International Monetary Fund

Hungary and the IMF

Press Release:
IMF Executive Board Completes Fifth Review Under Hungary's Stand-By Arrangement
March 24, 2010

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Hungary: Letter of Intent, Memorandum of Economic and Technical Memorandum of Understanding

March 4, 2010

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

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

Budapest, March 4, 2010

Dear Mr. Strauss-Kahn:

1. The significant strengthening of policies over the past 1½ years has placed Hungary firmly on the path towards stability and growth. Macro-financial vulnerabilities have been reduced, through an improvement in the underlying fiscal position, an upgrading of bank supervision, and timely liquidity support to the financial system. As a result, confidence has begun to return and the economy is on the road to recovery. To be sure, there are still significant risks, much remains to be done, and firm adherence to prudent policies will be essential, especially against the backdrop of still fragile external conditions.

2. We have met our commitments for the Fifth Review of the Stand-By Arrangement (Tables 1 and 2):

- *Quantitative performance criteria*. All end-2009 criteria were observed.
- *Structural benchmarks*. Parliament approved amendments to strengthen the remedial powers of the Hungarian Financial Supervisory Authority on December 14, 2009 (¶21). Amendments to improve the bank resolution framework were submitted to parliament on February 12, 2010 (¶24). The financial stability sub-committee that monitors the financial soundness and stress-resilience of banks receiving capital or refinancing support from the government remains operational and is consulting with Fund staff on its work program (continuous benchmark, ¶23).

3. We request modifications to the performance criteria at end-March 2010 on net international reserves to lock in the increase in reserves. Quantitative performance criteria through end-June 2010 are set out in Table 2 and the attached Technical Memorandum of Understanding.

4. We also request modification of the end-March 2010 structural benchmark on the completion of reports on thematic inspections focusing on credit risk and loan portfolio quality for at least three banks selected with a systemic risk-based approach. Owing to higher than anticipated demands on resources, we are preparing reports on thematic inspections of two banks in the first quarter. Plans are being finalized for two more banks to undergo

similar inspections in the second quarter. We therefore propose to modify the end-March benchmark to two banks, and to introduce a new benchmark for two more banks at end-June. Structural conditionality is set out in Table 3.

5. The policies set forth in this letter and our previous letters (of November 4, 2008; March 12, 2009; June 11, 2009; September 16, 2009; and December 4, 2009) are adequate to achieve the objectives of our economic program, and we remain committed to meeting all our targets. Our government stands ready, however, to take additional measures as appropriate to achieve its objectives. As is standard under all IMF arrangements, we will consult with the IMF before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the IMF with the necessary information for program monitoring. The sixth review of the arrangement will take place after June 14, 2010 and the seventh review after September 14, 2010.

6. On account of our strengthened economic and financial condition, we are taking decisions on drawings on a review-by-review basis. As at the Fourth Review, we do not intend to draw the amount that would be made available upon the completion of this review (SDR 725.1 million, 70 percent of quota). The cumulative IMF resources of SDR 1,450.2 million from the Fourth and Fifth Reviews that would remain available to us subject to satisfactory policy performance provide assurance against unforeseen deteriorations in financing conditions.

Macroeconomic framework

7. The turning point in economic activity is getting closer. The pace of economic decline eased further in the fourth quarter of 2009, with real GDP falling by 4.0 percent (y-o-y), as a positive contribution from net exports partly offset weak domestic demand. Overall, output contracted by 6.3 percent in 2009. Looking forward, real GDP is projected to fall by 0.2 percent in 2010, as the pick-up in exports continues. Private consumption remains weak as the improvement in the labor market is lagging (the unemployment rate is still increasing) and credit is stagnant.

8. Consumer price inflation is projected to average 4.3 percent in 2010 and to slow to about 2½ percent in 2011. CPI inflation accelerated to 6.4 percent in January 2010 from 5.6 percent in December, due to increases in excise taxes, higher food and energy prices, and the reweighting in the CPI basket. However, inflation is projected to gradually moderate in the coming months, owing to the continued disinflationary impact of the large output gap. In the second half of 2010, CPI inflation is projected to fall to a level around the central bank's midpoint target of 3 percent, as last year's VAT and excise tax hikes will no longer affect the consumer price index.

