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Hungary: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement

This Ex Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement with Hungary was prepared by a staff team of the International Monetary Fund as background document for the periodic consultation with the member country. It is based on the information available at the time it was completed on May 24, 2011. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Hungary or the Executive Board of the IMF.

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Washington, D.C.**

INTERNATIONAL MONETARY FUND

HUNGARY

**Ex Post Evaluation of Exceptional Access
Under the 2008 Stand-By Arrangement**

Prepared by an Interdepartmental Staff Team¹

Authorized for Distribution by the European and
Strategy, Policy, and Review Departments

May 24, 2011

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EXECUTIVE SUMMARY

The 2008 SBA with Hungary successfully stabilized financial market conditions – averting a major banking crisis and regional contagion – and strengthened the economy through sizable fiscal consolidation and important structural reforms, despite significant challenges.

While surveillance in the run-up to the crisis had highlighted important vulnerabilities, banks' liquidity risks from the increasing use of FX swaps in the context of a shortening of funding maturities had not been fully identified prior to the crisis. In October 2008, as the global crisis unfolded, foreigners retracted *en masse* from government securities, prompting liquidity pressures on banks and threatening spillovers to the region.

The timely request by the authorities and the prompt response by the Fund and the EU with a large and front-loaded financing package were critical in stabilizing market confidence and together with strengthened policies laid the ground for a successful program. Funding pressures receded, parent banks supported their subsidiaries consistently with their initial commitments, and the government tapped international markets earlier than expected.

Important progress was made to enhance bank supervision and resolution, and substantial fiscal consolidation was accomplished under the program to set the basis for fiscal sustainability in the medium-term. These achievements were obtained despite political uncertainty, institutional constraints, and an unprecedented global financial crisis.

The program was a successful example of joint collaboration between the authorities, the EU, and the Fund, setting an important precedent for future joint programs. Policy conditionality was set consistently with the authorities' strong commitment to the fiscal targets under the EU framework, ensuring ownership and anchoring short-term consolidation efforts. At the same time, the experience highlighted the need to revise headline fiscal targets under the EU framework flexibly in response to unanticipated cyclical developments.

The program could have been improved in a few areas, offering important lessons for future engagement. The Refinancing Guarantee Fund established to guarantee bank debt proved ineffective because of the relatively low sovereign credit rating, and the uncollateralized loans eventually extended to banks by the government posed risks to public finances, calling for general guidance to staff on the design of bank support packages with use of Fund resources to ensure their effectiveness and the presence of adequate safeguards. Moreover, further consideration could have been given to using a more comprehensive set of fiscal targets for effective program monitoring. Finally, initial growth projections turned out too optimistic, reflecting a generalized underestimation of the real effects of the global deleveraging process, and were revised downwards relatively slow. Together with the underestimation of banks' liquidity risks associated with FX lending in the run-up to the crisis, this reiterates the need for greater focus on macro-financial surveillance, including the development of macro-prudential tools that effectively limit the build-up of systemic risks.

Despite considerable efforts since the start to reach broad political support, the program lapsed upon disagreement with the newly elected government about additional fiscal measures. Although the program was able to deliver a considerable fiscal adjustment, much of the structural fiscal adjustment has since been reversed. Hungary's stock vulnerabilities arising from high public and external debt call for continued fiscal consolidation efforts and completion of the financial reform agenda, notably the reform of the bank resolution regime.

I. INTRODUCTION

1. **In October 2008, Hungary requested a Stand-By Arrangement (SDR 10.5 billion, 1015 percent of quota) in the context of a rapidly spreading global financial crisis.** Against the backdrop of this turmoil, a selloff of government securities by non-residents and a sharp exchange rate depreciation rapidly translated into liquidity pressures for banks, including from FX swaps. On October 11, a staff team left on an exploratory mission to Budapest requested by the Hungarian central bank (MNB) governor and minister of finance on October 9. Staff-level agreement on the program was reached on October 28 and the SBA request was approved by the Board on November 6.
2. **As an EU member, Hungary was required to consult with the EU before requesting Fund assistance.** The Hungary program represented the first case of a joint EU/Fund-supported program, setting a precedent for future requests by EU members. The United Kingdom in 1976 had been the last EU (then EEC) member to approach the Fund for financial assistance. Article 143 of the EU Treaty required Hungary to consult with the EU's Economic and Financial Committee on its balance of payments needs before seeking assistance from the Fund and other sources. In view of the urgency of developments in Hungary, the EU agreed to joint consultations with the Fund under accelerated procedures.
3. **The program faced significant political uncertainty because it was negotiated with a minority government.** At the time of the SBA request, the Socialist Party had the support of the Alliance of Free Democrats, even though the formal coalition had broken up in March 2008. Given this political uncertainty, efforts were made to build broad political consensus and avoid disrupting program implementation. In April 2009, the prime minister was replaced following a no confidence vote and a new technical government was formed. National elections took eventually place in May 2010, bringing the opposition party, Fidesz, into power with a large majority.
4. **This report assesses the effectiveness of the Fund's involvement in the context of the 2008 SBA.** Fund policy requires an ex post evaluation (EPE) of GRA-supported programs with exceptional access within a year after the end of the arrangement.² This EPE focuses on the following questions: why did Hungary request Fund assistance? (Section II); was the program design appropriate? (Section III); did the program achieve its objectives? (Section IV); and what are the key lessons to be drawn (Section V)?³

² See [Ex Post Evaluations of Exceptional Access Arrangements Revised Guidance Note \(2/25/10\)](#).

³ In accordance with procedures, this report was prepared by an interdepartmental staff team, primarily on the basis of documents and data available at the time it was completed on May 24, 2011. Naturally, this assessment benefits from hindsight. The team is grateful for conversations with present and former officials in Hungary, staff from the European Commission (EC), the European Central Bank (ECB), and the European Bank for Reconstruction and Development (EBRD), and present and former Fund mission chiefs and other Fund staff who were involved in the 2008 SBA. The key findings from the EPE were discussed with the authorities during a staff visit on March 21–28, 2011 and their general reactions are presented in Attachment I.

II. WHY DID HUNGARY REQUEST FUND ASSISTANCE?

5. **Hungary's high degree of financial and trade integration left it highly exposed to external shocks.** With a banking sector that was mostly foreign-owned and highly dependent on international bank flows, and an economy that was highly integrated with global trade flows (Figure 1), Hungary was hit particularly hard by the 2008 global financial crisis, which sparked global deleveraging and a decline in risk appetite.

Home Country 1/	Recipient Country	
	Region 2/	Hungary
Austria	66.1	8.8
Belgium	27.8	3.6
Ireland	13.2	1.4
Italy	9.2	1.1
Germany	6.2	0.9
Hungary (OTP only)	8.1	

Source: BIS.

1/ Home countries of banking systems with the five largest foreign bank exposures to the CESE region, which equals home countries of the six largest foreign bank subsidiaries in Hungary.

2/ Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Kosovo, Hungary, Latvia, Lithuania, Macedonia FYROM, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Turkey, and Ukraine.

6. **High debt levels left little room to absorb such shocks, despite fiscal consolidation efforts in 2007–08.** Public debt reached close to 70 percent of GDP due to consistently high fiscal deficits since the early 2000s. Consolidation efforts had reduced the fiscal deficit of the general government to 5 percent in 2007, and 3¾ percent in 2008, but public debt remained high. On the external side, large current account deficits and resulting external financing needs were funded mainly through debt-creating flows. External debt, at close to 100 percent of GDP, and the negative net international investment position were among the highest in the region. Significant exchange rate risk exposures for households from the prevalence of FX lending by banks added to these vulnerabilities.

7. **In the context of these high debt levels and a global deterioration in market sentiment, a crisis erupted in October 2008 with a sell-off by non-residents of government paper and pressures in FX markets.** Hungary stood out in the region for its large non-resident holdings of forint-denominated government paper (about 13 percent of GDP in mid-2008), combined with a large fraction of FX lending to unhedged retail borrowers. In 2007, once the subprime crisis started taking a global dimension, demand for FX swaps increased as foreign investors began hedging their forint positions and Hungarian banks were forced to close their on-balance sheet FX positions with increasingly shorter maturities (Figure 2).⁴ While the government bond market had already experienced some pressures in the first half of 2008, with several undersubscribed bond issuances, the global financial turmoil following the collapse of Lehman Brothers generated a downward shift in investors' sentiment in early October 2008 that led to a sell-off of government securities, a failed bond auction, and a sharp currency depreciation.

⁴ Hungarian banks with long on-balance sheet positions in FX had been using short FX swaps (or structured derivative products—both recorded off-balance sheet) to close their positions. These FX swaps exposed the banks to exchange rate and maturity risk. As the forint depreciated in October 2008, the underlying collateral value of the swaps deteriorated, triggering margin calls by the swap counterparty and eventually freezing the swap markets as short term contracts were no longer rolled over, putting FX liquidity pressures on the banks.

8. **The stress in FX markets prompted liquidity pressures at banks, which faced difficulties in rolling over FX swaps.** Rollover risks and margin calls on swap contracts exacerbated FX liquidity pressures, especially for banks without foreign parents, which held a total of €3.7 billion of FX swaps maturing through end-2009, more than a third of the total. The largest domestic bank, OTP, also faced liquidity pressures from other countries in Central Eastern and Southern Europe (CESE) through its subsidiaries abroad. Despite an increase in the policy rate and parent bank support, implied FX volatility remained high.

9. **Fund surveillance in the run-up to the crisis had highlighted key risks and vulnerabilities, although the underlying transmission channels were not fully identified prior to the crisis.** Hungary's pre-crisis vulnerabilities stand out when contrasted with past crises and other countries in the region. Previous Article IV Consultations had highlighted important vulnerabilities, including an overvalued currency, high external and public debt,

significant credit risk from FX lending to unhedged retail borrowers, excessive reliance on foreign parent bank funding, and liquidity risks from a decline in liquid asset ratios and a shortening of bank funding maturities.⁵ Nevertheless, the liquidity risks from the increasing use of FX swaps, in the context of a shortening of bank funding maturities, had been underestimated. Although the authorities had monitored activity in these markets and were aware of the increasing maturity mismatch, they also did not fully recognize the underlying liquidity risks. This was partly due to shortcomings in supervision, with greater focus on aggregate macro and financial soundness indicators than on bank-specific data and on-site inspections in the pre-crisis period.

	Pre-crisis Vulnerabilities (In percent of GDP)		
	Past Crises 1/	Hungary (2007)	Emerging Europe 2/
Current Account Balance	-3.2	-6.9	-14.4
Fiscal Balance	-2.5	-5.0	-1.9
Gross Public Debt	32.8	66.1	30.5
Change in Credit 3/	4.4	4.6	6.6
Gross External Debt	50.9	103.2	65.4

Source: WEO

1/ Selected crises: Mexico (1994), Indonesia (1997), Korea (1997), Philippines (1997), Thailand (1997), Brazil (1998), Ecuador (1998), Russia (1998), Turkey (2000), Argentina (2001), and Uruguay (2001).

2/ Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Latvia, Lithuania, Macedonia, Poland, Romania, Serbia, and Turkey. As of end-2007.

3/ Percentage points change in the ratio of bank credit to GDP.

10. **With rising pressures and limited buffers to absorb the shock, Fund assistance was needed to prevent a financial meltdown in Hungary and regional contagion.**

Although the government had a two-month cash buffer and the banking system was well capitalized, the stock of reserves—just above 60 percent of short-term debt at remaining maturity (including intercompany loans)—cast doubt on the ability to absorb the shock without external assistance. A crisis in Hungary could have resulted in significant losses at foreign parent banks, with significant risks of contagion to the Euro area and in turn to the rest of the CESE region.

⁵ See [IMF Country Report No. 08/313](#) (9/24/08).

III. WAS THE PROGRAM DESIGN APPROPRIATE?

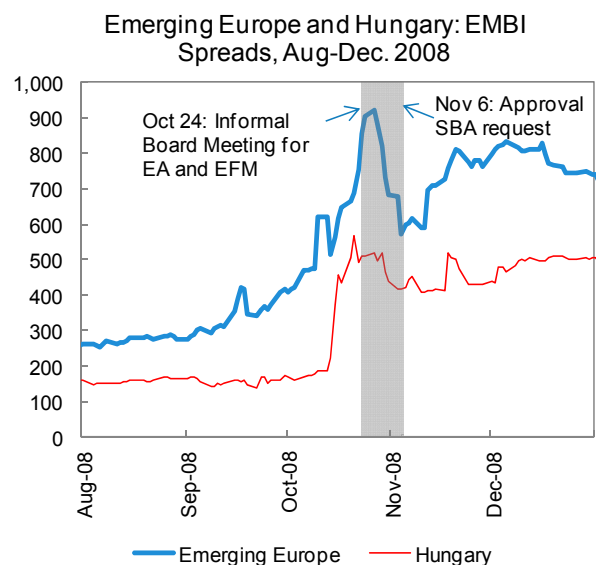
11. **The program was designed to strengthen the economy and foster a return to normal market conditions.** The program relied on early policy action and external support to restore market confidence and minimize negative feedback effects on the economy from further capital outflows and sharp exchange rate depreciation. The main objectives of the program focused on fiscal and financial sector policies and included:

- Substantial fiscal consolidation to provide confidence that the government’s financing needs could be met in the short and medium term, given the large public debt;
- Liquidity support and bank capital enhancement to ensure that banks were sufficiently strong to weather the forthcoming economic downturn.

