FOR AGENDA

EBS/09/31
Correction 1

CONFIDENTIAL

March 24, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Hungary—First Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria**

The attached corrections to EBS/09/31 (3/12/09) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 12, para. 14, line 1: for "with regard to across-the-board spending"
read "with regard to spending"
para. 15, line 7: for "2010", read "2011"
line 8: for "tax to replace inefficient and uneven local property taxes"
read "tax to gradually replace inefficient and uneven local property taxes"

Typographical Errors

Page 26, Table 4: revised to reflect corrected denominations for gross official reserves, total external debt, and short-term debt at remaining maturity.

Page 27, Table 5: revised to reflect corrected data on structural general government and primary balances.

Page 28, Table 6: revised to reflect corrected data on output gap and attribution of 2010–11 estimates.

Questions may be referred to Mr. Morsink (ext. 37875), Mr. Wiegand (ext. 38750), and Mr. Joshi (ext. 34467) in EUR.

Att: (4)

Other Distribution:
Department Heads

outlook (estimated to be about 1.1 percent of GDP relative to the 2009 budget). Given still fragile external financing conditions, a reduction in the government's financing need between 2008 and 2009 is essential to build confidence in fiscal sustainability. However, with substantial fiscal adjustment already under way in 2009, it is also important to limit the negative impact on demand in the short term. The authorities and staff agree that a temporary slowing of headline fiscal consolidation should not be detrimental to market confidence if accompanied by measures that give assurance about future adjustment.

12. **To enhance fiscal sustainability, the revised program includes comprehensive structural measures that yield a permanent reduction in spending over the medium term** (LOI ¶15). In line with past staff advice and with the need to protect the poor, the core measures are pension reform (performance criterion), improving the targeting of social transfers, and rationalizing subsidies. However, in staff's view, the new indexation formula for pensions is complicated and procyclical, and entails lower long-term savings than straight price indexation. In addition, further reforms of social transfers (such as maternity leave and housing subsidies) would still be desirable. Nevertheless, the budgetary saving from the measures in the program should grow over time, reaching 1.2 percent of GDP in 2010 and 1.4 percent of GDP in 2011.

13. **To mitigate the adverse impact on growth, the revised program relaxes the fiscal deficit target for 2009 from 2.6 percent of GDP to 2.9 percent of GDP** (LOI ¶12). Given the downward revision to economic activity, this implies an increase in the targeted structural adjustment from 2.5 percentage points of GDP to 3.3 percentage points of GDP. Although staff recommended a slightly higher deficit target to limit the procyclicality of fiscal policy, the authorities preferred a general government deficit target (accrual basis) of below 3 percent of GDP in line with EU commitments. Regarding the composition of the additional adjustment, staff suggested a mix of well-targeted tax and expenditure measures to limit the impact on demand, but the authorities preferred spending cuts, given the high level of government expenditure. The measures in the revised program are expected to yield savings of about ¾ percent of GDP, with the largest contributions coming from cuts in allocations to line ministries, agricultural subsidies, and health care expenditures.[2] The scoring of some of the measures is inevitably uncertain, particularly the better targeting of disability pensions (relying on stricter enforcement of existing rules) and the reduction in energy subsidies (linked to prices). The higher deficit will be financed by greater use of official financing from the EU and the World Bank (Table 7).

14. **There are important risks to achieving the program targets for 2009**. First, growth, inflation, and interest payments could turn out less favorably than currently forecast, negatively affecting the overall fiscal balance. Second, tax revenue may underperform as compliance may decline during the crisis. Third, there are implementation risks, including

[2] A supplementary budget is not needed as the planned reduction in spending does not exceed the 5 percent threshold.

with regard to spending cuts in public health institutions and reductions in farm subsidies. In view of these risks, the program includes a contingency buffer of 0.3 percent of GDP in the budget. With respect to 2010-11, further measures will be required to attain the fiscal consolidation envisaged under the program.

