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Ex-Post Evaluation of Balance of Payments Support Operation to Hungary Decided in November 2008

Laura Thissen

Ferdinand Pot

Dafina Dimitrova

Peter Mihalyi

S¡ndor Richter

See next page for additional authors

Author/Creator
Laura Thissen, Ferdinand Pot, Dafina Dimitrova, Peter Mihalyi, S¡ndor Richter, Wojciech Paczynski, and Janusz Szyrmer

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Final report

Client: European Commission, Directorate for Economic and Financial Affairs

Rotterdam, 6 February 2013

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Laura Thissen (Ecorys)
Ferdinand Pot (Ecorys)
Dafina Dimitrova (Ecorys)
Peter Mihalyi (contracted by Ecorys)
Sándor Richter (WIIW)
Wojciech Paczynski (CASE)
Janusz Szyrmer (CASE)

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ECORYS Nederland BV
Watermanweg 44
3067 GG Rotterdam

P.O. Box 4175
3006 AD Rotterdam
The Netherlands

T +31 (0)10 453 88 00
F +31 (0)10 453 07 68
E netherlands@ecorys.com
Registration no. 24316726

W www.ecorys.nl

Ecorys Macro & Sector Policies
T +31 (0)10 453 87 53
F +31 (0)10 452 36 60

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List of abbreviations

ÁKK	Hungarian Debt Management Agency
BOP	Balance of Payments
BUX	Budapest Stock Exchange index
CDS	Credit Default Swap
CEE	Central and Eastern Europe
CEO	Chief Executive Officer
CEU	Central European University
DG ECFIN	Directorate General Economic and Financial Affairs
DPL	Development Policy Loan
DSGE	Dynamic Stochastic General Equilibrium
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
EDF	Excessive Deficit Procedure
EIB	European Investment Bank
EFC	Economic and Financial Committee
EU	European Union
EWI	Early Warning Indicators
FC	Fiscal Council
FDI	Foreign Direct Investment
FRL	Fiscal Responsibility Law
FSAP	Financial Sector Assessment Program
FSC	Financial Stability Council
FX	Foreign Exchange
GDP	Gross Domestic Product
GF	Guarantee Fund
GYED	Salary related child allowance
HFSA	Hungarian Financial Supervisory Authority
HUF	Hungarian Forint
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IFI	International Financial Institution
LOI	Letter of Intent
IMF	International Monetary Fund
MFA	Macro Financial Assistance
MNB	Magyar Nemzeti Bank (National Bank of Hungary)
MP	Member of Parliament
MOF	Ministry of Finance
MOND	Ministry of National Development
MONE	Ministry for National Economy
MOU	Memorandum of Understanding
MS	Member State
OECD	Organisation for Economic Cooperation and Development
PFM	Public Financial Management
SBA	Stand-By Arrangement
SGP	Stability and Growth Pact

SMOU	Supplementary Memorandum of Understanding
TA	Technical Assistance
USD	United States Dollars
WB	World Bank

Executive summary

This ex-post evaluation of the Balance of Payments (BoP) support operation to Hungary in 2008-2010 analyses the operation's effects on the country's macroeconomic stabilisation, external sustainability and structural developments. The evaluation also provides recommendations for the design of future financial assistance operations provided by the European Union (EU).

In November 2008, the Council of the EU decided to make available to Hungary a medium-term assistance of up to €6.5 billion under the Balance of Payments facility for Member States, in conjunction with a €12.5 billion loan from the IMF supported by a Stand-By Arrangement (SBA) and a €1 billion loan from the World Bank. The assistance package was aimed to restore investor confidence and alleviate the stress experienced in the financial markets at that time. It was designed in four separate disbursements, each tied to achievement of policy conditionality on fiscal consolidation, fiscal governance, financial sector regulation and supervision, and other structural reforms. Hungary drew a €14.2 billion loan, composed of €8.7 billion from the IMF and €5.5 billion from the EU.

The BoP operation to Hungary had several novel aspects: it was the first time that the reworked Council regulation was applied - EU BoP assistance had been last used for EU member states in the first half of the 1990s; the joint leadership with the IMF in the programme context was a new approach; and the amount of the operation was large compared to most prior operations.

The operation was clearly effective: investor confidence was restored and Hungary was able to tap into international financial markets again in July 2009. Thanks to the operation, significant progress was made in fiscal consolidation embedded in a strengthened fiscal governance framework, and reforms in financial sector regulation and supervision.

Key to the success of the operation was the ability to respond quickly to address the emergency situation that arose in Hungary in October 2008. Without the joint EU/IMF operation, the evaluation concludes that the Hungarian government would have eventually defaulted on its debt obligations (*most likely macroeconomic counterfactual scenario*). Given the underlying problems with the FX positions of Hungarian banks, and given empirical evidence of linkages between debt and banking crises, the absence of BoP support would, in addition to a currency and debt crisis, probably also have resulted in a banking crisis.

We assess 12-20% cumulative output losses (relative to the pre-crisis path) had our counterfactual scenario materialised in 2008/2009. Our estimates draw on existing literature on financial and banking crises and are also supported by experts' views revealed by interviews and structured questionnaires. These estimates need to be compared with output losses in the actual scenario that already involved a currency crisis (output losses in the actual scenario are calculated to be around 8%, cumulatively). Comparing the actual developments with the counterfactual scenario results allows estimation of the net impact of the BoP assistance operation to Hungary. The difference between the two output loss measures (i.e. net impact) is a range from 4% to 12%. We therefore conclude that the BoP operation likely added between 4 and 12% to the Hungarian GDP growth path (cumulatively).

Regarding the impact of the BoP support operation on Hungary's external sustainability, we conclude that (given the assumption about the counterfactual) the operation clearly saved Hungary from a default on its public debt obligations. Based on an assessment of the balance of payments outlook and debt projections, the team currently classifies the risk attached to Hungary's external debt distress as moderate. This is due to a combination of external and domestic factors which are not related to the BoP operation, but which can exert negative impact on Hungary. These factors include European financial turbulence due to public debt sustainability in several euro area countries, weak growth prospects in Hungary and/or weakening confidence in Hungarian economic policies.

The operation significantly impacted the implementation of reforms. The conditionality attached to the loan agreement had a distinct value-added in the implementation of financial sector supervision reforms. The operation raised financial sector supervision in the policy agenda and preventive measures were introduced for the banking sector that would not have been introduced without the BoP operation. The Hungarian bank resolution regime was and is however not implemented, and the initial Refinancing Guarantee fund[1] was not effective and remained unused. The operation speeded up the implementation of fiscal governance reform, but a policy shift was introduced by the Orbán government, lowering the net impact in the medium term. The operation provided external pressure that speeded up the implementation of other structural reforms such as the pension reform that had long been on the government agenda. The caretaker Bajnai government had political momentum to implement some of those structural reforms. However, in certain areas, a policy shift was introduced by the Orbán government (e.g. repealing the shortening of the eligibility for child allowances), lowering the net impact of the operation in the achievement of selected reforms. Reforms to implement sustainable, long term savings in the public transport sector were not achieved.

Two case studies were selected that focus in detail on key conditions included in the SMOU that are directly related to the objectives of the BoP support operation - the Fiscal Council and the banking resolution regime. The foundation and launching of the Fiscal Council on a relatively short notice is clearly the result of the BoP conditionality. Following the revision of its structure and mandate by the Orbán government after the expiry of the EU-IMF programme, the Fiscal Council now has a very strong licence as it can potentially prevent the adoption of the budget. This leverage coupled with political affiliation of its members bears the risk of serious political conflicts in the future. This risk could be mitigated by enhancing the mandatory analytical tasks to be carried out by the FC and ensuring that it is supported with the necessary resources to undertake these tasks. The bank resolution regime demanded reshaping legislation on early remedial actions and resolution in case of bank failure. Steps were taken in the area of legislation on the banks resolution regime as a result of the BoP operation. However, although the draft law was submitted to Parliament, it was not adopted, which may be linked to the complexity of the legislation and the fact that the Bajnai government was a technical government in place only for a limited time (before the May 2010 elections). Political willingness after the elections to implement this reform was low.

Due to its emergency nature, the operation was designed within four weeks. Conditionality were initially scarce in this operation; on top of the original conditions, further ones for later tranches were added during the implementation phase.This did not negatively affect the effectiveness of the operation; IMF conditionality for later tranches was elaborated only in the course of the programme and this helped to ensure consistency between the conditionality of both institutions. As one of the main objectives of the operation was to restore confidence in financial markets, the calculation of the overall amount of financial assistance (up to €20 bn) was crucial. During the discussions on the amount, at first only the budgetary financing need was taken into account. The amount was

[1] The Refinancing Guarantee Fund's rating was directly linked to the low sovereign credit rating of Hungary. The Fund was also highly leveraged and access to it was reduced by a set of stringent conditions.

increased to include a preventive bank safety net, from which three loans were provided to banks for a total amount of EUR 2.5 billion.

The fact that the Hungarian authorities drew only 74% of the funds that were available to them does not justify the conclusion that may be drawn in hindsight that the amount was too high. Agreement on an operation with a smaller size may not have calmed down financial markets and would in that case have resulted in a more costly scenario. Therefore, the contrary conclusion holds: the fact that not all the funds were drawn implies that the amount was adequate.

The joint character of the operation was mutually beneficial for the EU and the IMF. The IMF was better used to address the emergency nature of such an operation, including the necessity to design the operation within weeks. The EC had to adjust its practice to the emergency nature of the operation and managed to do so in an adequate manner. The operation was designed within four weeks including Council approval.

EC and IMF cooperation was also beneficial for the timing of disbursements and repayments: the IMF was able to frontload part of the loan, whereas the EC had a longer repayment window than the IMF does.

The EC had value added from a financial perspective – the IMF could not have provided the total amount of the operation. The EU also had a comparative advantage on the fiscal side as it had expertise on the details of fiscal consolidation measures. Attention was paid to make sure that the conditionality was in line with the EDP that Hungary was subject to. Although the EDP framework provided boundaries for targets, a similar fiscal path would have been followed without the EDP fiscal target boundaries. In view of the worse than earlier expected macro-environment, the 2009 deficit target (i.e. the deadline for bringing the excessive deficit to an end) was raised above 3% of GDP, and the Council agreed to extend the deadline of the EDP by an exceptional two years. Regular fiscal surveillance allowed the EC and the Hungarian authorities to maintain a dialogue on fiscal consolidation. The EC also added value in the addition of the structural reform package. In line with IMF practice, the EC introduced post-programme surveillance for the BoP assistance, which became an integral part of the MOU in later operations.

The IMF's involvement had value added for several reasons: from a financing need perspective – to calculate the amount that was required to alleviate stress in the financial markets; from a financial perspective – to increase the total amount that could be provided to Hungary; and from a financial market perspective – to define the conditionality in banking supervision and regulation.

Alignment of EC- and IMF-procedures was learning by doing given the emergency nature of the operation. Throughout the operation's implementation, it was also attempted to align press releases, review and disbursement cycles. Although the conditionality were set out in two distinct documents with different phrasing (the MOU and the LOI), this did not complicate implementation or achievement of conditionality. Given the sensitivity of financial markets to public information, timing of the press releases was important.

As for intra-DG cooperation, DG Competition became involved when part of the funds were used for extending government loans directly to banks, which called for prior examination by DG Competition due to state aid rules. The largest loan – €1.4 billion to OTP – was fully repaid in 2010. Although the mission team was informally aware and in contact with DG COMP on this matter, the Commission, and notably DG Competition, was officially notified by the Hungarian authorities only post-factum, i.e., after the loans were paid out. Good communication is essential in high-profile operations such as the one in Hungary***.***

As for the effectiveness of the conditionality attached to the operation, it is noted that the operation was agreed upon with a minority government. In the design phase, discussions were held with opposition parties in an attempt to gain support. The policy shift that occurred during and after the implementation of the operation could not be prevented by a different design of the operation. Following the formation of the new Orbán government in June 2010, the last review in July could not be concluded as a number of policy issues, notably regarding fiscal strategy, remained open. The BoP assistance programme expired in November 2010 without a follow-up programme (the IMF SBA similarly expired in October 2010). Starting from Spring 2011, a post-programme surveillance framework was established to monitor the situation (in principle every 6 months) to ensure continued sound policies and the repayment of the EU funds (at least until 70 percent of funds have been reimbursed).

The team recommends the following:

1. This operation was novel for DG ECFIN and quite different from MFA operations in non-EU countries. At the time of the start of the operation, DG ECFIN had to acquire rapidly the full expertise to manage such an operation by itself. Recent years have revealed that the EC had to engage in similar operations for non-euro area countries (Latvia, Romania), and in the course of managing these three operations ECFIN has taken steps to increase its ability to respond adequately. Financial sector expertise was enhanced by ECFIN and additional staff hired to be able to engage in in-depth discussions with the Hungarian authorities alongside IMF experts. ECFIN should indeed cover all policy areas included in the programme, when engaging in such operations, as the EU has rules and responsibilities on a wide range of policy areas (including economic surveillance) and is accountable to its own citizens.

2. The objectives of the operation were both short term (restore confidence and alleviate stress in financial markets) and long term (to make progress with fiscal governance, financial sector regulation and supervision reforms to support the sustainability of the BoP). These objectives are closely aligned as the reforms support fiscal consolidation in the long term, and thereby ensure that financial markets remain calm. It should however be noted that some reforms were not (fully) implemented due to a lack of political will, for instance the bank resolution regime or the reforms in the transport sector. As for the bank resolution regime, significant progress was made, but given its complexity it may have been too ambitious to expect it to be completed during the life time of the programme. Legislative changes often require a substantial time path and may be dependent on factors that cannot be foreseen or influenced by the sitting government, such as the outcome of legislations. In designing the conditionality attached to the operation, the timeline for completion should be clear, identifying what is expected to be completed within the programme horizon and what should be started during the programme horizon but may only be completed later. Ownership of the programme by the government has to be maintained to uphold the credibility of conditionality.

3. Given the particular design of the Refinancing Guarantee Fund by the IMF and the Hungarian authorities, it did not function effectively, and in view of the urgency of the liquidity assistance to Hungarian banks the authorities unilaterally decided to provide on-lending directly to a number of Hungarian banks. This was not in line with EC state-aid rules and DG Competition was only consulted ex post. Communication on the one hand between and within the international institutions and on the other hand between the authorities and the international institutions is vital and should receive priority when designing and implementing joint operations, in particular in EU member states to ensure compliance to all EU regulation.

4. The repayment of loans of this magnitude, despite the fact that assistance is being provided on terms significantly more advantageous than those that the country could obtain from the markets,

creates a heavy burden on a country's budget in the medium term. When the EC provides loans of this magnitude, an explicit analysis should be made on its effect on the debt sustainability of the country. That being said, in the case of the Hungary BoP operation, implicitly debt sustainability considerations were taken into account when designing the maturities of the loan tranches: the EC loan is to be repaid in the coming years until 2016 whereas the IMF loan has a shorter maturity (the loan is due to be fully repaid in 2014).

5. The Commission should design and implement an appropriate communication strategy to explain clearly the program targets and the program benefits towards the broad public in the country concerned. The EU and the IMF should argue in a consistent manner for the adequate country-specific economic policies to clarify the situation in the eyes of the population of the country concerned. In the case of Hungary, the IMF's local Resident Representative was able to "sell" the IMF policy messages, while the EU did not have a representative authorised specifically to perform this function.

1 Evaluation Objective and Approach

1.1 Objectives

Under its Financial regulation (art. 27.4), the EC is legally obliged to evaluate its main programmes. This is ex-post evaluation focuses on the EC Balance of Payment Support (BoP) provided to Hungary in the period November 2008 to early 2010.

The main objective of this ex-post evaluation of BoP assistance is to learn key lessons, which can be applied to future interventions and/or the possible need for a reorientation of the present approach.

1.2 Overall evaluation approach

Core areas of effects

The evaluation has focused on three core areas of economic effects. Each area focuses on the effects over specific time horizons:

- Macroeconomic effects in the short-term (up to 2 years after the initial disbursement);
- Effects on the sustainability of the external financial situation in the medium to long term (3 years or more after the initial disbursement);
- Structural effects in the short and medium term effects (up to 4 years after the initial disbursement).

Three-step methodological approach

For the attribution of effects to the BoP assistance operation, we followed a three-step methodology in accordance with the Guidelines for ex post evaluation of MFA/BoP assistance.

- The **first step** was to identify the gross macroeconomic and structural effects on the economy. This gross effects refer to the actual developments in the macroeconomic and structural domains and are not necessarily related to the BoP operation.

- The **second step** was to establish a counterfactual situation. The table below provides the questions for establishing the counterfactual situation for the evaluation of the BoP assistance.

- The **third step** determined the net effects of the operation, which, for both macroeconomic issues and structural issues amounts to the difference between observed developments and the counterfactual situation. Unexpected and indirect effects, as well as consequences of programme design were also analysed.

Table 1a: Establishing the counterfactual situation

Q0.	**How would the economy of Hungary have evolved in the absence of the assistance?**
Q0.1	What are the macroeconomic and structural effects if the total assistance package (EU + IMF) had not been granted?
Q0.2	What are the macroeconomic and structural effects if only EU assistance (BOP) had not been granted?

In this approach, the magnitude of the net effect is related to the gross effect. It is noted that the gross effect has been affected by many other factors other than the BoP operation. Adverse developments after closure of the BoP operation that negatively affect the macroeconomic situation and progress in structural reforms have an impact on the gross effect. For example, in Hungary, it can be assumed that the major policy changes introduced by the new government and the new wave of the crisis hitting the euro area have had such adverse effects after 2010. Such exogenous factors have been carefully taken into account in the analysis of the gross effect of the BoP operation. However, such exogenous factors should, in principle, not affect the net effect. As they are exogenous developments to the evaluation, they have affected the counterfactual situation after 2010 in a similar way as the gross effect.

Evaluation questions

The three step evaluation approach is worked out into eight evaluation questions.[2] Table 1b below lists these questions and indicates in which section we have addressed the specific evaluation question.

Table 1b: Main evaluation questions

Nr.	Evaluation Question	Section
Q0	How would the economy of Hungary have evolved in the absence of the BoP assistance?	Sections 3.4, 3.5 and 5.4, 5.5
Q1	To what extent has the BoP assistance operation been effective in terms of the macroeconomic stabilisation of the recipient country?	Chapter 3
Q2	To what extent has the BoP assistance operation been effective in terms of supporting structural reform in the recipient country?	Chapter 5
Q3	What have been the indirect and/or unexpected effects of the BoP assistance operation?	Sections 3.7 and 5.7
Q4	To what extent has the BoP assistance operation contributed to returning the external financial situation of the recipient country to a sustainable path over the medium to longer-term?	Chapter 4
Q5	How has the way in which the BoP assistance operation was designed and implemented conditioned its effectiveness and efficiency?	Chapter 6
Q6	To what extent has EU added value been maximised?	Chapter 7
Q7	How does the BoP assistance interact with other Commission activities, such as Excessive Deficit Procedures (EDP) and regular economic forecasting?	Chapter 7
Q8	How was the interplay between the EU BoP assistance and the IMF assistance operations?	Chapter 7

Evaluation instruments

Four instruments are used to collect the data on which the evaluative analysis is built:

- Document analysis (see Annex 1);
- Interviews (see Annex 2);
- Historical analysis of crisis situations in comparable countries (see Chapter 3 and Annex 3);
- Delphi technique (Annex 4).

Figure 1 shows how these instruments are used in relation to the three step methodological approach described above.

2 Q1, Q7 and Q8 have been taken from the Terms of References for this specific Request for Services. The other evaluation questions are suggested by the *Guidelines for the Ex Post Evaluation of MFA and BoP assistance Operations*.

Figure 1: Evaluation approach

Methodological step	Use of evaluation instruments	Findings
Gross effect	Document analysis	Actual developments in: GDP, fiscal, debt
Counterfactual	- Interviews - Historical analysis - Delphi technique Assumptions on the counterfactual scenario	Estimated developments in GDP, fiscal and debt in the absence of BoP support
Net effect		Gross effect -/- counterfactual

1.3 Structure of the Report

The final report has the following structure: Chapter 2 presents the basic information about the BoP operation based on a chronological presentation of the BoP operation. Chapters 3 to 7 present the four main evaluations areas, together with discussion of area specific methodological approaches. Chapter 3 presents the effect of the operation on macroeconomic stabilisation; chapter 4 discusses the effect of the operation on external sustainability; chapters 5 and 6 present the effects on the implementation of structural reforms; and chapter 7 discusses the design and implementation of the operation.

The annexes provide the following further details on the data collection methods:
- the list of interviewees;
- an analysis of contagion effects;
- the results of the ‘second-round’ Delphi questionnaire.

2 The BoP operation in Hungary

2.1 Background and overview of the BoP operation

On 4 November 2008, the Council of the EU decided to make available to Hungary a medium-term assistance of up to €6.5 billion under the Balance of Payments facility for Member States, in conjunction with a €12.5 billion loan from the IMF supported by a Stand-By Arrangement (SBA) and a €1 billion loan from the World Bank. The assistance package was provided in order to support the comprehensive economic policy programme that the Hungarian Government had adopted in order to restore investor confidence and alleviate the stress experienced in the financial markets at that time. The EU assistance was aimed to help the country to build a prudent, stability-oriented and sustainable economic policy by supporting the sustainability of Hungary's balance of payments.[3]

The EU assistance was divided into four separate instalments, each of which was linked to specific conditions related to Hungary's economic policy. The conditions included improvements in fiscal consolidation, fiscal governance, financial sector regulation and supervision reforms and other structural reforms. Table 2 below presents the implementation of the BoP operation to Hungary in terms of the disbursements and conditions:

Table 2: EU BoP assistance to Hungary 2008-2010

Package	Date of Approval	Date of disbursement	Loan amount	Conditions
1st Instalment	November 2008	December 2008	€ 2 billion	• Implementation of the new economic policy programme (National Reform Programme) of the Hungarian Government, adopted last week of October 2008. Connected to this, submission to Parliament of legislative amendments for the 2009 budget (also backed by the IMF arrangement and included in the Convergence Programme of Hungary)
2nd Instalment	March 2009	March 2009	€ 2 billion	• Fiscal consolidation (progress with achievement of the 2008 deficit target of 3.4% of GDP, adoption of 2009 budget targeting deficit of 2.6% of GDP) • Fiscal governance reform • Financial regulation and supervision • Other structural reforms
3rd Instalment	June 2009	July 2009	€ 1.5 billion	• Fiscal consolidation (outcome of the 2008 budget deficit, progress with meeting 2009 deficit target of 2.6% of GDP) • Fiscal governance reform • Financial sector regulation and supervision

3 Memorandum of Understanding between the European Community and the Republic of Hungary: http://ec.europa.eu/economy_finance/publications/publication13495_en.pdf

Package	Date of Approval	Date of disbursement	Loan amount	Conditions
4th Instalment (original package)	Not drawn		€ 1 billion	• Fiscal consolidation (progress with meeting 2009 deficit target of 2.6% of DGP, submission of the 2010 draft budget proposal), full implementation of additional expenditure reducing package of 0.6% of GDP) • Fiscal governance reform • Financial sector regulation and supervision • Structural reforms
4th Instalment (revised, 1st sub-tranche)	Not drawn		€ 300 million	• Fiscal consolidation (2009 budget deficit in line with deficit target of 3.9%, progress made towards achievement of 2010 deficit target of 3.8%) • Fiscal governance reform- improve general government public finance administration • Financial sector regulation and supervision • Structural reforms
4th Instalment (revised, 2nf sub-tranche	Not drawn		€ 300 million	• Fiscal consolidation (2009 budget deficit in line with deficit target of 3.9%, progress made towards achievement of 2010 deficit target of 3.8%) • Fiscal governance reform- review of achievements after 6 months • Financial sector regulation and supervision • Structural reforms
4th Instalment (revised, 3rd sub-tranche	Not drawn		€ 400 million	• Fiscal consolidation (Progress made towards achievement of 2010 deficit target of 3.8%, draft 2011 budget submitted to parliament with a deficit target below 3%) • Fiscal governance reform • Financial sector regulation and supervision • Structural reforms

Source: MoU between the EC and Hungary; subsequent amendments.

2.2 Timeline and Milestones

Overall, Hungary received €14.2 billion of balance of payment assistance composed of €8.7 billion from the IMF and €5.5 billion from the European Union. No financial assistance was drawn from the World Bank (IMF, 2011).[4] The following events describe the milestones of the BoP operation in chronological order:

[4] IMF, (2011), Hungary: Staff Report for the 2010 Article IV Consultation and Proposal for Post-Program Monitor, IMF Country Report No. 11/35, International Monetary Fund

15 September 2008: Lehman Brothers collapses

Lehman Brothers collapses and repercussions of the financial crisis on the Hungarian banking sector become evident. The country is facing a liquidity crisis as access to international finance markets is severely restricted.

08-09 October 2008: Hungary contacts EU and IMF

A sudden stop occurs at Hungarian government bond market. After a discussion between the Hungarian Central Bank and representatives of the banking sector, a decision is made to contact IMF and EU to discuss options on how to solve the situation on the bond market. The same evening, additional measures for budget cuts are decided upon in order to boost market confidence, but they prove to be insufficient.

13-14 October 2008: EC extraordinary mission to Hungary

Provided background information to assess whether or not BoP support should be granted, in parallel with on-going discussions on the IMF loan and conditionalities. Arguments were provided both against and in favour of the EC support, but the recommendation was given to take a prompt decision on the matter, also in light of the risk of contagion to the region.

22 October 2008: Note to EFC prepared

Discusses possible Community support to BoP facility. Labels it as “appropriate”.

30 October 2008: Commission decision and recommendation for a Council Decision granting mutual assistance for Hungary

Proposal for a Council decision providing EU medium-term financial assistance to Hungary through a) activating the Facility to provide assistance to Hungary and b) granting a loan of up to €6.5 billion. Motivates decision: ensuring fiscal deficit levels as recommended under the excessive deficit procedure launched at 10 October 2006, as well as restoring investor confidence and providing support to structural reform measures consistent with the Lisbon Strategy.

4 November 2008: Council Decision 14953/2/08

Council decision to provide medium-term finance assistance to Hungary.

10 November 2008: Consultation of draft MoU with ECFIN members

Draft MoU with Hungary on the terms of the BoP support consulted successfully. After the initial draft, the main changes proposed and adopted are the more explicit listing of measures and conditionalities and the removal of monetary policy (monitoring of reserves) issues from the MoU. Latter to be kept confidential due to ECB´s concerns of negative reactions on the financial markets. Version approved by EFC on 10 November 2008.

19 November 2008: Loan agreement and MoU between the EC and Hungary signed

Agreement for a loan granted to Hungary of a maximum of €6.5 billion, with a maximum average maturity of five years to be disbursed in maximum four instalments. MoU is signed in its version of 10 November 2008.

01st December 2008: Gentlemen’s agreement

The foreign banks with subsidiaries in Hungary sign a Gentlemen’s agreement with the Central bank not to decrease exposure to their Hungarian subsidiaries.

9 December 2008: Disbursement of first instalment

Upon finalization of legal procedures on the Hungarian side, €2 billion.

9-11 December 2008: ECFIN review mission

In the context of the IMF interim review. Joined IMF review team and gathered information for an upcoming extraordinary forecasting round.