These program goals were complemented by longer-term policy priorities, including the need to reduce the size of the large public sector and to lower the structural risks stemming from balance sheet mismatches in the financial sector. Supporting improvements in supervision and central bank liquidity management were also included in the program design.

12. **The initial program design reflected the expectation by staff and the authorities of a short-lived liquidity crisis.** At the time of the SBA request, the economic impact from the crisis was expected by staff to be less severe than in previous crises, in view of relatively lower overheating, assurance from parent banks to maintain exposures, and stable financing support from EU structural funds. This translated into a relatively short program (initially of 18 months), with large frontloaded access and streamlined conditionality. As the global crisis deepened, the medium term goals continued to anchor the program, while the short term objectives, notably the fiscal deficit targets, were in part adjusted to respond to the new cyclical conditions (Section III). The program was extended at the time of the Third Review by six months to bridge the possible transition to a new government following the elections.

13. **The need to reduce risks of regional contagion was an important pillar of the program.** The SBA request made explicit reference to the need to reduce the scope for financial spillovers to other countries, given the exposure of OTP to the CESE region and of several euro-area banks to Hungary via their subsidiaries. The approval of the Hungary’s program did contribute to stabilizing spreads in Emerging Europe, although this effect was only temporary and quickly offset by renewed balance of payments pressures in Hungary and the region.



Was the Financing Package Adequate?

14. **Hungary’s financing package relied on exceptional and front-loaded access to Fund resources with joint support from the EU.** At the time of the request, access at SDR 10.5 billion placed the Hungary program as the largest Fund arrangement since Turkey in 2002 and Korea in 1997 (although in line with other programs later approved in the region). The SBA was frontloaded with a first purchase of SDR 4.2 billion (Figure 3). The total financing package, for €20 billion, included substantial burden-sharing from the EU (for 33 percent of total), with a remaining €1 billion from the World Bank.⁶ Hungary’s SBA was the first access case under the EU balance of payments assistance facility, setting a precedent for subsequent programs in Latvia and Romania.

15. **The access request was justified by large balance of payments needs through end-2009.** The main drains on the financial account were projected to come from portfolio and other investment flows. Debt rollovers for domestic banks were estimated at 70 percent and at 80 percent for foreign-owned banks. FX swaps were also an identified source of net financing needs, given the margin calls at the time of the request, with rollovers assumed at 80 percent in December 2008 and expected to recover to only 90 percent in 2009. Finally, no FX issuance by the government was assumed throughout 2009, and further pressures on non-resident holdings of forint-denominated securities were also embedded in the program.

16. **The financing need projections were underpinned by the need for a credible package to restore market confidence despite uncertainty about banks’ pressure points.** In October 2008, liquidity pressures were widespread and there was large uncertainty about the extent of potential losses from FX swaps, with concerns of contagion to other countries in the region calling for a strong financing package. While staff recognized that the assumed rollover rates were seen as highly conservative by the authorities, these were in line with past crisis experiences and assumptions under staff’s stress scenarios for the Vulnerability Exercise for Emerging Markets. Moreover, the commitments by parent banks to maintain their exposures were not binding and called for prudent rollover assumptions.

17. **The program was successful in stabilizing financial conditions, reducing financing needs.** Financing conditions in 2009 turned out to be more favorable than expected. Foreign banks increased exposure to their subsidiaries at the peak of the crisis and reined them in once pressures receded in April 2009, highlighting the specific nature of intra-group capital flows in a systemic crisis. Government debt rollovers were also better than envisaged and drains from FX derivatives contained. Nevertheless, the large financing package was instrumental in meeting larger than expected pressures from non-residents’ holdings of forint-denominated securities in late 2008, in providing liquidity to the domestic

⁶ Total amounts drawn under the program were SDR 7.6 billion from the Fund and €5.5 billion from the EU BoP Facility. The World Bank loan was approved in September 2009 but never signed.

banking sector (where rollover rates for 2009 ended up in line with projections), and in boosting the relatively low reserve coverage. Moreover, bond buy-backs by the government helped support demand once domestic auctions re-started in the spring, easing market conditions and securing an early return of the government to the international bond market.⁷

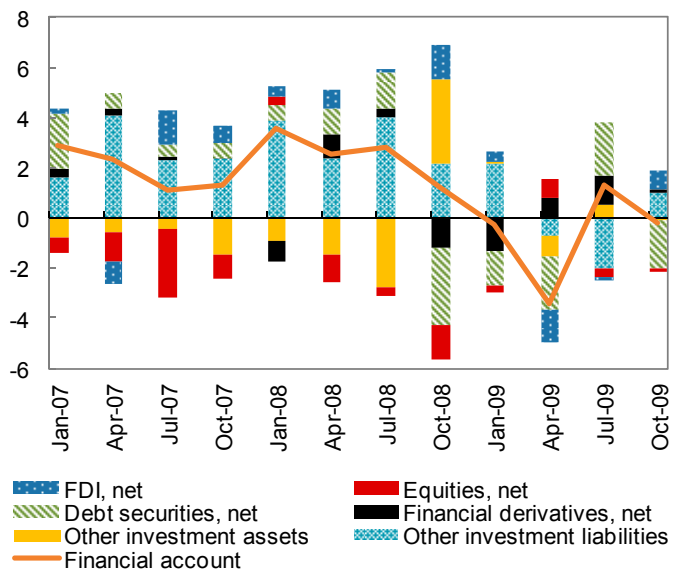
18. **As Fund financing addressed multiple financing needs, part of the purchases under the arrangement were disbursed directly to the government.** Specifically, the first two purchases under the SBA were disbursed to the government, through the Hungarian Debt Management Office, to meet its financing needs, provide FX liquidity to domestic credit institutions, and backstop the bank support package. The last purchase at the time of the Third Review was also directed to the government to increase its cash reserves. The direct budget support modalities helped allay concerns about central bank independence, which would have been triggered by on-lending of Fund resources to the government.

Did the Program Meet the Four Exceptional Access Criteria?

19. **Hungary’s SBA access request for 1015 percent of quota triggered exceptional access policy procedures.** Annual and cumulative access to the Fund’s general resources was above normal limits (at the time, 100 and 300 percent of quota, respectively). Staff consulted the Board at an early stage in the context of an informal meeting on October 24, 2008 and finally at the Board meeting for the SBA request on November 6, 2008, according to the procedures for exceptional access use in a capital account crisis. Specifically, the access request was assessed by staff against the four exceptional access criteria:⁸

- **Criterion I: “The member is experiencing exceptional balance of payments pressures on the capital account resulting in a need for Fund financing that cannot be met within the normal limits.”** At the time of the request, Hungary was experiencing large and sudden

Hungary: Net Capital Flows, 2007-09
(In billions of euros)



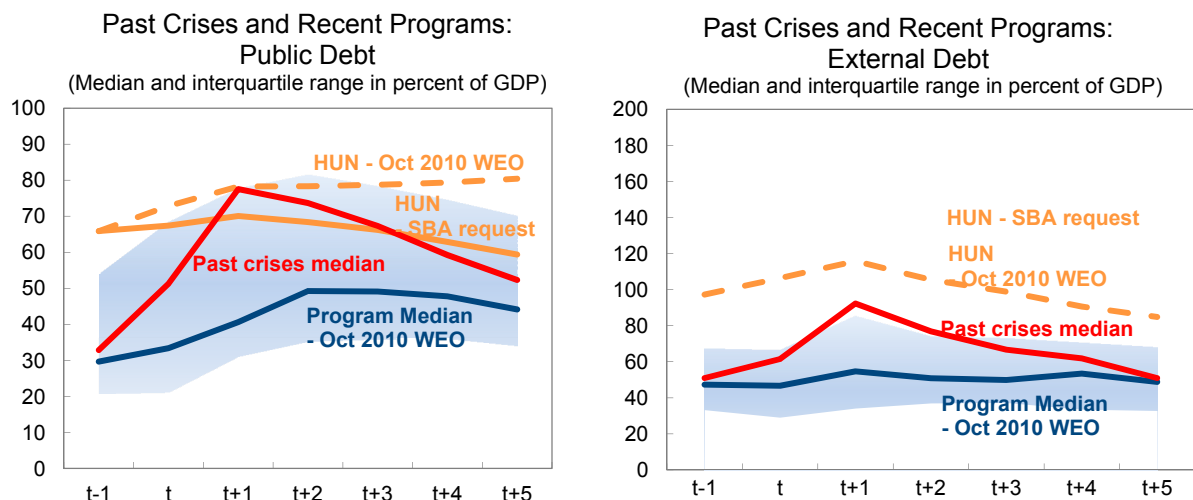
Source: WEO

⁷ Bond buy-backs amounted to Forint 366 billion in the second quarter of 2009, mostly with 3–5 year maturity.

⁸ The SBA arrangement was approved before the modifications to the exceptional access policy criteria approved by the Board in [GRA Lending Toolkit and Conditionality—Reform Proposals](#) (3/24/09).

portfolio outflows by non-residents (equivalent to over 200 percent of quota in October 2008 alone). Market access was limited with sovereign spreads increasing sharply. The liquidity position of domestic banks was deteriorating and, although foreign banks had not reduced exposures to their subsidiaries, there was large uncertainty going forward. The forint had depreciated by more than 10 percent in the first week of the staff mission. These developments support staff's assessment that the criterion was being met.

- Criterion II: “A rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable.”** Public and especially external debt were high compared to recent program and past crisis cases. Although staff assessed that debt sustainability was met with high probability, it also stated that this hinged on the success of a strong economic program, notably further fiscal consolidation as well as continued investor confidence and the absence of sharp exchange rate depreciation.⁹ Ex post, continued parent banks' support helped secure exchange rate stabilization and private sector external debt sustainability, whereas lower growth and revenue performance than initially projected delayed public debt adjustment.



Source: WEO

Note: t denotes the year 2008 for recent programs and the beginning of the crisis for past crises. Sample of past crises includes: Mexico (1994), Indonesia (1997), Korea (1997), Philippines (1997), Thailand (1997), Brazil (1998), Ecuador (1998), Russia (1998), Turkey (2000), Argentina (2001), and Uruguay (2001).

- Criterion III: “The member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding, so that the Fund’s financing would provide a bridge.”** At the time of the request, staff reported that

⁹ Staff's assessment implicitly expanded the restrictive application of the Exceptional Access criterion, which until then had been interpreted to exclude forward-looking assessments, including programmed policy adjustments. The successive 2009 GRA reform ([GRA Lending Toolkit and Conditionality—Reform Proposals](#), 3/24/09) revised the criterion exactly in this direction and focused the assessment exclusively on public debt.

Hungary's access to capital markets had deteriorated and that a return to normal market conditions, while likely, depended on global developments and the strength of policy measures. Specifically, staff expected that government financing difficulties would have persisted throughout 2009, although with continued access to the T-bill market, mostly financed by domestic banks. Eventually, financing constraints eased earlier than expected: by July 2009, the government had already issued a five-year €1 billion bond and forint-denominated bonds at a pace sufficient to cover its financing needs for the remainder of 2009 and 2010. In view of improved market conditions, the authorities stopped drawing on Fund resources upon completion of the Fourth Review in December 2009, turning the arrangement into a precautionary one.

- **Criterion IV: “The policy program of the member country provides a reasonably strong prospect of success, including not only the member’s adjustment plans but also its institutional and political capacity to deliver that adjustment.”** The criterion was considered to be met by staff on the basis of Hungary’s recent track record of sound macroeconomic policy implementation over the previous two years and the robust institutions underpinning the proposed program, notably the significant fiscal consolidation and the credibility of the MNB’s inflation targeting mandate. Nevertheless, staff emphasized that successful program implementation was conditional on reaching political agreement on the economic program, given a minority government. To this purpose, efforts were made by staff to build broad political consensus with declared buy-in from opposition parliamentarians. Once the new interim government was formed in April 2009, staff continued its outreach to the media and the political opposition to ensure continued and broad-based ownership of the program in view of the forthcoming parliamentary elections. The opposition party was elected in April 2010 with a large majority but disagreement on the economic policies under the program eventually led to the interruption of the discussions for the combined Sixth and Seventh Review.