15. **The comprehensive tax reform aimed at shifting the tax burden from labor to consumption and encouraging job creation is expected to be revenue neutral** (LOI ¶16)**.** These initiatives, which also include tax-broadening measures, are in line with past staff advice. They are expected to be enacted by June 2009 and mostly come into force on July 1, 2009. Along with the structural spending cuts discussed above, they should provide a welcome boost to labor market participation over the medium term. Additional tax measures along the same lines are expected for 2011, including a new proposal for a central property tax to gradually replace inefficient and uneven local property taxes.

16. **Parliament adopted the Fiscal Responsibility Law in November 2008 (structural benchmark) and the Fiscal Council has now been appointed** (LOI ¶11). By subjecting budget preparation to fiscal rules aimed at reducing public debt and limiting expenditure growth, the law provides important institutional underpinnings to fiscal discipline. The newly appointed Fiscal Council will enhance external scrutiny on fiscal policy design and implementation. The authorities are committed to provide appropriate funding for the Fiscal Council.

C. Financial Sector Policies

17. **Banks' forint liquidity positions have improved and capital positions remain well above regulatory requirements** (Table 8 and LOI ¶17). Parent banks increased funding of their Hungarian subsidiaries in October and November, and have since maintained their exposures, though the average maturity of such funding has shortened. Deposits have increased, which banks have used to acquire liquid assets. Conditions in the foreign exchange swap market have eased somewhat, though maturities remain short. Although nonperforming loans at end-2008 were still low (2.9 percent of gross loans), banks increased loan loss provisions sharply, resulting in a marked deterioration in profitability in 2008Q4. Hungary's largest bank, which does not have a foreign parent, increased its (consolidated) capital adequacy ratio to 15.3 percent (Tier I to 11.2 percent).

18. **Going forward, risks to financial stability are increasing with the economic downturn and continued external financing difficulties**. External funding will likely remain expensive and constrained, increasing rollover risk, especially for banks without a strong foreign parent. Similarly, the foreign currency swap market continues to be volatile and vulnerable to shocks, thus hampering banks' capacity to hedge their currency mismatch. Rising unemployment and corporate defaults will increase loan delinquencies. The exchange rate depreciation has increased the debt service burden of foreign currency loans (more than 70 percent of loans to households are denominated in foreign currencies, notably Swiss

Table 3. Hungary: Balance of Payments, 2007–10
(In millions of euros)