23 January 2009: First meeting of the Vienna Initiative

Following reaction from six major parent banks[5] to Commissioner Barroso and to G20 on financial stability concerns in emerging Europe, a first meeting of the so-called Vienna initiative takes place at the Austrian Ministry of Finance. EBRD, EIB, IMF, World Bank, IFC central banks and ministries of finance from many Central and Eastern European countries, as well as key advanced EU countries which are home authorities of cross-border banks, adopt the framework for coordinated crisis management between EU-based cross-border bank groups based on principles of burden-sharing.

14-16 February 2009: EC and IMF first review missions in Hungary

In the light of deteriorating GDP forecasts for 2009 (from -1% to -3%), the main findings and suggestions of the first review mission were to adopt a series of further short term measures on the expenditure side (amounting to 0.7% of GDP) and a slight upward adjustment of the deficit target to 2.9% of GDP.

18 February 2009: Compliance Statement submitted by Hungarian authorities

Assesses the conditions set in the MoU in relation to the first tranche as satisfied. Deficit target of 3.4% of GDP for 2008 was met, a new fiscal responsibility law was adopted, and a “Pathway to Work” programme on employability of low-skilled workers was approved as a part of the structural measures.

11 March 2009: Supplemental MoU signed

Agrees on the adjustment of the deficit target, as well as on the proposed further fiscal consolidation and structural measures.

26 March 2009: Disbursement of second instalment

Disbursement made upon finalization of legal procedures on the Hungarian side, €2 billion.

14 April 2009: New technical government of Gordon Bajnai

Following the resignation of Prime Minister Ferenc Gyurcsány, Gordon Bajnai heads an interim cabinet. He declares his intention to stay in office for no longer than one year, focusing on the implementation of austerity measures.

7-18 May 2009: EC and IMF second review mission to Hungary

Progress with respect to conditionalities attached to the third instalment can be considered as fulfilled. Progress satisfactory in the fiscal sphere and structural reforms, but some further assurance needed in the area of financial sector regulation, e.g. compliance of the new Financial Stability Act with EU principles and specific guidance given. Macroeconomic conditions expected to deteriorate further with GDP growth contraction projected to reach -6.7%. Proposal made to adjust the deficit target to 3.9%. New Council recommendation under the Excessive Deficit procedure, extending deadline by two years, needed.

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5 Raiffeisen, Erste, Intesa SP, Société Générale, KBC, Unicredit. For exact timeline of the Vienna Initiative, see http://www.ebrd.com/downloads/research/economics/events/Vienna_timeline.pdf.

21 May 2009: 2nd compliance statement submitted by Hungarian authorities
Detailed account given on the achievement of commitments stipulated in the MoU and the supplemental MoU. Includes, among others, details on the deteriorated macroeconomic situation and the corresponding adjusted deficit path, as well as on the changes undertaken in the pension system.

11 June 2009: Second supplemental MoU signed
New deficit target of 3.9% of GDP stipulated. Foresees as conditionality the full implementation of a further expenditure reduction package of 0.6% of GDP (e.g. abolishment of universal housing subsidy scheme; abolishment of 13th month salary for the public sector for 2010 onwards and nominal freeze of total public sector wage bill). Further requirements include review of budget preparation, control and monitoring against the new Fiscal Responsibility Law, as well as further progress in the area of financial regulation and supervision. Structural measures include adjustments in the social security system as well as tax reforms (revenue-neutral) to reduce tax wedge on labour.

6 July 2009: Disbursement of third instalment
Disbursement made of third instalment, EUR 1.5 billion.

August/September 2009: 3rd IMF review with full participation of EC staff
Agrees rescheduling of both IMF and EU assistance. Follow-up note sent to EFC explaining the Hungarian request to re-phase the remainder of the assistance and divide the fourth instalment into three sub-tranches over a longer period of time than previously envisaged (Q1, Q2 and Q3 of 2010 rather than Q4 2009).

04-16 November 2009: Third review mission
Completion of outstanding reforms (e.g. public transport and fiscal governance) concluded.

26 November 2009: 3rd compliance statement submitted by Hungarian authorities
Signals that the Hungarian authorities do not intend to draw on the fourth instalment.

15 January 2010: Third supplemental MoU signed
Divides the fourth instalment into three sub-tranches with specific attached conditions in four areas- fiscal consolidation; fiscal governance; financial sector regulation and supervision; and structural reforms; attached to each of the sub-tranches.

3-15 February 2010: Fourth review mission
Review conditionalities attached to first sub-tranche of fourth instalment. Concludes that economic policy criteria as well as the deficit target of 3.9% of GDP for 2009 are likely to have been achieved.

12 March 2010: Fourth compliance statement submitted by Hungarian authorities
Re-states intention not to draw on the sub-trances of the fourth instalment. Outlines a slightly more favourable forecast for 2010 and does not change deficit targets for 2010 and 2011.

29 May 2010: Orbán Government elected
At the second round of the parliamentary elections, the centre-right Fidesz party wins 263 seats in the Hungarian parliament. By this, it gains two-third majority, a requirement for amending changes in the Hungarian Constitution.

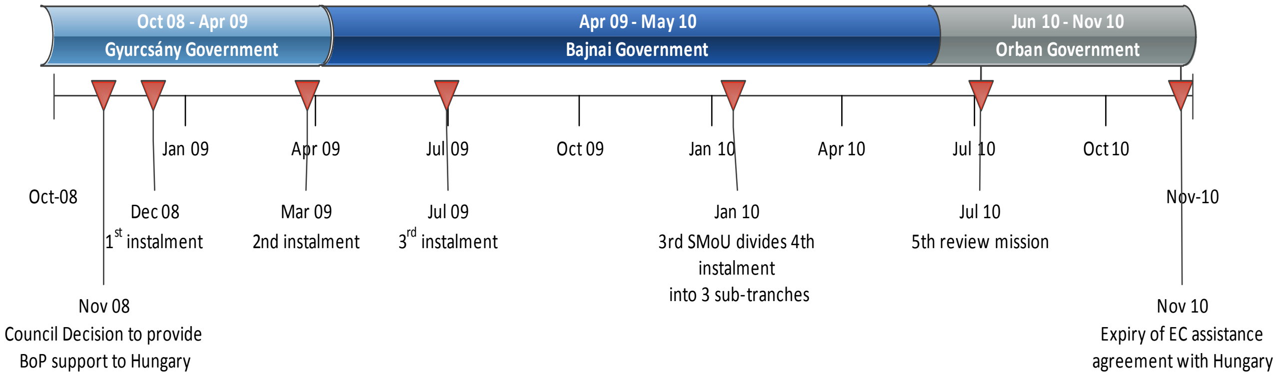
6-17 July 2010: Fifth review mission

EC and IMF undertook a fifth review mission to review progress towards conditionalities attached to the release of the second sub-tranche of the fourth instalment. EC and IMF decided not to conclude the review. The reasons were that following some expenditure side slippages (some incurred under the term of the previous government) and revenue shortfalls as well as measures intended to counterbalance them, there was still a 0.3% of GDP gap to the deficit target of 3.8% of GDP in 2010. At the same time, there was no clarity provided by the Hungarian government on structural measures to close the gap. The corrective measures package of 1% of GDP that the new government was implementing fell short of the required adjustment and included mainly short-term measures. One of the planned measures to meet short term budgetary commitments, the financial sector levy, would negatively impact the country's investment climate and economic growth. Further foreseen measures, such as a ban on foreign exchange mortgages, changes in excise duties, as well as provisions that could threaten the operational independence of the Central Bank, were regarded as incompatible with corresponding EU legislation. Therefore, unclarity persisted as to how the agreed budget deficit targets would be met in the future.

As the IMF programme for Hungary was running out in early October 2010, the Fifth Review mission concluded that the declared wish of the new government to continue negotiations with the EC only, was not realistic in the context of increased international cooperation. The EC assistance agreement expired in November 2010.

Figure 2 gives a schematic overview of the major milestones of the BoP support operation:

Figure 2: Milestones of the BoP support operation



2.3 The use of the funds

The Hungarian government decided not to use the whole BoP support package. The agreement with the World Bank for €1 billion has never been finalised.[6] Out of the available €19 billion, €14.1 billion was used. Table 3 shows how the support package of €14.1 billon has been allocated by the

[6] Initially, the World Bank was to take part in the BOP assistance package, but the agreement between the Hungarian authorities and the World Bank was never signed. Hungary had graduated from the Bank's financial assistance in Spring 2007 and engaged into negotiations over a development policy loan in 2008. Hungary's graduation prompted the WB to change its pricing policy for the country during the negotiations. By then, the Hungarian authorities had regained access to international financial markets and resigned from signing the agreement. Instead, a Financial Sector and Macro Stability loan of US$ 1 billion was approved by the WB's board in September 2009 and shares three objectives with the EU/IMF package: (i) to support to fiscal reforms designed to ensure long-run fiscal and macroeconomic sustainability and restore investor confidence; (ii) to support the financial stability program, designed to ensure adequate levels of liquidity and healthy capital cushions, (iii) to support pension reforms. Its fourth aim was to achieve cost containment and deficit prevention in the health sector while ensuring access to care.

Hungarian authorities. It can be observed that actually disbursed EU support from the BoP support operation was focused exclusively on sovereign debt financing. In the case of the IMF part, sovereign debt financing amounted to 42% of total disbursements. The remaining share was used for building reserves and to support the financial sector, as is typical for IMF funds .

Table 3: Disbursements from the EU-IMF support package[7,8]

Disbursements from the EU-IMF support package	IMF bn. EUR (eqv)	EU bn. EUR
1st tranche	**4.9**	**2.0**
Reserves	1.1	
sov. debt financing	1.3	2.0
bank consolidation	2.6	
of which: OTP loan	1.5	
MFB loan	0.6	
FHB loan	0.4	
FHB capital	0.1	
2nd tranche	**2.3**	**2.0**
sov. debt financing	2.3	2.0
3rd tranche	**1.4**	**1.5**
MNB reserves	1.4	
sov. debt financing		1.5
4th tranche	**0.05**	
sov. debt financing	0.05	
TOTAL	**8.65**	**5.5**

Source: Ministry for National Economy of Hungary.

[7] Part of the funds used to finance sovereign debt also increase the FX reserve of the MNB

[8] At the expiry of the programme, significant part of the disbursed financial assistance was available in the form of the government's FX deposit at the MNB

3 Impact on macroeconomic stabilisation

3.1 Introduction

In this Chapter, we explain our approach for the first group of evaluation questions linked to the area of macroeconomic stabilisation (see the table below).

Table 4 Evaluation question on macroeconomic stabilisation and sub questions[9]

Q1.	**To what extent has the MFA assistance been effective in terms of the macroeconomic stabilisation of Hungary?**
Q1.1	What are the short and medium-term macroeconomic objectives* of the assistance?
Q1.2	To what extent have the short and medium-term macroeconomic objectives* of the assistance been achieved?
Q1.3	What has been the contribution of the grants and/or loans provided by the operation to the achievement of objectives?
Q3.2	What, if any, has been the contribution of actions resulting from the respect of structural conditionality criteria to the achievement of short and medium-term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria)?
Q3.3	Has the assistance given rise to any unexpected short and medium-term structural and/or macroeconomic effects? What were they and how did they occur?

* Or expected effects if explicit objectives cannot be identified

3.2 Macroeconomic objectives of the intervention

Q1.1 What are the short and medium-term macroeconomic objectives of the assistance?*

3.2.1 Findings

On 4 November 2008, the Council of the EU decided to make available to Hungary a medium-term assistance of up to €6.5 billion in conjunction with €12.5 billion loan from the IMF supported by a Stand-by arrangement and €1 billion loan from the World Bank. The Council decision states the objectives of the assistance as follows:

“The EU financial assistance is provided in support of the new comprehensive economic policy programme adopted by the Hungarian authorities... to restore investor confidence and alleviate the stress experienced in recent weeks in the Hungarian financial markets.”[10]

The Memorandum of Understanding signed on 19 November refers to the fiscal consolidation efforts started in mid-2006 and explains that:

“By supporting the sustainability of Hungary’s balance of payments, the assistance will help the country ...to make progress with fiscal governance, financial sector regulation and supervision reforms and other measures to support a prudent stability oriented, and sustainable economic policy.”

[9] See pp. 9-11 of the “Guidelines for ex post evaluation of MFA/BoP assistance”, May 2010.

[10] Memorandum of Understanding between the European Community and the Republic of Hungary: http://ec.europa.eu/economy_finance/publications/publication13495_en.pdf

3.2.2 Conclusions

Based on the above findings we recapitulate the macroeconomic objectives of the BoP assistance for Hungary in the table below.

Table 5 Macroeconomic objectives of the BoP for Hungary

Objective	Source
1. To help restoring investor confidence and alleviating the stress experienced in late 2008 in the Hungarian financial markets	MoU
2. To support Hungary in enhancing fiscal consolidation measures started in mid-2006 and improving fiscal governance.	MoU

3.3 Gross impact – actual macroeconomic outcomes

Q1.2 To what extent have the short and medium-term macroeconomic objectives of the assistance been achieved?

We analyse actual macroeconomic developments on the basis of relevant indicators relating to the macroeconomic objectives of the BoP assistance. While in the MoU target levels have only been set for the general government deficit in 2008 and 2009, we examine selected macroeconomic indicators concerning their general direction and accordance with the identified BoP objectives. The list of these indicators is provided in the table below.

Table 6 Macroeconomic indicators

Objectives	Effect Indicators
Restoring investor confidence	Growth rates in GDP and components
	Inflation
	Exchange rate
	Interest rates
Enhancing fiscal consolidation	Level of government revenue
	Level of government expenditure
	General government balance
	Financing of the deficit

To ensure consistency, the main data source used for the drafting of this chapter is EUROSTAT. In addition, data from the IMF, the Central Statistical Office of Hungary and the National Bank of Hungary have been used as well.

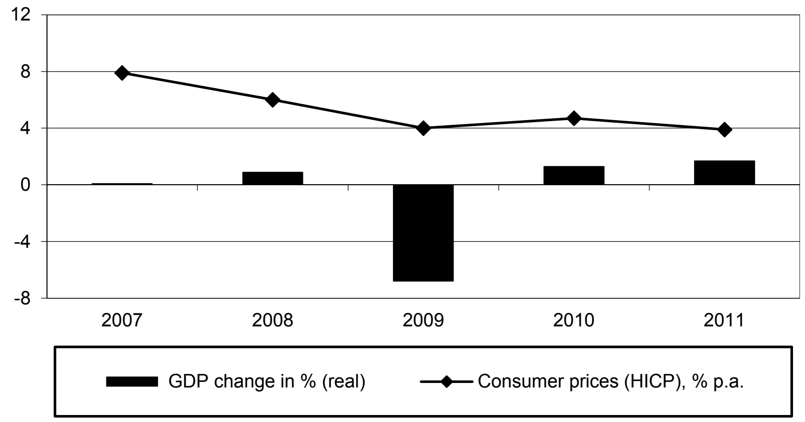
3.3.1 Macroeconomic performance

Economic growth

Figure 3 depicts the GDP growth dynamics and inflation development in the years 2006-2010. In this period, Hungary's growth performance was moderate. After the general election in Spring 2006, the re-elected socialist-liberal government headed by Prime Minister Ferenc Gyurcsány addressed the fiscal deficit that had increased over time to above 10%. In the framework of an austerity package, the Hungarian general government deficit was reduced in only two years to below 4% in 2008. As a side effect of the fiscal austerity, domestic demand shrunk and economic growth decelerated to below 1% in 2007.

A recovery of growth as recorded in the first two quarters of 2008 was interrupted by the impact of the international financial crisis in the second half of 2008. The repercussions of the crisis on Hungarian economic growth were strongest in 2009. In that year, the GDP decline amounted to 6.8% caused by a simultaneous drop in domestic and foreign demand of the economy.

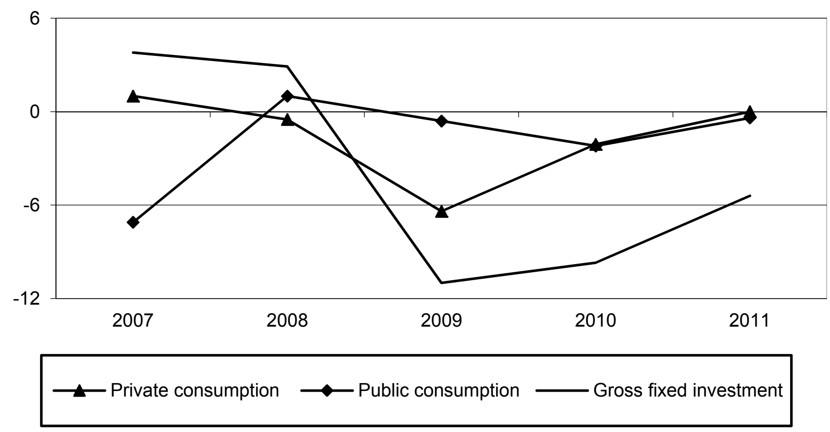
Figure 3: GDP growth and CPI, 2007-2011



Source: wiiw Database incorporating Eurostat statistics.

Analysing the components of the GDP decline, it can be observed that household consumption decreased in accord with the GDP decline while gross fixed investment's contraction was substantially stronger than that of the GDP (see Figure 4). The only component of GDP which counterbalanced, to some extent, the decline of consumption, investment and depletion of inventories, was net exports. Though both exports and imports substantially contracted that year, the drop in exports was a third smaller than that in imports.

Figure 4: GDP growth by expenditure, 2007-2011 (change in %, in real terms)



Source: wiiw Database incorporating Eurostat statistics.

The Fidesz government, that came into office in Spring 2010, envisaged the stimulation of economic activities. However, the restructuring of the tax system and a series of economic policy measures introduced by the government did not bear fruit in terms of higher growth. The new "flat" 16% personal income tax rate favours only the high income social strata whose propensity to additional consumption is low. The measures which were approved in order to make up for the loss of revenues due to this and other tax reductions included a levy charged on financial institutions and new, temporary taxes imposed on predominantly foreign owned large firms in the retail, telecommunication and energy sectors. The bank levy, supplemented by the detrimental effects of an early repayment scheme for foreign exchange denominated mortgage loans diminished the banks' ability to fulfil their role in financial intermediation. As a consequence, lending to the private sector has been declining since 2009, in accelerating pace. The sectoral taxes affected the investment activity negatively in the segments concerned. Finally, depreciation of the forint increased the debt service burden of those households which are indebted in CHF or Euro and which were unable to participate in the early repayment scheme. Since this group constituted 80% of all households with FX mortgage loans, higher debt service led to smaller consumption expenditures.

While decline of private consumption decelerated in 2010 and halted in 2011, strong contraction of gross fixed investment carried on in both years. The moderate increase of the economy both in 2010 and 2011 is explained by net exports, thanks to rapid recovery of exports after the crisis coupled with slower increase of imports due to depressed domestic demand.

Inflation

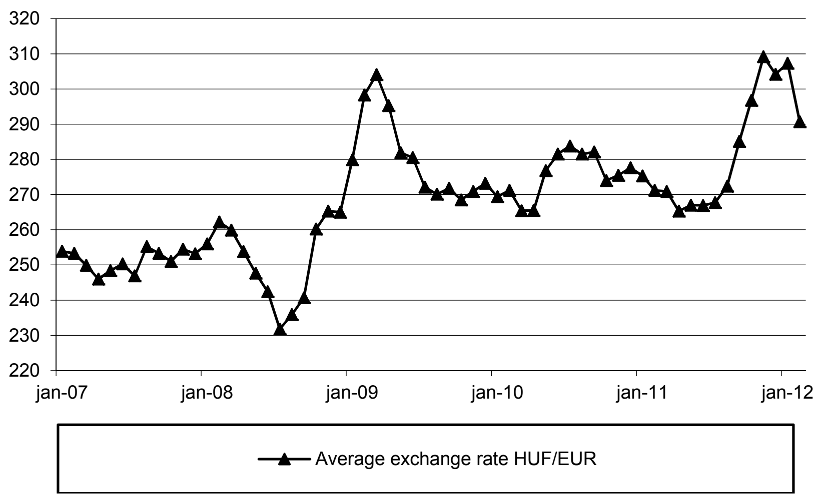
In order to comply with its statutory objective to achieve and maintain price stability, the Central Bank of Hungary (MNB) has adopted an inflation targeting framework for monetary policy since 2001. In 2005 the government and the MNB jointly adopted an explicit medium-term inflation target for the period starting in 2007 and defined it as a 3% rate of increase in the consumer price index regularly published by the Central Statistical Office.

During 2006-2011, the medium-term inflation target of 3% was not achieved in any of the years (see Figure 3). Inflation has been pushed upwards by shocks on imported energy, commodity prices as well as on food prices due to bad harvest. In addition, in the second half of 2011 excise taxes were raised and from January 2012 on the VAT rate was raised from 25% to 27%. These measures will accelerate inflation again, to an estimated 5% in 2012. Nevertheless, the inflationary pressure will be counterbalanced to a large extent by decreasing domestic demand as the consequence of the forthcoming wave of fiscal consolidation.

Exchange rate

Up to the 2008 crisis the HUF/EUR exchange rate had been oscillating at around 250 for a decade. In the first weeks of the crisis a moderate depreciation of the HUF began, which swiftly accelerated in January 2009 and reached its climax in March 2009 at close to 310 HUF/EUR. With the easing of the liquidity crisis following the signature of the Vienna Initiative, a gradual appreciation of the HUF began. By spring 2010 the HUF strengthened to below a level of 270 HUF/EUR. This unambiguous

Figure 5: HUF/EUR exchange rate 2007-2012



Source: wiiw Database incorporating Eurostat statistics.

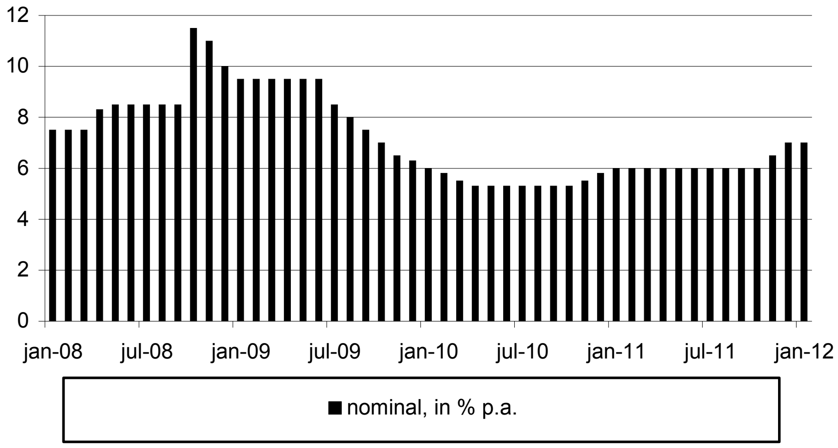
improvement switched over to slow deterioration following the election victory of Fidesz and the first communication on the new government's economic policy. A new wave of appreciation followed after government's fiscal consolidation measures in the "Széll Kálmán Plan" were announced in March 2011. However, a strong depreciation pushed the exchange rate above 300 HUF/EUR between the end of October 2011 and the end of January 2012. In February and March 2012 the exchange rate of the forint strengthened below 300 HUF/EUR but remained volatile.

Interest rates

On 22 October 2008, at an extraordinary meeting of the Monetary Council, the central bank policy rate was raised from 8.5% to 11.5%. This step was a reaction to the strong depreciation of the HUF. The main purpose of this decision was to stop speculation against the Hungarian currency and help restore investor confidence. This strong monetary tightening, while beneficial for restoring stability, also had undesirable side effects. Coupled with the fiscal austerity measures, it dragged economic activities and accelerated the switchover of the business sector, the households and municipalities from raising HUF denominated to foreign-exchange (FX) denominated loans.

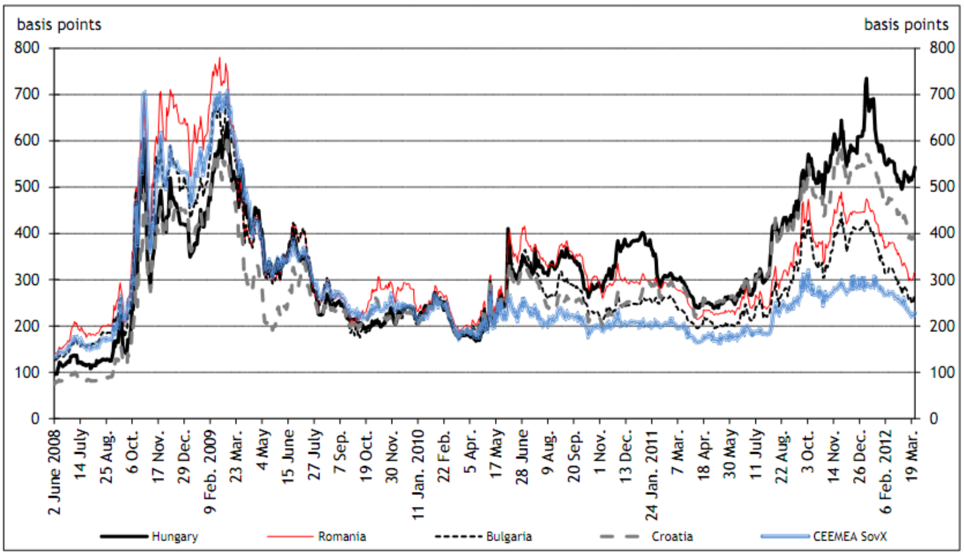
Following the signature of the IMF/EU agreement, improved financial stability allowed the start of an interest cutting cycle (See Figure 6) as early as November 25 2008. The interest cutting cycle stopped at 5.25% (being from April to November 2010). From November 2010 onwards, interest rates were raised again. The justification of the decision referred to curbing increasing inflationary pressure and deteriorating international investor sentiment as reflected in increasing CDS spreads.

Figure 6: Central bank policy rate, 2008-2011



Source: wiiw Database incorporating Eurostat statistics.

Figure 7a: 5 year sovereign CDS spreads in Hungary and selected emerging markets 2008-2012

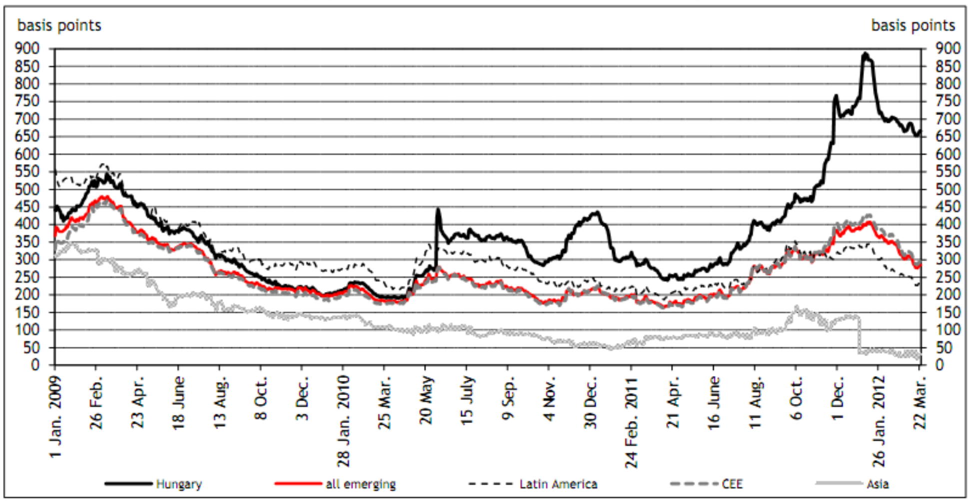


Source:National Bank of Hungary, Thomson Reuters Notes: CEEMEA is a composite index calculated from the 15 most liquid sovereign CDS spreads in the CEEMEA region.