20. **The Emergency Financing Mechanism (EFM) was invoked in parallel to the exceptional access procedures to enable a prompt crisis response.** On October 8, the Managing Director had announced that emergency procedures had been activated to respond quickly to member requests for support with high-access financing, based on streamlined conditionality that focused on crisis response priorities.¹⁰ The EFM had been previously used in six occasions (during the 1997 Asian crisis, in Turkey in 2001, and in Georgia in 2008) to facilitate rapid approval of Fund support to members faced with a truly exceptional situation threatening their financial stability. Management officially informed the Board of the intention to activate emergency procedures for Hungary in the context of the informal meeting on exceptional access on October 24, 2008, as soon as the urgency and extent of the financing needs became clear. The report for the Interim Review under the EFM was issued

¹⁰ See [Statement by the IMF Managing Director to the International Monetary and Financial Committee \(IMFC\) on the IMF's Lending Role and Surveillance Priorities \(October 8, 2008\)](#).

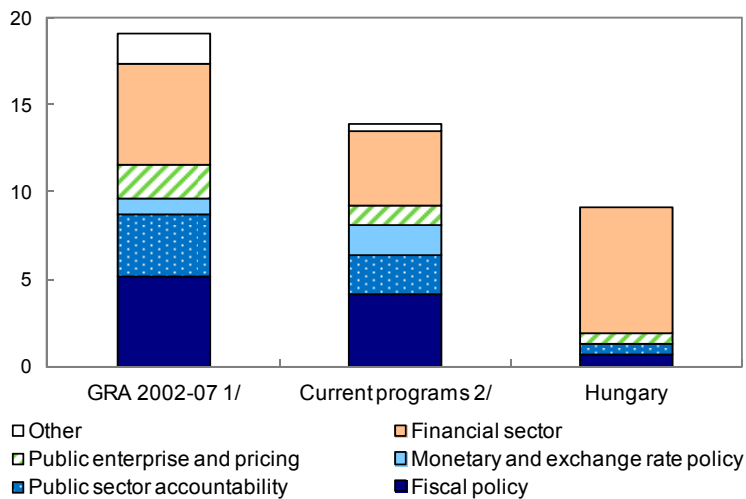
on December 23, 2008 to provide the Board with a staff assessment of the initial policy response and market reaction.

Was Program Conditionality Correctly Focused?

21. **Program conditionality aimed at restoring market confidence and securing long-term external and public debt sustainability.** Accordingly, it was focused on structural reforms to lower the risks stemming from financial sector balance sheet mismatches, while building credibility through fiscal consolidation and targeted public sector reforms.

Compared to past programs, the Hungary program was more streamlined, with structural conditionality tailored to the country's identified areas of macro-criticality. The authorities' 12-point program, announced during the first days of the mission, served broadly as the blueprint of the policies to be implemented. On fiscal conditionality, although the required measures went beyond initial plans, ownership by the authorities was secured by their strong commitment to adhere to the targets under the EU convergence program and excessive deficit procedure (Box 1).

Structural Conditionality in Recent and Past Programs
(Cumulative number of conditions divided by years covered by conditionality)



Source: Fund staff estimates.

1/ All 32 nonconcessional arrangements approved during 2002-07.

2/ Cumulative number of conditions in current programs as of May 2010, divided by years covered by conditionality.

Fiscal Policy Conditionality

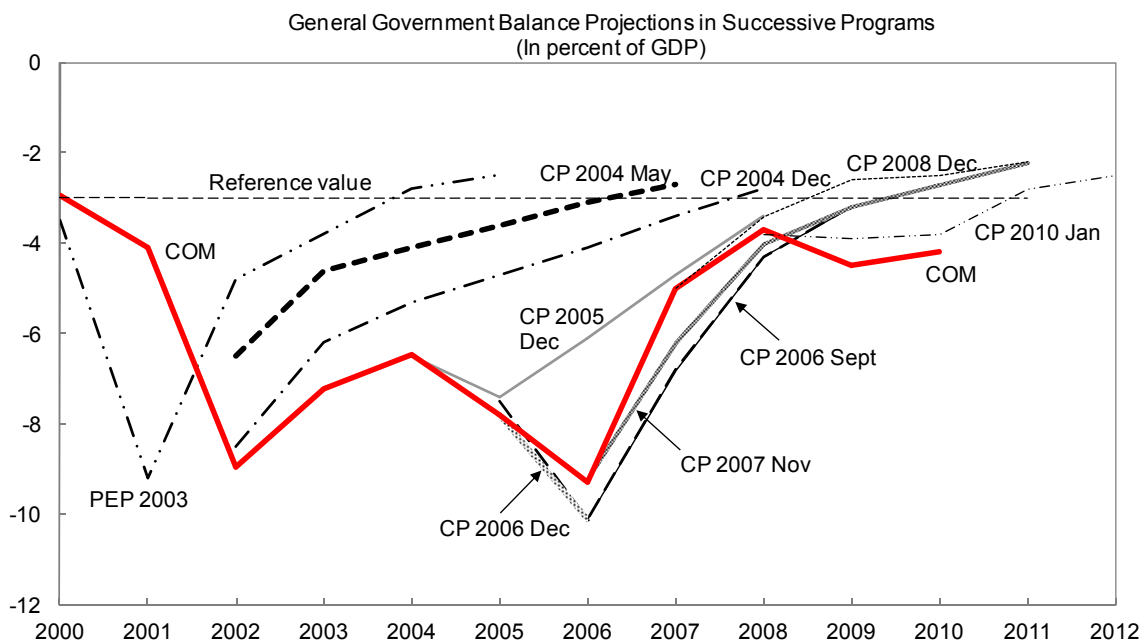
22. **Fiscal conditionality required a sizable adjustment and was streamlined in view of the authorities' ongoing efforts and commitments to the EU targets.** The fiscal consolidation efforts under the program were sizable (originally projected at 5 percent of potential GDP for 2009–11) and frontloaded in light of the high public debt. A quantitative performance criterion on the primary surplus of the central government on a cash basis was set to monitor fiscal conditionality. The use of a cash target responded to the need to limit the government actual financing needs. The central government definition included the state budget as well as extra-budgetary funds and social security funds. However, it did not cover other general government accounts, notably of local governments, due to data constraints. Specifically, final data for the large number of municipalities was published only with a lag of four months, making it incompatible with the program quarterly monitoring requirements. Finally, the use of the primary rather than overall balance responded to the need to

accommodate potential interest rate shocks, given the large uncertainty about the interest rate path at the time of the request.

Box 1. The EU Convergence Program and Excessive Deficit Procedure (EDP)

Under the Stability and Growth Pact (SGP), non-euro member states are requested to prepare convergence programs to be submitted to the European Commission (EC) and the Council each year. The aim of these programs is to ensure more rigorous budgetary discipline through surveillance and coordination of budgetary policies within the EU. The convergence programs include the medium-term adjustment path to comply with the 3 percent of GDP fiscal deficit threshold of the EU Treaty and the resulting debt path to ensure the long-term sustainability of public finances. Whenever a member state exceeds the 3 percent of GDP fiscal deficit threshold, the EDP is triggered at EU level under the corrective arm of the SGP, unless the breach is considered temporary and exceptional and the deficit remains close to the threshold. The EDP entails several steps—including the possibility of sanctions—to encourage the member to take effective measures to reduce the deficit below the threshold by a given deadline.

Before the crisis hit, the authorities had submitted a series of satisfactory semi-annual progress reports to the EC and Council under the EDP. The EDP was triggered for Hungary in 2004. The Council recommendation aimed at correcting the deficit by 2008. However, in 2006, the deadline was extended by one year, in view of the substantial consolidation effort required and the lack of any effective action in the previous years. In that context, Hungary was also asked to adopt and implement structural reforms and to improve budgetary control. In April 2007, the government submitted the first progress report on the implementation of its consolidation and reform programs, on the basis of which the EC concluded that the country had taken effective action. This was followed by satisfactory progress reports in September 2007, in April 2008, and in November 2008, which did not provoke any further step in the EDP.



Source: Commission Services (COM), Successive Convergence Programs (CP), and Pre-Accession Economic Program (PEP)

23. **A more comprehensive set of fiscal targets supported by additional efforts to improve data monitoring could have been considered.** Quantitative performance criteria on the primary cash balance of the central government were consistently met at each review, although the cash definition left room for payment postponements to meet the target. A shift to an accrual/ESA95 definition would have removed scope for accounting adjustments and thus provided a more accurate representation of the fiscal stance, as well as allowed the same definition for IMF and EU conditionality. However, as only preliminary data were available for the central government on an accrual basis for quarterly monitoring, staff had to rely on monthly cash data for its quarterly monitoring of the fiscal PC and addressed the shortcomings in the target definition by holding regular meetings with the authorities to check spending arrears by central budgetary entities.¹¹ Nevertheless, indicative targets under the program on non-accumulation of arrears and the ESA95 fiscal balance (with possibly a consultation clause in case of a significant deviation from the cash target) could have been considered early in the program as an additional safeguard.¹² Moreover, while the burdensome data collection process constrained the ability to include municipalities in the fiscal balance definition, in view of the faster deterioration of the general government deficit during the program period, consideration might have been given to gradually improve data monitoring (especially of healthcare and education entities under the municipalities' responsibility, where most arrears were reportedly concentrated).¹³

24. **The fiscal balance quantitative target was complemented by structural measures intended to buttress the authorities' medium-term efforts toward fiscal sustainability.** Among them, a fiscal responsibility law was adopted to target a decline in the budget deficit over the following two years and to require that public debt does not increase in real terms thereafter, as well as to enhance the transparency of the budget process through specific disclosure requirements. Moreover, as the economic crisis intensified, further structural measures were introduced to rationalize social transfers, notably pensions and subsidies. Legislation for reducing the fragmentation of municipalities, while essential to simplify bureaucracy and improve frequency of data provision, could not be included as part of the structural conditionality in the program, given lack of broad political support and the need for a two-third majority.

¹¹ Quarterly figures on the ESA95 general government balance were provided with a three-month lag, in line with the EU quarterly data transmission deadline.

¹² Staff did consider additional conditionality to conduct a full inventory of unpaid bills, which had been observed at end-2009, at the time of the combined Sixth and Seventh Review.

¹³ Between 2008 and 2009, the general government balance on an ESA95 basis deteriorated from -3.7 percent of GDP to -4.3 percent of GDP, while the central government balance on a cash basis remained unchanged at -3.4 percent of GDP. An extension of the coverage of the state-owned Hungarian State Railways (MAV) in the cash balance definition was considered at the time of the Fourth and Fifth Reviews.

Monetary Policy Conditionality

25. **To preserve central bank credibility, the program maintained the monetary policy framework of the central bank.** A quarterly inflation consultation mechanism was introduced, as had been the case for other inflation targeting frameworks in previous programs, notably Brazil in 2002 (Box 2). The MNB had been targeting inflation since 2001, and since February 2008 the horizontal bands of ± 15 percent around the central parity of the forint had been removed. The main policy instrument was the monetary policy rate.

Box 2. Inflation Consultation Mechanism

Monetary policy conditionality was set in the context of an inflation consultation mechanism. This required the central bank to consult with the Fund if the 12-month CPI inflation rate would fall outside an inner band of ± 1 percent around the central point. Moreover, an inflation rate outside an outer band of ± 2 percent around the central point would halt further purchases under the program until a completed consultation with the Fund on the proposed policy response. The central point was initially set at 5.1 percent by December 2008, above the MNB's inflation target of 3 percent, and would decline by 0.3 percent each quarter.

The mechanism was revised on different occasions during the program. The central point was revised during the First Review from 4.8 percent to 3 percent, given lower than projected inflation and downward growth revisions. Moreover, an adjustor to account for the impact of increases in VAT and excise taxes was introduced during the Second Review for monitoring purposes.

26. **Foreign currency intervention was allowed under the program to smooth any disruptive exchange rate movements, in line with the central bank's mandate.** Program design included a floor on net international reserves (NIR). The floor was set at a lower level than the baseline projection in the balance of payments to meet the intervention needs of the central bank in case of worse than expected market developments. Nevertheless, the size of this buffer was constrained by the need to maintain an adequate level of reserves, given the low initial coverage. Due to the authorities' concerns about market sensitivity, notably that the reserves drawdown implied by the target could be interpreted as an actual rather than stress scenario, the NIR performance criterion was not published until the Third Review, once market uncertainty had receded.

Financial Sector Conditionality

27. **A strengthening of financial sector balance sheets and improved financial market conditions were among the main policy objectives.** The program aimed at halting the heightened liquidity pressures and lowering the structural risks stemming from balance sheet mismatches in the Hungary's financial sector. This included securing continued exposure by foreign parent banks to their Hungarian subsidiaries and providing liquidity support to domestic banks.

