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Report No. 47194-HU

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED LOAN

IN THE AMOUNT OF €1.0 BILLION
(US$1.4 BILLION EQUIVALENT)

TO THE

REPUBLIC OF HUNGARY

FOR A

FINANCIAL SECTOR AND MACRO STABILITY POLICY LOAN

August 21, 2009

Private and Financial Sector Development Department
Central Europe and the Baltics Country Department
Europe and Central Asia Region

Hungary

GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of June 30, 2009)

Currency Unit
US$1.00 HuF 193.04

Weights and Measures
Metric System

ABBREVIATIONSAND ACRONYMS

CDS	Credit Default Swap
CEE	Central and Eastern Europe
CPS	Country Partnership Strategy
CBEF	Capital Base Enhancement Fund
DIF	Deposit Insurance Fund
EC	European Commission
ECB	European Central Bank
EU	European Union
FDI	Foreign Direct Investment
FRL	Fiscal Responsibility Law
FSAP	Financial Sector Assessment Program
FX	Foreign Exchange
GF	Guarantee Fund
GP	General Practitioner
HFSA	Hungarian Financial Supervisory Authority
HIF	Health Insurance Fund
HuF	Hungarian Forints
IBRD	International Bank for Reconstruction and Development
IFI	International Financial Institution
IMF	International Monetary Fund
LDP	Letter of Development Policy
LIBOR	London Inter-Bank Offered Rate
MNB	Magyar Nemzeti Bank (Hungarian Central Bank)
MOF	Ministry of Finance
MTEF	Medium-Term Expenditure Framework
PAYG	Pay-as-you-go
PER	Public Expenditure Review
SAO	State Audit Office
SME	Small and Medium Enterprise

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HUNGARY

HUNGARY - FINANCIAL SECTOR AND MACRO STABILITY LOAN

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LOAN AND PROGRAM SUMMARY

HUNGARY

FINANCIAL SECTOR AND MACRO STABILITY LOAN

Borrower	REPUBLIC OF HUNGARY
Implementing Agencies	Ministry of Finance (MoF), Hungarian Financial Supervisory Authority (HFSA), Magyar Nemzeti Bank (central bank of Hungary, MNB)
Financing Data	IBRD Loan **Front end fee**: 1.0 % **Maturity**: 8.5 year final maturity **Interest rate**: LIBOR (Euribor) + 2.0 % **Amount**: € 1.0 billion (US$ 1.4 billion equivalent)
Operation Type	Policy loan (DPL) consisting of two tranches under a single loan. Prepared as part of an international financial support package; financing is also being provided by the International Monetary Fund and the European Commission. The Bank's assistance is part of a joint IFI initiative, where the EBRD, the EIB, and the World Bank Group have pledged to support banking sectors in Central and Eastern Europe with up to €24.5 billion over a two year period.
Main Policy Areas	The loan supports reforms in four main policy areas: (a) fiscal reforms including further reduction in the fiscal deficit, introduction of legally binding fiscal rules and structural measures; (b) a comprehensive financial sector stability program; (c) pension reforms in the public sector and privately funded pillar, and (d) health sector reforms.
Key Outcome Indicators	- Restoration of investor confidence and increased demand for government securities evidenced by: lower government borrowing spreads, lower interest swap spreads, and lower credit default swap (CDS) spreads. - Capital adequacy ratios for all banks at required levels after the results of in-depth supervisory examinations and stress tests. - No increase in the average share of FX loans in household loans (at constant exchange rates); reduction in the share of FX denominated loans in currencies other than the Euro. - Reduction in average loan/deposit ratio. - Increase in the effective retirement age. - Reduction in the long term public pension deficit. - Stability of pharmaceutical expenditures in real terms. - Reduction in number of outpatient visits.

Program Development Objective(s)	The objectives are fourfold and include: (a) support to fiscal reforms designed to ensure long-run fiscal and macroeconomic sustainability and restore investor confidence, improving access of the government, banks and the corporate sector to external funding; (b) support to the financial stability program, designed to ensure adequate levels of liquidity and healthy capital cushions, able to absorb the effects of the international crisis and the contraction of economic activity, (c) support to pension reforms designed to preserve adequate benefits while tightening eligibility criteria and containing expenditures to improve the sustainability of the pension system; and (d) cost containment and deficit prevention in the health sector while ensuring access to care.
Risks and Risk Mitigation	**Further worsening of the external environment.** The financial and economic crisis has continued despite the activation and rescue programs implemented in developed countries. There is a risk that money and credit markets will remain clogged and that the downturn in the EU will be more severe and protracted than recently projected. The access to foreign exchange finance will likely remain restricted and the exchange rate uncertain. The contraction of real GDP and the increase in unemployment in 2009 could be more pronounced than anticipated. This would strain the banks and the corporate sector, and would also create difficulties for the achievement of fiscal targets. **Mitigation measures.** The multilateral package is geared toward a cautious scenario of lack of external funding. With this program, Hungary's financing requirements would be met, reducing the risk of further strains on the banks and the corporate sector, and reducing the need for even more drastic fiscal adjustments beyond the new second phase of cuts recently implemented. The Program also mitigates risks in the banking system through in-depth intensified examinations and the strengthening of supervisory powers. Finally, the fiscal program includes a new fiscal responsibility law that should restore investor confidence, by imposing strict indebtedness limits and ensuring a steady decline in the ratio of debt to GDP in the long-run. **Potential change in policies following the 2010 elections.** The Program contains a robust set of measures in the banking, fiscal and social sectors. However, the Program approaches an election period in 2010 and thus there is the potential for changes in government policies, toward Program objectives. **Mitigation measures.** Many reforms supported by the Program are to be implemented under newly enacted laws. The provisions most at risk would be those approved annually under the budget law. Even with a reversal, this is unlikely to impact fiscal trends significantly since other measures in place (e.g.: the Fiscal Responsibility Law) would constrain the room for reckless spending without revenue financing and IMF/Multilateral financing is contingent on maintaining

	the fiscal measures. **Insufficient institutional autonomy and capacity.** The reforms in the banking system require an increase in autonomy and substantial capacity of the supervisory agency for anticipating deteriorating trends and undertaking the necessary corrective actions. **Mitigation measures.** To mitigate the risk of inadequate implementation, the Bank is expected as part of loan supervision work, to provide technical support on request, to the supervisory agency during the Program period, and the government is committed to modifying the relevant legislation to provide increased powers and flexibility to the agency. **Need to ensure a strengthened toolkit for early supervisory intervention.** In line with international practice, it is important to update the early intervention powers of the supervisory authorities in order to make them capable of acting early (sometimes based on ex ante risk assessments), and not only after a potential default. **Mitigation measures.** The Program includes a sufficiently broad range of policy tools that would allow the financial authorities to intervene, if necessary in a forceful manner, if a systemically important institution is weakening but does not wish to avail itself of government capital support measures. The features of the program not only specify triggers where the government can intervene in such cases, but also contain the afore-mentioned forward looking measures to allow strong early corrective actions to mandate self-capitalization measures. As well, the intensified inspections will include an examination of consolidated bank group risks which will better assess the liquidity versus solvency issues in vulnerable banks.
Operation ID	PE-P114991-LEN-BB

IBRD PROGRAM DOCUMENT

PROPOSED FINANCIAL SECTOR AND MACRO STABILITY LOAN TO THE REPUBLIC OF HUNGARY

I. INTRODUCTION

1. The financial crisis that originated in mature markets continues to generate adverse economic effects, despite the rescue packages that have been introduced in the US and the EU. The crisis became global, being transmitted worldwide through financial and trade channels. It has affected emerging countries, disrupting financial intermediation, reducing exports, and contributing to a sharp contraction of output and increases in unemployment. The countries that are more open and financially integrated have been more substantially affected.

2. Hungary was one of the first emerging economies affected by the financial crisis. In the past two years (2007 and 2008) the government made an impressive effort to address the serious fiscal and macroeconomic imbalances generated in the first half of the decade and restore investor confidence. However, the crisis reduced overall risk tolerance, and Hungary was still perceived as a high risk country due to the large deficits and liabilities that had been accumulated in the first half of the decade. Hungary eventually lost access to foreign exchange (FX) funding in the second half of 2008 and was forced to request a €5 billion repurchase-based (repo) facility from the European Central Bank (ECB) for short term FX funds.

3. To demonstrate its commitment to fiscal and financial stability, the government launched a reform program that includes further fiscal reforms and a financial stability program, and requested support for this program from the IMF, the European Commission and the World Bank, notwithstanding the fact that Hungary had "graduated" from IBRD in 2007. The requested financial rescue package amounts to €19.8 billion, including €12.3 billion from the IMF, €6.5 billion from the European Union, and €1 billion from the World Bank. The IMF and the EU operations were approved in October 2008 and November 2008, respectively, and €14.1 billion have been disbursed, of which €5.5 billion from EU funds.

4. This program document proposes a two-tranche Financial Sector and Macro Stability Loan to the Republic of Hungary. The proposed loan would amount to €1 billion, equally distributed in two tranches. The program supported under the proposed operation would be implemented by the Ministry of Finance, with collaboration from the National Bank of Hungary and the Hungarian Financial Supervisory Authority.

5. The loan will support reforms for a continued reduction in the fiscal deficit, a solid financial sector architecture to mitigate the impacts of the global crisis and ensure banking stability, and reforms in the pension and health sectors to increase cost efficiency and improve the targeting of fiscal resources in these areas. The loan will be a euro denominated fixed spread loan of LIBOR plus 2 percent, a front end fee of 1 percent, with a maturity of 8.5 years.

II. COUNTRY CONTEXT

A. Hungary's Economic Performance Before the 2008 Financial Crisis

6. Hungary was at the forefront of economic reforms in the 1990s and started the new millennium with a strong economic performance, as indicated by high GDP growth, a stable fiscal framework, and declining debt levels. However, in the early 2000s economic performance started faltering due to reform reversals and poor macroeconomic policies, illustrated by large fiscal deficits averaging 8 percent of GDP in 2002-2006. As shown in Figure 1 and Table 1, the fiscal deficits contributed to large current account deficits and rising debt ratios. Macroeconomic imbalances peaked in mid-2006, raising significant concerns about the sustainability of Hungary's economic policies.

7. In mid-2006, the government initiated a reform program designed to restore investor confidence and secure external financing. The program included strong fiscal measures with immediate impact on the deficit combined with structural reforms aimed at putting public finances on a sustainable path. These measures reduced the deficit from 9.3 percent of GDP in 2006 to 4.9 percent of GDP in 2007.[1] This outcome was achieved both through spending restraint and increased revenue collection. The reduction in expenditures included a reduction in the wage bill (a nominal wage freeze and a fall in public sector employment) and reduced subsidies (housing, transportation, gas and heating). Among key expenditure items, only social transfers (mainly pensions) and interest spending increased.

8. This fiscal austerity program came at the cost of a contraction of private consumption and a significant slowdown in real output growth to 1.2 percent in 2007. The economy started to recover slowly in the first half of 2008, but these positive trends were interrupted by the global financial crisis. The drawback was broad based, with negative consumption growth, a drop in investment, and weak net exports. On the production side, all major sectors went into recession.

9. Despite the impressive fiscal adjustment in 2007 and 2008, the country remained vulnerable, as the current account deficit and debt ratios stayed high. The persistence of large current account deficits was partially due to an increasing deficit of the income balance,[2] as shown in Figure 1. The country's vulnerability was mitigated by the fact that a large share of external liabilities entailed direct corporate borrowing from foreign parent companies and bank borrowing from foreign parent banks.

10. However, Hungary's dependence on foreign finance still remained substantial, and both non-financial parent companies and parent banks proved to be themselves vulnerable to the financial crisis that unfolded in 2008. A large share of bank lending was in foreign currency, which made Hungarian banks vulnerable to exchange rate movements. These exposures were hedged by foreign exchange swaps, but exposed the banks to significant rollover risk in the foreign exchange swap market.

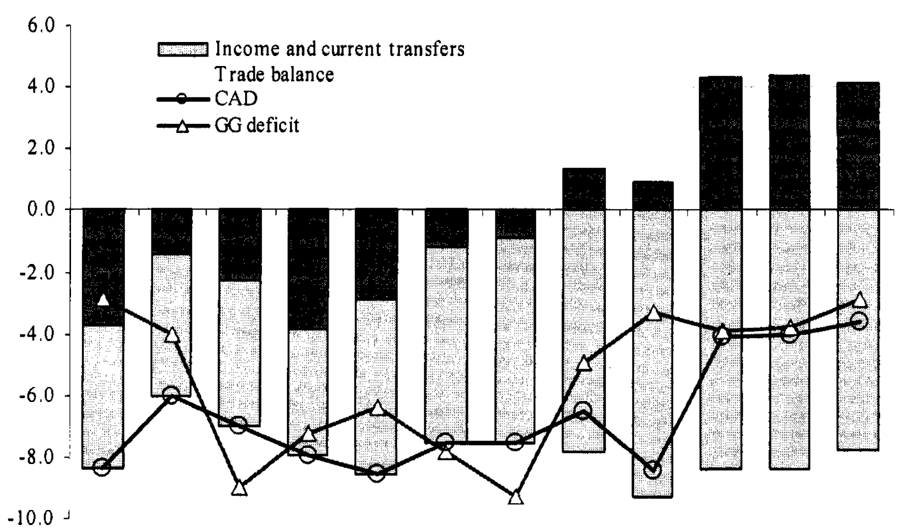
[1] The cyclically adjusted balance shows an even tighter adjustment

[2] The income balance deficit was caused by increased profit remittances plus interest payments.

Table 1. Main Economic Indicators, 2000-2011

	2000-2001	2002-2003	2004-2005.	2006	2007	2008	2009	2010	2011
							IMF forecasts		
Output (real growth rates, in % p.a.)									
	4.7	4.4	4.4	4.0	1.2	0.6	*-6.7*	*-0.9*	*3.2*
	2.3	6.4	2.8	1.7	-1.0	0.4	*-8.3*	*-2.2*	*2.4*
	5.4	8.3	2.8	2.3	-1.9	-0.2	*-6.2*	*-2.5*	*1.0*
Gross Fixed Capital Formation	6.2	6.3	6.9	3.7	1.8	-2.6	*-10.3*	*0.8*	*6.0*
Exports (volume)	15.1	5.1	13.2	18.6	16.4	4.8	*-15.1*	*3.0*	*4.6*
Prices (growth rates, in % p.a.)									
Consumer Prices (average)	9.5	5.0	5.2	3.9	7.9	6.1	*4.5*	*3.8*	*2.8*
Nominal Exchange rate (EUR)	132	248	250	264	251	251	-	-	
Public Finances (in % of GDP)									
Overall Balance	-3.5	-8.1	-7.1	-9.3	-4.9	-3.3	*-3.9*	*-3.8*	*-2.9*
Cyclically Adjusted	-3.1	-7.7	-7.5	-10.4	-5.4	-3.1	*0.4*	*1.6*	*1.6*
Gross Public Debt	53.2	56.9	60.6	65.6	65.9	72.8	*77.4*	*80.4*	*79.1*
External Accounts (in % of GDP)									
Trade balance	-2.6	-3.0	-2.0	-0.9	1.4	0.9	*4.3*	*4.4*	*4.1*
Current Account	-7.2	-7.5	-8.0	-7.5	-6.5	-8.4	*-4.1*	*-4*	*-3.6*
External Debt*	63.5	59.5	71.1	90.5	97.2	119.8	*138.8*	*136.7*	*132.6*

Figure 1. Current Account and General Government Balances as % of GDP



B. The Impact of the International Financial Crisis

11. The international financial crisis first started affecting Hungary and other emerging countries in mid-2007, with the suspension of redemptions from several investment funds in the US. The outflows from the Hungarian equity market and their impact on equity prices

were pronounced and sustained, as shown in Figure 2. The second major shock happened in early 2008, when several negative news in the US (e.g., large bank losses, downgrading of instruments and bond insurers) led to additional contractions of international capital flows, affecting for the first time the Hungarian bond market. As shown in Figure 2, foreign holdings of government bonds declined substantially, sovereign CDS spreads increased, and government bond yields increased significantly above interbank swap rates with the same maturity.

12. The third major shock happened in September 2008, with the collapse of Lehman Brothers. Hungary experienced massive outflows from the government bond market and sovereign CDS spreads increased dramatically. The government debt market eventually became illiquid, as indicated by the high interest swap spreads. During this period, Hungarian banks also experienced net reductions in funding from third party institutions (foreign banks and other investors excluding parent banks), including restricted access to the FX swap market. The lack of access to foreign exchange resulted in a sharp depreciation of the exchange rate and eventually led the MNB to request a €5 billion facility from the European Central Bank. In October, the government requested an international rescue package from the IMF and including the European Commission and the World Bank, in order to restore investor confidence and stabilize financial markets.

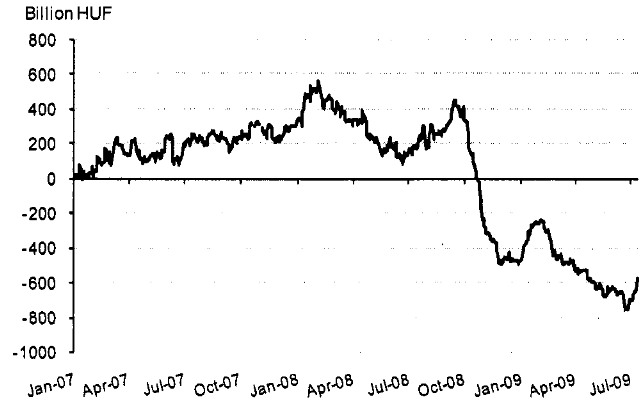
Table 2. Indicators of Vulnerability

	2002-2004	2005	2006	2007	2008
Fiscal indicators					
Balance of general government /GDP (%)	-5.89	-7.8	-9.2	-4.9	-3.3
Primary Balance of the Public Sector /GDP (%)	-1.40	-3.7	-5.3	-0.9	0.8
Gross debt of general government /GDP (%)	55.92	61.7	65.6	65.8	73.0
Foreign Currency to Central Government Debt in (%)	27.89	28.1	28.0	28.7	37.4
External indicators					
Current Account Balance /GDP (%)	-7.58	-7.5	-7.5	-6.5	-8.4
Net Direct Investment /GDP (%)	3.84	5.0	3.2	1.7	3.0
Gross external debt/GDP (%)*	61.81	75.1	90.5	96.9	114.2
Net external debt /GDP (%)*	26.80	34.1	42.2	47.6	53.6
Gross external debt (% of exports) (%)*	92.87	111.0	118.0	121.6	140.5
Net external debt (% of exports) (%)*	40.39	50.3	55.1	59.7	66.0
Short-term External Debt/Total External Debt (%)	14.11	15.1	13.0	14.8	15.2
Gross Reserves/Short-Term External Debt (%)	195.91	155.9	155.4	112.9	130.6
Financial indicators					
Foreign currency deposits/Total deposits (%)**	17.08	14.9	21.1	18.6	18.4
Foreign currency loans/Total loans (%)**	32.97	45.9	49.6	57.2	65.5
Domestic credit to private sector (y-o-y change %)	25.37	18.8	17.3	17.1	19.5
Loan to deposit ratio (%)	107.16	116.9	120.5	129.4	139.2
EMBI Global Bonds Spread (in basis points)	57.15	53.5	71.6	71.9	214.0
Sovereign Credit Default Swap (ave)	43.50	12.5	27.4	20.8	54.8
Sovereign Credit Default Swap (eop)		26.2	20.8	54.8	419.1
Sovereign Debt Ratings: Standard and Poor's (eop)	A-	A-	BBB+	BBB+	BBB

* Including inter-company loans. ** Only commercial banks, end of period.
Sources: MOF, MNB, Morgan Markets, AKK, WB staff calculations

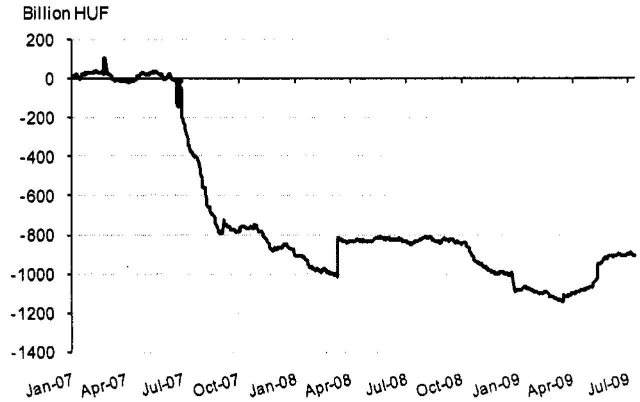
Figure 2. The Impact of the International Financial Crisis (selected indicators)

Cumulated change in non-resident holdings of HUF government securities (Jan 2, 2007 = 0)



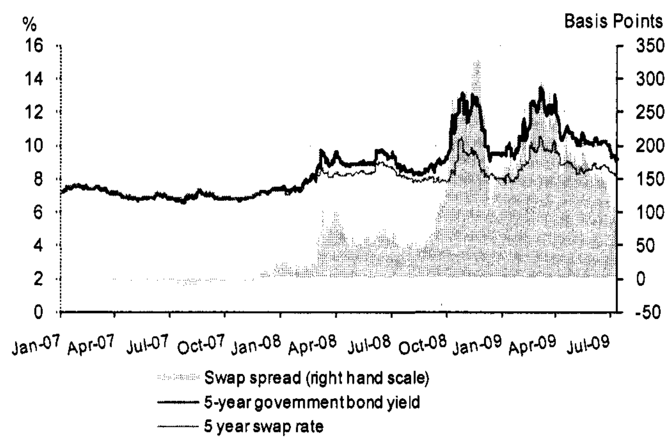
Source: MNB.

Cumulated change in non-resident holdings of HUF equities (Jan 2, 2007 = 0)



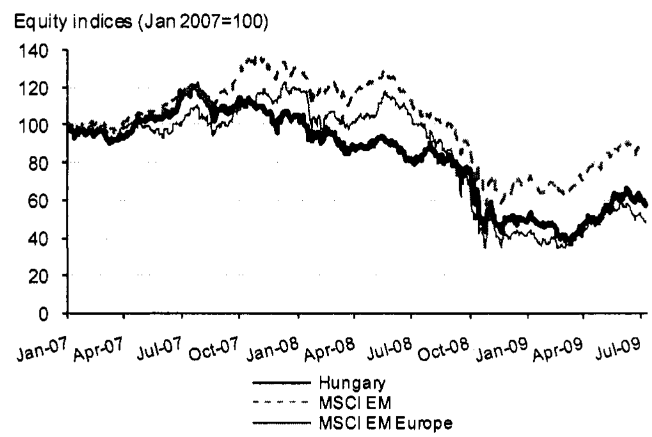
Source: MNB.

5 year interest rate swap spread



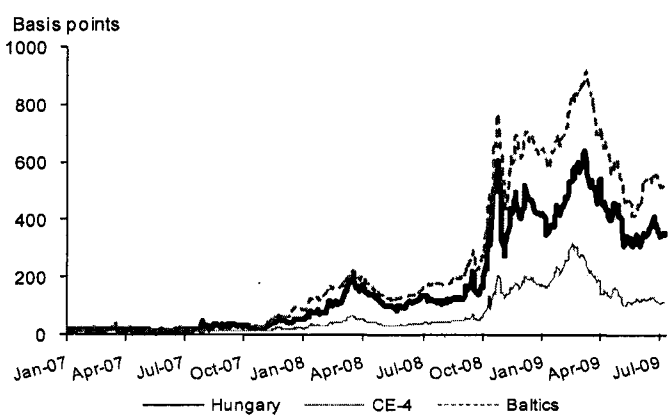
Source: Bloomberg.

Equity indices



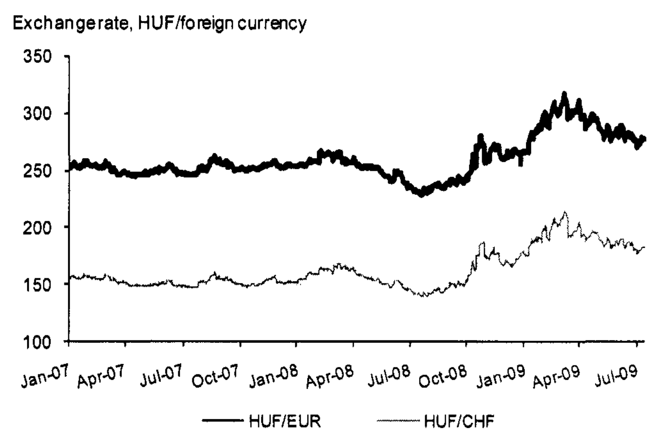
Source: Datastream.

Sovereign CDS spreads



Source: Datastream.

HUF exchange rates



Source: Bloomberg.

13. After moderating at the end of 2008, following the announcement of the IMF-led financial package, financial market stress increased again in the first quarter of 2009 reflecting worse than expected news on the economy, and similar capital flow movements in the region. The depreciation continued until end-March (19 percent decline from end-December to end-March), and the yield of the five year bills in the secondary market and the CDS spread rose quickly in February and March, exceeding their October levels while bond market liquidity deteriorated somewhat (as shown by the higher interest swap spreads, Figure 2). Though parent bank funding of their Hungarian bank subsidiaries remained fairly stable, the non-resident holdings of forint-denominated government securities declined in Q1 2009.