Data of Figure 7a clearly shows the benevolent effect of the EU-IMF assistance package and the programme related economic policy measures of the government on Hungary's credit default swaps (CDS) spreads, which sharply fell over 2009. From spring 2010 a new wave of upturn in Hungary's CDS spreads is registered which, after a temporary improvement, sharply deteriorated in the second half of 2011 and the first days of 2012. Contrary to the situation in late 2008 and early 2009, Hungary in the recent period of high CDS spreads decoupled from the other new EU member states as it is displayed on the right hand scale of Figure 7a. In the first quarter of 2012 Hungary's CDS spreads again declined but the relative position the regional peers has not improved.

A similar development is observed in Figure 7b which displays Hungary's sovereign foreign currency bond spreads.

Figure 7b: Emerging market sovereign foreign currency bond spreads



Source: National Bank of Hungary, Thomson Reuters. Notes: calculated from JP Morgan Euro EMBI data. The series are differences between euro denominated (liquid) foreign currency bond yields and euro zero coupon yields of the corresponding maturities.

3.3.2 Public finances

Beginning in mid-2001, Hungary entered a period of expansionist fiscal policy. Measures included, among others, a 60% increase of minimum wages in two years, 50% wage raises for public servants in a single year and the introduction of a 13th month pension. In 2001-2005, household consumption increased by 33%, while GDP grew only by 18%. After the 2006 elections, in the wake of vanishing investor confidence, the government launched a consolidation package including tax raises, staff cuts in the public sector and reductions in the energy and utility price subsidies. A series of reforms were initiated in public health care, higher education, the pension system and the local governments to secure a longer term sustainability of the already improved fiscal balance. However, in a referendum about the reform, the government suffered a landslide defeat in March 2008. As a result, long due reforms in public finances subsystems remained unrealized. In autumn 2008, as a consequence of the global financial crisis, the Hungarian authorities required external assistance in order to preserve the country's solvency.

The table below shows the general government balance indicators for Hungary for the period 2006-2012 which are commented in the sections below.

Table 7a: Government balance, percent of GDP, 2006-2010

Fiscal indicators	2006	2007	2008	2009	2010
Total current revenue	41.8	44.7	44.9	45.4	42.5
Current tax burden	37.3	40.5	40.4	40.2	37.3
Total revenue	42.7	45.6	45.5	46.9	45.2
Total current expenditure	45.8	45.1	45.1	47.1	44.8
Interest payments - EDP	3.9	4.2	4.2	4.7	4.1
Total expenditure	52.1	50.7	49.2	51.5	49.4
Primary government balance	-5.5	-0.9	0.5	0.1	-0.1
Total government balance	-9.3	-5.1	-3.7	-4.6	-4.2

Source: AMECO.

Revenue

As evident from Table 7a, total revenues relative to GDP have increased considerably in programme years 2008-2009, especially compared to 2006 but dropped again with the termination of the programme in 2010 and the tax reductions of the new Fidesz government. On the revenue side, measures undertaken during the BoP operation included the raising of the standard VAT rate from 20% to 25% and reducing tax concessions. Corporate tax was raised from 16% to 19% by the Bajnai government. The effect of those measures for 2010 on revenues is somewhat counterbalanced through the reduction of employers' social security contributions from 32% to 27%, as well as by the elimination of the so-called 'solidarity tax' of 4% on businesses and individuals in the highest tax bracket.

Expenditure

Between 2006 and 2008, total government expenditure was decreasing, reflecting efforts related to reaching the EDP targets. However, as a result of the global financial crisis, expenditures increased by almost 2 percentage points in 2009 compared to 2008. Table 7a shows that the pre-crisis level was re-gained in 2010. Some of the measures undertaken by the Bajnai government to curb expenditures in that period were: the abolishment of the13th month pension and the 13th month wage in the public sector; the introduction of a pension indexation which follows only the inflation; and a gradual increase of the retirement age from 62 to 65 years. In addition, a public sector wage freeze was introduced for 2009. A streamlining of social and welfare expenditures took place with the purpose to target the real needy recipients only.

General government balance

The main conditionality of Hungary's agreement with the European Community was the reduction of the fiscal deficit below 3% of GDP and the improvement of fiscal governance. Consequently, from late 2008 on a series of consolidation measures were approved first by the Gyurcsány government and, via a second wave of economic policy measures from March 2009 on, by the technical government of Gordon Bajnai. Between the autumn 2008 and spring 2009 a considerable fiscal adjustment took place, even if the original nominal deficit target was not achieved due to the much steeper decline of GDP than originally reckoned with. Table 7b shows the deficit targets and the factual fiscal deficit levels achieved during the BoP support operation period.

The 2008 fiscal deficit target of 3.4% to be achieved according to the MoU was slightly missed (fact 3.7%) but the real concern was the 2.6% deficit target set for 2009, based on the assumption of 1% GDP contraction in that year. In the Supplemental Memorandum of Understanding (SMoU) signed on March 10, 2009 a new, somewhat higher fiscal deficit target, 2.9% was prescribed, with reference to a substantial change in the expected magnitude of the recession (3 to 3.5%).

Table 7b: Fiscal deficit achievement compared to target

	2008		2009			2010	
	Target	Actual	Target		Actual	Target	Actual
			original	revised			
Fiscal deficit	3.4%	3.7%	2.9%	3.9%	4.6%	3.8%	4.2%

Source: IMF

This target was in line with the EDP recommendation to bring the deficit below 3% by 2009. That meant a 0.7% of the GDP corrective measures and altogether a greater than originally designed fiscal adjustment. On June 11 2009, a second SMoU was signed again with a revised fiscal deficit target. The new 3.9% deficit target was one percentage point above the previous one but the revised predicted GDP contraction, 6.7%, was 4.2 - 4.7 percentage points larger than the previous one. The achievement of the changed deficit target required additional efforts amounting to 0.8% of the GDP. All in all, due to the strong contraction of the economy the nominal fiscal loosening in 2009 had actually been a considerable fiscal tightening in real terms with pro-cyclical effects. The overall structural fiscal adjustment in the programme period is estimated to have reached 2.5% of potential GDP[11].

It is the second SMoU where for the first time the government's commitment for the 2010 deficit targets was required. It was set at 3.8%. However, following the spring 2010 elections the new government started with measures to stimulate the expansion of the economy. As growth had not really taken off and the deficit remained above 4%, in spring 2011 the government made an economic policy half-turn and announced that fight against public debt would be the new focus of its efforts. It adopted a detailed program (Széll Kálmán Plan) including measures aimed at attaining a less than 3% (relative to GDP) deficit in 2012. The 2011 fiscal surplus (4.3% of the GDP as reported by the Hungarian government) achieved through accounting the revenues from the pension fund assets' nationalisation in that single year disguises actual fiscal loosening in 2011.

[11] IMF: Hungary: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-By Agreement, Country Report No. 11/145, p. 18.)

Stability and Growth Pact: Convergence Programme and Excessive Deficit Procedure

Under the provisions of the preventive arm of the Stability and Growth Pact (SGP) non euro-area MS prepare annual convergence programmes and submit them to the EC and the European Council each year. The aim of these programme is to ensure fiscal discipline through surveillance and coordination of fiscal policies within the euro area and EU. The most recent convergence programme for Hungary is the "Convergence Programme of Hungary 2011-2015" based on the Széll Kálmán Plan published in April 2011[12].

Hungary has been in the Excessive Deficit Procedure since its EU accession in 2004, longer than any other Member State. In 2004, Hungary was in violation of the Treaty's reference values (of 3% of GDP for the general government deficit and 60% of GDP for the government debt). The Council decided in July 2004 that Hungary was in excessive deficit and set the deadline of 2008 to correct the situation. Following two cases of non-compliance the deadline was extended to 2009. In the context of the BOP programme, in view of the significant deterioration in the macroeconomic outlook (as explained above in 3.3.1), the Council recommendation of July 2009 set 2011 as a new deadline for compliance with the Treaty reference value. While the 3% of GDP threshold was formally observed in 2011, in January 2012 the Council established that Hungary had not taken effective action, as the 2011 budgetary surplus was not based on a structural and sustainable correction and hinged upon substantial one-off revenues. It should be noted that according to calculations of the government the fiscal balance cleared from one-off items displays a deficit of 2.4%. Alternative calculations arrived at 4.6%[13], while the European Commission calculated a deficit amounting to 5.25% of GDP.[14] In the latter two calculations one-off items were taken into consideration (sector specific taxes and a part of the nationalized pension funds' assets) which were already part of the budget when it was approved by the Parliament.

Based on the additional fiscal consolidation steps contained in the April 2012 Convergence Programme, the Commission concluded in May 2012[15] that in response to the Council's March 2012 recommendation, the 2012 deficit target of 2.5% of GDP was expected to be met and the 2013 budget deficit was foreseen to be well below the threshold of 3% of GDP.

3.4 The macroeconomic counterfactual

In answering Question Q.0 we determine a counterfactual scenario in case no BoP operation would have been implemented.[16] In the next two subsections, we first outline our approach to constructing the macroeconomic elements of possible counterfactual scenarios (3.4.1), and then construct and analyse the scenarios themselves (3.4.2).

3.4.1 Our approach

Constructing a counterfactual scenario in the case of the BoP operation in Hungary is particularly difficult, *inter alia*, for the following two reasons:

12 http://ec.europa.eu/economy_finance/sgp/pdf/20_scps/2009-10/01_programme/hu_2010-01-29_cp_en.pdf

13 http://www.portfolio.hu/gazdasag/a_rendkivuli_adatot_magyarazza_matolcsy.165459.html downloaded on 18.04.2012

14 European Economic Forecast May 2012, page 90.

15 http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/communication_to_the_council/2012-05-30_hu_communication_en.pdf

16 The Evaluation Guidelines require that two separate counterfactuals are constructed and analysed: one referring to the lack of the total assistance package (EU + IMF) (question Q0.1 of the Evaluation Guidelines) and the other one where the IMF package is in place but it is not accompanied by the BoP assistance operation of the EU (question Q0.2 of the Evaluation Guidelines). While this question is very relevant for balance of payment operations outside the EU27, it is considered very unlikely that the IMF would support an EU member state without a coordinated involvement of the EU because of the legal provisions relevant for EU members. For this reason, we have abstained from answering Q0.2.

- Hungary was on a verge of a financial (currency) crisis (or – depending on the definition used – already in a crisis) at the time the operation was granted;
- The operation coincided with the unfolding global financial crisis that significantly affected global financial conditions.

Taking into account the above, we proceed in three steps. First, we present the most likely counterfactual scenario based on qualitative interviews with key stakeholders representing the EU, the IMF and the Hungarian authorities and our own ex-post analysis of the macroeconomic situation in Hungary in the end of 2008. The qualitative interviews are supported by the use of the "Delphi methodology" (see box below), an evaluation method that aims to reach a consensus view among stakeholders. Gathered information indicates that the most likely counterfactual scenario – in addition to the observed currency crisis - would have included a sovereign debt default and a wider financial crisis in the banking sector. We explicitly abstain from defining the exact character of a debt default (e.g. all parameters of debt rescheduling, share of debt obligations affected by a default, etc.). This is mainly motivated by a large heterogeneity of default options and lack of any solid evidence that could reasonably guide our decision on specifics of such debt default in Hungary and therefore its final macroeconomic outcome.

In the second step, we conduct a quantitative and qualitative analysis of the selected counterfactual scenario basing it on existing empirical evidence on financial crises, and especially triple crises (a combination of debt, banking and currency crises). This analysis serves as a basis for determining a range of macroeconomic effects if no assistance was provided to Hungary. Importantly, in our analysis we go beyond the Hungarian case and discuss potential effects of Hungarian crisis on other countries that could have been affected.

In the third step of our approach we derive a net effect of the BoP support operation by comparing actual and counterfactual developments in key macroeconomic variables. This is presented in section 3.5.

Delphi methodology

The Delphi methodology is based on a system of iterative questionnaires and attempts to form a qualitative and consensus view. The use of the Delphi technique added a level of transparency in the more recent evaluations[17]. The Delphi methodology's aim is to reach a consensus stakeholders' view on the main aim of the support operation, the most likely macroeconomic counterfactual scenario, and the implementation of structural reforms as a result of the support operation. The results of the Delphi questionnaire is attached to this report as Annex 4.

For this evaluation, we practised two rounds to come to a consensus view. The first round of the Delphi questionnaire was administered on the 7th of February 2012 to 37 respondents identified through the evaluation team meetings in Brussels, Washington and Budapest. Of those, 19 persons, or 52% returned the questionnaire. Given the particular survey design, which required that the respondents do not click on the finish button so that they can access their answers for the second round, some responses have been recorded by the system as "partial". A closer look reveals that of the 19 respondents that completed the questionnaire, 18 reached the one but last question, and 17 completed the questionnaire fully. This yields a response rate of 46% for the first round. In the second round, we received feedback from 15 out of the 19 respondents (79% response rate).

[17] GHK Consulting Ltd on behalf of the European Policy Evaluation Consortium (2009): "Meta-evaluation of Macro-Financial Assistance Operations (MFA) (2004 – 2008)" evaluated seven MFA evaluations, of which six carried out by Ecorys (Rotterdam), CASE (Warsaw) and Economisti Associati (Bologna). The meta-evaluation was commissioned by the Directorate General for Economic and Financial Affairs in December 2008.

What constitutes an optimal number of subjects in a Delphi study never reaches a consensus in the literature. Delbecq, Van de Ven, and Gustafson (1975) [18] suggest that ten to fifteen subjects could be sufficient if the background of the Delphi subjects is homogeneous. As regards the issue of statistical significance, it needs to be underlined that this concept is only valid in the context of a statistical confidence test where a formulated hypothesis is being questioned. In the context of the Delphi technique, where the survey is administered to a small selection of experts (non-randomly selected sample), research has proven that a small response rate does not impact the reliability of results (Akins, Tolson and Cole, 2005)[19]. In particular, comparison between actual responses of a small survey sample with augmented, computer-generated larger sample proved that the mean response remained stable for both samples, and the confidence intervals of the small and bigger sample were overlapping.

3.4.2 The macroeconomic counterfactual scenario

This section constructs and analyses which macroeconomic scenario would have been most likely if the EU and IMF's BoP support had not been implemented. Our analysis starts from the macroeconomic state of affairs in October 2008.

The state of the Hungarian macroeconomy in October 2008

In deciding on the BoP support operation in the second week of October 2008, the Hungarian government and the mission of the EC and the IMF were confronted with the following mix of events:

- The international banking sector was in a general disarray due to the collapse of Lehman Brothers on 15 September 2008;
- The FX reserves of the Magyar Nemzeti Bank (Hungarian central bank) were low (€17.4 bn) in light of the FX re-financing needs of the Hungarian private and public debtors. FX reserves amounted to 18% of gross FX external debt on September 30 2008;
- Foreigners holding HUF-denominated bonds started to sell off their government paper. The share of non-resident owners in total outstanding government securities dropped from about 32% to below 24% over the last quarter of 2008. The yields on 10-year bonds were at a nine-year high (10.78%). Subsequently, the Hungarian primary dealers refused to indicate buy/sell prices. The next auctions for government HUF-denominated bonds were cancelled;
- Sharp depreciation of the HUF (16% between September 1 and October 22) and problems in the FX swap market were observed;
- The main domestic commercial bank OTP was hit by margin calls at the Budapest stock market and share prices fell (the Budapest Stock Exchange index BUX dropped by 32% between September 1 and October 22).

The full depth of the problem became clear in only a few weeks time which was reflected in almost 20 per cent depreciation of the HUF between September and October. The BUX index fell by more than 40% during that time. HUF 600 billion was withdrawn from the state securities market, one sixth of the previous stock. The growing sales on the secondary market brought yield increases of

[18] Delbecq, A. L., Van de Ven, A. H., & Gustafson, D. H. (1975). Group techniques for program planning. Glenview, IL: Scott, Foresman, and Co, quoted after Chia-Chien Hsu, & Brian A. Sandford (2007): The Delphi Technique: Making Sense Of Consensus, in: Practical Assessment, Research & Evaluation 10:12.

[19] Ralitsa B Akins, Homer Tolson and Bryan R Cole (2005): "Stability of response characteristics of a Delphi panel: application of bootstrap data expansion", in: BMC Medical Research Methodology 2005, 5:37. Further similar studies that prove the reliability of low response rates in both non-random sample selection: Holbrook, Allyson, Jon Krosnick, and Alison Pfent (2007): "The Causes and Consequences of Response Rates in Surveys by the News Media and Government Contractor Survey Research Firms", in Advances in telephone survey methodology, (ed. James M. Lepkowski).

3-6 percentage points. This development, in turn, frightened the large domestic investors, because they expected further declines in bond prices. These developments led to a freeze on the primary market.

Most likely counterfactual scenario

The selection of the most likely counterfactual depends on the interpretation of the above developments. Our interpretation was primarily supported by (1) interviews with experts and stakeholders in Budapest, Brussels and Washington DC and (2) the Delphi questionnaire. Based on a range of information and opinions from these sources we conclude that Hungarian government would have eventually defaulted on its debt obligations if no BoP support operation had been granted. Additional arguments supporting a debt default in our counterfactual are related to the relatively long duration of the crisis actually observed in the Hungarian financial market (after end-2008) and the decline of confidence in sovereign debtors (e.g. following the October 2008 events, March 2009 saw a further decrease in confidence in central European countries).

Given underlying problems with FX positions of Hungarian banks (evident in the data and also underlined in several interviews), and given empirical evidence of linkages between debt and banking crises, in addition to a currency and a debt crisis, in our counterfactual scenario, we also assume a banking crisis, i.e. we assume that Hungary underwent a triple crisis.[20]

It is important to realise that a debt default is a general concept. It can include every form of non-compliance with the original terms of the debt contract, including repudiation, standstill, moratorium, restructuring, rescheduling of interest or principal repayment etc. We do not have basis that would allow us to make evidence-based decisions on the specific parameters of a Hungarian debt default. We therefore explicitly maintain the description of the counterfactual scenario quite general.

In the counterfactual scenario, the Hungarian government would have gained time by using its financial reserves available at the Treasury account, the auction of Treasury Bills and its existing stand by and roll over facilities.

In the meantime, the Hungarian government would have explored other instruments to address the liquidity needs to service its debts:
1. MNB's international reserves;
2. FX swaps from the European Central Bank;
3. Concealed ways of monetary financing by MNB.

Soon after the announcement of these measures it would have turned out that these alternative instruments are not available (ECB swaps), ill-advised (using MNB's reserves would have further lowered trust in the government's financial position) or illegal (monetary financing) and therefore would not have provided even a short-term solution to the liquidity crisis.

As the capital market would have become increasingly aware of these problems, the HUF would have further depreciated. Further HUF depreciation combined with large FX-funded mortgages would have put strong pressure on Hungarian households stimulating them to exchange domestic currency holdings for foreign currencies. Given the international shortage in liquidity, Hungarian banks (both OTP and Hungarian subsidiaries of foreign banks) would have had problems to respond to increased demand in FX. Initially, the Hungarian government and the MNB would have used their reserves to support the banking sector. However, the limited access of the Hungarian

[20] Reinhart C. and K. Rogoff, 2011, From Financial Crash to Debt Crisis, American Economic Review 101 (August 2011): 1676–1706.

government to financial markets and the low reserve position of the MNB would not have allowed this to continue for long. After a few weeks and further depreciation of the HUF, it would have left the Hungarian Government with no other option than to default. Some of the domestic banks would have faced bankruptcy.

3.5 Net impact on macroeconomic stabilisation

3.5.1 Most likely scenario - Triple crisis

The most likely scenario involves a triple crisis: currency, sovereign debt and banking. The analysis of macroeconomic outcomes (and net effects) is based primarily on comparative historical analysis, drawing from empirical literature investigating the consequences of financial crises. We start by outlining the potential macroeconomic effects in Hungary and later proceed to a discussion on potential impact on other countries.

Effects on Hungary

There is a large body of literature on macroeconomic effects of financial crises. These studies typically distinguish between three types of crises: currency, debt and banking. There is limited consensus regarding important issues, such as macroeconomic costs associated with those crises, but general conclusions are as follows:

- Financial crises differ substantially from one another;
- The large majority of crises leads to substantial output contractions;
- Different types of crises often coincide;
- Banking crises appear to be particularly costly in terms of output losses especially if they coincide with currency crises;
- There is particularly large heterogeneity of views on the effects of debt crises. A debt crisis accompanied by a banking crisis may lead to lower output losses than a banking crisis alone;
- The duration of negative effects of crises differs considerably and is particularly difficult to foresee in the case of debt crises.

Cecchetti et al (2009) estimate the costs of 40 systemic banking crises that took place from 1980-2007 in countries worldwide.[21] They conclude that the median cumulative output loss (relative to peak) resulting from these 40 financial crises is just above 9 per cent of GDP[22]. A quarter of analysed crises led to cumulative losses exceeding 25 per cent of GDP. When repeating their calculations for the ten European countries in the sample, the median cumulative output loss (relative to peak) is just under 10 per cent of GDP.

Distinguishing between different combinations of crises, Cecchetti et al (2009) conclude that when a banking crisis is accompanied by a currency crisis, it is more than five quarters longer, and the trough in output is on average 6 percentage points lower when compared with the situation in which only a banking crisis occurs. In contrast, when a banking crisis coincides with a sovereign debt default, the effects are less severe – a duration is nearly two years shorter and the trough is higher by 7 percentage points of pre-crisis GDP relative to a banking crisis only. Another interesting finding

21 Cecchetti et al (2009) refer to Laeven and Valencia's (2008) definition of a systemic banking crisis: an event in which a country's corporate and financial sectors experience a large number of defaults and financial institutions and corporations face great difficulties repaying contracts on time. As a result, non-performing loans increase sharply and all or most of the aggregate banking system capital is exhausted. This situation may be accompanied by depressed asset prices… sharp increases in real interest rates, and a slowndown or reversal in capital flows. In some cases, the crisis is triggered by depositor runs on banks. Though in most cases it is a general realization that systematically important financial institutions are in distress.

22 It is measured as the cumulative loss in GDP over the length of the crisis, taken as a fraction of the peak (pre-crisis) level. Stephen G. Cecchetti & Marion Kohler & Christian Upper, 2009. "Financial Crises and Economic Activity," NBER Working Papers 15379, National Bureau of Economic Research, Inc.

from Cecchetti et al (2009) is that if a crisis is preceded by a low growth period (e.g. because a crisis itself is induced by a recession) it tends to be more severe. Each percentage point decline in pre-crisis GDP growth on average implies that crisis-related contractions are longer by one quarter and the trough in economic activity is 1 percentage point lower.

The above range of output effects is not very different from those found in several other recent studies. For instance, Reinhart and Rogoff (2009) show that short term output falls in the aftermath of banking crises in 14 developed and emerging market economies during 1929-2001 are, on average, over 9 per cent[23].

IMF's World Economic Outlook (1998) focuses on banking and currency crises in 50 industrial and emerging market countries during1975-1997 and identifies that for approximately 40 per cent of examined currency crises and 20 per cent of banking crises, there are no significant output losses[24]. For countries which do suffer cumulative output losses relative to the trend, the results vary for different types of crises (currency crises, currency crashes, banking crises, and currency and banking crises). On average, a cumulative output loss per crisis during the investigated period is above 9 per cent. The largest output losses are detected for countries which went through banking as well as currency crisis: on average, the cumulative output drop in those countries is above 14 per cent. Output decline is larger in industrial than in emerging economies: 18 and 14 per cent, respectively. Incidents of severe currency crashes resulted in cumulative output losses to the tune of 7 per cent.

With respect to debt defaults, the evidence appears to be particularly mixed, possibly owing to definitional problems. Debt defaults rarely appear in isolation, but when they do, their negative impact may in some instances be quite limited. Some evidence suggests that contractions precede defaults, the trough of the contraction coincides with the quarter of default, and that output starts to grow thereafter[25]. This is in contrast to a much more negative view of effects of debt defaults in Furceri and Zdzienicka (2011) who suggest that debt crises reduce contemporaneous output growth by about 6–10 percentage points, even in case of defaults not associated with other types of financial crises[26]. The effects are persistent and eight years after the occurrence of a debt crisis, output is still lower by about 10 per cent.

De Paoli et al (2009) suggest that a combination of sovereign crisis with a currency crisis, a banking crisis or both is much more costly than debt crises alone. The ranking of output losses between other combinations of crises is unclear.

Before interpreting the results summarised above in the context of potential output losses in Hungary in the counterfactual scenario, we explain why, in our approach, we focus on output losses only. The literature on effects of financial crises (debt and banking crises in particular), apart from

23 Carmen M. Reinhart & Kenneth S. Rogoff, 2009. "The Aftermath of Financial Crises," American Economic Review, American Economic Association, vol. 99(2), pages 466-72, May.

24 IMF (1998), *World Economic Outlook*, Chapter IV, The International Monetary Fund. A currency crisis is defined to occur when a speculative attack on the exchange value of a currency results in a devaluation (or sharp depreciation) of the currency, or forces the authorities to defend the currency by expending large volumes of international reserves or by sharply raising interest rates. The WEO's definition for a baking crisis follows Bordo (1985): A banking crisis refers to a situation in which actual or potential bank runs or failures induce banks to suspend the internal convertibility of their liabilities or which compels the government to intervene to prevent this by extending assistance on a large scale.

25 Yeyati, Eduardo Levy & Panizza, Ugo, 2011. "The elusive costs of sovereign defaults," Journal of Development Economics, Elsevier, vol. 94(1), pages 95-105, January. This may also be consistent with the result for debt defaults not associated with currency or banking crisis in De Paoli, Bianca & Hoggarth, Glenn & Saporta, Victoria, 2009. "Output costs of sovereign crises: some empirical estimates," Bank of England working papers 362, Bank of England.

26 Davide Furceri & Aleksandra Zdzienicka, 2011. "How Costly Are Debt Crises?," IMF Working Papers 11/280, International Monetary Fund.

evaluating output losses, sometimes also discusses financial costs. In case of debt crises these costs are related to the ability of creditors to impose higher borrowing costs on defaulting sovereigns. However, there is evidence that - with time - these costs have become less important in particular owing to increased competition in debt markets[27]. In case of banking crises fiscal costs are sometimes discussed but we follow the argument of Cecchetti et al. (2009) that fiscal costs are not a good proxy of real losses resulting from a financial crisis[28].

Our interpretation of the above cross-country findings in view of the situation in Hungary should the counterfactual scenario have materialised takes into account the following factors:
- A substantial share of Hungarian debt was held by foreigners; as of 2008 close to 40% was denominated in foreign currencies;
- The share of private-sector foreign-currency denominated debt was very high;
- The loan-to-deposit ratio was growing making the banking system vulnerable to sudden withdrawal of foreign funds (in 2008 this ratio was around 140);
- Pre-crisis output growth was weak (1.7% YoY in 3Q2008) compared to average growth rates till end-2006, but stronger than during a recession at the turn of 2006/2007;
- The global economic environment during late 2008 and early 2009 was fragile and more difficult than during the crises periods analysed in empirical studies discussed above;
- The actual scenario against which the counterfactual scenario needs to be compared (for the assessment of net effects of the BoP operation) involves a currency crisis and deep recession.