28. **The main foreign parent banks were asked to state their support to Hungary.** On October 17, 2008, representatives of seven commercial banks, including OTP and the major foreign-owned banks in the country, met with the MNB and affirmed their willingness to support their clients' liquidity needs, while tightening their lending standards and reducing the share of CHF-denominated loans. In this context, parent banks provided general assurances to the MNB that they would continue to fund their Hungarian subsidiaries, supporting the credibility of the financing package and market confidence. These soft commitments were later confirmed in the context of the European Bank Coordination Initiative (EBCI) in May and November 2009 (see Appendix II). The positive impact of the EBCI underscores the potential value of co-financing with regional financing arrangements.

29. **The program supported financial stability by committing adequate resources to the banking sector, although the proposed bank guarantee fund proved ineffective.** The program was front-loaded with a large bank-support package, including a Capital Base Enhancement Fund and a Refinancing Guarantee Fund, with total funding of HUF600 billion (2.2 percent of GDP).¹⁴ However, the Refinancing Guarantee Fund (on interbank loans and wholesale securities) proved ineffective in its original setup, given the low sovereign credit rating which automatically translated into a low credit rating for the guarantee.¹⁵ Moreover, the Fund was designed to guarantee debt for up to five times its funds, providing only a partial credit guarantee, and was subject to appropriate but stringent conditions which further reduced its attractiveness to banks.

30. **The program included important structural measures to improve the resilience of the banking sector and maintain financial sector stability.** A draft law was to be submitted to parliament to grant the Hungarian Financial Supervisory Authority (HFSA) special remedial powers to accelerate the resolution of any failed bank. Moreover, financial sector regulation and supervision was to be strengthened through the setting up of a credit registry for households, the introduction of maximum loan-to-value requirements for new mortgage loans, and intensified monitoring of banks' foreign exchange exposures.

IV. DID THE PROGRAM ACHIEVE ITS OBJECTIVES?

31. **Despite difficult and evolving circumstances, program conditionality was met throughout the program.** All the quantitative performance criteria were met at each review for both fiscal and NIR targets (Table 3). The indicative debt target was not met on one instance, but only by a small amount (end-June target). Inflation remained below the program central point during the program, but breached the lower limit of the inner band on two

¹⁴ The final law passed by Parliament granted all banks the option to apply for support upon satisfaction of certain requirements, correcting upon recommendation from the EC a provision in the draft law that limited the eligibility de facto to two systemically important banks.

¹⁵ The Refinancing Guarantee Fund had been designed along the lines of guarantee programs in other EU countries, notably the UK, with significantly higher sovereign ratings.

occasions triggering discussions with staff, under the consultation mechanism. Structural conditionality was also successfully met (with at most minor delays and prompt corrective actions), with the exception of the bank resolution regime law which was submitted to Parliament, but with the program lapsing, was eventually never approved (Table 4).

32. **This section reviews the program’s performance compared to its initial objectives.** It starts with an analysis of the macro developments, notably the sharp downturn and required adjustments in the program projections in subsequent reviews. It then assesses the implications for the fiscal targets and the overall fiscal stance, followed by an assessment of the monetary and financial outturns as well as the factors determining the program lapse.

A. Comparative Macroeconomic Developments

33. **Hungary’s economic downturn was severe but comparable to that of past capital account crises.** Real GDP contracted by 6¾ percent from peak to trough, driven by a sharp decline in domestic and external demand and a decline in credit growth, in line with the median peak to trough contraction in previous emerging market crises.¹⁶ While in earlier crises external demand had mostly been supportive and allowed affected countries to export their way out of the crisis, Hungary’s downturn was compounded by a worsening external environment, with collapsing import demand from advanced trading partners.

34. **Pre-crisis vulnerabilities did not leave space to run countercyclical macroeconomic policies, exacerbating the economic downturn.** Hungary’s contraction was in line with those experienced in other program cases in Emerging Europe, although larger than in non-program cases where buffers and better fundamentals had allowed room for countercyclical policies. In Hungary, the primary fiscal balance under the program was projected to improve by 1¼ percentage points of GDP in 2009, and the MNB raised the policy interest rate by 300 bps when the exchange rate came under pressure in October 2008.

35. **The initial growth projection for 2009 turned out too optimistic due to the generalized underestimation of the extent of the global crisis.** The GDP growth rate of -1.0 percent, projected for 2009 at the time of the SBA request, turned out to have a large projection error of -5.7 percent (Figure 4). While underestimating the extent of the trade and financial shock, the initial growth projection was in line with external demand assumptions by the WEO for main trading partners, reflecting the large degree of uncertainty about the global deleveraging process and the macro outlook during the global crisis.¹⁷ Moreover, the program projection was more pessimistic than the authorities’ and consensus forecasts.

¹⁶ The median peak to trough contraction in annual real GDP in earlier emerging market crises was 5.7 percent, based on the sample of capital account crises in [Review of Recent Crisis Programs](#) (9/14/09).

¹⁷ Nevertheless, earlier capital account crises recorded a median decline in real GDP growth of 5.7 percent during the first crisis year (see [Review of Recent Crisis Programs](#), 9/14/09).

36. **The export collapse and deleveraging effect had repercussions for all growth components and in turn for the current account adjustment.** In the context of a global crisis, exports declined by about 10 percent in 2009, against an initially projected increase of 2 percent underpinned by some exchange rate depreciation and continued import demand by trading partners. Given the large export contribution to GDP and employment, private consumption contracted by almost 7 percent. Gross fixed investment fell by 8 percent, with an even larger projection error due to both lower external demand and underestimated deleveraging effects. The resulting import compression of 15 percent more than offset the exports decline, leading to a larger current account adjustment than initially projected.

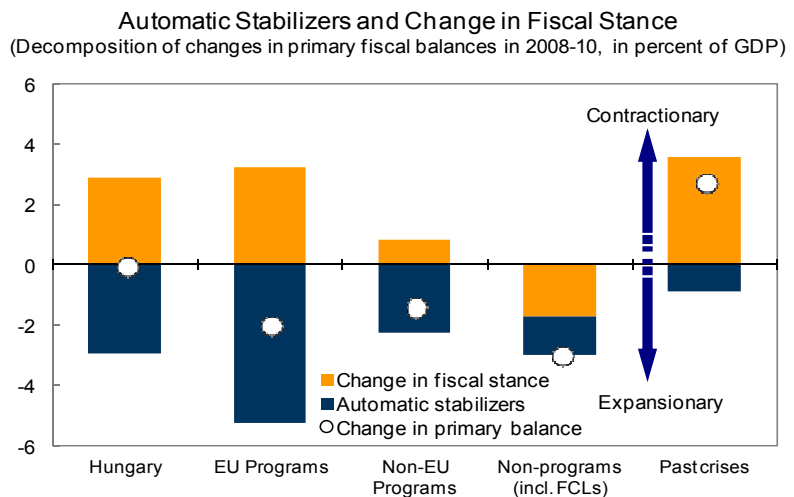
37. **Despite rapidly deteriorating conditions in Hungary and abroad, growth projections were revised downward relatively slow.** Growth for 2009 was revised from -1 to -3.3 percent at the First Review in March 2009, with a relatively slower adjustment than in Hungary's trading partners and other crisis countries in the region. The projections were also somewhat more optimistic than consensus forecasts and the MNB's projection of -3.5 percent in its February Inflation Report, although more pessimistic than those of the EU and the Hungarian government. However, by the Second Review in June 2009, growth was adjusted further down to -6.7 percent, which also turned out to be the final outcome for 2009.

B. Fiscal Policy

38. **Fiscal policy during the program was broadly appropriate, balancing fiscal sustainability concerns with the need to avoid a sharper downturn.** Hungary's high

public debt, at about 70 percent of GDP, uncertain debt rollover prospects, and contingent liabilities from the financial sector did not leave much room for countercyclical policies. As a result, the program delivered a large and frontloaded structural fiscal adjustment of about 2.5 percent of potential GDP over the program period. Overall, the fiscal stance was less

contractionary than in past crises, despite a comparable downturn, and in line with other EU programs, although tighter than in non-program countries with room for countercyclical policies.



Source: Staff estimates; "Review of Recent Crisis Programs", SM/09/246.
1/ Averages for all categories.

39. **The program was able to adjust to evolving cyclical conditions, while ensuring consistency in the application of the EDP instrument at EU level.** The authorities' commitment under the EDP to keep the general government deficit target below 3 percent of GDP in 2009 required a more procyclical stance at the First Review, with additional measures in light of the rapidly deteriorating outlook. However, at the time of the Second Review, the severity of the downturn led to a substantial revision in the growth projection, justifying a revision of the EDP with an extension of the deadline by two years. As a result, the general government fiscal deficit for 2009 could be relaxed to 3.9 percent of GDP to reflect falling revenues and limit procyclical tightening.

40. **The resulting fiscal package was large, but was delivered by both temporary and more sustainable measures.** The agreed fiscal package agreed to during program negotiations was significant, with additional measures of 2 percent of GDP with respect to the fiscal package presented in the earlier Article IV staff report. The authorities' adjustment was focused on the expenditure side, given the need to reduce the large public sector (among the highest in the region). Although most expenditure measures were of a long-term nature (e.g. the limits on pensions and the elimination of the 13th month compensations on pensions and wages), the adjustment also relied on transitory measures difficult to sustain over time, especially towards the end of the program.

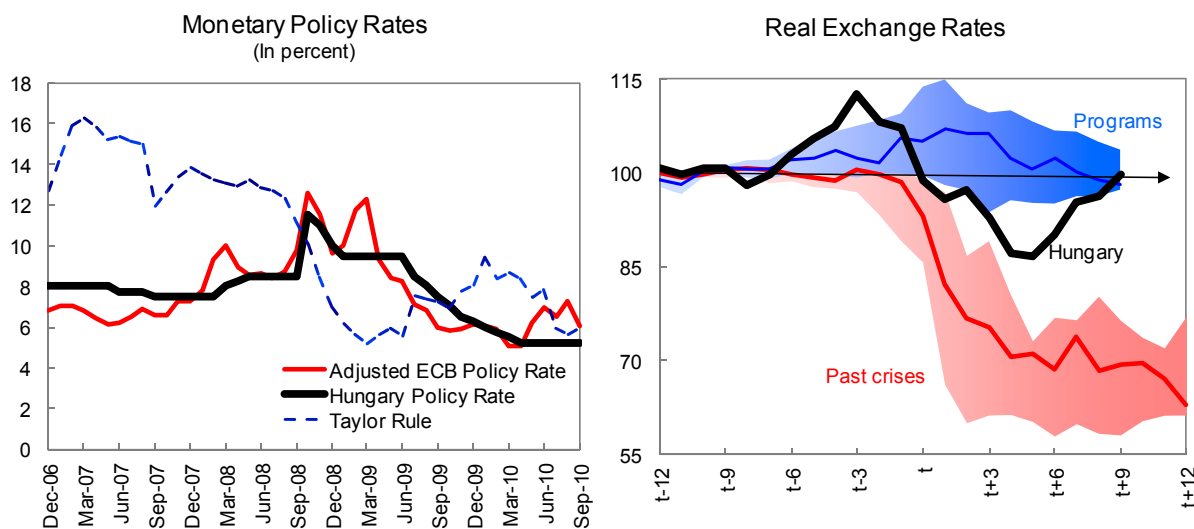
41. **Important institutional enhancements towards medium-term fiscal performance were achieved during the program, despite constraints from limited political support.** The Fiscal Responsibility Law (FRL), passed by Parliament in December 2008, included quantitative ceilings on public debt, on the primary balance, and on expenditures. It also created a Fiscal Council, tasked to prepare macro forecasts and projections of budgetary aggregates, assess budgetary impact of draft legislation, and have an advisory role to all branches of government upon request.

42. **Among the structural measures, enhancements to the pension system improved its long-term sustainability prospects.** The authorities' pension reform, implemented before the crisis, was further strengthened during the program by gradually increasing the statutory retirement age to 65; introducing a new indexation formula for pension benefits; abolishing the 13th month pension; and tightening early retirement conditions by introducing a proportional reduction in benefits. As a result of these and previous reforms, the Hungarian pension system compared relatively well in terms of long-term sustainability within Europe.

43. **As a result, the fiscal adjustment set public debt on a sustainable medium-term path, despite downward revisions to primary fiscal deficit targets.** The primary surplus projections for the general government were systematically revised downwards (Figure 5), mainly reflecting deteriorating macroeconomic conditions and low tax revenue performance. Nevertheless, the medium-term primary surplus remained comfortably above its debt stabilizing level throughout the program, leaving adequate room to accommodate additional shocks from external conditions and contingent liabilities from the financial sector.

