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COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL DECISION

Granting mutual assistance for Hungary

Proposal for a

COUNCIL DECISION

Providing EU medium-term financial assistance for Hungary

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and

Proposal for a

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EXPLANATORY MEMORANDUM

1. INTRODUCTION

Since mid-2006, the Hungarian authorities are making significant efforts to correct the country's accumulated external and internal imbalances. Despite the tangible results achieved over the last two years, including the significant reduction in the general government deficit and the gradual decrease in the current account deficit, the Hungarian financial markets came under severe stress from early October 2008. This is linked to the comparatively high financial vulnerabilities due to Hungary's large external debt (close to 100% of GDP), recently fuelled by foreign-currency loans to the private sector and the highest public debt ratio in the region (around 66% of GDP). The authorities rapidly announced a comprehensive policy package designed to restore investor confidence and alleviate the stress experienced in financial markets. Measures include an accelerated deficit reduction both in 2008 and 2009, which would decrease the government's financing need, and a number of targeted steps to unfreeze the government debt market and increase liquidity in the foreign exchange swap market. However, as a rapid deterioration in the capital and financial account could be expected in 2008 and especially 2009 induced by the financial markets turbulences, the country will need substantial financial support in this period, possibly in the order of EUR 20 billion until end 2009.

2. MACROECONOMIC DEVELOPMENT AND OUTLOOK

In mid-2006, a fiscal consolidation programme was launched to correct the high fiscal and external imbalances that have built up in previous years (the general government deficit stood at 9.3% in 2006 and the current account at 7.5%). The measures included, inter alia, expenditure freezes, cuts in public investments, tax increases and reduced price subsidies. Consequently, the output of the government sector was reduced considerably, especially in health care, education and administration. In 2007, the private sector showed some resilience in dealing with the downturn supported by access to new credit. Thanks to a strong expansion of exports of some 16%, investment still expanded slightly although corporate profits fell due to a substantial increase in wage-related costs. Consumption also increased moderately by

0.7% despite a drop in real wages as the surge in oil and food prices was accompanied by increases in regulated prices and a value-added tax hike. Overall, annual GDP growth slowed down from 4.1% in 2006 to 1.1% in 2007 while inflation doubled to nearly 8%, well above the official inflation target.

With the effects of the fiscal package gradually phasing out, the economy was set to recover starting in 2008 and reach potential growth (somewhat below 3%) in 2-3 years. However, the stronger-than-anticipated slowdown in the EU and the rest of the world substantially weakened the outlook for export performance, the main driving force for the Hungarian economy in the past years. The current financial difficulties and related tightening of credit conditions have added to the downturn, and further worsened growth prospects. Private consumption and household investment suffer most from tighter credit conditions, while corporate investments would still hold, with some support expected from inflows from EU (structural and cohesion) funds. Thus annual GDP growth is expected to remain well below 2% in 2008 and sharply fall in 2009 before it slowly recovers in 2010. Given the high uncertainties in the context of present financial market conditions, there are even some risks that GDP could contract in 2009 followed by a protracted recovery thereafter.

3. PUBLIC FINANCES

In 2007, the general government deficit came out at 5% of GDP, sharply down from 9.3% of GDP in 2006. This was the result of the fiscal consolidation programme started by the re-elected Government in summer 2006, including a series of tax increases as well as cuts in price subsidies, expenditure freezes (notably for the public wage bill) and a nominal cut in public investment. In mid-July 2008, based on the better-than-expected central government revenues in the first half, the Government revised its deficit forecast to 3.8% of GDP (from its target of 4% of GDP contained in the most recent Convergence Programme update and endorsed by the Council).