It is clear that a combination of evidence from past crises of various types and specific circumstances relevant for Hungary at the turn of 2008/2009 do not provide explicit suggestions for the magnitude of output effects that could appear in our counterfactual scenario. Therefore, at best, a plausible range of effects can be indicated. Taking into account all the above factors and our qualitative judgement from interviews, we assess that an indicative range of cumulative output losses is likely to be between 12% and 20% of GDP relative to the pre-crisis growth path. These estimates refer to the effects of the 2008/2009 crisis only, i.e. we do not take into account a subsequent deepening of the global / euro area crisis and its implications for Hungary. Putting it differently, we assume that developments from 2010 onwards would have exerted broadly similar impact on Hungary in a counterfactual scenario as has been actually the case.

The 12-20% range is constructed as follows. Our lower bound of cumulative output losses relative to a pre-crisis average growth path (12%) is in line with the median of those crises episodes analysed by Cecchetti et al (2009) where the cumulative output loss was in excess of 5% (i.e. around three quarters of all crisis episodes analysed in that paper). The logic of taking the median output cost of crises with non-negligible output losses as a lower bound of our estimates is that the global 2008 crisis was very severe by historical standards and led to substantial output loss in Hungary (in actual scenario - more on this below in section 3.5.2). This estimate (12% output loss in the counterfactual scenario relative to a pre-crisis average growth path) can be also taken as corresponding to a view that a debt default would have mitigated negative consequences of the

27 Wright (2005), for example, discusses how in the past three decades, the sovereign debt market has become more competitive and explains how an increase in number of creditors may diminish the creditors' ability to coordinate and thus execute higher borrowing costs (Wright, M. L. J., 2005, Coordinating Creditors, The American Economic Review, Papers and Proceedings 95 (2): 388–92). See on this also Gelos, R. G, Sahay, R and G Sandleris, 2004, Sovereign borrowing by developing countries: what determines market access?, IMF Working Paper No 221.

28 The argument is that for a given banking crisis a very activist policy with a large budget deficit could prevent a sharp general contraction, while a policy of doing nothing would result in a protracted downturn. Fiscal costs are clearly lower in the second instance, but real losses could very well be higher. See Stephen G. Cecchetti & Marion Kohler & Christian Upper, 2009. "Financial Crises and Economic Activity," NBER Working Papers 15379, National Bureau of Economic Research, Inc.

banking and currency crises in Hungary[29]. Notice that this implies only somewhat higher output losses than losses that materialised in the actual scenario (for the discussion on these losses see section 3.5.2 below). Such an interpretation can – to a certain degree – be supported by a high share of foreign debt to total debt so that a default would have left more financial resources in the country.

The key counter argument against our lower bound estimate is that in a particularly unfavourable international environment (that could have further deteriorated following an unexpected sovereign default of any EU member country) several forces could induce a deeper and/or longer lasting recession in Hungary.

The upper bound of cumulative effects was set on the grounds that output losses in excess of 20% of GDP, while not implausible based on some historical crisis episodes, would nevertheless put the Hungarian case among the most costly crises (e.g. among a quarter of most costly crises analysed by Ceccetti et al, 2009). This could have materialised in case of severe mismanagement of a debt default and a banking crisis. However, such risks appear limited given the relatively high quality of Hungarian institutions and the fact that EU membership would had ensured a degree of cooperation with the EU institutions and institutions of other EU member states even in the absence of the BoP assistance instrument.

In summary, our indicative range of cumulative output losses in the counterfactual scenario (relative to the pre-crisis path) is between 12 and 20%.

Impact on other countries: global effects of BoP assistance to Hungary

In this section we assess the effects of the BoP assistance granted to Hungary on other countries. The key task in assessing the impact on other countries is to evaluate how a deeper (than actually observed) crisis in Hungary (including a debt default and a banking crisis in addition to a deeper currency crisis) and lack of international support in the form of a combined EU-IMF assistance would have translated into the situation in other countries and in particular their resilience to a crisis. We proceed in two steps. In the first step we try to identify countries that could have suffered from contagion from Hungary assuming no EC and IMF assistance to this country. In the second step we refer to the literature on macroeconomic effects of financial crises to assess the potential scale of effects in the group of identified countries.

The key problem with the first step is that financial crises can spread for many reasons, some of which are impossible to predict. One meta-analysis has identified contagion variable as the third least useful leading indicator of crises in 83 analysed studies on early warning indicators[30].

Bekaert et al. (2011) discuss three different hypotheses why a crisis in one country may spread to other countries[31]. One hypothesis implies that contagion during crises hits those economies that are highly integrated through trade and/or financial linkages[32]. Another hypothesis is based on

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29 This view could be consistent with elements of findings reported by Yeyati, Eduardo Levy & Panizza, Ugo, 2011. "The elusive costs of sovereign defaults," Journal of Development Economics, Elsevier, vol. 94(1), pages 95-105, January. and Stephen G. Cecchetti & Marion Kohler & Christian Upper, 2009. "Financial Crises and Economic Activity," NBER Working Papers 15379, National Bureau of Economic Research, Inc.

30 Frankel, J. A. and G. Saravelos, 2010, Are Leading Indicators of Financial Crises Useful for Assessing Country Vulnerability?, NBER Working Paper No. 16,047, National Bureau of Economic Research, Inc.

31 Bekaert G., Ehrmann M., Fratzscher M, and A. J. Mehl, 2011, Global Crises and Equity Market Contagion, NEBR Working Paper 17121, National Bureau of Economic Research, Inc., National Bureau of Economic Research Inc.

32 See also Baduel B., Prat S. and J. C. Rodado, 2011, Which emerging countries are most exposed to the risk of contagion from advanced economies?, Flash Economics, Natixis; Glick, R. and A. K., Rose., 1999. Contagion and trade: Why are currency crises regional?, Journal of International Money and Finance, Elsevier, vol. 18(4), pages 603-617, August.

learning and states that a crisis initially restricted to one market segment or country provides new information that may force investors to reassess the vulnerability of other market segments or countries[33]. Pesaran and Pick (2007) go a step further along similar lines and claim that a financial crisis in one country can be a signal that a certain type of economic development strategy is unsustainable, which can lead investors to withdraw their money from countries with apparently similar strategies[34]. In this case domestic fundamentals are likely to play a dominant role in the transmission of the crisis. Finally, contagion may be driven by herding behaviour of investors, which has little to do with global integration or the strength of observable fundamentals.

There is also no consensus in the empirical literature on the transmission channels through which contagion may occur. On one hand, Bekaert, et al. (2011) present an evidence that during 2008 global financial turmoil countries that experienced the largest equity market declines and contagion due to the US sub-prime crisis were those with poor macroeconomic fundamentals, high sovereign risk and poor institutions[35]; the size of FX reserves, the current account position and the sovereign rating of those countries were found to matter the most. Factor such as trade openness, or financial depth, do not explain contagion. On the other hand, some other studies identify trade and financial linkages as a crisis-spreading factor, which suggests that crises should be regional[36]. Finally, crises can spread through a multiple of channels.

Given the lack of consensus on the best strategy to identify countries that could had been vulnerable to a deeper financial crisis in Hungary (in a counterfactual scenario) we adopt a hybrid approach analysing the potential contagion countries by looking at their fundamentals (provided by the most successful crises predictors such as a real exchange rate overvaluation and a measure of reserves adequacy[37]), trade linkages with Hungary (proxied by a ratio of country exports to Hungary to GDP in 2007), and financial linkages.

For the analysis of financial linkages we apply a combination of two approaches. First, we analyse the behaviour of Exchange Market Pressure (EMP) indices in selected countries and correlations between these EMP indices with the Hungarian one. The EMP index is an index of speculative market pressure, which is commonly used in crisis literature to identify episodes of financial crashes as well as episodes of turbulence in financial markets which do not necessarily result in successful currency attacks. A second element of our assessment of financial linkages between Hungary and other countries is an analysis of cross-border banking activity. Since many Western European banks expanded their presence in Central and Southern European banking systems in a recent decade, negative developments in Hungary could have had adverse implications for parent financial systems. Likewise, problems in parent countries could have affected the daughter countries with a possibility of spillover to other countries in the region. To this end, we evaluate the exposure of foreign parent banks to their Hungarian subsidiaries and of a leading Hungarian bank (OTP) to its foreign subsidiaries.

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33 See also Masson P., 1999, Contagion: macroeconomic models with multiple equilibria, Journal of International Money and Finance 18 (1999) 587–602, Goldstein, M., Kaminsky, G. L. and C. M. Reinhart, 2000, Assessing Financial Vulnerability: An Early Warning System for Emerging Markets, Washington: Institute for International Economics.

34 Pesaran H., and A. Pick, 2007, Econometric Issues in the Analysis of Contagion, Journal of Economic Dynamics and Control 31(4).

35 Bekaert G., Ehrmann M., Fratzscher M, and A. J. Mehl, 2011, Global Crises and Equity Market Contagion, NEBR Working Paper 17121, National Bureau of Economic Research, Inc., National Bureau of Economic Research Inc.

36 Glick, R. and A. K., Rose., 1999. Contagion and trade: Why are currency crises regional?, Journal of International Money and Finance, vol. 18(4). Similar point explaining that Eastern European countries appear more exposed to a shock originating in the eurozone and US precisely due to the importance of trade (and financial links) with the former is made by Baduel B., Prat S. and J. C. Rodado, 2011, Which emerging countries are most exposed to the risk of contagion from advanced economies?, Flash Economics, Natixis.

37 Frankel, J. A. and G. Saravelos, 2010, Are Leading Indicators of Financial Crises Useful for Assessing Country Vulnerability?, NBER Working Paper No. 16,047, National Bureau of Economic Research, Inc.

As an additional element of the analysis of exposure to a financial crisis risk in 2008-2009 we also identify countries that had an on-going IMF program at that time as well as present their sovereign credit rating.

The initial set of countries included in the analysis was very broad and largely driven by the data availability and regional representation (Europe, Asia, Africa, and Americas). The technical details of the analyses (specific formulas, data issues, time span) as well as detailed results for all countries are available in Annex 3. Table 8 contains the summary of results from all these

Table 8: Indicative summary assessment of a risk of contagion from the Hungarian crisis

Country	Financial linkage	Vulnerability indicators	Trade linkage	Fitch sovereign rating	IMF programme	Summary: contagion risk
Austria	+++	N/A	++	↔AAA	-	+++
Croatia	++	++	+	↓BBB-	-	+
Cyprus	+++	+++	+	↓↓AA-	-	++
Czech Rep.	++	++	++	↔A+	-	+++
Denmark	+++	++	+	↔AAA	-	+
Estonia	+++	++	+	↓BBB+	-	++
Germany	++	N/A	+	↔AAA	-	
Iceland	+	++		↓BBB-	√	
Italy	++	++	+	↔AA-	-	+
Latvia	++	++		↓↓BBB-	√	++
Lithuania	+	+++	+	↓BBB	-	++
Macedonia	+	++	N/A	↓BB+	√ (expired in Sep 2008)	
Morocco	+++	++		↔BBB-	-	
Montenegro	++	N/A	+++	N/A	-	++
Netherlands		N/A	+	↔AAA	-	
Norway	++	+++		↔AAA	-	
Poland	++	++	+	↔A-	-	+
Romania	+	+	++	↓BBB	√	++
Slovak Rep.	+++	+++	+++	↔A	-	+++
Sweden	++	++	+	↔AAA	-	
Ukraine	+	++	+	↓B-	√	+

Notes:
Column 1, which describes financial linkages uses the following indicative scale: blanks denote negligible linkages, + denotes weak linkages, ++ denotes strong linkages, and +++ denotes very strong linkages. Financial linkages are established based on correlation of EMP indices with Hungarian EMP and cross-border banking links (Tables A3.2 and A3.4 in Annex 3 as well as the indices of exposure to regional contagion in Table 6a in Arvai et al., 2009).
Column 2, which describes crisis vulnerability assessed in terms of two indicators calculated in Table A3.1, Annex 3, uses the following scale: + little vulnerability, ++ vulnerability (one indicator sends warning signals) and +++ significant vulnerability (two indicators send warning signals). Wherever selected indicators could not be calculated, the field is marked as 'N/A'.
Column 3 assesses trade linkages (Table A3.3, Annex 3), and uses the same scale as applied to financial linkages in Column 1.
Column 4 presents Fitch sovereign credit rating, where arrows "↑", "↔", "↓↓"denote a positive, stable or negative rating outlook, respectively. Bold downward pointing arrows, "↓", indicate inclusion on the credit watch negative list. In circumstances when credit rating changed between January 2008 and December 2008, the lowest ranking was presented.
In Column 5, presence of the IMF programme is denoted by "√".
Overall contagion risk (Column 6) uses the following scale: blank denotes low risk, + denotes moderate risk, ++ denotes high risk and +++ denotes very high risk. Experts' opinion based on conducted interviews was also used in the overall risk judgement.

Sources: Own assessment based on calculations discussed in Annex 3. Presence of IMF programmes (Stand By Arrangements) was sourced from IMF Financial Activities - Update December 30, 2010.

approaches and an overall qualitative assessment taking into account results of all approaches as well as other factors, such as geographical proximity, assessment of linkages as perceived by international investors etc. The presented table focuses on countries which are most relevant from the European perspective and for which we could establish interdependence with Hungary (either through financial or trade linkages).

Clearly, the interpretation of these results requires caution and indeed the entire identification exercise should be seen as indicative only. This is even more so given that the possible contagion from the Hungarian crisis would have been affected by the unprecedented 2008 global crisis making the analysis yet more difficult (e.g. feedback effects).

In summary, Table 8 suggests that the Czech Republic, Slovak Republic and Austria were most exposed to the risk of contagion from Hungary. However, the risk was also relatively high in Cyprus, Estonia, Latvia, Lithuania Montenegro, Ukraine and Romania. Countries with moderate risk of contagion from Hungary include Denmark, Italy, Poland and Croatia.

Having identified the overall risk of potential contagion from Hungarian crisis to the rest of the world, we turn to the evaluation of macroeconomic costs of such contagion. It should be noted that two outcomes are possible: (a) contagion could lead to a financial crisis or (b) a crisis could be avoided despite market pressures but probably at some cost.

Referring once again to the literature on crisis effects surveyed above we observe that materialisation of a financial crisis in any of the identified countries could lead to cumulative output losses in this country to the tune of 5-10%. Therefore, if the counterfactual scenario had materialized in Hungary, global effects would have been very substantial – in a particularly negative circumstances a few countries would have suffered output losses exceeding 5 percent of GDP and some other countries would have also been negatively affected. A more contained outcome of financial pressures due to contagion from Hungary could still have led to non-negligible output losses in some countries.

3.5.2 Conclusion: net impact

Comparing the actual developments with the counterfactual results presented above allows estimation of the net impact of the BoP assistance operation to Hungary. The discussion carried out in the previous section explains the rationale behind our estimated 12-20% cumulative output losses (relative to the pre-crisis path) had our counterfactual scenario materialised in 2008/2009. These estimates need to be compared with output losses in the actual scenario that already involved a currency crisis. To do that – again focusing on 2008/2009 developments only – we calculate a measure of cumulative output loss in the actual scenario, relative to the pre-crisis growth path.

This last calculation is carried by comparing GDP outcomes (at the end of 2009) between what was actually observed (i.e. 6.8% recession in 2009) and the hypothetical growth path if there was no 2008/2009 crisis in Hungary. We assume that in the latter case the 2009 growth figure would have remained consistent with the 2006-2008 average, i.e. 1.6%. This implies that the 2008/2009 crisis has led to around 8% cumulative output loss (Figure 8).

In the final step we compare two estimates of cumulative output losses (relative to pre-crisis trend) in Hungary: 8% in the actual scenario and 12-20% in the counterfactual scenario (i.e. triple crisis). The difference between the two is a range from 4% to 12% (Figure 8 and Table 9).

Figure 8: Calculations of net effects of the BoP operation – an illustrative exposition

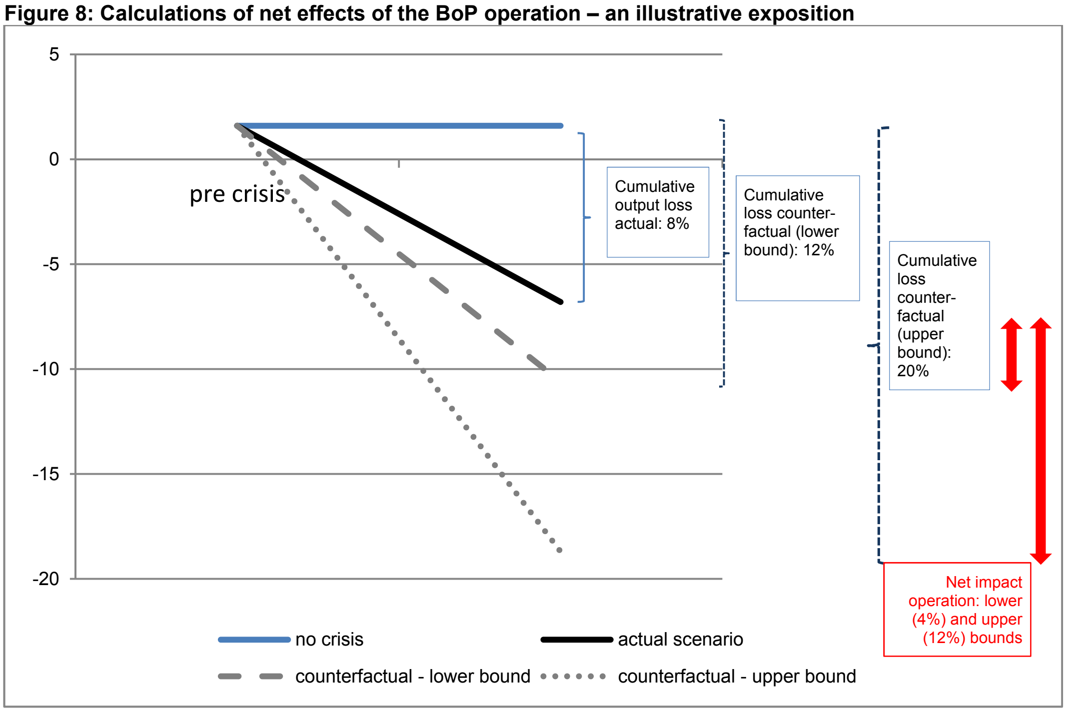


Table 9: Calculations of net effects of the BoP operation

	2009 GDP growth	Cumulative output loss until end-2009	Net effect of BOP (cumulative)
No crisis	1.6%	0	
Actual scenario	-6.8%	1.6% + 6.8% ≈ 8%	
Counterfactual scenario [lower bound]	+1.6 -12% ≈ -10.6%	12%	12% - 8% ≈ 4%
Counterfactual scenario [upper bound]	+1.6 - 20% ≈ -18.7%	20%	20% - 8% ≈ 12%

Notes: The operations on percentages are carried as follows. In the second column counterfactual 2009 growth figures are calculated with the precision to one decimal place. Hence, -10.6% satisfies the condition (1+x) / 1.016 = (1-0.12) (rounded to the first decimal place). This formula just states that the ratio of GDP level at end 2009 in the counterfactual scenario to the GDP level at end 2009 should GDP have grown at 1.6% is 0.88 (i.e. 12% lower than if the pre-crisis trend has continued). Similarly,-18.7% is the solution to an analogous problem for a 20% decline relative to trend (1+x)/ 1.016 = (1-0.2). The figures in the third column (cumulative output losses) are rounded to the nearest unit in line with estimate ranges of output losses found in the literature. Hence, 8% emerges as an approximate solution to (1+x) = (1-0.068) / 1.016.

We therefore conclude that the BoP operation likely added 4-12% to Hungarian GDP path (cumulatively). Importantly, these estimates should be considered as only very indicative as the nature of BoP operation, and the Hungarian and global context in which it took place all make it close to impossible to present quantitative estimates of effects with a reasonable degree of precision.

In addition to this the BoP operation have likely helped to avoid contagion to some other European countries that could have led to non-negligible output losses in some countries. In addition to this, the BoP operation has likely prevented contagion to some other European countries that could have led to non-negligible output losses in some countries (mainly in the Czech Republic, Slovak Republic and Austria) with possible feedback effects on Hungary.

There have been new developments since the last disbursements of the EU and IMF operations affecting the path of the Hungarian economy from 2010-2011 onwards. In particular, the sovereign debt crisis of several euro area economies has started. Also, several policy changes have been introduced by the Hungarian government. These developments clearly matter for the prospects of the Hungarian economy but should not affect our estimates of the net impact of the BoP support operation.

3.6 Indirect macroeconomic effects of structural conditionality

Q3.2 What, if any, has been the contribution of actions resulting from the respect of structural conditionality criteria to the achievement of short and medium-term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria)?

This question focuses on the indirect effects of the BoP structural conditions on macroeconomic developments. In answering this question we follow a two step procedure:
Step 1 – Identification of the structural conditions in the MoU
Step 2 - Analysis of the potential of these conditions to generate macroeconomic effects

Step 1 – Identification of the structural conditions in the SMoU

The structural conditionality that was linked to this BOP operation is discussed in chapter 5. In short, conditionality focused on three areas: fiscal governance reform, financial sector regulation and supervision, and structural reforms.

Step 2 - Analysis of the potential of these conditions to generate macroeconomic effects

The following conditions were attached to the operation that could potentially have macroeconomic effects – if implemented:

1. Improving the financial sector regulation and supervision
2. Strengthening the sustainability of the pension system
3. Improving the financial sustainability of the social support system
4. Launching revenue-neutral tax reforms aimed at reducing the tax wedge on labour
5. Achieving sustainable savings in the area of long-distance public transport.

In case that these conditions were implemented as a result of the BOP operation, and in case that they have significant macroeconomic effects, then these effects may have contributed indirectly to the achievement of the macroeconomic objectives of the operation.

Chapter 5 concludes that no gross impact was achieved in the fifth conditionality (achieving durable savings in public transport), and therefore no macroeconomic effect can have resulted. The operation did speed up the implementation of structural reforms to improve the financial sustainability of the pension and social support system, as well as the implementation of tax reforms. As policy shift was introduced after the operation ended in certain areas (notably eligibility period for child allowances), we conclude that potential macroeconomic effects of these reforms turned out to slightly smaller.

The operation raised a number of financial sector supervision reforms on the government's agenda. The macroeconomic effects of a strengthened regulation and supervision for the domestic banking sector is beyond the scope of this study.

3.7 Unexpected macroeconomic results

Q3.3 Has the assistance given rise to any unexpected short and medium-term (…) macroeconomic effects? What were they and how did they occur?

We have identified one unexpected effects of the BoP support that have had macroeconomic effects, i.e. the European Bank Coordination Initiative (EBCI), also known as the Vienna initiative.

To prevent foreign banks reducing their exposure to their Hungarian subsidiaries, the Hungarian Central Bank, the foreign mother banks (Erste Group Bank, RZB Group, Intesa SanPaolo, KBC Group, Unicredit Group, Société Generale) signed a gentlemen's agreement in December 2008 that the mother banks would not reduce financing. A large part of the EU/IMF operation was designated for the preventive support package for the banking sector which raises the question if an earlier agreement would have reduced the EU/IMF amount. In hindsight, the agreement solved the prisoner's dilemma for foreign banks by providing a collective insurance for the foreign banking sector, yet the biggest stress on the Hungarian market was in March 2009, months after the Agreement was signed. The agreement alone was not enough to restore investor confidence to prevent the sell-off of Hungarian bonds. At the end of 2009, with a view to reaffirming this commitment, the banks signed a letter of intent on maintaining an appropriate level of financing in Hungary.

The Hungarian initiative was the front-runner of the Vienna Initiative that was successfully implemented in other countries such as Romania later on. The beneficial macroeconomic effects in the wider region can be considered as unexpected results of the Hungarian BoP-operation.

4 Impact on external sustainability

4.1 Introduction

The table below presents the evaluation questions that help to analyse the impact of the BoP support on the country's external sustainability. This Chapter explains our findings on these evaluation questions.

Table 10: Evaluation question on macroeconomic stabilisation and sub questions[38]

Q4. To what extent has the BoP assistance contributed to returning the external financial situation of Hungary to a sustainable path over the medium to longer-term?	
Q4.1	How did the external financial situation of the recipient country evolve prior to and during the operation?
Q4.2	What are the main internal and external factors on which the current trend in the country's external financial situation and its prolongation into the future are conditional?
Q4.3	How is the country's external financial situation likely to evolve in the 5 years following the final disbursement given the likelihood of changes to current conditions?

4.2 Gross impact – actual evolution of external sustainability indicators

Q4.1 How did the external financial situation of Hungary evolve prior to and during the operation?

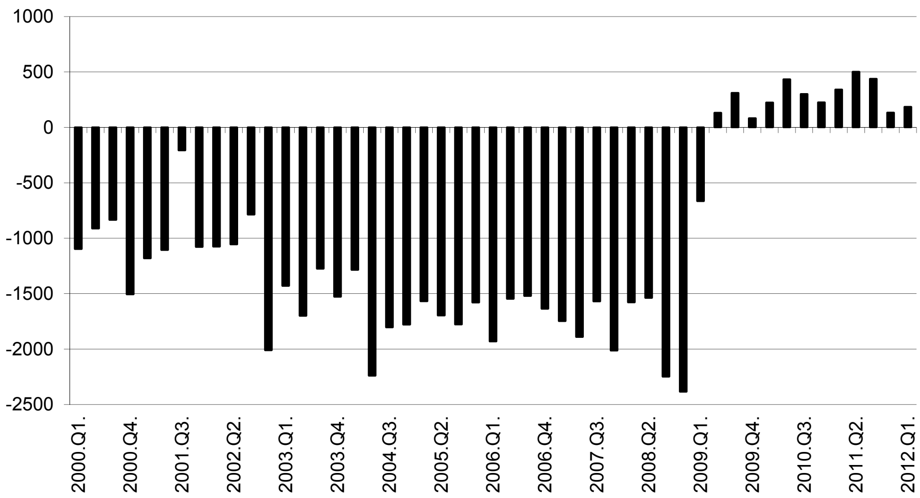
This section answers the above evaluation question by analysing the current account (4.2.1) and the debt position of Hungary (4.2.2).

4.2.1 Current account

Hungary was running current account deficits between 2000 and the beginning of 2009. Since then, the current account balance turned positive (see Figure 9). This turnaround was, on the one hand, influenced by the moderation of imports due to stagnant or recessionary economy since 2007 (see discussion in the previous chapter) and, on the other hand, due to robust export expansion. Export dynamics has been the key driver of the overall balance of payments adjustment of Hungary. Both exports and imports have been on the rise since 2000, but after the EU accession in 2004, export growth (both in terms of volume and value) started to consistently outpace import growth (Figure 10). As a result, the merchandise trade deficit started to decline from around 4% of GDP during 2001-2005 to around 1% of GDP during 2007-2008 to subsequently turn to a significant surplus of 2.6% of GDP in 2009 and 3.3% in 2010.