9. A sharp adjustment of the external current account by about 7½ percentage points of GDP resulted in an annual surplus for the first time in over 15 years (estimated at 0.4 percent of GDP in 2009). This adjustment was due largely to an improvement in the balance on

goods and services by about 6 percent of GDP, as imports contracted more sharply than exports. The income balance also improved on account of weaker earnings. A modest deterioration—to a deficit of 0.4 percent of GDP—is forecast for 2010, as domestic demand recovers and the terms of trade worsen.

10. Gross international reserves have nearly doubled from €17.4 billion in September 2008 to €32.5 billion in January 2010. External financing conditions have been broadly stable in recent months, notwithstanding some strains in international markets. Rollover rates of bank liabilities falling due in the fourth quarter of 2009 are expected to have been close to 100 percent. The commitments by parent banks to maintain their exposures to their subsidiaries in the context of the European Bank Coordination Initiative were met (¶20). On January 26, 2010, the government successfully placed a 10-year, $2 billion bond at 265 bps over U.S. Treasuries. No further foreign currency bond issues are planned this year.

Fiscal Policy and Structural Fiscal Reforms

11. The cash primary balance of the central government at end-2009 was above the program floor (performance criterion). Tax revenue was in line with program projections and nontax revenue was higher than expected (owing to higher interest revenues, revenues related to the voluntary shift of eligible workers from the second pillar to the first pillar of the pension system, and dividends). Spending was lower than expected, as lower transfers to local government and lower spending by the social security funds were only partly offset by slightly higher spending by line ministries. Interest payments were in line with projections.

12. We expect to have achieved our objective to limit the overall deficit of the general government to 3.9 percent of GDP in 2009 (Maastricht definition). The central government deficit (in ESA terms) is expected to have been 3.6 percent of GDP, in line with projections. Developments at the local government level also appear to have been as expected.

13. We remain fully committed to our general government deficit target (Maastricht definition) of 3.8 percent of GDP in 2010. Compared to the budget, we expect tax revenue to be lower, owing partly to rulings of the Constitutional Court on the property tax and the taxation of family allowances. Moreover, primary spending is expected to be higher, reflecting higher healthcare spending and transfers to Budapest public transport company (BKV). The impact of these developments on the overall balance will be partly offset by lower net interest payments and higher revenues related to the shift from the second pillar to the first pillar of the pension system. To cover the residual impact, we froze half of the stability reserve and allocated part of the general reserves to finance the transfer to BKV.

14. Downside risks to the fiscal target in 2010 include the uncertainty surrounding tax revenue and interest payments projections, the financial performance of MAV, BKV and Malev, and spending by local governments in an election year. Further, there is a possibility that Eurostat may decide that revenues related to the shift from the second pillar to the first

pillar of the pension system would count towards the 2009 fiscal balance. To mitigate these risks:

- treasurers assigned to line ministries should reduce overspending risks, by keeping spending in line with budgetary commitments (in contrast to 2009 when the treasurers were assigned towards the end of the year).

- we have discussed the MAV business plan that we prepared in December 2009 with the company. While progress has been slow, we expect final adoption by the Ministry of Transport on behalf of the state by end-March. We will sign a public service agreement for 2010 with the company, consistent with the government support in the 2010 budget.

Should risks materialize nevertheless, the policy response would include both the use of budgetary reserves, which amount to about ½ percent of GDP, and the implementation of identified additional spending cuts of 0.2 percent of GDP.

15. Any extra revenue that could result from a better-than projected macroeconomic performance will be used to boost reserves, which are being kept available to safeguard against risks and to reduce the adjustment in spending that will be needed in 2011. Also, any additional revenue that could result from the sale of emission credits accrued under the Kyoto protocol will be either spent on new environmental projects or saved for such projects in later years.

16. Looking ahead, we remain committed to reducing the general government deficit to below 3 percent of GDP in 2011. Measures will be needed, including to offset the revenue losses from the planned increase that year in the top personal income tax bracket, and the Constitutional Court's abolishment of the property tax. As regards property taxation, the first-best solution would be to address the constitutional court's concerns to correct the implied structural fiscal loosening. Further, we intend to review, with Fund technical assistance, expenditure rationalization aimed at improving the efficiency of the delivery of public services. Measures are also needed to safeguard that the activities of local governments and state-owned enterprises are consistent with fiscal sustainability.