	2007	2008					2009						2010
		Sep.	Dec	Dec.	Year		Mar.	Jun.	Sep.	Dec.	Year		
		Est.	Prog.	Est.	Orig. Prog.	Est.	Revised Program				Orig. Prog.	Rev. Prog.	Proj.
Current Account	**-6,510**	**-2,492**	**-1,214**	**-2,247**	**-6,632**	**-8,320**	**-940**	**-973**	**-899**	**-811**	**-1,915**	**-3,623**	**-3,364**
Goods and service, net	1,370	376	895	205	1,956	1,501	848	1,290	1,095	1,266	7,272	4,499	5,264
Exports	80,824	22,123	21,560	19,753	85,209	85,652	18,470	20,028	20,532	22,011	86,704	81,041	86,724
Imports	-79,454	-21,747	-20,666	-19,548	-83,253	-84,150	-17,622	-18,738	-19,437	-20,745	-79,433	-76,542	-81,460
Income, net	-7,386	-2,510	-2,169	-2,084	-7,810	-8,546	-1,664	-2,140	-1,870	-1,953	-8,657	-7,628	-8,103
Current transfers, net	-494	-357	61	-367	-778	-1,275	-124	-124	-124	-124	-529	-494	-525
Capital Account	**1,139**	**127**	**302**	**67**	**1,384**	**1,109**	**412**	**412**	**412**	**412**	**1,785**	**1,648**	**1,676**
Net capital transfers from the EU	1,220	144	302	37	1,387	1,098	420	420	420	420	1,803	1,679	1,676
Financial Account	**7,100**	**2,723**	**-3,362**	**2,392**	**5,049**	**10,649**	**-2,776**	**-2,122**	**-1,418**	**-1,053**	**-9,393**	**-7,370**	**1,157**
Direct investment, net	1,608	-373	-163	1,542	985	3,284	16	14	390	327	577	747	946
Direct Investment Abroad	-2,765	-790	-778	-407	-1,651	-906	-267	-240	-42	-176	-1,054	-725	-755
In Hungary	4,373	417	615	1,949	2,636	4,190	283	254	433	503	1,631	1,472	1,702
Portfolio investment, net	-789	1,560	-1,449	-5,287	2,072	-2,499	-655	-291	-296	242	-4,660	-999	1,235
Assets	2,491	1,996	1,042	2,294	4,850	5,872	296	332	346	310	1,570	1,283	990
Equity	-1,885	-507	-51	48	-1,718	-1,694	-126	-77	-26	-27	-211	-257	-106
Debt securities	4,376	2,503	1,093	2,246	6,568	7,566	422	409	372	338	1,781	1,540	1,096
Liabilities	-3,280	-436	-2,491	-7,581	-2,777	-8,370	-951	-623	-641	-68	-6,231	-2,283	245
Equity	-3,635	465	217	-1,185	1,519	-229	212	216	221	227	923	875	58
Debt securities	355	-901	-2,708	-6,396	-4,296	-8,141	-1,162	-839	-862	-295	-7,154	-3,158	187
Other investment	6,281	1,537	-1,750	6,136	1,992	9,864	-2,137	-1,846	-1,512	-1,622	-5,310	-7,117	-1,025
Assets	-3,326	-2,739	-288	3,859	-4,374	-1,451	-379	-253	-171	78	-1,209	-725	-548
o/w: short-term assets	-618	-1,965	-139	4,403	-1,554	1,633	-119	-122	-84	72	-583	-253	-121
Liabilities	9,606	4,276	-1,462	2,277	6,366	11,315	-1,758	-1,593	-1,341	-1,701	-4,101	-6,392	-477
o/w short-term liabilities	4,350	168	-1,225	896	-258	2,302	-1,132	-1,056	-985	-918	-3,310	-4,091	-136
Net errors and omissions	-1,595	-486	-657	-815	-3,751	-2,959	-647	-647	-647	-647	-2,626	-2,588	-1,294
Overall Balance	**134**	**-127**	**-4,930**	**-602**	**-3,950**	**479**	**-3,951**	**-3,330**	**-2,552**	**-2,099**	**-12,148**	**-11,933**	**-1,825**
Prospective Financing	**...**	**...**	**2,000**	**2,000**	**2,000**	**2,000**	**2,000**	**2,000**	**0**	**1,500**	**5,500**	**5,500**	**0**
European Union	...	...	2,000	2,000	2,000	2,000	2,000	1,500	0	1,000	4,500	4,500	0
World Bank	...	...	0	0	0	0	0	500	0	500	1,000	1,000	0
Bank Guarantee Fund	...	...	-1,034	0	-1,034	0	0	-2,069	0	0	0	-2,069	0
Net International Reserves (increase -)	**-134**	**127**	**3,965**	**-1,398**	**2,984**	**-2,479**	**1,951**	**3,399**	**2,552**	**599**	**6,648**	**8,501**	**1,825**
Gross Reserves	-134	127	-2,070	-6,321	-3,050	-7,402	-500	1,929	1,081	-871	-352	1,639	1,335
Reserve Liabilities	0	0	6,034	4,923	6,034	4,923	2,451	1,471	1,471	1,471	7,000	6,863	490
Bank Guarantee Fund 1/	0	0	1,034	0	1,034	0	0	0	0	0	0	0	0
Fund disbursements	0	0	5,000	4,923	5,000	4,923	2,451	1,471	1,471	1,471	7,000	6,863	490
Current account (in percent of GDP)	-6.4	-8.8	-5	-8	-6.2	-7.8	-4.5	-4.3	-3.9	-3.2	-2.0	-3.9	-3.4
Gross external debt (in percent of GDP) 2/	97.2	107.3	106	114	106.4	114.4	133.2	133.1	131.2	131.1	115.8	131.1	127.2
Gross official reserves	16,385	17,409	19,479	24,040	19,479	24,040	24,540	22,611	21,530	22,401	19,830	22,401	20,576
In percent of short-term debt at remaining maturity	88.9	67.4	67	82	67.2	82.0	85.9	75.9	72.0	80.3	79.5	80.3	80.0