C. Recent Developments and Macroeconomic Outlook

14. Financial market stress appears to have subsided recently thanks to improved global sentiment, sound fiscal policies, combined with the central bank's readiness to maintain interest rate levels and support foreign currency liquidity. The debt management agency (AKK) re-started auctions of the government bonds in April 2009, and in July managed to place a five-year €1 billion euro bond, priced at 395 bps spread above euro mid-swaps. The yield on the benchmark 5-year bond fell from about 13½ percent in March to about 9½ percent in July and the CDS spread fell from more than 600 bps in March to about 300 bps in recent weeks (Figure 2). Conditions in the FX swap market, which banks use to match the currency structure of their liabilities with that of their assets, have also improved. Nonresidents sold about €1 billion of local-currency government securities in Q2 2009, but have become net buyers in recent weeks. The forint appreciated nearly 14 percent by mid-July from an all time low of HuF316/€ earlier in March. Yet, it still remains 15 percent weaker than a year before.

15. Economic activity has contracted significantly since the IMF led program was initially designed, reflecting mostly a larger deterioration of the external environment and tighter lending conditions. Real GDP fell by 6.4 percent year-on-year in Q1 2009 and preliminary data suggest that output continued to contract during the second quarter. Exports, industrial production, and retail sales continue falling, though year-on-year rates of decline have stabilized. Credit growth keeps on slowing sharply, especially due to a marked reduction in new FX lending (mainly Swiss francs, but also Euros) given recent FX risks.

16. The labor market started to react more deeply to the worsening economic conditions than earlier anticipated. The unemployment rate rose to 9.8 percent in the three months to May, compared to 7.7 percent a year ago. Slack demand notwithstanding, rising prices for food and fuel helped increase 12-month headline inflation to 3.7 percent by May 2009 from 3.5 percent in December. Core inflation slowed, however, from 3.8 to 3.2 percent over the same period, as the effects of weak demand more than offset those of forint weakness.

17. The current account has improved dramatically, with the collapse in domestic demand offsetting the effect of weaker growth in partner countries. Sharply smaller income payments to foreign direct investors, stepped-up EU transfers and a decline in import volumes that has been sharper than that of export volumes, has limited the current account deficit to 3 percent of GDP as compared to 8.4 percent for last year. External financing in Q1 2009 was stronger than expected thanks to higher rollover rates for private sector external debt, in particular parent banks, and lesser reductions in other net external flows. Overall, international reserves have increased substantially, leading to an increase in reserve coverage of 89 percent of short term debt by end-March, 2009.

18. The fiscal deficit in the first half of the year was larger than projected. Although fiscal policy has remained geared toward the policy conditions set forth under the IMF program, the sharper than envisaged contraction in economic activity led to some widening of the central government deficit to 3.1 percent of GDP during January to June, 2009, from 2.7 percent a year earlier. On the revenue side, the income tax and social security contribution shortfalls were only partial offset with higher non-tax revenues. At the same time, some mandatory spending (mainly interest payments, unemployment benefits) exceeded expectations.

19. The outlook for 2009 and 2010 is uncertain, as it depends on global events and, crucially, the extent to which investor confidence in Hungary can be restored and maintained. In the baseline scenario, global financial market stresses will gradually abate, which over time should reduce pressures in financial markets in Hungary. However, the global deleveraging may further reduce net capital inflows, slowing down further credit growth in Hungary. Coupled with projected weak EU demand and pro-cyclical fiscal tightening, this will put significant stresses on the domestic economy. After dropping close to 7 percent this year, real GDP looks set to decline another 1 percent next year.

20. Over the medium term, growth is anticipated to recover, and public and external debt to decline, but risks are large. Economic growth is projected to slowly recover starting in 2011 but looks unlikely to be higher than 4 percent a year over the medium term, even assuming a cyclical upturn in Europe. Output prospects have already slipped to about 1 percent, and it is not expected to pick up to 2.5 percent until 2014. Exports should benefit from the increased import demand growth from trading partners, the reduced tax wedge on labor and the net depreciation. Private consumption is expected to resume its growth in 2011, in line with the improvements on the labor market. The moderation of the global financial market stress should support private investment, while fiscal measures under the program support expenditure sustainability. The main risks to Hungary's outlook stem from (i) global developments and (ii) uncertainties about fiscal policy in the future.

21. Although medium term fiscal deficit targets were revised upward, longer-term spending cuts were enacted by the government, with a view toward strengthening fiscal sustainability and helping to contain increasingly adverse government debt dynamics. Deficit targets for this year under the IMF program have been revised from an initial 2.6 percent of GDP, first to 2.9 percent and then to 3.9 percent, offsetting roughly half the reduction in revenues due to weaker activity with measures to trim spending (see Section III). For 2010, a modest reduction of the fiscal deficit as a share of GDP is planned. This would still imply a substantial improvement of the cyclically-adjusted deficit (Table 1). At the same time the authorities have strengthened their commitment to medium-term fiscal sustainability, by introducing a number of structural measures that yield reduction in government spending in the medium-term (Section III).

22. The gross public debt-to-GDP ratio is expected to peak at 80 percent by 2010 before declining gradually to 67 percent of GDP in 2014. However, a steady rise in the primary surplus is essential to keep the government debt-to-GDP ratio firmly on a declining path under a broad range of adverse shocks (Table 3). The Fiscal Responsibility Law, approved by the Parliament in at the end of 2008 (introducing, inter alia, a cap on real public debt levels) will certainly help to ensure the steady decline in the ratio of debt to GDP in the medium- and long-term.

Table 3. Public and external debt sustainability
(in percent of GDP)

	Actual			Projections					
	2006	2007	2008	2009	2010	2011	2012	2013	2014
Baseline: Public sector debt 1/	65.6	65.9	72.8	77.4	80.4	79.1	76.1	71.8	66.9
o/w foreign-currency denominated	18.5	18.5	26.5	32.2	31.7	30	28	25.9	24.1
Change in public sector debt	3.8	0.3	6.9	4.6	2.9	-1.2	-3.1	-4.3	-4.9
Identified debt-creating flows	1.7	-1.1	3.3	5.4	2.9	-1.2	-3.1	-4.3	-4.9
Primary deficit	5.4	0.9	-0.8	-1.0	-0.9	-2.0	-2.6	-3.3	-3.9
Revenue and grants	42.6	44.9	46.3	46.8	46.4	46.3	46.1	45.9	45.6
Primary (noninterest) expenditure	48	45.8	45.5	45.8	45.5	44.4	43.5	42.5	41.7
Automatic debt dynamics 2/	-2.4	-2	4	6.5	3.8	0.7	-0.5	-0.9	-1
Contribution from interest rate/growth differential 3/	-0.7	-0.2	1.5	6.5	3.8	0.7	-0.5	-0.9	-1
Of which contribution from real interest rate	1.6	0.5	1.8	1.5	3.1	3.2	2.5	2.3	2.1
Of which contribution from real GDP growth	-2.3	-0.7	-0.3	5	0.7	-2.4	-3	-3.3	-3.1
Contribution from exchange rate depreciation 4/	-1.7	-1.8	2.6	...	...				
Other identified debt-creating flows	-1.2	0	0	0	0	0	0	0	0
Privatization receipts (negative)	-1.2	0	0	0	0	0	0	0	0
Recognition of implicit or contingent liabilities	0	0	0	0	0	0	0	0	0
Other (specify, e.g. bank recapitalization)	0	0	0	0	0	0	0	0	0
Residual, including asset changes 5/	2.1	1.4	3.6	-0.8	0	0	0	0	0
Public sector debt-to-revenue ratio 1/	154.1	146.9	157.4	165.3	173.3	170.7	165	156.6	146.6
Scenario with key variables at their historical averages 7/				**77.4**	**77.7**	**77.9**	**78.1**	**78.3**	**78.4**
Scenario with no policy change (constant primary balance) in 2009-2014				**77.4**	**85.4**	**87.8**	**86.7**	**84.5**	**82.3**
Baseline: External debt	**90.5**	**97.2**	**119.8**	**138.8**	**136.7**	**132.6**	**127.0**	**118.6**	**116**
Change in external debt	15.4	6.7	22.6	19	-2	-4.2	-5.6	-8.3	-2.6
Identified external debt-creating flows	9.2	4.5	9.5	17.5	5.2	-2.1	-5.8	-6.2	-5.4
Current account deficit, excl. interest payments	4.4	2.9	3.1	-2.4	-3	-3.3	-4.1	-5.1	-5.6
Deficit in balance of goods and services	0.9	-1.4	-0.9	-4.3	-4.4	-4.1	-3.7	-3.7	-3.2
Exports	76.7	79.9	81.6	82.8	86.7	88.2	90.2	93.7	96.6
Imports	77.6	78.6	80.7	78.4	82.3	84.1	86.5	90	93.4
Net non-debt creating capital inflows (negative)	4.1	6.9	4.9	3.7	0	-1.5	-4.3	-3.9	-3.4
Automatic debt dynamics 8/	0.8	-5.3	1.5	16.2	8.2	2.7	2.6	2.7	3.6
Contribution from nominal interest rate	3.2	3.7	5.4	6.5	7	6.9	7.6	8.2	8.8
Contribution from real GDP growth	-3	-0.9	-0.4	9.7	1.3	-4.2	-5	-5.4	-5.2
Contribution from price and exchange rate 9/	0.6	-8.1	-3.4						
Residual, incl. change in gross foreign assets 10/	6.1	2.2	13.2	1.5	-7.3	-2.1	0.2	-2.1	2.8
External debt-to-exports ratio (in percent)	118	121.6	146.7	167.7	157.7	150.2	140.7	126.7	120
Scenario with key variables at their historical averages 11/				**138.8**	**130.5**	**128.0**	**128.1**	**126.0**	**127.9**

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

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/ Public sector deficit, plus amortization of medium/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/ 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

9/ 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

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

11/ 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.

Source: IMF, Second Review Under the Stand-By Arrangement, June 2009.

23. Larger receipts of EU transfers, falling imports and markedly smaller income payments to direct investors are expected to halve the current account deficit in 2009. Subdued domestic demand should keep the deficit modest next year as well.

24. External Debt: The gross external debt (public plus private) is expected to peak at 139 percent of GDP at end-2009 – higher than envisaged in the program in November 2008, mainly due to a weaker exchange rate and lower nominal GDP. Net external debt (derived as the difference between debt-related external liabilities and debt related external assets of residents, as well as end-period derivative positions with negative net present value) is considerably lower than gross debt and is estimated to be 79 percent of GDP in 2009 (up from 54 percent of GDP in 2008). Of this amount, private external debt accounts for around 75 percent of the total (59% of GDP) and public debt only 25 percent of the total (20% of GDP). The external debt ratio is expected to decline over the next few years, as economic growth resumes and the exchange rate mildly appreciates and stabilizes.

25. Total Public Debt: Government gross debt (both domestic and external, combined) is expected to peak at 80 percent of GDP in 2010 and decline thereafter. In the short to medium term, prior to this debt level declining, external financing requirements will remain larger in order to fill the gaps that cannot count on full market access, and to increase the international reserves to levels covering short term debt obligations.

Table 4. Total financin requirements in the program period
(l llions of euros)

	2008 Dec	2009	2008+2009
Total financing requirements	**-0.7**	**-13.6**	**-14.2**
Current account deficit	-2.6	-3.6	-6.2
Financial accounts outflow	2.6	-6.0	-3.4
Direct investment, net	1.5	1.1	2.6
Portfolio investment, net	-5.6	-3.9	-9.5
Other investment	6.6	-3.2	3.5
Bank Guarantee Fund	0.0	-2.4	-2.4
Net errors and omissions	-0.6	-1.6	-2.3
Total financing sources	**0.1**	**1.8**	**1.9**
Capital account inflows	0.1	1.8	1.9
Financing requirement of C/A	-0.6	-11.7	-12.3
Increase (-) in gross reserves	-6.3	0.1	-6.2
Financing gap (IMF/EC/WB)	**-6.9**	**-11.6**	**-18.5**

Main Assumptions:
1/ Banks with foreign parent banks are expected to roll over 80 percent of short-term debt, and others, 70 percent. As a result, short-term financing for banks will be negative in 2009 (following years of large build-up of debt).
2/ 80 percent of FX swaps are expected to be rolled over, recovering to 90 percent in second half of 2009.
Source: IMF, Second Review Under the Stand-By Arrangement, June 2009, Staff Report - Request for Stand-By Arrangement, November 2008.

26. Projections for funding forecast an external financing gap of about €18.5 billion through end-2009 (Table 4) to be covered by the IMF/EC/WB package and consistent with the original program's size. The government's recent bond issue is expected to be used to build up reserves which are likely to be raised beyond that, thus the financing gap may be slightly increased under a prudentially sound scenario. The overall projections remain subject to changes due to the difficulty to forecast current account movements and financial flows with extreme accuracy, including the roll-over ratios of credits from the private sector which had

increased since the start of the crisis and still remain at levels above the September 2008 period prior to the manifestation of financial stresses.

27. Risks to external financing are expected to remain substantial over 2010–11 although recent investor receptivity of the euro market bond issuance in 2009, provides some comfort that the program is favorably impacting external investor confidence levels and future market financing prospects. Based on cautious assumptions, the Bank estimates additional increases in international reserves to levels allowing coverage of 100 percent of maturing short-term debt by end-2011. A further economic downturn is always possible, given the newly revised estimates of close to 7 percent GDP contraction as the basis for the fiscal, debt and financing projections. With signs of an upturn and favorable investor sentiment, a further downside risk appears less likely than perhaps 4-5 months earlier. Hungary's external position and earlier devaluation effects, provide elements of reactivation once external market financing is stabilized.

III. THE GOVERNMENT REFORM PROGRAM

A. The Overall Reform Program

28. As mentioned previously, the Government had already initiated a substantial reform program in 2006, in order to address the imbalances accumulated in previous years and restore investor confidence. However, the financial crisis reduced the overall risk tolerance of foreign investors, and Hungary was still perceived as a high risk country, despite the impressive fiscal adjustment, because of the large foreign and domestic liabilities that had been accumulated.

29. As the financial crisis unfolded and affected Hungary, the Government realized the need to deepen and broaden the reform program, strengthening the fiscal reforms and implementing a financial stability program. The measures that have already been implemented in 2007-2008 and that will be implemented in 2009, can be grouped into four major areas: (i) Consolidation of the fiscal adjustment, combined with structural measures designed to ensure fiscal sustainability in the medium- and long-runs; (ii) a comprehensive financial stability program, designed to address financial risks and ensure a resilient banking system; (iii) pension reforms, designed to stabilize public pension expenditures and prepare the payout phase of the young private system; (iv) health reforms, designed to control health expenditures and reduce the health deficit while ensuring access to health care.

B. Fiscal Reforms

Further Fiscal Adjustments in 2009 and 2010

30. As described in Section II, the Government implemented a fiscal program that reduced the general government deficit from 9.3 percent of GDP in 2006 to 3.3 percent of GDP in 2008. The budget for 2009 is now estimated to result in a budget deficit 3.9 percent of GDP mainly as a result of the sharp downturn in growth. In contrast to previous years, when the adjustment involved expenditure reductions and revenue increases, the adjustment in the 2009 budget relies primarily on expenditure reductions while remaining revenue neutral (Table 5).

31. ***Consecutive Fiscal Adjustments.*** Specific measures initially included in the 2009 Budget bill covered: (i) a nominal wage freeze and the elimination of the 13th monthly salary for all public employees; (ii) the elimination of the 13th monthly pension for early retirees and a cap of the 13th monthly pension to HuF 80,000 (the average pension) for other pensioners; (iii) postponement or elimination of indexation of selected social benefits; (iv) cuts in the public transport subsidy and (iv) across-the-board cuts in other spending allocations to ministries. A second set of measures undertaken during early 2009 have included revenue-neutral tax reforms to reduce the tax wedge on labor and bolster potential growth, including lowering social security contributions, cutting the overall personal income tax, and increasing consumption and wealth taxes.

32. ***Deteriorating Growth Prospects.*** As mentioned in Section II, the contraction of GDP is proving much more severe than projected at the time the 2009 budget was submitted and approved by Parliament. This will imply lower than projected revenues and a larger nominal deficit, given the now projected 6.7 percent contraction in GDP. The nominal deficit would remain somewhat constant moving to 3.8 percent of GDP in 2010, but the cyclically-adjusted

deficit would still decline. These growth and deficit projections, however, imply additional expenditure cuts to be implemented.

33. ***Incremental Expenditure Reductions.*** To adjust to the above conditions, the government will implement additional cuts including a freeze in the expenditures of budgetary chapters, not spending funds received from the sale of carbon credits, elimination of subsidies for farmers above EU agricultural support payments, reductions in subsidies for gas and heating costs as well as pharmaceuticals and the media, an absolute elimination of the 13th monthly salary for all public servants and the 13th monthly pension payment for pensioners, further postponement of the pension correction and planned increases in family allowances and disability pensions, and cancellation of subsidies for new housing purchases. The government also has decided to freeze the public sector wage bill, along with family allowances and social benefits linked to the minimum old-age pension during 2010 and 2011.

Table 5. General Revenues and Expenditures, 2002-09 (in % of GDP unless otherwise indicated)

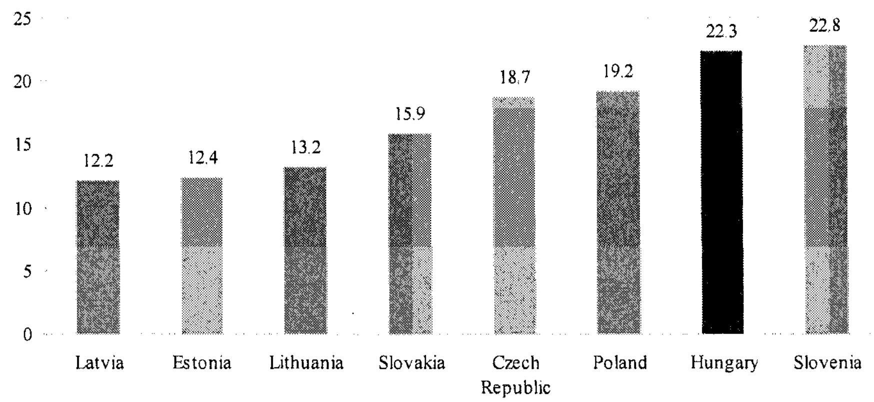
	2002-2003	2004	2005	2006	2007	2008	2009 budget	2009 forecast	2010 forecast
Total Revenue	42.2	42.6	42.3	42.6	44.9	46.5	45.8	46.5	46.4
Total Expenditure	50.3	48.9	50.1	51.9	49.8	49.9	48.4	50.3	50.0
of which:									
Intermediate consumption	6.6	6.4	6.4	7.0	6.7	7.0	6.6	6.9	6.6
Compensation of employees	12.7	12.6	12.6	12.1	11.5	11.6	10.9	11.4	11.0
Interest	4.0	4.4	4.1	4.0	4.0	4.3	4.5	4.4	4.7
Subsidies	1.6	1.6	1.4	1.4	1.4	1.1	1.0	0.9	0.9
Social benefits	16.3	16.9	17.8	18.5	18.1	18.7	18.5	19.3	18.5
Gross fixed capital formation	4.2	3.5	4.0	4.4	3.6	2.8	3.0	3.2	3.7
General Government balance	-8.1	-6.4	-7.8	-9.3	-4.9	-3.3	-2.6	-3.9	-3.8
CAB in % of potential GDP	-7.7	-6.6	-8.3	-10.4	-5.4	-3.1	-1.8	0.4	1.6
Memo item:									
Social spending share (% of total)	*32.4*	*34.5*	*35.5*	*35.6*	*36.3*	*37.5*	*38.2*	*38.4*	*37.0*

Source: Eurostat, IMF, 2009 based on MOF (Report on the measures taken in response to Council recommendation of 10 October 2006under Article 104(7) of the Treaty, May 2009), staff calculations.

34. Despite the substantial consolidation total expenditures will remain high, at about 50 percent of GDP. Social spending has increased during the decade, both as a share of GDP and as a share of total expenditures (Table 5). Social spending is high by comparison with other new EU members (Figure 3), suggesting the scope for further reforms in this area.[3] The government has started to address this issue through specific reforms in the pension and health areas (examined in greater detail below). The government has also committed and implemented various measures intended to improve the financial sustainability of the social support system (including the tightening of eligibility criteria and improved targeting of benefits) and providing more incentives for work and employment.

[3] The differences between social spending figures in Table 5 and Figure 3 are due to different definitions used in ESA 95 and ESSPROS.

Figure 3. Social Expenditures in Hungary and Other CEE Countries (% of GDP), 2007



Structural Reforms in the Fiscal Area

35. ***The Fiscal Responsibility Law.*** In November 2008, the Hungarian Parliament approved a key piece of legislation – the Fiscal Responsibility Law (FRL). The FRL includes a number of institutional mechanisms designed to ensure long-run fiscal sustainability. The policy rules set for the central government include: (i) from 2012, a basic rule establishing that public debt cannot increase in real terms; (ii) during a transitory period (2010-11), a rule establishing that the growth in real primary expenditures cannot exceed half the projected growth of real GDP; (iii) safeguards assuring that expenditure increases can be only be proposed if their 'worsening effects' can be offset by cutting other expenditures or increasing revenues.

36. ***A Fiscal Council.*** The FRL also establishes a fiscal council, consisting of three experts[4] and a secretariat with a mandate to report directly to the Parliament providing an independent view on budget projections and forecasts. The Council, which should be fully operational by the end of 2009, will prepare macroeconomic forecasts and projections of budgetary aggregates, assess the budgetary impact of draft legislation, and make recommendations on corrective measures. The government has committed to ensuring an adequate budgetary allocation during the first year of the establishment of the Council after which subsequent allocations will be decided by the Parliament directly based on Council proposals.

37. ***Debt Dynamics under the new Law.*** The FRL is expected to strengthen fiscal discipline in a fundamental way and ensure that public finances are put on a sustainable path. The most important component of the Law is arguably the rule that stipulates that real public debt cannot increase. This will ensure that the ratio of debt to GDP declines at the rate of real GDP growth. Assuming that real GDP will increase at 3 percent p.a. from 2012 on, this rule implies that the ratio of debt to GDP will decline from about 80 percent in 2010-2011 to at least 60 percent of GDP in 2016.

38. ***The Law on the Legal Status and Management of Budgetary Institutions***. In December 2008, the Hungarian Parliament approved another important piece of legislation –

[4] Its members have been nominated by the President of the Republic, the Governor of the central bank and the head of the State Audit Office, and are expected to be appointed by Parliament.

the Law on the Legal Status of Budgetary Institutions. The new Law will strengthen public sector efficiency by providing increased management autonomy for budget-dependent units, agencies and institutions as part of their charters, while stressing performance and efficiency in operational performance and financial management. Differentiated regulatory frameworks may be approved, and institutions will be differentiated by the nature of their activities. For instance, agencies responsible for public services (hospitals, universities, museums) would have regulations closer to those of the private sector.

39. ***Norms and Controls under the Legal Status Law.*** The increased autonomy awarded under the Legal Status Law would allow greater independence in operational strategy and budgetary decisions (including generation of own fee-based revenues for enhanced or expanded services) and lead to increased public sector productivity and higher quality provision of public services. However, for public sector agencies wishing to become more autonomous in their operations and funding, they will require review and approval of their business plans at the Ministerial levels and will be subject to monitoring as part of the budget execution process, particularly in those cases where reductions of debts or contingent liabilities constitute a pre-requisite for institutional reforms. The government in addition, for all public sector entities being allocated budgets, will issue a new Decree specifying the rules for budgeting and results measurement as part of the implementation of the law, and the quantitative objectives for attaining more efficient and cost effective management of public sector institutions.

C. The Financial Sector Stability Program

The Situation of the Banking System before the Crisis

40. The Hungarian banking sector comprises 31 commercial banks and 5 specialized banks. The sector grew very rapidly during the decade, and total assets exceed 100 percent of GDP, as shown in Table 6. The banking sector's market share has remained relatively stable and dominates the financial sector, accounting for 70 percent of total financial institution assets. Common with many other CEE countries, the banking sector is concentrated, with the 8 largest banks controlling more than 75 percent of total banking assets. Due to extensive privatization in the 1990s, the banking sector is dominated by subsidiaries of large multinational banks based in EU states. However, the largest bank (OTP), accounting for more than 20 percent of banking assets, is considered a domestic bank despite being owned primarily by foreign investors since it does not have any majority strategic foreign investor.

41. As shown in Table 6 below, the balance sheet of the banking system is characterized by six major features:

- High loan to deposit ratios (exceeding 150 percent) and high ratios of borrowings to total liabilities (45 percent). These ratios reflect a pattern consistent with other CEE countries, which have financed rapid credit growth in recent years through borrowings, especially from foreign sources;

- High level of dependence on funding from foreign parent banks, with parent-provided funding amounting to about 50 percent of total non-deposit borrowings;

- A high proportion (70 percent) of all lending denominated in foreign exchange (FX), primarily in Swiss Francs, resulting in a significant level of FX mismatch, with FX-denominated assets amounting to around 130 percent of FX liabilities;

- Only moderate levels of liquidity, with short-term liquid assets equal to approximately 15 percent of total assets;

- High levels of profitability and capital as indicated by a an average return on equity (ROE) of between 11-16 percent and a total capital ratio of over 11 percent;

- Given the rapid growth of the system over the past five years, unusually low levels of classified assets with only 3.3 percent of loans adversely classified.

