2.6	2.4	2.2	2.4	2.4	2.4
Other (incl. wealth, capital, and property taxes)	0.4	0.4	0.3	0.4	0.4	0.6	0.6	0.6
Taxes on payroll and workforce and Social Security contributions	12.6	13.6	13.9	13.5	13.4	12.3	12.3	12.0
Taxes on goods and services	15.0	15.6	15.6	15.9	16.3	17.1	16.9	16.8
VAT	7.4	7.8	7.6	8.0	8.2	8.9	8.7	8.6
Other (incl. excises and duties)	7.5	7.8	8.0	7.9	8.1	8.2	8.1	8.2
Current non-tax revenues	4.0	3.8	4.1	4.1	4.2	4.0	4.0	3.6
Of which : interest	0.3	0.3	0.5	0.4	0.4	0.4	0.4	0.2
Current transfers (incl. grants)	0.8	0.6	0.7	0.7	0.9	1.0	0.9	0.9
Capital revenues and capital transfers (incl. grants)	0.9	0.9	0.6	1.5	1.3	1.2	1.3	1.6
Total expenditures	51.9	49.7	49.2	50.1	50.1	49.4	49.3	47.4
Current expenditures and current transfers	45.7	44.2	45.1	45.9	46.1	45.3	45.3	43.4
Compensation of employees 2/	12.2	11.5	11.5	11.5	11.6	10.9	11.1	10.5
Goods and services	7.0	6.6	7.1	7.0	7.3	6.8	7.3	6.9
Interest payments	4.0	4.0	4.1	4.4	4.4	4.4	4.5	4.6
Subsidies	1.4	1.4	1.1	0.9	0.8	0.9	0.9	0.7
Current transfers to households	18.5	18.1	18.7	19.5	19.6	19.0	19.0	18.3
Social security	13.5	13.4	14.3	15.2	15.2	14.8	14.8	14.3
Of which unemployment benefits	0.4	0.4	0.4	0.6	0.6	0.5	0.5	0.5
Other	5.0	4.6	4.4	4.4	4.4	4.2	4.2	4.0
Other current transfers	2.7	2.6	2.5	2.4	2.5	3.4	2.5	2.3
Capital expenditures	4.3	3.6	2.6	2.9	2.7	2.5	2.7	2.9
Capital transfers	1.9	1.9	1.5	1.4	1.4	1.5	1.3	1.2
Other net expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
General government balance	-9.3	-4.9	-3.7	-3.9	-3.9	-3.8	-3.8	-2.8
Primary balance	-5.4	-0.9	0.4	0.5	0.4	0.7	0.7	1.8
Memorandum items:								
Primary expenditure	48.0	45.7	45.1	45.6	45.8	44.9	44.8	42.9
Output gap (in percent of potential GDP)	3.6	2.7	1.3	-6.2	-6.2	-7.8	-7.5	-6.2
Cyclically-adjusted overall balance (CAB, in percent of potential GDP)	-11.2	-6.3	-4.4	-0.8	-0.8	0.1	-0.1	0.1
Change in CAB	-2.3	4.9	1.9	3.3	3.6	0.9	0.7	0.2
One-off items (net)	-0.8	-1.0	-0.3	0.0	0.1	-0.1	-0.2	-0.1
Structural balance (in percent of potential GDP)	-10.3	-5.3	-4.1	-0.7	-0.9	0.2	0.1	0.2
Change in the structural balance	-1.1	5.1	1.2	3.0	3.2	0.9	1.0	0.1
Gross public debt	65.6	65.7	72.9	78.8	78.7	79.9	80.2	79.0
Real GDP growth (in percent)	3.9	1.2	0.6	-6.7	-6.7	-0.9	-0.6	3.2
In nominal terms (HUF billions)								
Total revenue	10,133	11,411	12,077	11,913	11,876	11,995	11,922	12,290
Of which tax revenues	8,797	10,043	10,654	10,257	10,233	10,365	10,288	10,620
Total expenditure	12,350	12,666	13,069	12,916	12,884	12,985	12,925	13,061
Of which primary expenditure	11,409	11,638	11,970	11,774	11,761	11,815	11,746	11,806
Primary balance	-1,276	-227	107	140	115	180	176	484
Overall balance	-2,217	-1,256	-992	-1,003	-1,008	-990	-1,003	-771

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 8. 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	244.6	-66.8	962.4	644.2	205.0	122.5	-104.9	866.8
Redemptions										
In Hungarian forints	1,105.9	1,935.3	1,734.4	1,506.0	6,281.6	964.5	1,450.3	1,419.8	1,569.7	5,404.2
In foreign currency (euro)	160.2	113.0	9.7	5.9	288.8	10.1	8.1	337.1	10.9	366.1
Gross borrowing requirement	1,832.1	2,266.9	1,988.7	1,445.1	7,532.7	1,618.7	1,663.3	1,879.3	1,475.7	6,637.1
Actual and planned financing										
Gross issuance (actual and planned)										
In Hungarian forints	1,044.5	1,208.9	1,755.0	1,444.0	5,452.4	1,266.4	1,452.1	1,605.7	1,513.9	5,838.1
In foreign currency	1,307.5	0.0	686.9	2.6	1,996.9	0.0	557.8	0.0	0.0	557.8
Drawing on deposits with banking system	-519.8	1,058.0	-453.2	-1.5	83.5	352.3	-346.6	273.7	-38.2	241.3

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

Table 9. Hungary: Financial Soundness Indicators for the Banking Sector, 2005–09 Q3
(In percent unless otherwise indicated, end of period)

	2005	2006	2007	2008	2009Q1	2009Q2	2009Q3
Capital adequacy							
Regulatory capital to risk-weighted assets	11.6	11.0	10.4	11.2	10.3	12.3	13.1
Capital (net worth) to assets	8.2	8.3	8.2	8.0	7.3	8.1	8.8
Asset composition and quality							
Annual growth of bank loans	19.8	18.4	22.1	20.9	21.3	11.0	7.7
Sectoral distribution of bank loans (in percent of total)							
Corporates	45.7	43.2	39.8	35.3	35.1	35.6	35.8
o/w in foreign currency	21.8	20.3	20.9	21.3	23.0	21.8	21.4
Households	29.2	31.5	32.7	36.0	35.2	35.9	36.2
o/w in foreign currency	9.5	14.8	19.3	25.4	25.9	25.2	25.1
Other loans	25.0	25.3	27.5	28.7	29.7	28.5	28.1
o/w in foreign currency	18.8	19.1	22.5	25.0	26.4	24.6	24.2
Financial institutions	12.3	11.3	10.7	9.5	10.7	9.9	9.7
Central government	0.6	0.5	0.5	0.2	0.2	0.4	0.1
Nonresidents	5.1	6.2	9.1	12.2	12.9	12.1	12.0
Other	7.0	7.2	7.2	6.8	5.9	6.1	6.3
Denomination of FX loans to corporates							
EUR	74.7	70.8	67.6	66.9	70.2	72.3	73.8
USD	5.7	4.6	4.9	4.1	3.6	3.3	3.2
CHF	19.2	24.4	26.4	27.8	25.2	23.5	22.1
Other	0.4	0.2	1.0	1.1	1.0	0.8	0.9
NPLs to gross loans 1/	2.3	2.6	2.3	3.0	3.5	5.1	5.9
Provisions to NPLs	65.1	57.1	64.8	58.9	56.5	48.8	51.2
NPLs net of provisions to capital	6.3	8.9	6.8	11.3	14.8	21.8	21.9
Earnings and profitability							
ROA (after tax)	1.4	1.5	1.2	0.8	1.3	1.1	1.1
ROE (after tax)	24.5	23.8	18.4	11.6	18.3	15.3	14.8
Net interest income to gross income	64.4	64.7	61.3	56.0	50.3	54.7	55.6
Noninterest expenses to gross income	48.6	48.7	50.2	50.4	39.3	40.7	42.0
Personnel expenses to noninterest expenses	47.2	48.3	48.9	49.4	49.8	48.8	48.5
Trading and fee income to total income	33.8	32.3	36.1	30.7	37.5	38.3	39.4
Spread between loan and deposit rates	3.7	3.5	3.2	2.6	2.2	2.4	2.3
Liquidity							
Liquid assets to total assets	21.0	20.0	16.4	15.6	14.6	19.4	21.5
Liquid assets to short term liabilities	35.7	36.8	30.5	31.4	29.9	39.8	43.8
Loans to deposits	107.7	109.9	121.6	125.1	127.3	120.8	119.7
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	45.9
Sensitivity to market risk							
Net open position in FX to capital	3.5	7.2	6.0	13.7	14.1	18.1	14.9

Source: Magyar Nemzeti Bank.