As a reaction to the turbulences on the Hungarian financial markets, the Government announced on 10 October a 12-point action plan to foster market confidence. Most notably, the plan included the lowering of the budget deficit targets: to 3.4% of GDP from 3.8% for 2008, and to 2.9% of GDP from 3.2% for 2009, which was subsequently further reduced to 2.6% of GDP. For 2008, the achievement of the more ambitious deficit target of 3.4% of GDP would be backed by the following measures: (i) expenditure savings in some government programmes and lower expected expenditure on co-financing due to slower-than-targeted absorption of EU funds (0.15 of GDP); as well as (ii) a permanent freeze of the unutilised budgetary reserves (0.3% of GDP) if needed. Regarding 2009, the lower deficit target by 0.6% of GDP is foreseen to be achieved through (i) the withdrawal of the planned tax changes which were officially expected to result in a 0.55% of GDP revenue loss in 2009, while the compensatory expenditure measures would remain in place and (ii) additional 0.6% of GDP expenditure cuts (reducing government programmes and operative costs of budgetary institutions as well as postponing the indexation of some social transfers) included in the revised draft budget submitted on 18 October as well as (iii) additional measures of around 1% of GDP namely reducing the 13th month payments of pensions and public salaries, as well as freezing public sector wages.

The revitalisation of the fiscal governance reform process is also part of the Government's 12-point action plan. The revised legislative document was submitted to Parliament on 17 October. It integrates some important elements of the alternative proposals of opposition parties (e.g. multiannual expenditure ceilings for the central government subsector and the establishment of a Fiscal Council next to the Legislative Budget Office). The revised plan

prescribes that the annual budget would be embedded in a 3-year framework, including medium-term numerical rules. The new legislative proposal is foreseen to be passed by simple majority.

4. FINANCIAL MARKETS

While for most of 2008 the conditions on Hungarian financial markets had evolved broadly in line with those of its regional peers (though with some episodes of higher volatility¹), markets came under heavy pressure at the beginning of October, with a freeze on the government primary bond market, a very sharp fall in the stock market and a sharp depreciation of the exchange rate, leading to a significant increase in spreads of government bond yields and of credit default swaps (CDS). This seems to be linked to a liquidity shortage in the financial system, in particular regarding foreign exchange liquidity, which is becoming more costly due to the perception that counterparty risk has increased and heightened risk aversion vis-à-vis the Central and Eastern European Countries.

Following the market turmoil in early October, the authorities announced several measures aimed directly at reducing financial stress. On top of the tightening of budgetary plans, which lowers net financing requirements, these included the following elements: (1) an easing of investment rules for pension funds, (2) the opening of a new foreign exchange swap facility the National Bank of Hungary (MNB) on 13 October, aimed at matching buyers and sellers for foreign exchange swaps to overcome counterparty risk, (3) a new stand-by facility for banks offered from 16 October by which the MNB can provide banks overnight euro-forint swaps. This new facility is backed up by an agreement on repurchase transactions with the ECB, by which the ECB will provide MNB with a facility to borrow up to EUR 5 billion. (4) On 16 October, the MNB also announced measures to shore up the domestic bond market in agreement with primary dealers. (5) On 22 October, the NBH raised its interest rate by 300 basis points in order to stem the falling of the local currency (by that time, the Hungarian forint had lost 14% against the euro since the beginning of October).

In addition, the Hungarian Parliament adopted on 13 October an increase of the deposit insurance threshold from HUF 6 million to HUF 13 million. Around 90% of eligible deposits are estimated to be covered by this new limit. The legislative action was accompanied by a political commitment to guarantee all deposits in case of need. Moreover, the Hungarian authorities have intensified their co-operation with the country's Financial Stability Committee (created in 2004) and scaled up cross-border contacts among supervisors.

