MEMORANDUM OF UNDERSTANDING

BETWEEN

THE EUROPEAN COMMUNITY

AND

THE REPUBLIC OF HUNGARY

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 to make available to Hungary a medium-term financial assistance of up to EUR 6.5 billion. The assistance will be provided as a medium-term loan ("the 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. The EU financial assistance is provided in support of the new comprehensive economic policy programme adopted by the Hungarian authorities in the last week of October 2008 to restore investor confidence and alleviate the stress experienced in recent weeks in the Hungarian financial markets. Relevant elements of this policy programme were already included in the legislative amendments to the draft budget submitted to Parliament on 2 November. By supporting the sustainability of Hungary's balance of payments, the assistance will help the country to continue and enhance the fiscal consolidation efforts started in mid 2006 and 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.

2. The assistance will be disbursed in four instalments. The amount of the first instalment will be EUR 2 billion and shall be released subject to the entry into force of the Loan Agreement and the present Memorandum of Understanding, which will be approved after the consultation of the Economic and Financial Committee (EFC), and will be based on the submission to Parliament of the legislative amendments to the draft 2009 budget proposal, which target a deficit of 2.6% of GDP and include the underpinning budgetary measures (notably (i) a nominal wage freeze in the public sector in 2009; (ii) eliminating the 13th monthly salary for all public servants in 2009; and (iii) capping the 13th monthly pension payment at HUF 80 000 (around the level of the average pension) as well as abolishing it for some groups of early pensioners). A second instalment will be made in the amount of up to EUR 2 billion, followed by a third instalment of up to EUR 1.5 billion and a fourth disbursement of up to EUR 1 billion. The disbursement of the four instalments is tentatively foreseen for the fourth quarter of 2008, the first and second quarters of 2009 and the fourth quarter of 2009. The European Commission ("the Commission") shall decide on the release of the instalments following the first one after having obtained the opinion of the EFC. The disbursement of each further instalment shall be made on the basis of the implementation of the new economic policy programme of the Hungarian Government which is backed by the IMF arrangement and will be included in the forthcoming Convergence Programme of Hungary. More particularly, the release of the funds will be based on a positive evaluation of progress made with respect to specific economic policy criteria as detailed in Annex I.

3. The effective payment of the Loan instalments shall be subject to the signature and entry into force of the corresponding legal commitment (Loan Agreement) by the parties.

4. The disbursement date of each loan instalment or tranche will be agreed by the two parties in accordance with the Loan Agreement.

5. Starting from the second instalment, before the release of funds, the Commission will review in collaboration with the EFC that the economic policy conditions attached to the assistance are fulfilled. The specific economic policy criteria are set out in Annex I.

6. The EFC shall be kept informed by the Commission of possible refinancing of the borrowings or restructuring of the financial conditions.

7. The European Central Bank will act as an agent to the Commission and shall transfer the proceeds of the Loan instalments or tranches to a euro account of the Ministry of Finance of Hungary ("the Recipient") held at the National Bank of Hungary ("the Agent").

8. During the implementation of the assistance, the Hungarian authorities shall make available to the Commission without delay all the relevant information for the monitoring of its economic and financial situation and for the assessment of progress in economic conditions and reform measures as specified in Annex I. Prior to the release of the second and subsequent instalments by the Commission, the Hungarian authorities shall provide the Commission with Compliance Statements on the fulfilment of the conditionality attached to the instalment in question.

9. Investigation and satisfactory treatment of any suspected and actual cases of fraud, corruption or any other illegal activity in relation to the management of the European Community (EC) balance of payments assistance, detrimental to the EC's financial interests, shall be ensured. All such cases as well as measures related thereto taken by national competent authorities shall be reported to the Commission without delay.

10. The Commission, including the European Anti-Fraud Office, and the European Court of Auditors shall have the right to send their own agents or duly authorised representatives to carry out any technical or financial controls or audits that they consider necessary in relation to the management of this assistance as long as the Loan has not been fully repaid.

11. An independent ex-post evaluation of the assistance may be carried out by the Commission or its duly authorised representatives. The Hungarian authorities are committed to supply relevant information for the evaluation. The draft evaluation report will be made available to them for comments.

12. The authorities will ensure, as appropriate, close co-operation with the European Commission and the EFC.

13. This Community financial assistance shall be made available during a period of two years starting from the first day after the entry into force of the Council Decision 14953/2/08 of 4 November 2008.

14. The Annexes form an integral part of this Memorandum.

15. All notices in relation with the present 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

16. For Hungary the present Memorandum shall become effective after completion of internal procedures required under the Laws of Hungary. The Memorandum may be amended upon mutual agreement of the parties in form of an Addendum. The Addendum will be an integral part of this Memorandum and will become effective according to the same procedures as the Memorandum.

Done in Brussels 19/11/2008. and Budapest on 17/11/2008 in four originals in the English language.