Sources: Hungarian authorities and IMF staff projections.

1/ The Reserve Guarantee Fund was included both in reserve assets and liabilities at program approval, but is now expected to be separated from gross reserves.

2/ Includes inter-company loans—estimated at 21.4 percent of GDP at end-2008—and non-resident holdings of forint-denominated assets.

Table 4. Hungary: Indicators of External Vulnerability, 2005-08

	2005	2006	2007	2008 Est.
Financial Indicators				
M3, end-of-period, percent change	14.5	13.6	11.0	9.1
Credit to nongovernment, flow-based	15.4	17.3	15.9	10.6
T-bill , 90-day, average, in percent	6.7	7.0	7.6	8.9
Government bond yield, 5-year, average, in percent	6.8	7.4	7.0	9.3
Share of foreign currency liabilities in total liabilities	34.4	39.3	42.4	42.0
Share of foreign currency loans in total credit to: 1/				
Corporates	47.7	47.1	52.6	60.3
Households	32.6	46.8	59.0	70.7
Other loans	75.2	75.4	81.7	87.2
Non-performing loans to gross loans 2/	2.5	2.5	2.5	2.9
External Indicators				
Exports of goods and services, annual percentage change	12.9	15.0	17.1	6.0
Imports of goods and services, annual percentage change	10.0	14.2	13.8	5.9
Real effective exchange rate, percentage change, + = appreciation	2.0	-4.5	19.4	..
Current account balance, in percent of GDP	-7.5	-7.5	-6.4	-7.8
Capital and financial account, in percent of GDP	0.8	0.6	1.1	1.0
Financial account, in percent of GDP	13.0	10.3	7.0	10.0
Net foreign direct investment, in percent of GDP	5.0	3.2	1.6	3.1
Gross official reserves, in millions of euros	15,721	16,397	16,385	24,040
In months of imports	2.7	2.5	2.3	3.8
In percent of short-term debt at remaining maturity	112.2	123.6	88.9	82.0
Total external debt, in millions of euros	66,608	81,428	98,266	121,616
In percent of GDP	75.1	90.5	97.2	114.4
Short-term debt at remaining maturity, in millions of euros	14,012	13,270	18,428	29,304
Financial Market Indicators				
Stock market index, local currency, end-of-period	20,785	24,844	26,236	12,242
EMBI Global bonds spread, end-of-period	74.0	58.0	84.0	504.0
CDS spread, 5-year, end-of-period	26.5	21.0	48.5	430.2

Source: Hungarian authorities; and staff estimates.

1/ EBS/09/199 reported on the share of foreign currency loan in total credit. The corresponding values for 2008 are corporates (21.3 percent), households (25.4 percent) and other loans (25 percent).
2/ Non-performing loans are defined as loans past due more than 90 days.