5. BALANCE OF PAYMENT AND EXTERNAL FINANCING REQUIREMENTS

Net export growth, boosted by brisk growth worldwide, was the main driving force of GDP growth over the past years, and it also largely contributed to the gradual decline in the current-account-deficit-to-GDP ratio, which fell from 7.5% in 2006 to 6.4% in 2007. The other main factor in 2007 proved to be the substantial reduction in the financing need of the government. In the capital account an increasing surplus was registered that reached 1.1% of GDP in 2007, partly due to the growing absorption of EU funds so that overall net external liabilities stabilised, albeit at a high level (at 97% of GDP). At the same time, debt-type instruments gained a larger share in the external deficit. This reflects inter alia persistently high FDI and portfolio outflows by residents which over time should contribute positively to the income

¹ For example, the government bond market came temporarily under pressure in spring 2008, mainly due to a portfolio shift by domestic pension funds.

balance on the current account. While the share of non debt-creating financing rebounded slightly in the first half of 2008 (to about one-third of the total), the share of short-term debt (with a maturity below 1 year) in overall debt increased to a level of some 23% of GDP, mainly due to rising external liabilities of the financial sector, which now represents 35% of GDP (while the share of the government in external debt is 30%).

The current account is expected to continue declining this and especially next year in view of the recent depreciation of the forint and a sharp reduction in import growth in 2009. The capital account is also likely to improve as the absorption of already committed EU funds increases. On the other hand, based on recent developments, in particular since the beginning of October, it can be expected that net portfolio outflows (including financial derivatives) would accelerate, notably as external borrowing by the government and banks contracts sharply, contributing to a substantial deterioration in the capital and financial account in 2008 and especially 2009. Against this background, in order to support the balance of payments and bring international currency reserves to a prudent level, the IMF and the Commission consider that Hungary will need substantial financial assistance in the short and medium term, in the order of EUR 20 billion until end 2009.

In light of the above, the Commission is of the opinion that there is a serious threat to the Hungarian balance of payments; the Commission thus recommends to the Council a decision granting mutual assistance.

6. EU SUPPORT UNDER THE BALANCE OF PAYMENTS FACILITY PART OF INTERNATIONAL EFFORT

Medium-term financial assistance for Hungary under the balance of payments facility for Member States (in view of Regulation No 332/2002) appears to be appropriate under the current circumstances. It would intervene at a moment when Hungary is seriously threatened with difficulties in its balance of current payments in view of the heightened financial market stress although its policy record has substantially improved since mid 2006. The EU support for Hungary would be part of a bigger financing package for Hungary in which the IMF provides a loan of SDR 10.5 billion (around EUR 12.5 billion) under the Stand-by arrangement expected to be approved on 6 November 2008 and the World Bank a loan of EUR 1 billion. It is crucial that the large financial institutions operating in Hungary continue providing adequate financing of the economy. The EU financial assistance is provided in support of the strong commitment by the Hungarian authorities to implement a comprehensive economic policy programme designed to restore investor confidence and alleviate the stress experienced in recent weeks in the Hungarian financial markets. This programme will be included in the Convergence Programme update. In particular, the acceleration of the fiscal consolidation, which reduces the financing needs, and the planned progress in fiscal governance reform are in line with previous Council recommendations in the context of opinions on the November 2007 convergence programme and on the October 2007 Implementation Report of the National Reform Programme. The EU assistance and the Commission's involvement would also help ensure full consistency of current policies supported by the whole financing package with EU policy recommendations.

Economic policy conditionality would include reform of fiscal governance and support the increased ambition in terms of deficit reduction which would ensure that the planned correction of the excessive deficit (by 2009 at the latest), as recommended in the Council recommendation under the excessive deficit procedure of 10 October 2006, is respected. It would also include structural reform measures supported in the context of the Lisbon strategy, such as the reinforcement of incentives to work with a view to raising employment rates and

contributing to the long-term sustainability of public finances. Monetary policy should remain geared towards price stability and the achievement of the MNB inflation target (currently 3%). Moreover, it would include the speedy and forceful implementation of the decisions to shape up the functioning of the financial sector. Finally, the monitoring of conditionality would also take into account progress with the implementation of performance criteria under the IMF programme. They include (i) quarterly ceilings on cumulative cash primary spending of the central government, social security funds and extra-budgetary funds; (ii) no accumulation of external arrears by the public sector; (iii) floor on the flow of net international reserves; and (iv) a consultation band for the 12-month rate of change of the national CPI. In particular, the enhanced monitoring of within-the-year budgetary developments could be a useful additional tool of keeping the budget on track to achieve the official deficit target.