38 See pp. 9-11 of the "Guidelines for ex post evaluation of MFA/BoP assistance", May 2010.

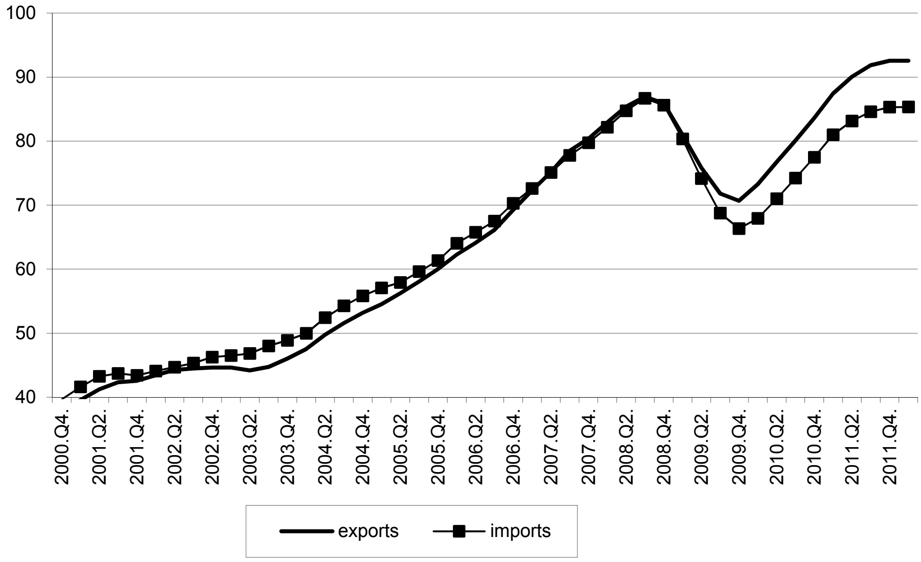
Figure 9 Current account quarterly evolution, 2000-2012 (EUR million)



Note: excluding special purpose entities

Source : Magyar Nemzeti Bank.

Figure 10 Exports and imports of goods and services, 2000-2012, 4 quarter sum (EUR billion)

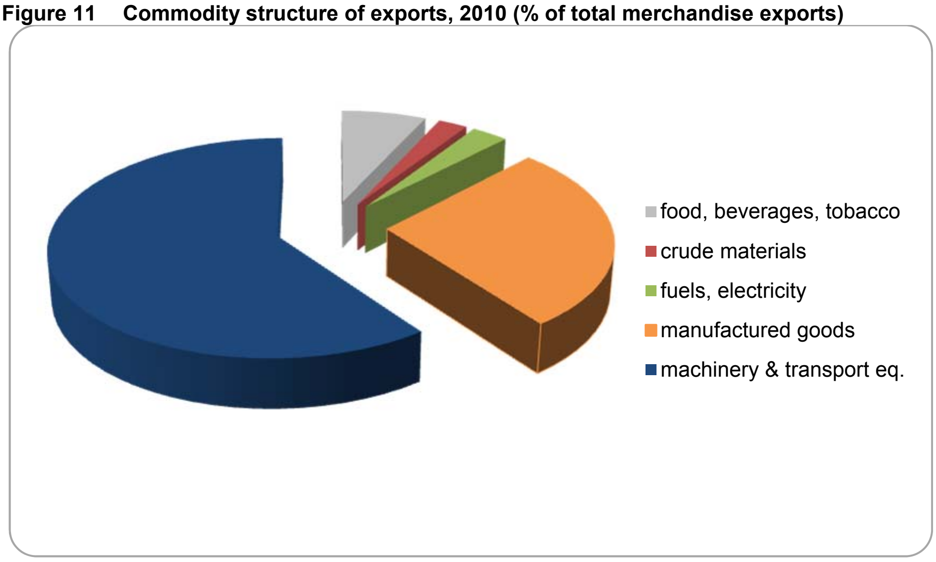


Source : Magyar Nemzeti Bank.

The export expansion has been broad based as evidenced by stable export shares of major categories of merchandise trade. Machinery and transport equipment (especially HS chapters 85, 84 and 87) have dominated Hungary's exports accounting for around 60% of the total throughout the last decade (Figure 11)[39]. Germany is the leading trade partner of Hungary accounting for around ¼ of both exports and imports, followed by other EU countries (Italy, UK, Romania) on the side of exports and China and Russia on the side of imports.

[39] HS chapter 85 consists of Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles; HS 84 includes: Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof and HS 87 includes: Vehicles other than railway or tramway rolling-stock, and parts and accessories thereof.

Figure 11 Commodity structure of exports, 2010 (% of total merchandise exports)



Source : Magyar Nemzeti Bank.

In summary, Hungary underwent a major current account adjustment that coincided with the EU-IMF BoP assistance operation. Between 2008 and 2010 current account position changed by around 9.5% of GDP. The trends observed until early 2012 suggest that this change has been persistent. However, foreign trade patterns underpinning this adjustment have started to change already before the country found itself on the brink of a crisis and received the BoP support. Thus, and also based on an analysis of trade and real effective exchange rate data we note that improved relative export performance cannot be simply attributed to the weaker forint.

4.2.2 Debt sustainability

Hungary's public debt has been on the rise since 2000 due to loose fiscal policies (see Table 11). During 2000-2007 Hungary recorded an average general government deficit to the tune of 7% of GDP annually, by far the largest among EU economies. For comparison Greece recorded average deficits of 5.7% of GDP during this period and the third worst performing economy (on this count), Malta – 4.9%[40]. As a result between 2000 and 2007 Hungary's gross public debt to GDP ratio increased by above 12 percentage points. Among the EU countries, only Portugal saw a larger increase, while the large majority of countries recorded a decline of public debt to GDP ratio over this period.

Compared to regional peers Hungarian household debt to income ratio has been rising much stronger than explained by fundamentals. This suggests an excessive debt growth[41]. From the perspective of this analysis it is also important to note that substantial part of private sector credit growth – in particular loans extended to households were denominated in foreign currency creating a risk in case of currency depreciation. Between 2004 and 2008 the stock of foreign currency lending to households increased from around 0 to above 15% of GDP[42]. This is believed to have exacerbated the impact of the global financial crisis on Hungarian economy becoming an increasingly important risk factor for Hungarian banks. Hungarian foreign-owned banks have been relying on FX lending from parent institutions and hedging the remaining share of foreign currency exposure by FX swaps and other instruments.

40 Calculations based on Eurostat data on net lending /net borrowing under the EDP (Excessive Deficit Procedure).

41 Barrell, Ray E Philip Davis, Tatiana Fic and Ali Orazgani (2009), Household Debt and Foreign Currency Borrowing in New Member States of the EU, Brunel University West London, Economic and Finance Working Papers, 09-23

42 Barrell, Ray E Philip Davis, Tatiana Fic and Ali Orazgani (2009), Household Debt and Foreign Currency Borrowing in New Member States of the EU, Brunel University West London, Economic and Finance Working Papers, 09-23

Table 11 Selected public and external debt indicators, 2007-2011

	2006	2007	2008	2009	2010	2011p
Gross public debt (EUR billion)	59	67	77	73	79	76
Gross public debt (% of GDP)	65.9	67.0	72.9	79.7	81.3	77.7
Gross public debt (% of government revenues)	155	148	162	171	181	193
Foreign currency denominated gross public debt (% of GDP)	16.2	17.6	27.8	35.5	36.0	37.8
Gross financing needs (% of GDP) *	25.0	19.4	17.2	18.7	19.7	21.6
External debt (EUR billion)	86	104	123	137	138	137
External debt (% of GDP)	97	105	117	150	142	141
External debt/ exports ratio (%)	125	129	144	194	164	150
Gross financing needs (% of GDP) **	32	31	34	38	39	42
Gross official reserves (EUR billion)	16.4	16.4	24.0	30.7	33.7	35.3
Gross official reserves (months of imports of goods and services)	2.5	2.3	4.3	4.8	4.8	4.7
Gross official reserves (% of short term external debt at remaining maturity)	96	64	71	84	78	81

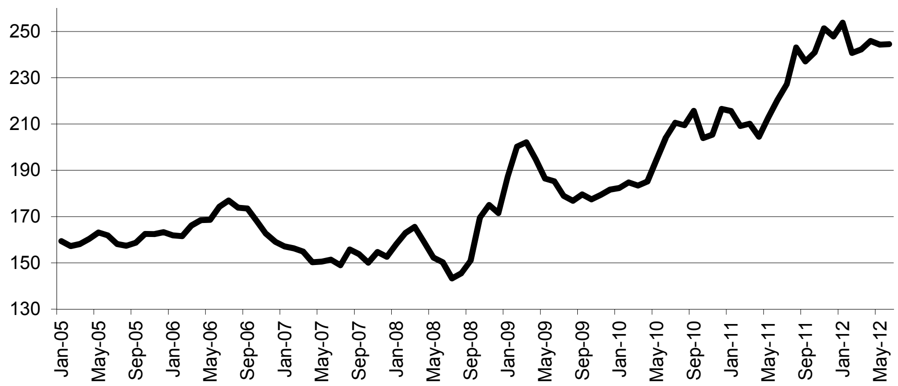
Notes: * Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

** Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Source: IMF Hungary country report 12/13 and own calculations.

During 2008-2010 both public and external debt indicators have been worsening driven by recession and only very weak recovery, continued public finance imbalances, exchange rate swings, and in particular significant forint depreciation vis-à-vis the Swiss franc in nominal terms between 2005-mid-2008 average and end-2011 (Figure 12). However, the worsening of Hungarian indicators over the 2008-2010 period was generally less dramatic than in the case of other EU economies. For instance, between 2008 and 2010 Hungarian debt to GDP ratio increased by 8.3 percentage points, below half of the average level for the EU (17.6 percentage points) and lower than in 17 other EU member states. In particular the increase of debt to GDP ratio in Hungary was similar to the one observed in countries such as the Czech Republic, Austria, Poland and visibly lower than in Slovakia.

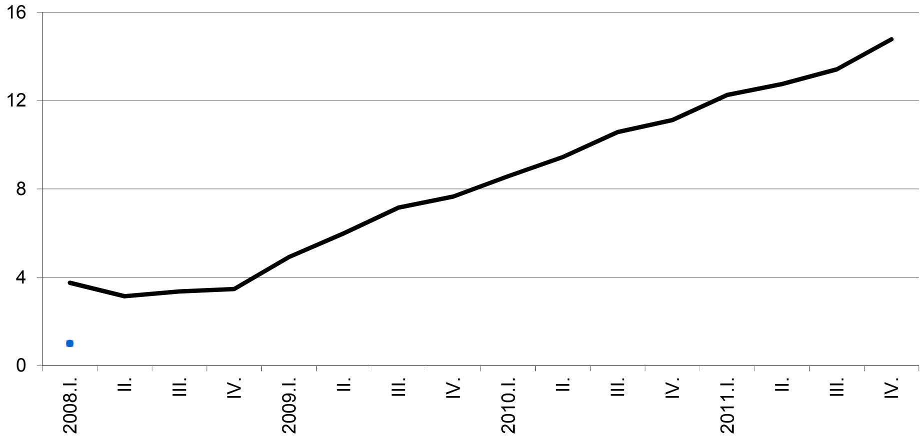
Figure 12 HUF / CHF average monthly exchange rate, Jan 2005 – Jun 2012



Source : Magyar Nemzeti Bank.

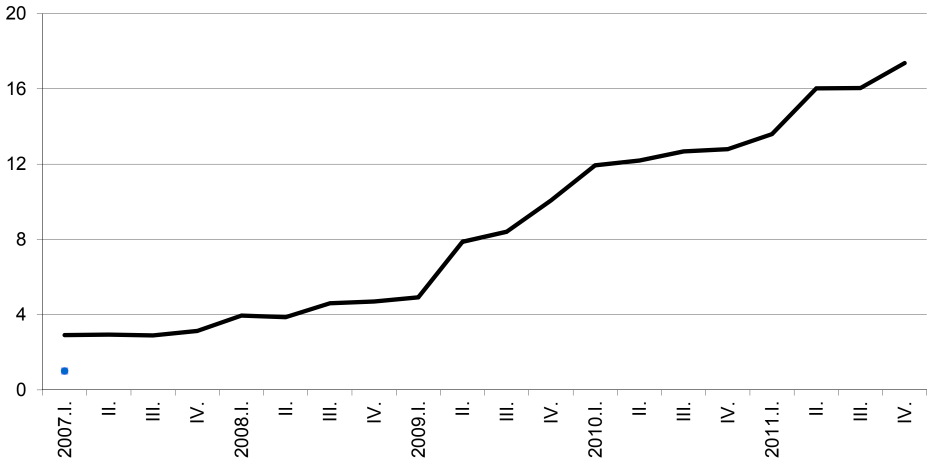
The depreciation of the Forint against the Swiss franc has also resulted in an increase of substandard and non-performing loans to both households and corporate sector. The share of non-performing household loans increased almost four-fold between mid-2008 and end-2011 (Figure 13). The increase has to a significant extent been driven by problems with foreign-currency lending, including Swiss franc mortgages. For instance, non-performing loans of FX mortgages have closely mirrored the overall trend for non-performing household loans (Figure 13), while in the case of forint-denominated mortgages, the share of non-performing loans stabilised below 5%. Non-performing corporate loans have been rising yet faster (Figure 14).

Figure 13 Non-performing loans to households, 2008-Q4 2011 (% of the total – by customers)



Source : Magyar Nemzeti Bank (Report on Financial Stability, April 2012).

Figure 14 Non-performing corporate loans, 2007-Q4 2011 (% of the total portfolio)



Note: The share presented is the 90+ days delinquency rate.

Source : Magyar Nemzeti Bank (Report on Financial Stability, April 2012).

The debt position improved in 2011. In that year, a reduction in public debt /GDP ratio was realised largely to one-off revenue stemming from the elimination of the obligatory private pension scheme. The total fiscal effect of this move is estimated to be close to 10% of GDP, part of which will directly lead to a reduction of the public debt. While this policy change is controversial on several grounds (including the adverse effects on the very long term fiscal outlook) the external sustainability implications of this move are positive in the horizon relevant for this evaluation and in fact also in a longer perspective, up to around two decades. The significant costs of this shift of obligations will be mostly felt after 2030.

4.3 Identification of major risks

Q4.2 What are the main internal and external factors on which the current trend in Hungary's external financial situation and its prolongation into the future are conditional?

In this section we present our analysis of the key risk factors to Hungary's external sustainability. Three major risks are identified:

- financial and macroeconomic risks to EU economies;
- weak short- and medium-term growth prospects for Hungary; and
- weak confidence of economic actors in Hungarian economic policies.

These factors are clearly strongly inter-related. In the context of this evaluation it is also important to realise that the risks identified below are little or not at all related to the BoP assistance operation, but rather to domestic economic policies in the period after disbursement of last BoP assistance tranches as well as external economic environment, especially the on-going turbulences in the euro area.

Risk of crises hitting EU economies

Several EU economies, including in particular southern euro-area members are currently in a very difficult situation with public debts perceived as not sustainable, intensifying financial market turmoil determined by a combination of interrelated sovereign debt and banking sector concerns, political difficulties in pushing sufficiently ambitious and socially acceptable austerity plans, and risk of contagion from one country to the other.

These risks have been recently intensifying in the context of the EU recovery coming to a standstill and a gloomy outlook until at least end-2012. The spring 2012 ECFIN forecast sees EU growth declining from 2% in 2010 and 1.5% in 2011 down to zero in 2012. The 2012 outlook for some of Hungary's main export partners (especially Italy) is particularly subdued. The 2013 recovery is not expected to be particularly strong (1.3% for the EU, but only 1% for the euro area).

Hungary is especially prone to the aggravation of the sovereign-debt crisis in the euro-area due to its high openness (exports of goods and services at around 86% of GDP), high foreign indebtedness including in foreign currencies (with a large role of Swiss franc denominated debt) and currency mismatches in balance sheets of several economic actors, and high level of public debt relative to other Central and East European EU member countries, among other factors.

The contagion from potential worsening of the situation in euro-area countries is likely to predominantly affect Hungary through the following channels:

- A slowdown in economic activity (especially in industry) in major Hungary's export markets (see below);
- Banking sector channel, where a substantial share of the domestic banking sector is owned by Western European institutions that would be negatively affected and hence less capable to provide funding to Hungarian daughter banks;
- Exchange rate channel would act on several fronts. A large stock on private sector foreign denominated debt and in particular Swiss franc mortgages (CHF-denominated household debt was equivalent to some 16% of GDP in mid-2011) weight on domestic demand. Banking sector may also be negatively affected with non-performing loans rising further beyond already significant level. Further forint depreciation would also increase refinancing risks on external

sovereign debt, while Hungary's refinancing needs for foreign exchange denominated debt are estimated at around EUR 4.6 billion in 2012, and EUR 5.0-5.6 billion annually in 2013-14[43].

Weak growth prospects

In order to strengthen its public finances and improve prospects of external sustainability Hungary would need to embark on a path of sustainable fiscal consolidation and debt reduction. This is hardly possible without a return to a sustainable growth path of the entire economy.

While Hungary has returned to economic growth after a 6.7% contraction in 2009, the pace of growth has remained subdued and its economy still hasn't reached the pre-crisis level output level. A combination of structural factors (including very low labour participation rate and high unemployment, a long period of very weak investment and resulting low real labour productivity) and strong reliance on external demand (mainly EU) do not add up to buoyant growth prospects in the near future. Domestic demand will be depressed by the need to curb fiscal deficits, deleveraging of the private sector, and expected constrained lending by the banking sector due to rising non-performing loans and the reduced ability of foreign parent banks to provide liquidity support to their Hungarian operations. Indeed, there are views that Hungary's potential growth may have weakened to around 2-2.5% per annum or less[44]. Growth forecasts until 2013 (e.g. DG ECFIN Spring 2012 forecast, recent IMF and EBRD forecasts) are well below these levels. For instance DG ECFIN Spring 2012 forecast sees a 1% rebound in 2013 following o 0.3% recession in 2012, still more optimistic than some other sources. With little growth, the debt-to-GDP ratios are likely to remain only minimally below 2011 levels during 2012-2013 despite various one-off fiscal measures[45].

Confidence in economic policy

The series of unorthodox economic policies implemented by the Hungarian authorities during 2011 and the clashes between the government and other stakeholders in Hungarian economy (central bank, banking sector, and international community) have all created an environment where the course of future economic policies in Hungary is increasingly perceived as difficult to predict by domestic and international economic actors. This is likely to exert negative pressure on macroeconomic outlook and external sustainability prospects in general, irrespective of the assessment of direct impact of some actually implemented policy moves.

The generally declining confidence in Hungary's external sustainability has been reflected in the country ratings (Tables 12-14). Hungary started the 2000s decade with substantially better rating than regional peers (Czech Republic, Poland, and Slovakia). Major rating agencies started to lower Hungary's ratings from 2005-2006, and 2008-2010 brought about quite significant downgrades, in contrast to the situation in the Czech Republic, Slovakia and Poland. Among regional peers, Bulgaria and Romania saw their ratings reduced, but much less. The most recent (end-2010 till January 2012) wave of downgrades to below investment grades was related to the assessment of new policy measures of the current government and impact of the euro area crisis.

43 Fitch Ratings press release, 11 November 2011. Cited by portfolio.hu: Fitch cuts rating outlook on Hungary to negative - Country one step closer to junk grade (12 November 2011).

44 IMF, Hungary country reports 11/35 and 12/13. European Commission estimates pointed to even lower values.

45 According to the ECFIN spring 2012 forecast.

Table 12: Deterioration of Hungary's long-term foreign currency rating by Fitch: 2000-2012

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
A-	↔	↔	↔	↓	↓	↓							
BBB+						↔	↓	↔	↓				
BBB									↔	↓			
BBB-											↓	↔↓	
BB+(junk)													↓

Note: arrows denote the rating outlook (positive, stable or negative)

Source: Fitch Ratings.

Table 13: Deterioration of Hungary's long-term foreign currency rating by S&P: 2000-2011

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
A-	↔	↔	↔	↔	↔	↔	↓					
BBB+							↓↔	↔	↓ ↓			
BBB									↓			
BBB-										↓ ↔	↓	↓
BB+(junk)												↓

Note: arrows denote the rating outlook (positive, stable or negative). Bold downward pointing arrows indicate inclusion on the credit watch negative list.

Source: Standard & Poor's.

Table 14: Deterioration of Hungary's long-term foreign currency rating by Moody's: 2000-2011

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
A1			↔	↔	↔	↔	↓					
A2							↔	↔				
A3	↔	↔	↔						↔			
Baa1	↑									↓		
Baa2												
Baa3											↓	
Ba1 (junk)												↓

Note: arrows denote the rating outlook (positive, stable or negative).

Source: Magyar Nemzeti Bank.

4.4 Projections for external sustainability

Q4.3 How is the country's external financial situation likely to evolve in the 5 years following the final disbursement given the likelihood of changes to current conditions?

The question is answered in view of the balance of payment and the debt position of Hungary.

4.4.1 Balance of payments outlook

Given the weak prospects for domestic demand at least until 2013, the current account is expected to remain in surplus to the tune of 2% of GDP during 2012-2013[46]. This baseline scenario assumes dynamic export expansion. The timing of transfers of EU funds imply that capital account should stay in surplus picking at above 3% of GDP during 2012. On current trends, neither FDI nor portfolio investments are likely to pick up from subdued levels seen in recent years and financial account is likely to remain in a small surplus.

46 The exposition draws from the recent IMF analysis published in Hungary country report no. 12/13.

Overall balance is expected to remain positive allowing a further gradual build-up of net foreign reserves. This reflects a combination of relatively weak domestic demand, depreciated exchange rate and internationally competitive export sector. While the balance of payment developments do not appear to reflect a particularly strong Hungarian economy, nevertheless, the risks of balance of payment shocks can be assessed as very small in the period of 5 years following final disbursement of the BoP support.

4.4.2 Debt projections

Given the availability of the current public and external debt analysis carried by the IMF in this section we mainly relay on the IMF's debt sustainability framework[47]. The baseline scenario sees public debt to GDP ratio declining at a very gradual rate, to just above 75% in 2013. Other debt indicators also improve moderately, in particular debt to government revenues ratio falls to below 2009 levels during 2012-2013. The share of foreign currency denominated debt in total debt stays broadly stable over the analysed period (Table15). One the of the key drivers of this outlook is positive current account balance as this moderately optimistic scenario is largely determined by an increase in primary surpluses and the continuation of a relatively small interest rate-growth differential in the coming years.

Table 15: Outlook for selected public and external debt indicators, 2009-2013

	2009	2010	2011p	2012p	2013p
Gross public debt (% of GDP)	79.7	81.3	77.7	75.5	75.1
Gross public debt (% of government revenues)	171	181	193	166	167
Gross public debt (% of GDP)					
Foreign currency denominated gross public debt (% of GDP)	35.5	36.0	37.8	34.4	34.1
Gross financing needs (% of GDP) *	18.7	19.7	21.6	17.9	21.1
External debt (% of GDP)	150	142	141	137	129
External debt/ exports ratio (%)	194	164	150	140	131
Gross financing needs (% of GDP) **	38	39	42	41	40
Gross official reserves (EUR billion)	30.7	33.7	35.3	36.6	37.9
Gross official reserves (% of short term debt at remaining maturity)	84	78	81	82	81
Total external financing requirements (EUR billion)	31.4	35.7	35.5	33.5	36.5
Of which: general government amortisation	4.3	4.7	7.3	9.4	11.7
of which: IMF and EU loans	0	0	2	3.6	4.3

Notes: * Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
** Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
Source: IMF Hungary country report 12/13 and own calculations.

There are more downward risks to the above scenario than upward ones. Keeping the key variables (real GDP growth; real interest rate; and primary balance / GDP ratio) at their historical averages or keeping the primary balance constant from 2010 onwards would result in public debt / GDP ratio increasing rather than declining in the coming years. The future public debt path is also

47 IMF, Hungary country report no. 12/13, January 2012.

highly sensitive to exchange rate assumptions with a 10% forint depreciation leading to an increase in public debt to GDP ratio to the tune of 3-4 percentage points.

The major risks are related to possible exchange rate volatility that would be problematic both for the public sector (that has a significant share of foreign and foreign-denominated debt, as discussed above), the banking sector and households. Although, the risk is mitigated as a significant share of Hungarian banks' foreign debt is in the form of Hungarian banks' borrowing from their foreign parent institutions, problems may emerge due to the large portfolio of corporate and household sector loans in foreign currency. As is evident from the analysis of the rise in nonperforming loans, forint exchange rate depreciation should be seen as an important risk factor.

In summary, based on the information currently available we assess the risks to the external financial situation outlook as *medium.*

5 Impact on structural reforms

5.1 Introduction

In this chapter, we will describe the BoP operation in the context of structural reforms
This evaluation questions on structural reforms are presented in Table 6.1. The structural conditionalities related to the BoP operation are listed in section 5.2. In this section, we will also assess the rational and relevance of the conditionalities. The chapter will then move to a review of the gross impact of conditionality and of the specific contribution of the MFA to their achievement. This will lead to a counterfactual scenario in section 5.4. Finally the complementarities between BOP and other EU and IFI instruments is reviewed and unexpected structural effects are identified.

Table 16: Evaluation question on structural reform and sub questions[48]

Q2.	**To what extent has the BoP assistance been effective in terms of supporting structural reform in Hungary?**
Q2.1	What are the short and medium-term expected structural effects* of the assistance to Hungary?
Q2.2	How relevant are the short and medium-term expected structural effects of the assistance to the needs of Hungary?
Q2.3	To what extent have the short and medium-term expected structural effects* of the assistance to Hungary occurred as envisaged?
Q2.4	What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects?
Q2.5	To what extent have structural effects been enhanced, if at all, by complementarities between the BoP assistance and other EU instruments?

* Or explicit objectives if there have been identified.

5.2 Relevance of structural conditions for BOP operation in Hungary

Q2.1 What are the short and medium-term expected structural effects of the assistance to Hungary?

Q2.2 How relevant are the short and medium-term expected structural effects of the assistance to the needs of Hungary?

The BOP support package predominantly had an emergency character: investor confidence had to be restored to alleviate stress in the financial markets (first objective). The other two objectives of the BOP support package have a longer term horizon: enhancing fiscal consolidation measures and improving fiscal governance; and foster the government’s efforts in financial sector regulation and supervision reforms for a stability oriented and sustainable economic policy. The structural conditionality focuses on achieving those objectives.

Because of its emergency character, the operation was designed in a very short period of time: on 13-14 October 2008, a joint EU-IMF mission to Hungary took place; on November 4 2008, the Council of the EU adopted the decision to make available the assistance. Given the short duration for the design of the assistance given the situation’s urgency, there was limited time to have a

48 See page 10 of the “Guidelines for ex post evaluation of MFA/BOP assistance”, May 2010.

structured discussion on structural reform measures. During the implementation of the programme, conditionality were added. For instance, structural measures were included, especially under Bajnai government.

The emphasis of the BOP assistance to Hungary was on fiscal consolidation and financial sector supervision. The annexes to the (S)MOUs state the Specific Economic Policy Criteria, and categorize them into:
A. Fiscal consolidation
B. Fiscal governance reform
C. Financial sector regulation and supervision
D. Structural reforms.

The conditionality under 'A. Fiscal consolidation' is covered in Chapter 3 of this report. This chapter covers the categories 'B', 'C' and 'D'.

5.2.1 Fiscal governance reform

In response to the feared disruption of Hungary's external financing capacity in October 2008, the Hungarian Government responded with a range of measures, in particular the so-called 12-point action plan. This plan, announced on October 10 2008, included the revitalisation of the fiscal governance reform process through the Public Management and Fiscal Responsibility Law. The law was adopted by Parliament on 17 November 2008.[49]

Other elements of the 12-point action plan were included in the fiscal governance conditionalities of the BoP operation as stated in the annexes to the MOU and three supplementary MOUs. Table 17 below gives an overview.

