

SUPPLEMENTAL MEMORANDUM OF UNDERSTANDING

(Third addendum to the Memorandum of Understanding)

between the European Union 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 143¹ of the Treaty on the Functioning of the European Union and Regulation No 332/2002²) 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 (EUR 1 billion).
2. The Memorandum of Understanding ("the Memorandum") signed on 19 November 2008 laid down the economic policy criteria linked to each instalment and the reporting and monitoring conditions of the loan. Their aim has been to 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 signing 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. The Commission services concluded that the conditions linked to the release of the second instalment of the European Union loan of EUR 2 billion were met. In the light of the deteriorated growth outlook for 2009 (GDP was expected to contract by 3 to 3.5% rather than by 1% expected in autumn 2008) it was agreed that the deficit target for 2009 would be revised from 2.6% of GDP to 2.9% of GDP in spite of the additional savings measures of 0.7% of GDP. The revision, as well as a number of additional economic policy conditions, was laid down in a first Supplemental Memorandum of Understanding (SMoU). Following the consultation of the Economic and Financial Committee (EFC), this first SMoU was signed on 11 March 2009, and the second instalment of EUR 2 billion was disbursed on 26 March 2009.
4. The Commission services carried out a second review mission in cooperation with the IMF staff in May 2009. Based on the findings of the mission and the compliance note of the authorities, the economic policy conditionality for the third instalment was considered to be overall fulfilled. In particular, satisfactory progress was made in the fiscal sphere and with structural reforms, and conditions in the area of financial sector regulation and supervision were also broadly fulfilled with some elements still in need to be finalised by the time of the review mission. Since the economic outlook had further deteriorated significantly and

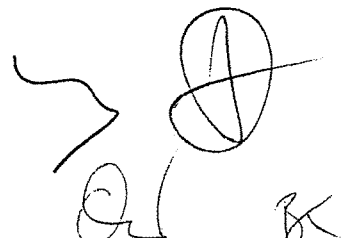
¹ Ex Article 119 of the Treaty establishing the European Community.
² As amended by Regulation No 431/2009.

GDP was now expected to decline by 6.7%, the deficit target for 2009 was revised upwards by the government in the context of the mission findings from 2.9% of GDP to 3.9% of GDP. This was coupled with additional adjustment measures of 0.8% of GDP, mainly on the expenditure side, and with a commitment to further reduce the deficit to a level not exceeding 3.8% of GDP in 2010 and to less than 3% of GDP in 2011. A second SMoU was signed on 11 June 2009, following the consultation of the EFC, to reflect these new targets. It also included a series of additional economic policy conditions and reporting requirements. A third instalment of EUR 1.5 billion was disbursed on 6 July 2009.

5. In August/September 2009, the IMF and Commission services carried out a joint mission in the context of the 3rd IMF review under the Stand-by arrangement. The Commission services found that, on the basis of an unchanged macroeconomic outlook, the economic programme of the authorities was adequate, and fiscal targets were confirmed. In view of the government's markedly improved access to market-based financing, and taking into account the recent IMF allocation of SDR 991 million to Hungary in the context of general and special allocations, the Hungarian authorities requested a re-phasing of the international assistance, whereby the remaining assistance would be disbursed over a longer period of time. On 25 September, the IMF Board completed the review and decided on the release of a disbursement of about EUR 55 million to be followed by four equal disbursements of about EUR 800 million each over the remainder of the arrangement (until 5 October 2010). Similarly, it was agreed that the remaining EU assistance would be rescheduled in the context of the next review by subdividing the planned fourth instalment in three sub-tranches to be disbursed in the first three quarters of 2010; the EFC was informed accordingly in September 2009.
6. The Commission services carried out a review mission in cooperation with the IMF staff from 4 to 16 November 2009 to assess progress made with respect to the specific conditions attached to the fourth instalment. In line with reporting requirements, authorities reported on a monthly basis on the progress made towards compliance with these conditions. The macroeconomic outlook was considered to be broadly unchanged compared to the last review in May, and the authorities remained committed to the budget deficit targets for 2009, 2010 and 2011, as endorsed in the Council recommendation under the excessive deficit procedure in July 2009.
7. Based on the findings of the mission and the monthly progress reports as well as the compliance note of the authorities (signed on 26 November 2009), and after having consulted with the Economic and Financial Committee, the economic policy criteria for the fourth instalment as laid down in the Memorandum and the two SMoUs are considered to be broadly fulfilled. The government made progress towards achieving the general government deficit target of 3.9% of GDP in 2009 although there are still some risks. It also submitted a budget for 2010 that is in line with the general government deficit target of 3.8% of GDP. However, it is subject to significant risks which could materialize in the form of lower than expected revenues as well as from lower than planned savings in the long-distance public transport system and the local government sector. Against this background, the reserves of 0.8% of GDP have been considered to provide sufficient caution so far while the authorities are committed to take steps should