1/ Non-performing loans are defined as corporate, household, interbank, foreign and other loans that are past due for more than 90 days.

Table 10. Hungary: Schedule of Reviews and Purchases

Date	Schedule: Amount of Purchase 1/ Millions of SDRs	Percent of Quota	Conditions
November 6, 2008	4,215.0	405.9	Approval of arrangement
March 25, 2009	2,107.5	203.0	First review and end-December 2008 performance criteria
June 23, 2009	1,264.5	121.8	Second review and end-March 2009 performance criteria
September 25, 2009	50.0	4.8	Third review and end-June 2009 performance criteria
December 18, 2009	725.1	69.8	Fourth review and end-September 2009 performance criteria
March 15, 2010	725.1	69.8	Fifth review and end-December 2009 performance criteria
June 15, 2010	725.1	69.8	Sixth review and end-March 2010 performance criteria
September 15, 2010	725.2	69.8	Seventh review and end-June 2010 performance criteria
Total	**10,537.5**	**1,014.8**	

Source: IMF staff estimates.

1/ For November 2008-September 2009. After September 2009 it reflects the amounts available for purchase.

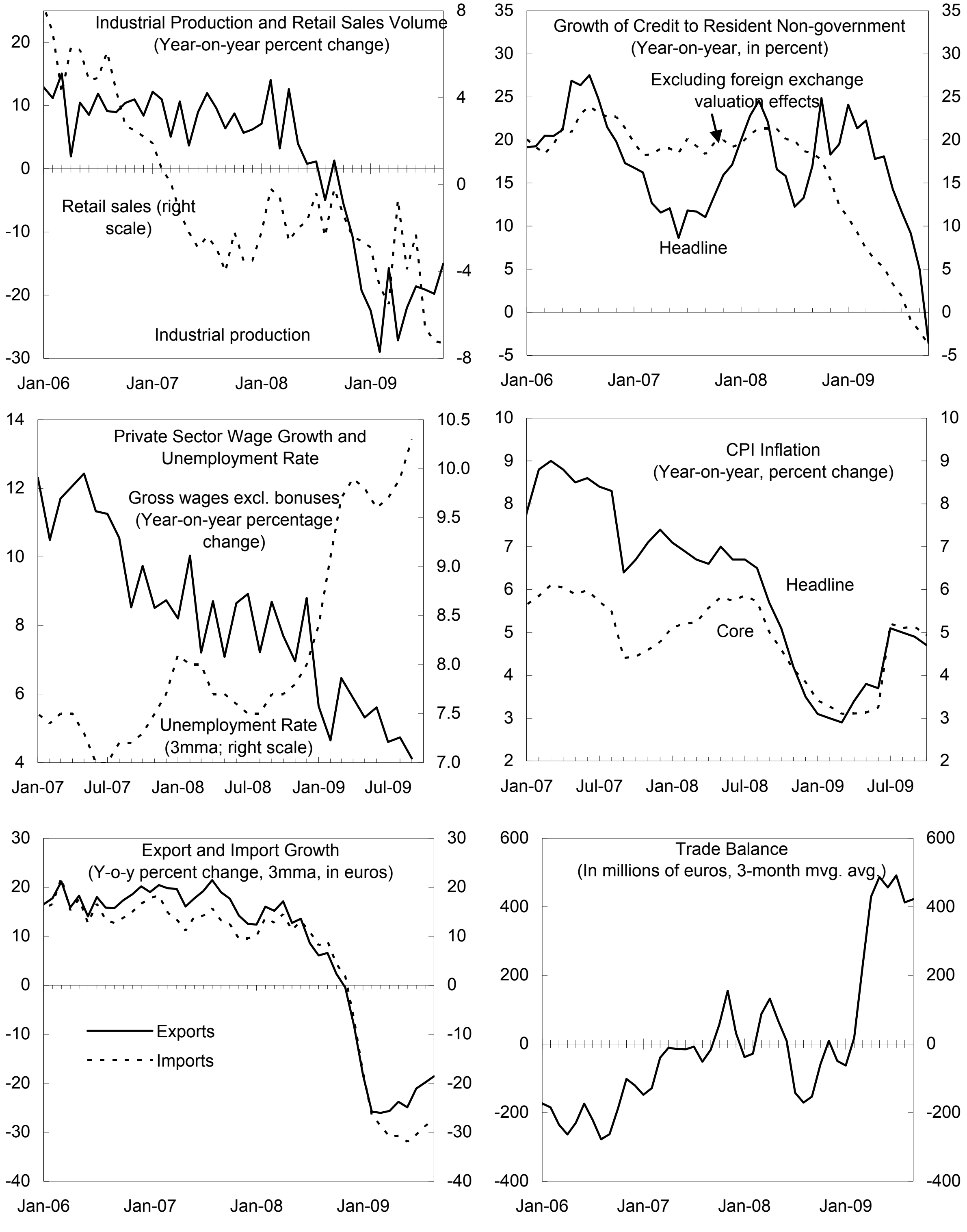
Table 11. Hungary. Indicators of Fund Credit, 2008-16
(In millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Existing and prospective Fund credit									
Disbursement	4,215	4,147	2,175	-	-	-	-	-	-
Stock 1/	4,215	8,362	10,538	10,538	7,317	2,592	544	-	-
Obligations	0	104	247	281	3,487	4,889	2,075	548	0
Repurchase	-	-	-	-	3,220	4,725	2,049	544	0
Charges	0	104	247	281	267	164	26	4	0
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	11.9	11.4	7.5	2.5	0.5	-	-
In percent of exports of goods and services	5.2	13.2	15.8	14.8	9.6	3.2	0.6	-	-
In percent of gross reserves	18.8	30.7	35.0	36.0	26.0	9.4	2.2	-	-
Obligations to the Fund from existing and prospective Fund arrangements									
In percent of quota	0.0	10.0	23.7	27.1	335.8	470.8	199.8	52.8	0.0
In percent of GDP	0.0	0.1	0.3	0.3	3.6	4.7	1.9	0.5	0.0
In percent of exports of goods and services	0.0	0.2	0.4	0.4	4.6	6.0	2.4	0.6	0.0
In percent of gross reserves	0.0	0.4	0.8	1.0	12.4	17.6	8.2	2.1	0.0

Source: IMF staff estimates.

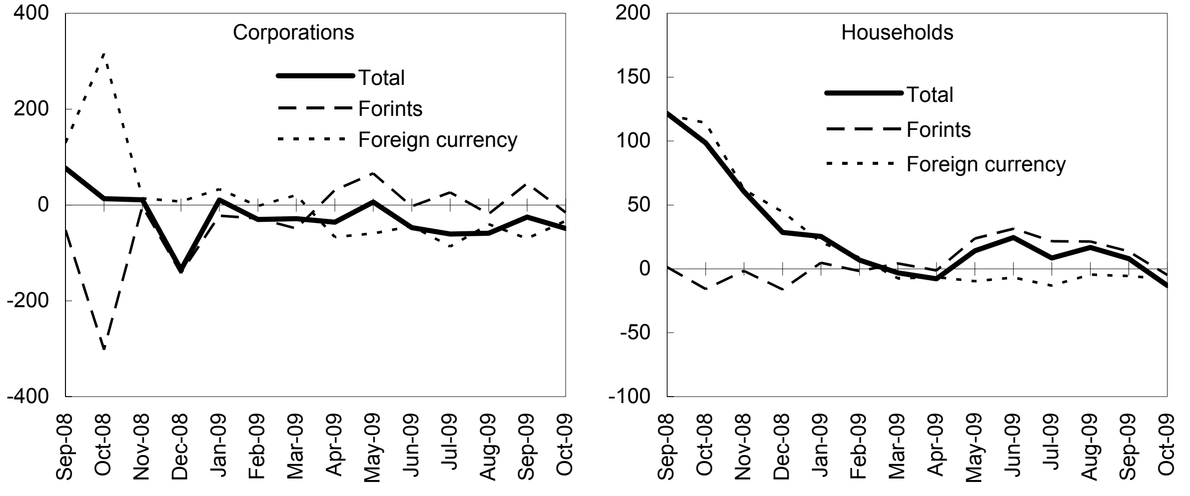
1/ End of period. Assumes that all prospective Fund resources would be disbursed.