17. To ensure the consistency of budget procedures with the Act on the legal status and financial management of budgetary institutions adopted in December 2008, we adopted and published in December 2009 a government regulation on the implementation of the Act. We have also adopted a government regulation relative to the rules on advance payment of EU subsidies, aligning these rules with best practices. To improve fiscal transparency, we will publish annually by end-August a report on the contingent liabilities of the financial and non-financial state-owned enterprises. This would be a first step towards preparing and publishing statistics on the non financial public sector balance. We will continue to implement our tax administration (APEH)'s medium-term modernization strategy, which has been instrumental

in avoiding a general decline in taxpayer compliance during the crisis. In particular, by end-August, we will review the selection criteria for assigning taxpayers to the large taxpayer unit (LTU) to give it control over at least 50-60 percent of the tax revenue base.

Financial Sector Policies

18. The banking system has continued to be profitable, with capital buffers well above regulatory requirements and stable funding. According to preliminary data, after-tax return on equity was 9.8 percent in 2009, compared to 11.6 percent in 2008. Interest margins remained stable in 2009, profits from investment activities increased—due largely to rising prices of Hungarian government bonds—and costs were compressed, resulting in a sizeable increase in pre-provisioning profits. However, non-performing loans increased to 6.7 percent at end-2009, compared to 5.9 percent at end-September and 3.0 percent at end-2008,[1] and the corresponding sharp increase in provisioning triggered a reduction in net profits. The banking system's capital adequacy ratio stood at 12.9 percent at end-December, compared to 11.2 percent a year earlier, reflecting retained profits that strengthened the capital base, capital injections, and reductions in risk-weighted assets. As regards the banking system's funding situation, corporate deposits fell in the second half of 2009, following a significant increase in the first half, but household deposits and external bank funding remained stable. Banks' credit to the private sector fell by 4.7 percent in 2009,[2] with a stronger contraction in credit to small and medium-sized enterprises, reflecting both weak demand and increased risk aversion among lenders.

19. Going forward, the challenges to the banking system are significant but appear manageable. Profits are expected to shrink substantially in 2010 and may be negative for some banks as interest margins narrow, profits from investment activities fall and banks continue to step up provisioning. Non-performing loans are expected to peak around 9-10 percent during the course of 2010. Under the macroeconomic baseline scenario, most systemically important banks should be able to absorb projected loan losses from gross profits. Moreover, banks can dip into substantial capital buffers should this be needed. Less well capitalized banks are expected to take measures as needed to safeguard adequate capital cushions above the regulatory minimum, under close supervision from the Hungarian Financial Supervisory Agency (HFSA).

20. We have received letters confirming the commitments given by the parent banks of Hungary's six largest subsidiaries, as discussed during the meeting in Brussels on November 19, 2009 as part of the European Bank Coordination Initiative. Parents' minimum

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[1] Non-performing loans are defined as corporate, household, interbank, foreign and other loans that are past due for more than 90 days.
[2] Exchange rate adjusted growth rate of bank credit to households, non-financial corporations and other financial corporations.

exposure level to Hungary was fixed at 95 percent of the level at end-September 2008, i.e., just before the initiation of program discussions. At end-December 2009 all parent banks were in compliance, based on the data for their subsidiaries in Hungary available to the HFSA. The banks also agreed to provide additional data on exposure to non-affiliated entities in Hungary, so that their overall exposure to the country can be monitored. Such data are in the process of being collected by the HFSA and are expected to be available by end-March.

21. We have implemented the wide-ranging changes to the legislative framework for financial sector supervision that were approved by parliament on December 14. The HFSA has been upgraded to an autonomous organization accountable directly to Parliament, paving the way for a thorough internal reorganization to strengthen the HFSA's operational effectiveness. The HFSA's management structure has been streamlined, performance incentives for staff have been reinforced, and the HFSA's management is now able to reallocate staff flexibly and rapidly to respond to supervisory challenges. The HFSA has also been given the right to issue binding administrative acts to temporarily suspend financial products in case of threats to financial stability. The new tri-partite Financial Stability Council (FSC) established in law—consisting of the Minister of Finance, the Governor of the Hungarian National Bank (MNB), and the Chairman of the HFSA—is meeting monthly to review developments and policies related to the stability of the financial system. Both the MNB and the FSC have the right to propose legislation or regulation on a "comply and explain" basis, i.e., the government needs to indicate agreement with the proposal within 15 days or explain why it disagrees. Looking forward, the effectiveness of financial supervision would be increased if the HFSA would obtain the right to issue binding regulations.

