

SUPPLEMENTAL MEMORANDUM OF UNDERSTANDING
(Second addendum to the Memorandum of Understanding)

BETWEEN

THE EUROPEAN COMMUNITY

AND

THE REPUBLIC OF HUNGARY

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SUPPLEMENTAL MEMORANDUM OF UNDERSTANDING

(Second addendum to the Memorandum of Understanding)

between

THE EUROPEAN COMMUNITY and THE REPUBLIC OF HUNGARY

1. On 4 November 2008, the Council of the European Union adopted a decision 2009/102/EC to make available to Hungary a medium-term financial assistance of up to EUR 6.5 billion. The assistance is provided as a medium-term loan under the balance of payments facility for Member States (based on Article 119 of the Treaty and Regulation No 332/2002) and in conjunction with loans from the International Monetary Fund (IMF) of SDR 10.5 billion (around EUR 12.5 billion) supported by a Stand-by arrangement approved on 6 November 2008 and from the World Bank of EUR 1 billion.
2. The Memorandum of Understanding ("the Memorandum"), laying down the economic policy criteria linked to each instalment and the reporting and monitoring conditions of the loan, was signed on 19 November 2008. These specific economic policy conditions will help the country to continue and enhance the fiscal consolidation efforts, to make progress with fiscal governance, financial sector regulation and supervision reforms and other measures to support a prudent, stability-oriented, and sustainable economic policy. The first instalment of EUR 2 billion was disbursed on 9 December 2008 following the signature of the loan agreement on 19 November 2008 and the fulfilment of conditions related to the 2009 budget. Subsequent instalments were tentatively scheduled for the first, the second and the fourth quarter of 2009, respectively.
3. In February 2009, a first review mission was carried out by the Commission services in cooperation with the IMF staff. Also based on a compliance statement provided by the authorities, the Commission services concluded that the conditions linked to the release of the second tranche of the Community loan of EUR 2 billion were met. Moreover, in the light of the deteriorated growth outlook for 2009 from -1% expected at the beginning of the Government's programme in Autumn 2008 to a contraction of 3 to 3.5% expected at the time of the mission, it was agreed that that, in spite of the additional expenditure-based measures of 0.7% of GDP, the deficit target for 2009 would have to be slightly revised upwards from 2.6% of GDP to 2.9% of GDP. This revision of the target as well as a number of additional economic policy conditions linked to the savings and structural measures announced by the authorities and to further commitments in the area of financial sector reform were laid down in a Supplemental Memorandum of Understanding. Following the consultation of the Economic and Financial Committee, this first Supplemental Memorandum of Understanding was signed on 11 March and the second instalment of EUR 2 billion was disbursed on 26 March.
4. The Commission services carried out a review mission in cooperation with the IMF staff from 7 to 18 May 2009 to assess progress made with respect to the specific conditions attached to the third instalment, which will amount to EUR 1.5 billion. The Hungarian authorities sent to the Commission a Compliance Statement dated 25 May, which reports on progress achieved with respect to the criteria

mentioned above. Based on the findings of the mission and the compliance note of the authorities and after having consulted with the Economic and Financial Committee, the economic policy criteria for the third instalment as laid down in the Memorandum of Understanding and the Supplemental Memorandum of Understanding are considered to be fulfilled. In particular, progress in the fiscal sphere and structural reforms was satisfactory, and in the area of financial sector regulation and supervision conditions are also broadly fulfilled but some elements still need to be finalised.