Figure 1. Hungary: Recent Economic Developments



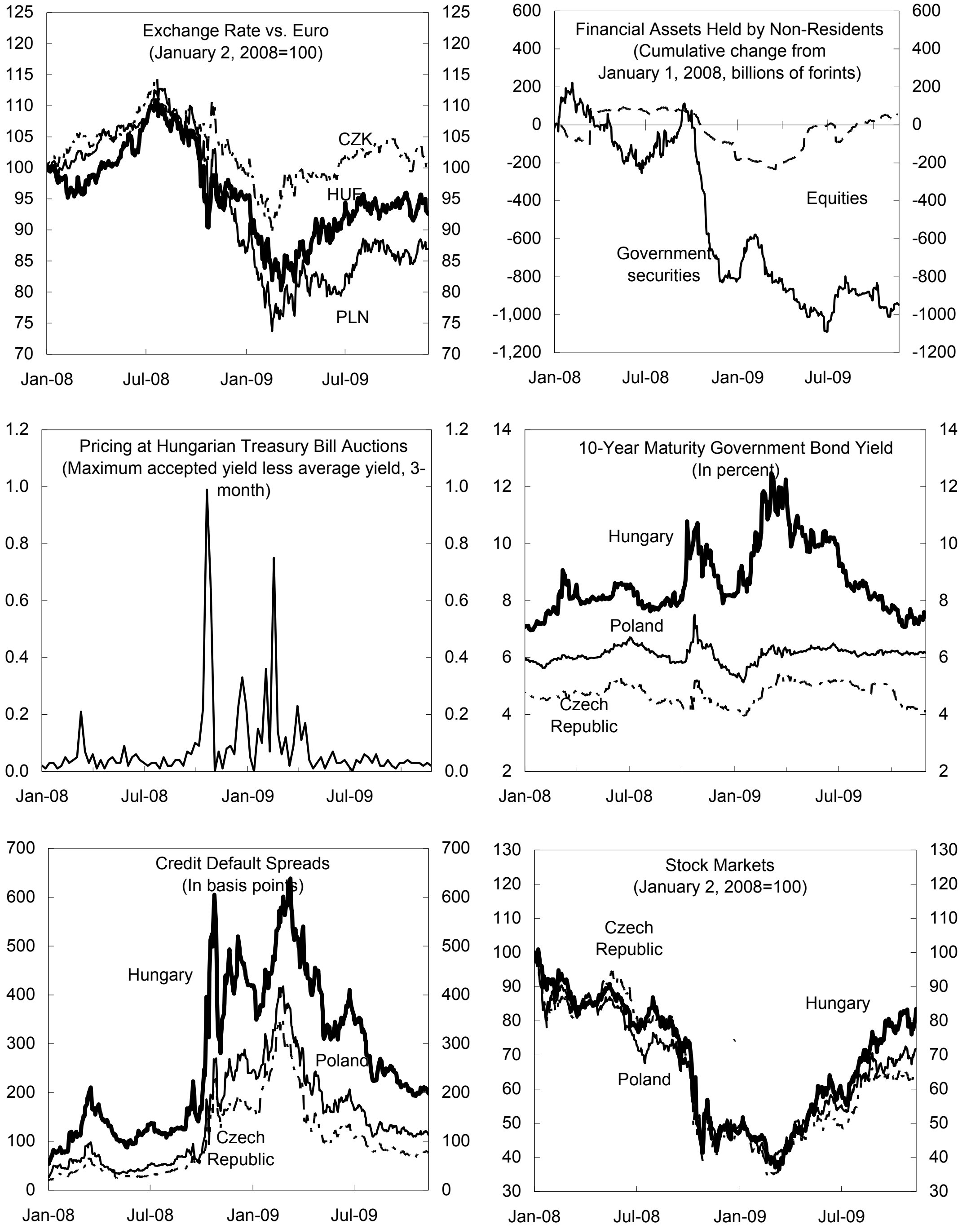
Sources: Hungarian Statistical Office; and IMF staff calculations.

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



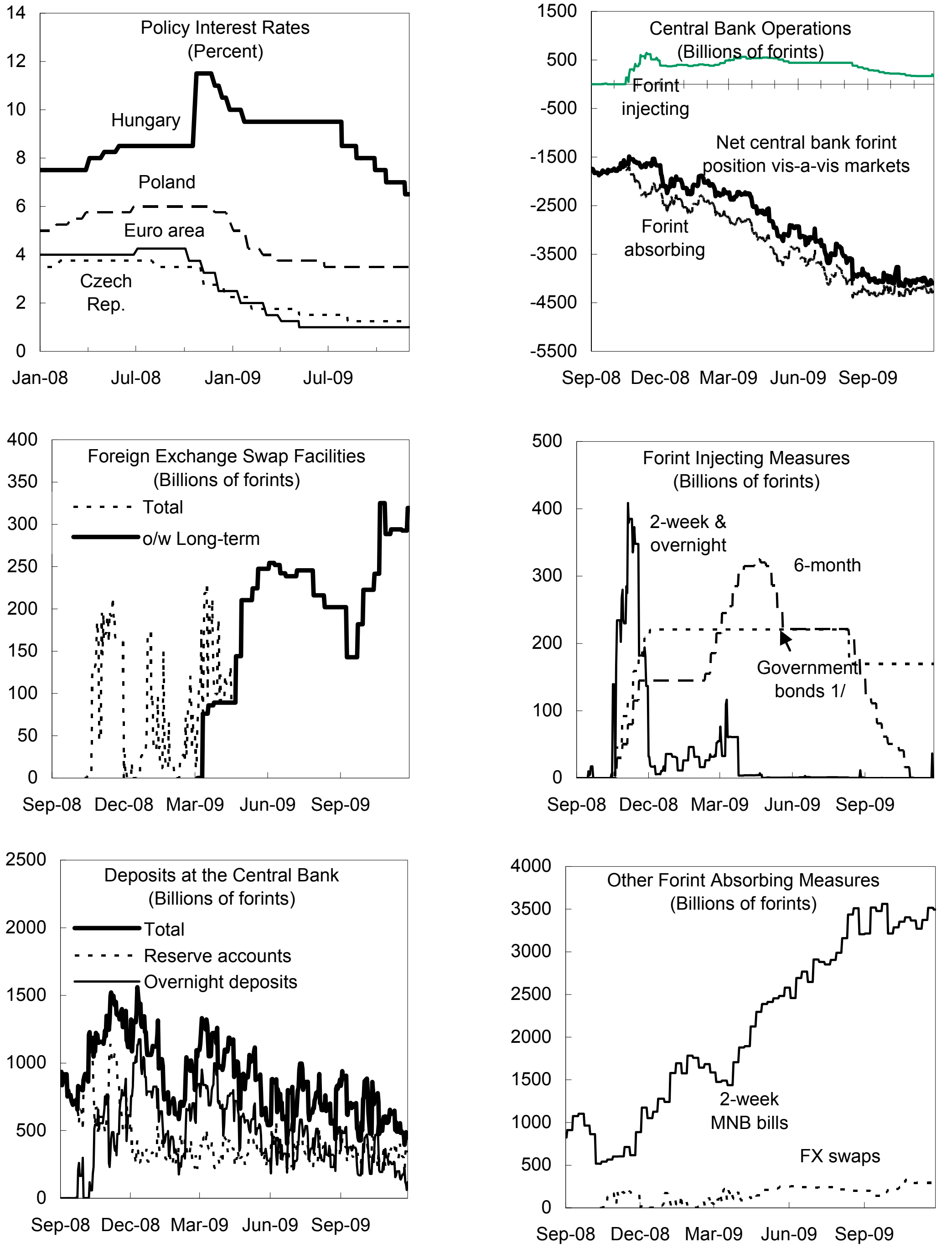
Source: Magyar Nemzeti Bank.