42. The rapid growth of credit and past high levels of profitability are not surprising given that banks expanded their new business lines (mortgage, consumer, SME lending) from a low initial base. However, the levels of classified assets (and corresponding provisions) appear low given the rapid credit growth and the resulting accumulation of risks. The high proportion of FX loans has been an element of concern for some time. While banks have substantially closed their FX exposure through the swap market, the credit risk created through extending FX loans to households and SMEs with little or no hedging capacity, remains.

43. Recent years have seen lending standards increasingly relaxed in the face of escalated competition for volume and yield. Although such trends appear to have recently slowed or stopped, they embedded themselves in higher loan-to-value (LTV) ratios, declining customer creditworthiness, and the use of lending through bank agents. Many retail customers in recent years emanated from the lower income category, and therefore, possess a thinner cushion to absorb escalating loan payments as a result of FX movements.

44. Furthermore, mortgage loan sales through broker-intermediated channels escalated with approximately 55 per cent of mortgage based loans sold by brokers in 2007, up from 30 percent in 2005. Credit distributed through such channels has historically performed significantly worse than that distributed through traditional branch networks.[5] Finally, banks are exposed to a downturn in the economy and its implications for debt repayment capacity. These and other weaknesses became apparent in 2008-09, with the unfolding of the international financial crisis.

[5] MNB Report on Financial Stability; October, 2008, pg. 45.

Table 6. Basic Indicators of the Banking Sector, 2007 – 2009

Item	December 31, 2007			December 31, 2008			May 31, 2009		
	Largest 8 Banks	Other 28	TOTAL	Largest 8 Banks	Other 28	TOTAL	Largest 8 Banks	Other 28	TOTAL
Liquidity									
Cash, Trading Sec, Dep./All Assets	14.5%	24.1%	**16.8%**	12.8%	16.2%	**13.5%**	15.0%	17.2%	**15.5%**
Loans/Deposits	138.2%	241.9%	**153.0%**	144.8%	294.3%	**162.7%**	142.0%	373.0%	**161.7%**
Funding Structure									
Total Borrowing/Total Liabilities	38.3%	62.1%	**44.1%**	40.1%	65.4%	**45.8%**	41.2%	73.4%	**47.5%**
Short-term borrowing/All borrowing	49.2%	44.4%	**47.5%**	49.6%	35.1%	**44.9%**	47.8%	39.7%	**45.4%**
Parent Banks/Total Borrowing	43.4%	38.1%	**41.6%**	55.6%	39.6%	**50.5%**	56.4%	35.3%	**50.0%**
Foreign Currency Exposure									
FX Loans/Total Loans	67.4%	48.9%	**63.2%**	74.6%	61.3%	**71.7%**	75.3%	62.4%	**72.7%**
FX Assets/FX Liabilities & Capital	135.1%	101.6%	**127.2%**	134.2%	115.4%	**130.3%**	130.2%	118.0%	**127.9%**
Capital									
Equity/Total Assets	8.6%	7.2%	**8.2%**	7.7%	6.8%	**7.5%**	8.0%	7.4%	**7.9%**
Tier 1 Capital Ratio	9.1%	21.1%	**10.7%**	8.5%	13.2%	**9.3%**	9.1%	13.9%	**9.8%**
Total Capital Ratio	9.9%	23.1%	**11.6%**	10.7%	14.2%	**11.2%**	11.3%	14.6%	**11.8%**
Portfolio Quality									
Share of classified assets[a]	2.51%		**2.42%**	2.93%	2.73%	**2.88%**	3.49%	2.72%	**3.34%**
Profitability									
ROE	18.3%	12.2%	**17.0%**	10.6%	12.9%	**11.1%**	15.6%	17.1%	**15.9%**
Provisions/Operating Revenues	9.7%	10.1%	**9.7%**	14.2%	11.5%	**13.7%**	27.9%	23.7%	**27.2%**
Share of Total Bank Assets	76.2%	23.8%	**100.0%**	78.0%	22.0%	**100.0%**	81.0%	19.0%	**100.0%**
Total Bank Assets/GDP[b]	73.2%	22.9%	**96.1%**	86.0%	24.3%	**110.2%**	91.6%	21.5%	**113.2%**

a. Data in end-May column, for this item, is as of March 31, 2009.

b. GDP data in end-May column is based on HNB estimated for 2009.

Impact of the Financial Crisis on the Banking Sector and Initial Responses

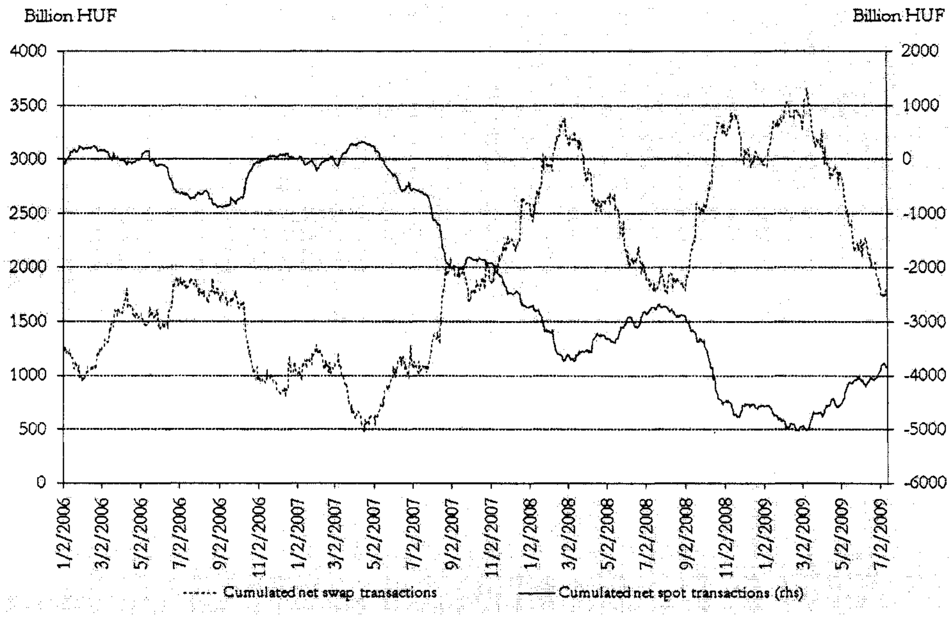
45. Hungary started being affected by the crisis in mid-2007, with large outflows from the equity market and a sharp drop in stock prices. However, the banking system was not significantly affected in these initial stages. The exchange rate at first remained broadly stable, banks retained access to FX funding (including FX swaps), and the domestic markets remained reasonably liquid, including the domestic government debt market.

46. However, during late 2008 the banking system was progressively affected by the crisis. The massive outflows from the government debt market and the resulting lack of liquidity impacted banks significantly given the size of their securities portfolios and the importance of these for liquidity management. Non-deposit funding substantially reduced in tenor or exited, and most importantly, banks experienced increasing difficulty in accessing FX funding from external third party financial institutions, including the FX swap market. The foreign-owned subsidiaries began to rely more heavily on their European parents, while the domestic banks experienced greater difficulties given their greater dependence on wholesale funding.

47. In response to the increasingly tight FX availability that the banking sector was experiencing, the Hungarian authorities took steps to restore systemic liquidity with additional facilities. To illustrate, from mid August to early November, for example, spot market trading

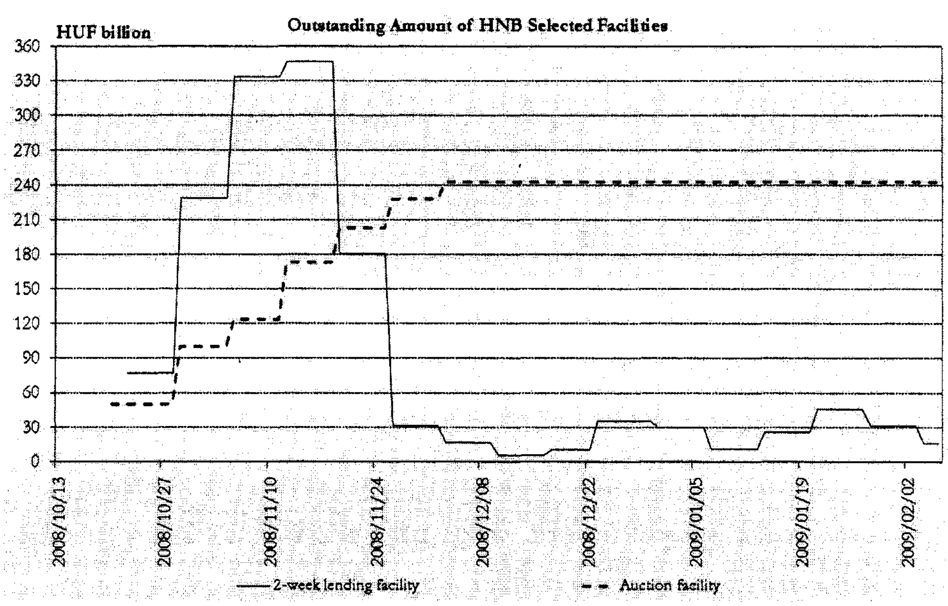
of FX used by Hungarian banks to fund loans, decreased by over US$ 6.0 billion equivalent while during the same period the FX swap market supported by the MNB as a last resort supplier, increased by about US$ 8 billion (Figure 4).[6] After a small decline, the FX swap needs rose again in April 2009.

Figure 4. Hungary – Banking FX Markets



48. In addition to the provision of FX, the Government and the MNB also offered additional funds through the overnight deposit facility which increased by almost US$ 3 billion equivalent. MNB's short term credit facilities increased lending to the banking sector by US$1.4 billion equivalent (Figure 5).

Figure 5. Use of MNB Liquidity Facilities



[6] A similar FX shock (though slightly less pronounced) had already occurred during March 2008, coinciding with the Bear Stearns bail-out in the U.S.

49. Additional actions taken by the MNB to increase bank liquidity included decreasing deposit reserve requirements by an overall US$1.7 billion equivalent to provide immediate cash liquidity. The MNB also increased liquidity through monetary operations by purchasing some US$1.2 billion equivalent in government bonds. However, the volatility and funding scarcity generated worries that the global crisis would continue disrupting FX funding. To prevent such a scenario, the MNB entered into an agreement with the ECB to avail itself of a €5 billion FX liquidity line, based on a collateralized repo facility, to ensure access to foreign exchange by domestic banks.

The Government Reform Program for the Banking System

50. The measures taken by the authorities have been consistent with crisis responses seen in other EU countries but with added elements. The full package of measures including those developed by the Bank with the authorities under the proposed loan, are shown in Table 7. These include: (i) measures to assure access to short term liquidity both in foreign and domestic currency; (ii) increased deposit insurance protection; (iii) a debt guarantee fund facilitating access to longer term debt based (non deposit) funding; (iv) a capital enhancement fund for strengthening the levels of bank capital; and (v) strengthened forward-looking supervisory powers and sector diagnostic tools.

51. Some of these measures have already been introduced through new legislation, including the Financial Stability Law, approved by Parliament in December 2008 that introduced the debt guarantee and capital enhancement funds (items iii and iv, above). Foreign exchange liquidity access (item i) was arranged through agreement with the ECB establishing a collateralized repurchase (repo) facility with the MNB.

Table 7. Main Components of the Financial Stability Program

Instrument/Policy Mechanism	Characteristics
Liquidity support to banks a. 2-week lending facility b. 6-month lending facility c. Foreign exchange (FX) facility d. Collateral	a. Fixed rate repo-based collateralized facility for HuF liquidity b. Variable rate (auction based) collateralized facility for HuF c. Repo-based collateralized FX facility of up to €5 billion agreed with the ECB to provide liquidity to MNB's overnight FX swap facility d. Increased flexibility in expanded use of securities as collateral including covered mortgage bonds, for borrowing from MNB
Deposit Insurance Coverage Increased level of government guarantee of deposits (payable by the deposit insurance fund (DIF)). Increase in capital of the DIF	Increase of coverage for depositor funds per bank from €20,000 to €50,000; removal of co-insurance (initial loss sharing component); subsequent announcement of overall blanket coverage for all deposits. Deposit insurance premium increased from 0.9 to 2 basis points.
Guarantee Fund (GF) Facility to guarantee honoring of new financing from third party funding for banks (interbank loans, issued wholesale securities) or for roll-over financing	HuF 300 billion (US$ 1.4 billion) allocated to the Fund from multilateral proceeds to be invested in euro-denominated bonds. Eligible maturities from 3 months to 5 years. Eligible banks to apply for facility by end-December, 2009.
Recapitalization Fund (Capital Base Enhancement Fund – CBEF) Facility for injecting new equity into banks with potential need for capital enhancement	HuF 300 billion (US$ 1.4 billion) funding allocated. Government would invest in two classes of preferred stock: (a) one class has dividends earning 1-year government bond yield plus 2%, (b) second class allows government Board representation and veto over key decisions. Applications may be voluntary or initiated by the State.
Strengthened Bank Regulation and Supervisory Powers Amendments to Stability Law and the HFSA Law to be undertaken, giving supervisory authority powers to obtain exceptional information from banks (Stability Law) and powers to engage in early preemptive actions (HFSA Law) to correct perceived deterioration in banking institutions' financial conditions. Supervisory program in 2009 is substantially strengthened by intensified inspections of the largest institutions with the objective of ensuring long term solvency and systemic stability	a. Supervisory authority provided, with powers to demand ad hoc special financial reporting from banks in fragile situation, to extend inspections for up to one year, and to hire forensic auditor to participate during inspection process. b. Supervisory authority to be provided, to execute forward-looking proactive actions to preempt distress at the banking systemic level by implementing across-the-board measures for maintaining stability. c. Corrective actions to be defined, applying to individual banks (based on deteriorating indicators or risky practices). d. Loan classification and provisioning norms to be revised to reflect proper accounting treatment and provisioning for rescheduled, renegotiated and refinanced loans. e. Intensified site inspections initiated to evaluate balance sheet & credit portfolio condition of banks and identify required adjustments to capital or provisions. f. Scenario stress testing exercises initiated to project asset quality and asset servicing capacity for bank portfolios given anticipated economic slowdown, and financial risks.

52. ***Provision of Liquidity***. Given the increasing tightness witnessed in the local currency HuF interbank and deposit markets, the MNB increased the availability of HuF liquidity through a new two week term lending window and a six month auction-based lending facility.

These were assisted by broadening the types of acceptable collateral instruments, to include securities such as covered mortgage bonds. In addition, an agreement with the ECB was entered into for the ECB to provide the MNB with foreign exchange arrangements of up to € 5 billion (US$ 7 billion), backed by a collateralized repo facility, to support foreign exchange demand from domestic banks using FX to fund their balance sheet assets given the drying up of the offered supply in the market.

53. ***Deposit Insurance***. Deposit insurance coverage was more than doubled in the fourth quarter of 2008, in line with EU standards, and a broad blanket guarantee for all deposits was announced. The Deposit Insurance Fund (DIF) increased the premium from 0.9 to 2 basis points to increase the level of reserves in line with the increase in the insured deposit base.

54. ***Guarantees of New Bank Debt.*** The Debt Guarantee Fund (GF) was established by the new Financial Stability Law to provide guarantees of third party funding given to banks, such as interbank credits or bank-issued securities used for rolling over or refinancing domestic banks' funding needs, or new funding (mainly to complement short term funding, with medium and longer term funding). This measure is meant to assure ongoing, more sustainable liquidity sources for banks' liabilities given the current market uncertainties.

55. ***Capital Support.*** The Capital Base Enhancement Fund (CBEF) was established by the new Financial Stability Act to inject new equity into banks that may need a stronger capital cushion. The government would be a shareholder of the new capital and in some cases would have special powers (see table above). Banks may voluntarily apply for capital assistance or capitalization may be initiated by the State based on the authorities' assessment of risks and capital condition. The Financial Stability Law sets forth the conditions which trigger the government's exit as shareholder of an institution.

56. Decisions on bank applications to use CBEF funds are made by a tri-partite financial stability committee represented by the MoF, MNB, and the HFSA, using criteria related to systemic impact. Specific bank indicators and parameters will be detailed within individual agreements between the government and participating banks. The GF will be available for banks without a need to apply for a capital injection. Any portion of unused funds from the CBEF not committed by December 2009 will be transferred to the GF. The government has the option of returning to Parliament for authorization to provide additional funds to the GF should they be needed.

57. ***Agreements for Continued Foreign Parent Bank Funding***. In addition to the above measures, a non-binding but written confirmation from foreign bank parents of domestic banks was provided to the government and central bank via letters of comfort, stating that parent banks will continue to provide inter-company funding to their Hungarian subsidiaries. Similar agreements have also been established at the regional level via the IFI representatives' meeting in Vienna during March 2009 establishing this protocol. While the government has established new liquidity facilities in case of funding shortages, the agreement with parent banks is essential to maintain stability, given that a withdrawal of parent bank funding (in the form of loans or deposits to Hungarian subsidiaries) would imply large funding gaps in the entire system.

58. ***Assessment of Parent Bank Funding Risks***. The main western European parent banks, however, besides the letters of comfort submitted to the authorities, appear fully committed to support the Hungarian market in which their subsidiaries operate. Not only does

the Hungarian market represent a significant portfolio of their financial group assets, but a withdrawal from this relatively high end market would send adverse signals toward other neighboring countries with greater or lesser financial problems and could accelerate a contagion process through the region. While Hungary's economic issues were initially fiscally driven, besides the expected GDP contraction, Hungary's banking sector had not experienced a credit boom as in other countries, and therefore over-extension of credit exposure does not represent a fundamental issue in the banking asset structure. In this sense, maintenance of parent bank investment and funding makes sense, particular in light of the supporting multilateral program that provides the additional funding cushions.

59. ***Initiatives to Alleviate Borrower Stress***. To address the potential impact of a depreciation of the exchange rate on households who only have domestic currency income, the government also sponsored an agreement with the banking sector, whereby the banks may convert FX-denominated loans to borrowers into HuF loans without a penalty, and capitalize the increase in mortgage payments arising from the conversion for creditworthy borrowers.

60. ***Strengthening Bank Regulation and Supervisory Powers.*** In collaboration with the Bank, the Government is taking steps to ensure the long term stability of the banking system by strengthening bank regulation and supervision. A key feature of this effort is to provide the HFSA enhanced tools and authority (while using powers necessary to apply pillar 2 of the Basel II Capital Accord) to identify and act promptly on deteriorating developments in bank conditions and proactively address systemic risks.

61. To put into effect these new measures, the Government included as part of the Financial Stability Law initial discretionary measures allowing the HFSA to require more extraordinary financial reporting from banks being closely monitored, as well as allowing examinations of such banks to be extended for up to one year, if needed to more closely monitor potential effects on stability. As well, these amendments permit the HFSA to contract qualified auditors to accompany inspections under such cases, in order to critically assess or detect risky bank practices.

62. The Government will also submit to Parliament amendments to the HFSA Law (currently being drafted) to enhance the capacity of the HFSA to take preventive action. As per the table above, the reforms include:

- Allowing the HFSA to take proactive action to preempt financial distress at the systemic level by mandating actions applicable to all affected financial institutions.

- Granting the HFSA new powers under its Law to take supervisory actions to ensure that corrective actions are taken by banks where risks are increasing (e.g.: as related to solvency, portfolio quality, business lines, liquidity, credit assessment procedures, risk management systems, and other).[7] This includes the authority to issue cease and desist orders and require strengthening plans to be undertaken by banks.

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[7] For example, wile Hungary's exchange rate has stabilized recently, during the recent short period of depreciation, worries were also raised about banks' high shares of lending in foreign currencies (75 percent of all loans) to domestic borrowers, and the borrowers' abilities to repay in the event of a sharp and permanent depreciation.

- Modifying a Government Decree for accounting reporting purposes, on the classification and corresponding loss provisions, regading the treatment of restructured, rescheduled or renegotiated loans so as to better reflect underlying portfolio risks loan expected values.

63. ***Enhanced Supervisory Monitoring and Intensified Examinations.*** In order to effectively apply supervisory corrective actions, the HFSA requires an in depth understanding of banks' condition, particularly of their underlying credit quality. For this purpose, a 2009 Supervisory Plan for the HFSA was prepared with a special focus on the on-site verification of banks' safety and soundness and enumerates the assumptions used to drive internal risk models. The Plan requires intensified on-site inspections for the eight largest banks, and is based on comprehensive TORs agreed with, in collaboration with the Bank. This commenced in the second quarter of 2009.

64. The above inspections will evaluate, on a consolidated basis, the asset quality, adequacy of loan loss provisions and reserves, collateral values, intercompany transactions, solvency capital, and governance, and calculate required adjustments to capital and provisions as needed. Following completion of the exercise, and by end of the third quarter, the HFSA will require banks to adjust their financial statements, provisions and capital, in line with the results of such inspections or mandate corrective actions for such purpose.

65. ***Stress Testing Exercise.*** An additional tool to be implemented by the MNB with collaboration of the HFSA will include conducting stress test "scenario analyses" for individual banks in order to project future balance sheet strength. This will be using economic and financial projections such as Hungarian and EU GDP growth figures, employment and disposable income projections (e.g.: for debt servicing purposes), as well as foreign exchange and interest rate movements affecting borrower capacities to repay. Such analyses will be used to estimate potential impacts on banks' credit portfolios with a view to establishing under what scenarios banks will need to adjust their provisioning and capital requirements. These and the above measures will permit the government to address financial system risks before they become problematic, and thus improve financial stability.

66. ***Additional Mechanisms for the Resolution of Troubled Banks.*** The Government has also begun an initiative to tackle legal amendments dealing with the treatment of troubled bank assets and liabilities in a pre-bankruptcy, but unstable situation. The objective is to reduce major bank losses and minimize the financial outflows from the State or the Deposit Insurance Agency under bank failure cases. This involves the potential use of supervisory authority powers to transfer viable assets with matching deposits and liabilities, to sound banks with an interest and capital capacity to absorb such. Other mechanisms may include creating a new "clean" bank to achieve improved solvency or a bridge bank whose new balance sheet can later be converted or sold to an existing institution. These issues are legally complex in the Hungarian legislative and constitutional framework where private property rights need to be fully protected under any such process. The Ministry of Finance will submit a legislative proposal to the Government Cabinet on this matter for approval as a new legal amendment to the HFSA Law and/or related financial sector laws.

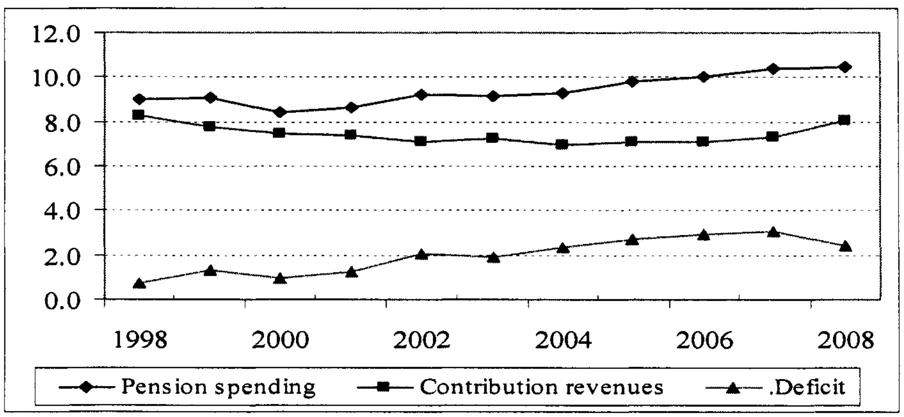
D. Pension Reforms

Development of the Public Pension Scheme after the 1997 Reform

67. The Hungarian pension system underwent a structural reform in 1997, when the public pay-as-you-go (PAYG) system was subjected to substantial parametric reforms and the second pillar was introduced. The reform greatly contributed to a more balanced pension system, but it was clear at the time of the reform that demographic developments would reintroduce pressures on the pension system in the longer-run. The relatively benign demographic environment of the first two decades was expected to be used to reform further the PAYG pillar, so as to absorb future demographic shocks and enable some reduction in contribution rates, which were high at 31 percent of gross wages.[8]

68. The actual evolution of pension system finances after the reform is presented in Figure 5. The ratio of pension expenditures to GDP initially declined in line with projections made at the time of the reform, but increased again as result of the failure to substantially raise the effective retirement age, and several benefit increases. These included an extra 3 percent increase in pensions in 2001; an extra permanent increase in pensions by HUF 19,000 in 2002; and one extra week of benefit added in each year between 2003 and 2006, culminating in a 13[th] pension worth 4 weeks of benefits; and some additional targeted benefit increases for retirees unfairly treated by the pension system in the past.

Figure 6. PAYG expenditures, revenues, and balance as % of GDP



69. While expenditures increased, revenues declined due to cuts in contribution rates not planned at the time of the reform – from 31 percent of wages in 1997 to 26 percent in 2002. As a result, pension deficits grew steadily to 3 percent of GDP in 2007 and the demographic dividend of the last decade never materialized in pension finances. As fiscal pressures started to build, contribution rates were raised to 29.5 percent in 2006 and 33.5 percent in 2008 (although this last increase was due to the transfer of health contributions to the pension scheme). The increase in revenues was not sufficient to halt the increase in deficits until 2007 (Figure 6), prompting the government to initiate a number of reforms in 2007 and 2008.