Table 5. Hungary: Staff's Illustrative Medium-Term Scenario, 2005–11

	2005	2006	2007	2008	2009	2010	2011
				Est.		Program	
	(In percent, unless otherwise indicated)						
Real GDP growth	4.0	4.0	1.1	0.6	-3.3	-0.4	2.5
Nominal GDP, forint billions	21,997	23,785	25,419	26,700	26,640	27,323	28,846
Inflation (CPI; year average basis)	3.6	3.9	7.9	6.1	3.8	2.8	3.0
Inflation (CPI; end-year basis)	3.3	6.5	7.4	3.5	4.3	2.8	3.0
	(Annual percentage change, constant prices)						
Domestic demand	0.5	1.3	-1.8	-0.4	-4.7	-1.7	2.0
Consumption	3.2	2.4	-1.8	0.6	-3.7	-0.8	1.0
Gross fixed capital formation	8.0	-5.7	1.5	-2.4	-5.0	1.1	5.0
Exports of GNFS	11.5	18.4	15.9	7.3	-3.2	3.8	4.6
Imports of GNFS	6.9	15.0	13.1	6.7	-4.3	3.0	4.3
	(In percent of GDP, unless otherwise indicated)						
External current account balance	-7.5	-7.5	-6.4	-7.8	-3.9	-3.4	-3.1
Gross national saving	16.7	16.7	17.2	14.7	15.4	15.8	16.9
Gross national investment 1/	24.2	24.3	23.7	22.5	19.4	19.2	20.1
Capital account, net	0.8	0.6	1.1	1.0	1.8	1.7	1.6
Financial account, net	12.9	10.3	7.0	10.0	-8.0	1.2	3.2
Gross external debt 2/	75.0	90.4	97.2	114.4	131.1	127.2	123.1
General government (ESA-95)							
Revenue, primary	42.0	42.3	44.6	45.6	46.3	45.7	45.5
Expenditure, primary	46.0	48.0	45.8	45.1	45.0	43.9	43.5
Primary balance	-3.7	-5.4	-0.9	0.7	1.5	2.0	2.2
General government balance (incl. costs of pension reform)	-7.8	-9.3	-4.9	-3.3	-2.9	-2.5	-2.2
Net interest	3.9	3.7	3.8	3.8	4.1	4.2	4.0
General government debt	61.7	65.6	65.8	72.2	75.9	72.2	69.0
Memorandum items							
Output gap	0.6	2.0	1.0	-0.4	-5.8	-8.3	-8.0
Potential GDP growth	3.5	2.6	2.1	2.0	2.0	2.1	2.2
Structural general government balance	-8.1	-7.1	-4.5	-3.4	0.0	1.1	0.9
Structural primary balance	-4.3	-3.4	-0.7	0.4	4.1	5.4	4.9

Sources: Hungarian authorities; and IMF staff projections.
1/ Includes change in inventories.
2/ Includes intercompany loans.
3/ Consistent with the balance of payments data (not necessarily with the national accounts data).

Table 6. Hungary: Consolidated General Government, 2006-11 1/
(In percent of GDP, unless otherwise indicated)