22. Banking supervision capacity continues to increase. Comprehensive on-site inspections of the seven largest banks were finalized in 2009. The inspection of another large bank will be completed in April 2010. The findings of these inspections have confirmed the need to focus on banks' credit portfolios. As a consequence, the HFSA has assigned priority to targeted follow-up on-site inspections in this area. By end-March 2010 such thematic inspections will be completed for two large credit institutions without a foreign parent (structural benchmark) and by end-June 2010 for two large subsidiaries of foreign parent banks (structural benchmark). The credit portfolios of the other large systemically important banks will be inspected in the second half of 2010. The reviews of foreign subsidiaries of Hungarian banks within EU countries are progressing as scheduled. The public tender to commission reviews of subsidiaries outside the EU was inconclusive because of the lack of competition, but a new tender is being launched.

23. A sub-committee of the FSC[3] has continued to monitor the three credit institutions that received loans from the government in 2009, in line with the continuous structural

[3] Previously sub-committee of the financial stability committee.

benchmark under the program. Any request for a loan or stand-by facility from the government will be granted only in case of unusually unfavorable funding conditions for the affected credit institution, a well-documented public interest, and after in-depth verification by the sub-committee of the institution's financial standing and stress-resilience, including by analyzing recent supervisory reports and recommendations from the HFSA. Moreover, we will ensure compliance with EU rules. The sub-committee is expected to report to the FSC on a regular basis, and in addition when supervisory and external audit reports become available.

24. We have made further progress in strengthening the remedial action and resolution regime for banks.

a. A set of amendments to the Law on Credit Institutions and Financial Enterprises was passed on December 14, 2009, thus assuring that the end-December structural benchmark was met. These amendments stipulate an additional mandatory threshold for the appointment of a supervisory commissioner and clearly state that only the HFSA has the power to initiate bank liquidation proceedings.

b. Moreover, draft legislation to further strengthen the bank resolution framework has been submitted to parliament on February 12, in line with the corresponding structural benchmark. The draft legislation broadens the available bank resolution techniques by allowing, among other things, for purchase-and-assumption transactions and the creation of bridge banks. These powers related to systemically important credit institutions would become available where the financial condition has deteriorated significantly but prior to reaching the threshold for the initiation of liquidation proceedings. As parliament will not be able to consider these amendments before the elections scheduled for April, the draft legislation will need to be reintroduced when parliament reconvenes. At the time, there will be the opportunity to further improve the draft legislation. Future progress will benefit from the technical work already made.

c. We will seek the European Commission's approval for the extension of the capital enhancement fund under the financial stability act until end-2010. The act grants extended resolution powers to the authorities, and therefore provides a safety net while the enhanced bank resolution framework is not yet in place.

Monetary and Exchange Rate Policy

25. The MNB remains committed to the inflation target of 3 percent over the medium term, while acting as needed to mitigate risks to financial stability. Since July 28, 2009 the MNB has cut the key policy rate by a cumulative 375 bps to 5.75 percent, in line with the strengthening of investor confidence and the associated easing of financial strains. Given that inflation is projected to be below the target at the policy horizon (¶8), there is room for

further gradual and cautious cuts in policy rates should the improvement in market sentiment prove sustainable.

26. The MNB is creating temporary facilities to support the Hungarian mortgage bond market, whose functioning continues to be affected by insufficient liquidity.
From March 2010, the central bank will purchase mortgage bonds in both the primary and secondary markets up to a total notional value of HUF100 billion (0.4 percent of GDP) to improve market liquidity. The central bank will buy parts of mortgage bond issues in the primary market only if the issuer proves that continuous market making in the bonds in the secondary market is granted. The experience with these facilities will be reassessed later in the year. Over the longer term, the objective of the program is to support foster alternative domestic currency funding options for banks, which may help boost domestic currency lending. The facility will be complemented by regulatory initiatives to support the mortgage market.