[8] See Palacios and Rocha: "The Hungarian Pension System in Transition", in Bokros and Dethier (1999), and Rocha and Vittas: "A Preliminary Evaluation of the Hungarian Pension Reform", in Feldstein and Siebert (2002).

Ongoing Reforms to the Public Pension System

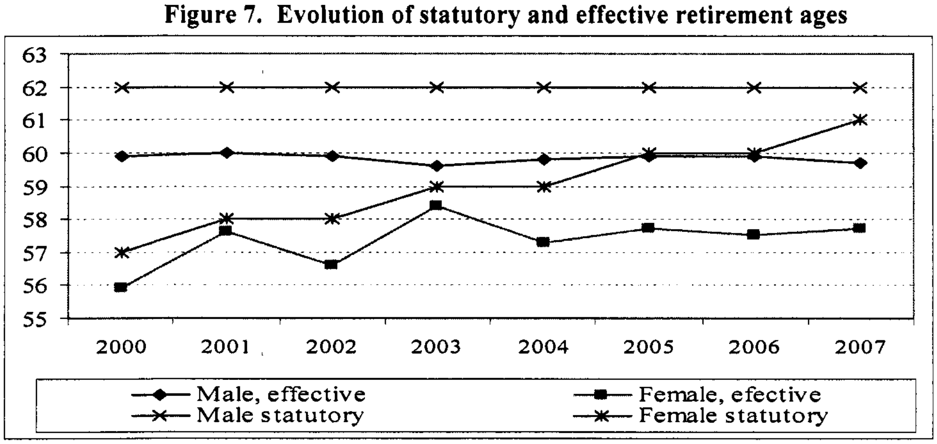
70. By the time financial crisis had hit Hungary at the end of 2008 the government had already started addressing the imbalances of the pension system generated in recent years. The major areas of reform included efforts to restrict early retirement in order to increase effective retirement ages and a set of other measures directed to control expenditures like levying contributions on working pensioners, reducing newly awarded pensions, and limiting spending related to the 13^{th} pension. In addition, the government also started preparing the regulation of the payout phase of the new second pillar, which is scheduled to start in 2013.

71. Facing strong fiscal pressures generated by the financial crisis, and realizing that pre-crisis reforms were not sufficient to put the pension system on the fiscally sustainable path the government passed another strong package of pension reforms in the first half of 2009. They included increase in statutory retirement age, permanent abolition of 13th pension, and new indexation rules that tie the pension indexation parameter to GDP growth resulting in slower increase in benefits when GDP growth is subdued.

72. **Increasing the effective retirement age.** The 1997 reform included a gradual increase in the statutory retirement age from 57 and 60 for women and men, respectively, to a universal retirement age of 62. As shown in Figure 7, the statutory retirement age of men reached this level in 2000, and that of women in 2009.

73. However, early retirement eligibility rules remained the same during this period (minimum career length of 33 and 38 years for reduced and regular early retirement pensions, respectively), which greatly decreased the effect of the reform on effective retirement ages. Figure 7 shows that the gap between statutory and effective retirement ages has remained the same for men, and has actually widened in the case of women, as more and more women have retired through the early retirement program.

Figure 7. Evolution of statutory and effective retirement ages



74. To discourage early retirement, the government amended the pension law with the following measures legislated over the 2007-2008 period:

- suspension of pension payments for employed pensioners aged under 62 except for minimum wage workers (applies to new retirees from January 2008 and will apply to existing retirees from January 2010);
- tighter eligibility requirements: from 38 and 33 years of service for regular and reduced

early retirement pensions, to 40 and 37 years of service, respectively (will apply from January 2010);

- increasing penalties for early retirement and bonuses for postponed retirement (penalties will apply from 2011 in the case of men and from 2013 in the case of women).[9]
- In addition, statutory retirement age was again set to gradually increase starting in year 2012 and reaching age 65 by the year 2021.

75. **Other tightening measures.** To further address fiscal pressures in the pension fund the government has implemented the following additional measures:

- reduction in newly awarded pensions by about 8 percent through changes in net wage base calculations (applies from January 2008);
- levying of pension contributions on wages of working pensioners (applies from January 2008);
- immediate elimination of the 13th pension for all retirees starting from July 1, 2009;
- switching to price indexation of benefits in low growth environments (GDP growth below 3%) while gradually increasing indexation generosity until it reaches the more generous "Swiss" indexation rule at GDP growth rates above 5%.[10]

76. The reduction in newly awarded pensions is justified from both fiscal and equity perspectives, as the cohorts that started to retire in the last 4 years have retired with markedly higher pensions compared to older retiree cohorts. This one time shift to higher pensions will be partly reversed by the new policy, resulting in comparable pensions of older and younger retirees.

77. Levying contributions on working pensioners is also justified. Many countries go even further and exclude the possibility of collecting pensions and wages at the same time. The policy is based on the principle that a pension is a compensation for the lost capacity to earn income, rather than entitlement to a benefit stream at a certain age.

78. From the very beginning the 13th pension represented a departure from the social insurance principle upon which the 1997 reform was built. It constituted effectively an unfunded bonus that has benefitted all pensioners, regardless of income and need and has constituted an especially heavy fiscal burden for the pension system. Its elimination is expected to generate immediate annual savings of about 0.7 percent of GDP.

79. Finally, changes in pension indexation rules present a reasonable compromise between protecting fiscal sustainability of the pension scheme and providing an opportunity for the pensioners to partially benefit from fast economic growth when it occurs. Even under the new rules, purchasing power of pensioners remains fully protected while the gap between wage and pension growth is prevented from increasing drastically.

[9] As expected, the reform provoked a wave of early retirement in 2007 temporarily boosting pension expenditures, but the number of pension applicants dropped to trend levels in 2008, ensuring future fiscal gains.
[10] Under "Swiss" indexation rule pensions are increased to the average of price and wage growth.

Projected Expenditures and Balances of the Pension System

80. The lower solid line in Figure 8 represents the projected path of pension deficits of the public PAYG component of the pension system.[11] Although these projections are less than one year old, a drastically different macroeconomic environment and important pension reforms in 2009 have made them dated now. New projections are expected to be prepared in the fall of 2009 and meanwhile approximate calculations by Bank staff based on the recent parametric reforms, are available to adjust these original calculations to the new realities which are presented as dotted lines in the figure.

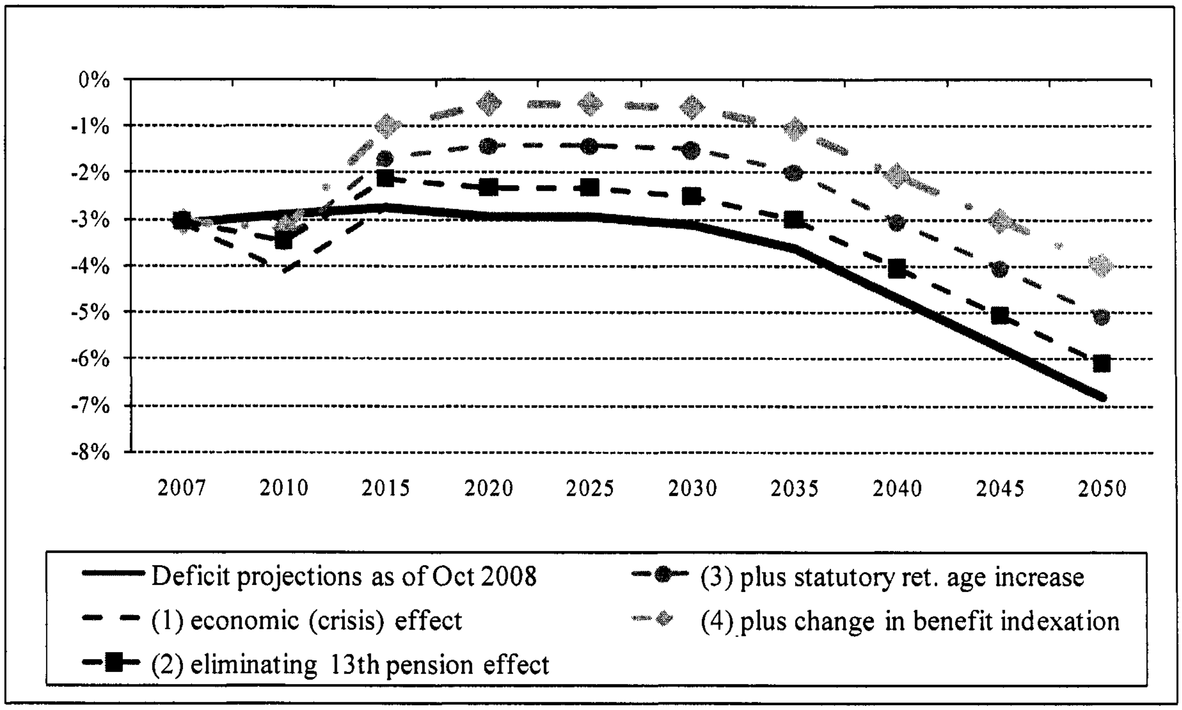
81. In October 2008 it was expected that the increase in the effective retirement age due to the changes in early retirement rules and demographic tail winds would allow pension deficits to decrease slightly by 2015, to stabilize at around 2 percent of GDP until 2030 and later start rising again due to demographic developments. These projections show that the pension system was expected to be stable for the next two decades, although still requiring budget transfers and high contribution rates that generate inefficiencies and contribute to informality.

82. However, the financial crisis is expected to deliver a shock to the pension system, mainly due to the rapidly falling revenues. The deficit is projected to increase by more over 4 percent of GDP in the short term before it decreases again to a 3 percent deficit in 2015; as shown by the lowest dotted line before rising again in 2030 as with the original forecast before the new reforms. Although pension reforms are usually slow to deliver desired savings, in this case, the combined package of strong 2009 pension reforms is now estimated to be able to cover the shortfall generated by the crisis, by 2010. It is further projected to deliver longer term gains and almost balance the system until 2030. New sets of reforms are likely to be needed before then to prepare the system for future demographic shocks while also enabling a reduction in contribution rates.

83. In the figure below, the effect of each reform as recently enacted (lines 2, 3 and 4) show their cumulative effect. Line 2 showing the elimination of the 13th month pension benefit is the first effect which demonstrates the positive impact on the pension deficit. Adding in the reform on increasing the retirement age, on top of the 13th month pension reform, one obtains the next line (line 3) with the cumulative effect of both these measures as well as their effect in counteracting the economic crisis impact on fiscal finance of the pension system. Finally, when the reform on the change of indexation (line 4) is added cumulatively to the other reforms, the total cumulative impact of the combined factors is shown in line 4, where near balance in the system is reached between 2020 and 2030.

[11] Based on the calculations by Deloitte and Touche conducted in October 2008 that incorporate all of the reforms legislated by that time.

Figure 8. Projected deficit balances of the pension system (% of GDP)



Source: Original calculations by Deloitte and Touche, adjustments by Word Bank staff.

84. ***Designing the Payout Phase of the Second Pillar.*** The government has introduced a number of institutional and regulatory improvements to the young private pension system, including a centralized collection system, regulations designed to curb the high fees, and lifestyle pension portfolios. The performance of the pension system has been affected by the current crisis, but there is an expectation that pension funds will have time to recover the losses incurred in 2008 (a negative return of 26 percent on the balanced portfolio), as the first cohorts in the second pillar will only begin retiring in 2013. However, the government still needs to prepare the framework for the payout phase, including the menu of retirement products (annuities, phased withdrawals, other), marketing rules, and solvency regulations. In 2009, the government will complete draft amendments to the pension law that would address these elements. It also plans to introduce a strategy for issuing inflation-indexed bonds which would be essential to allow private annuity providers to hedge the inflation risk of their indexed liabilities.

E. The Health Sector

Main Challenges

85. Total health expenditures (THEs) increased from 7.0 to 8.3 percent of GDP from 2000 to 2006, driven by increases in both public and private spending, and are rather high by EU-8 standards, as shown in Figures 9 and 10. The Health Insurance Fund (HIF) reported deficits in the first half of the decade, but a surplus was achieved in 2007 with mandatory transfers from the state budget to the HIF on behalf of pensioners and other non-contributing persons,[12] coupled with formal co-payments by patients, strict expenditure controls, and a reduction in

[12] Including persons receiving social allowances, children, students, beneficiaries of maternity leave, prisoners and others. In 2008, the transfer amount is approximately HuF 4,500 (about $22.5) per person per month.

hospital beds. But the situation in the health sector still looks precarious, considering the negative effects of the crisis on the revenues of the HIF, and the difficult financial situation of hospitals – hospitals have accumulated debts and arrears with suppliers up to 0.4 percent of GDP, putting additional financial pressure on the municipalities who are the owners of the hospitals.

86. The government faces the challenge of improving the health status of the Hungarian population which is poor by comparison with other EU states,[13] while avoiding large deficits in the HIF. The scope for enhancing health revenues looks limited, as the contribution rate is relatively high at 12.5 percent of wages. A recent effort to introduce co-payments by patients had to be abolished in April 2008 following a popular referendum.[14] Moreover, the growing unemployment resulting from the crisis and the wage freeze recently implemented will reduce contribution revenues in the foreseeable future and increase the pressures on the HIF.

Ongoing Reform Efforts

87. The government and the HIF have responded to these pressures through a number of measures designed to contain expenditures while generating efficiency gains. The package of measures include: (i) strengthening the purchasing power of the HIF; (ii) containing pharmaceutical expenditures through administrative and legislative measures; (iii) reducing the overcapacity of hospitals; (iv) strengthening the role of general practitioners (GPs) to reduce overutilization of health care; and (v) ensuring an adequate number of GPs.

88. ***Measures to strengthen the purchasing power of the HIF***. Health insurance reforms have been focused towards strengthening the purchasing power of the HIF. To this end, the 19 county level branches of the HIF are being consolidated into 7 regional offices responsible for selective contracting based on explicit performance criteria. The provider payment reform will reward providers for better efficiency and quality and for serving population groups in low-income areas. The HIF has started substantive investment in independent data collection, analysis and simulations to estimate the financial impact of these purchasing reforms, and to implement cost containment measures.

89. ***Containment of pharmaceutical expenditures***. In 2006, about 30 percent of total health expenditures were related to pharmaceuticals and Hungary reported pharmaceutical expenditures per capita above the OECD average. As a result, the HIF introduced strict expenditure management and prescription controls, such as the introduction of generics, contributing to a reduction in pharmaceutical expenditures from 1.65 percent of GDP in 2006 to 1.2 percent of GDP in 2008. An important step was taken in 2008, when Parliament passed the pharmaceutical law to sustain these measures and outcomes. The government's plan to centralize pharmaceutical procurement at the county level for all hospitals based on the public procurement law is expected to further decrease health expenses.

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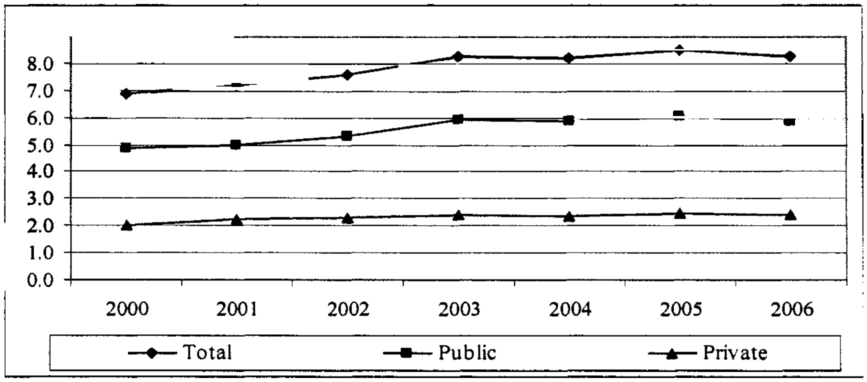
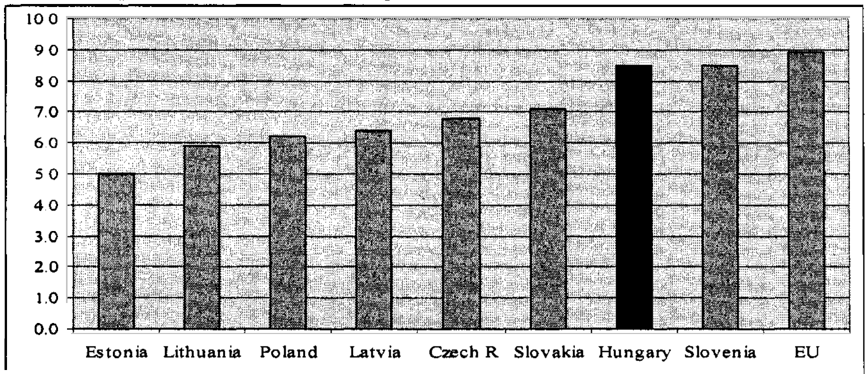
[13] Hungary's poor health outcomes are illustrated by the highest rates of cancer and cardiovascular disease in the EU. The recent OECD Health Report (OECD (2008)) provides detailed cross-country comparisons.

[14] The co-payment was implemented in February 2007 but abolished in April 2008.



Sources: OECD and WHO Health for All Database. http://data.euro.who.int/hfadb/

Figure 10. Total health expenditure in % of GDP, EU-8, 2005



Source: WHO Health for All Database. http://data.euro.who.int/hfadb/

90. ***Reduction of overcapacity in hospitals.*** There are substantial overcapacities in the hospital sector which have contributed to the sector's indebtedness. In 2006, Parliament passed the hospital network act to restructure hospitals and reduce the number of beds. In April 2007, the MOH closed hospital beds reducing the bed/population ratio to 7.2, which is still substantially above European best practice of less than 5 beds per 100 persons. The MOH has taken steps to further consolidate overcapacities by issuing a Ministerial order to implement the procurement law and centralize procurement of goods and services in hospitals at a county level.

91. The recently passed Status Law (section III.A) will allow the MOH and the local governments to move hospitals on a selective basis, toward more corporatized management, which will open more possibilities for dealing with hospital inefficiencies. The MOH expects to issue Ministerial Guidelines during 2009 on norms for implementing the Status Law. In order to prepare the ground for corporatization, the MOH is already proceeding with the clearing of hospital debts and arrears, defining borrowing restrictions, and introducing annual independent hospital audits.

92. ***Strengthening the role of GPs to reduce overutilization***. There is substantial overutilization of care as indicated by highest utilization rates for outpatient care (10.8 visits per capita per year) and second highest hospitalization rates[15] (20.8 discharges per 100

[15] Hospitalization rates have only been surpassed by the Czech Republic which introduced co-payments in January 2008 to moderate over-utilization in hospital care. (See OECD (2008).

population) in Europe in 2007.[16] This situation has been caused by restricted treatment and prescription authorities for GPs, resulting in high referral rates to specialists, hospital overcapacities, and the financial incentives set by the fee-for-service payment to specialists and case-based payments (DRGs) to hospitals. A Governmental decree is being drafted to strengthen the role of GPs with the objective of reducing the number of costlier visits to specialists and hospital admissions, and to be enacted during 2009.

93. ***Ensuring an adequate number of GPs***. Although migration of medical personnel to Western Europe is estimated to be high, this has not yet resulted in a shortage of staff. In 2006, Hungary reported similar ratios for GPs and nurses per population as other European countries.[17] However, demographic surveys show that most GPs are approaching the retirement age. A draft GP Law currently in discussion in Parliament, aims to facilitate GP market entry, handover practice rights to younger physicians, and increase future availability.

IV. BANK SUPPORT TO THE GOVERNMENT'S PROGRAM

A. LINK TO COUNTRY PARTNERSHIP STRATEGY

94. The World Bank has been working with Hungary since 1982. The last Country Assistance Strategy was dated 1998, for which a progress report was discussed at the Board in 2002. At that point, Hungary had already discontinued new Bank lending and the focus had shifted to analytical and advisory support. The last investment project in the portfolio closed in December 2008.

95. In 2007, Hungary graduated from World Bank financing but has maintained an active dialogue and engagement with the Bank since then, making full use of the limited free technical assistance available to graduates, which expired at the end of fiscal year 2009. Post-graduation collaboration includes several technical cooperation projects to promote Hungary's energy and climate change objectives, as well as work on reducing undeclared employment and introduction of cost-sharing in health and education.

96. The global financial crisis has led to an exceptional request by the Government of Hungary for renewed access to World Bank resources. The crisis has exposed underlying macro-vulnerabilities, and the deep economic contraction that followed left Hungary with significant borrowing needs and constrained access to external financing on reasonable terms. As part of international efforts to stabilize Hungary's economy, the Bank is proposing a two-tranche development policy loan totaling EUR 1 billion (US$ 1.4 billion equivalent). The DPL is a part of the EUR 20 billion package which also includes contributions from the IMF and the EU.

97. The proposed operation is consistent with the Bank's Articles of Agreement. Pursuant to Article III, Section 4 (ii), the Bank may make loans if "[it] it satisfied that in the prevailing market conditions the borrower would be unable otherwise to obtain the loan under conditions which in the opinion of the Bank are reasonable for the borrower." In this case, the Bank is satisfied that in the prevailing market conditions, Hungary would have been unable to otherwise borrow under reasonable terms, given the volatility in the sovereign bond market

[16] Modern health care systems report considerably lower utilization rates: Finland for instance reports 4.3 outpatient visits and 19 hospital discharges.
[17] Source: WHO Euro: Health for All database Year 2006 or latest year. http://www.euro.who.int/hfadb

and the withdrawal of non resident investor holdings. While in July 2009, Hungary did manage to issue a Eurobond on the market, its market spread for that, was high in comparison with similar neighboring central European countries. During the stabilization program, continued policy dialogue is envisaged between the Bank and the Hungarian authorities combined with analytical and advisory activities to support the implementation of ongoing structural reforms.

98. The Bank's involvement in this operation is also crucial given that, starting during the crisis in Asia in 1989, Bank technical teams were seen as having a comparative advantage and specialized skills in issues of financial sector resolution and restructuring, which were applied in Asia, and subsequently in Latin America and other regions. Since then, the mechanisms used for supervisory assessment and enforcement as well as the financial mechanisms for handling potentially weak or insolvent institutions have been increasingly refined in the Bank, updated in line with regulatory reforms (e.g.: Basel), and now constitute one of the core financial sector policy design products in the Regions and the Network. Such mechanisms and knowledge are particularly apt in the Hungarian context and in the development of measures that imply averting major bank asset or funding losses via the application of a variety of preventive forward looking actions and regulatory powers.

99. The importance of the Bank's involvement, given the above, is also key to ensure that policies promoting financial stability, along with the IMF and the EU roles, are implemented in depth considering all scenarios, and providing confidence for the return of external capital to the Hungarian economy. The policy actions under the operation are also meant to ensure an orderly transition out of a crisis-induced environment and to avoid adverse developments that could have a contagion effect and a including investor and funding withdrawals from neighboring countries in Eastern Europe. In this context, the operation provides a demonstration effect, which, along with the multilateral partners, would show the effectiveness of a well designed macro and financial stability program in restoring confidence.

B. COLLABORATION WITH THE IMF AND OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

100. The Bank's assistance is part of a joint IFI initiative, where the EBRD, the EIB, and the World Bank Group have pledged to support banking sectors in Central and Eastern Europe with up to €24.5 billion over a two year period. The Bank program supports and complements an overall multilateral policy package involving the IMF and the European Union which it is a part of. The entire policy reform package amounts to €19.8 billion of which the Fund has committed €12.3 billion to Hungary and the European Union €6.5 billion. However, the loan proposed by the Bank is a Development Policy Loan with differentiated terms offered by the Bank in response to the tightening financial markets caused by the global financial crisis and economic recession.

101. The proposed loan represents the Bank's share of €1.0 billion in the package. The Bank team has collaborated closely with the Fund team and discussed the complementarity and mutually supportive measures covered under the respective institutions' parts. The Bank has also discussed the measures under the loan with the European Commission representatives, where there are mutually supporting measures in the social and fiscal sectors as well as the banking system. In the fiscal sector in particular, the program is fully consistent

with EU Convergence Program targets which the government has committed itself to reaching in the medium term.

102. The proposed loan supports the overall reform package but also adds a number of regulatory and supervisory reforms designed to strengthen the government's ability to mitigate ongoing and future risks. While the IMF/EU focus is primarily on support for bank-liability funding continuity and liquidity management (as well as targeted short term capitalization), the Bank's focus is on medium and forward looking measures and credit portfolio risks which are of particular concern given latest GDP forecasts.

103. The proposed loan goes beyond support for immediate banking liquidity needs and needed fiscal adjustment to regain market confidence; and addresses bank asset quality issues. This includes, inter alia, having HFSA, the supervisory authority, conduct special intensified-supervision diagnostics of ongoing and future solvency prospects of Hungary's financial institutions – the new Stability Law will permit the use of HFSA-funded special auditors for this purpose. The loan also includes new regulatory and supervisory tools needed to correct the course of negative trends in financial institutions in a preventive manner with powers to halt potential systemic problems and resolve problem banks expeditiously. Additional structural fiscal measures and social sector reforms in the pension and health sectors ensure fiscal sustainability while maintaining a level of basic social expenditures and social protection.