To ensure the necessary flexibility in the current market context, it is proposed to allow the option of using interest rate swaps for the borrowing operation which finances the loan. The counterparties of a potential swap would have to be of the highest credit quality in order to safeguard the EU budget.

Against this background, following the consultation of the Economic and Financial Committee, the Commission is recommending to the Council the granting of the mutual assistance foreseen by the Article 119 of the Treaty.

The Commission, following the consultation of the Economic and Financial Committee, is furthermore proposing that, after adopting the above-mentioned decision of the Council to provide mutual assistance to Hungary on a recommendation from the Commission, the Council adopts a decision providing under the EU facility for Member States (as governed by Council Regulation (EC) No 332/2002 of 18 February 2002) a medium-term financial assistance to Hungary of up to EUR 6.5 billion to underpin its balance of payments sustainability. This support would be provided in conjunction with an IMF arrangement. It would be disbursed in up to 5 instalments and be linked to economic policy conditions. The proposed decision would expire two years after entry into force.

Recommendation for a

COUNCIL DECISION

Granting mutual assistance for Hungary

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 119,

Having regard to the recommendation from the Commission made after consulting the Economic and Financial Committee,

Whereas:

- (1) Since mid-2006, the Hungarian authorities have been making significant efforts to correct the country's accumulated external and internal imbalances. Despite the tangible results achieved over the last two years, including the significant reduction in the general government deficit and the gradual decrease in the current account deficit, the Hungarian financial markets have come under severe stress from early October 2008,
- (2) The authorities of Hungary adopted in October 2008 a comprehensive economic policy programme designed to restore investor confidence and alleviate the stress experienced in recent weeks in the Hungarian financial markets; it includes measures to secure adequate liquidity and financing for the banking system, actions to ensure adequate capitalization of banks, as well as plans to ensure fiscal sustainability and contain financing needs; in particular, the Government revised its deficit target for 2008 to 3.4% of GDP compared to a budgeted 4% of GDP and for 2009 from 3.2% of GDP to 2.6% of GDP; this economic programme and in particular the fiscal targets will be reflected in the Government budget as well as in the Convergence Programme which also contain other policy measures and structural reforms,
- (3) The Council is reviewing on a regular basis the economic policies implemented by Hungary, in particular in the context of the annual reviews of Hungary's update of the convergence programme and implementation of the National Reform Programme, the regular review of progress made by Hungary related to the Council recommendation the Excessive Deficit Procedure, as well as in the context of the Convergence Report,
- (4) Despite the expected improvement in the current account, Hungary faces important financing needs in 2008 and 2009 (estimated at around EUR 20 billion) as the recently experienced financial market developments suggest that the capital and financial account could substantially deteriorate, with the acceleration of net portfolio outflows,
- (5) The Hungarian authorities have requested substantial financial assistance from the EU and other international financial institutions and countries to support balance of payments sustainability and bring international currency reserves to a prudent level,
- (6) There is a serious threat to the Hungarian balance of payments which justifies the urgent granting of mutual assistance by the Community.

HAS ADOPTED THIS DECISION:

Article 1

The Community shall grant mutual assistance to Hungary.

This Decision is addressed to the Member States.

Done at Brussels,

*For the Council
The President*

Proposal for a
COUNCIL DECISION

Providing Community medium-term financial assistance for Hungary

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 332/2002² of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balance of payments and in particular Article 3(2),

Having regard to the proposal from the Commission made after consulting the Economic and Financial Committee (EFC),

Whereas:

- (1) Council decision [...] has decided to grant mutual assistance to Hungary.
- (2) Despite the expected improvement in the current account, Hungary's external financing needs in 2008 and 2009 are estimated at EUR 20 billion as in view of the recently experienced financial market developments the capital and financial account could substantially deteriorate, with the acceleration of net portfolio outflows,
- (3) It is appropriate to provide Community support to Hungary of up to EUR 6.5 billion under the Facility providing medium-term financial assistance for Member States' balance of payments established in 2002 by Regulation (EC) No 332/2002. That assistance should be provided in conjunction with a loan from the International Monetary Fund of SDR 10.5 billion (around EUR 12.5 billion) under a Stand-by arrangement expected to be approved on 6 November 2008. The World Bank has also agreed to provide a loan to Hungary of EUR 1 billion,
- (4) The assistance should be managed by the Commission who would agree with the authorities of Hungary, after consulting the EFC, the specific economic policy conditions attached to the financial assistance. Those conditions should be laid down in a Memorandum of Understanding. The detailed financial terms should be laid down by the Commission in the Loan Agreement,
- (5) The assistance should be provided with a view to supporting the balance of payments sustainability in Hungary and, in this way, contributing to the successful implementation of the Government's economic policy programme under current economic and financial conditions.

² OJ L53/1 [23 February 2002]

HAS DECIDED AS FOLLOWS:

Article 1

1. The Community shall make available to Hungary a medium-term loan amounting to a maximum of EUR 6.5 billion, with a maximum average maturity of 5 years.
2. The Community financial assistance shall be made available during two years starting from the first day after the entry into force of this Decision. If circumstances so require, the Commission may after consultation of the Economic and Financial Committee, decide to extend that period by a maximum of two years.

Article 2

1. The assistance will be managed by the Commission in a manner consistent with Hungary's undertakings and recommendations by the Council, in particular in the context of the implementation of the National Reform Programme as well as of the convergence programme and the excessive deficit procedure.
2. The Commission shall agree with the authorities of Hungary, after consulting the EFC, the specific economic policy conditions attached to the financial assistance as laid down in Article 3(4). Those conditions shall be laid down in a Memorandum of Understanding consistent with the undertakings and recommendations referred to in paragraph (1). The detailed financial terms shall be laid down by the Commission in the loan agreement.
3. The Commission shall verify at regular intervals in collaboration with the EFC that the economic policy conditions attached to the assistance are fulfilled. The EFC shall be kept informed by the Commission of possible refinancing of the borrowings or restructuring of the financial conditions.

Article 3

1. The Community financial assistance shall be made available by the Commission to Hungary in maximum five instalments the size of which would be laid down in the Memorandum of Understanding.
2. The first instalment shall be released subject to the entry into force of the Loan Agreement and Memorandum of Understanding.
3. If required in order to finance the loan, the prudent use of interest rate swaps with counterparties of highest credit quality shall be permitted.
4. The Commission shall decide on the release of further instalments after having obtained the opinion of the EFC. The disbursement of each further instalment shall be made on the basis of a satisfactory implementation of the new economic programme of the Hungarian Government included the Convergence Programme of Hungary and, more particularly, the specific economic policy conditions laid down in the Memorandum of Understanding. These would include, inter alia, progress with fiscal consolidation planned by the Government in line with the Council recommendation under the excessive deficit procedure of 10 October 2006 as well as the Council Opinion on the November 2007 convergence programme update; specific measures to control expenditure underlying the consolidation process, as well as progress with fiscal governance and financial supervision reform; structural

reform measures supported in the context of the Lisbon strategy, such as the reinforcement of incentives to work with a view to supporting employment and contributing to the long-term sustainability of public finances.

This Decision is addressed to the Republic of Hungary.

Done at Brussels,

*For the Council
The President*

BUDGETARY IMPACT STATEMENT

(cf. Article 16 of the Internal Rules)

POLICY AREA: TITLE 01 – ECONOMIC AND FINANCIAL AFFAIRS

ACTIVITY: FINANCIAL OPERATIONS AND INSTRUMENTS

TITLE OF ACTION: EU MEDIUM-TERM FINANCIAL ASSISTANCE FOR HUNGARY

1. NAME OF THE PROPOSAL: BUDGET HEADING CONCERNED AND TITLE

01 04 01 01 EC guarantee for Community loans raised for balance-of-payments support

2. LEGAL BASIS:

Art. 119 EC and 308 EC; Council Regulation N° 332/2002 of 18 February 2002.