C. Monetary and Exchange Rate Policy

44. **Monetary policy under the program was appropriately cautious to preserve financial stability, while continuing to support the inflation target.** The MNB acted independently in its monetary policy decisions, although Fund staff supported the authorities in the context of the inflation consultation mechanism. While inflation risks from commodity and domestic demand shocks subsided rapidly, financial stability became an important concern in setting policy rates. Specifically, the central bank's initial policy rate hike aimed at avoiding a disorderly depreciation that would have led to negative effects on inflation and on banks' balance sheets, given the large fraction of FX loans.¹⁸ Faster relaxation in early 2009 could have helped reduce the negative output gap, although at the risk of further downward pressure on the exchange rate. Moreover, resurgence in inflation toward the end of 2009 indicates that monetary policy was broadly appropriate. Overall, the real exchange rate adjusted by about 25 percent, less than in past crises but more than in other programs and in line with other inflation targeters in the region (e.g., Czech Republic and Poland).¹⁹



Source: NBH, WEO, and Fund staff estimates.
 Note: Adjusted ECB Policy Rate is computed as the ECB main refinancing facility rate plus the spread between German and Hungarian 5-year government bonds, each in their domestic currencies. The Taylor rule assigns equal weights of 0.5 to inflation and output gap, with expected inflation proxied by average inflation over the previous four quarters, and the equilibrium real interest rate proxied by the average real GDP growth over 1995-2010.

Source: IMF, Information Notice System and Fund staff estimates.
 Note: Median and interquartile ranges, average of t-12 to t-7 = 100, monthly "t" represents Oct 2008 for current programs, and the beginning of the crisis for past crises. Selected crises, SM/09/246: Mexico (1994), Indonesia (1997), Korea (1997), Philippines (1997), Thailand (1997), Brazil (1998), Ecuador (1998), Russia (1998), Turkey (2000), Argentina (2001), and Uruguay (2001).

¹⁸ This included a policy hike of 300 basis points on October 22, 2008, followed by four 50 basis points cuts from November 2008 until January 2009.

¹⁹ The real exchange rate overvaluation of 10 percent estimated at the time of the 2008 Article IV Consultation (September 2008) was corrected by August 2009.

45. **The central bank expanded its liquidity management toolkit to relieve banks' liquidity pressures.** In response to the crisis, the MNB introduced a forint facility with expanded useable collateral, as well as short-term FX swap facilities, supported by repo and swap lines from the ECB and the Swiss National Bank.²⁰ In early March 2009, to facilitate longer term FX funding and support the real economy, the MNB made available a six-month FX liquidity facility against a commitment by banks to secure external funding and maintain corporate lending exposures in Hungary, as well as a more expensive three-month facility without these additional conditions. Throughout the crisis, the MNB struck an appropriate balance between its role as a lender of last resort to banks with FX liquidity needs and the need to preserve adequate reserve coverage.

D. Financial Sector

46. **Parent bank support complemented central bank response in providing the banking system with the necessary liquidity to withstand the global crisis.** Foreign banks increased exposures by over 35 percent (almost €5 billion) in the period between September 2008 and March 2009 to provide additional liquidity to their Hungarian subsidiaries. Notwithstanding global deleveraging and the economic downturn, the banking sector as a whole remained profitable and adequately capitalized throughout the program. Although nonperforming loans as a share of total loans increased to 5.9 percent at end-September 2009 from 3 percent at end-2008, banks' capital adequacy ratios remained robust, increasing to 13.1 percent on average by end-September 2009 from 11.2 percent at end-2008.

47. **Medium-term FX loans extended by the government were successful in reducing funding pressures at three domestic banks.** In March 2009, given the shortcomings of the Refinancing Guarantee Fund (Section III), the government unilaterally decided to extend uncollateralized loans to three banks with immediate FX funding needs.²¹ The loan recipients included OTP, the largest domestic bank (€1.4 billion), MFB, the state-owned development bank (€600 million), and FHB, a mortgage lender (€400 million). These loans were made possible after an amendment to the Act on Public Finances, authorizing the government to provide loans to banks upon recommendation of the MNB and HFSA. In addition to addressing banks' liquidity needs, the loans were also intended to support the real economy by requiring that recipient banks maintain certain credit exposures, notably to SMEs.

48. **However, the initial design of the government's loans lacked transparency and posed risks to public finances.** Originally, while the loans were conditional on continued

²⁰ The Swiss National Bank provided a EUR/CHF swap line (for €5 billion) and the ECB a repo line (for €5 billion), although the latter was tied to the ECB's collateral requirements (A- rating) that the Hungarian government bonds did not satisfy. Half of this was later on made available as an ECB swap line for €2.5 billion.

²¹ The decision to extend FX loans was reportedly also influenced by the risk that banks would meet their FX needs through the sale of local currency, putting downward pressure on the exchange rate.

corporate lending, they lacked further safeguards, including clarity on banks' eligibility. In response to staff's request for adequate safeguards, a government representative was placed on the banks' boards and a new Financial Stability Subcommittee (composed of the MOF, MNB, and HFSA) was established to monitor the financial soundness of the recipient banks—a continuous structural benchmark since the First Review. Once informed, the EC also required an adjustment of the pricing of the loans to reduce the subsidy element and ensure consistency with EU competition rules. Moreover, one of the recipient banks received a capital injection of HUF 30 billion (about €100 million) under the Financial Stability Act soon after the FX loan had been disbursed, without notifying the EC for approval of the measure. The EC has subsequently ruled that the remuneration paid by the bank for the capital provided by the state did not comply with EU state aid rules and had not been granted in accordance with the criteria set in the Capital Base Enhancement Fund, with the recapitalization amount notably exceeding the limit of 2 percent of risk-weighted assets for recapitalizations that did not require notification.

49. **The authorities made important steps to enhance bank supervision and resolution, although reform of the latter remains incomplete.** Shortcomings in supervision were identified early on into the program and measures to strengthen supervision were included as a structural benchmark at the First Review. The HFSA was upgraded to an autonomous institution, a tri-partite Financial Stability Council (FSC) was established, and the introduction of a “comply or explain” mechanism gave the FSC and the MNB the right to propose legislation or regulation. The authorities adopted legislation for enhancing the provisions on special administration, legal protection, and the initiation of bank liquidation proceedings during the program. The structural benchmark on the bank resolution regime had to be reset in part because of legal issues involving shareholders' rights and the protection of property rights under the constitution. Although the authorities submitted the draft law to Parliament in line with the structural benchmark under the program, it was never voted on and has subsequently been withdrawn.

50. **Nevertheless, on-site inspections of systemically important banks were subject to significant delays due to operational and legal constraints, in the context of high market uncertainty about the liquidity of banks.** The on-site inspections of systemic banks envisaged under the program did not start until April 2009, after the government FX loans had already been granted to three domestic banks, and were only completed in March 2010. While conditionality in this area was only introduced at the First Review with an action plan to be prepared by May 2009, the delay was largely due to the need to strengthen the HFSA operational capacity to conduct thorough on-site inspections. Moreover, non-Hungarian external auditors could not be hired to outsource the process due to legal objections raised by the government in the initial phase of the program. In the case of OTP, an external audit of its foreign operations was also envisaged—which could have helped alleviate undue market concerns about the bank's consolidated position, but the procurement process was also subject to delays (the audit has been initiated only recently and is expected to be completed in July 2011).

E. End of the Program

51. **The program lapsed before completion of the combined Sixth and Seventh Review due to disagreement on the economic policies of the newly elected government.** The elections in April 2010 saw the opposition party Fidesz win a two-thirds parliamentary majority. Expenditure acceleration and revenue shortfalls at the general government level in the first half of 2010 prompted the new government to seek additional consolidation measures for the second part of the year to contain the fiscal deficit.²² The combined Sixth and Seventh Review was not concluded upon disagreement about the extent and sustainability of the proposed fiscal measures, notably on expenditure and corporate income tax cuts, as well as the size of a financial sector levy, regarded by staff as posing risks to growth and financial stability. Modifications to the central bank law also raised concerns at the EU level about central bank independence. Most importantly, there was no firm commitment on the 2011 budget to preserve the EDP fiscal target of below 3 percent of GDP. Eventually, the program expired and the government stated it was not seeking a successor arrangement.

52. **The 2010 Article IV Consultation expressed concerns about the ultimate impact of recent policy initiatives to meet the headline deficit target.** In late 2010, the government embarked on additional temporary tax measures and an expenditure freeze and created incentives to divert second pillar private pension assets as contributions to the budget, reversing the pension reform. These initiatives aimed at meeting the 2010 deficit target of 3.8 percent of GDP, while creating additional room for expenditures. However, they also raised staff's concerns that the fiscal improvements towards long-term sustainability achieved during the program period could be undermined. Indeed, recent estimates point to a sizeable deterioration in the structural primary balance in 2010, undoing a large part of the fiscal consolidation in previous years (see Hungary's First Post-Program Monitoring Report). Nevertheless, the authorities have since announced new measures to strengthen their fiscal consolidation plans.

53. **Substantial changes have been made to the Fiscal Council and Financial Stability Council established under the program and the reform to the bank resolution regime is still pending.** The Fiscal Council, intended under the Financial Responsibility Law to provide important institutional underpinnings to fiscal discipline, has been replaced by a smaller body consisting of the chairman of the State Audit Office, the MNB governor, and a presidential appointee, with formal veto power over the budget but with reduced mandate and resources. Moreover, a new law has removed the right of the FSC to propose regulation or legislation on a "comply or explain" basis. Finally, the legislation for the bank resolution regime, submitted to Parliament during the program period, still needs to be approved.

²² Although part of this excess spending was due to flood damage and higher-than-expected healthcare costs, it also included spending from state-owned companies and local governments.

54. **Two years after the crisis outbreak, Hungary's private and public debt vulnerabilities remain its main challenge.** High public and external debt, low reserve coverage, large-scale currency mismatches, and the economy's reliance on external funding have allowed vulnerabilities to persist. Nevertheless, liquidity buffers in the financial sector and the external current account have improved, while the government's cash position has strengthened. Government efforts to support distressed homeowners and limiting new FX mortgages aim at increasing the resilience of the financial system, while the EDP continues to serve as a medium-term anchor for public debt sustainability.

V. CONCLUDING REMARKS AND LESSONS

55. **The program was successful in strengthening the economy and stabilizing market conditions, although part of the fiscal achievements were reversed after the program lapsed.** Prompt and large-scale liquidity as well as a credible policy program supported market confidence, avoiding a financial meltdown in Hungary and in the region. Moreover, Fund staff made substantial efforts to build broad political consensus, in the context of a minority government lacking support from the opposition, and avoid any disruption to program implementation. Substantial fiscal consolidation was accomplished during the program setting the basis for long-term sustainability, while important progress was made to enhance bank supervision. Funding pressures receded gradually, parent banks supported their subsidiaries, and the government returned to international markets earlier than expected. However, much of the structural fiscal adjustment achieved during the first 1½ years of the program has since been reversed.

56. **These achievements were obtained despite significant challenges, notably political constraints.** Fund staff made substantial efforts from the start to build political consensus and avoid disrupting program implementation. Nevertheless, political opposition restricted in some cases the scope for structural reforms, such as the reform of the bank resolution regime and needed steps to improve monitoring capabilities at general government level. Ultimately, the program lapsed over disagreement with the newly elected government about economic policies, given concerns by EU and Fund staff about the fiscal and financial risks of the proposed measures as well as the authorities' fiscal commitments for 2011.