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	75.6	91.0	98.1	115.3	**136.6**	**131.7**	**120.9**	**116.8**	**114.3**	**111.6**	**-2.5**
Change in external debt	12.5	8.7	15.4	7.1	17.2	21.3	-4.9	-10.8	-4.1	-2.5	-2.8	
Identified external debt-creating flows (4+8+9)	-5.2	-2.3	2.2	0.8	2.2	8.2	-0.2	-3.2	-3.4	-2.7	-1.7	
Current account deficit, excluding interest payments	5.8	4.3	4.2	3.1	1.8	-4.3	-3.4	-2.2	-1.8	-1.5	-1.4	
Deficit in balance of goods and services	2.7	1.2	0.9	-1.2	-0.7	-5.6	-5.6	-4.3	-3.7	-3.1	-2.7	
Exports	65.0	67.7	77.0	79.7	81.8	76.9	75.5	76.9	78.2	78.9	80.8	
Imports	67.7	68.9	77.9	78.4	81.0	71.2	69.9	72.6	74.5	75.8	78.1	
Net non-debt creating capital inflows (negative)	-5.4	-5.0	-2.9	3.2	-1.0	-1.1	-2.6	-2.4	-1.6	-1.7	-1.4	
Automatic debt dynamics 1/	-5.5	-1.6	0.8	-5.5	1.4	13.6	5.7	1.5	0.0	0.6	1.1	
Contribution from nominal interest rate	2.6	2.9	3.2	3.7	5.4	4.7	4.9	5.5	5.2	5.1	4.9	
Contribution from real GDP growth	-4.3	-2.4	-2.9	-1.0	-0.6	8.9	0.8	-4.0	-5.1	-4.4	-3.8	
Contribution from price and exchange rate changes 2/	-3.8	-2.2	0.5	-8.2	-3.4	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	17.7	11.0	13.2	6.3	14.9	13.1	-4.7	-7.6	-0.7	0.2	-1.0	
External debt-to-exports ratio (in percent)	103.1	111.7	118.3	123.2	141.0	177.6	174.4	157.3	149.4	144.9	138.1	
Gross external financing need (in billions of euros) 4/	19.0	20.8	21.8	20.7	32.7	34.3	37.4	41.7	38.7	42.7	45.2	
in percent of GDP	23.1	23.4	24.2	20.4	31.0	37.4	38.4	40.7	35.4	36.8	37.0	
Scenario with key variables at their historical averages 5/						**136.6**	**134.8**	**124.4**	**120.6**	**117.6**	**113.5**	**-8.7**
Key Macroeconomic Assumptions Underlying Baseline 6/												
Real GDP growth (in percent)	9.2	3.9	3.9	1.2	0.6	-6.7	-0.6	3.2	4.5	4.0	3.5	
GDP deflator in euros (change in percent)	6.6	3.7	-2.3	11.3	3.6	-6.9	6.9	2.0	2.0	2.0	2.0	
Nominal external interest rate (in percent)	5.6	4.7	4.3	4.5	5.7	3.6	3.8	4.4	4.6	4.6	4.5	
Growth of exports (euro terms, in percent)	20.2	12.2	15.4	16.6	7.0	-18.3	4.4	7.0	8.4	7.0	8.1	
Growth of imports (euro terms, in percent)	20.8	9.7	14.7	13.5	7.7	-23.6	4.3	9.2	9.3	7.9	8.8	
Current account balance, excluding interest payments	-5.8	-4.3	-4.2	-3.1	-1.8	4.3	3.4	2.2	1.8	1.5	1.4	
Net non-debt creating capital inflows	5.4	5.0	2.9	-3.2	1.0	1.1	2.6	2.4	1.6	1.7	1.4	

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

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

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

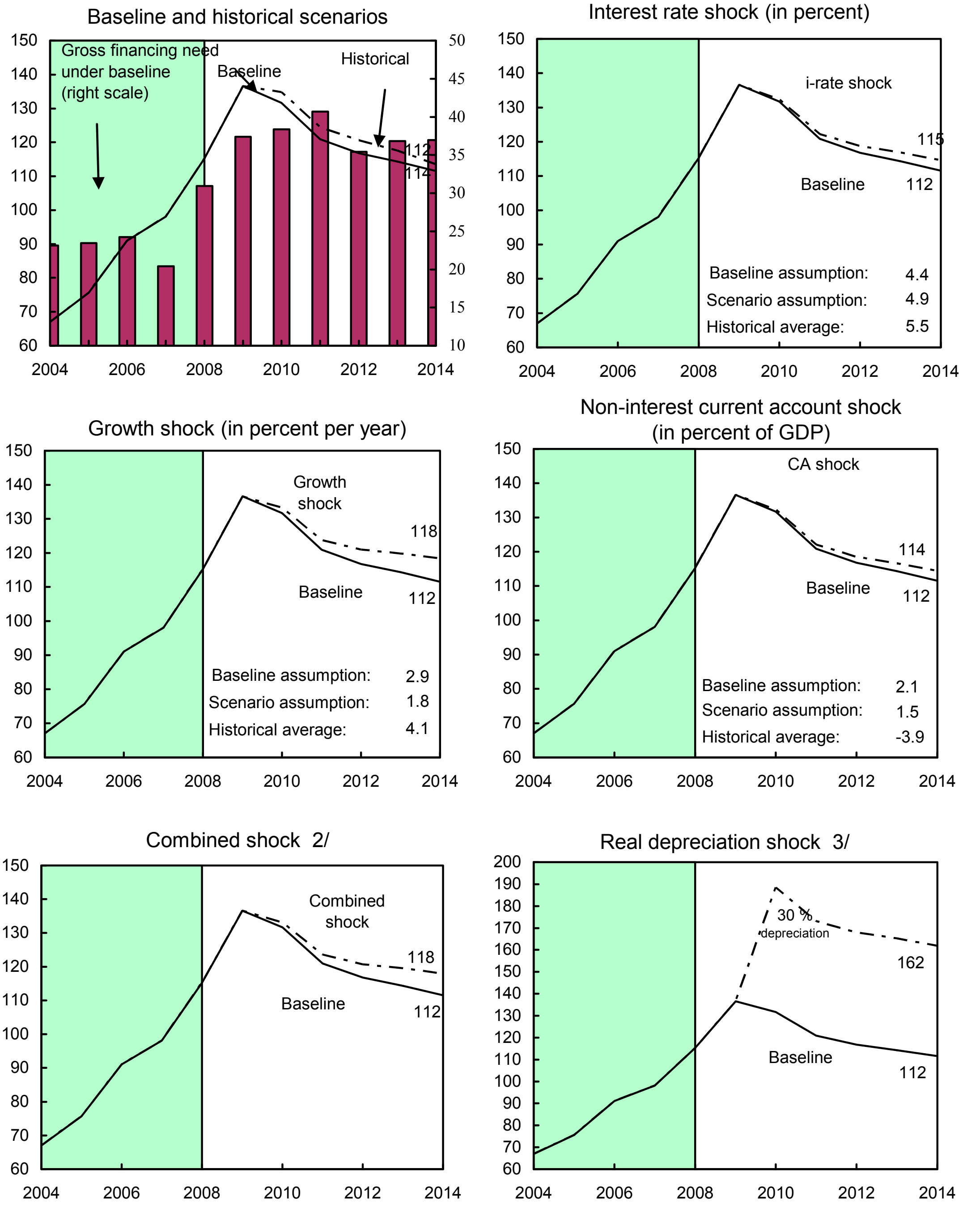
4/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