C. RELATIONSHIP TO OTHER BANK OPERATIONS

104. There have not been any recent related Bank operations to which this loan may be directly linked. Nevertheless, there are early precedents on Bank involvement in the banking and pensions sector which have a bearing on this operation and where analytical work and staff continuity exists. The *Enterprise and Financial Sector Adjustment Loan* (4141-0 HU) approved in 1997 and which closed in 1998 had components of banking regulation and supervision strengthening as well as bank restructuring and privatization. The *Public Sector Adjustment Loan* (4275-0 HU), approved in 1998 and which closed in 1999 dealt with the systemic pension reform which included parametric reforms to the pay-as-you-go (PAYG) system and the introduction of a privately funded pillar.

105. Besides operations, there has also been work on major ESW pieces covering the banking system. In particular, for the financial system, this includes the last Financial Sector Assessment Program (FSAP) Update conducted in 2005, and the original FSAP conducted in 2001. More recently the Bank has conducted technical assistance activities in 2008 related to the pay-out phase of the young privately funded pillar introduced in the 1997 reform.

D. ALTERNATIVES CONSIDERED

106. Besides a policy loan, other options considered and discussed with the authorities, included a policy-based guarantee operation. This would have involved the same policy conditions but using a Bank partial credit (policy-based) guarantee of new government issued sovereign debt, given the difficulties with market access that the government was experiencing. However, since the government recently successfully issued a sovereign Eurobond in the market, it may wish to keep on monitoring the market first to determine if access is maintained, and during the interim, a guarantee option would likely be less critical.

107. Another option in the policy based guarantee area considered, involved a guarantee under the Government's safety net liquidity guarantee facility for bank debt (e.g.: interbank loans provided to banks, bonds issues by banks to fund their liquidity). This option would have added an additional layer of credit enhancement to the government's own guarantee of bank debt, and which might have been useful for external investors that might have not considered the government's own guarantee solid enough. This was not pursued as most of the banks' liquidity needs were met by foreign parent banks, and in the case of domestic banks, the funding needs were provided via available government loans.

E. ANALYTICAL UNDERPINNINGS

108. The knowledge of the structure and regulatory issues in the financial system are based on the last FSAP update report as well as recent updating based on mission work, market sources and official analysis. The FSAP covered a wide range of issues from the overall macro environment and banking sector, to pensions, capital markets and insurance. The report provided a detailed overview of the structure of the financial system and emerging issues regarding ownership configurations of financial institutions as well as lending portfolio growth and composition. It also flagged key issues in the non bank sectors, and recommended actions for regulatory and supervisory development. Some, but not all of the issues remain pertinent for the proposed loan described in this document.

109. The preparation for this operation has also included an assessment of the risks in the banking sector and their potential impact on balance sheets. This assessment indicated the need to deepen diagnostics of the banks via a new program of on-site examinations and forward-looking scenario testing, supported by the loan. Such analysis will incorporate projected downturns in economic growth, which coupled with less credit availability to smaller and medium sized enterprises, and potential exchange rate or interest rate changes, could put a strain on the repayment capacity of certain borrowers.

110. The analysis of the above factors, which are primarily forward looking, will take into account, besides the recent banking stresses caused by lack of overseas funding sources, the additional stresses that might materialize for banks, if loans require reclassifications and additional loss provisioning and possibly incremental capital requirements. Such diagnostics would form the basis to support supervisory corrective actions needed to stem deteriorating trends before they become amplified, either at the individual bank – or systemic level.

111. On the macroeconomic front, the Bank has remained engaged through the periodic production of the Regular Economic Reports (RERs) for the EU New Member States in which each country's economic prospects and fiscal trends is reported and assessed. During implementation of this loan a Public Expenditure Review focused on social expenditures will also be conducted, enabling the continuation of the policy dialogue in a key area, ensuring a sustainable fiscal path while maintaining an adequate social safety net.

112. In the health and education sectors, the Bank has remained engaged through a variety of AAA and technical assistance well received by the authorities on topical issues. In the pension area, Bank teams started a substantive dialogue with the authorities in early 2008 regarding issues and design of the post-retirement payout (including annuities) phase of the private pension pillar. This work will continue during loan implementation and as part of other regional work initiatives in Central Europe.

F. LESSONS LEARNED

113. The FSAP Update conducted in 2005 had identified issues that were not sufficiently addressed in recent years, but are now incorporated into this proposed operation. These issues included the risks associated with the growth of lending in foreign exchange (FX), and the lack of supervisory powers of the HFSA to deal with this and with other issues. This proposed loan addresses these issues through a variety of components. For example, the diagnostic work that will be conducted through the on-site examinations and the stress tests will identify the need to implement corrective actions at the level of individual institutions' risks, as mentioned above. The amendments to the HFSA Law will provide the supervisor with forward looking preemptive powers that should prevent unsustainable risks from emerging in the first place. The lack of progress in recent years reflects the general failure of the Bank to provide sufficient follow-up technical assistance after the FSAPs, not only in Hungary, but also in most other member countries.

114. In the area of pension reform, the past operation also yields valuable lessons for future reforms and Bank involvement. The 1997 pension reform, supported by the earlier Public Sector Adjustment Loan, suffered from the lack of further institutional build-up (e.g. revenue collection, regulatory capacity) and also from some reform reversals (e.g. post-reform increases in benefits). Some of these problems could have been addressed earlier and more effectively if the Bank had remained engaged. The current loan follows up on the unfinished agenda items from that reform, in particular the additional parametric changes required in the public pillar, as well development of the pay-out phase of the young privately funded pillar.

V. THE PROPOSED HUNGARY FINANCIAL SECTOR AND MACRO STABILITY LOAN

A. OBJECTIVE AND RATIONALE

115. The objective of the proposed operation is to support the Government's fiscal reform and financial stability programs, aimed at ensuring fiscal sustainability and a sound banking system, thereby restoring investor confidence and Hungary's full access to international financial markets. These are also pre-conditions for improved growth performance, which is the ultimate objective of the Government's program. The proposed operation would achieve these targets by contributing to the international financial support package, initiated by the IMF and the EU and under the objectives of the Joint IFI Initiative to support banking sectors in Central and Eastern Europe, affected by the crisis.

116. The direct financial contribution of the operation is relatively modest – €1 billion in an overall package of almost €20 billion. However, the overall contribution of the operation is significant, considering the additional reform measures that it supports including institutional implementation aspects, and that have increased the depth and the breadth of the government's programs, as well as the enhancement of the international seal of approval to Hungary's reforms, implicit in the Bank's participation in the international support package.

117. The unfolding international financial crisis provides a strong rationale for the operation. The crisis was initiated in mature markets, but has been transmitted to Hungary and other emerging countries through financial and trade channels. While Hungary graduated from IBRD borrowing in the Spring of 2007, the government continued an ongoing program of analytical and technical assistance work with the Bank, and requested Bank support when the crisis curtailed the country's access to external finance. The operation is consistent with the Bank's mandate in its Articles of Agreement to provide funding to members in the event they are unable under prevailing market conditions to obtain a loan under reasonable terms. This was effectively manifested after the sharp rise in government bond spreads and the flight of external investors from both the government and the equity markets.

118. While it is true that Hungary had accumulated many macroeconomic imbalances during the first half of the decade, the government had already made a substantial effort to address these imbalances by the time the country was affected by the crisis. Moreover, by supporting the restoration of fiscal and financial stability in Hungary, the operation also generates positive externalities by reducing the risk of contagion effects to other countries in Central and Eastern Europe (CEE). Finally, the experience gained by Bank staff in dealing with this early crisis case can be usefully applied to other CEE countries and in other regions.

B. OPERATION DESCRIPTION AND POLICY AREAS

119. The proposed operation supports the government's fiscal reforms and financial stability program, designed to restore fiscal sustainability and ensure financial stability. The operation also supports reforms in specific social areas (pensions and health) that aim at protecting basic social benefits while also contributing to fiscal sustainability. Box 1 further below shows the main policy actions supported by the operation, grouped in the four policy areas. The first column shows the policy actions already met prior to Board approval, while

the second column depicts the policy actions required before disbursement of the second tranche.

120. As indicated previously, the operation has been prepared in coordination with the IMF and the EU. Under the four sectoral areas of policy actions listed, the IMF/EU components of the conditionality as compared with the Bank initiated components contained the following focus: (a) in the Fiscal area, the IMF and EU primarily engaged on the deficit and debt reduction measures, while the Bank worked primarily on the legal status law, social program expenditures and revenue, and the fiscal council; (b) in the banking area, the IMF/EU program primarily supported the crisis architecture involving the liquidity and capitalization mechanisms – while the Bank engaged mainly in the development of the supervisory framework, loan classification, enhanced on-site inspections, scenario stress analyses, and supervisory corrective actions.

121. In the Pensions section, the first reforms included an IMF/EU supported component (pension expenditure reductions) while the Bank initiated the dialogue on pension system projections and reducing the 13^{th} pension and its ceiling more permanently – in the second area (the private pension pillar) the Bank has had an ongoing policy dialogue with the government. In the Health area, the Bank mainly focused on these reforms and engagement with the government.

Fiscal Reforms (first and second tranche conditions)

122. ***Revenue Neutral Growth Bolstering Measures***. For the first tranche, the operation supports the government enactment of a revenue-neutral tax reform which together with reforms to trim and better target social benefits, are intended to support growth potential and encourage work and employment. The main measures, resulting in lowering the labor tax wedge (from 54.1% in 2008 to below 46% by 2010), include a 5-percentage-point reduction in the social contribution rate paid by employers, cuts in the 18 and 36 percent rates to 17 and 32 percent, respectively, a higher placement of the tax brackets, and redefinition of taxable income to expand the tax base, along with the gradual withdrawal of deductions and allowances. Ninety percent of the taxpayers will be liable for a lower rate, and for mid-income earners the marginal tax rate will be significantly lower.

123. ***Operation of the Independent Fiscal Council.*** The first tranche of the operation supports the establishment under the FRL law of an independent budget analysis body reporting directly to the Parliament, named the Fiscal Council, and providing an autonomous assessment of budget, revenue and macroeconomic projections including a view of the Administration prepared budget. Under the second tranche, the initial budget and resource allocation to allow for the operation of the Fiscal Council, would be assured, and it will have been verified that the Council will have begun its operations under its defined mandate.

124. ***Approval and Regulation of the Legal Status Law***. As a first tranche policy action, the proposed operation supports the Parliamentary approval of the Legal Status Law and Management of Budgetary Institutions. As explained in Section III, this law aims to reform the regulatory and operating framework of public budget-funded institutions and increase public sector budgetary performance and service delivery. By the second tranche, the government will have issued the necessary Decrees specifying the operational requirements

for public institutions to begin implementing budget and performance monitoring reports, and business plan proposals to meet the objectives of the law.

125. ***Expenditure Measures for Sustainability in the Social Support System.*** For the second tranche, the operation will support the implementation of reforms in the fiscal sector particularly covering health services, child-care benefits, family allowances, housing subsidies household gas consumption and district heating. Implementation of these reforms and allocation of corresponding budgets will ensure improvement in the financial sustainability of the social support system, including the tightening of eligibility criteria and improved targeting of benefits, allowing the necessary fiscal adjustment required to reach the deficit target of 3.9 percent of GDP, as well as the inclusion of incentives toward work and employment to achieve savings in the social benefits system, for employable able workers.

126. ***Consolidation of the Fiscal Adjustment (IMF/EU conditions).*** The proposed operation supports the deepening of the fiscal adjustment and structural measures designed to ensure long-run fiscal sustainability. As shown in Box 1, as a prior action under the multilateral package, Parliament approved the 2009 Budget Bill that includes further reduction in the deficit. For the second tranche, the verification of broad compliance with the fiscal program through verification of a reduction of the cyclically adjusted deficit, would constitute a key condition.

127. ***Approval and Implementation of the Fiscal Responsibility Law (IMF/EU conditions).*** Parliamentary approval of the new Fiscal Responsibility Law (FRL) in December 2008 is a key structural measure, and while initiated under the IMF/EU discussion it constitutes a core basis for the Bank program conditions. As noted in Section III, the law introduces critical rules ensuring fiscal discipline and constitutes a major reform in the conduct of public finances. Under the FRL, a fiscal/budgetary council has been nominated. The operation will verify that the FRL rules have been met in 2009 and that a fiscal council has been appointed by Parliament and is well resourced.

The Financial Sector Stability Program (first and second tranche conditions)

128. The proposed operation supports the Government's financial sector stability program addressing a number of elements, both immediate and forward looking. Immediate measures were tackled in the IMF/EU package, addressing bank funding and liquidity shortages generated from the worldwide contraction of credit. As the financial crisis unfolded, and economic activity in the EU continues to contract, additional forward looking measures are being put in place to ensure that banks have sufficient capital cushions, an area where the Bank has contributed in formulating policy measures.

129. ***Intensified On-Site Inspections of Banks.*** A key component of the operation is the initiation under the first tranche, via an HFSA resolution, of intensified on-site supervision examinations and diagnostic procedures in order to assess banks' portfolio quality, reserves, provisions, capital levels, consolidated group risks, credit assessment procedures, institutional governance and other factors. These on-site inspection and diagnostic processes will be crucial for taking a snapshot of banks' balances sheet assets, sampling of credit portfolios, and other diagnostics to measure vulnerabilities, so as to identify embedded risks. It will be used to assess the current state of the financial system in Hungary, and conducted for the at least the banks covering 75 percent of banking system assets, or the 8 largest systemically important

banks. The Bank has assisted the supervisory authorities in crafting terms of reference for the exercise and provided inputs in risk elements to address. Under the second tranche, the authorities will have completed these intensified inspections and undertaken the necessary regulatory and supervisory corrective measures toward subject banks, to preempt deterioration in bank capital, financial condition and lending or other business practices.

130. ***Scenario Stress Test Analyses.*** Given the adverse macroeconomic scenario projected for the next 2 years, under the operation's first tranche, the Magyar Nemzeti Bank (Central Bank or MNB) will conduct a stress test using estimates of economic projections (GDP growth, unemployment, interest and exchange rates, loan repayment capacities, other factors) to assess the stresses on bank balance sheets and the potential need for forward looking provisioning or recapitalization to confront upcoming risks. This exercise (expected to be completed prior to the second tranche) will cover banks representing at least 75 percent of assets in the system, and serve as input to the MNB, HFSA and the government to carry out any needed proactive supervisory actions that should be applied to maintain the sector fully solvent and protected.

131. ***Supervisory Corrective Programs.*** By the second tranche, as per above, both the scenario stress test analyses and the intensified inspections program, will have been completed and used as diagnostic inputs for the financial authorities to issue corrective actions to banks, to initiate and implement financial improvement plans to assure adequate capitalization.

132. ***Protection of Depositors.*** To avoid further liquidity pressures via depositor withdrawals, the government, in line with EU wide directives, increased depositor coverage from €20,000 to approximately €50,000 per depositor for each bank and introduced a blanket guarantee. Under the operation's first tranche, the governing Board of the Deposit Insurance Fund (DIF) will have increased the premium charged to banks to better fund the expanded potential obligations of the DIF in line with the increased coverage. The premium (as a percentage of the insured deposits) is to be increased from 0.9 to 2.0 basis points of such deposits.

133. ***Increased Supervisory Options under Situations of Instability.*** The government will provide additional flexibility and ability of the HFSA to work effectively within a potential unstable financial sector situation. In order to ensure a quicker and more adequate "on-time" flow of information and diagnosis of banks in such environment, under the first tranche, the Financial Stability Law will provide the supervisory authorities powers to require ad hoc extraordinary financial reporting from banks to assess their quickly evolving financial situation, as well as to permit inspections to be extended for up to one year under such scenarios. As well, the law will also allow the supervisory authority to appoint a qualified forensic auditor to assist in critical diagnoses during the course of an examination.

134. ***Strengthened Supervisory Powers for Prompt Action.*** The current pressures on the financial system demand proactive and preventive supervisory functions and strengthened regulation. Under the second tranche, the operation directly supports the submission to Parliament of amended legislation to strengthen supervisory powers. The legal amendments will permit authorities to take systemic actions applied to the sector as a whole upon the manifestation of risks that affect all banks. Another feature of the amendment under the second tranche, is providing authorities powers to issue forward looking corrective actions to individual banks if their risks are rising, even if they are not legally contravening codified

banking regulations. Such powers will be crucial as banks' portfolio quality may be affected with the economic downturn.

135. ***Restructured Loan Classification Regulations.*** For the second tranche, the operation supports the implementation of stricter rules on rescheduled, refinanced or renegotiated loans for accounting purposes, to ensure that such loans and their classification, take into account the inherent borrower risks that prompted such modifications and any projected losses on such loans. As part of the operation, the government will prepare a modified regulatory Decree specifying the criteria and loan valuation norms for restructured/rescheduled loans, and the appropriate loan classification and related loss provisioning requirements.

136. ***Liquidity Facilities (IMF/EU conditions).*** Facilities aimed for both the foreign exchange and domestic currency markets are a critical part of the financial architecture. Foreign exchange (FX) availability is supported through an FX facility agreed with the ECB. For domestic currency, beyond overnight funding, MNB established a 2-week term lending window with expanded eligible collateral instruments such as highly rated covered mortgage bonds,[18] and a six-month term variable priced loan window.

137. ***Bank Debt Guarantee Facility (IMF/EU conditions).*** Besides short term liquidity needs, banks require access to longer term funding particularly for banks without foreign 'parents.' The Financial Stability Law introduced a new Guarantee Facility, where the government, for a fee, guarantees repayment of funds from third parties that provide credit to banks (bond investors, interbank creditors, other creditors).

138. ***Bank Capital Support (IMF/EU conditions).*** The Financial Stability Law also created a Capital Base Enhancement Fund (CBEF) to provide capital injections for systemically important banks. The CBEF provides clear government exit mechanisms based on the maintenance of capital levels and earnings of a subject bank.

Pension Reforms (first and second tranche conditions)

139. ***Parametric Reforms for the Sustainability of the Public Pension Pillar.*** Under the first tranche, the operation will support a major reform to ensure the funding sustainability of the publicly funded pension system. This includes a number of new reforms which also have a positive fiscal impact. The reforms, reflected in amendments to the Pension Law, include: (a) a phased increase in the retirement age from 62 to 65, starting from 2012, (b) introduction of penalties to discourage early retirement, (c) elimination of the 13th month pension, (d) tightening of pension disability criteria, and (e) introduction of a new pension indexation rule leaning towards price versus wage indexation and which would weight the indexation by both, according to GDP growth levels as follows: (i) For GDP growth lower than 3%, the price (inflation) index would have a 100% weight; (ii) for GDP growth between 3% and 4%, index weights would be 80% for prices and 20% wages; (iii) for GDP between 4% and 5%, a 60% weight for prices would apply and 40% for wages, and (iv) for growth above 5%, the index weights would be divided on a 50/50 basis.

[18] Such bonds are not securitized mortgage bonds or collateral debt obligations which were at the source of the U.S. financial crisis. Covered mortgage bonds are securities issued by a mortgage financial institution where such bonds remain on the balance sheet of the institution and debt service is backed by the same institution's portfolio of loans that generate earnings and which also remain on the institution's balance sheet.

140. ***Preparation of the legal and regulatory framework of the payout phase of the second pillar.*** The new private pillar introduced in 1997 accumulated a substantial volume of assets, and the first cohorts enrolled in this pillar will start retiring in 2013. The institutional and regulatory framework for a well managed, market-based payout phase has not yet been prepared, however. To ensure progress in this key area, the second tranche of the operation would support the submission to cabinet of draft proposals to the pension law regulating the payout phase, including the menu of retirement products, annuities, indexation rules, the institutional framework for providers, solvency rules, as well as marketing rules. The Bank is expected to provide technical and policy input for this task.

141. ***Budget Reforms to the PAYG System (IMF/EU conditions).*** The operation supports Parliamentary approval of amendments to the Pension Law under the multilateral package, and which constitute an important step towards greater pension sustainability. This package of measures (being implemented over the 2008-2010 period) which were implemented at the start of the IMF led program, restrict early retirement, eliminate the 13^{th} pension bonus for early retirees, and introduce a ceiling (equal to the average pension) for other retirees.

Health Reforms (first and second tranche conditions)

142. ***Efficiencies in Health Services Management.*** Under the first tranche, following Parliamentary approval of the Pharmaceutical Law, the containment of pharmaceutical expenditures will be implemented through the approval of regulations by the Ministry of Health (MoH), promoting cost containment in medical appliances and expenditures.

143. ***Implementation of Legal Status Law Provisions.*** By the second tranche MoH Guidelines will be issued to support improved financial and debt management, and efficient organizational and cost structures for hospitals, to more closely approach corporate practices, as contemplated under the Legal Status Law for public institutions.

144. ***Role of General Practitioners (GP) in the Provision of Health Care.*** Under the second tranche, a MoH Decree will be issued, increasing the role of the GP practice, allowing GPs more authority to issue prescriptions for special conditions, thus reducing, for example, medical costs of specialist visits, solely for prescription renewals.

Box 1. Prior Actions/Tranche Release Conditions ***(core Bank conditionality in bold)***

BOARD PRIOR ACTIONS POLICY ACTIONS TAKEN PRIOR TO BOARD APPROVAL	SECOND TRANCHE CONDITIONS POLICY ACTIONS FOR 2nd TRANCHE RELEASE
The Government has continued to: (i) implement its current fiscal program in a manner consistent with the provisions agreed upon with the IMF and the EU, and (ii) make available to domestic banking institutions, financial sector safety net facilities. (IMF/WB/EU).	**The Government continues to: (i) implement its current fiscal program in a manner consistent with the provisions agreed upon with the IMF and the EU, and (ii) make available to domestic banking institutions, financial sector safety net facilities.** (IMF/WB/EU).
<u>Fiscal Reforms</u> • Reduction in the general deficit to 3.3% in 2008, and deficit target of 3.9% of GDP in 2009 (IMF/EU). • Adoption by Parliament of Fiscal Responsibility Law (IMF/EU). • **The Government has adopted revenue-neutral tax reforms that reduce the tax wedge on labor to bolster potential growth, and which include: (i) lowering of social contributions, (ii) cutting the overall personal income tax, and (iii) increasing consumption and wealth taxes** (WB). • **The Government has established the Fiscal Council, as mandated by the Fiscal Responsibility Law, to serve as an independent body for scrutiny of budget preparation and execution, reporting directly to the Parliament** (WB). • **The Parliament has adopted a Law on the Legal Status and Management of Budgetary Institutions ("Legal Status" law), designed to increase autonomy of public sector institutions with the potential for augmenting performance and self-funding, and requiring a stronger accountability framework** (WB).	<u>Fiscal Reforms</u> • Reduction in the general deficit to 3.9% in 2009, and deficit target of 3.8% of GDP in 2010 (IMF/EU). • **The Government has implemented the budgetary provisions stipulated in the amendments to Acts and Decrees covering mandatory health service, child-care benefits & family allowances, housing subsidies, household natural gas consumption, and district heating, in order to: (i) ensure improvement in the financial sustainability of the social support system (including the tightening of eligibility criteria and improved targeting of benefits) and (ii) provide more incentives for work and employment in the social benefits framework** (WB). • **The Government has approved a budget appropriation commensurate with the mandate of the Fiscal Council** (WB). • **The Ministry of Finance has approved a Decree to implement the provisions of the Legal Status Law, and which specifies rules and procedures for budgeting, results measurement, and service delivery; with a view to attain more efficient operations and management of public sector institutions** (WB).
<u>Financial Sector Stability Program</u> • Establishment of Banking Sector Safety Net Measures via: Additional Liquidity Facilities (IMF/EU) Increased Deposit Protection (IMF/EU) Government guarantees on new bank borrowing / debt issues (IMF/EU) Capital strengthening facility (IMF/EU) • **The HFSA has adopted a resolution which initiated an intensified inspection program for the largest commercial banks comprising at least 75 percent of assets in the financial system, with a view, inter alia, to evaluate financial condition on a consolidated basis, governance, asset quality, collateral values, adequacy of provisions and reserves, intercompany transactions, bank solvency, and overall adequacy of capital and provisions** (WB). • **In accordance with the Concluding Statement of the European Banking Group Consolidation Meeting held on May 20, 2009, in Brussels, the MNB (Central Bank of Hungary) initiated an exercise of scenario analyses (stress tests) of bank portfolios and assets against economic developments, to assess the solvency of banks comprising at least 75 percent of assets in the banking system** (WB/IMF). • **The Board of the DIF has approved an increase in the insurance premium from $^{9}/_{10}$th of one basis point, to 2 basis points in line with funding needs for increased deposit insurance coverage under EU directives** (WB). • **Pursuant to the approved Financial Stability Law and amendments to the HFSA Law, strengthened supervisory powers have been provided to the HFSA in cases that threaten financial stability, allowing it to: (i) require ad hoc extraordinary reporting from a subject bank, (ii) extend an inspection for up to one year, and (iii) appoint a qualified forensic auditor during the course of an inspection** (WB).	<u>Financial Sector Stability Program</u> • The Banking Support Program is maintained and the tri-partite Stability Committee established (IMF/EU). • **The Government has submitted to Parliament an amendment to the relevant legislation pertaining to the banking sector for inclusion of powers to the supervisory authorities to: (a) undertake pro-active and preventive supervisory actions (mandate increased capital, provisioning, or halting risky practices) so as to mitigate risks at the individual institution level; and (b) quickly react to systemic financial risks and adopt mitigating measures applicable to all financial institutions simultaneously** (WB). • **The intensified inspection program by the HFSA, and the scenario analyses exercises of the MNB, are completed for the largest commercial banks representing at least 75 percent of system assets, and implementation of supervisory actions addressing deficiencies where applicable, and/or bank strategic plans approved by the financial authorities, are undertaken, based on the results of the diagnostics from the inspections and scenario analyses** (WB). • **The Cabinet has issued an amendment to the Government Decree on Accounting Standards for Banking Institutions, specifying the standards for classification, valuation and treatment for accounting purposes, of rescheduled, renegotiated and restructured credits and related provisioning requirements** (WB).
<u>Pension Reforms</u> • **The Government has submitted to Parliament and the Parliament has approved amendments to the Pension Law introducing new parametric reforms to improve the sustainability of the public pension system including:** **a. A gradual increase in the statutory retirement age of men and women, from 62 to 65 years of age, starting in 2012;** **b. Introduction of penalties for early retirement;** **c. Introduction of a new indexation rule for pensions, implying a move from wage to price indexation, with the weights of wages and prices depending on GDP growth where indexation weights would involve:** **(i) For GDP growth lower than 3%: 0% weight for wages, 100% for prices;** **(ii) For GDP growth between 3% and 4%: 20% wages, 80% prices;** **(iii) For GDP growth between 4% and 5%: 40% wages, 60% prices; and** **(iv) For GDP growth above 5%: 50% weight for wages, 50% for prices; and** **d. Abolishment of the 13th month pension from July 2009; and other measures, including tightening of disability pension criteria.** (WB).	<u>Pension Reforms</u> • **The Government continues to maintain the pension reform policies in the public, thereby, ensuring fiscal sustainability** (WB). • **The MoF has submitted to the Government Cabinet draft amendments to the Pension Law providing proposed regulations for the payout phase of the second pillar, including the design of annuities products, indexation rules, and the menu of pension payout options for retirees from the privately funded system** (WB).
<u>Health Sector Reforms</u> • **In line with the provisions of the Act on the Safe and Efficient Supply of Pharmaceuticals and Medical Appliances, as well as on the general rules of distribution of pharmaceuticals, the Government through the Ministry of Health has approved regulations which further promote the containment of pharmaceutical and medical appliances expenditures.** (WB).	<u>Health Sector Reforms</u> • **The Ministry of Health has issued guidelines concerning the corporatization of hospitals, in line with the Law on the Legal Status of Budgetary Institutions** (WB). • **The Ministry of Health has issued a Decree strengthening the role of General Practitioners in the provision of health care** (WB).