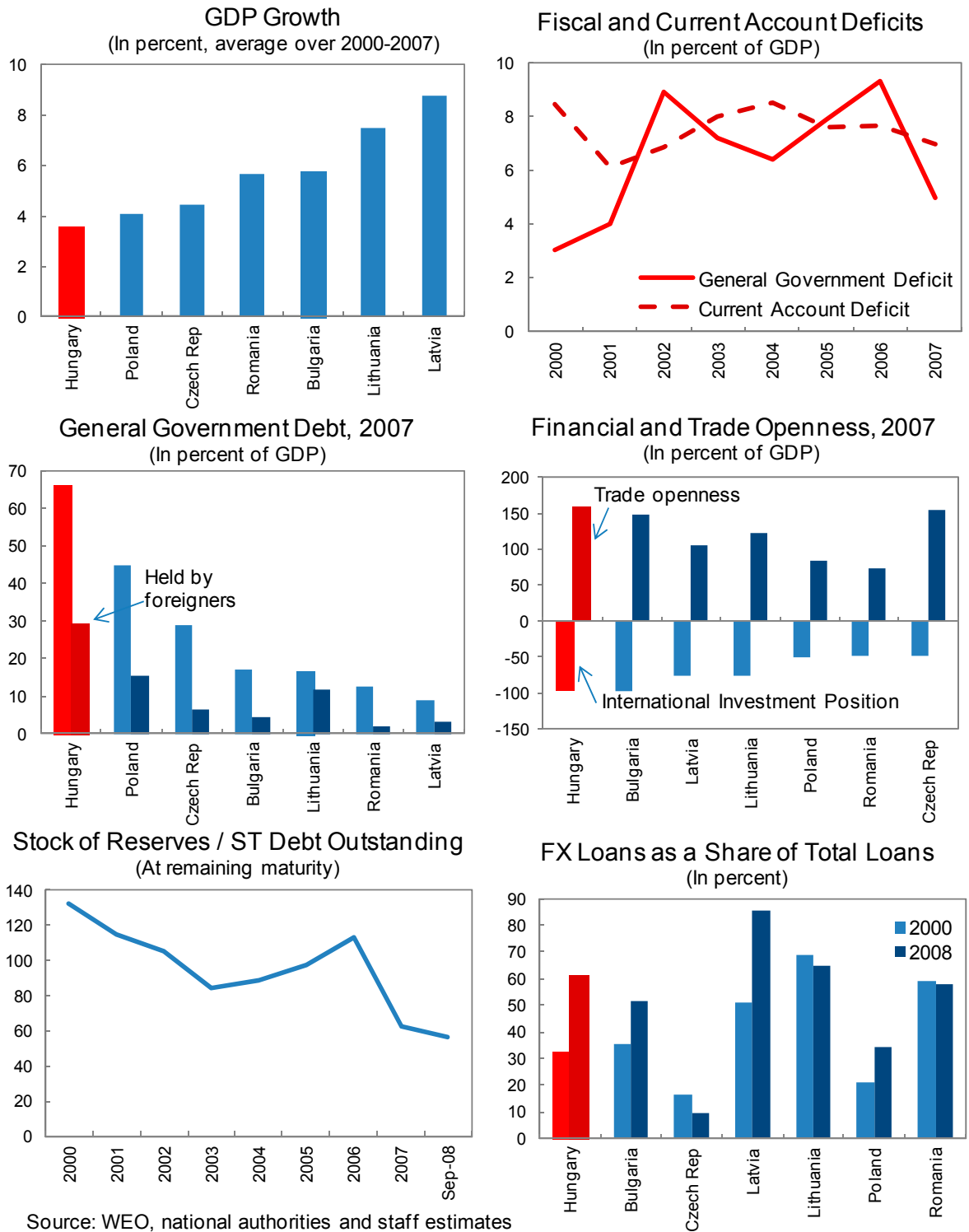
57. **This experience has provided important lessons for future Fund engagement,** given the global circumstances under which it was conceived and the unprecedented joint collaboration with the EU:

- **Macro-financial linkages.** A key lesson drawn from the global crisis refers to the need for greater attention to macro-financial linkages in Fund surveillance going forward. The experience from the Hungary program provides an insightful example in this regard. The generalized underestimation of the broader effects of the global deleveraging process on the real economy had important implications for the growth projections and the pace of fiscal adjustment under the program. Moreover, while the liquidity risks arising from the

increasing use of FX swaps would have been difficult to detect earlier, the excessive FX credit growth and rising FX and maturity mismatches that preceded the crisis in Hungary highlight the importance of effective macro-prudential policies in the context of intensive and intrusive supervision. Specifically, the large exposures by foreign banks in Hungary confirm the importance of a cross-border resolution framework at the EU level with enhanced supervision of cross-border banking exposures. Finally, the success of the EBCI in securing foreign parent bank support to subsidiaries highlights the importance of a better understanding of cross-border and intra-group financial spillovers to secure effective private sector involvement in crisis resolution.

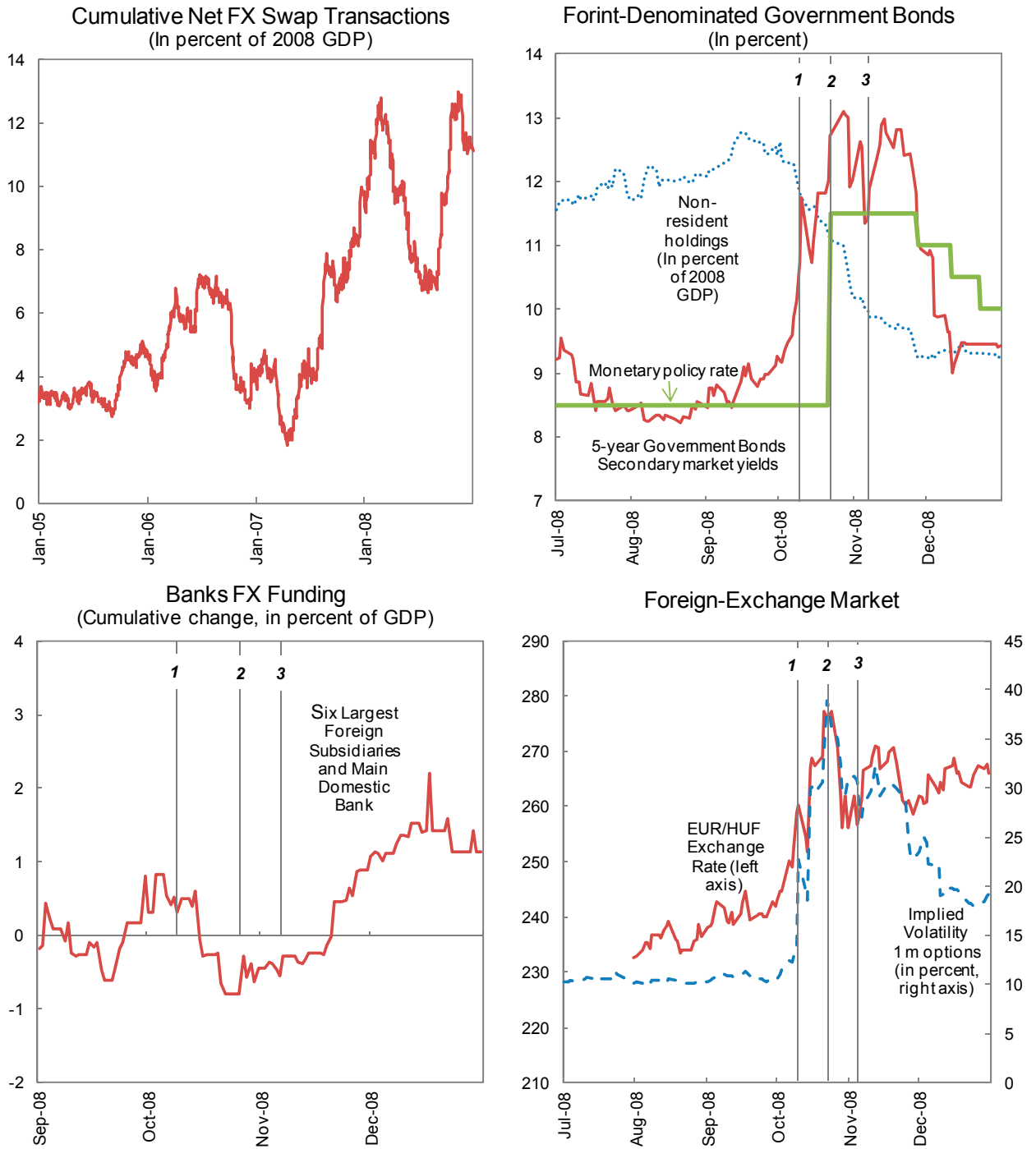
- ***Bank support packages.*** The timeliness and size of the financing package were instrumental in avoiding a systemic banking crisis in Hungary and limiting regional contagion, showing the importance of the Fund's readiness to promptly deploy large financial assistance. At the same time, the Refinancing Guarantee Fund proved ineffective because of the relatively low sovereign credit rating, and the uncollateralized loans eventually extended by the government to banks posed substantial risks to public finances under the program. It could be useful to identify general guidance to staff on the design of bank support packages with use of Fund resources to ensure their effectiveness and the presence of adequate safeguards.
- ***EU-Fund cooperation.*** The program was a successful example of joint collaboration between the EU and the Fund, setting an important precedent for future joint programs (see also Appendix I). The combined financing package allowed for substantial and effective burden sharing. Policy conditionality was set consistently with a strong commitment by the authorities to adhere to targets under the EU convergence program and EDP, ensuring ownership and anchoring short-term consolidation efforts to Hungary's medium-term EU objectives. Although the deficit ceiling under the EDP was not guided by cyclical considerations, the Fund and the EU cooperated effectively in suggesting to the authorities a pragmatic course of action in terms of additional measures as well as eventually adjusting the quantitative targets, consistently with the EU framework, in view of the extreme cyclical circumstances.

