SUPPLEMENTAL MEMORANDUM OF UNDERSTANDING

(Addendum to the Memorandum of Understanding)

BETWEEN

THE EUROPEAN COMMUNITY

AND

THE REPUBLIC OF HUNGARY

SUPPLEMENTAL MEMORANDUM OF UNDERSTANDING

(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 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 are tentatively scheduled for the first, the second and the fourth quarter of 2009, respectively.

3. The Commission services carried out a review mission in cooperation with the IMF staff from 4 to 15 February to assess progress made with respect to the specific conditions attached to the second instalment. This second instalment will also amount to EUR 2 billion. The Hungarian authorities sent to the Commission a Compliance Statement on 18 February, 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 second instalment as laid down in the Memorandum are considered to be fulfilled. This concerns the fiscal sphere, financial sector regulation and supervision, as well structural reforms.

4. In the light of the latest economic developments, the growth outlook underlying the economic programme of the Government appears outdated, as GDP growth is now expected to decline by 3 – 3.5%, against the forecast of a 1% decline in October 2008. Against this background, the authorities revised their economic programme. The new strategy comprises a slight upward revision of the deficit target to 2.9% of GDP coupled with expenditure-based corrective measures of 0.7% of GDP (together implying a larger-than-planned fiscal effort), as well as a series of structural measures to improve the long-term sustainability of Hungary's public finances, in particular in the areas of the pension and social support systems.

5. To ensure consistency with the revised economic policy programme based on the updated macroeconomic outlook, the conditions attached to the future instalments of the financial assistance need to be adjusted. The additional specific economic policy criteria are laid out in the Annex to this Supplemental Memorandum of Understanding, which is an addendum to the Memorandum of Understanding.

6. Based on the fulfilment of conditions indicated in the Memorandum, the second instalment shall be released after the signature of the Supplemental Memorandum by the parties following the consultation of the Economic and Financial Committee.

7. The articles and the economic policy criteria as laid down in the Memorandum remain valid, with the exception of the 2009 budget deficit target of 2.6% of GDP, which shall be replaced by a new target of 2.9% of GDP.

8. The Annex forms an integral part of this Supplemental Memorandum.

9. 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..3...09. and Budapest on 10..3..09 in four originals in the English language.

REPUBLIC OF HUNGARY
Represented by

János Veres, Dr.
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

ANNEX

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 significantly deteriorated economic outlook for 2009 in the context of the global financial crisis, the 2009 ESA deficit target of 2.6% of GDP referred to in the Memorandum of Understanding, as far as the conditions for the release of the third and fourth instalments of the Community assistance are concerned, shall be replaced by a new target of 2.9% of GDP. The corresponding cash-flow deficit target for the central government subsector is 2.7% of GDP. Thus progress shall be monitored against this basis and reviewed before the release of the third and fourth instalments. Furthermore, the specific economic policy criteria spelled out in the Memorandum of Understanding shall be augmented by the following actions:

Third instalment

A: Fiscal consolidation

- Full implementation of the recently announced corrective package of 0.7% of GDP. These deficit-reducing measures notably include: (i) further cuts in the operational expenditures and chapter-administered appropriations of budgetary chapters; (ii) reducing the national top-up in agricultural subsidies; and (iii) effectively tightening of the eligibility criteria for disability benefits and rehabilitation allowances.

C: Financial sector regulation and supervision

- Revision of the Financial Stability Act, in line with agreed EU principles and in conformity with the guidance provided by the Commission on the application of EU state aid rules, including such amendments as: i) aligning the expiration date of the recapitalisation measure with that of the guarantee measure; ii) specifying that the option granted to shareholders of a troubled bank to sell their share to the state should be exercised at a price reflecting the current and prospective conditions of the bank as determined by an independent third party jointly selected by the central bank and the HFSA.

D: Structural reforms

In line with the Government announcement of 16 February:

- Submission to the Parliament of a draft law aiming to improve the financial sustainability of the pension system, including (i) a move to increase the weight of inflation-related adjustment in the indexation mechanism; (ii) the abolition of the 13th month pension for new beneficiaries; (iii) containing the size of the last phase of the pension correction programme; and (iv) a 3-year increase in the mandatory retirement age between 2016 and 2025.

- Submission to the Parliament of draft laws to improve the financial sustainability of the social support system, including (i) the tightening of eligibility for housing subsidy programmes and reducing interest subsidies for housing loans as well as (ii) the achievement of savings by reforming the cash support system for the first years of parenthood, also by taking into account the time during which the eligible person has been employed when defining the length of the salary related child allowance (GYED).

<u>Fourth instalment</u>

A: Fiscal consolidation

- Incorporation of the budgetary measures in the 2010 budget which underpin (i) the planned reforms in the social transfer system leading to lower-than-planned social spending from 2010; and (ii) reforms for the sub-national sector, including effective rules to encourage further progress in the joint service provision of local governments as well as in the establishment of joint administrative offices.

D: Structural reforms

- Adoption by Parliament of a draft law aiming to improve the financial sustainability of the pension system, including (i) a move to increase the weight of inflation-related adjustment in the indexation mechanism; (ii) the abolition of the 13th month pension for new beneficiaries; (iii) reducing the size of the last phase of the pension correction programme; and (iv) a 3-year increase in the mandatory retirement age between 2016 and 2025.

- Adoption by the Parliament of draft laws to improve the financial sustainability of the social support system, including (i) the tightening of the eligibility of housing subsidy programmes and reduction of interest subsidies for housing loans as well as (ii) the achievement of savings by reforming the cash support system for the first years of parenthood, also by taking into account the time during which the eligible person has been employed when defining the length of the earning related child allowance (GYED).