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



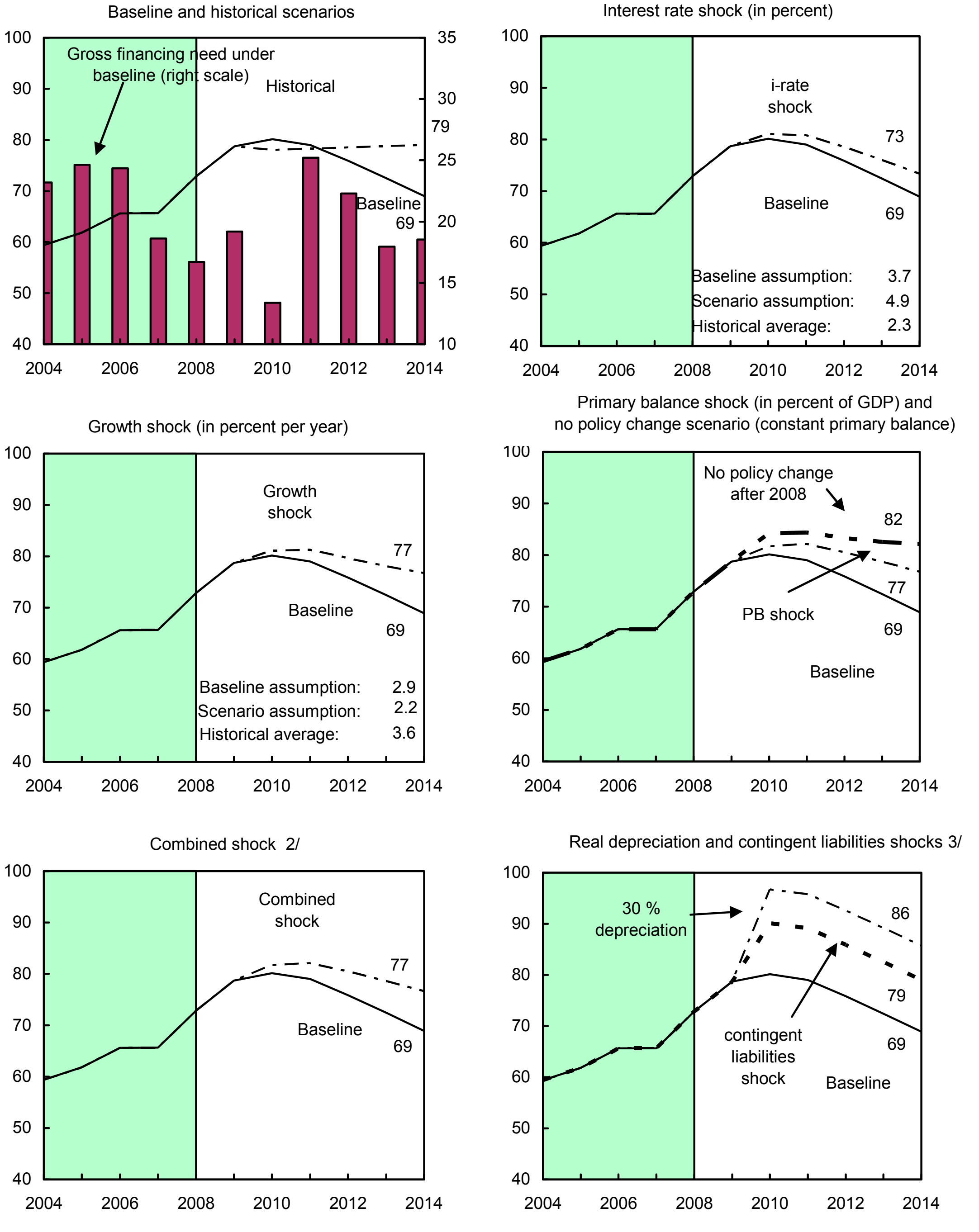
Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. 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 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	65.7	72.9	**78.7**	**80.2**	**79.0**	**75.9**	**72.4**	**68.9**	**0.3**
o/w foreign-currency denominated	15.3	17.4	18.5	18.5	26.2	33.8	34.2	28.3	26.3	24.3	22.5	
Change in public sector debt	1.4	2.4	3.8	0.0	7.2	5.9	1.4	-1.1	-3.1	-3.4	-3.5	
Identified debt-creating flows (4+7+12)	-1.2	5.2	1.7	-1.2	3.4	6.3	2.3	-1.1	-3.1	-3.4	-3.5	
Primary deficit	2.0	3.7	5.4	0.9	-0.4	-0.4	-0.7	-1.8	-2.6	-3.2	-3.6	
Revenue and grants	42.6	42.3	42.6	44.8	45.5	46.2	45.5	44.6	44.4	44.3	44.4	
Primary (noninterest) expenditure	44.6	46.0	48.0	45.7	45.1	45.8	44.8	42.9	41.9	41.2	40.8	
Automatic debt dynamics 2/	-2.4	3.4	-2.4	-2.1	3.8	6.8	3.0	0.6	-0.6	-0.3	0.1	
Contribution from interest rate/growth differential 3/	-0.6	0.6	-0.7	-0.3	1.5	6.8	3.0	0.6	-0.6	-0.3	0.1	
Of which contribution from real interest rate	2.0	2.9	1.6	0.3	1.9	1.7	2.5	3.0	2.8	2.6	2.5	
Of which contribution from real GDP growth	-2.6	-2.3	-2.3	-0.7	-0.4	5.0	0.5	-2.4	-3.4	-2.9	-2.4	
Contribution from exchange rate depreciation 4/	-1.8	2.8	-1.7	-1.8	2.3	...	...	...	...	...	...	
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	1.3	3.8	-0.5	-0.9	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	139.5	146.3	154.1	146.6	160.2	170.4	176.1	177.1	170.8	163.4	155.4	
Gross financing need 6/	23.2	24.6	24.3	18.6	16.7	19.2	13.4	25.2	22.3	18.0	18.5	
in billions of U.S. dollars	23.7	27.2	27.5	25.9	26.0	24.2	18.4	36.2	33.9	28.7	30.9	
Scenario with key variables at their historical averages 7/						**78.7**	**78.1**	**78.3**	**78.5**	**78.8**	**79.0**	**-0.7**
Scenario with no policy change (constant primary balance) in 2009-2014						**78.7**	**84.2**	**84.4**	**83.3**	**82.6**	**82.2**	**0.4**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.8	4.0	4.0	1.1	0.6	-6.7	-0.6	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	6.6	5.8	5.8	6.0	5.8	5.7	5.7	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.9	5.2	3.0	0.6	3.0	2.1	3.2	4.0	3.8	3.8	3.7	
Nominal appreciation (increase in US dollar value of local currency, in percent)	15.3	-15.6	11.5	11.0	-11.2	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	4.4	2.2	3.9	6.0	3.6	3.7	2.6	1.9	2.0	2.0	2.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.7	7.2	8.6	-3.8	-0.7	-5.3	-2.6	-1.4	2.1	2.4	2.5	
Primary deficit	2.0	3.7	5.4	0.9	-0.4	-0.4	-0.7	-1.8	-2.6	-3.2	-3.6	
Memorandum item												
Growth of real public debt	6.2	7.0	7.8	-0.2	11.7	-1.1	0.0	1.3	-0.9	-1.7	-2.5	

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 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: HUNGARY LETTER OF INTENT

Budapest, December 4, 2009

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

Dear Mr. Strauss-Kahn:

1. Significant progress has been made over the past year in strengthening policies that underpin fiscal sustainability and financial stability. Government spending has been reduced in a durable way, while allowing the fiscal deficit to increase somewhat to avoid exacerbating the economic contraction. We plan to reduce the fiscal deficit as the economy recovers, in line with our commitments. In the financial sector, bank supervision and the remedial action framework have been enhanced.

2. We request completion of the fourth review under the Stand-By Arrangement, as the implementation of our economic program has remained in line with our commitments (Tables 1 and 2):

- The September quantitative performance criteria were all met. Inflation adjusted with the total effect of the indirect tax increases was below the lower inner band of the inflation consultation mechanism under the program, and discussions were held with the Fund staff (para 26).

- Legislation to strengthen the institutional framework for banking supervision was submitted with only a minor delay (structural benchmark, para 22). 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 (continuous structural benchmark).

3. We request modifications to two performance criteria at end-December 2009: the performance criteria on net international reserves to lock in the increase in reserves, and on the central government's cumulative cash primary balance to account for the macro-related revenues shortfalls and higher spending on unemployment benefits. Quantitative performance criteria through end-March 2010 are set out in Table 2 and the Technical Memorandum of Understanding, both attached to this letter.

4. We request modification of the end-December 2009 structural benchmark on the remedial action and bank resolution regime as follows. The end-December benchmark would refer only to points (i), (ii), and (iv) in paragraph 20 of the March 2009 Letter of Intent. A new benchmark would be introduced for the remaining point (iii) in the same paragraph, which relates to broadening the available bank resolution techniques. Instead of "passage by" parliament, the new benchmark would refer to "submission to" parliament by February 12, 2010. In addition, sending draft legislation and presentation note to Fund staff by December 11, 2009 is a prior action for completion of this review (para 24 b). The extra time is needed because progress on this element has been slower than expected, reflecting the complexity of the technical work and a crowded legislative agenda. Another prior action for completion of this review is sending a business plan for the state-owned railway company (MAV) consistent with the planned savings in the 2010 budget, along with a presentation note, to Fund staff by December 7, 2009 (para 14). Structural conditionality is set out in Table 3.

5. We believe that the policies set forth in our previous letters (of November 4, 2008; March 12, 2009; June 11, 2009; and September 16, 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. The fifth review of the program will take place after March 15, 2010 and the sixth review after June 15, 2010.