Box 2. Good Practice Principles for Conditionality

Principle 1: ***Reinforce Ownership***

There is ownership commitment at the executive, parliamentary and industry level as evidenced by a number of policy actions taken under the multilateral package. The government had already embarked on a macroeconomic and fiscal adjustment path prior to the events that gave rise to the need for the multilateral support package. The Bank's contribution is based on analysis conducted during preparation and accepted by the authorities as the basis for further policy actions to add to and strengthen the set of reforms underway. The Bank team includes experts with lengthy field experience in the country and knowledge of the executive, parliamentary, and other consultative and consensus building procedures.

Principle 2: ***Agree up front with the government and other financial partners on a coordinated accountability framework***

The accountability framework delineated in the policy matrix contains very specific actions with associated indicators for measuring results to gauge success of the program. The program is very closely coordinated with the other collaborating donors/partners, namely, the IMF and the EU with mutually supporting measures..

Principle 3: ***Customize the accountability framework and modalities of Bank support to country circumstances***

The financing package and associated policy measures are specifically geared to both the government's funding (and contingency) needs as well as to mitigate future risks generated by the global financial turmoil. As such, the measures are tailored directly to Hungary's situation and the funding is earmarked for specific or potential gaps, with a view to ensuring macroeconomic and financial stability while external economic effects fully roll out.

Principle 4: ***Choose only actions critical for achieving results as conditions for disbursement***

The policy actions are maintained at a modest number but with sufficient critical mass, focusing on those that are considered crucial toward strengthening the banking, fiscal and social package. The actions are those which contain key added value features as contributions from the Bank to the policy agenda. Other actions, already agreed with the other donors/partners, are essential to the overall basis of the program and listed supporting measures to be maintained during the execution of the program, and which complement the policy measures developed by the Government in collaboration with the Bank.

Principle 5: ***Conduct transparent progress reviews conducive to predictable and performance-based financial support***

Monitoring of the program will take place during loan implementation as a second tranche is embedded within the implementation period. Key fiscal conditions are aligned with the government's budget cycle and monitoring indicators will include measures included and approved during the government's future year budget program. The banking diagnostic indicators are built into the financial supervisory authorities' inspection cycle, and the results emerging from such will form part of the monitorable actions to be taken under the program to provide in-course feedback mechanisms and ensure the financial health of the banking system.

C. EXPECTED OUTCOMES OF THE OPERATION

145. The main long-run objectives of the operation include the achievement of overall fiscal sustainability and the restoration of financial stability and efficient markets as evidenced by the improvement in economic, financial and market indicators. In the pension and health areas the long-run objective is to generate adequate outcomes (adequate pensions, improved health status of the population) while avoiding chronic large deficits. The long-run objectives in these two latter areas include a strong fiscal component that also contributes to the objective of fiscal sustainability.

146. Fiscal sustainability would be reflected in a significant decline in the ratio of public debt to GDP, down from the high ratio of close to 80 percent in 2009. The debt rule introduced by the Fiscal Responsibility Law (preventing an increase in real debt) will ensure a sustained decline in the ratio of debt to GDP in the medium- and long-run, but this rule will only apply from 2012 onwards. In the intermediate years, the ratio is actually expected to increase slightly, due to the contraction of GDP and high real interest rates. Therefore, the effectiveness of the program will be assessed by monitoring intermediate outcomes.

147. As shown in Table 8 the expected outcomes in the fiscal area would include an improvement in the government primary surplus by 2010 to no less than 0.5 percent of GDP. If the fiscal program is able to improve investor confidence, this improvement should be reflected in reductions in the credit default swap (CDS) spreads in absolute terms and relative to peer countries, reductions in borrowing spreads relative to EU treasury securities, and reduced interest rate swap spreads. The latter indicator would also be used to assess improvements in market liquidity; notwithstanding that some of the outcome indicators are beyond the direct control of government.

148. The financial stability program is expected to ensure a resilient and well capitalized banking system, able to compete and intermediate efficiently. By the end of the program, all the banks should have robust capital adequacy ratios, considering the results of the assisted on-site examinations and stress tests. The program should also lead to lower and safer loan/deposit ratios and lower shares of FX loans within total household loans. The ratio of private credit to GDP (a celebrated indicator of financial depth) would not be used as a benchmark of program effectiveness, mainly because this ratio may decline during the program period given economic contraction, and due to funding restrictions and ongoing balance sheet adjustments (which should result *inter alia* in the lower loan to deposit ratios).

149. The expected outcomes in the pension area would include an increase in the effective retirement age and stabilizing of pension expenditures – aggregate fiscal expenditures under the public pillar should be reduced by the end of the program. If all the measures designed to restrict early retirement are effectively implemented, the average retirement age should increase and approach the statutory age, improving the sustainability of the pension system. As well, the penalties for early retirement and the elimination of the 13th pension will generate more cost reductions. The impact of the program on pension expenditures would be assessed by monitoring the trend of the pension deficit, or the gap between contribution revenues and pension payments which should decline or remain constant in the medium term. If expenditures increase at lower rates, considering all the above factors, this would be evidence that the elements of the reform are producing an effect. The ratio of pension expenditures to GDP would not be monitored, because it could increase in a period when GDP is contracting.

150. Some of the reforms in the health area may not produce sizable effects by the end of the program. For example, it may take time to reduce the overcapacity in hospitals, as this will still require the implementation of restructuring plans and the completion of corporatization of hospitals. However, the approval of the pharmaceutical law in 2008, and regulations on cost containment of drugs and medical appliances should stabilize real expenditures in pharmaceuticals and hospital equipment at the 2008 levels. The enactment of the Government Decree enhancing the role of General Practitioners should reduce overall visit rates for outpatient care, and prescription renewals, versus costlier visits to specialists.

Table 8. Long-Run Objectives and Expected Outcomes

LONG-RUN OBJECTIVES	KEY EXPECTED OUTCOMES BY END OF THE PROGRAM (December 2010)

Fiscal Reforms
 	
Restoration of fiscal sustainability, evidenced, inter alia, by (a) moderate fiscal deficits, (b) declining ratio of public debt to GDP, (c) low borrowing spreads over EU treasuries, and (d) a liquid government debt market.
	• Primary surplus no less than 0.5% of GDP by 2010.
	• Reduction in sovereign risk and increase in the demand for government debt, as reflected in:
	  • Lower sovereign debt CDS spreads
	  • Lower borrowing spreads over EU Treasuries
	  • Lower interest swap spreads

Financial Stability Program Resilient and efficient banking system, able to intermediate effectively, as evidenced by a sustained increase in the ratio of private credit to GDP and moderate intermediation (lending vs. deposit) spreads.	• All banks have high CARs after the diagnostics conducted under the intensive examinations and stress tests. • No increase in the share of FX loans in total household loans (using constant exchange rates); reduction in the share of FX denominated loans in currencies other than the Euro. • Reduction in the average loan/deposit ratio (i.e.: increased funding of loans with deposits).
Pension Reforms Pension system that provides adequate, fiscally sustainable, affordable pensions, while maintaining adequate minimum pension levels.	• Increase in the effective retirement age. • The aggregate level of fiscal expenditures in the public pillar is reduced in real terms.
Health Reforms Health system able to contain growth of public expenditures and reduce deficits through efficiency gains, while ensuring access to health care.	• Containment of real pharmaceutical expenditures at existing levels. • Reduced number of outpatient visits.

VI. OPERATION IMPLEMENTATION

A. POVERTY AND SOCIAL IMPACTS

151. **The global financial crisis will continue to pose potentially serious economic risks to poverty and vulnerability in Hungary.** The EC has forecast a more than 4 percent GDP contraction in 2009 and unemployment rates, a lagging indicator, have increased sharply in the first quarter of 2009 to 9.7 percent from 8 percent a year earlier. The rapid worsening in labor market conditions is particularly pronounced among the youth, where more than one in four 15-24 year olds is unemployed, a rise from 20.2 percent a year earlier. Job losses have been more concentrated among unskilled labor and for the first time male unemployment rates exceed female unemployment rates.[19] The strain on the labor market is also demonstrated by the rise in part-time employment, which rose by 13 percent in Q1 2009 relative to a year earlier.

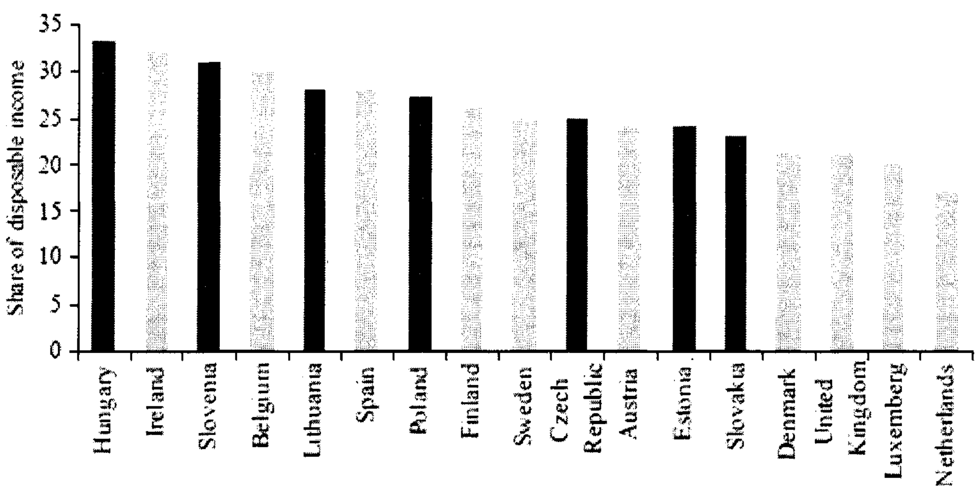
[19] Unlike in the recent past, job losses are leading to increased unemployment rather than to increased inactivity.

152. **The loan promotes measures that would facilitate growth and thus mitigate worsening secondary effects from the global crisis.** Despite the adverse external factors surrounding this operation, the policies included in the loan have been designed to protect the funding of basic needs and services for low income segments. Any directly negative socioeconomic impacts of the program, are within acceptable limits given Hungary's comprehensive and extensive welfare system and in view of the need to adopt austerity measures to ensure sustainability and promote economic growth.

153. **Poverty rates in Hungary are low relative to other ECA countries (which in aggregate, is the region with the lowest poverty rate) but certain segments are vulnerable to poverty.** Eight percent of the population lived below the poverty line (PPP US$5/day) in 2005, down from 10.3 percent in 2002. While poverty and human development indicators are generally better than regional averages, there still remain issues of economic integration of minority groups (e.g. the Roma) who can easily fall into poverty. Extreme poverty rates, however, are very low, with two percent of the population living on less than PPP US$2/day.

154. **Hungary, like other Central European countries, inherited an extensive social protection system designed to complement low wages and redistribute income.** Although the system helped to cushion the impact of the transition and subsequent economic downturns, social transfers have imposed an enormous burden on public expenditures. Hungary spends 21.4% of GDP on social protection, which is one of the highest rates in the EU and is second only to Slovenia of the EU-8 countries. Benefits as a share of disposable incomes are also very high at 33 percent (Figure 11). At 2.8 percent of GDP, spending on social assistance is high relative to other countries in ECA, largely due to universal family and child benefits, where however, relatively greater subsidies are paid to younger, poorer, and single-parent households. In addition to the fiscal burden, the relatively generous (by ECA standards) social assistance has, along with the pension system, triggered work disincentives - Hungary has the second lowest activity rate in the OECD. In addition, Hungary is the only country in the EU-10 where unemployment rates have steadily climbed since 2001.

Figure 11. Benefits as a share of disposable income



Source: World Bank (2008) using 2006 EU-SILC data.

155. **To improve the sustainability of the public pensions system, the Government has introduced parametric reforms with limited negative impact on the poor.** From a distributional point of view, abolishing the 13th pension payment is likely to impose the biggest direct short run impact. In order to cushion the impact on the poor, a portion of the 13th payment will continue until 2010 for lower income recipients. From 2010, the 13th payment will be eliminated for all pension recipients. However, the distributional analysis conducted by MoF shows that less that 1 percent of the population will fall below the poverty line as a consequence of eliminating the 13th payment, which is consistent with the finding that households receiving pensions are clusters in the middle of the income distribution.[20] The relatively small poverty impact can be mitigated by ensuring that regular social assistance be made available to elderly people who qualify, and that the work requirements are exempt for elderly people.

156. **The distributional impacts of the increase in the effective retirement age is yet unclear.**[21] Women will be affected more since they tend to take advantage of early retirement provisions more often. However, to the extent that the affected older population is employable, their incomes will actually rise because of this measure (they will receive a wage instead of the pension for a few years, and the subsequent pension will be higher). The effect on vulnerable people is mitigated by following factors:

- unemployment, disability and/or social assistance programs are available;
- the most vulnerable population, namely those people in the informal sector, are not covered by the social security scheme and hence are not affected. The exception might be old unemployed people who may have qualified for early retirement pension under current rules, but will have to spend more time drawing from unemployment and/or social assistance programs under the new rules. However, the chronically unemployed likely do not qualify for the early retirement benefit since they lack the required length of service;
- the reform will be implemented in 2010, and hence, will allow individuals to plan their strategy to deal with the change.

157. **To improve the financial sustainability of social assistance and to increase the employment rate in the country, a work requirement has been instituted.** The work requirement, which applies to people who are capable of work, demands at least 90 days per year of public works participation. To ease the difficulties of this work requirement on some groups, the Government has included exemptions from this work requirement for people under 35 who have not completed the 8th class of primary school, health impaired, elderly (55 years and older), and persons who bring up a child under 14. Besides the community asset creation/maintenance benefit of public works, the work requirement is likely to dissuade some people from exiting the labor force. This incentive to remain in the labor force is crucial because, as mentioned earlier, Hungary has the 2nd lowest activity rate among OECD countries. 57 percent of the population aged 15 to 64 years are employed, while the average

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[20] Economic Research Division, Ministry of Finance. The poverty line used is 60 percent of the per capita household income, which is also the Laeken poverty measure. The pre- and post-reform poverty rates are calculated assuming that the poverty threshold remains constant before and after the 13th payment is eliminated. If however, relative poverty measures are used in both pre- and post-reform periods, then the change in the poverty rate is negligible.

[21] This reform can also be interpreted as a removal of unfair subsidy in the early retirement provision, rather than as a reduction of the benefit.

employment rate is 64 percent in the EU-27 and only Poland has a lower employment rate among the former socialist EU members.[22]

158. **To reduce the tax wedge on labor, the Government has adopted tax reforms but static simulations show that these reforms may hurt the poor.** MoF simulations using the TARSZIM micro-simulation model reveals that changes in the VAT will reduce the after tax position of households in quintile 1 by about 5.3 percent, while reductions in the personal income taxes will increase the after tax position of the poorest households by 0.32 percent. However, available simulations do not incorporate expected behavioral changes, which are crucial to evaluating the distributional impact. As a result, changes in consumption patterns and changes in employment rates are not simulated in the TARSZIM micro-simulation model.

159. **The basic health benefits package is maintained at existing levels and is not part of adjustment policies, to ensure that basic service needs continue to be met despite expenditure cuts in the public sector and other programs.** Hungary currently has the highest service use rate for outpatient and inpatient care in Europe. Reforms are expected to reduce the number of outpatient visits and lead to efficiency gains. As there is no co-payment for health care services it is not likely that this expected reduction would lead to inequality in service use.

B. ENVIRONMENTAL ASPECTS

160. The specific country policies supported by the operation are not likely to cause significant effects on the country's environment and natural resources. Moreover, Hungary has adequate environmental controls in place. Hungary's environmental legislation and regulation is reinforced by EU environmental directives, including the EU's guidelines on adoption of environmental assessments at the planning and programming level (June 2001) and the EU's Environmental Liabilities Directive setting out liability for damage to properties and natural resources (April 2007). None of the sectors included in the operation are expected to have any significant link to the environment.

C. IMPLEMENTATION, MONITORING AND EVALUATION

161. Implementation of the loan will require close coordination among the Bank and the respective institutions responsible for implementation. These include the Ministry of Finance, the Central Bank (MNB), the Hungarian Financial Supervisory Authority, and the Ministry of Health, all of which have provided the requisite baseline data from which to measure outcomes by the end of the program. The Ministry of Finance will assist in the coordination of information reporting on the program's monitoring indicators which will be assessed and discussed among the Bank team and the implementing agencies during field visits between the first and the second tranches, and supplemented by periodic electronic communications and exchange of information.

162. The implementation actions which are set forth in the policy matrix (Annex 2) as prior actions for each tranche, require careful institutional interventions which will be areas of discussion and technical exchange among the implementing institutions and the Bank. In this

[22] Research has shown that Hungary's welfare system is too generous and is leading to low employment rates. See Benedek, Dóra, Réka Firle and Ágota Scharle (2006) "Degree and Efficiency of Redistribution" Ministry of Finance Working Paper No. 17, Budapest, Hungary.

respect, technical cooperation during the monitoring and implementation is expected to be significant, with the Bank providing, in some cases, examples of best practices which can serve as models for certain institutional actions (e.g.: carrying out the terms of reference for special bank diagnostics methodologies, and generating the needed supervisory actions based on the portfolio quality and loan provisioning for specific cases).

163. At the overall program level, including the signals that the adjustment effort is sending to the investor market, external monitoring indicators will also be used. These include market spreads on credit default swaps for sovereign bonds, as well as emerging market bond index (EMBI) reported spreads. Independent of the macroeconomic and banking sector adjustment actions being taken, these monitoring indicators will serve as useful market benchmarks to determine if the overall actions under the operation are generating the desired market responses and fully restoring Hungary's access to the capital markets.

164. At the banking sector level, several sectoral indicators will be used to monitor progress in fully implementing policy reforms and achieving desired program outcomes. The Bank, in collaboration with the Hungarian financial authorities will continue to monitor the non-deposit funding sources for domestic banks (parent funding, third party funding, wholesale funding, other sources) and assess the terms of such funding (maturities and rates) to determine if such resources are being maintained or increased thus assuring more stable bank funding. Likewise, the trends in deposits at banks will continue to be monitored, and there is already evidence that these have begun to increase, partly due to the broader more inclusive guarantee on deposits that the government has given.

165. At a measurable level, a key indicator of banking strength will be determined through the evaluation of overall capital levels and financial condition of credit institutions. By implementing the policy actions related to special diagnostics and stress tests, as well as the regulatory actions requiring the adequate provisioning for potential loan losses, foreign exchange, or other risks, which would be followed by implementation of adequate overall solvency capital levels, the monitoring process under the operation will allow an overall evaluation of the capital position of banks, profitability, and capacity for new lending. These indicators will be crucial for evaluating the impact of the operation's policy changes and for ensuring that the financial system is ready to emerge from the global and regional economic downturn from a position of strength.

166. At the institutional level, results reflecting institutional change and capacity will be assessed primarily through the application of the newly approved laws and regulations. The evidence of supervisory prompt enforcement action regarding both forward looking risks as well as corrective measures applied to financial institutions where necessary, will be key determinants regarding the efficacy of the supervisory agency in applying preemptive actions. While such information may be of a confidential nature for specific banking institutions, the Bank team will nevertheless agree with the government on sharing information demonstrating that the application of new powers and corrective actions (or special resolution procedures) meant to address deteriorating financial trends at a very early state, and minimizing further losses, have indeed been applied and in what number and type. At a qualitative level, the flexibility in redeploying resources and applying regulatory actions based on new diagnostics will also be assessed as part of the institutional readiness for reform under the program.

167. In other areas of the operation, such as the fiscal program, indicators will be based mainly on the macroeconomic and fiscal expenditure reporting. In conjunction with IMF

monitoring of the same, the Bank will liaise with the Ministry of Finance in order to receive government reports on fiscal expenditures against program targets and debt levels commensurate with the policy changes incorporated in the implementation of the new Fiscal Responsibility Law and specific expenditure reduction measures. At the institutional level, besides the enactment of the Law on the Legal Status of Budget Institutions, monitoring of the law's adoption and application by samples of public institutions will be conducted with a view toward determining the success and results of its implementation (e.g.: reform plans for institutions wishing to raise own-revenue sources, reduce their debts, and overall budgetary efficiency goals and achievements).

168. Within the social sector aspect of the operation, the monitoring of results will include both quantitative and qualitative measures. Progress in streamlining public pillar pension expenditures and targeting benefits for the basic pension segments, will be monitored via MoF reporting on adherence to the pension spending targets and maintenance of the parametric reforms introduced. For the private pillar, the main evaluation will be qualitative and based on the proposed pay-out/annuities design of the system (to be a joint effort by the MoF and the HFSA) which will be assessed based on its effectiveness in addressing the market risks, actuarial risks, burden sharing aspects (among beneficiaries, the industry and government), retiree/consumer protection issues, and other market and benefit options included in the second pillar pension pay-out design.

169. In the health sector, assessments of the implementation of institutional changes will be conducted throughout the program. Measurable indicators will be used for assessing the cost efficiency, quality, and savings achieved via the new consolidated procurement procedures for the purchase of medical supplies and drugs. Monitoring of other reforms will be conducted through assessing the Health Ministry's progress in promoting more efficient expenditure and contract management procedures, for example, of the Health Insurance Fund, as well as progress in the reforms towards corporatizing and making health agencies and hospitals more cost effective and fiscally self sufficient.

D. FIDUCIARY ASPECTS

Public Financial Management System and Budgetary Resources[23]

170. The Hungarian Public Financial Management (PFM) system is supported by a robust legal and institutional framework. Although the PFM system had been fairly well performing, Hungary introduced a series of PFM reforms during the 2006-2008, after joining the European Union. Most important was the introduction of a medium term framework to improve fiscal discipline and providing greater budgetary transparency and predictability.

171. In addition, the Fiscal Responsibility Law, passed by the Parliament on November 17, 2008, introduced further significant reforms. They include the preparation of the budget for a two year period with a primary surplus target, and state debt maintained at a constant real level. Based on the two year budget the government shall issue a decree with planned revenue and expenditure limits of the budget program categories (chapters). More extensive budgetary

[23] As Hungary joined EU in 2004 and graduated from the World Bank financial assistance in 2007, no recent analytical work on PFM had been conducted by the Bank in Hungary. Therefore, the assessment and adequacy of the PFM system to support this operation were derived from the ongoing monitoring by the Bank, of PFM reforms and previous diagnostic work conducted by the Bank and external organizations.

oversight will also be performed by the three-member Budget Council, nominated by the president, the central bank governor and the head of the State Audit Office.

172. The Budget Council will have the mandate to make macroeconomic forecasts, monitor the performance of the budget, and evaluate the budget impact of the proposed legislation. Additional enforcement mechanisms will be introduced including inter alia setting limits on primary central state spending, and treatment of unplanned surpluses. The new set of fiscal reforms aims at restricting budget policy and is a long awaited measure to bring down the country's debt to a sustainable level and curb budget spending in the long term.