Table 17: Fiscal governance reform conditionalities

Fiscal governance reform - Conditions in the SMOU
Second tranche
MOU: Adoption by Parliament of the planned fiscal governance reform, including the introduction of medium-term numerical rules and the establishment of independent fiscal bodies.
Third tranche
MOU: Appointment of the members of the Fiscal Council, supported by adequate staffing.
Fourth tranche
MOU: the preparation and deliberation of the 2010 draft budget proposal is based on the procedural rules as established in the new fiscal framework.
SMOU2: Carrying out by end September a review of the budget preparation as well as budgetary control and monitoring procedures against the background of the new Fiscal Responsibility Law, in consultation with the Fiscal Council and the relevant Parliamentary committees, identifying possible improvements.
SMOU3 (first subtranche): on the basis of Act CV of 2008 on the legal status and financial management of budgetary institutions and the amended Public Finance Act, prepare and adopt a new government regulation on the general rules of public finance administration (i.e. the implementing rules of Public Finance Act) revamping the budgetary planning and execution of budgetary institutions in order to increase their efficiency and transparency.

[49] The original proposal for the law was also adjusted in such a way that amendments to the Constitution and the Act of Local Governments were not required (and therefore, a qualified majority was no longer required). As a result, the regulation only covers central government.

Fiscal governance reform - Conditions in the SMOU
SMOU3 (first subtranche): modify the current budgetary process of advance payments by the Government to the final beneficiaries of EU funds (i.e. to establish differentiated advance payment procedures instead of general rules) in order to better target the available sources.
SMOU3 (second subtranche): on the basis of Act CV of 2008 on the legal status and financial management of budgetary institutions and the amended Public Finance Act, prepare and adopt a new government regulation on the general rules of public finance administration (i.e. the implementing rules of Public Finance Act). In order to enhance the proper application of new processes, the authorities make available the necessary technical assistance and resources to budgetary institutions in the context of a targeted project under the State Reform Operative Programme.
SMOU3 (second subtranche): after the treasurers' system has been in place for six months, by 30 April 2010 prepare a review of the results and the proper functioning of procedures and identify possible improvements.
SMOU3 (second subtranche): monitor and report on the methods and average amounts of advance payments to final beneficiaries of EU funds.
SMOU3 (third subtranche): based on the experiences of the implementation of the fiscal responsibility law, identify its possible inconsistencies with the relevant legislation, and make arrangements to resolve them.
SMOU3 (third subtranche): submit to Parliament the 2011 draft budget in full accordance with the prevailing fiscal framework.
SMOU3 (third subtranche): report on the results of changes in the implementation process of EU funded projects and programmes.

The focus of the conditionalities is on the adoption of the law and staffing of the Fiscal Council. The first SMOU did not have additional conditionalities related to fiscal governance reform. The second and third SMOU add a number of conditionalities that focus on the implementation of the Public Finance Act, and on modifying the practice of advance payments to final beneficiaries of EU funds. The conditionalities in the third SMOU were attached to three subtranches. This division of the last tranche was initiated to better align disbursements of instalments with EC/IMF reviews.

Based on the interviews and the Delphi questionnaire, we can conclude that the fiscal governance conditionality was deemed relevant at the time.

5.2.2 Financial sector regulation and supervision

High public debt levels and declining market sentiment due to the global economic crisis led to non-residents selling off government paper in October 2008. A bond auction to generate financing did not succeed to interest buyers. At that time, non-residents were holding about 40% of total forint-denominated government securities. The sell-off led to pressure in the market for FX swaps – matching liquidity needs by domestic banks with forint demands by non-residents. The unbalanced FX market in turn posed a risk to the liquidity position of banks. In October 2008, the Hungarian Financial Supervisory Authority (HFSA) – which monitors banking sector liquidity on a daily basis – did not identify solvency problems or a worrisome portfolio of non-performing loans, but there were rumors that the largest Hungarian bank, OTP, has difficulties rolling over a large FX swap position. The majority of the banks in Hungary are foreign-owned, implying a potential risk to foreign parents banks and contagion to the euro area in case of liquidity problems.

In this context, the BoP operation was accompanied with conditionalities relating to strengthen the financial sector. Table 18 below gives an overview of the conditionality on financial regulation and supervision linked to the assistance as stated in the annexes to the MOU and three supplementary MOUs.

Table 18: Financial sector regulation and supervision conditionalities

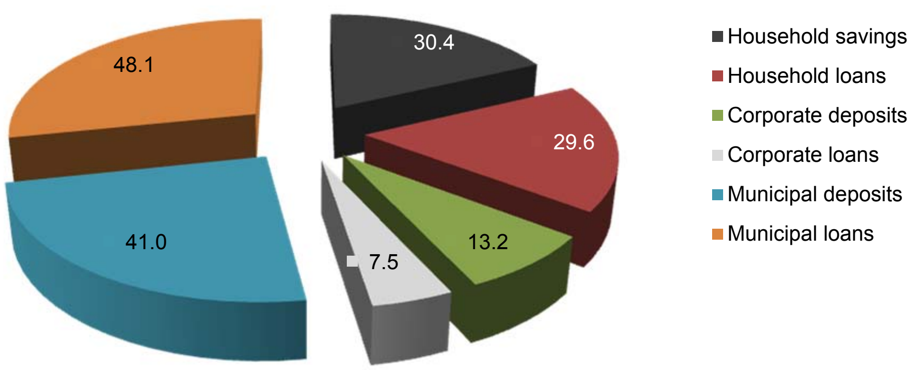
Financial sector regulation and supervision - Conditions in the SMOU
Second tranche
MOU: Introduction of a support package for the domestic banking sector in line with agreed EU principles and in conformity with the guidance provided by the Commission on the application of EU state aid rules.
MOU: Adoption of measures to carefully monitor banks' funding needs so as to enhance the capacity to support banks in case of need. In this context, the authorities will: 1) monitor closely the commitment of foreign banks to support their Hungarian subsidiaries; ii) establish a special fund to guarantee the rollover of loans and wholesale securities against an appropriate fee with proper monitoring of actual guarantees.
MOU: Strengthen financial sector supervision through: i) initiation of the creation of a positive credit registry for households; ii) making the necessary changes to the Central Bank Act to allow the MNB to request disaggregated data on individual banks to adequately analyse credit risks; iii) close monitoring of banks' foreign currency exposure both directly and indirectly through their clients' credit risk; iv) enhanced cross-sectoral risk analysis by financial supervisors.
MOU: Seeking an agreement with commercial banks that facilitates the restructuring of household debt by means of adjustments in the maturity and repayment schedule of the debt, also including the option to convert to foreign-currency loans into loans, thereby mitigating the large household foreign currency risk.
Third tranche
MOU: Take measures to strengthen financial sector supervision and regulation. These measures would notably include: i) enhanced oversight of insurance and credit brokers and their products; ii) measures to ensure prudent loan-to-value ratios for mortgage loans and loan-to-income ratios for household credit.
MOU: Take measures to further strengthen the HFSA's and MNB's capacity to assess and address solvency and liquidity concerns in banks in a timely manner. This would notably involve: i) establishing a mechanism for early remedial actions, including effective emergency powers for the HFSA; ii) improving the efficiency of the bank resolution regime to facilitate the payments to depositors in case of need.
SMOU1: Revision of the Financial Stability Act, in line with agreed EU principles and in conformity with the guidance provided by the Commission on the application of EU state aid rules, including such amendments as: i) aligning the expiration date of the recapitalisation measure with that of the guarantee measure; ii) specifying that the option granted to stakeholders of a troubled bank to sell their share to the state should be exercised at a price reflecting the current and prospective conditions of the bank as determined by an independent third party jointly selected by the central bank and the HFSA.
Fourth tranche
MOU: Take measures to strengthen cross-border supervision and communication between the supervisory authorities in home and host countries. This requires a structured exchange of information between the HFSA and the supervisory authorities of the home countries of the major foreign banks present in Hungary, including in the context of colleges and supervisors, as well as regular meetings to review the situation in each bank, including joint stress tests and onsite inspections as needed.
SMOU2: Make further progress in the area of financial sector regulation and supervision. In particular, i) complete the approval by the Parliament of the bill amending the Hungarian deposit guarantee scheme (containing the transposition of the provisions set out in Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay), and ii) amend the Financial Stability Act to ensure that it is clear that the auditor under Act CXII of 1996 on Credits Institutions.
SMOU2: To ensure compliance of measures adopted in support of the financial sector with agreed EU principles and the guidance provided by the EU competition authorities (European Commission), timely inform the Commission in due form of such measures.
SMOU3 (first subtranche): Ensure timely notification of state-aid measures adopted in support of the financial sector to the Commission and their compliance with the agreed EU principles and the guidance provided by the Commission. In particular, the Hungarian authorities will make strong efforts to regularize the case of government capital injection to the FHB (by March 2010), in close cooperation with the

Financial sector regulation and supervision - Conditions in the SMOU
Commission services.
SMOU3 (first subtranche): the Hungarian Financial Sector Authority (HFSA) will take measures to strengthen its consumer protection arm in line with the Draft HFSA Law, expected to be approved by the Parliament in late 2009. In this context, the HFSA Board will adopt the Consumer Protection Strategy and the 2010 Action Plan by end-2009.
SMOU3 (second subtranche): the HFSA continues to enhance on-site inspections, particularly with a focus on credit quality and provisioning, and will complete reports on examinations of three large banks by end-March 2010.
SMOU3 (second subtranche): the HFSA will reflect on 2009 external audit recommendations on improving consumer protection by adopting an action plan for implementing the audit recommendations by end-April 2010.
SMOU3 (third subtranche): the HFSA will finalize Basel II Internal Rating based validation examinations for credit risk and/or operational risk, in cooperation with respective home supervisors, in at least four foreign subsidiaries by end-June 2010.
SMOU3 (third subtranche): the HFSA continues to enhance on-site inspections, particularly with a focus on credit quality and provisioning, and will complete reports on examinations of six large banks by the end-August 2010.

Based on the interviews and the Delphi questionnaire, we can conclude that the financial sector conditionality was deemed relevant at the time. As the Hungarian financial market was potentially at risk but at the time Hungarian and foreign banks were still well capitalized, the conditionality related to financial sector regulation and supervision were preventive rather than corrective, focusing for instance on surveillance of FX-loans. Moreover, the emphasis was on supervision rather than regulation. The focus of the conditionality was on support to the domestic banking sector in case of need, safeguarding that foreign banks did not withdraw from Hungary, and strengthening capacity in banking supervision institutions HFSA and the Bank of Hungary.

The support package for the domestic banking sector was targeted at OTP bank, as the perception existed that this bank had trouble rolling over a large FX swap position. Quite unusual for the region, this domestic bank held dominant positions in market shares at the end of 2008 (see pie chart below). In February 2008, French insurance company Groupama purchased OTP's insurance branch - Garancia - from OTP Bank together with its wholly-owned insurance subsidiaries in Bulgaria, Romania and Slovakia. Groupama also committed to acquire up to 8% of the existing

Market shares of OTP in credit supply in Hungary, end of 2008



shares of OTP Bank.[50] Therefore, OTP was well capitalized at the time of the crisis, although the bank may not have had adequate forex at its disposal at the time it had to roll-over the large swap position. During 2008, Moody's and Standard & Poor's downgraded Hungary, with the result that OTP's credit rating also deteriorated. Moody's end of 2008 rating for OTP was A3, S&P's rated the Bank BBB, in both cases with a negative outlook. Reduced risk appetite led to a drop in OTP's stocks with 67.3% in value in 2008, to HUF 2,785 at the close of the year.[51] Given its systemic nature, the Hungarian authorities provided a lending to OTP Bank, which it fully repaid in 2009.

Stakeholders have different views on the relevance of the conditionality to strengthen the consumer protection arm of the Hungarian Financial Sector Authority (HFSA) in line with the draft HFSA Law. This specific conditionality is not considered as relevant as the other financial sector conditionality.

5.2.3 Structural reforms

As mentioned, structural reforms were not emphasized in this operation and in the design phase only detailed structural measures linked to the second tranche were included in the MOU. The structural reform conditions were in a later stage of the operation linked to one of the primary objectives of the BOP operation: fiscal consolidation. Conditionality focused on improving the financial sustainability of the social support and the pension systems. It also included adoption of revenue-neutral tax reforms aimed at reducing the tax wedge on labour and bolstering economic growth.

Table 19 below gives an overview of the conditionality on structural reforms linked to the assistance as stated in the annexes to the MOU and three supplementary MOUs.

Table 19: Structural reforms conditionalities

Structural reforms - Conditions in the SMOU
Second tranche
MOU: Adoption by the Parliament of the legislation in the context of the "Pathway to work", which includes the reorientation of some resources of the Labour Market Fund from passive towards active labour market policies and is expected to be included in the National reform Programme of November 2008.
Third tranche
SMOU1: Submission to the Parliament of a draft law aiming to improve the financial sustainability of the pension system, including: i) a move to increase the weight of inflation-related adjustment in the indexation mechanism; ii) the abolition of the 13th month pension for new beneficiaries; iii) containing the size of the last phase of the pension correction programme; and iv) a 3-year increase in the mandatory retirement age between 2016 and 2025.
SMOU1: Submission to the Parliament of draft laws to improve the financial sustainability of the social support system, including: i) the tightening of eligibility for housing subsidy programmes and reducing interest subsidies for housing loans as well as ii) the achievement of savings by reforming the cash support system for the first years of parenthood, also by taking into account the time during which the eligible person has been employed when defining the length of the salary related child allowance (GYED).
Fourth tranche
MOU: Take further steps to improve the sustainability of the pension system and based on the expert work of the Roundtable on pension issues present options of possible future steps.
SMOU1: Adoption to the Parliament of a draft law aiming to improve the financial sustainability of the pension system, including: i) a move to increase the weight of inflation-related adjustment in the indexation

[50] OTP Bank & Groupama, Extraordinary announcement, 11 February 2008.
[51] OTP Bank, Annual Report 2008.

Structural reforms - Conditions in the SMOU
mechanism; ii) the abolition of the 13th month pension for new beneficiaries; iii) containing the size of the last phase of the pension correction programme; and iv) a 3-year increase in the mandatory retirement age between 2016 and 2025.
SMOU1: Adoption to the Parliament of draft laws to improve the financial sustainability of the social support system, including: i) the tightening of eligibility for housing subsidy programmes and reducing interest subsidies for housing loans as well as ii) the achievement of savings by reforming the cash support system for the first years of parenthood, also by taking into account the time during which the eligible person has been employed when defining the length of the salary related child allowance (GYED).
SMOU2: In line with the programme of the new Government published on 21 April 2009: Adoption by Parliament of draft laws to further improve the financial sustainability of the social support system, including: i) reduction in the illegible age of family allowance from 23 years to 20 years; ii) limiting the length of the cash support system for parenthood to a maximum of two years.
SMOU2: In line with the programme of the new Government published on 21 April 2009: Adoption by Government of appropriate decrees to further streamline social support schemes, including: i) further tightening in the gas- and district heating subsidy scheme in 2010; and ii) increasing the share of households in paying for the costs of school meal.
SMOU2: In line with the programme of the new Government published on 21 April 2009: Adoption of decisions by the Government and amendment of relevant laws by Parliament to underpin the foreseen reduction in local government's expenditure of HUF 120 bn.
SMOU2: In line with the programme of the new Government published on 21 April 2009: Adoption of revenue-neutral tax reforms aimed at reducing the tax wedge on labour and bolstering economic growth, including: i) lowering social security contributions and cutting the personal income tax by increasing the tax brackets, as well as ii) the increase in consumption and wealth related taxes.
SMOU3 (first subtranche): Continue to implement appropriate measures to ensure the realization of the planned durable savings in the area of long-distance public transport with a view to underpin the reduced budgetary appropriations of at least HUF 30 bn. In particular, tariffs will be increased and subsidies reduced. Moreover, redundant railway lines will be suppressed as announced.
SMOU3 (second subtranche): Continue to implement appropriate measures to ensure the realization of the planned durable savings in the area of long-distance public transport with a view to underpin the reduced budgetary appropriations of at least HUF 30 bn. In particular, steps will be taken to achieve efficiency gains and savings (including on public procurement and staff costs). Progress will be measured against steps taken at the company level and the financial outcome in Q1 2010.
SMOU3 (third subtranche): Continue to implement appropriate measures to ensure the realization of the planned durable savings in the area of long-distance public transport with a view to underpin the reduced budgetary appropriations of at least HUF 30 bn. Progress will be measured against steps taken at the company level and the financial outcome in H1 2010.

Interviews and the Delphi questionnaire show that the conditionality on improvements to the financial sustainability of the pension system and the social assistance system are assessed as most relevant at the time. The structural reforms on the adoption on the Pathway to work was considered less relevant at the time.

5.2.4 Conclusions

The rationale behind the choice of the conditions was straightforward:
- The lack of solid fiscal governance was regarded as one of the root causes for fiscal slippages and Hungary's bad track record in fiscal policy;
- The financial sector regulation and supervision conditionality were aimed to prevent bank liquidity problems which – given the large share of foreign owned banks – posed the risk of

contagion to the European countries in which the parent banks were located as well as to OTP's subsidiaries in the Baltics, Slovakia, Romania, Bulgaria and Ukraine. The financial sector conditionality was preventive in nature;

- The structural reform conditionality was aimed at supporting fiscal consolidation in the medium and long term.

In hindsight, stakeholders find the areas of selected conditionality relevant, and, in general, they also assess the specific measures as relevant. The structural conditionality that stakeholders perceive as the most relevant are the improvements to the financial sustainability of the pension system and the social assistance system. Stakeholders have different views on the relevance of the conditionality to strengthen the consumer protection arm of the Hungarian Financial Sector Authority (HFSA) in line with the draft HFSA Law. The majority of stakeholders do not consider this conditionality the most relevant at the time.

5.3 Gross impact – actual structural reform outcomes

Q2.3 To what extent have the short and medium-term expected structural effects of the assistance to Hungary occurred as envisaged?

5.3.1 Review missions

The mission reviews conclude that the implementation of policies that were covered by the MOU (linked to the first instalment), SMOU1 (second instalment was disbursed upon signing) and SMOU2 (third instalment was disbursed upon signing) were (broadly) satisfactory. At the time of the November 2009 mission, the Hungarian authorities had indicated that – in view of improved access to market financing – it was not their intention to draw on the IMF assistance upon completion of the current review, nor would they request disbursement of the EU funds. Nevertheless, it was agreed to divide the remaining tranche into three subtranches, with separate conditionality for each subtranche that would give guidance and provide stability. The fourth review (3-15 February 2010) indicates that progress was also made in a number of conditions stated in the SMOU3 but that some conditionalities required attention. The EC postponed the conclusion of the fifth review (6-17 July 2010), following differing views on in particular fiscal consolidation measures with the Fidesz majority government that won the elections in May 2010. Most notably, the review points at the temporary nature and potential negative effects on the investment climate of the introduction of a financial sector levy. The Fidesz government introduced this levy to correct budgetary slippages. In addition, several draft laws proposed by the government were potentially not in compliance with EU law. Moreover, most structural reforms in the transport sector – designed to lead to budgetary savings – were postponed. The EC therefore left the conclusion open pending a later mission but no other mission took place before the BOP assistance expired in November 2010, as it became clear that the government did not intend to make policy adjustments.

5.3.2 Unrealised conditionality

Given that most conditionality was implemented at the time of the operation, we will highlight those specific conditionality that were not (fully) met:

Financial sector conditionality: Introduction of a support package for the domestic banking sector; and establish a special fund to guarantee the rollover of loans and wholesale securities. The domestic banking sector support package was adopted by Parliament in December 2008 and approved by the Commission in February 2009. The support package consisted of two components: the Capital Base Enhancement Fund; and the Refinancing Guarantee Fund. The latter turned out to be ineffectively designed since the guarantee credit rating was linked to the sovereign credit rating. Hungary's low credit rating therefore automatically led to a low credit rating for the guarantee. The fund was designed by the Hungarian authorities and the IMF, based on countries with a higher sovereign rating. The EC review concludes that the condition is met, but that amendments to the guarantee scheme might be necessary to make it fully operational.[52]

As the guarantee fund was unattractive to banks, the Hungarian authorities used part of the first IMF-tranche for direct on-lending to three domestic banks (see table below). On-lending by the government to banks contradicted EU state-aid regulation. The second SMOU included the conditionality to ensure compliance of measures adopted in support of the financial sector with agreed EU principles and the guidance provided by the EU competition authorities, and to timely inform the Commission in due form of such measures. OTP repaid the loan in 2009; state-owned development bank MFB and state-owned mortgage-bank FHB will repay their loan this year.

Table 20: On-lending to banks

Loan	Amount (bn EUR)	Maturity date
OTP loan	1.5	repaid
MFB loan	0.6	11 November 2012
FHB loan	0.4	11 November 2012

Financial sector conditionality: Improving the efficiency of the bank resolution regime to facilitate the payments to depositors in case of need.

Strengthening of the bank resolution regime to provide safeguards in case a domestic bank went bankrupt was included in the MOU and linked to the third instalment. The IMF provided technical assistance in September 2009. The law was amended to improve the bank resolution framework, submitted to Parliament but was never adopted and withdrawn in 2010. This was predominantly a legal issue, relating to property rights as laid down in the constitution. The HFSA, MNE, and NMB are working on the resolution framework.

Structural reforms: Continue to implement appropriate measures to ensure the realization of the planned durable savings in the area of long-distance public transport with a view to underpin the reduced budgetary appropriations of at least HUF 30 bn.

Reform of public transportation was linked to the third SMOU (signed in January 2010), but limited progress was made during the operation. The incoming government introduced the Széll Kálmán plan which identifies public transportation as one of the areas in which structural reform is needed. Limited progress has been made since.

5.3.3 Ex post developments in conditionality

When the operation expired, the Commission agreed with the authorities to monitor Hungary under post-programme surveillance and missions were carried out in the Spring and Fall of 2011. For subsequent BOP operations in EU member states, post-programme monitoring was included in the MOU. Post-programme monitoring activities were coordinated with the Commission's regular activities that continued to take place in Hungary: EU fiscal surveillance, the macroeconomic forecast exercises in the Spring and Autumn, and Europe 2020 (the EU's growth strategy for the coming decade).

During the last phase of the operation and the post-programme monitoring period, some specific conditionality was met at the time of the operation, was reversed. Therefore, the impact of these

[52] Community Balance of Payments Assistance Hungary – Review of the 2nd installment.

reforms is low, despite it having been implemented during the operation. Most notably, the following policy shifts were implemented:

- the staffing of the Fiscal Council was changed and now consists of the chairman of the State Audit Office, the MNB governor, and member appointed by the President.
- The Pension Fund was reformed under the program with the abolition of the 13th month, increase in the retirement age and a change in the indexation mechanisms. In the last year, the private pillar of the pension fund was abolished.
- A bank levy was introduced, and schemes to aid FX mortgage holders which negatively affect the banking sector and investor confidence.
- The early parenthood allowance (maternity leave) – under the operation reduced from 3 to 2 years – was again raised to 3 years.
- Plans exist to change the institutional set-up of the HFSA – which was established as an autonomous institution under the operation.

5.4 Counterfactual

Q0. "How would the economy of the recipient country have evolved in the absence of the assistance?"

In this section, we aim to identify "which reforms would have been implemented in the absence of an EU/IMF package so that we can derive possible scenarios for the dynamics of structural reforms in case no BoP assistance to Hungary would have been provided. It may be expected that those reforms that were already prioritised by the government have a higher chance of implementation than those that were not prioritised. Our sources of the counterfactual scenario are the interviews and Delphi questionnaire.

Fiscal governance reform

The fiscal governance conditionality had been on the government agenda. The deterioration in public finances in the spring of 2006, in the run-up to general elections, sparked a renewed interest in containing overspending by introducing permanent fiscal rules and an independent fiscal institution.[53] The Fiscal Council and implementation of regulation to curb spending had been on the government agenda, but political momentum was needed to realize implementation. It is therefore likely that these reforms would also have been implemented in a counterfactual scenario without BoP.

Reform in financial sector supervision and regulation

Financial sector supervision and regulation conditionality were to a lesser extent on the priority list of the government prior to the EU/IMF operation. The introduction of the preventive support package for the domestic banking sector was one of the core components of the operation to restore investor confidence. It is unlikely that this specific conditionality would have been implemented without the package.

Strengthening the HFSA was also not a government priority before the operation: conditionality included monitoring banks' funding needs, granting the HFSA special remedial powers to accelerate the resolution of any failed bank, and building capacities to perform on-site inspections. In a counterfactual scenario without the EU/IMF operation, it is likely that the conditionality on financial sector supervision and regulation would have had less priority.

[53] see Romhanyi, 2007, and Kopits, 2007.

Other structural reforms

The structural reform measures had been present in the political domain for quite some time, as reflected by the National Action Programme (NAP) for Growth and Employment 2008-2010, drawn up by the Hungarian authorities. The Excessive Deficit Procedure– in place since 2004 – and Convergence programme reports further emphasized fiscal consolidation measures in the medium-term. The Bajnai government used the political momentum and the caretaker- nature of the government to reform the pension system (by abolishing the 13th month pension, introducing an indexation-based mechanism, and increasing the retirement age by 3 years) and reform of the cash support system for the first years of parenthood (by reducing the maternity leave from 3 to 2 years). In a counterfactual scenario, these reforms would probably have been implemented by this government. The Orbán government however introduced policy shift in both these areas. Not all structural reforms were on the government agenda; restructuring public transportation had less priority. The Széll Kálmán Plan again highlights the structural bottlenecks: the functioning of the labour market, the pension system, public transportation, higher education, health care financing, and local government financing.

Summary

The table below summarizes the counterfactual assumptions per conditionality.

Table 21: Counterfactual assumptions per conditionality

Conditionality	Counterfactual	Comments
Fiscal governance reform		
Adoption of reform, appointment of Fiscal Council, and preparation of budget in line with new fiscal framework	Would probably have been implemented.	This had been on the government agenda, but the set-up may have been different and political momentum was needed to realize implementation.
Adoption of new government regulation on the general rules of public finance administration	Would probably have been implemented.	This had been on the government agenda, but the set-up may have been different and political momentum was needed to realize implementation.
Financial sector supervision and regulation		
Introduction of support package for the domestic banking sector	Would not have been implemented.	Financial support package was not available in a counterfactual scenario.
Adoption of measures to carefully monitor banks' funding needs to support banks in need: i) commitment by foreign by foreign banks to support Hungarian subsidiaries; ii) establish a guarantee fund	Would have been implemented partly.	The first component would not have been implemented as no financial support was available in a counterfactual scenario. The second component would have been implemented.
Strengthen financial sector supervision (household credit registry, monitoring of credit risk, prudent ratios for mortgages and household credit, deposit guarantee scheme, on-site inspections)	Would probably not have been implemented.	This conditionality would probably not have been implemented in a counterfactual scenario as it was not on the government's agenda.
Take measures to further strengthen the HFSA's and MNB's capacity to assess and address solvency and liquidity concerns in banks in a timely manner	Would not have been implemented.	This conditionality was only partially met and would also not have been implemented in a counterfactual scenario as it was not on the government's agenda.

Revision of the Financial Stability Act, in line with agreed EU principles	Would probably not have been implemented.	Not regarded as priority by the government.
The Hungarian Financial Sector Authority (HFSA) will take measures to strengthen its consumer protection arm in line with the Draft HFSA Law	Would probably not have been implemented.	Not regarded as priority by the government.
Structural reforms		
Adoption of Pathway to work, moving from passive to active labour market policies	Would have been implemented.	Part of the NAP, and part of the measures recommended as part of the EDP.
Improve the financial sustainability of the pension system	Would have been implemented.	Part of the NAP, and part of the measures recommended as part of the EDP.
Improve the financial sustainability of the social support system	Would have been implemented.	Part of the NAP, and part of the measures recommended as part of the EDP.
Adoption of revenue-neutral tax reforms aimed at reducing the tax wedge on labour and bolstering economic growth	Would have been implemented.	Part of the NAP, and part of the measures recommended as part of the EDP.
Implement durable savings in the area of long-distance public transport.	Would probably not have been implemented.	On government agenda, but difficult to tackle.