6. Reflecting consistent policy implementation and the improvement in external financing conditions, we do not intend to draw the amount that would be made available upon completion of this review (SDR 725.1 million, 70 percent of quota). The availability of Fund resources will help to insure against the impact of any unforeseen deterioration in the external environment throughout the remainder of the program period.

Macroeconomic Framework for 2009 and 2010

7. The economy continues to evolve largely as expected. In 2009Q3, real GDP declined by 7.2 percent (y-o-y), though recent monthly data on exports and industrial production suggest that the pace of economic contraction is slowing. The unemployment rate increased to 10.3 percent (from 9.6 percent in 2009Q2) and the weak labor market continued to dampen retail sales. As at the third review, real GDP is projected to contract by 6.7 percent in 2009. Looking forward, the pick-up in growth in export markets, combined with a gradual easing of domestic lending conditions, are expected to lead to positive GDP growth (q-o-q) in 2010Q2. Overall, real GDP is projected to contract by 0.6 percent in 2010 (compared to 0.9 percent at the third review).

8. CPI inflation is projected to be 4.2 percent for 2009, down by 0.3 percent from the third review. The revision is due to a smaller-than-expected pass-through of the indirect tax increases in July 2009, lower food price inflation, and moderation in service sector wage growth. Inflation in 2010 has also been revised down (from 4.1 percent to 3.9 percent), on account of the downward revision of the impact of the increase in indirect taxes in 2009 and the reduction in VAT for district heating, effective from January 2010.

9. The current account deficit is projected to narrow to 0.5 percent of GDP in 2009, from 7.2 percent of GDP in 2008. With imports falling more rapidly than exports, the trade balance is expected to improve by 5 percentage points of GDP. The investment income deficit is expected to narrow by 1.5 percentage points of GDP on account of weaker profits. In 2010, as domestic demand recovers and oil prices rise, the current account deficit is expected to widen to 1.5 percent of GDP, which is still low by historical standards.

10. External financing conditions have continued to improve. Gross official reserves increased from €17.4 billion at end-September 2008 to €30.6 billion at end-September 2009. Banks experienced financial outflows in 2009Q2, with the unwinding of emergency support from parent banks that was provided during the period of acute financial strains, but the outflows moderated in the third quarter. Going forward, banks' external financing need will be supported by parent banks' commitments (in the context of the European Bank Coordination Initiative) to maintain their exposures to their subsidiaries (para 20). The government expects to cover its financing need in domestic and international markets.

Fiscal Policy and Structural Fiscal Reforms

11. 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 continued to implement a comprehensive package of entitlement, public service, and tax reforms (June 2009 Letter of Intent, paragraphs 11 and 12) aimed at permanently reducing public expenditures 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 fiscal discipline, higher growth, and lower interest rates is expected to put the public debt-to-GDP ratio firmly on a declining path.

12. The primary balance of the central government through end-September was above the program floor (performance criterion). Higher-than-projected spending administered by line ministries and on housing subsidies was more than offset by lower-than-projected spending in other areas (including by the social security and labor market funds) and higher-than-projected revenue, especially VAT and personal income tax.

13. We remain fully committed to our general government deficit target (Maastricht definition) of 3.9 percent of GDP in 2009. Compared to the third review, we expect higher

spending by line ministries and on health care and unemployment benefits, as well as lower corporate tax revenue, to be offset by lower interest expenditures and a reduction in identified contingency reserves. We have revised down the end-December 2009 central government primary cash balance target to accommodate the lower revenue and higher spending (on unemployment benefits) that are related to the macroeconomic situation. For the remainder of the year, a downside risk to corporate tax revenue is offset by upside risks from (i) advance purchases of excise stamps by tobacco companies ahead of the January 2010 hike in excises on tobacco products and (ii) one-off revenue due to the shift of employees from the second to the first pillar of the pension system.

14. The budget adopted by parliament on November 30, 2009 is consistent with our commitment to reduce the general government deficit (Maastricht definition) to 3.8 percent of GDP in 2010. Compared to the draft that was submitted to parliament, the adopted budget allocates part of the specific reserves to higher spending on healthcare, school meals, and education (the latter two will help to reduce pressures on local government spending) and to a reduction in the VAT on district heating. Consistent with our commitment to gradually reduce the public transport system's need for government support, we are taking measures aimed at improving the financial situation of the sector. These measures include eliminating the redundancy between railway and long-distance bus lines, and implementing efficiency gains (including in procurement procedures). We will prepare a business plan for the state-owned railway company (MAV) consistent with the planned savings in the 2010 budget, along with a presentation note, and send them to Fund staff by December 7, 2009 (prior action). Also, we will announce decisions on fares and subsidies by December 15, 2009. Overall, these measures are expected to generate savings of at least HUF 30 billion.

15. The budget contains appropriate buffers to mitigate fiscal risks in 2010. Upside risks include the remaining one-off revenue related to the shift of employees from the second to the first pillar of the pension system, and the pending ruling by the constitutional court on the envisaged reduction in farm support (for which there is an expenditure allocation in the budget). Downside risks include the impact of the economic downturn on income tax revenue, lower revenue due to the advance purchase (in 2009) of excise stamps by tobacco companies, and the uncertainty about the magnitude of the budgetary savings due to structural measures. We have strengthened expenditure control by assigning treasurers to line ministries. In addition, the remaining amount of specific reserves was added to the stability reserve, bringing overall budgetary reserves to 0.8 percent of GDP. Any extra revenues that could result from a better-than projected macroeconomic performance would be used to boost reserves available to deal with risks and to reduce the adjustment in spending that will be needed in 2011 to bring the deficit (Maastricht definition) below 3 percent of GDP.

16. Looking ahead, we remain committed to reducing the general government deficit to below 3 percent of GDP in 2011. To offset the revenue loss from the planned increase that year in the top personal income tax bracket and the assumption of the loss of the MNB expected in 2010, permanent expenditures cuts will be considered. We intend to review

expenditure rationalization aimed at improving the efficiency of the delivery of public services, possibly with Fund technical assistance.

17. We have completed a review of possible inconsistencies between the Fiscal Responsibility Law and budget procedures. We will publish it by December 15, 2009. The review identified some areas for further improvement, including in medium-term budgeting procedures, which we intend to address. We have also taken on board most of the recommendations of the Fiscal Council related to the consistency of the 2010 budget law with the Public Finance Act. From this process, the only significant pending recommendation relates to the consolidation in the general government budget of the profits and losses of the state-owned enterprises. We intend to work with the Fiscal Council to determine the best way to implement this recommendation. More generally, we intend to strengthen further the ongoing dialogue and information sharing with the Council.

Financial Sector Policies

18. The banking system has remained profitable, funding levels have been stable, and capitalization levels have been well above regulatory requirements. Return on equity was 14.8 percent in the first three quarters of 2009, compared to 24.9 percent in the same period of 2008. Continued profitability has permitted a further increase in the banking system's capital adequacy ratio to 13.1 percent at end-September, from 12.3 percent at end-June. Corporate deposits have fallen somewhat in the third quarter, following a significant increase in the first half of the year, but household deposits have continued to increase, and external bank funding has stabilized. Credit to the economy has continued to contract at a modest pace, reflecting in part a lack of demand and tight credit conditions. The ratio of non-performing loans to total gross loans has increased to 5.9 percent of at end-September, from 5.1 percent at end-June.[1]

19. Going forward, the challenges to the banking system are significant but appear manageable. Profits are expected to fall further in the final quarter of 2009 and the first half of 2010 and may even turn negative for individual banks, as interest margins narrow and banks continue to step up provisioning. According to projections of the central bank, non-performing loans are expected to peak around 9-10 percent during the course of 2010. The capital buffer of systemically important banks is expected to suffice to absorb projected loan losses under the macroeconomic baseline scenario in both 2009 and 2010.

20. We have secured specific commitments from the parent banks of Hungary's six largest subsidiaries in the context of the European Bank Coordination Initiative (EBCI) and are now receiving from them individual letters confirming these commitments. A meeting

[1] Non-performing loans are defined as corporate, household, interbank, foreign and other loans that are past due for more than 90 days.

was held on November 19 in Brussels to add specificity to the general commitments made by the parent banks in May 2009. Some limited flexibility was introduced as regards the stability of parents' exposures, with a minimum level of 95 percent of that prevailing at end-September 2008, just before the initiation of program discussions, and with which all banks are in compliance. These banks are also committed to follow sound risk, capital and liquidity management practices, including proper asset and liability maturity structure. The capital levels of subsidiaries appear adequate, taking into account the results of the stress-tests, which were discussed individually, and the capital position of the consolidated group.