173. The key strengths of the PFM system in Hungary include integration of expenditures and special funds within the budget, centralized cash management within a single treasury account structure, timely preparation and audit of government financial statements, and a strong audit capacity of the State Audit Office. Key weaknesses, including the budgetary framework being exposed to fiscal slippages, weak multi-annual planning, inadequate budgetary enforcement, and lack of institutional checks and balances, are addressed by the 2008 reforms that will start implementation during the 2009 fiscal year.

174. Notwithstanding the ongoing reforms and a series of other actions required to improve the financial accountability framework in Hungary, the fiduciary risk to Bank funds and other donor funds managed through the mainstream government system remains minimal.

Foreign Exchange Environment

175. The Magyar Nemzeti Bank (MNB or central bank of Hungary) is legally independent and has no role in the financing of the fiscal deficit. The MNB is a member of the European System of Central Banks, and its legal independence is granted by the Act of the MNB. The Act prohibits MNB financing of the government fiscal deficit, describes its responsibilities regarding management of the single treasury account and other government accounts held at MNB, and regulates profit transfers to the budget. The MNB has full operational autonomy in setting monetary policy. It holds and manages the foreign exchange reserves of the country. The government and the MNB mutually decide on the parameters of the exchange rate regime in accordance with the Act which makes exchange rate policy a shared responsibility.

176. An IMF Safeguards Assessment of MNB is being completed. A review of external audit reports of the central bank was performed by the World Bank. The MNB's financial management and operations are transparently disclosed and presented on its website. The MNB annual financial statements are regularly audited by reputable independent auditors and the most recent audit reports for 2005-07 have unqualified audit opinions.

E. DISBURSEMENT ARRANGEMENTS

177. The proposed loan will follow the World Bank's disbursement procedures for development policy lending. Loan proceeds will be disbursed in two tranches to the foreign currency account at the MNB. Disbursement will be made upon declaration of loan effectiveness, meeting tranche conditions, and submission of a withdrawal application to IBRD. At the request of the MOF, IBRD will deposit the proceeds of the loan into the designated account at the MNB – this forming part of the country's official foreign exchange reserves.

178. The Borrower shall ensure that upon the deposit of the Loan into said account, an equivalent amount is credited in local currency[24] to the Single Treasury Account also kept at MNB and available to finance budgeted expenditures. Disbursements will not be linked to specific purchases, thus no procurement requirements will be necessary. The Government shall maintain accounts and records with respect to the deposit of loan proceeds in MNB. If the loan proceeds are used for ineligible purposes as defined in the loan agreement, IBRD will require the borrower to refund the amount directly to IBRD.

179. The Bank will not require an audit of the designated account, but will require the Government to provide a confirmation to the Bank in the form of an official letter from the Ministry of Finance on the amounts deposited in the foreign currency account and credited to the budget management system (Single Treasury Account) within 30 days of receiving the funds.

F. RISKS AND RISK MITIGATION

180. **Further worsening of the external and macroeconomic environment.** The financial crisis continues to generate effects, despite the rescue programs implemented in many developed countries. There is a risk that money and credit markets will remain clogged and that the downturn in the EU will be more severe and protracted than currently projected. The access to foreign exchange finance would remain restricted and the exchange rate could remain volatile. The contraction of real GDP and the increase in unemployment in 2009 and 2010 could be more pronounced than anticipated. Parent banks could potentially reduce their funding if their own balance sheets became constrained. This would further strain banks and the corporate sector, and could also create difficulties for the achievement of fiscal targets.

181. The multilateral package is geared toward a worse case scenario of a significant shortage of external funding, in order to mitigate these risks. Hungary's financing requirements would be met, reducing the risk of further strains on the banks and the corporate sector, and reducing the need for even more drastic fiscal adjustments. Nevertheless, recent signs of the external environment (despite further contraction domestically) show that external lenders are now increasingly willing to fund Hungary via the market. The fiscal adjustment has been very sharp, but credible, and backed by the multilateral package. The Program also mitigates risks in the banking system through the in-depth assisted examinations and the substantial strengthening of supervisory powers with options for prompt action to avert contagion effects. Parent banks would likely avoid withdrawal (and in the past months their funding has increased to Hungary) given the regional contagion effects this could produce and affect their own profitability. Finally, the fiscal program includes the new fiscal responsibility law coupled with a substantial cost cutting adjustment measures that should restore investor confidence, by imposing strict indebtedness limits and ensuring a steady decline in the ratio of debt to GDP.

182. **Potential change in government policies following 2010 election.** The Program contains a robust set of measures in the banking, fiscal and social sectors. However, the Program approaches an election period in 2010 and thus there is the potential for changes in government policies toward Program objectives. This risk is mitigated by the fact that many

[24] The Bank can also agree that the proceeds of the loan will remain in the loan currency (Euro) which should be reflected in the loan document.

reforms supported by the Program are being implemented by new laws already enacted, as prior actions for the first tranche, and additional laws by the second tranche. The provisions most at risk would be those approved annually under the budget law which can be modified the following year. Even with a reversal, this is unlikely to impact fiscal trends significantly since other measures in place (e.g.: major expenditure and revenue reforms, FRL law ceilings) would constrain the room for reckless spending without additional available funding. The Government recently gained access to the external capital markets again by issuing a Eurobond in July 2009, and this provides a potential signal of increased investor confidence in the Government's program and its adjustment efforts.

183. **Insufficient institutional autonomy and capacity.** The reforms in the banking system require an increase in autonomy and capacity of the supervisory agency for anticipating deteriorating trends and undertaking the necessary corrective actions. To mitigate the risk of inadequate implementation, the Bank expects to provide continuous technical cooperation with the supervisory agency as part of loan supervision during the Program period, and continue the dialogue with the Ministry of Finance and the Central Bank to ensure the tri-partite collaboration needed to address financial imbalances, if they occur. On the fiscal expenditure side, to ensure a socially sustainable program, the Bank intends to also conduct a Public Expenditure Review focused on social expenditures. The report will be an important vehicle of policy dialogue and will also provide inputs for further reforms in key areas while maintain adequate safety nets for the most vulnerable segments of the population.

184. **Need to strengthen the toolkit of early supervisory intervention.** In line with international practice, it is important to update the early intervention powers of supervisory authorities in order to make them capable of acting early (sometimes based on ex ante risk assessments) and not only after a potential default. The menu of instruments, policies and measures contemplated in the operation should suffice to resolve any banking weaknesses, but there is a risk that large domestically owned banks may attempt to prolong periods of potential financial weakness without government support, and risk negative investor sentiment that may affect other parts of the system. To mitigate this risk, the Program includes a sufficiently broad range of policy tools that would allow the financial authorities to intervene, if necessary, if a systemically important institution is weakening and does not avail itself of government capital support measures. Contagion, however, would be unlikely to affect other large banks as parent companies have committed to maintaining or increasing funding to their subsidiaries. The features of the program, as mentioned, also contain forward looking discretionary measures to allow strong intervention and resolution actions to complement any capitalization measures. As well, within the available funding allocations in the fiscal envelope and the multilateral package, the government has already provided lending to banks facing liquidity shortages in order to tide over the period of reduced access to external third party markets which have shown some signs of improvement recently.

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MINISTER OF FINANCE
REPUBLIC OF HUNGARY

PÉNZÜGYMINISZTÉRIUM

11.758/2/2009

HUNGARY: LETTER OF DEVELOPMENT POLICY
Letter of Sectoral Policy from the Republic of Hungary

Mr. Robert Zoellick
President
World Bank
1818 H Street NW
Washington, D.C. 20433
U.S.A.

August 17, 2009

Dear Mr. Zoellick:

Developments in Hungary's sovereign bond market and banking sector starting late last year, coupled with the economic and financial developments in the U.S. and Western Europe impacted Hungary's financial sector and macroeconomic prospects. These developments generated higher sovereign spreads and lack of sufficient capital market access as well as uncertainties regarding funding sources, pricing, and maturities in the domestic banking sector. For these reasons, and to assure a smooth path toward increased equilibrium, complemented with a host of Government adjustment measures described in this Letter, the Government of Hungary is seeking a € 1.0 billion loan from the World Bank as part of the multilateral funding package agreed with the IMF and the European Commission.

The funding would assure resources to finance potential gaps and meet our external obligations, while ensuring adequate capital and liquidity in our financial system, if needed. The measures which the Government will support as part of a Word Bank policy loan are elaborated below. The main objectives of our policy measures are to: (i) meet government financing and balance of payments needs, (ii) reduce fiscal spending and long term indebtedness, (iii) maintain adequate liquidity, capitalization and stability in the domestic banking system, and (iv) undertake additional measures in the pensions and health sectors to not only reduce spending but ensure that the necessary social services and support are maintained and are well targeted.

Macroeconomic and Fiscal Policies

The fiscal consolidation that began over two years ago narrowed the general government deficit by 6 percent of GDP to 3.4 percent in 2008. Despite a solid fiscal adjustment, the external current account deficit increased by nearly 2 percentage points in 2008 to 8.4 percent of GDP. The fiscal austerity program has resulted in a contraction of domestic demand and a significant slowdown in real GDP in 2008. Domestic demand weakness has persisted during 2009, as a result of the combined effects of labor market adjustments, the government's tightening measures, and reduced access to bank credit; and exports have declined sharply. Headline inflation slowed to very near the central bank's 3 percent target as the effects of slack demand more than offset those of forint weakness. With domestic demand collapsing, the current account improved dramatically in early 2009.

Periodic forint selling pressures and the need to sustain demand for local currency-denominated government bonds prevented the Magyar Nemzeti Bank (cental bank of Hungary or MNB) from cutting interest rates despite the intensified economic downturn, tightened bank liquidity and sizable rate cuts abroad. The MNB's key policy interest rate was left unchanged at 9.5 percent since late January, followed by a 1-percentage-point cut at the end of July. The forint appreciated nearly 14 percent by June from an all time low of forint 316/euro earlier in March. However, it still remains 15 percent weaker than a year before.

The outlook for 2009 and 2010 is uncertain, as it depends on global events and, crucially, the extent to which investor confidence in Hungary can be maintained. In our baseline scenario, global financial market stress will gradually abate, which over time should reduce pressures in financial markets in Hungary. However, the global deleveraging that is already under way may further reduce net capital inflows, slowing down credit growth. Coupled with projected negative euro zone growth in 2009 and further fiscal tightening, this will put stresses on the domestic economy. After falling close to 7 percent this year, GDP looks set to decline another 0.9 percent next year. Larger EU transfers, falling imports and smaller income payments to direct investors will help halve the current account deficit in 2009.

The targeted fiscal deficit was revised to 3.9 percent, with projected reductions in revenues due to weaker activity, addressed with new spending measures. The main measures on the spending side, additional to those incorporated in the 2009 budget, include: (i) a freeze in the expenditures of budgetary chapters, (ii) a decision not to spend funds received from sale of carbon credits, (iii) elimination of subsidies for farmers, above EU agricultural support payments, (iv) reductions in subsidies for gas and heating costs, and pharmaceuticals, (v) elimination of the 13th monthly salary for public servants earning 149,000 HUF/month or more, and gradual decrease the amount of the 13th monthly salary to zero for those who earn more than 131,000 but less than 149,000 HUF/month and the 13th monthly pension payment for pensioners, (vi) postponement of corrective type increases of pensions and planned increases in family allowances, and (vii) cancellation of subsidies for new housing purchases. The government also decided to freeze the public sector wage bill, along with family allowances and social benefits linked to the minimum old-age pension, for 2010-11.

In addition, the government enacted a revenue-neutral tax reform. Together with trimming and better targeting of social benefits, it is intended to support growth potential. Main measures resulting in lowering the labor tax wedge, include a 5-percentage-point reduction in employer paid social security contributions, cuts in certain tax rates, raising of tax brackets, elimination of the 4 percent solidarity tax, redefinition of taxable income to expand the tax base, and gradual withdrawal of deductions and allowances. With these, 90 percent of taxpayers will have a lower rate. For mid-income earners, the marginal tax rate will be significantly lower.

The government is committed to maintaining fiscal discipline in the long-term, recognizing that this is a key element in retaining investor confidence. To put fiscal sustainability on a permanent footing, a Fiscal Responsibility Law was approved, which establishes fiscal rules on public debt limits and the primary deficit, strengthens the medium-term expenditure framework (rolling three-year expenditure ceilings) and creates a Fiscal Council reporting to Parliament to provide independent scrutiny. Additionally a law on the

Legal Status of Budgetary Institutions was approved, aimed at providing more budgetary and institutional autonomy in exchange for efficiency gains and higher accountability.

For the second phase of the Bank-supported program, in the fiscal sector we intend to reach the government budget deficit target of 3.9 percent in 2009. We will apply the expenditure provisions based on legal reforms undertaken, to cover health services, child-care benefits, family allowances, housing subsidies household gas consumption and district heating. Implementation of these reforms will ensure improvement in the financial sustainability of the social support system, including the tightening of eligibility criteria and improved targeting of benefits, as well as better incentives toward work and employment within the social benefits system. Funding for the Fiscal Council will be put in place, and the Government will issue a Decree to implement provisions of the Legal Status Law to specify the new rules for budgeting, performance monitoring and service delivery.

Reform Program for the Financial Sector

The financial stress experienced late last year was mainly due to external factors. Investors' extreme risk aversion, which spilled over from difficulties in global financial markets, negatively affected the foreign exchange markets, government securities, and equity markets in Hungary. The effect in Hungary may have been more pronounced than elsewhere in the region because underlying vulnerabilities (public and external debts) remained high, and financial markets are deeply integrated with EU markets.

Since the last quarter of 2008, in response to increased stress in domestic financial markets, we took a number of measures to improve liquidity. The MNB established a foreign exchange swap facility, supported by a repo facility with the ECB, for up to €5 billion. We established an auction facility to purchase government bonds from market makers of these securities, intended to improve liquidity in the secondary market. The MNB also created two new facilities to inject forint liquidity into the banking system: a two-week refinancing window at a fixed price, and a six-month bid-based funding facility with no fixed price. Supporting these facilities, the expansion of collateral instruments was instituted, including allowance for the use of covered mortgage bonds, among other collateral types.

We developed a comprehensive package of support measures available to all qualified domestic banks. The domestic banks entered the period of market stress with strong solvency positions, which they have been able to preserve in spite of the turmoil. We approved, through the new Financial Stability Law, a banking sector package with provisions for added capital, and resources for a guarantee fund for interbank lending and the issuance of new bank securities for funding. A total allocation of approximately €2.2 billion is divided between a Capital Base Enhancement Fund (CBEF) to strengthen bank capitalization, and a Guarantee Fund to back-up bank funding lines. The CBEF was sized to raise eligible banks' capital adequacy ratios (CARs) to provide a cushion against risks, and would operate through the participation of government preferred shares and special classes of shareholding powers allowing government board representation, veto powers over key decisions, and management changes if necessary. The Guarantee Fund was designed to bring comfort to the providers of wholesale funding and secure the refinancing of the eligible banks. In addition, the Government more recently approved direct loans to domestic banks without parent organizations, but that continue to face constrains in raising new funding in the markets.

As per above, liquidity availability in the banking system, particularly foreign exchange funding, declined substantially following the unfolding of the global crisis.

However, most external liquidity funding is sourced from parent banks in the euro area, which now have access to liquidity through ECB facilities and which pledged their continuous support of their subsidiaries in Hungary, as reaffirmed in the statement of leading foreign-owned banks in Hungary. The MNB and the Financial Supervisory Authority (HFSA) have been monitoring this commitment closely. As well, the government not only increased the level of deposit insurance coverage of retail deposits in line with EU agreements, but also pledged to provide a blanket guarantee on all deposits. Given the increase in the deposit insurance coverage, the Board of the Deposit Insurance Agency also approved an increase in the premium contribution by banks commensurate with the higher coverage requirements and the long term funding target.

The stability of banking functions needs to be preserved and in this context, we have begun to strengthen the HFSA's and MNB's ability to assess and address solvency and liquidity concerns of banks in a timely manner. As part of supervisory strengthening, an exercise of intensified on-site inspections has begun to be carried out by the HFSA for the systemically important banks to ensure detailed diagnostics of banks' portfolio asset quality and classification, adequacy of loss provisions and collateral, solvency positions and capital, and other financial risk indicators including overall group positions and contingent obligations vis-à-vis domestic subsidiaries abroad. This information will be used in the second phase of the program, to determine if corrective actions, capitalization or other measures are needed to maintain a healthy solvency of financial institutions. In parallel, according to the Concluding Statement of the European Banking Group Coordination Meeting held on 20 May, 2009 in Brussels, the MNB initiated an exercise of scenario analyses (stress tests) of banks portfolios and assets against economic developments to assess the solvency of banks comprising at least 75 percent of system assets. In the second phase of the program, based on the results of the stress tests, MNB will, along with the other financial authorities, take the appropriate regulatory actions if cases arise where deficiencies are identified.

Mechanisms for early remedial actions, including well-defined supervisory powers for the HFSA to act in the case of systemic problems or before substantial deterioration of an institution is observed; have been initiated and will be expanded as part of proposed new amendments to the HFSA Act to be implemented in the second phase. Amendments to the Stability Act and the HFSA Act give powers to the HFSA allowing it to require extraordinary reporting from a respective bank, inspections lasting up to one year, and/or appointing a qualified forensic auditor during the course of an inspection. Under the second phase, we plan to present HFSA Act amendments to Parliament to enrich the powers for HFSA to require prompt preventive actions by banks where risks and deteriorating trends are observed, so as to ensure that preemptive measures take place before conditions worsen. Such measures will complement the existing measures in our Banking Act. In addition, the new supervisory powers would allow the appointed authority to issue orders at the system-wide level applicable to all institutions, to prevent practices or developments that might increase instability.

In the second phase if the Ministry of Justice agrees we also intend to present to the Government Cabinet, a legal amendment to the HFSA Act to allow the HFSA to undertake bank resolution procedures involving the partial balance sheet transfer of bank assets and liabilities to sounder institutions or to a newly created institution, in order to promptly resolve insolvent banks and save potential fiscal outlays to repay depositors or to provide other types of bank support. We expect to eventually submit this amendment to the Parliament provided that some of the constitutional issues regarding the protection of private property rights (equity holders and creditors) can be resolved satisfactorily within the framework of this new proposed legislative amendment. In the second phase, we will also issue new accounting regulations on loan classification and the prudent treatment, for accounting purposes, of restructured, refinanced or renegotiated loans, as well as associated provisioning requirements to ensure that such loans are properly classified according to their assessed repayment prospects, present values, and risks.

Social Sector Policies

As part of the Government efforts to identify longer term structural and institutional actions to ensure fiscal sustainability, and at the same time providing sufficient space for social safety net expenditures in a period of negative growth, the government has identified a number of reform areas covering the pensions and health sectors. Hungary has one of the highest levels of social protection spending in the EU's New Member States, and covers benefits for housing, family, children, unemployment, sickness/health care, old age, and disability. A part of these subsidies are based on means-tested criteria and the other part can be claimed by the poorest households. Expenditure reductions in the social sectors are not directed at minimum benefits that are targeted to the poorest households.

In the pension area, under the publicly funded pillar, the government took a first set of actions in 2008, to reduce fiscal outlays. Changes to the Pension Law approved by the Parliament included: (a) requiring payment of pension contributions on wages of pensioners working on new jobs, (b) reducing newly awarded pensions by 7-8 percent through changes in the net wage base calculation, (c) restricting early retirement by raising the years of service requirement from 38 to 40 for regular pensions and from 33 to 37 for reduced pensions, (d) suspension of pension payments under age 62 if the earnings are exceeding the yearly minimum wages, and (e) improving incentives to delay retirement by increasing early retirement penalties and late retirement bonuses.

More recently in 2009, Parliament approved a new set of measures presented by the Government, modifying the Pension Law and which introduced: (a) a gradual increase in the statutory retirement age from 62 to 65, beginning in 2012, (b) introduction of penalties for early retirement, for men beginning in 2011, and for women beginning in 2013, (c) a new pension indexation rule implying a move from wage to price indexation, depending on GDP growth, with under 3% growth implying a 100% weight for price indexation, and with growth above 5% implying 50/50 weights for prices and wages, respectively, with weighting graduations in between such range of growth rates; (d) an elimination of the 13th monthly pension benefit beginning July 2009, and (e) other measures including the tightening of disability pension criteria.

In the private pensions area, the Government earlier implemented a centralized contribution collections system via the tax authorities, to increase efficiencies; and authorized a more flexible investment regime for pension funds, based on the need for lifecycle portfolio planning. For the second phase, the Ministry of Finance in collaboration with the HFSA, is committed to developing a draft legislative design of the payout phase of the private pension pillar including the design of retirement products such as annuities, their indexation rules, and the menu of options for pension payout products.

In the health sector, the Government has maintained the basic health package to citizens while implementing a number of institutional measures to increase the efficiency and accountability in the provision of health services. In line with the provisions of the Act on the safe and efficient supply of pharmaceuticals and medical appliances as well as on the general rules of distribution of pharmaceuticals, the Government with the Ministry of Health has approved regulations which are expected to yield further budget savings based on cost containment measures undertaken.

In the second phase of the program, the Ministry of Health intends to issue guidelines concerning the corporatization processes for hospitals, in line with the provisions of the Legal Status Law (discussed above under the fiscal section). Coupled with this, the implementation of cost reducing measures will be carried out via a government decree that strengthens the role of General Practitioners. The Government will maintain the basic health package for citizens and does not intend to reduce basic benefits in this upcoming period. However, the above institutional reforms will help to increase transparency in the sector's operations and promote efficiency.

Conclusion

The above package of multi-sectoral policy measures is intended to address both the priority issues affecting our financial system and access to global markets, as well as the elements of fiscal discipline needed to provide markets the confidence that Hungary continues its adjustment on a sustainable reform path. At the same time medium and longer term reforms are contemplated in the fiscal and financial spheres to ensure respectively, sustainability and stability, as well as in the social sector spheres. In the latter areas, the Government's approach involves maintaining a reasonable level of benefits to ensure that social safety net requirements are met during the economic downturn, while improving targeting of benefits to the most vulnerable, and reducing excess outlays in line with the necessary fiscal tightening and debt reduction measures.