Figure 1. Hungary: Initial Macroeconomic Conditions



Source: WEO, national authorities and staff estimates

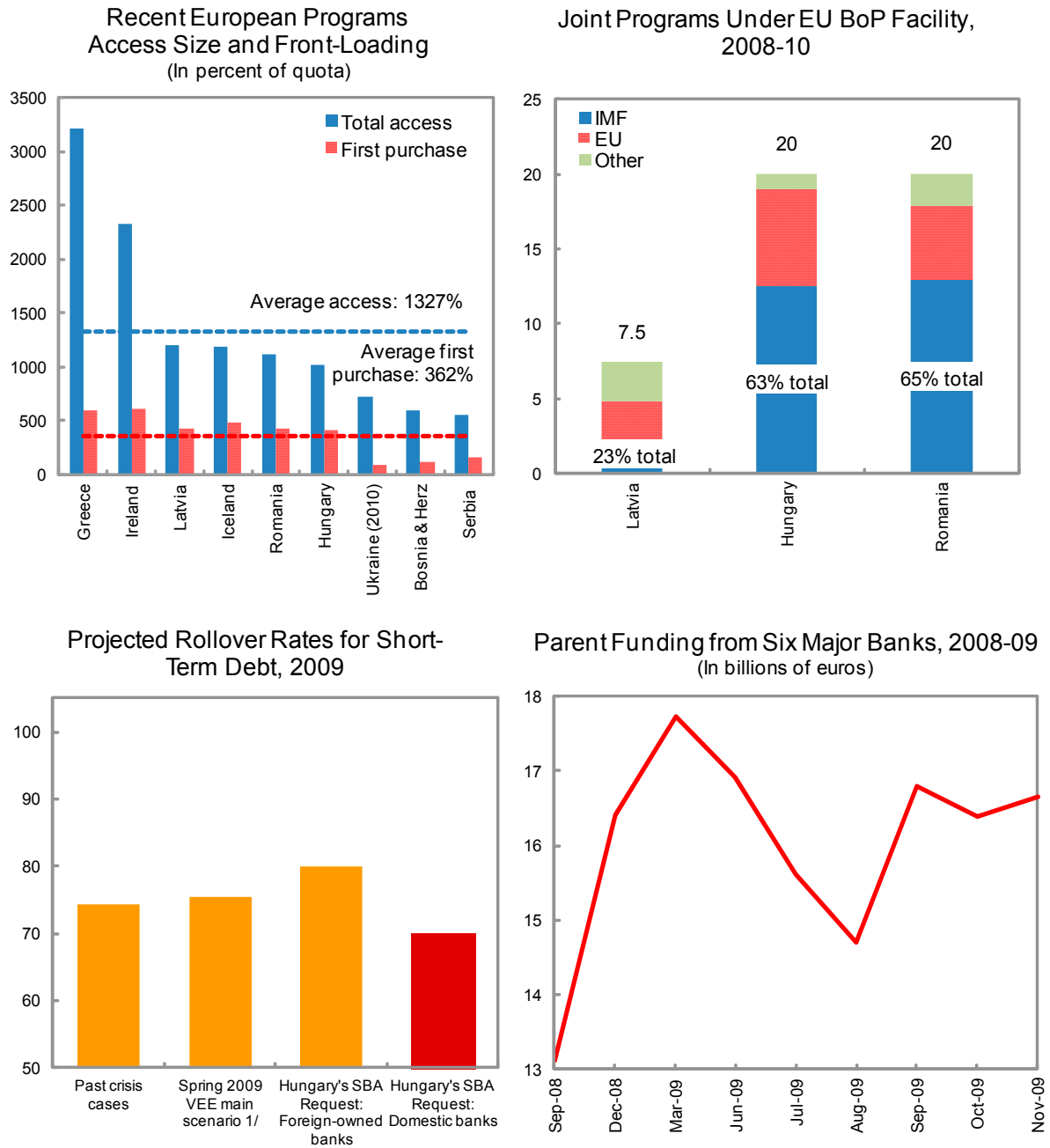
Figure 2. Hungary: Initial Pressures



Source: Bloomberg, national authorities, and Fund staff estimates

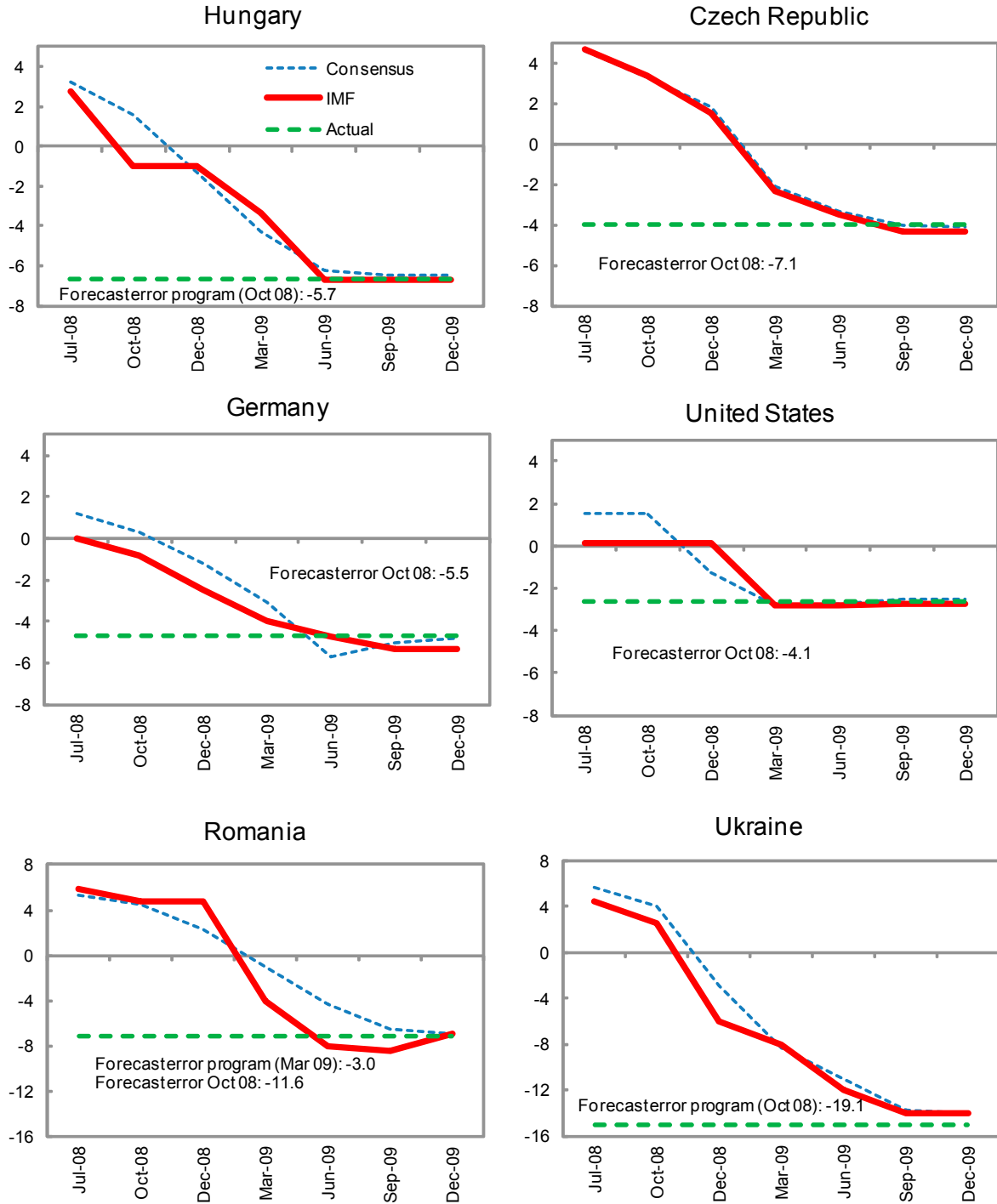
- 1: Hungary approaches the IMF to discuss financial assistance
- 2: Staff level agreement with authorities is announced
- 3: IMF Board of Directors approves Hungary's request for an SBA

Figure 3. Main Features of Selected Recent European Programs



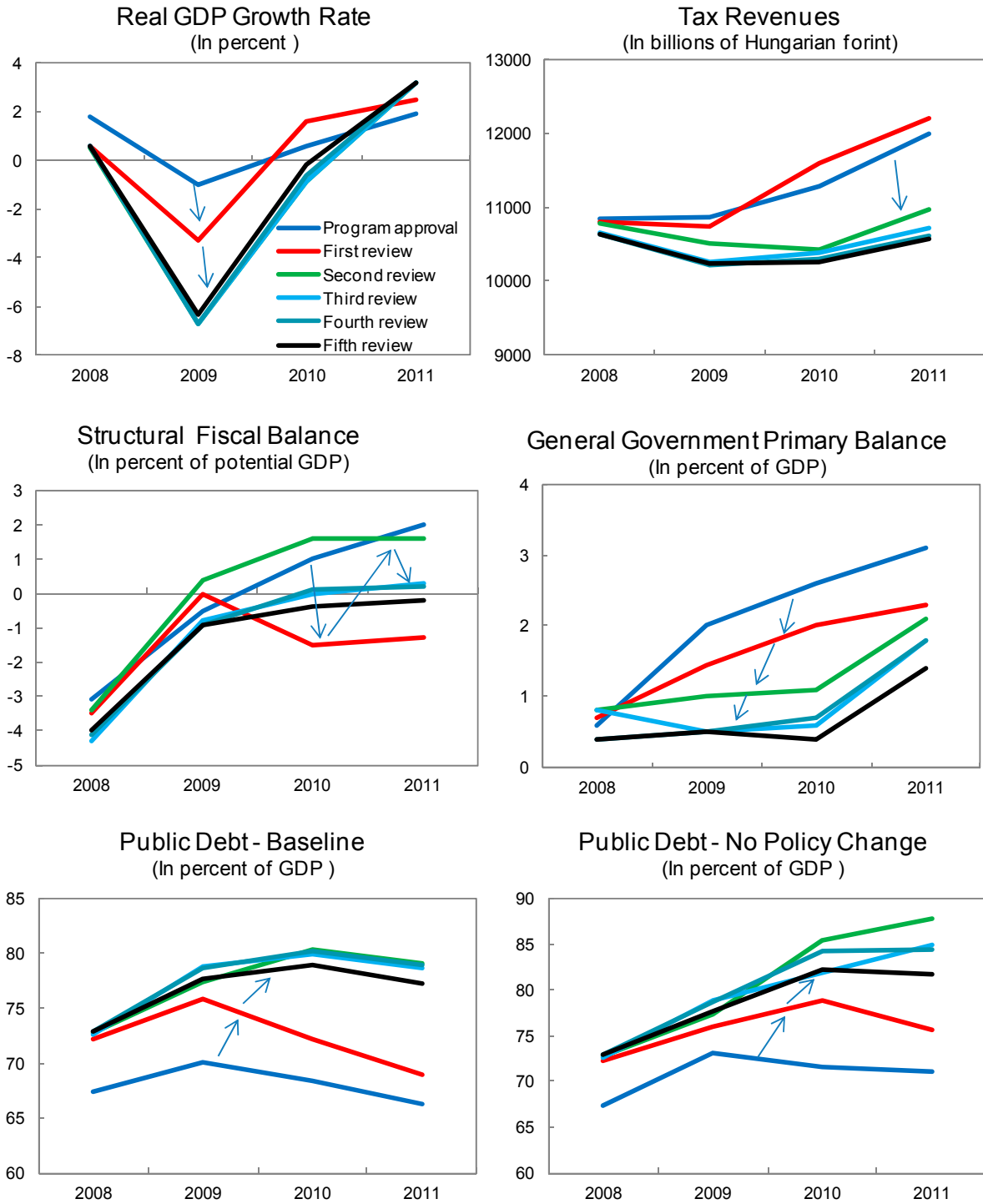
Source: National authorities and Fund staff estimates.
1/ Based on market analysts' tail-risk expectations

Figure 4. Projected and Actual Real GDP Growth in Hungary and Its Main Trading Partners, 2009 (July 2008-Dec. 2009, in percent)



Source: Consensus forecast, IMF WEO and desk projections.

Figure 5. Hungary: Fiscal Performance During the Program



Source: National authorities and Fund staff estimates.

Table 1. Hungary: Main Economic Indicators, 2006–09

	2006	2007	2008		2009	
			Program	Actual	Program	Actual
Real economy (change in percent)						
Real GDP	3.3	0.8	1.8	0.8	-1.0	-6.7
Total domestic demand 1/	0.3	-1.3	2.1	0.8	-2.8	-10.7
Private consumption	2.1	-1.7	0.9	0.6	-3.9	-6.8
Gross fixed investment	-3.2	1.7	1.0	2.9	-0.9	-8.0
Foreign balance 1/	3.0	2.1	-0.3	0.0	1.7	4.0
Exports	18.7	16.2	7.6	5.7	2.1	-9.6
Imports	14.9	13.3	8.1	5.8	0.7	-14.6
CPI (end year)	6.5	7.4	5.1	3.5	4.2	5.6
CPI (average)	3.9	8.0	6.3	6.1	4.5	4.2
General government (percent of GDP), ESA-95 basis 2/						
Overall balance	-9.3	-5.0	-3.4	-3.6	-2.5	-4.5
Primary balance	-5.4	-0.9	0.6	0.5	1.9	0.1
Primary structural balance 3/	-6.1	-0.9	0.6	0.2	3.0	2.8
Debt	65.7	66.1	67.4	72.3	70.1	78.4
Balance of payments						
Goods and services trade balance (percent of GDP)	-1.4	0.9	1.8	0.4	7.5	5.1
Current account (percent of GDP)	-7.6	-6.9	-6.2	-7.3	-2.0	0.4
Reserves (in billions of euros)	16.4	16.4	19.5	24.0	19.8	30.7
Gross external debt (percent of GDP) 4/	96.5	103.2	106.4	116.0	115.8	146.6

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and IMF staff estimates.

1/ Contribution to growth. Calculated using 2000 prices. It includes change in inventories.

2/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments.

3/ As reported in the 2010 Article IV.

4/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.

Table 2. Hungary: Program Financing, 2008–09

(In millions of euros)

	2008		2009		2008-09	
	Dec		Jan-Dec		Total	
	SBA request	Fifth Review	SBA request	Fifth Review	SBA request	Fifth Review
Total financing requirements	-6,267	-1,341	-13,934	-3,709	-20,201	-5,050
Current account deficit	-1,214	-2,268	-1,915	376	-3,128	-1,892
Financial account outflows	-3,362	992	-9,393	-3,549	-12,755	-2,557
Direct investment, net	-163	1,310	577	-591	414	719
Portfolio investment, government net	-159	-4,407	-3,547	-2,494	-3,706	-6,902
Portfolio investment, private net	-1,291	-1,256	-1,113	-326	-2,404	-1,583
of which, financial derivatives	-2,484	-1,157	-3,355	654	-5,838	-502
Other investment	-1,750	5,346	-5,310	-137	-7,060	5,209
Bank Guarantee Fund	-1,034	0	0	0	-1,034	0
Net errors and omissions	-657	-66	-2,626	-536	-3,283	-602
Total financing sources	233	-3,582	6,934	-1,185	7,166	-4,767
Capital account inflows	302	739	1,785	1,238	2,088	1,977
Net capital transfers from the EU	302	660	1,803	1,645	2,105	2,305
Prospective Financing	2,000	2,000	5,500	3,500	7,500	5,500
European Union	2,000	2,000	4,500	3,500	6,500	5,500
World Bank			1,000	0	1,000	0
Change in gross reserves	-2,070	-6,321	-352	-5,923	-2,421	-12,244
Financing need	-6,034	-4,923	-7,000	-4,894	-13,034	-9,817
Bank Guarantee Fund	1,034	0	0	0	1,034	0
Fund credits	5,000	4,923	7,000	3,811	12,000	8,734
SDR allocation	0	0	0	1,083	0	1,083
Reserves (in percent of ST debt at r.m.)	67.2	72.2	79.5	84.9	79.5	84.9

Sources: Hungarian authorities and staff projections.

1/ Financing difficulties are expected to persist through 2009, with no FX issuance. Non-residents share of forint-denominated securities is projected to fall from 38 to 30 percent.

2/ Banks with foreign parent banks are expected to roll over 80 percent of short-term debt, and others 70 percent. As a result, short-term financing for banks will be negative in 2009 (following years of large build-up of debt).

3/ 80 percent of FX swaps are expected to be rolled over, recovering to 90 percent in second half of 2009.

Table 3. Hungary: Quantitative Program Targets Under SBA Approved on November 6, 2008 1/

	End-December, 2008 First Review		End-March, 2009 Second Review		End-June, 2009 Third Review		End-September, 2009 Fourth Review		End-December, 2009 Fifth Review	
	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.
I. Quantitative Performance criteria										
1. Overall floor on the cumulative cash primary balance of the central government system (floor, in billions of forints) 1/	215	226	-280	-248	-155	-123	-160	-148	190	273
2. Cumulative change in net international reserves (floor, in millions of euros) 2/	-6,465	1,397.8	-4,451	1,464	-4,629	-1,195	-3,540	1,574	-2,378	1,028
II. Continuous performance criterion										
3. Non-accumulation of external debt arrears	0	0	0	0	0	0	0	0	0	0
III. Inflation Consultation										
4. 12-month rate of inflation in consumer prices 3/										
Outer band (upper limit)	7.1		5.0		5.0		5.0		5.0	
Inner band (upper limit)	6.1		4.0		4.0		4.0		4.0	
Central point	5.1	3.5	3.0	2.9	3.0	3.7	3.0	1.2	3.0	3.1
Inner band (lower limit)	4.1	4/	2.0		2.0		2.0	4/	2.0	
Outer band (lower limit)	3.1		1.0		1.0		1.0		1.0	
III. Indicative Target										
5. Ceiling on the total debt stock of the central government system (in billions of forints) 5/ 6/	16,320	15,925	15,872	16,281	15,074	15,100	15,070	15,057	15,050	14,992

Sources: Hungarian authorities; and IMF staff estimates and projections.