21. Banking supervision capacity continues to increase, and the implementation of the Hungarian Financial Supervisory Authority's (HFSA) Action Plan is on track. The on-site inspections of seven of the eight largest banks were finalized by end-November, and the last one has been postponed to early 2010. The reviews of foreign subsidiaries of Hungarian banks is progressing as scheduled. The HFSA is also preparing for the next inspection cycle, including inspections of credit quality for selected banks in early 2010, and will complete the reports on these inspections for three banks during the first quarter (structural benchmark for end-March 2010).

22. We have submitted to parliament legal amendments to overhaul the organizational framework for banking supervision (in line with the structural benchmark for October 15, 2009). The submitted legislation would upgrade the HFSA to an autonomous organization with the right to issue regulations, would give the central bank the authority to issue temporary regulations on macro-prudential issues, and would establish a Financial Stability Council consisting of members of the HFSA, the Central Bank (MNB) and the Ministry of Finance. The HFSA and the MNB would also be given the right to propose legislation or regulation to the government on a "comply or explain" basis.[2]

23. The government plans to issue regulations to prevent a further buildup of household balance sheet vulnerabilities. We will establish maximum loan-to-value ratios for all new mortgage and long-term mortgage-backed consumer loans in line with best international practice, with lower limits applying to loans in foreign currency. Moreover, the regulation governing banks' procedures for approving household loans will assure that the monthly installment for a loan denominated in foreign currency will be lower than the installment for a comparable forint loan. In the short-term, we expect these measures to have only a small

[2] Other financial sector legislation in front of Parliament aims at (i) implementing the EU directive on consumer lending to strengthen the lenders' obligations to provide adequate information to households about loan products and facilitate early repayment, (ii) regulating non-bank financial intermediaries, including on licensing and skill requirements, (iii) implementing a code of conduct for banks to ensure responsible lending behavior, limit lenders' options to make unilateral changes to contracts, and introduce set procedures in case of payment arrears or foreclosures.

impact on lending activity. Over the medium-term, however, they should yield a less risky composition of the stock of outstanding household loans.

24. We remain committed to completing the ongoing work to strengthen the remedial action and resolution regime for banks:

a. As part of a comprehensive package of financial sector reform measures, and in addition to legislative changes already made earlier this year, we have submitted to parliament on October 22 a set of amendments to the Law on Credit Institutions and Financial Enterprises that are expected to be passed by December 15, 2009. These amendments will establish a stronger regime for the removal of bank executives that no longer meet “fit and proper” criteria, stipulate an additional mandatory threshold for the appointment of a supervisory commissioner, and clearly state that only the HFSA has the power to initiate bank liquidation proceedings.

b. Progress in refining and complementing specific bank resolution techniques has been slower than expected, because of the complexity of the technical work and an overcrowded legislative agenda. We will complete by December 11, 2009 the remaining technical work (including a full legislative proposal and a presentation note) on broadening the available bank resolution techniques that would facilitate the timely and efficient resolution of a problem bank, consistent with paragraph 20 (iii) in the March 2009 Letter of Intent (prior action). We will then complete all necessary consultation (including on compliance with the EU Acquis) and approval processes and submit the proposed legislation to parliament by February 12, 2010. As described in para 4, we request that the corresponding structural benchmark be modified accordingly. We believe that the development of such a comprehensive proposal will be a major step towards strengthening the bank resolution regime.

Monetary and Exchange Rate Policy

25. 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 300 bps to 6.5 percent, in line with the strengthening of investor confidence and the associated easing of financial strains. There is room for further cuts in policy rates should the improvements in market sentiment prove sustainable, as consumer price inflation is 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.

26. CPI inflation in September 2009, adjusted for the technical effect of the indirect tax increases in July 2009 (3.7 percent), was below the lower inner band of the inflation consultation mechanism (ICM). The actual pass-through of the indirect tax increases was much lower than expected, reflecting the weakness of economic activity. Going forward, we request that the adjustor under the ICM be modified in line with estimated actual pass-through (Table 2, and Technical Memorandum of Understanding). 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.

27. A key objective of the government's economic program is to maintain an adequate level of international reserves. The target on 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

Table 1. Hungary: Program Monitoring

	Measure	
Quantitative Performance Criteria		September 2009
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	Not Observed - Discussion held with Fund staff
	Outer band	Observed
Indicative Target		
	Ceiling on total debt stock of the central government system	Observed
Structural Benchmarks		
1	Operation of the sub-committee described in the March LOI para 18 as long as there is any government capital or funding support outstanding to banks, and consultation of the sub-committee with Fund staff on its work program (Continuous)	Observed
2	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)	Observed with a minor delay

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.	Outcome	Prog.	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	-148	190	-280	-185
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	1,574	-2,378	-2,962	-2,942
II. Continuous Performance Criterion												
3. Non-accumulation of external debt arrears	…	0	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	1.2	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	15,267	15,057	15,050	15,400	15,900

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 2008 is from September 2008, while all cumulative changes for 2009 and 2010 are from December 2008.
End-June program target is before adjustment for the delayed EU BoP support disbursement (see TMU).
3/ The inner band for consultation is +/-1 percent around the central point, and the outer band is +/-2 percent around the central point. Under the inflation consultation mechanism we will monitor the headline CPI inflation adjusted by 2.5 percent in end-December 2009 and by 3.0 percent in 2010 based on the actual pass through of indirect tax increases (see TMU).
The figure of 1.2 percent in end-September 2009 corresponds to the headline inflation of 4.9 percent adjusted by the technical effect of the indirect tax increases (3.7 percent).
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, 15,074 for end-June and 15,070 for end-September.

Table 3. Hungary: Structural Conditionality

	Measure	
Prior Actions		
1	Prepare a business plan for the state-owned railway company (MAV) consistent with the planned savings in the 2010 budget	By December 7, 2009
2	Complete the remaining technical work—including a full legislative proposal and a presentation note—on broadening the available bank resolution techniques, consistent with paragraph 20 (iii) in the March 2009 Letter of Intent	By December 11, 2009
Structural Benchmarks		
1	Operation of the sub-committee described in the March LOI para 18 as long as there is any government capital or funding support outstanding to banks, and consultation of the sub-committee with Fund staff on its work program	Continuous
2	Passage by parliament of the amendments strengthening the remedial powers of the HFSA as listed in paragraph 20 (i), (ii), and (iv) of the March 2009 Letter of Intent	By end-December 2009
3	Submission to parliament of the amendments strengthening the bank resolution regime as listed in paragraph 20 (iii) of the March 2009 Letter of Intent	By February 12, 2010
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)

December 4, 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 (actual)	1,574
End-December 2009 (performance criterion)	-2,378
End-March 2010 (performance criterion)	-2,962
End-June 2010 (indicative target)	-2,942

[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 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 the government and the MNB's credit outstanding from the Fund. Non-Euro denominated foreign assets and liabilities will be converted into Euro at the program exchange rates. Data will be provided by the MNB to the Fund with a lag of not more than five days past the test date.

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

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

7. NIR targets will be adjusted upward (downward) by the surplus (shortfall) in program disbursements relative to the technical assumption below. Program disbursements are defined as external disbursements from official creditors that are usable for the financing of the overall central government budget. For program purposes, any program disbursement from the EU or the World Bank in 2010 would result in an upward adjustment of the NIR target. NIR is not affected by the SDR allocations received by Hungary in September and October 2009, as the central bank's reserves assets and its liabilities to the SDR department increased at the same time.

External Program Disbursements (technical assumption)

Cumulative flows from end-December 2008:	(In millions of Euros)
End-March 2009	2,000
End-June 2009	2,000
End-September 2009	3,500
End-December 2009 (technical assumption)	3,500
End-March 2010 (technical assumption)	3,500
End-June 2010 (technical assumption)	3,500

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-December 2009 and end-March 2010 are performance criteria, while the target for end-June 2010 is an indicative target. For the purpose of monitoring performance under the inflation consultation mechanism, CPI inflation will be adjusted by 2.5 percentage points in 2009 in December 2009 and by 3.0 percentage points in March and June 2010, which is equal to the estimated impact of the increases in VAT (2.2 percentage points) and excise taxes (0.3 percentage points in the final quarter of 2009 and 0.8 percentage points in the first half of 2010) on the consumer price index.[3]

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-December 2009 (performance criterion)	190
Cumulative primary balance from January 1, 2010:	
End-March 2010 (performance criterion)	-280
End-June 2010 (indicative target)	-185

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

[3] These estimates have been revised down from 3.7 percentage points in 2009 and 4.1 percentage points in 2010 in the TMU of September 16, 2009.

