International Monetary Fund

Hungary and the IMF

Press Release:
IMF Executive Board Completes Third Review Under Hungary's Stand-By Arrangement, Extends the Arrangement, and Approves €53.7 Million Disbursement
September 25, 2009

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Hungary: Letter of Intent and Technical Memorandum of Understanding

September 16, 2009

The following item is a Letter of Intent of the government of Hungary, which describes the policies that Hungary intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Hungary, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Mr. Dominique Strauss-Kahn Budapest, September 16, 2009
Managing Director
International Monetary Fund
Washington, DC, 20431
U.S.A.

Dear Mr. Strauss-Kahn:

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

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

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

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

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

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

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

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

Macroeconomic Framework for 2009 and 2010

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

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

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

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

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

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

Fiscal Policy and Structural Fiscal Reforms

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

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

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

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

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

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

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

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

Financial Sector Policies

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

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

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

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

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

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

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

e. We are developing schemes to strengthen the stress-resilience of the household and corporate sectors against the expected further deterioration in economic conditions. In June 2009, parliament enacted the extension of a partial household debt servicing guarantee scheme, which was approved by the European Commission (EC) on July 13. For rephased mortgages of households whose debt-service-to-income ratio has increased by at least 25 percent, the government offers a guarantee of 80 percent of the rephased portion of the loan. The scheme contains safeguards aimed at preserving credit discipline and limiting potential fiscal costs, including limits on initial indebtedness and the size of the loan. Also in June, a reform of the corporate bankruptcy legislation was enacted that provides tools and incentives for restructuring debts of a bankrupt corporation, rather than entering into liquidation. Moreover, the government is promoting schemes to encourage bank lending to small and medium-sized enterprises, including through partial cross-guarantees of default insurance on such loans.

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

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

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

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

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

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

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

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

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

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

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

Monetary and Exchange Rate Policy

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

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

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

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

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

Attachments

Table 1. Hungary: Program Monitoring

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

Table 2. Hungary: Quantitative Program Targets

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

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

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

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

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

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

Table 3. Hungary: Structural Conditionality

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

TECHNICAL MEMORANDUM OF UNDERSTANDING

September 16, 2009

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

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

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[3]

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

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

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

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

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

6. **Gross foreign liabilities** are defined consistently with SDDS as all foreign exchange liabilities of the MNB to residents and nonresidents, including commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options), and banks foreign currency deposits against reserve requirements. Hungary's SDR allocation is treated as a foreign liability of the MNB.[4] Government foreign exchange deposits and forward liabilities arising from swap arrangements with the MNB are not treated as foreign liability of the MNB.

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

External Program Disbursements (Baseline Projection)

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

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

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

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

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

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

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

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

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

discrepancies arise, reconciliation between reported transfers and reported revenues from other CGS entities will be required before compliance with the CGS primary balance ceiling can be assessed. Data will be provided by the Ministry of Finance to the IMF with a lag of no more than seven days past the test date.

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

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

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

14. The ceiling on the overall stock of the debt, as outlined below, shall apply to the HUF value of total stock of debt contracted by the central government system. Excluded from this indicative ceiling are credits from the IMF, external program financing, normal trade-related credits, reserve and long-term liabilities of the MNB, and the absolute net value of mark-to-market deposits of the Hungarian Debt Management Agency (ÁKK).[5] Liabilities related to the bank support package are not included. All stated benchmarks of ÁKK in terms of public debt management will be maintained as much as possible, depending on market conditions and the possible use of IMF credit.

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

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

[5] 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.

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-September 2009 (program projection)	-11
End-December 2009 (program projection)	-152
End-March 2010 (program projection)	218
End-June 2010 (program projection)	31

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

Cash reserves at the Single Treasury Account (Baseline Projection)

Baseline projections:	(In billions of forints)
End-September 2009 (program projection)	269
End-December 2009 (program projection)	160
End-March 2010 (program projection)	320
End-June 2010 (program projection)	721

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

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

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

21. The performance criterion will apply on a continuous basis. The ÁKK will provide the final data on the stock of the central government system external arrears to the Fund, with

a lag of not more than seven days after the test date. This performance criterion does not cover trade credits.