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

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

Table 1. Hungary: Program Monitoring

	Measure		
Quantitative Performance Criteria		December 2009	February 2010
1	Floor on the cash primary balance of the central government system	Observed	
2	Floor on net international reserves	Observed	
Continuous Performance Criteria			
	Non-accumulation of external debt arrears	Observed	
Inflation Consultation Clause			
	Inner band	Observed	
	Outer band	Observed	
Indicative Target			
	Ceiling on total debt stock of the central government system	Observed	
Structural Benchmarks			
1	Operation of the sub-committee described in the March LOI para 18 as long as there is any government capital or funding support outstanding to banks, and consultation of the sub-committee with Fund staff on its work program (Continuous)	Observed	
2	Passage by parliament of the amendments strengthening the remedial powers of the HFSA as listed in paragraph 20 (i), (ii), and (iv) of the March 2009 Letter of Intent (end-December, 2009)	Observed	
3	Submission to parliament of the amendments strengthening the bank resolution regime as listed in paragraph 20 (iii) of the March 2009 Letter of Intent (February 12, 2010)		Observed

Table 2. Hungary: Quantitative Program Targets

	2008			2009								2010	
	end-Sep	end-Dec		end-Mar		end-Jun		end-Sep		end-Dec		end-Mar	end-Jun
	Actual	Prog.	Outcome	Prog.	Outcome	Prog.	Outcome	Prog.	Outcome	Prog.	Outcome	Prog.	Prog.
I. Quantitative Performance Criteria													
1. Overall floor on the cumulative cash primary balance of the central government system (floor, in billions of forints) 1/	130	215	226	-280	-248	-155	-123	-160	-148	190	273	-280	-280
2. Cumulative change in net international reserves (floor, in millions of euros) 2/	17,096	-6,465	+1,398	-4,451	+1,464	-4,629	-1,195	-3,540	1,574	-2,378	1,028	-1,075	-937
II. Continuous Performance Criterion													
3. Non-accumulation of external debt arrears	…	0	0	0	0	0	0	0	0	0	0	0	0
III. Inflation Consultation													
4. 12-month rate of inflation in consumer prices 3/													
Outer band (upper limit)	...	7.1	...	5.0	...	5.0	...	5.0	...	5.0	...	5.0	5.0
Inner band (upper limit)	...	6.1	...	4.0	...	4.0	...	4.0	...	4.0	...	4.0	4.0
Central point	5.7	5.1	3.5	3.0	2.9	3.0	3.7	3.0	1.2	3.0	3.1	3.0	3.0
Inner band (lower limit)	...	4.1	...	2.0	...	2.0	...	2.0	...	2.0	...	2.0	2.0
Outer band (lower limit)	...	3.1	...	1.0	...	1.0	...	1.0	...	1.0	...	1.0	1.0
III. Indicative Target													
5. Ceiling on the total debt stock of the central government system (in billions of forints) 4/ 5/	15,973	16,230	15,925	16,281	15,936	15,100	15,162	15,267	15,057	15,166	14,992	15,800	15,800

1/ Cumulative flows from the beginning of the calendar year.
2/ The end-September 2008 NIR figure is a stock. The change in NIR for December 2008 is from September 2008, while all cumulative changes for 2009 and 2010 are from December 2008.
End-June program target is before adjustment for the delayed EU BoP support disbursement (see TMU).
3/ The inner band for consultation is +/-1 percent around the central point, and the outer band is +/-2 percent around the central point. Under the inflation consultation mechanism we will monitor the headline CPI inflation adjusted by 3.0 percent in 2010 based on the actual pass through of indirect tax increases (see TMU).
The figure of 1.2 percent in end-September 2009 corresponds to the headline inflation of 4.9 percent adjusted by the technical effect of the indirect tax increases (3.7 percent; see September TMU).
The figure of 3.1 percent in end-December 2009 corresponds to the headline inflation of 5.6 percent adjusted by the technical effect of the indirect tax increases (2.5 percent; see November TMU).
4/ Foreign-currency denominated debt calculated at program exchange rates.
5/ These are the indicative target ceilings adjusted for EU transfers and other items described in the TMU. Before adjustment, these ceilings were 16,320 for end-December 2008, 15,872 for end-March 2009, 15,074 for end-June, 15,070 for end-September, and 15,050 for end-December 2009.