Sincerely,

Dr. Péter Oszkó

PÉNZÜGYMINISZTER

ANNEX 2

POLICY MATRIX

HUNGARY: FINANCIAL SECTOR & MACRO STABILITY LOAN

FIRST PHASE/TRANCHE POLICY ACTIONS TAKEN PRIOR TO BOARD APPROVAL	SECOND PHASE/TRANCHE POLICY ACTIONS FOR SECOND TRANCHE
I. FISCAL/MACROECONOMIC FRAMEWORK	
The Government has continued to: (i) implement its current fiscal program in a manner consistent with the provisions agreed upon with the IMF and the EU, and (ii) make available to domestic banking institutions, financial sector safety net facilities. The Government has adopted revenue-neutral tax reforms that reduce the tax wedge on labor to bolster potential growth, and which include: (i) lowering of social contributions, (ii) cutting the overall personal income tax, and (iii) increasing consumption and wealth taxes. The Parliament has established the Fiscal Council, as mandated by the Fiscal Responsibility Law, to serve as an independent body for scrutiny of budget preparation and execution, reporting directly to the Parliament. The Parliament has adopted a Law on the Legal Status and Management of Budgetary Institutions ("Legal Status" law), designed to increase autonomy of public sector institutions with the potential for augmenting performance and self-funding, and requiring a stronger accountability framework.	The Government continues (i) to implement its current fiscal program in a manner consistent with the provisions agreed upon with the IMF and the EU and (ii) to make available to domestic banking institutions, financial sector safety net facilities. The Government has implemented the budgetary provisions stipulated in the amendments to Acts and Decrees covering mandatory health service, child-care benefits & family allowances, housing subsidies, household natural gas consumption, and district heating, in order to: (i) ensure improvement in the financial sustainability of the social support system (including the tightening of eligibility criteria and improved targeting of benefits) and (ii) provide more incentives for work and employment in the social benefits framework. The Government has approved a budget appropriation commensurate with the mandate of the Fiscal Council. The Ministry of Finance (MoF) has approved a Decree to implement the provisions of the Legal Status Law, and which specifies rules and procedures for budgeting, results measurement, and service delivery; with a view to attain more efficient operations and management of public sector institutions.
II. FINANCIAL CRISIS MANAGEMENT ARCHITECTURE: STRENGTHENING OF THE BANKING REGULATORY AND SUPERVISORY FRAMEWORK	
The Hungarian Financial Supervisory Authority (HFSA) has adopted a resolution which initiated an intensified inspection program for the largest commercial banks comprising at least 75 percent of assets in the financial system, with a view, inter alia, to evaluate financial condition on a consolidated basis, governance, asset quality, collateral values, adequacy of provisions and reserves, intercompany transactions, bank solvency, and overall adequacy of capital and provisions. In accordance with the Concluding Statement of the European Banking Group Coordination Meeting held on May 20, 2009, in Brussels, the MNB (the central bank of Hungary) initiated an exercise of scenario analyses (stress tests) of bank	The Government has submitted to Parliament an amendment to the relevant legislation pertaining to the banking sector for the inclusion of powers to the supervisory authorities to: (a) undertake pro-active and preventive supervisory actions (e.g.: to mandate increased capital, provisioning, or halting risky practices) so as to mitigate risks at the individual institution level; and (b) quickly react to systemic financial risks and adopt mitigating measures applicable to all financial institutions simultaneously. The intensified inspection program by the HFSA, and the scenario analyses exercises of the MNB, are completed for the largest commercial banks representing at least 75 percent of system assets, and implementation of

FIRST PHASE/TRANCHE POLICY ACTIONS TAKEN PRIOR TO BOARD APPROVAL	SECOND PHASE/TRANCHE POLICY ACTIONS FOR SECOND TRANCHE
portfolios and assets against economic developments to assess the solvency of banks comprising at least 75 percent of assets in the banking system. The Board of the Deposit Insurance Fund has approved an increase in the insurance premium from $^{9}/_{10}{}^{th}$ of one basis point, to 2 basis points in line with funding needs for increased deposit insurance coverage under EU directives. Pursuant to the approved Financial Stability Law and amendments to the HFSA Law, strengthened supervisory powers have been provided to HFSA in cases that threaten financial stability, allowing it to: (i) require ad hoc extraordinary reporting from a subject bank, (ii) extend an inspection for up to one year, and (iii) appoint a qualified forensic auditor during the course of an inspection.	supervisory actions addressing deficiencies where applicable, and/or bank strategic plans approved by the financial authorities, are undertaken, based on the results of the diagnostics from the inspections and scenario analyses. The Government' Cabinet has issued an amendment to the Government Decree on Accounting Standards for Banking Institutions, specifying the standards for classification, valuation and treatment for accounting purposes, of rescheduled, renegotiated and restructured credits and related provisioning requirements.
III. SOCIAL SECTOR REFORMS	
A. PENSION SECTOR	
The Government has submitted to Parliament and the Parliament has approved amendments to the Pension Law introducing new parametric reforms to improve the sustainability of the public pension system including: a. A gradual increase in the statutory retirement age of men and women, from 62 to 65 years of age, starting in 2012; b. Introduction of penalties for early retirement; c. Introduction of a new indexation rule for pensions, implying a move from wage to price indexation, with the weights of wages and prices depending on GDP growth where indexation weights would involve: (i) For GDP growth lower than 3%: 0% weight for wages, 100% for prices; (ii) For GDP growth between 3% and 4%: 20% wages, 80% prices; (iii) For GDP growth between 4% and 5%: 40% wages, 60% prices; and (iv) For GDP growth above 5%: 50% weight for wages, 50% for prices; and d. Abolishment of the 13th month pension from July 2009; and other measures, including tightening of disability pension criteria.	The Government continues to maintain the pension reform policies in the public pillar, thereby, ensuring fiscal sustainability. The MoF has submitted to the Government Cabinet draft amendments to the Pension Law providing proposed regulations for the payout phase of the second pillar, including the design of annuities products, indexation rules, and the menu of pension payout options for retirees from the privately funded system.
B. HEALTH SECTOR	
In line with the provisions of the Act on the Safe and Efficient Supply of Pharmaceuticals and Medical Appliances, as well as on the general rules of distribution of pharmaceuticals, the Government through the Ministry of Health has approved regulations which further promote the containment of pharmaceutical and medical appliances expenditures.	The Ministry of Health has issued guidelines concerning the corporatization of hospitals, in line with the Law on the Legal Status of Budgetary Institutions. The Ministry of Health has issued a Decree strengthening the role of General Practitioners in the provision of health care.

POLICY MATRIX WITH OUTCOME INDICATORS

HUNGARY: FINANCIAL SECTOR & MACRO STABILITY OPERATION

FIRST PHASE/TRANCHE POLICY ACTIONS	SECOND PHASE/TRANCHE POLICY ACTIONS	KEY EXPECTED RESULTS AND OUTCOMES AT END OF PROGRAM (BASELINE DATA: 12/31/2008)
I. FISCAL/MACROECONOMIC FRAMEWORK		
The Government has continued to: (i) implement its current fiscal program in a manner consistent with the provisions agreed upon with the IMF and the EU, and (ii) make available to domestic banking institutions, financial sector safety net facilities. The Government has adopted revenue-neutral tax reforms that reduce the tax wedge on labor to bolster potential growth, and which include: (i) lowering of social contributions, (ii) cutting the overall personal income tax, and (iii) increasing consumption and wealth taxes. The Parliament has established the Fiscal Council, as mandated by the Fiscal Responsibility Law, to serve as an independent body for scrutiny of budget preparation and execution, reporting directly to the Parliament. The Parliament has adopted a Law on the Legal Status and Management of Budgetary Institutions ("Legal Status" law), designed to increase autonomy of public sector institutions with the potential for augmenting performance and self-funding, and requiring a stronger accountability framework.	The Government continues (i) to implement its current fiscal program in a manner consistent with the provisions agreed upon with the IMF and the EU and (ii) to make available to domestic banking institutions, financial sector safety net facilities. The Government has implemented the budgetary provisions stipulated in the amendments to Acts and Decrees covering mandatory health service, child-care benefits & family allowances, housing subsidies, household natural gas consumption, and district heating, in order to: (i) ensure improvement in the financial sustainability of the social support system (including the tightening of eligibility criteria and improved targeting of benefits) and (ii) provide more incentives for work and employment in the social benefits framework. The Government has approved a budget appropriation commensurate with the mandate of the Fiscal Council. The Ministry of Finance (MoF) has approved a Decree to implement the provisions of the Legal Status Law, and which specifies rules and procedures for budgeting, results measurement, and service delivery; with a view to attain more efficient operations and management of public sector institutions.	Restoration of fiscal sustainability and macroeconomic stability, evidenced by: Primary surplus no less than 0.5% by 2010. (Baseline: Dec. 31, 2008 = 0.8% of GDP) Reduction in sovereign risk and increase in the demand for government debt, reflected in: (a) Lower sovereign CDS spreads. (Baseline: 12/31/08 5-yr. CDS = 430 bp) (b) Lower borrowing spreads over EU Treasuries. (Baseline: 12/31/08 spread of 10-yr. Gov't. eurobond over 10-yr. Bund = 464 bp) (c) Lower interest rate swap spreads. (Baseline: Q3-average ending 12/31/08 for 5-yr government bond = 229 bp)
II. FINANCIAL CRISIS MANAGEMENT ARCHITECTURE: STRENGTHENING OF THE BANKING REGULATORY AND SUPERVISORY FRAMEWORK		
The Hungarian Financial Supervisory Authority (HFSA) has adopted a resolution which initiated an intensified inspection program for the largest commercial banks comprising at least 75 percent of assets in the financial system, with a view, inter alia, to evaluate financial condition on a consolidated basis, governance, asset quality, collateral values,	The Government has submitted to Parliament an amendment to the relevant legislation pertaining to the banking sector for the inclusion of powers to the supervisory authorities to: (a) undertake pro-active and preventive supervisory actions (e.g.: to mandate increased capital, provisioning, or halting risky practices) so as to mitigate risks at the individual institution	Bank funding stability increased through maintenance/increase in deposit base. (Baseline: Deposit volume as of 12/31/08) Roll over credit lines from foreign banks to local

FIRST PHASE/TRANCHE POLICY ACTIONS	SECOND PHASE/TRANCHE POLICY ACTIONS	KEY EXPECTED RESULTS AND OUTCOMES AT END OF PROGRAM (BASELINE DATA: 12/31/2008)
adequacy of provisions and reserves, intercompany transactions, bank solvency, and overall adequacy of capital and provisions. In accordance with the Concluding Statement of the European Banking Group Coordination Meeting held on May 20, 2009, in Brussels, the MNB (the central bank of Hungary) initiated an exercise of scenario analyses (stress tests) of bank portfolios and assets against economic developments to assess the solvency of banks comprising at least 75 percent of assets in the banking system. The Board of the Deposit Insurance Fund has approved an increase in the insurance premium from $^{9}/_{10}{}^{th}$ of one basis point, to 2 basis points in line with funding needs for increased deposit insurance coverage under EU directives. Pursuant to the approved Financial Stability Law and amendments to the HFSA Law, strengthened supervisory powers have been provided to HFSA in cases that threaten financial stability, allowing it to: (i) require ad hoc extraordinary reporting from a subject bank, (ii) extend an inspection for up to one year, and (iii) appoint a qualified forensic auditor during the course of an inspection.	level; and (b) quickly react to systemic financial risks and adopt mitigating measures applicable to all financial institutions simultaneously. The intensified inspection program by the HFSA, and the scenario analyses exercises of the MNB, are completed for the largest commercial banks representing at least 75 percent of system assets, and implementation of supervisory actions addressing deficiencies where applicable, and/or bank strategic plans approved by the financial authorities, are undertaken, based on the results of the diagnostics from the inspections and scenario analyses. The Government' Cabinet has issued an amendment to the Government Decree on Accounting Standards for Banking Institutions, specifying the standards for classification, valuation and treatment for accounting purposes, of rescheduled, renegotiated and restructured credits and related provisioning requirements.	subsidiaries maintained at least at 80% and above, relative to baseline period, preventing a severe credit contraction. (Baseline: Parent bank funding outstanding as of 9/30/08 = HuF 4290 billion) Capital adequacy ratios of banks in the financial system kept above the regulatory minimum, providing additional solvency cushion in case of further economic/credit downturn contingencies. (Baseline: System CAR at 12/31/08 = 11.2%) No increase in the share of FX in total household loans (with constant exchange rates); reduction in the share of FX denominated loans in currencies other than the Euro.. (Baseline: System FX share at 12/31/08 = 72%) Reduction in the average loan/deposit ratio. (Baseline: System L/D ratio at 12/31/08 = 163%) Increased accuracy and transparency in bank financial accounts, classification of restructured credits, and provisioning/capital cushions.
III. SOCIAL SECTOR REFORMS		
A. PENSION SECTOR		
The Government has submitted to Parliament and the Parliament has approved amendments to the Pension Law introducing new parametric reforms to improve the sustainability of the public pension system including: a. A gradual increase in the statutory retirement age of men and women, from 62 to 65 years of age, starting in 2012; b. Introduction of penalties for early retirement; c. Introduction of a new indexation rule for pensions, implying a move from wage to price indexation, with the weights of wages and prices depending on GDP growth where indexation weights would involve: (i) For GDP growth lower than 3%: 0% weight for wages, 100% for prices;	The Government continues to maintain the pension reform policies in the public pillar, thereby, ensuring fiscal sustainability. The MoF has submitted to the Government Cabinet draft amendments to the Pension Law providing proposed regulations for the payout phase of the second pillar, including the design of annuities products, indexation rules, and the menu of pension payout options for retirees from the privately funded system.	Increase in the effective retirement age. (Baseline: Actual retirement age average at 12/31/07 = 57.8 (women), 59.8 (men) for old age pension. Reversal of the pension deficit trend. (Baseline: Deficit at 12/31/08 = 2.1% of GDP) Substantial progress in preparing the framework for the payout phase of the second pillar including market structure and regulatory framework.

FIRST PHASE/TRANCHE POLICY ACTIONS	SECOND PHASE/TRANCHE POLICY ACTIONS	KEY EXPECTED RESULTS AND OUTCOMES AT END OF PROGRAM (BASELINE DATA: 12/31/2008)
(ii) For GDP growth between 3% and 4%: 20% wages, 80% prices; (iii) For GDP growth between 4% and 5%: 40% wages, 60% prices; and (iv) For GDP growth above 5%: 50% weight for wages, 50% for prices; and d. Abolishment of the 13th month pension from July 2009; and other measures, including tightening of disability pension criteria.		
B. HEALTH SECTOR		
In line with the provisions of the Act on the Safe and Efficient Supply of Pharmaceuticals and Medical Appliances, as well as on the general rules of distribution of pharmaceuticals, the Government through the Ministry of Health has approved regulations which further promote the containment of pharmaceutical and medical appliances expenditures.	The Ministry of Health has issued guidelines concerning the corporatization of hospitals, in line with the Law on the Legal Status of Budgetary Institutions. The Ministry of Health has issued a Decree strengthening the role of General Practitioners in the provision of health care.	Growth in pharmaceutical expenditures contained/reduced. (Baseline: 2000-08 average pharmaceuticals expenditure growth versus 2008-10 period) Growth in hospital spending contained. (Baseline: 2008 actual aggregate hospital expenditures vs. 2009-10 average expenditure) Reduced number of outpatient visits due to declining referral rates from GPs to specialists. (Baseline: 2006-08 average visit rates to specialists and GPs versus 2009-10 average)

ANNEX 4

HFSA RESOLUTION ADOPTING ON-SITE SUPERVISION PROGRAM

PÉNZÜGYI SZERVEZETEK ÁLLAMI FELÜGYELETE
HUNGARIAN FINANCIAL SUPERVISORY AUTHORITY

English translation

Az FT elfogadta az alábbi 2008/181. (XII. 11.) FT határozatot:	The Board of the HFSA has adopted the following Board Resolution No. 2008/181. (XII.11.)
1. A Felügyeleti Tanács elkötelezett abban, hogy hozzájáruljon a magyar pénzügyi szektor helyzetének javítását célzó világbanki hitel kölcsönnyújtási feltételeinek teljesítésében. 2. A Felügyeleti Tanács jóváhagyja a Felügyelet 2009-es munkatervének olyan tartalmú módosítását, amely tartalmazza a nyolc legnagyobb bankra vonatkozó kiterjesztett könyvvizsgálatot is magába foglaló helyszíni vizsgálatokat.	1. The Board of the HFSA is committed to contribute to the fulfillment of the preconditions to the loan of the World Bank aiming to improve the status of the financial sector. 2. The Board of the HFSA approves the amendments to the 2009 Work Plan, which amendments include on-site examinations for conducting – among others – extended audit for the eight largest banks.
3. A Felügyeleti Tanács jóváhagyja azon - döntést tartalmazó - dokumentumok átadását a világbanki hitel hivatalos dokumentációjához, amelyet a Világbank a jelen határozat alapját képező előterjesztés szerint elvár. 4. A Felügyeleti Tanács utasítja a főigazgatót, hogy a tegye meg a szükséges intézkedéseket a 2009-es Munkaterv módosításához, ideértve azokat a fent említett operatív szervezési feladatokat (projekt-irányító bizottság, munkaerő allokáció, közbeszerzési eljárás a könyvvizsgálók alkalmazására) is, amelyeket a Világbank javasol.	3. The Board of the HFSA approves handing over documents – including decisions – forming part of the formal documentation of the World Bank loan that is expected on the basis of this proposal by the World Bank. 4. The Board of the HFSA instructs the Director General to take adequate measures for the amendment of the 2009 Work Plan including the above mentioned operative arrangement tasks (project steering committee, human resources allocation, public procurement procedure for engaging audit firms) that are proposed by World Bank.
Felelős: Farkas István, a Felügyeleti Tanács elnöke Határidő: azonnal, illetve folyamatos	Responsible person: Farkas István, Chairman of the Board Deadline: immediate and ongoing

Dátum 2008. december 11. / ***Dated** December 11, 2008*

FUND RELATIONS NOTE

Press Release No. 09/231
June 23, 2009

International Monetary Fund
700 19th Street NW
Washington, DC 20431

Public Information Notice
Statement by IMF Staff Mission to Hungary
(Reference.: €12.3 Billion Stand-By Arrangement)

The Executive Board of the International Monetary Fund (IMF) today completed the second review of Hungary's economic performance under a program supported by a 17-month Stand-By Arrangement (SBA). The completion of the review enables the immediate disbursement of SDR 1.26 billion (about €1.4 billion or US$1.9 billion), bringing total disbursements under the program to SDR 7.58 billion (about €8.4 billion or US$11.7 billion).

The SBA was approved on November 6, 2008 (see Press Release No. 08/275) for SDR 10.53 billion (about €11.7 billion or US$16.2 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, stated:

Weaker than expected external demand and tighter external financing conditions exacerbated the recession in Hungary. In these circumstances, policy settings have been revised to strengthen fiscal sustainability and preserve financial stability. More ambitious structural spending and tax reforms are under way to strengthen fiscal sustainability, allowing the partial accommodation of automatic stabilizers and an increase in the fiscal deficit target in 2009. The authorities' commitment to the firm and timely implementation of appropriate policies is reassuring.

Fiscal sustainability is being strengthened through structural spending reforms, while allowing an increase in the fiscal deficit in 2009, owing to the partial operation of automatic fiscal stabilizers. The permanent budgetary savings from expanded reforms to the pension system, social transfers, and subsidies are encouraging. These reforms, together with tax reform that will shift the tax burden from labor to consumption and wealth should boost labor participation and potential growth over the medium-term.

The prompt implementation of the authorities' revised program to preserve financial stability, including the careful monitoring of banks that receive government financial support and strengthening bank supervision, are important steps. It is recommended that the authorities explore institutional arrangements that would provide the financial supervisory agency with the necessary regulatory powers, and that remedial action and bank resolution frameworks be quickly strengthened.

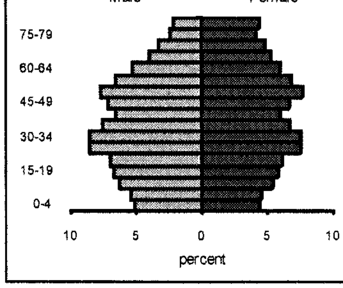
Monetary and exchange rate policy will continue to target inflation over the medium term, while being prepared to act as needed to mitigate risks to financial stability and avoid risks to destabilizing the exchange rate. Looking ahead, a further strengthening of investor confidence and a corresponding easing of financial strains would create room for interest rate cuts, Mr. Lipsky stated.

Hungary at a glance

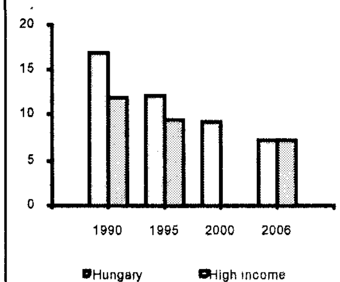
9/24/08

Key Development Indicators	Hungary	High income
(2007)		
Population, mid-year (millions)	10.1	1,056
Surface area (thousand sq. km)	93	35,094
Population growth (%)	-0.2	0.7
Urban population (% of total population)	67	78
GNI (Atlas method, US$ billions)	116.3	39,682
GNI per capita (Atlas method, US$)	11,570	37,566
GNI per capita (PPP, international $)	17,430	36,106
GDP growth (%)	1.3	2.6
GDP per capita growth (%)	1.5	2.0
(most recent estimate, 2000–2007)		
Poverty headcount ratio at $1.25 a day (PPP, %)	..	..
Poverty headcount ratio at $2.00 a day (PPP, %)	..	..
Life expectancy at birth (years)	73	79
Infant mortality (per 1,000 live births)	6	6
Child malnutrition (% of children under 5)	..	..
Adult literacy, male (% of ages 15 and older)	..	99
Adult literacy, female (% of ages 15 and older)	..	98
Gross primary enrollment, male (% of age group)	98	101
Gross primary enrollment, female (% of age group)	96	101
Access to an improved water source (% of population)	100	100
Access to improved sanitation facilities (% of population)	100	100

Age distribution, 2007

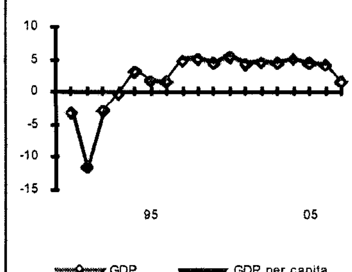


Under-5 mortality rate (per 1,000)



Net Aid Flows	1980	1990	2000	2007 [a]
(US$ millions)				
Net ODA and official aid	–	67	252	*303*
Top 3 donors (in 2006):				
European Commission	–	37	196	*238*
Germany	–	6	24	*23*
France	–	0	6	*13*
Aid (% of GNI)	–	0.2	0.6	*0.3*
Aid per capita (US$)	–	6	25	*30*

Growth of GDP and GDP per capita (%)



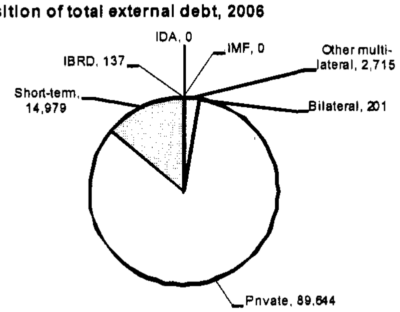
Long-Term Economic Trends	1980	1990	2000	2007	1980–90	1990–2000	2000–07
					(average annual growth %)		
Consumer prices (annual % change)	9.3	29.0	9.8	7.9			
GDP implicit deflator (annual % change)	5.7	25.7	12.9	5.4			
Exchange rate (annual average, local per US$)	32.5	63.2	282.2	183.6			
Terms of trade index (2000 = 100)	117	111	100	*96*			
Population, mid-year (millions)	10.7	10.4	10.2	10.1	-0.3	-0.2	*-0.2*
GDP (US$ millions)	22,163	33,056	47,944	138,182	1.3	1.5	*4.0*
		(% of GDP)					
Agriculture	19.1	14.5	5.4	4.2	1.7	-2.4	*5.6*
Industry	47.1	39.1	32.2	29.5	0.1	3.6	*3.7*
Manufacturing	..	*22.6*	23.5	22.4	..	*7.9*	*5.7*
Services	33.8	46.4	62.5	66.3	1.9	1.3	*3.9*
Household final consumption expenditure	61.2	61.4	63.1	65.8	0.9	-0.1	*5.2*
General gov't final consumption expenditure	10.3	10.6	10.1	9.7	1.9	0.9	*2.8*
Gross capital formation	30.7	25.4	30.4	22.3	-1.0	9.6	*0.3*
Exports of goods and services	39.1	31.1	72.1	80.0	3.6	9.9	*10.2*
Imports of goods and services	41.3	28.5	75.7	77.7	1.8	11.4	*9.4*
Gross savings	*24.8*	26.0	22.2	17.0			

Balance of Payments and Trade	2000	2007
(US$ millions)		
Total merchandise exports (fob)	28,192	94,160
Total merchandise imports (cif)	32,172	94,792
Net trade in goods and services	-1,787	*475*
Workers' remittances and compensation of employees (receipts)	281	363
Current account balance	-4,004	*-7,421*
as a % of GDP	-8.4	*-6.6*
Reserves, including gold	11,217	24,052

Central Government Finance		
(% of GDP)		
Revenue (excluding grants)	37.5	*35.8*
Tax revenue	21.9	*20.1*
Expense	40.9	*44.1*
Cash surplus/deficit	-2.7	*-8.6*
Highest marginal tax rate (%)		
Individual	40	36
Corporate	18	16

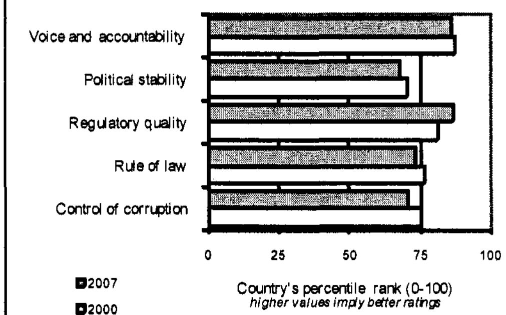
External Debt and Resource Flows		
(US$ millions)		
Total debt outstanding and disbursed	29,520	*107,677*
Total debt service	7,938	*30,828*
Debt relief (HIPC, MDRI)	–	–
Total debt (% of GDP)	61.6	*95.4*
Total debt service (% of exports)	22.1	*33.1*
Foreign direct investment (net inflows)	2,770	*6,098*
Portfolio equity (net inflows)	-369	*917*

Composition of total external debt, 2006



Private Sector Development	2000	2008
Time required to start a business (days)	–	5
Cost to start a business (% of GNI per capita)	–	8.4
Time required to register property (days)	–	17
Ranked as a major constraint to business	**2000**	**2007**
(% of managers surveyed who agreed)		
Tax rates	..	*50.2*
Access to/cost of financing	..	*37.0*
Stock market capitalization (% of GDP)	25.1	34.5
Bank capital to asset ratio (%)	8.3	*8.7*

Governance indicators, 2000 and 2007



Source: Kaufmann-Kraay-Mastruzzi, World Bank

Technology and Infrastructure	2000	2007
Paved roads (% of total)	*43.7*	*43.9*
Fixed line and mobile phone subscribers (per 1,000 people)	67	142
High technology exports (% of manufactured exports)	26.4	*24.0*

Environment		
Agricultural land (% of land area)	65	*65*
Forest area (% of land area)	21.3	*22.1*
Nationally protected areas (% of land area)	..	*9.3*
Freshwater resources per capita (cu. meters)	..	*595*
Freshwater withdrawal (% of internal resources)	*127.3*	..
CO2 emissions per capita (mt)	5.3	*5.7*
GDP per unit of energy use (2005 PPP $ per kg of oil equivalent)	5.6	*6.2*
Energy use per capita (kg of oil equivalent)	2,450	*2,752*

World Bank Group portfolio	2000	2007
(US$ millions)		
IBRD		
Total debt outstanding and disbursed	582	104
Disbursements	38	2
Principal repayments	95	38
Interest payments	42	7
IDA		
Total debt outstanding and disbursed	0	0
Disbursements	0	0
Total debt service	0	0
IFC *(fiscal year)*		
Total disbursed and outstanding portfolio	44	27
of which IFC own account	39	27
Disbursements for IFC own account	1	0
Portfolio sales, prepayments and repayments for IFC own account	19	0
MIGA		
Gross exposure	–	–
New guarantees	–	–

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