the downward risks materialize. The authorities also presented the details of the planned restructuring in the long-distance public transport system in order to further substantiate the planned budgetary savings in this area. In particular, the Government decided to suspend the operation on 29 railway lines from 1 January 2010 and publicly announced on 9 December 2009 to increase fares. Moreover, the cut in the subsidies for public transport has been published in the Official Gazette on 11 December 2009 as part of the adopted 2010 budget. Progress was made in the field of fiscal governance, and the authorities took first steps to cooperate with the newly established Fiscal Council. A review of budgetary procedures against the background of the new fiscal framework was published on 15 December 2009. Progress in the financial sector area was satisfactory, while it was broadly satisfactory in the area of structural reforms. In particular, the long-run sustainability of the pension system was improved, and a number of social transfers became better targeted whereas some progress was achieved in adopting structural measures to support savings in the local government sphere.

8. In view of the improved access to market financing, the authorities indicated during the November 2009 mission that it is not their intention to draw on the IMF assistance upon the completion of the current review. Similarly, the authorities do not request the disbursement of the EU funds become available upon the completion of this review. As far as the outstanding fourth instalment of up to EUR 1 billion is concerned, it is tentatively foreseen to be released in three sub-tranches of up to EUR 0.3 billion in Q1 2010, up to EUR 0.3 billion in Q2 2010 and up to EUR 0.4 billion in Q3 2010. This disbursement schedule is subject to satisfactory progress with the conditions specified in this third SMoU and will take into account the external financing situation. The annex of the present SMoU contains the policy conditions for the three sub-tranches of the EU assistance.
9. The Hungarian Government Debt Management Agency (AKK) has opened a special account with the National Bank of Hungary (MNB) for the management of the medium-term financial assistance. This special account is a sub-account of the euro-account of the AKK within the MNB.
10. This third SMoU will be signed by the parties following consultation of the Economic and Financial Committee.
11. The Articles laid down in the Memorandum and in the previous Supplemental Memoranda and Annexes on reporting requirements remain valid, unless explicitly amended in this third Supplemental Memorandum.
12. The Annexes form an integral part of this SMoU.
13. All notices in relation with the present Supplemental Memorandum shall validly be given if in writing and sent to:

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For the European Union

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For the Ministry of Finance of Hungary

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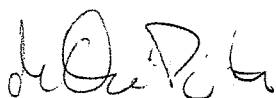
For the National Bank of Hungary

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Fax No.: (+36 1) 428 25 23

Done in Brussels on 21/01/2010 and in Budapest on 15/01/2010 in four originals in the English language.

REPUBLIC OF HUNGARY

Represented by



Péter Oszkó
Minister of Finance

NATIONAL BANK OF HUNGARY

Represented by



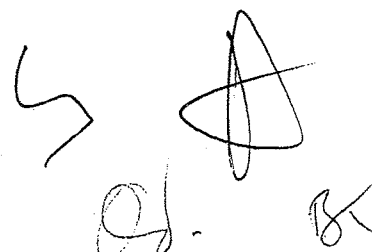
András Simor
Governor of the National Bank of Hungary

EUROPEAN UNION

Represented by
EUROPEAN COMMISSION



Joaquín Almunia
Member of the European Commission



SPECIFIC ECONOMIC POLICY CRITERIA

At the time of the Commission staff review that will precede the decision on the disbursement of each sub-tranche of the fourth instalment, the Hungarian authorities are committed to have accomplished progress in the areas of fiscal consolidation and expenditure control, fiscal governance reform, financial sector regulatory and supervisory reforms, and other structural reforms.

Fourth instalment – first sub-tranche*A: Fiscal consolidation*

- Confirmation of the general government 2009 deficit target of 3.9% of GDP supported by achieving the official 2009 cash flow deficit target for the central government (of 3.8% of GDP).
- Implement expenditure controls, including through the newly established system of treasurers, to ensure the achievement of the 2010 general government deficit target of 3.8% of GDP. Take steps to ensure that budgetary reserves remain at a sufficiently high level in case of adverse developments.

B: Fiscal governance

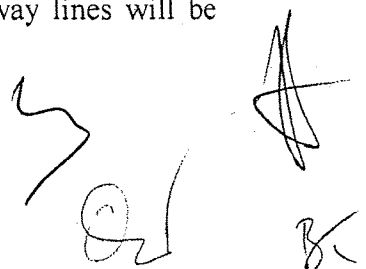
- On the basis of Act CV of 2008 on the legal status and financial management of budgetary institutions and the amended Public Finance Act, prepare and adopt a new government regulation on the general rules of public finance administration (i.e. the implementing rules of Public Finance Act) revamping the budgetary planning and execution of budgetary institutions in order to increase their efficiency and transparency.
- Modify the current budgetary process of advance payments by the Government to the final beneficiaries of EU funds (i.e. to establish differentiated advance payment procedures instead of general rules) in order to better target the available sources.