Table 3. Hungary: Structural Conditionality

	Measure	
Structural Benchmarks		
1	Operation of the sub-committee described in the March 2009 LOI para 18 as long as there is any government capital or funding support outstanding to banks, and consultation of the sub-committee with Fund staff on its work program	Continuous
2	Completion of reports on thematic inspections focusing on credit risk and the quality of the loan portfolio for two large credit institutions without a foreign parent bank	By end-March 2010
3	Completion of reports on thematic inspections focusing on credit risk and the quality of the loan portfolio for two large subsidiaries of foreign parent bank	By end-June 2010

TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

March 4, 2010

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

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

Central Government System

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

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

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

	(Millions of Euros)
Outstanding stock: end-December 2008	18,493.8
Floor on cumulative change in net international reserves from end-December 2008:	
End-March 2009 (actual)	1,464
End-June 2009 (actual)	-1,195
End-September 2009 (actual)	1,574
End-December 2009 (actual)	1,028
End-March 2010 (performance criterion)	-1,075
End-June 2010 (performance criterion)	-937

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

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

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

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

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

7. **NIR targets** will be adjusted upward (downward) by the surplus (shortfall) in program disbursements relative to the technical assumption below. Program disbursements are defined as external disbursements from official creditors that are usable for the financing of the overall central government budget. For program purposes, any program disbursement from the EU or the World Bank in 2010 would result in an upward adjustment of the NIR target. Furthermore, the SDR allocations received by Hungary in August and September 2009 are excluded from NIR.

External Program Disbursements (technical assumption)

Cumulative flows from end-December 2008:	(In millions of Euros)
End-March 2009	2,000
End-June 2009	2,000
End-September 2009	3,500
End-December 2009	3,500
End-March 2010 (technical assumption)	3,500
End-June 2010 (technical assumption)	4,300
End-September 2010 (technical assumption)	5,200

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

8. **The quarterly consultation band for the 12-month rate of inflation in consumer prices** is based on the measure of the headline consumer price index (CPI) published by the Hungarian Central Statistical Office no later than the 15th day of the following month.[3] Consistent with the headline CPI inflation target of the MNB, the central point for end-quarter inflation will be 3 percent, with lower and upper bands around each target of ±1 and ±2, respectively. The targets for end-March and end-June 2010 are performance criteria. For the purpose of monitoring performance under the inflation consultation mechanism, CPI inflation will be adjusted by 3.0 percentage points, which is equal to the estimated impact of the increases in VAT (2.2 percentage points) and excise taxes (0.8 percentage points) on the consumer price index.

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

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

	(In billions of forints)
Cumulative primary balance from January 1, 2009:	
End-December 2009 (actual)	273
Cumulative primary balance from January 1, 2010:	
End-March 2010 (performance criterion)	-280
End-June 2010 (performance criterion)	-280

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

[3] The exact publication rule is as follows. Data is published on the 11th day of the following month. If the 11th day of the month falls during a week-end, the publication takes place the following Tuesday. In January and February there is an exception to this rule, as it takes an additional couple of days to compute the annual average for the previous year and the new basket weights. The exact calendar of releases can be found online at: http://portal.ksh.hu/portal/page?_pageid=38,863287&_dad=portal&_schema=PORTAL

11. The floor on the primary balance of the CGS will be monitored from above the line on a cash basis. It is understood that transfers among entities of the CGS are mutually consistent; hence, the difference between the simple sum of revenues and the simple sum of primary expenditures across all CGS entities yields the consolidated CGS balance. Should discrepancies arise, reconciliation between reported transfers and reported revenues from other CGS entities will be required before compliance with the CGS primary balance ceiling can be assessed. The floor on the primary balance of the CGS will be adjusted upward for the revenue from the sale of emission credits accrued under the Kyoto protocol and will be adjusted downward for the expenditure on new environmental projects financed from this revenue. Data will be provided by the Ministry of Finance to the IMF with a lag of no more than seven days past the test date.

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

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

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

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

Outstanding stock:	(In billions of forints)
End-December 2008 (actual)	15,925
End-March 2009 (actual)	15,936

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

End-June 2009 (actual)	15,162
End-September 2009 (actual)	15,057
End-December 2009 (actual)	14,992
End-March 2010 (indicative ceiling)	15,800
End-June 2010 (indicative ceiling)	15,800

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

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

17. The indicative ceiling will also be adjusted upward (downward) by the shortfall (surplus) in net EU transfers relative to the baseline projection which forms the basis of the government budget and financing plans. The term "net EU transfers" refers to the net effect of pre- and post-financing of certain EU transfers, which are excluded from the public deficit but included in the public debt.

Net EU Transfers (Baseline Projection)

Baseline projections:	(In billions of forints)
End-March 2010 (program projection)	73
End-June 2010 (program projection)	160

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

Cash reserves at the Single Treasury Account (Baseline Projection)

Baseline projections:	(In billions of forints)
End-March 2010 (program projection)	466
End-June 2010 (program projection)	220

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

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

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

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