1/ Cumulative flows from the beginning of the calendar year.

2/ The end-September 2008 NIR figure is a stock. The change in NIR for December 2008 is from September 2008, the cumulative changes for 2009 are from December 2008. Program PCs published after Third Review.

3/ The inner band for consultation is +/-1 percentage points around the central point, and the outer band is +/-2 percentage points around the central point. Headline CPI adjusted to account for the estimated technical effect of increases in VAT and excise taxes.

4/ Breached. Discussion with staff held.

5/ Foreign-currency denominated debt calculated at program exchange rates.

6/ Indicative target ceilings adjusted for EU transfers and other items described in the TMU.

Table 4. Hungary: Structural Conditionality, 2008–10

Structural Conditionality	Type	Date	Report	Status
Submission to parliament of draft support package for domestic banks and request initiation of extraordinary procedure for early passage	PC	Nov 10, 2008	SBA request	Observed
Passage of the draft fiscal responsibility law	SB	end-Dec 2008	SBA request	Observed
Submission to parliament of a law granting the HFSA special remedial powers to accelerate the resolution of any failed bank	SB	end-Dec 2008	SBA request	Observed
Submission to parliament of all legislative changes required to implement the measures on pension reform described in paragraph 15, first bullet point	PC	end-Mar 2009	First Review	Observed
Submission to parliament of amendments to the Financial Stability Act as listed in paragraph 18	PC	end-Mar 2009	First Review	Partially observed, corrective action
Establishment of a sub-committee of the tripartite Financial Stability Committee to monitor the financial soundness and stress-resilience of banks that receive capital or refinancing support from the government, as described in paragraph 18	PC	end-Mar 2009	First Review	Observed
Passage by parliament of the amendments strengthening the remedial powers of the HFSA and bank resolution regime as listed in paragraph 20 of the March 2009 LOI ¹	SB	end-Jun 2009	First Review	Observed
Development of an action plan to strengthen the operational capabilities of the HFSA in the field of on-site bank examinations	SB	end-May 2009	First Review	Observed
Operation of the new-subcommittee described in paragraph 18 as long as there is any government capital or funding support outstanding to banks, and consultation of the sub-committee with Fund staff on its work program	SB	Continuous	First Review	Observed
Passage by parliament of the amendments strengthening the remedial powers of the HFSA and bank resolution regime as listed in paragraph 20 of the March 2009 LOI	SB	end-Dec 2009 Re-set	Second Review	Observed
Completion of reports on thematic inspections focusing on credit risk and the quality of the loan portfolio for at least 3 banks	SB	end-Mar 2010	Third Review	Revised
Submitting legislation to parliament that upgrades the HFSA's legal status to an autonomous organization, grants the MNB the authority to issue temporary regulations on macro-prudential issues of systemic importance, and establishes the FSC	SB	Oct 15, 2009	Third Review	Observed with a minor delay
Prepare a business plan for the state owned railway company (MAV)	PA	Dec 7, 2009	Fourth Review	Observed
Complete remaining technical work on broadening the available bank resolution techniques consistent with paragraph 20 (iii) in the March 2009 LOI	PA	Dec 11, 2009	Fourth Review	Observed
Submission to parliament of amendments strengthening the bank resolution regime as listed in paragraph 20 (iii) of the March 2009 LOI	SB	Feb 12, 2010	Fourth Review	Observed
Completion of reports on thematic inspections focusing on credit risk and the quality of the loan portfolio for two large credit institutions without a foreign parent bank (Revision of Third Review SB)	SB	end-Mar 2010	Fifth Review	Observed with a minor delay
Completion of reports on thematic inspections focusing on credit risk and the quality of the loan portfolio for two large subsidiaries of foreign parent bank	SB	end-Jun 2010	Fifth Review	Observed

1 [T]he amended legislation will (i) strengthen the provisions on the appointment and role of the supervisory commissioner (including by defining certain thresholds where appointment of the supervisory commissioner becomes mandatory); (ii) ensure adequate legal protection for the supervisory commissioner; (iii) refine and complement the powers for the use of specific bank resolution techniques, in particular in bank liquidation proceedings (including purchase-and-assumption transactions and bridge banks); and (iv) affirm that the HFSA has the sole authority for the initiation of bank liquidation proceedings.

APPENDIX I. LESSONS FROM EU-FUND COLLABORATION

The joint EU-Fund supported programs in Hungary and, later on, in Latvia and Romania, have required the development of new operational procedures. Specifically, the EC has developed, in collaboration with the Fund, internal guidelines on practical implementation issues in the context of the EU Balance of Payments (BoP) assistance under the assumption that any future BoP assistance program for EU members will be in coordination with the Fund, given the effectiveness of past experiences in maximizing the impact and credibility of the assistance packages. The key elements and early lessons from the EU-Fund coordination efforts included in the EU guidelines (ECFIN/G/C ARES(2009) 365646 (REV)) can be summarized as follows:

- **Comparative expertise.** The Fund has drawn on its extensive cross-country experience and financial crisis expertise, as well as its ability to mobilize resources quickly in emergency situations. The EU assistance has been embedded in the broader policy framework set by the Treaty, which is a key difference to other regions. This includes detailed fiscal and structural policy surveillance, close co-operation in financial supervision and regulation, and the broader institutional backdrop of the Single Market.
- **Challenges.** The Fund has had to adapt to integrate the EU dimension (e.g., surveillance framework, competition policy rules) in its analysis and operational procedures. The challenges on the EU side have been to ensure sufficient flexibility in the decision-making process to cope with the need for adjustments of policy recommendations in response to rapidly evolving conditions, to ensure adequate consultation of various EU institutions including under time pressure, and to make sure that policies recommended in the context of the joint EU-Fund programs remained consistent with those recommended under other instruments of the EU framework.
- **Technical procedures.** The need to react promptly to adverse BoP developments and a volatile macro-financial environment during a crisis has highlighted the need to develop clear procedural arrangements on disbursements terms and timing, early consultations, reviews, and more recently, post-program monitoring. While these procedures remain independent for the EU and the Fund, coordination efforts have been successful in ensuring consistency between programs.

APPENDIX II. THE EUROPEAN BANK COORDINATION INITIATIVE

The European Bank Coordination Initiative (EBCI) was established in January 2009 in response to the global financial crisis to support liquidity to the banking sectors and lending to the real economy in the Central and Eastern European region. Beyond commitments made by the parent banks, this initiative aimed at managing other challenges such as reducing the large exchange rate risk exposures.

- **Cooperation.** The EBCI has allowed the creation of a public-private sector collective action platform, involving representatives of large cross-border banking groups operating in the region, home and host authorities, the Fund, the European Commission, the European Bank of Reconstruction and Development (EBRD), the European Investment Bank (EIB), and the World Bank Group. The ECB also took part in the process as an observer.
- **Bank commitments.** Under the initiative, banking groups with systemic presence in the region have committed to maintain their exposure and keep their subsidiaries well capitalized. In May 2009, the main parent banks with subsidiaries in Hungary (Bayerische Landesbank, Erste Group, RZB Group, Intesa SanPaolo, KBC Group, and Unicredit Group) declared their commitment to their subsidiaries in Hungary. In November 2009, with a view to reaffirming this commitment, these banks signed a letter of intent on maintaining an appropriate level of financing in Hungary.
- **Financing from International Financial Institutions (IFIs).** Under the Joint IFI Action Plan, concluded at end-2010, the EBRD, EIB and the World Bank Group have made available about €33 billion in crisis-related support for the financial sectors in the Central and Eastern European region (including in the form of capital support, guarantees, and SME lending facilities), exceeding their initial commitment of €24.5 billion.²³ Out of the overall support package, a total of €3.4 billion was made available to financial institutions in Hungary, of which €1.3 billion was disbursed.

²³ Final Report on the Joint IFI Action Plan, European Bank for Reconstruction and Development, European Investment Bank, and World Bank Group, March 2011.

ATTACHMENT I. COMMENTS BY THE HUNGARIAN AUTHORITIES¹

The short term effects of the financial crisis on exchange rate movements and banking indicators were relatively limited and Hungary regained market access rather fast, helped by the program and the unfolding macroeconomic adjustment. The new government, however, would have preferred a different strategy and we offer the following comments on this ex post evaluation report.

We have some reservations about the general applicability of the Fund's SBA as a lending facility, because we believe that it was designed more for countries whose external financing needs arise from severe and prolonged balance of payments (BoP) problems. This facility seems less appropriate for an EU member country facing temporary financing problems, partly related to its foreign dominated banking system, as Hungary did in 2009 (Hungary regained access to market financing in early 2010). We appreciate the Fund's response in updating its lending facilities and improvements to the surveillance framework since the global crisis hit.

Regarding cooperation between the EU and the Fund we acknowledge that there has been important adjustment on both sides during the Hungarian program. Several other European program countries benefited from this adjustment, but we see some room for further improvements in harmonizing the practice in different approaches of the Fund and the European Commission. The EU tends to take a longer-term horizon and less likely to pay due attention to short-term pressures, partly because of its specific procedures and the more forward-looking nature of the excessive deficit procedure (EDP).

The analysis emphasizes too strongly that the economic policies introduced in 2010 by the newly elected government were the main reason for the program lapse in June 2010. In our view, these measures were taken in order to bring the fiscal deficit on a sustainable path. A significant fiscal gap was expected at the time, and doubts about the possible measures required made it difficult to agree on the next steps. The ex post evaluation offers a critical view of the fiscal strategy of the newly-elected government, especially about some of the measures taken by the government at end-2010 in order to meet the 2010 deficit target, while not mentioning the fact that these measures were instrumental in meeting the 2010 deficit target for the central government (and keeping the slippage for the general government within a small margin). While the report acknowledges that the program's growth forecast was too optimistic, it is silent on the possible large slippage of the budget deficit caused by the forecast error. Without decisive action on the part of the new government, the deficit target for 2010 could not have been met. Although the report correctly acknowledges that the new government took measures to meet the deficit target, it also mentions that additional spending occurred in relation to the public transport companies and local governments.

¹Comments received from the Ministry for National Economy (MfNE), the MNB, and the HFSA.

However, the report does not point to the specific nature of this additional spending, which was caused by past unresolved issues, suggesting instead that it was due to discretionary decisions by the new government, while raising objections that this additional spending used some of the proceeds from the transfer of private pension assets to the budget. This additional spending represented only a fraction of the gap between the 2010 actual deficit path and the previous projections.

On the evaluation of the loans extended by the government to banks under the program, we would like to emphasize that in our view these loans were necessary because the risk of individual banking crisis and contagion was significant and action had to be taken. At the time, there was no other way to provide long term liquidity for banks without strategic foreign owners.

Regarding the presentation of the bank-support package, some more clarification is needed. This program consisted of three components: the Capital Base Enhancement Fund, the Refinancing Guarantee Fund, and the extension of government loans. As mentioned in the report, the Refinancing Guarantee Fund was never used. The Capital Base Enhancement Fund was used by one bank and government loans were extended to three banks. Against this background, two elements seem to be missing from the report, namely:

- The use of the bank-support package was limited in practice both in terms of the number of beneficiaries and in time: the government credit was granted to three banks, with one of the recipient banks (OTP Bank) having repaid the government loan well before the program terminated. Another recipient bank (FHB), being the beneficiary of government capital support as well, had purchased back shares before the program terminated. This should be interpreted as an early repayment of its capital support.
- The government loans served the purposes of supplying affordable credit to domestic enterprises. The government required recipient banks to maintain liquidity and lending exposures, and extended this credit under commercial terms. The early repayment by OTP Bank was due to these requirements and strict terms imposed by the government.

We do not believe that the liquidity risks associated with FX swaps could have been identified earlier, as they were caused by a drastic change in general market sentiment that was not anticipated elsewhere either. At the time, no one could imagine that the FX swap market could dry up.

Finally, we would like to emphasize a number of important accomplishments of the program regarding improvements in financial supervision, including:

- on-site inspections have become an integral and mandatory part of all comprehensive examinations of financial institutions by law.

- mandatory and comprehensive inspections have been re-introduced on a regular basis by law for all credit institutions and insurance companies.
- HFSA's independence has been substantially upgraded and was granted regulatory powers.
- HFSA established the OTP College of Supervisors, for the cross-border supervision of OTP Group.
- The Financial Stability Board was set up by the MNB, HFSA and the Ministry for National Economy to strengthen the macro-prudential surveillance of the financial sector.