Hungary: Letter of Intent and Technical Memorandum of Understanding

December 4, 2009

Mr. Dominique Strauss-Kahn Budapest, December 4, 2009
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

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[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

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.