5. In the light of the latest strong deterioration in the international and domestic economic environment, the growth outlook underlying the economic programme of the Government as modified in the context of the previous review mission appears outdated, as GDP growth is now expected to decline by 6.7%%, against the forecast of a 3-3.5 % decline in March 2009. Against this background, the authorities revised their economic programme. The new strategy comprises an upward revision of the deficit target to 3.9% of GDP coupled with further adjustment measures of 0.8% of GDP mainly on the expenditure side, and implies a larger-than-planned fiscal effort compared to the February plans, as well as a series of additional structural measures to improve the long-term sustainability of Hungary's public finances, in particular in the areas of the pension, social support and local government systems. It also comprises a commitment to further reduce the deficit in 2010 to a level that does not exceed 3.8% of GDP and to less than 3% of GDP in 2011.
6. To ensure consistency with the revised economic policy programme based on the updated macroeconomic outlook and to reflect the continued progress in the area of financial sector reform and supervision, the conditions attached to the last instalment of the financial assistance need to be adjusted. The additional specific economic policy criteria are laid out in the Annex 1 to this Supplemental Memorandum of Understanding, which is the second addendum to the Memorandum of Understanding. Moreover, to improve the flow of information regarding the compliance with economic policy conditions, additional reporting is introduced in Annex 2.
7. Based on the fulfilment of the criteria indicated in the Memorandum, the third instalment shall be released after the signature of the second Supplemental Memorandum by the parties following the consultation of the Economic and Financial Committee.
8. The articles and the economic policy criteria as laid down in the Memorandum and in the first Supplemental Memorandum of Understanding remain valid, with the exception of the 2009 budget deficit target, which shall be replaced by a new target of 3.9 % of GDP.
9. The Annexes form an integral part of this Supplemental Memorandum.
10. The Hungarian Government Debt Management Agency (AKK) shall open a special account with the National Bank of Hungary (MNB) for the management of the Community medium-term financial assistance. This special account will be a sub-account of the euro-account of the AKK within the MNB.

11. All notices in relation with the present Supplemental Memorandum shall validly be given if in writing and sent to:

For the European Community

Commission of the European Communities
Directorate General for Economic and
Financial Affairs
B-1049 Brussels
Fax No.: (+32-2) 296.48.85

For the Ministry of Finance of Hungary

Ministry of Finance of Hungary
József nádor tér 2-4, H-1051 Budapest
Fax No.: (+36 1) 327 27 51

For the National Bank of Hungary

National Bank of Hungary
Szabadság tér 8-9, H-1054 Budapest
Fax No.: (+36 1) 428 25 23

Done in Brussels 11/06/2009 and Budapest on 10/06/2009 in four originals in the English language.

REPUBLIC OF HUNGARY

Represented by

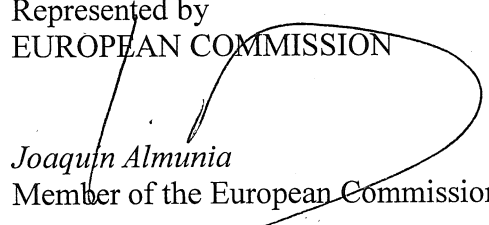


Péter Oszkó
Minister of Finance

EUROPEAN COMMUNITY

Represented by

EUROPEAN COMMISSION

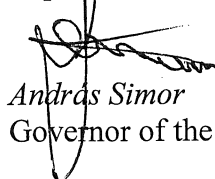


Joaquín Almunia

Member of the European Commission

NATIONAL BANK OF HUNGARY

Represented by



András Simor
Governor of the National Bank of Hungary

SPECIFIC ECONOMIC POLICY CRITERIA

At the time of the Commission staff review that will precede the decision on the disbursement of each instalment, the Hungarian authorities are committed to have accomplished progress in fiscal consolidation and expenditure control, fiscal governance reform, achievement of price stability, banking sector stability, financial sector regulation and supervision reforms, as well as structural reforms.