In summary, the most likely counterfactual scenario in terms of implementation of reforms would have been:

- implementation of those structural reforms on which consensus existed that these were needed but for which previously no political momentum existed, e.g. the abolition of the 13th month pension and the allowances for early parenthood;
- implementation of gentlemen's agreement between Central Bank and foreign parent banks to not decrease exposure to their Hungarian subsidiaries;
- less priority for financial sector supervision and regulation reforms;
- no support package for the domestic banking sector.

5.5 Net impact on structural reforms

The following generic question will guide our analysis of the net impact of structural reforms:

Q2.4. What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects?

Table 21 presents the conclusions on the net effect of the BOP operation. The net effect distinguishes between two possible effects:

- *The fact that the conditionality was linked to the BOP operation raised the reform on the policy agenda:* the conditionality put the reform on the government's agenda;
- *The fact that the conditionality was linked to the BOP operation speeded up the reform process:* the conditionality led to a verifiable speeding up of reform implementation.

The effects do not exclude one another.

Starting from the gross impact and the constructed counterfactual scenario, the table below gives the results of the net impact of the EU/IMF BOP operation. The net impact of the BOP operation on the implementation of reforms can be summarized as follows:

- the operation speeded up the implementation of fiscal governance reform. However, policy shift was introduced by the Orbán government, lowering the net impact in the medium-term;
- the operation had a distinct value-added in the implementation of financial sector supervision conditionality. The operation raised financial sector supervision in the policy agenda and preventive measures were introduced for the banking sector that would not have been introduced without the BOP operation. The bank resolution regime was and is however not implemented, and the initial guarantee fund was not effective and remained unused;
- the operation provided external pressure that speeded up the implementation of structural reforms that had long been on the government agenda. The caretaker Bajnai government had political momentum to implement some of those structural reforms. However, policy shift was introduced by the Orbán government in certain areas, lowering the net impact of the operation in the achievement of reforms. Reforms to implement sustainable, long-term savings in the public transport sector were not achieved.

The table below summarises the net effects of the BoP operation on the implementation of structural reforms. The second and third column indicate the nature of the effect. The fourth column indicates in which instances the reform was implemented during the operation, and the new government introduced policy shift after the end of the operation (indicated by the minus in the table). In the case of policy shift by the new government, the net impact in the medium term is low even though the reform was implemented under the operation.

Table 22 Net impact of BOP operation

Conditionality	Raised the reform on the agenda	Speeded up the reform	Policy shift by new government
Fiscal governance reform			
- Adoption of reform, appointment of Fiscal Council, and preparation of budget in line with new fiscal framework		+	-
- Adoption of new government regulation on the general rules of public finance administration		+	-
Financial sector supervision and regulation			
- Introduction of support package for the domestic banking sector	+		
- Adoption of measures to carefully monitor banks' funding needs to support banks in need: i) commitment by foreign by foreign banks to support Hungarian subsidiaries; ii) establish a guarantee fund	+		
- Strengthen financial sector supervision (household credit registry, monitoring of credit risk, prudent ratios for mortgages and household credit, deposit guarantee scheme, on-site inspections)	+	+	
- Take measures to further strengthen the HFSA's and MNB's capacity to assess and address solvency and liquidity concerns in banks in a timely manner	Limited gross impact	Limited gross impact	
- Revision of the Financial Stability Act, in line with agreed EU principles	Unclear	Unclear	
- The Hungarian Financial Sector Authority (HFSA) will take measures to strengthen its consumer protection arm in line with the Draft HFSA Law	+	+	
Structural reforms			
- Adoption of Pathway to work, moving from passive to active labour market policies		+	
- Improve the financial sustainability of the pension system	+	+	-
- Improve the financial sustainability of the social support system		+	-
- Adoption of revenue-neutral tax reforms aimed at reducing the tax wedge on labour and bolstering economic growth		+	-
- Implement durable savings in the area of long-distance public transport.	No gross impact		

5.6 Impact of complementarity with other EU instruments

The discussion in this section is built around the following generic evaluation question:

Q2.5. To what extent have structural effects been enhanced, if at all, by complementarities between the MFA and other EU instruments?

Throughout the BoP assistance implementation, attention was paid to make sure that the conditionality was in line with EU's regular fiscal surveillance through annual convergence programmes under the SGP, and the EDP that Hungary is subject to. The regular fiscal surveillance allowed the EC and the Hungarian authorities to maintain a dialogue on fiscal consolidation. In addition, the EC introduced post-programme monitoring for the BoP assistance, which became an integrated part of the MOU in later operations.

The BoP assistance had limited interaction with structural funds as the latter have different objectives and emphasis. Although there is no indication that structural effects have been enhanced by complementarity between BoP and other EU instruments, there was a macroeconomic interaction. In order to mitigate the impact of the crisis, advance payments from Structural Funds were raised from 25 to 40% and national co-financing rates were lowered in Cohesion Fund projects. Section 7.3 further elaborates on this interaction.

5.7 Unexpected impact on structural reforms

This section focuses on the unexpected impact of the BoP operation on structural reforms and is guided by the following generic evaluation question:

Q3.2. Has the assistance given rise to any unexpected short and medium-term structural effects? What were they and how did they occur?

During the intermediate phase, no indications about unexpected short and medium-term structural effects induced by the BoP operations have emerged.

6 Structural reforms: case studies

6.1 Selected case studies

Two case studies are selected that focus in detail on key conditions included in the SMOU and that are directly related to the objectives of the operation: *By supporting the sustainability of Hungary's balance of payments, the assistance will help the country to make progress with fiscal governance, financial sector regulation and supervision reforms and other measures to support a prudent stability oriented, and sustainable economic policy.*

In accordance with the selection criteria specified above, two case studies have been selected in the domain of fiscal governance and the domain of financial sector supervision. The table below includes the details of the two selected case studies.

Table 23: Characteristics of selected conditions proposed for case studies

	Fiscal governance	Financial sector supervision
BoP conditionality	Appointment of the members of the Fiscal Council (FC), supported by adequate staffing. (MOU, third instalment)	Take measures to further strengthen the HFSA's and MNB's capacity to assess and address solvency and liquidity concerns in banks in a timely manner. This would notably involve: i) establishing a mechanism for early remedial actions, including effective emergency powers for the HFSA; ii) improving the efficiency of the bank resolution regime to facilitate the payments to depositors in case of need. (MOU third instalment)
Origin and overall rationale	This conditionality was part of the revival of fiscal governance reform, which was part of the government's 12-point action plan. At the request of the opposition, the establishment of the Fiscal Council was included in the Public Management and Fiscal Responsibility Law. The Fidesz government made notable changes to the staffing of the FC.	This conditionality was included as it was part of the 12-point action plan. The conditionality on the resolution regime was one of the few conditionality that was not fully met.
Cross-conditions	IMF	IMF structural benchmark (First Review): - Passage by parliament of the amendments strengthening the remedial powers of the HFSA and bank resolution regime as listed in Par. 20 of the March 2009 LOI - Development of an action plan to strengthen the operational capabilities of the HFSA in the field of on-site bank examinations.
Complementarity with other EC assistance	Recommendation from fiscal surveillance (Council recommendation to end the excessive deficit situation).	None.

6.2 Fiscal Council

Introduction

With regard to Hungary's very poor track record concerning fiscal discipline since 2001 discussions in the expert community began as early as 2006 about the ways of establishing institutional guarantees for securing sound fiscal policy in Hungary.[54] Starting from mid-2006, successive Council opinions on Convergence Programme updates and EDP recommendations had called upon Hungary to reinforce the fiscal governance framework – both rules and institutions. However, implementation did not become feasible before the 2008 crisis and the adoption of the EU-IMF financial assistance programme. Beyond fiscal consolidation, fiscal governance was the focus of the BoP assistance.

Gross impact: the establishment of the Fiscal Council in Hungary

The first Fiscal Council

The Act on Fiscal Responsibility and the Fiscal Council (Act LXXX of 2008) was adopted by the Hungarian Parliament in November 2008. The new legal framework can be interpreted as a regulation containing a permanent (numerical) constraint on the fiscal policy decision makers.[55] The set of rules adopted has the aim to maintain the level of the real value of the central government debt. The nominal value of debt may grow only to the extent of inflation, in any year. With real GDP growth this results in a gradual decline in central government debt relative to the GDP. A reform of fiscal planning should help attain this aim. The new practice of fiscal planning will consist of a rolling three year process. Each year the debt level to be attained three years later will be determined. At the end of the period the actual debt may be different from the one envisaged as the budget act need not react to the cyclical fluctuations of the economic performance or changes in the interest rate levels.[56]

The Act on Fiscal Responsibility provided for the establishing of the Fiscal Council, an institution without precedent in Hungary. According to the law the Fiscal Council consisted of three persons and its work had been being supported by a secretariat consisting of a permanent staff. The Fiscal Council's task was to prepare macroeconomic forecasts, a baseline projection for the budget and provide methodological recommendations for fiscal planning. Relying on its own forecasts the Fiscal Council commented on the budget and supplementary budget bills and on all provisions of law with any possible effect on the budget. The baseline projection of the Fiscal Council was of outstanding importance since that document was meant to serve as the starting point for calculating the level of fiscal debt to be determined three years ahead. The Fiscal Council's power included forming of opinion but it had no legal means to intervene if the submitted bill was not in conformity with the provisions of the law.[57]

The fiscal rule determined in the law was intended to first apply from 2012. A special transitional regulation referred to 2010 and 2011. The consolidated adjusted primary expenditure of the state budget was allowed to increase by up to one-half of the real GDP growth rate. This was expected to keep the real value of expenditures in 2010 at unchanged level and enable a slight increase in it in 2011.[58]

[54] Kopits, G. Fiscal responsibility framework: comments on the Finance ministry proposal. Development and Finance 2007/4, pp. 67-72.; Public Finance Quarterly. 2007/2 thematic issue about fiscal rules.
[55] Baksay, G. and Kiss, P.G.: Act one, act first – the law on fiscal responsibility. MNB Bulletin may 2009. p. 15.
[56] Op. Cit. p. 16.
[57] Op. Cit. p. 16.
[58] Op. Cit. p. 16.

On February 2009 the parliament elected by unanimous vote the three members of the Fiscal Council nominated, pursuant to the law, by the President of the Republic, the President of the MNB and the President of the State Audit Office (each one member).

The goals of the Fiscal Council in practical terms were the restoration of credibility to fiscal policymaking, improving transparency and restoring public debt sustainability. Its independence was guaranteed by unanimous election of its members by the Parliament and the tenure of its members.

According to the Act on Fiscal Responsibility and the Fiscal Council the tasks of the Fiscal Council were defined as follows:
- Preparation of macroeconomic forecasts.
- Preparation of technical projections for the fiscal data.
- Preparation of methodological recommendations concerning fiscal planning, forecasting and impact analyses.
- Preparation of estimations about the fiscal effects of draft budgets, supplementary draft budgets, further any draft laws which may exert influence on external items both following the submission of the draft and before the final voting.
- The Fiscal Council may prepare estimation about the fiscal impact of draft law laws and draft amendments about which the parliament will have to vote according to the standing orders.
- If required, the Fiscal Council provides information on issues under its competence
- For the President of the Republic, the President of the State Audit Office, the Governor of the MNB and the committees of the Parliament.
- The Fiscal Council may inform the committees of the Parliament with tasks involving fiscal issues or the government about its recommendations concerning the observation of the budgetary discipline and the transparency of the budget.
- The Fiscal Council comments the draft laws with implications for accounting.

The evaluation activities at an aggregate level consisted of macro-fiscal projections which were made relying on current legislation; policy proposals were tested with real-time macro-fiscal projections. The toolkit of the Fiscal Council also included at the time long-term sustainability analyses, policy simulations, sensitivity tests. The investigations were helped by an enhanced DSGE model and expert opinion. Evaluation at disaggregate level consisted of real-time costing of mandatory programs, real-time assessment of fiscal risks based on parameter estimates and expert opinion. The FC increased transparency of public finances by publishing its projection methods. From mid-2010, the FC started to prepare impact assessments also for those draft legislative amendments for which the Ministry did not attach budgetary calculations. The members of the Fiscal Council put special emphasis on persuasion through multiple channels: this required simultaneous communication with parliament, government and the general public.[59]

The Fiscal Council had a good start, with competent members, around 35 person staff with excellent skills. The initial phase of operation enjoyed tailwinds by the EU-IMF agreement. The Bajnai government complied with some of the Fiscal Council's assessments. After the spring 2010 elections the incoming Orbán government was less receptive to criticism expressed by the Fiscal Council especially concerning the changes in the accounting rules, the effects of various changes in tax law and the pension reform. An especially critical point was the Fiscal Council's judgement on the effects of the government's tax measures in the medium term. The analysis of the Fiscal Council came to the conclusion that one-off extra taxes (bank levy, sector specific taxes and

[59] Kopits, G.: Independent Fiscal Institutions: Developing Good Practices. Presentation at the 3rd meeting of OECD Parliamentary budget Officials in Stockholm, April 28-29, 2011.

rechanneling of the contributions earmarked for the private pension funds to the state budget) will though make the less than 3% 2011 fiscal target attainable, once these one-off items will be phased out the risk of a recurring high fiscal deficit is large.

The Head of the Fiscal Council, in a speech in the Parliament, drew attention to the fact that the government buried in the small print of the 2011 budget draft that it intends to keep the extra taxes two years longer than originally pledged. A few days after this statement, an MP of Fidesz submitted an amendment to the 2011 budget draft to reduce the Fiscal Council's annual budget to HUF 10 million from the actual HUF 835.5 million. The MP proposed to channel the saved money to the Public Foundation for the Roma living in Hungary. A week later, in another amendment to the 2011 budget draft, another Fidesz politician proposed the cancellation of the remaining HUF 10 million budget of the Fiscal Council. The justification of the proposals was first, that the financial crisis is over, thus the services of the Fiscal Council were not required any longer, and second, that there are too many similarities in the activity of the Fiscal Council, on one hand, and the MNB and the State Audit Office, on the other hand. That makes the work of the Fiscal Council superfluous. On December 6, 2011 the amendments were adopted by the parliament, leaving the Fiscal Council without financing and staff. Soon the formal windup of the Fiscal Council took place.

The second Fiscal Council

Simultaneously a new Fiscal Council was set up consisting of three persons (but without staff and remuneration for the three new members). The regulations concerning the activity of the new Fiscal Council are part of Act CXCIV of 2011 "On the economic stability of Hungary" which came into force on December 30. 2011. According to the new constitution the operational rules of the Fiscal Council can be changed only by qualified (2/3) majority. One member of the Fiscal Council is the Governor of the MNB, the other the president of the State Audit Office and a third member (a reputed expert) is to be appointed by the President of the Republic.

The description of the Fiscal Council's tasks includes that it provides opinion on planning and implementation of the budget, the draft budget and any other issues related to public finances. The only really new field of activity is related to the public debt. Act CXCIV stipulates about the reduction of public debt. The central government budget must be planned in any year with such parameters which guarantee that the rate of growth of the public debt compared to the previous year will not surpass the difference between the forecasted inflation and the half of the real GDP growth rate. This regulation is to foster a gradual reduction of public debt to below 50% of the GDP, a threshold to be reached in the future according to the new constitution. It is important to note, that the above described regulations enforcing debt reduction will come into force only in January 1, 2015, what is beyond the current government's legislation period (the next general elections are due in spring 2014).

Public debt is central issue in the case of the new Fiscal Council. The final vote on the budget draft cannot be implemented before the Fiscal Council testifies that the draft budget is in accordance with the rules stipulating the reduction of public debt. If the Fiscal Council finds the draft budget in contradiction with rules on public debt, the government is obliged to amend the budget draft and the Fiscal Council investigates whether the amended draft is, after the changes, in accordance with the respective regulations. This procedure must be repeated as long as the Fiscal Council will see no more contradiction between the budget draft and the rules stipulating the reduction of public debt. In this construction the Fiscal Council has practically veto right above the budget.

Net impact: changes adopted due to BoP conditionality

Though the establishment of a Fiscal Council had been discussed by experts in Hungary before 2008, the probability that it would have been called into being solely upon the initiative of a

Hungarian government of any political direction is seen as rather low. Therefore, the foundation and launching of the Fiscal Council in a relatively short notice is clearly the result of the BoP conditionality. The first Fiscal Council became right after the beginning of its operation an integrated part of public life in Hungary. While concerning its license the first Fiscal Council's power was limited, the professional prestige of the three members and the staff gave weight to the institution.

The second Fiscal Council borrows its authority from the political weight of two of its members (MNB Governor and President of the State Audit Office). The capacity to evaluate issues relevant for public finances is also borrowed from outside, the staff of the MNB and the State Audit Office. The new Fiscal Council has a very strong licence as it can potentially prevent the adoption of the budget. This leverage coupled with political affiliation of its members bears the risk of serious political conflicts in the future, including the dissolution of the parliament in case of a budgetary stalemate and declaration of new elections. Moreover, given its strong veto-power, the FC should be assigned with more mandatory analytical tasks (e,g, assessment of major fiscal policy proposals outside the budgetary cycle) and supported by the necessary analytical resources to undertake these tasks.

6.3 Bank resolution regime

Introduction

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

We take a closer look at this conditionality as the second part of it was one of the few conditionality that were not met – and is still not implemented.

Rationale

The 2008 crisis in the financial sector revealed the need for reshaping legislation on early remedial actions and resolution regimes in case of bank failure. Existing legislation on bank insolvency was not appropriate in crises – when overnight decisions had to be taken to avoid bank run and systemic crises. Other options – selling off the bank to another bank or bailing them out with tax-payer money – are not always possible due to the size of banks. Some banks have grown substantially in size in recent decades, making them too big to save. The box below discusses the changes that countries have made in their resolution regime legislation since 2008.

As with most financial sector supervision and regulation conditionality, the IMF had a leading role in putting them on the agenda and defining them. The table below outlines the structural conditionality in the Letters of Intent.

Table 24 Structural conditionality in the Letters of Intent

Structural conditionality Letter of Intent	Deadline	Result
Submission to parliament of a law granting the HFSA special remedial powers to accelerate the resolution of any failed bank	SB end-Dec 2008	
Passage by parliament of the amendments strengthening the remedial powers of the HFSA	By end-Dec 2009	Observed (Dec 2009)
Submission to parliament of the amendments strengthening the bank resolution regime	By Feb 12, 2010	Observed (Feb 2010)
Completion of reports on thematic inspections focusing on credit risk and the quality of the loan portfolio for at least 3 banks selected with a systemic risk-based approach	By end-Mar 2010	No review
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	By end-Mar 2010	No review
Completion of reports on thematic inspections focusing on credit risk and the quality of the loan portfolio for two large subsidiaries of a foreign parent	By end-Jun 2010	No review

Design of bank resolution regimes in several countries

Policy makers have several options to deal with failed banks, for instance by letting the bank go bankrupt, with bail-outs using taxpayers' money or by selling the bank to another firm. All these options have disadvantages. The size of today's banks and their complex structure – with subsidiaries across the national or EU border – complicates the matter substantially. Using taxpayers' money will create moral hazard with banks increasing their risk appetite as a safety net is provided by the sovereign guarantee.[a, b] Banks may be too big to save – as in the case of Iceland – in which case the state or another bank does no have the financial capacity to bail them out or buy them.

The legal framework for insolvency that existed in 2008 was not applicable for the challenges at that time. In the US for instance, the legal framework did not cover Lehman Brothers. In 2010, the US Dodd-Frank Act was passed – to extend the reach of the US resolution authority FDIC outside insured depositary institutions only.[a, b] Other countries have also put in place or adapted their legislation. The regime recently introduced in the United Kingdom gives powers to the banking authorities that enable them to take far-reaching and rapid action without the need to seek prior agreement of shareholders or creditors.[c]

The fact that many banks have subsidiaries in other countries – with different regulatory frameworks – may call for a coordinated approach. There is currently no EU harmonisation of laws governing bank resolution. The European Commission is drafting plans for an EU framework for crisis management in the financial sector. Recent discussions focus on the specifications of the so-called bail-in tool, a debt write-down tool that enhances the ability of authorities to resolve large and complex financial organisations.[d]

Sources:
a. Bank Resolution Regimes, Draft briefing note, March 2012, European Parliament.
b. Bank resolution regimes – Comparative analysis, May 2011, Clifford Chance.
c. Brierley, Peter, 2009, "The UK Special Resolution Regime for failing banks in an international context," Bank of England, Financial Stability Paper No. 5.
d. Discussion paper on the debt write-down tool – bail-in, 2011, European Commission – DG Internal Market.

Gross impact

Hungary's legislation on corporate insolvency authorises Hungary's Financial Supervisory Authority (HFSA) to initiate bank liquidation proceedings under the supervision of the courts. The resolution regime lacks a clear framework for restricting shareholders' governance rights and for restructuring techniques such as purchase-and-assumption transactions or bridge banks. A deposit protection scheme is in place and functions as a pay box.[60]

During the BoP operation, progress was made with the conditionality. The EC's review related to the third instalment states that 'as regards the improvement of the bank resolution regime, a bill amending the Hungarian deposit guarantee scheme (containing the transposition of the provisions set out in Directive 2009/14/EC of the European Parliament and of the Council of 11 march 20119) was adopted by the Parliament of 20 May.'

The IMF's Fourth SBA review in December 2009 concludes that 'material but not yet sufficient progress has been achieved to strengthen the remedial action and resolution regime for banks'. By end of December of that year, stronger legal protection for the supervisory commissioner had been implemented, and in October the authorities submitted a set of amendments to the Law on Credit Institutions and Financial Enterprises to Parliament that was passed by December. These amendments:

- Included a stronger regime for the removal of bank executives following criteria;
- Stipulated an additional mandatory threshold for the appointment of a supervisory commissioner (capital adequacy falling below 4%); and
- Stated that only the HFSA has the power to initiate bank liquidation proceedings.

A full legislative proposal of the remedial action and resolution regime for banks was submitted to Parliament in February 2010.

The Letter of Intent of March 2010 concludes that the draft legislation will need to be reintroduced when Parliament reconvenes after the elections in April, and that the authorities will extend of the capital enhancement fund under the financial stability act if approved by the European Commission, allowing the fund to act as a safety net as long as the bank resolution regime is not in place. The bank resolution regime is still not in place in April 2012.

Net impact

Clearly, steps were taken in the area of legislation on the banks resolution regime as a result of the BOP operation. However, given the complexity of the legislation and the limited time scope of the Bajnai government (before the May 2010 elections), the reform has had no impact to date.

The IMF's fourth SBA review concludes that *'in the area of refining and complementing the powers for the use of specific bank resolution techniques progress has been slower than expected, owing to the complexity of the technical work and an overcrowded legislative agenda'.*

In the IMF's fifth SBA review, the authorities conclude that *'although parliament will likely not vote on this legislation before the elections, the completion of such a comprehensive proposal will be a major step towards strengthening the bank resolution regime. Staff will press this issue with the new government after the elections.'*

Clearly, the Ministry of Finance did not prioritize this reform after the elections. This may also have been linked to the fact that the peak of the crisis was behind Hungary and there was no urgent resolution of banks required.

[60] Source: Cihak, M. and E. Nier (2009), The need for special resolution regimes for financial institutions – the case of the European Union. IMF Working paper WP/09/200.

Given its complexity and limited time, this specific conditionality may have been a too ambitious one. Legislative changes often require a substantial time path and may be dependent on factors that can not be foreseen or influenced by the sitting government, such as the outcome of legislations.

Another difficulty with this specific conditionality might be that changing laws on topics like these might adversely affect financial markets and ability of banks to fund themselves from the markets. The European Commission’s DG Internal Market consultation on the bail-in provision for banks takes into account such aspects and is looking into delaying the provision to make sure banks have uninterrupted access to market funding.

7 Design and implementation of BOP assistance

This chapter will address various other aspects relating to the design of the BoP assistance:

- The efficiency of the operation;
- The EU-value added;
- The relation with other EC activities;
- The relation with other international assistance.

7.1 Efficiency of the BoP assistance

The table below shows the first set of evaluation questions relating to the design of the operation. The first sub-question focuses on the influence of the decision-making process in the design and implementation of the BOP assistance. The second sub-question addresses the impact of the design and implementation of the BOP assistance operation on its performance in terms of efficiency and effectiveness.

Table 25: Evaluation question on design and implementation effectiveness and efficiency

Q5. How has the way in which the BoP assistance operation was designed and implemented conditioned its effectiveness and efficiency?
Q5.1 What was the influence of the decision-making process in the design and implementation of the BoP assistance? Q5.2 In what way has the design and implementation of the BoP assistance conditioned the performance of the operation in respect to its cost and its objectives?

Q5.1 What was the influence of the decision-making process in the design and implementation of the BoP assistance?

Due to the emergency nature of the operation, the time available for the decision-making process in the design phase of the operation was quite restricted. Between October 10 and November 4, the operation was initiated, designed, and agreed on. On November 4, the Council of the EU adopted the decision to make available the assistance. In previous macro-financial assistance operations for non-EU countries, the time frame was larger.

The short decision-making process influenced the design and implementation of the operation. Initially, the focus of the operation was on the short-term objective: to alleviate the stress that Hungary experienced on the financial markets. Many conditionality that were related to the medium- and long-term objectives - to make progress with fiscal governance, financial sector regulation and supervision reforms and other measures to support a prudent stability oriented, and sustainable economic policy [61] - were added throughout the implementation of the operation. The reason behind this was that there was no time in the design phase for a structured discussion on a comprehensive package of structural reform measures, nor was the focus at that stage on those longer term reforms. Additional conditionality was laid down in three addenda to the MOU. ECFIN's regular practice is to agree on a comprehensive package of reforms in the design phase of the

[61] Memorandum of Understanding between the European Community and the Republic of Hungary: http://ec.europa.eu/economy_finance/publications/publication13495_en.pdf

operation, which are then reflected by the MOU conditionality. The EC's deviation from its regular practice did not hinder implementation of reforms throughout the operation.
The short-term objective was to a large extent achieved by the agreement on the €20 billion operation itself. The attached structural reforms had the objective to support fiscal consolidation in the longer term, and additional conditionality was included to implement fiscal governance and banking supervision reforms. As such, the structural reforms of the operation were clearly linked to the objective of fiscal consolidation. Once the situation had improved, the gradual inclusion of structural reforms reveals a shift in the design logic of the operation as to address longer-term issues.

Q5.2 In what way has the design and implementation of the BoP assistance conditioned the performance of the operation in respect to its cost and its objectives?

The effectiveness of the operation depended to a large extent on the decision-making process in the design phase. As one of the main objectives of the operation was to restore confidence of financial markets, the calculation of the amount of the operation was key. Initially, only the budgetary financing need was taken into account. During the discussions, the financial experts of the IMF were called in and the potential difficulties with the banking sector were revealed. As a result, the total amount of the package was increased substantially. On top of the calculated financing needs, a credibility buffer was added that should 'shock and awe', i.e. convince the financial markets that a crisis would be averted.