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 (actual)	15,057
End-December 2009 (indicative ceiling)	15,050
End-March 2010 (indicative ceiling)	15,400
End-June 2010 (program projection)	15,900

[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.

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 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-December 2009 (program projection)	-185
End-March 2010 (program projection)	217
End-June 2010 (program projection)	37

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

Cash reserves at the Single Treasury Account (Baseline Projection)

Baseline projections:	(In billions of forints)
End-December 2009 (program projection)	137
End-March 2010 (program projection)	144
End-June 2010 (program projection)	532

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

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

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

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

INTERNATIONAL MONETARY FUND

HUNGARY

Fourth Review Under the Stand-By Arrangement, and Request for Modification of Performance Criteria-Informational Annex

Prepared by the European Department

December 4, 2009

Contents | Page

Appendix
I. Fund Relations 2
II. IMF-World Bank Coordination 4

APPENDIX I HUNGARY: FUND RELATIONS

(As of October 31, 2009)

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

II. **General Resources Account**:

	SDR Million	Percent of Quota
Quota	1,038.40	100.00
Fund holdings of currency	8,601.57	828.35
Reserve position in Fund	73.83	7.11

III. **SDR Department**

	SDR Million	Allocation
Net cumulative allocation	991.05	100.00
Holdings	995.72	100.47

IV. **Outstanding Purchases and Loans:**

	SDR Million	Percent of Quota
Stand-By Arrangements	7,637.00	735.46

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	11/6/08	10/5/10	10,537.50	7,637.00
Stand-by	3/15/96	2/14/98	264.18	0.00
Stand-by	9/15/93	12/14/94	340.00	56.70

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

	Forthcoming				
	2009	2010	2011	2012	2013
Principal				3,220.19	3,818.50
Charges/Interest	47.21	188.26	188.26	165.88	59.90
Total	47.21	188.26	188.26	3,386.07	3,878.40

VII. **Exchange Rate Arrangement**:

The de facto exchange rate arrangement for the Hungarian forint is floating, effective November 1st, 2008.

VIII. **Article IV Consultations**:

Hungary is on a 24-month consultation cycle. The last Article IV Board discussion took place on September 17, 2008. The associated Executive Board assessment is available at http://www.imf.org/external/np/sec/pn/2008/pn08124.htm and the staff report and selected issues papers at http://www.imf.org/external/pubs/cat/longres.cfm?sk=22374.0 and http://www.imf.org/external/pubs/cat/longres.cfm?sk=22375.0. Hungary has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions on the making of payments and transfers on current international transactions except for those maintained solely for the preservation of national or international security and that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

IX. **Technical Assistance:**

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

X. **Resident Representative:**

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

APPENDIX II. HUNGARY: IMF-WORLD BANK COORDINATION

Joint-Management Action Plan Implementation Table
As of November 17, 2009

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Bank Work Program	Hungary Financial Sector Loan - Supervision and financial technical assistance Social Public Expenditure Review Private sector business regulatory environment Technical Assistance	November 2009, January 2010, May 2010 January 2010 November 2009, February 2010	Dec. 2009: T.A. report; February 2010: supervision report and 2nd tranche compliance April 2010: full draft report/recommend-dations March 2010: T.A. notes and policy recommendations
2. Fund Work Program	Mission for the 4th, review of Hungary's SBA-supported program Technical assistance mission on tax administration Missions for the 5th and 6th reviews of Hungary's SBA-supported program	November 4-16, 2009 December 1-9, 2009 February 2010, May 2010	December 2009 January 2010 March 2010, June 2010

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No.09/471
FOR IMMEDIATE RELEASE
December 18, 2009

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth Review Under Hungary's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of Hungary's economic performance under a program supported by a Stand-By Arrangement (SBA). The completion of the review makes available SDR 725 million (about €788 million or US$1.15 billion), but the authorities do not intend to draw this amount. The availability of Fund resources will help to provide insurance against the impact of any unforeseen deterioration in external financing conditions. The total amount disbursed under the program remains SDR 7.64 billion (about €8.27 billion or US$12.11 billion).

In completing the review, the Executive Board also modified two performance criteria on the central government primary cash balance and net international reserves.

The SBA was approved on November 6, 2008 (see Press Release No. 08/275) for SDR 10.54 billion (about €11.5 billion or US$16.7 billion). The arrangement entails exceptional access to IMF resources, amounting to 1,015 percent of Hungary's quota.

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

"Consistent implementation of economic policies in line with the program over the past year has contributed to an improvement in Hungary's external financing conditions. Reflecting this improvement, the authorities do not intend to draw the amount that would be made available upon completion of this review. The program continues to focus on improving fiscal sustainability and preserving financial stability, providing the basis for strong, sustainable growth over the medium term.

"Fiscal sustainability has been strengthened through structural spending reforms to the pension system, social transfers, and subsidies. The increase in the fiscal deficit in 2009 helped avoid exacerbating the economic contraction. 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. To put government debt as a share of GDP firmly on a declining path, strict expenditure control will be needed in 2010, and further measures will be required in 2011 to bring the fiscal deficit below 3 percent of GDP.

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"The authorities have made tangible progress in strengthening the institutional framework for bank supervision. The upgrading of the Hungarian Financial Supervisory Authority (HFSA) to an autonomous agency will help preserve financial stability. Looking forward, it will be important for the HFSA to obtain the authority to issue regulations. The authorities remain committed to the reform agenda aimed at strengthening the remedial action framework and bank resolution regime.

"Increased confidence in fiscal sustainability has better anchored market expectations and helped to create room for cautious interest rate cuts. Looking ahead, monetary and exchange rate policy will continue to target inflation over the medium term, while taking into account risks to financial stability," Mr. Lipsky stated.

Statement by the Staff Representative on Hungary
December 18, 2009

1. **This statement reports on economic and policy developments since the staff report was issued on December 7, 2009** (EBS/09/196). The information does not alter the thrust of the staff appraisal.

2. **Recent data releases have been consistent with the economic outlook in the staff report**. The second estimate of real GDP growth in 2009Q3 was -7.1 percent, 0.1 percentage point less negative than the first estimate. Fixed investment and exports were slightly stronger than staff expected, and stock building slightly weaker. Industrial production and exports continued to rebound in October, resulting in a higher-than-expected trade surplus. CPI inflation increased to 5.2 percent in November, reflecting higher food and energy prices. Consistent with improving access to external financing, the largest domestic bank contracted in mid-December a 12-month syndicated loan of €220 million at an interest rate of 125 bps over Euribor.

3. **Fiscal performance remains broadly in line with the program**. Following central government revenue and expenditure developments in November, the 2009 general government deficit target of 3.9 percent of GDP remains achievable, though, as discussed in the staff report, risks to the fiscal target remain skewed to the downside. The government announced increases in standard fares of the non-urban public transport system of 10-15 percent effective February 1, 2010, though no changes were made to discount fares. The government prepared a business plan for the state-owned railway company (MAV) consistent with the subsidy reduction envisaged in the 2010 budget, along with a presentation note (prior action). For 2010, the plan relies heavily on temporarily lower investment spending and one-off sales of real estate assets. While the risk that savings in 2010 may not fully materialize is covered by budget reserves (and is incorporated into the staff's baseline scenario), medium-term fiscal sustainability will require that the authorities strengthen their efforts to restructure the public transport system.

4. **Financial sector policy developments are also on track**. The legislation to upgrade the Hungarian Financial Supervisory Authority (HFSA) to an autonomous agency, as anticipated in the staff report, was approved by parliament on December 14, 2009. The authorities completed the technical work, including a full legislative proposal and a presentation note, on broadening the available bank resolution techniques (prior action). Specifically, the draft legislation provides the basis for purchase-and-assumption transactions and bridge banks. Staff will provide feedback on the proposal. The authorities aim to finish all necessary consultation processes and submit the legislation to parliament by February 12, 2010 (structural benchmark).