C: Financial sector regulation and supervision

- Ensure timely notification of state-aid measures adopted in support of the financial sector to the Commission and their compliance with the agreed EU principles and the guidance provided by the Commission. In particular, the Hungarian authorities will make strong efforts to regularize the case of government capital injection to the FHB (by March 2010), in close cooperation with the Commission services.
- The Hungarian Financial Sector Authority (HFSA) will take measures to strengthen its consumer protection arm in line with the Draft HFSA Law, expected to be approved by the Parliament in late 2009. In this context, the HFSA Board will adopt the Consumer Protection Strategy and the 2010 Action Plan by end-2009.

D: Structural reforms

- Continue to implement appropriate measures to ensure the realization of the planned durable savings in the area of long-distance public transport with a view to underpin the reduced budgetary appropriations of at least HUF 30 billion. In particular, tariffs will be increased and subsidies reduced. Moreover, redundant railway lines will be suppressed as announced.



Fourth instalment – second sub-tranche

A: Fiscal consolidation

- The 2009 budget deficit, as validated by Eurostat following the April 2010 Spring fiscal notification, is in line with the general government deficit target of 3.9% of GDP.
- Progress is made towards the achievement of the 2010 general government deficit target of 3.8% of GDP, as supported by progress made towards the revised official cash flow deficit target for the central government subsector (3.3%), in particular through a rigorous expenditure control and by ensuring that budgetary reserves remain at a sufficiently high level in case of adverse developments.

B: Fiscal governance

- On the basis of Act CV of 2008 on the legal status and financial management of budgetary institutions and the amended Public Finance Act, monitor and evaluate the implementation of general rules of public finance administration (i.e. the implementing rules of Public Finance Act) adopted. In order to enhance the proper application of new processes, the authorities make available the necessary technical assistance and resources to budgetary institutions in the context of a targeted project under the State Reform Operative Programme.
- After the treasurers' system has been in place for six months, by 30 April 2010 prepare a review of the results and the proper functioning of procedures and identify possible improvements;
- Monitor and report on the methods and average amounts of advance payments to final beneficiaries of EU funds.

C: Financial sector regulation and supervision

- The HFSA continues to enhance on-site inspections, particularly with a focus on credit quality and provisioning, and will complete reports on examinations of three large banks by the end-March, 2010.
- The HFSA will reflect on 2009 external audit recommendations on improving consumer protection by adopting an action plan for implementing the audit recommendations by end-April, 2010.

D: Structural reforms

- Continue to implement appropriate measures to ensure the realization of the planned durable savings in the area of long-distance public transport with a view to underpin the reduced budgetary appropriations of at least HUF 30 bn. In particular, steps will be taken to achieve efficiency gains and savings (including on public procurement and staff costs). Progress will be measured against steps taken at the company level and the financial outcome in Q1 2010.

Fourth instalment – third sub-tranche

A: Fiscal consolidation

- Progress in achieving the 2010 deficit target of 3.8% of GDP, as supported by progress made towards the revised official cash flow deficit target for the central government subsector (3.3%), in particular through a rigorous expenditure control and by ensuring that reserves remain at a sufficiently high level in case of adverse developments.

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- Submission to Parliament of a 2011 draft budget that is fully in line with a general government deficit of below 3% of GDP (ESA definition).

B: Fiscal governance

- Based on the experiences of the implementation of the fiscal responsibility law, identify its possible inconsistencies with the relevant legislation, and make arrangements to resolve them.
- Submit to Parliament the 2011 draft budget in full accordance with the prevailing fiscal framework.
- Report on the results of changes in the implementation process of EU funded projects and programmes.

C: Financial sector regulation and supervision

- The HFSA will finalize Basel II Internal Rating based validation examinations for credit risk and/or operational risk, in cooperation with respective home supervisors, in at least four foreign subsidiaries by end-June, 2010.
- The HFSA continues to enhance on-site inspections, particularly with a focus on credit quality and provisioning, and will complete reports on examinations of six large banks by the end-August 2010.

D: Structural reforms

Continue to implement appropriate measures to ensure the realization of the planned durable savings in the area of long-distance public transport with a view to underpin the reduced budgetary appropriations of at least HUF 30 bn. Progress will be measured against steps taken at the company level and the financial outcome in H1 2010.

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