REPUBLIC OF HUNGARY

Represented by

János Veres, Dr.
Minister of Finance

NATIONAL BANK OF HUNGARY

Represented by

András Simor
Governor of the National Bank of Hungary

EUROPEAN COMMUNITY

Represented by

EUROPEAN COMMISSION

Joaquín Almunia
Member of the European Commission

ANNEX I

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, and in particular the following actions:

Second instalment

The review will take into account the budgetary strategy presented in the December 2008 Convergence Programme update, including the primary balance targets for 2010 and 2011 as derived from the new fiscal governance framework.

A: Fiscal consolidation

- Progress with the achievement of the revised 2008 deficit target of 3.4% of GDP as supported by the progress in achieving of the revised official 2008 cash-flow deficit target for the central government subsector (also of 3.4% of GDP);

- The adoption by Parliament of the 2009 budget, targeting a deficit of 2.6% of GDP and including the underpinning measures.

B: Fiscal governance reform

- Adoption by Parliament of the planned fiscal governance reform, including the introduction of medium-term numerical rules and the establishment of independent fiscal bodies.

C: Financial sector regulation and supervision

- Introduction of a support package for the domestic banking sector in line with agreed EU principles and in conformity with the guidance provided by the Commission on the application of EU state aid rules. In addition, the government should also be ready to take further measures to ensure the stability of the banking sector in case of need.

- Adoption of measures to carefully monitor banks' funding needs so as to enhance the capacity to support banks in case of need. In this context, the authorities will (i) monitor closely the commitment of foreign banks to support their Hungarian subsidiaries; (ii) establish a special fund to guarantee the rollover of loans and wholesale securities against an appropriate fee with proper monitoring of actual guarantees.

- Strengthen financial sector supervision through: (i) initiation of the creation of a positive credit registry for households; (ii) making the necessary changes to the Central Bank Act to allow the MNB to request disaggregated data on individual banks to adequately analyze credit risk; (iii) close monitoring of banks' foreign currency exposure both directly and indirectly through their clients' credit risk; (iv) enhanced cross-sectoral risk analysis by financial supervisors.

- Seeking an agreement with commercial banks that facilitates the restructuring of household debt by means of adjustments in the maturity and repayment schedule of the debt, also including the option to convert foreign-currency loans into forint loans, thereby mitigating the large household foreign currency risk.

D: Structural reforms

- Adoption by the Parliament of the legislation in the context of the "Pathway to work", which includes the reorientation of some resources of the Labour Market Fund from passive means towards active labour market policies and is expected to be included in the National Reform Programme of November 2008.

Third instalment

The review will take into account the assessment of the December 2008 Convergence Programme update and the Spring 2009 EDP progress report.

A: Fiscal consolidation

- The outcome of the 2008 budget deficit, as validated by Eurostat following the 2009 Spring fiscal notification, in relation to the revised official 2008 ESA deficit target of 3.4% of GDP;
- Progress with the achievement of the new 2009 deficit target of 2.6% of GDP as supported by the progress made towards the revised official 2009 cash-flow deficit target for the central government subsector (2.3% of GDP).

B: Fiscal governance reform

- Appointment of the members of the Fiscal Council, supported by adequate staffing.

C: Financial sector regulation and supervision

- Take measures to strengthen financial sector supervision and regulation. These measures would notably include: (i) enhanced oversight of insurance and credit brokers and their products; (ii) measures to ensure prudent loan-to-value ratios for mortgage loans and loan-to-income ratios for household credit.

- Take measures to further strengthen the HFSA's and MNB's capacity to assess and address solvency and liquidity concerns in banks in a timely manner. This would notably involve: (i) establishing a mechanism for early remedial actions, including effective emergency powers for the HFSA; (ii) improving the efficiency of the bank resolution regime to facilitate the payments to depositors in case of need.

Fourth instalment

A: Fiscal consolidation

- Progress with the achievement of the new 2009 deficit target of 2.6% of GDP as supported by the progress made towards the revised official 2009 cash-flow deficit target for the central government subsector (2.3% of GDP);
- Submission of the 2010 draft budget proposal by 30 September 2009, which aims to achieve a further reduction in the deficit and is fully in line with the numerical rules included in the new fiscal governance framework.

B: Fiscal governance reform

- The preparation and deliberation of the 2010 draft budget proposal is based on the procedural rules as established in the new fiscal framework.

C: Financial sector regulation and supervision

- Take measures to strengthen cross-border supervision and communication between the supervisory authorities in home and host counties. This requires a structured exchange of information between the HFSA and the supervisory authorities of the home countries of the major foreign banks present in Hungary, including in the context of colleges of supervisors, as well as regular meetings to review the situation in each bank, including joint stress tests and onsite inspections as needed.

D: Structural reforms

- Take further steps to improve the sustainability of the pension system and based on the expert work of the Roundtable on pension issues present options for possible future steps.

Throughout the implementation of the assistance, performance in the following areas will be monitored:

Inflation

- Progress towards achieving price stability with a view to gradually bringing down inflation to the level of the medium-term target set by the authorities.

Structural Reforms

- Implementation of the Council Recommendation in the context of the assessment of the National Reform Programme under the Lisbon strategy.