In view of the significant further deterioration in the economic outlook for 2009 in the context of the global financial crisis, the 2009 European System of National and Regional Accounts in the Community (ESA) deficit target of 2.9% of GDP referred to in the Supplemental Memorandum of Understanding of March 2009 as far as the conditions for the release of the fourth instalment of the Community assistance is concerned, shall be replaced by a new target of 3.9% of GDP. The corresponding cash-flow deficit target for the central government subsector is 3.8% of GDP. Thus progress shall be monitored against this basis and reviewed before the release of the fourth instalment. Furthermore, the specific economic policy criteria spelled out in the Memorandum of Understanding as well as in the first Supplemental Memorandum of Understanding shall be augmented by the following actions:

Fourth instalment

A: Fiscal consolidation

Regarding 2009:

- Full implementation of the additional expenditure reducing package of 0.6% of GDP for 2009 announced in Spring. Following the Parliament decision of 11 May 2009 on the pension reform steps (including the abolition of the second part of the 13th month pension) and a reduction in sick pay with a combined savings of 0.35% of GDP, the remaining deficit-reducing measures notably include: (i) halving the second part of the public sector wage compensation; and (ii) fully abolishing the universal housing subsidy scheme as well as the interest subsidy schemes for all new home purchases as of 1 July 2009.
- Allocation of better-than-expected (windfall) revenues to further deficit reduction, in case cyclical conditions would lead to net gains for the budget.

Regarding 2010:

- Abolishment of the 13th month salary in the public sector from 2010 onwards, thereby making permanent the temporary suspension of the payment of the 13th month salary in 2009, and a nominal freeze of the total public wage bill for 2010.
- Adoption of measures to underpin the planned durable savings of HUF 40 bn from the budgetary appropriations for public transport (mainly targeting transfer to the railway company).

- Full incorporation of the planned budgetary measures in the 2010 budget to ensure the achievement of a declining deficit path from 2009 to 2010 (in line with the transitory numerical rule set in the Fiscal Responsibility Law of November 2008) and a 2010 deficit target that does not exceed 3.8% of GDP.

B: Fiscal governance

- Carrying out by end September a review of the budget preparation as well as budgetary control and monitoring procedures against the background of the new Fiscal Responsibility Law, in consultation with the Fiscal Council and the relevant Parliamentary committees, identifying possible improvements.

C: Financial sector regulation and supervision

- Make further progress in the area of financial sector regulation and supervision. In particular, (i) complete the approval by the Parliament of the bill amending the Hungarian deposit guarantee scheme (containing the transposition of the provisions set out in Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay), and (ii) amend the Financial Stability Act to ensure that it is clear that the auditor under par. 16(3) of the Financial Stability Act is different from the auditor under Act CXII of 1996 on Credits Institutions.
- To ensure compliance of measures adopted in support of the financial sector with agreed EU principles and the guidance provided by the EU competition authorities (European Commission), timely inform the Commission in due form of such measures.

D: Structural reforms

In line with the programme of the new Government published on 21 April:

- Adoption by Parliament of draft laws to further improve the financial sustainability of the social support system, including (i) reduction in the eligible age of family allowance from 23 years to 20 years; (ii) limiting the length of the cash support system for parenthood to a maximum of two years;
- Adoption by Government of appropriate decrees to further streamline social support schemes, including (i) further tightening in the gas- and district heating subsidy scheme in 2010; and (ii) increasing the share of households in paying for the costs of school meal.
- Adoption of decisions by the Government and amendment of relevant laws by Parliament to underpin the foreseen reduction in local government's expenditure of HUF 120 bn.
- Adoption of revenue-neutral tax reforms aimed at reducing the tax wedge on labour and bolstering potential growth, including (i) lowering social security contributions and cutting the personal income tax by increasing the tax brackets, as well as (ii) the increase in consumption and wealth related taxes.

MONITORING AND REPORTING SYSTEM

During the implementation of the Community assistance, the following indicators and reports shall be made available to the Commission by the relevant authorities on a monthly basis (in addition to the requested reporting on (1) fiscal developments; (2) financial sector developments; and (3) inflation and foreign exchange reserves as set out in the original Memorandum of Understanding of November 2008):

4. Report on progress with respect to the economic policy conditions

- Monthly reports on progress with the fulfilment of the economic policy criteria as laid down in all Memoranda of Understanding.

5. Monitoring changes in the special account

- Monthly statements of the operations on the special account