The Regulation limits the amount in principal of loans to be granted to Member States under this Facility to EUR 12 billion. No loans have been granted under the Facility since this Regulation came into force.

3. OVERALL FIGURES FOR THE FINANCIAL YEAR (IN EUROS)

This item constitutes the structure for the guarantee provided by the European Union. It will enable the Commission to service the debt (principal, interest and other costs) should the debtor (Hungary) default.

The budget entry ("p.m.") reflecting the budget guarantee will be activated only in the case of an effective call on the guarantee. It is expected that normally the budget guarantee will not be called. Before Hungary was not yet a Member State, the Council, based on decisions 1990/83/EEC of 25 February 1990 and 91/310/EEC of 24 June 1991 provided macro-financial assistance to Hungary totalling ECU 790 million. All macro-financial assistance had been repaid by 1998.

3a – Current year

Not applicable

		CA
Initial appropriation for the financial year (budget)		
Transfers		
Additional appropriation		
Total appropriation		
Appropriations already set aside by another work programme		

Balance available		
Amount for the action proposed		

3b – Carry overs

Not applicable

		CA
Carry-overs		
Appropriations already set aside by another work programme		
Balance available		
Amount for the action proposed		

3c – Next financial year

Not applicable

		CA
Initial appropriation for the financial year (budget)		p.m.
Transfers		
Additional appropriation		
Total appropriation		
Appropriations already set aside by another work programme		
Balance available		
Amount for the action proposed		p.m.

4. DESCRIPTION OF THE ACTION

The proposed medium-term financial assistance to Hungary consists of a Community loan (to be financed by Community borrowings in the international capital markets) in the amount of EUR 6.5 billion. It will be provided in the context of an international financing package, and in particular by an IMF loan of SDR 10.5 billion (around EUR 12.5 billion) supported by the stand-by facility. The World Bank has also committed a total of EUR 1 billion. The Community medium-term financial

support to Hungary is intended to support the balance of payments sustainability of Hungary which is seriously threatened and thereby also to support the new economic programme of the government aiming, among other things, at restoring investor confidence and alleviating the stress recently experienced in financial markets from early October 2008. The assistance reflects the willingness to support a Member State whose policy record has substantially improved since mid- 2006, including through the significant reduction in the general government deficit. At the same time, this assistance makes a contribution to financial stability that goes beyond the beneficiary country in view of the important international (including interbank) links. The new economic package hereby supported includes an accelerated deficit reduction both in 2008 and 2009, which would decrease the government's financing need, as well as a number of targeted steps to unfreeze the government debt market and increase liquidity in the foreign exchange swap market. Finally, the assistance managed by the Commission in consultation with the Economic and Financial Committee is a way to ensure that the EU remains closely involved in the shaping of economic policies in Hungary and that those policies are consistent with Hungary's undertakings in the EU context and recommendations by the Council, in particular as concerns the implementation of the National Reform Programme as well as of the convergence programme and the excessive deficit procedure.

The Community borrowings raised on the capital markets or from financial institutions for the purpose of extending the loan to Hungary are covered by the Community guarantee. The loan is raised on the capital markets or from financial institutions. The amount in principal of loans which will be granted to Hungary amounts to EUR 6.5 billion.

The structure for the guarantee provided by the European Union will enable the Commission to service the debt should Hungary default.

In order to honour its obligations, the Commission may draw on its cash resources to service the debt provisionally. In this case, Article 12 of Council Regulation (EC, Euratom) No 1150/2000 of 22 May 2000 implementing Decision 2000/597/EC, Euratom on the system of the Communities' own resources (OJ L 130, 31.5.2000, p. 1) will apply.

5. METHOD OF CALCULATION ADOPTED

Not applicable.

6. PAYMENT SCHEDULE (IN EURO)

Not applicable.

Heading	Appropriations		Payments				
			Year n	Year n+1	Year n+2	Year n+3	Subsequent financial years
	Year n						
	Year n+1						
	Year n						

	Year n+1						
	Total						