	2006	2007	2008		2009		2010	2011
			Orig. Prog.	Est.	Budget Auth.	Rev. Prog.	Convergence Program 2/	
Total revenues	42.6	44.9	45.3	45.9	45.8	46.5	46.0	45.8
Current revenues and current transfers (incl. grants)	41.7	44.0	44.1	44.9	44.2	44.8	43.9	43.5
Tax revenues	37.0	39.5	39.8	40.5	40.0	40.4	39.9	39.8
Taxes on income, profits and capital gains	9.4	10.2	10.5	10.7	10.8	10.5	10.9	11.0
Personal income tax	6.7	7.1	7.4	7.6	7.6	7.4	7.8	8.0
Corporate income tax	2.3	2.8	2.7	2.7	2.8	2.7	2.8	2.7
Other (incl. wealth, capital, and property taxes)	0.4	0.4	0.4	0.4	0.3	0.4	0.3	0.4
Taxes on payroll and workforce and Social Security contributions	12.6	13.6	13.8	14.0	13.7	13.7	13.8	13.8
Taxes on goods and services	15.0	15.6	15.5	15.8	15.4	16.1	15.2	14.9
VAT	7.4	7.8	7.7	7.8	7.6	8.2	7.5	7.4
Other (incl. excises and import taxes)	7.5	7.9	7.8	8.0	7.8	7.9	7.7	7.5
Current non-tax revenues	4.0	3.8	3.6	3.9	3.7	3.9	3.4	3.2
Of which: interest	0.3	0.3	0.3	0.3	0.2	0.2	0.3	0.3
Current transfers (incl. grants)	0.8	0.6	0.7	0.5	0.6	0.6	0.6	0.6
Capital revenues and capital transfers (incl. grants)	0.9	0.9	1.2	1.0	1.6	1.7	2.1	2.2
Memorandum item: subnational governments own revenues	6.3	5.9	-	-	-	-	-	-
Total expenditures	51.9	49.8	48.7	49.2	48.4	49.3	48.5	48.0
Current expenditures and current transfers	45.7	44.3	44.0	44.3	43.8	44.5	43.2	42.4
Compensation of employees 3/	12.1	11.5	11.3	11.6	10.9	11.3	10.9	10.7
Goods and services	7.0	6.7	6.6	6.5	6.6	6.5	6.4	6.2
Interest payments	4.0	4.0	4.0	4.0	4.5	4.3	4.5	4.5
Subsidies	1.4	1.4	1.4	1.2	1.0	0.8	0.9	0.8
Current transfers to households	18.5	18.1	18.3	18.6	18.5	19.1	18.1	17.6
Social security	13.5	13.5	-	14.4	14.3	14.8	14.1	13.9
Of which unemployment benefits	0.4	0.4	-	0.4	0.4	0.4	0.4	0.4
Other	5.0	4.6	-	4.3	4.2	4.3	4.1	3.7
Other current transfers	2.7	2.6	2.5	2.3	2.3	2.4	2.4	2.5
Capital expenditures	4.3	3.6	3.1	2.9	3.0	3.2	3.4	3.6
Capital transfers	1.9	1.9	1.5	2.1	1.6	1.7	1.8	2.0
Other net expenditure	-	-	-	-	-	-	-	-
Memorandum item: subnational governments total expenditure	12.8	11.6	-	-	-	-	-	-
General government balance	-9.3	-4.9	-3.4	-3.3	-2.6	-2.9	-2.5	-2.2
Primary balance	-5.4	-0.9	0.6	0.7	1.9	1.5	2.0	2.2
Memorandum items:								
Primary expenditure	48.0	45.8	44.7	45.1	43.9	45.0	43.9	43.5
Output gap (in percent of potential GDP)	2.0	1.0	-0.9	-0.4	-3.1	-5.8	-3.8	-3.6
Cyclically-adjusted overall balance (CAB, in percent of potential GDP)	-10.4	-5.4	-3.0	-3.1	-1.8	0.0	-1.5	-1.3
Change in CAB	-2.2	4.9	2.0	2.3	1.6	3.1	0.3	0.2
One-off items (net)	-3.3	-1.0	0.1	0.2	0.0	0.0	0.0	0.0
Structural balance	-7.1	-4.5	-3.1	-3.4	-1.8	0.0	-1.5	-1.3
Change in the structural balance	-	2.6	0.9	1.1	1.2	3.3	0.3	0.2
Gross public debt	65.6	65.8	67.4	72.2	72.5	75.9	72.2	69.0
Real GDP growth (in percent)	4.0	1.1	1.8	0.6	-0.9	-3.3	1.6	2.5
In nominal terms (HUF billions)								
Total revenues	10,133	11,411	12,317	12,243	12,993	12,381	13,363	14,039
Total expenditure	12,350	12,666	13,246	13,129	13,818	13,141	14,086	14,717
Primary balance	-1,276	-227	81	192	372	389	589	687
General government balance	-2,217	-1,256	-929	-886	-824	-759	-723	-678

Sources: Hungarian authorities; and staff estimates.
1/ Data are classified following the ESA'95 methodology, as reported to the European Commission.
2/ Based on the Hungarian authorities' Updated Convergence Program, 2008-2011, published in December 2008.
3/ Including social security contributions.