The amount that was drawn from the EU funds, €5.5 billion out of €6.5 billion, was unprecedented in the use of ECFIN's MFA instrument. During 2006-2008, the average annual disbursements of EC's balance of payments assistance (MFA) was €17 million per operation.[62]

The fact that the amount of the assistance was substantially larger than initially foreseen did not adversely affect the efficiency of the operation. Unlike other balance of payments operations that the EU was involved in – in which a mix of grants and loans is provided – the Hungary operation included a loan component only. The repayment schedules of the EU and IMF loans are indicated below. Interest payments are added on top of the principal amounts shown in the table. Loan repayment is recorded as a below the line transaction, therefore not affecting the deficit from an accounting point of view. €2 billion out of €5.5 billion EU loans have been repaid.

The fact that the Hungarian authorities drew only 74% of the funds that were available to them does not justify the conclusion that may be drawn in hindsight that the amount was too high. Agreement on an operation with a smaller size may not have calmed down financial markets and would in that case have resulted in a more costly scenario. Therefore, the contrary conclusion holds: the fact that not all the funds were drawn implies that the amount was adequate.

Table 26 Repayment schedules principal loan amounts

Repayment date / loan	Repayment amount (€ billion)
9 December 2011 / EU	2.0
2012 / IMF	3.7
2013 / IMF	4.4
2014 / IMF	0.7
7 November 2014 / EU	2.0
6 April 2016 / EU	1.5
Total	**14.3**

62 2006: Albania, Bosnia, Georgia, Tajikistan. 2007: Moldova. 2008: Moldova, Lebanon.

7.2 EU value added

The table below focuses on the EU value added of the BOP operation. It is noted that this set of questions is closely related to the questions Q7 and Q8, focusing on the interrelation between the BoP operation, other EC activities and the role of the IMF.

Table 27: Evaluation question on EU value added

Q6. To what extent has EU value added been maximised?
Q6.1 To what extent have the expected benefits from EU intervention been obtained?
Q6.2 What is the value resulting from EU assistance which is additional to the assistance obtained at other levels?
Q6.3 To what extent have the sharing roles between the European Commission (DG ECFIN and other DGs), IMF, Member States and others contributed to optimising the impact of the assistance?

Q6.1 To what extent have the expected benefits from EU intervention been obtained?

The MOU between the Hungarian authorities and the EC includes the general objectives of the assistance. The MOU mentions that the intervention is carried out jointly with the IMF and the WB. As a result, the objectives and the conditionality of the intervention were joint (with the IMF since the WB finally did not provide support). The general objectives of the assistance as phrased by the MOU were obtained.

Q6.2 What is the value resulting from EU assistance which is additional to the assistance obtained at other levels?

Besides the value that the EC added from a financial perspective, the EC's knowledge on budgetary / fiscal issues and the effects of fiscal consolidation measures added value to the operation's design and implementation. The EC also had the lead in some of the fiscal governance conditionality, and in all the structural reforms conditionality. Regular fiscal surveillance allowed the EC and the Hungarian authorities to maintain a dialogue on fiscal consolidation. The EC also added value in the addition of the structural reform package. Following IMF practice, the EC introduced post-programme monitoring for the BoP assistance, which became an integrated part of the MOU in later operations.

A few issues arose that are worth mentioning with regard to the setting of fiscal targets under the operation. Since Hungary had to adhere to the SGP, the fiscal targets under the BOP operation had to be in line with the EDP fiscal targets. Discussions arose between the EC, the IMF and the Hungarian authorities on the validity of applying these targets in the economic situation in Hungary at that time. The operation's target deviated from the EDP target once and the latter was revised accordingly. Implementation of fiscal targets did not alter the implementation of the operation; a similar fiscal path would have been followed without the EDP fiscal target boundaries.

The deadline of the EDP was 2009. The EU therefore made an exceptional decision to extend the deadline by two years instead of one year, to 2011. As it was initially not clear if this extension was possible under existing legislation, some members states criticised a two-year extension.

The third fiscal issue was that - in calculating fiscal deficits - both EC and IMF use an accrual approach. Since the Hungarian authorities reported on a cash basis and on central government fiscal data, arrears were not captured. Local government and state-owned enterprises' finances were not included in the figures. In 2010, this led to differing views between the Hungarian authorities and the EC on achievement of targets. Better quality of fiscal data could have prevented this.

Q6.3 To what extent have the sharing roles between the European Commission (DG ECFIN and other DGs), IMF, Member States and others contributed to optimising the impact of the assistance?
The cooperation between the EU and the IMF was mutually beneficial for the design and the implementation of the BoP operation as there was complementarity between focal areas of expertise: the EU had expertise on fiscal consolidation measures and the details of the budget, as well as on the structural reform conditionality, whereas the IMF had more expertise on financial sector supervision and regulation.

EC and IMF cooperation was also beneficial for the timing of disbursements and repayments: the IMF was able to frontload part of the loan, whereas the EC had a longer repayment window than the IMF does.

A joint EU-IMF operation was also indispensable due to the large amount, which neither of both parties would have been able to provide on its own. The maximum that the IMF can provide is 1,200% of quota. The Hungary BOP operation was the largest operation for the IMF since Korea. As for intra-DG cooperation, DG Competition became involved when part of the funds were used for extending government loans directly to banks, which called for prior examination by DG Competition due to state aid rules. The largest loan – €1.4 billion to OTP – was fully repaid in 2010. Although the mission team was informally aware and in contact with DG COMP on this matter, the Commission, and notably DG Competition, was officially notified by the Hungarian authorities only post-factum, i.e., after the loans were paid out. Good communication is essential in high-profile operations such as the one in Hungary*.*

7.3 BOP assistance vis à vis other EC activities

Table 28 focuses on the relation between the BoP assistance and other EC activities. We distinguish two other EU instruments identified to be relevant to the implementation of the BoP support: (i) Stability and Growth Pact (SGP), (ii) the Structural Funds. As we discussed the SGP / EDP in the previous question, we will focus on Structural Funds.

Table 28: Evaluation question on BoP assistance vis á vis other EC activities

Q7. How does the BoP assistance interact with other Commission activities, such as EDP and regular economic forecasting?
Q7.1 Which other activities did the Commission engage in in Hungary at the time of the BoP operation?
Q7.2 How and to what extent did the BoP assistance interact vis à vis these other EC activities?
Q7.3 What were the unexpected effects of the interaction, if any?

Q7.1 Which other activities did the Commission engage in in Hungary at the time of the BoP operation?
Hungary became eligible for Structural Funds support in mid-2004 when it joined the EU. During the period 2004-2006 almost 20,000 projects were supported from the Structural Funds. In the same period, 47 Cohesion Fund projects were approved by the EC – 25 environment, 9 transport and 13 technical assistance projects.[63]

For 2007-2013, Hungary has been allocated €25.3 billion in total: €22.9 billion under the convergence Objective, €2.03 billion under the Regional Competitiveness and Employment Objective and €386 million under the European Territorial Cooperation Objective.[64] The main

[63] Source: European Commission, "European Cohesion Policy for Hungary". Accessible at http://ec.europa.eu/regional_policy/sources/docgener/informat/country2009/hu_en.pdf
[64] Ibid.

priorities of the Cohesion Policy in Hungary, 2007-2013 includes improved accessibility of key economic centres, greater investment in Research and Development and innovation, better ICT infrastructure, supporting SMEs and improved educational and vocational trainings.

Table 29: Cohesion Funds for Hungary 2007-2013 (€ billion)

Objective	Fund	EU	National Public	Total
Convergence	CF	8.6	1.5	10.1
	ERDF	11.2	2	13.2
	ESF	3.2	0.5	3.7
Total Convergence		**22.9**		
Regional Competitiveness and Employment	ERDF	1.5	0.3	1.8
	ESF	0.5	0.1	0.6
Total Regional Competitiveness and Employment		**2**		
Total European Territorial Cooperation	ERDF	0.4	-	0.4
TOTAL		**25.3**	**4.4**	**29.7**

Source: European Commission, "European Cohesion Policy for Hungary".

To tackle cash flow problems, five Member States including Hungary received additional advance payments in 2010 by increasing the advance payments from the European Social Fund (ESF) by 4% (€145.2 million for Hungary) and from the Cohesion Fund by 2% (€172.8 million for Hungary).[65]

Q7.2 How and to what extent did the BoP assistance interact vis à vis these other EC activities?
The BoP assistance had limited interaction with structural funds as the latter have different objectives and emphasis. There is therefore no indication that structural effects have been enhanced by complementarity between BoP and other EU instruments.

Interaction did take place on a macroeconomic level. In order to mitigate the impact of the crisis, advance payments from Structural Funds were raised from 25 to 40% and national co-financing rates were lowered in Cohesion Fund projects.

Q7.3 What were the unexpected effects of the interaction, if any?
No unexpected results were identified.

7.4 BOP assistance vis à vis IMF assistance

Table 30 focuses on the relation between the BoP assistance and the IMF assistance.

Table 30: Evaluation question on EU BoP assistance vis à vis IMF assistance

Q8. How was the interplay between the EU BoP assistance and the IMF assistance operations?
Q8.1 To what extent was the EU BoP aligned with the IMF assistance in its design phase? Q8.2 To what extent was the EU BoP aligned with the IMF assistance in its implementation phase (e.g. discrepancies between the disbursement of EU and IMF tranches)?

65 European Council (2010), Press release, "Council facilitates access to EU structural funds to counter crisis".

Q8.1 To what extent was the EU BoP aligned with the IMF assistance in its design phase?

As mentioned before, this operation was unprecedented for the EC for a number of reasons and the EC had to reinvent the instrument for this purpose. For the IMF on the other hand, operations such as these are their core business, but the novelty of the operation was the fact that it took place in an EU member state. As a result, the cooperation was mutually beneficial for both institutions. The IMF was better used to the emergency nature of such an operation, including the necessity to design the operation within weeks.

The macro-financial assistance instrument, which is the BoP assistance for non-EU countries, is often criticized for the lengthy process to get approval from all EU member states. IFIs on the other hand are able to approve support more quickly. The meta-evaluation concludes that this potential constraint is a reflection of the EC not being an IFI and of the political nature of the MFA support. [66] In the case of the Hungary operation, the EU managed to obtain Council approval quickly. This may not only be linked to the urgency and the potential contagion effect but also to the fact that there was a Council regulation providing the framework for this type of assistance to non-euro area member states, which did not exist in the case of non-EU countries.

In earlier MFA operations for non-EU countries, the resources from the IMF have been disbursed prior to those of EC's instrument.[64] This was also the case in the Hungary operation. The IMF has the benefit that it has access to funds from members whereas the EU has to raise the funds on the capital market (back-to-back financing). Therefore, the IMF does not have to cope with market constraints; the EU does. In the fall of 2008, Lehman Brothers had just collapsed and this negatively impacted market conditions. Moreover, the EU had not been a major borrower on the capital market for decades. The EU managed to raise the funds (although the first tranche had a relatively short maturity of 3 years). Given the emergency character of the operation, it was therefore vital to have the IMF funds as they were available on a short notice and could be frontloaded. The first IMF funds were disbursed on 6 November; the first EU funds on 8 December.

Although limited in time period, there were discussions with the opposition in the design phase, to gain wider support for the reform package. Nevertheless, after the Fidesz government came to power in May 2010, the fifth review was not concluded notably due to the lack of clarity provided by the government on structural measures to close the deficit. Policy shift occurred during and after implementation of the operation. Little could have been done in the design phase to prevent this.

EC and IMF approach to structural conditionality

In the design phase of the BOP operation, the discussion with the Hungarian authorities on the conditionality was carried out jointly with the IMF. The IMF has extensive experience in operations of this kind in general, and with specific conditionality in particular, especially when it comes to financial sector conditionality. In the design phase of the joint IMF/EC BOP operation, attention was given to ensuring that the IMF conditionality was in line with EU regulations. The structural conditionality is annexed to Letters of Intent (LOI) to the IMF, with separate deadlines per measure. The IMF's reviews under the SBA attach the updated LOI with the structural conditionality measures that should be implemented before the next review. The MOU between the Hungarian authorities and the EC lists structural conditionality for all tranches of the operation and the SMOU adjusts or adds conditionality. Although sometimes slightly differently phrased, conditionality in the LOI and (S)MOU are broadly similar. Different phrasing did not lead to a different interpretation or any other difficulties for the Hungarian authorities. The authorities did not give prominence to one document over the other as they considered them belonging to one singular programme.

Source: Interviews, document review.

[66] Source: Meta-evaluation of Macro-Financial Assistance Operations (MFA) (2004 – 2008); EPEC, 2009.

The design of the conditionality and the inclusion of conditionality in the EU's (S)MOU and IMF's Letter of Intent was closely aligned (see Box).

Q8.2 To what extent was the EU BoP aligned with the IMF assistance in its implementation phase (e.g. discrepancies between the disbursement of EU and IMF tranches)?

From the start of the operation's implementation, attention was paid to alignment of review documents, review missions, and press releases. Progress was made with the alignment of review cycles during the operation's implementation. Cooperation with IMF proved fruitful with regard to establishing the frequency of reviews and speeding up the process. The EC monitors fiscal policy once a year but in the BOP operation, quarterly information was required. Review missions were longer than usual for ECFIN, and discussions and conditionalities more detailed. Repayment schedules were coordinated.

Lessons learnt on aligning EC's and IMF's practices in this operation fed into the subsequent operations in Latvia and Romania.

7.5 Conclusions and recommendations

Conclusions

The BOP operation to Hungary had several novel aspects: it was the first time that the reworked Council regulation was applied, the BoP was last used for EU member states in the first half of the 1990s, and there was a joint leadership with the IMF – rather than just cooperation as in MFA operations.

The operation was clearly effective: investor confidence was restored and Hungary was able to tap into international financial markets again in July 2009. Thanks to the operation, significant progress was made in fiscal consolidation, and reforms in fiscal governance, and financial sector regulation and supervision.

Key to the success of the operation was the ability to respond quickly to address the emergency situation that arose in Hungary in October 2008. Without the operation, the government may not have been able to service its debt, and FX-liquidity shortage at domestic banks may have caused a banking crisis.

Due to the emergency nature of the operation, the operation was designed within four weeks. Conditionality were initially scarce in this operation; on top of the original conditions, further ones for later tranches were added during the implementation phase. This did not negatively affect the effectiveness of the operation; IMF conditionality for later tranches was elaborated only in the course of the programme and this helped to ensure consistency between the conditionality of both institutions. As one of the main objectives of the operation was to restore confidence of financial markets, the calculation of the amount of the operation was crucial. During the discussions on the amounts, at first only the budgetary financing need was taken into account. The amount was increased to include a preventive bank safety net, from which three loans were provided to banks for a total amount of EUR 2.5 billion.

The fact that the Hungarian authorities drew only 74% of the funds that were available to them does not justify the conclusion that may be drawn in hindsight that the amount was too high. Agreement on an operation with a smaller size may not have calmed down financial markets and would in that case have resulted in a more costly scenario. Therefore, the contrary conclusion holds: the fact that not all the funds were drawn implies that the amount was adequate.

The joint character of the operation was mutually beneficial for both the EU and the IMF. The IMF was better used to address the emergency nature of such an operation, including the necessity to design the operation within weeks. The EC had to adjust its practice to the emergency nature of the operation and managed to do so in an adequate manner. The operation was designed within four weeks including Council approval.

EC and IMF cooperation was also beneficial for the timing of disbursements and repayments: the IMF was able to frontload part of the loan, whereas the EC had a longer repayment window than the IMF does.

The EC had value added from a financial perspective – the IMF could not have provided the total amount of the operation. The EU also had a comparative advantage on the fiscal side as EC had expertise on the details of fiscal consolidation measures. Attention was paid to make sure that the conditionality was in line with the EDP that Hungary was subject to. Although the EDP framework sets boundaries for targets, a similar fiscal path would have been followed without the EDP fiscal target boundaries. The operation's target deviated from the EDP target once, and the Council agreed to extend the deadline of the EDP by an exceptional two years. Regular fiscal surveillance allowed the EC and the Hungarian authorities to maintain a dialogue on fiscal consolidation. The EC also added value in the addition of the structural reform package. In line with IMF practice, the EC introduced post-programme monitoring for the BoP assistance, which became an integrated part of the MOU in later operations.

The IMF's involvement had value added for several reasons: from a financing need perspective – to calculate the amount that was required to alleviate stress in the financial markets; from a financial perspective – to increase the total amount that could be provided to Hungary; and from a financial market perspective – to define the conditionality in banking supervision and regulation.

Alignment of EC- and IMF-procedures was learning by doing given the emergency nature of the operation. Throughout the operation's implementation, it was also attempted to align press releases, review and disbursement cycles. Although the conditionality were set out in two distinct documents with different phrasing (the MOU and the LOI), this did not complicate implementation or achievement of conditionality. Given the sensitivity of financial markets to public information, timing of the press releases was important.

As for cooperation, DG Competition became involved when part of the funds were used for direct on-lending to banks which conflicted with state aid regulation. The largest loan – €1.5 billion to OTP – was fully repaid in 2010. Although the mission team was informally informed, the Commission, including DG Competition, was officially informed only after the loan was paid out. Communication between the authorities and the EC, and between DGs is essential in such high-profile operations such as the one in Hungary.

There is no indication that structural effects have been enhanced by complementarity between BoP and other EU instruments. The BoP assistance had limited interaction with structural funds as the latter have different objectives and emphasis. Interaction did take place on a macroeconomic level. In order to mitigate the impact of the crisis, advance payments from Structural Funds were raised from 25 to 40% and national co-financing rates were lowered in Cohesion Fund projects.

The effectiveness of the conditionality attached to the operation was reduced due to policy shift occurred during and after the implementation of the operation. In this regard it needs to be noted that the operation was agreed upon with a minority government. In the design phase, discussions were held with opposition parties in an attempt to gain support. Two changes in government occurred during the operation's implementation and the EC's fifth review was not concluded due to the lack of clarity provided by the Hungarian government on structural measures to close the deficit. No alternative design options are currently available to prevent unwanted policy shift after closure of the operation.

Recommendations

1. This operation was novel for DG ECFIN and quite different from MFA operations in non-EU countries. At the time of the start of the operation, DG ECFIN had to acquire rapidly the full expertise to manage such an operation by itself. Recent years have revealed that the EC had to engage in similar operations for non-euro area countries (Latvia, Romania), and in the course of managing these three operations ECFIN has taken steps to increase its ability to respond adequately. Financial sector expertise was enhanced by ECFIN and additional staff hired to be able to engage in in-depth discussions with the Hungarian authorities alongside IMF experts. ECFIN should indeed cover all policy areas included in the programme, when engaging in such operations, as the EU has rules and responsibilities on a wide range of policy areas (including economic surveillance) and is accountable to its own citizens.

2. The objectives of the operation were both short term (restore confidence and alleviate stress in financial markets) and long term (to make progress with fiscal governance, financial sector regulation and supervision reforms to support the sustainability of the BoP). These objectives are closely aligned as the reforms support fiscal consolidation in the long term, and thereby ensure that financial markets remain calm. It should however be noted that some reforms were not (fully) implemented due to a lack of political will, for instance the bank resolution regime or the reforms in the transport sector. As for the bank resolution regime, significant progress was made, but given its complexity it may have been too ambitious to expect it to be completed during the life time of the programme. Legislative changes often require a substantial time path and may be dependent on factors that cannot be foreseen or influenced by the sitting government, such as the outcome of legislations. In designing the conditionality attached to the operation, the timeline for completion should be clear, identifying what is expected to be completed within the programme horizon and what should be started during the programme horizon but may only be completed later. Ownership of the programme by the government has to be maintained to uphold the credibility of conditionality.

3. Given the particular design of the Refinancing Guarantee Fund by the IMF and the Hungarian authorities, it did not function effectively, and in view of the urgency of the liquidity assistance to Hungarian banks the authorities unilaterally decided to provide on-lending directly to a number of Hungarian banks. This was not in line with EC state-aid rules and DG Competition was only consulted ex post. Communication on the one hand between and within the international institutions and on the other hand between the authorities and the international institutions is vital and should receive priority when designing and implementing joint operations, in particular in EU member states to ensure compliance to all EU regulation.

4. The repayment of loans of this magnitude, despite the fact that assistance is being provided on terms significantly more advantageous than those that the country could obtain from the markets, creates a heavy burden on a country's budget in the medium term. When the EC provides loans of this magnitude, an explicit analysis should be made on its effect on the debt sustainability of the country. That being said, in the case of the Hungary BoP operation, implicitly debt sustainability

considerations were taken into account when designing the maturities of the loan tranches: the EC loan is to be repaid in the coming years until 2016 whereas the IMF loan has a shorter maturity (the loan is due to be fully repaid in 2014).

5. The Commission should design and implement an appropriate communication strategy to explain clearly the program targets and the program benefits towards the broad public in the country concerned. The EU and the IMF should argue in a consistent manner for the adequate country-specific economic policies to clarify the situation in the eyes of the population of the country concerned. In the case of Hungary, the IMF's local Resident Representative was able to "sell" the IMF policy messages, while the EU did not have a representative authorised specifically to perform this function.

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Annex 2 Interviewed stakeholders

Date	Name	Position and unit within	
04.11.2011	Ms Elena Flores	Earlier director of G, currently director of A	ECFIN
04.11.2011	Mr Matthias Mors	Director of G: Economies of Member States II	ECFIN
04.11.2011	Mr Michal Strowjas	E2 – Staff member – financial sector developments	ECFIN
04.11.2011	Ms Magdalena Lewandowska	E2 – Staff member – financial sector developments	ECFIN
07.11.2011	Ms Barbara Kauffmann	Head of unit G1 (France, Belgium, Luxembourg, Hungary)	ECFIN
07.11.2011	Mr Balazs Parkanyi	G1 – Earlier staff member macroeconomic developments	ECFIN
07.11.2011	Ms Anna Dimitrijevics	G1 – Staff member, macroeconomic developments	ECFIN
07.11.2011	Mr Zoltan Gyenes	G1 – Staff member, fiscal affairs	ECFIN
07.11.2011	Mr Anton Jevcak	E – Monetary policy	ECFIN
05.12.2011	Ms Bergljot Barkbu	Participated in review missions (BOP; policy coherence affairs)	IMF
05.12.2011	Ms Anne-Marie Gulde-Wolf	Senior Adviser, European Department	IMF
05.12.2011	Mr John D. Pollner	Lead Financial sector specialist, task manager DPL Hungary	WB
06.12.2011	Mr Olivier Frécaut	Participated in review missions (financial sector affairs)	IMF / MCM
06.12.2011	Mr Christophe Rosenberg	Previous mission chief	IMF / EUR
07.12.2011	Ms Alina Carare	Participated in review missions, participant in Ex Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement	IMF / EUR
07.12.2011	Mr Edouard Martin	Participated in review missions (fiscal affairs)	IMF / FAD
07.12. 2011	Mr Luc Laeven	Head of Ex Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement	IMF / RES
14.12.2011	Mr Jim Morsink	Head of review missions until 2010	IMF / EUR
30.01.2012, 03.04.2012	Mr Ferenc Karvalits	Deputy Governor	Central Bank
31.01.2012	Dr Levente Kovács	Secretary general	HBA
31.01.2012	Mr János Müller	Chief Advisor	HBA
31.01. 2012	Dr Mária Móra	Deputy Secretary General	HBA
31.01. 2012, 05.04.2012	Mr Márton Nagy	Director	Central Bank
31.01.2012, 05.04.2012	Ms Ágnes Ilsinszki	Senior Advisor, EU Department	Central Bank
31.01.2012,	Mr Áron Gereben	Director Financial Analysis	Central Bank

05.04.2012			
31.01.2012	Ms Judith Antal	Deputy Head Financial Analysis	Central Bank
31.01.2012	Mr. András Simonovits	Institute of Economics	CEU
31.01.2012	Mr. György Barcza	Chief Economist	K&H Bank
01.12.2012, 04.04.2012	Mr Roland Natran	Previous Deputy Secretary of State	MoNE
01.12.2012, 04.04.2012	Dr Roza Nagy	State Secretary for Public Administration	MoNE
01.12.2012, 04.04.2012	Dr Árpád Király	Managing Director	HFSA
01.12.2012	Mr Ferenc Tóth	EU and International Affairs Department	HFSA
01.12.2012	Dr Péter Oszkó	CEO, former Minister of Finance under the Bajnai Government	OTP-PortfoLION
01.12.2012, 04.04.2012	Ms Iryna Ivaschenko	IMF country rep in Hungary	IMF
02.12.2012	Ms Ágota Scharle	Labour market and social sector specialist	Budapest Institute
02.12.2012	Mr Gyorgy Suranyi	Regional head CEE Intesa Sanpaolo, former CB governor	Intesa Sanpolo
02.12.2012	Dr. Emse Farkas Gasparics	Deputy State Secretary for municipal affairs	MoInt
02.12.2012	Ms Marianna Holczreiter	Deputy Head Department of Economic Affairs of Municipalities	MoInt
02.12.2012	Ms Mária Vadászné Egegi	Deputy Head Department of Economic Affairs of Municipalities	MoInt
02.12.2012	Ms Gabriella Karafiáthné Doszpoth	Department of International Affairs	MoInt
02.12.2012	Mr Janos Kerekgyarto	Department for. Transport Services	MoND
02.12.2012, 04.04.2012	Mr Peter Banai	Deputy State Secretary for Budgetary Affairs	MoNE
02.12.2012, 05.04.2012	Mr Endre Török	Department for International Finance, IFIs Unit	MoNE
02.12.2012, 05.04.2012	Mr Daniel Palotai	Department for Macroeconomic Policy	MoNE
02.12.2012, 05.04.2012	Ms Erzsébet Kloknicer	Department for Int. Finance/ ECOFIN unit	MoNE
02.12.2012, 05.04.2012	Mr László Szabó	Department of Budgetary/ Fiscal Affairs	MoNE
02.12.2012, 05.04.2012	Ms Katalin Szilágyi	Department of Financial Services	MoNE
02.12.2012	Mr Álmos Kovács	Retired, previously at MoF	Retired MoF
02.12.2012, 04.04.2012	Dr. Pál Völner	Minister of State for Infrastructure	MoND
03.12.2012	Mr Peter Duronelly	CFA Budapest Bank	Budapest Bank
04.04.2012	Mr. István Töröcskei	Chief Executive Officer	ÁKK
04.04.2012	Mr. László Búzás	Deputy Chief Executive Officer	ÁKK
04.04.2012	Dr. András Réz	Head of Planning, Research and Risk Management	ÁKK

Annex 3 Contagion Effect – background calculations

This annex provides the details of calculations conducted in order to shed light on countries' exposure to contagion due to a *potential* crisis in Hungary, i.e. we present background calculations for qualitative conclusions gathered in Table 8 of the main text. As discussed in the main text, among a range of potential indicators we focus on two key ones: overvaluation of real exchange rates and changes in international reserves across 52 countries. The choice of these indicators was guided by Frankel and Saravelos' (2010) meta-data findings, which show that in all evaluated crisis economies foreign reserves were found to be significant predictors of financial crises; they were also found to be the best crisis predictor of the 2008 global crash. In the category of financial linkages we calculate simple correlations between the Exchange Market Pressure index in Hungary and elsewhere as well as look at cross-border banking links. Finally, to decide on the trade links, we measure the ratio of countries' exports to Hungary to domestic GDP in 2007.

The data for our calculations carried in Tables A3.1-A3.2 was sourced from the International Financial Statistics (IFS) database of ther IMF, for the period 1993M1-2008M12[67]. Trade data for table A3.3 come UN COMTRADE database.

To measure real exchange rate overvaluation we follow Kaminsky et al. (1998) and define it as a deviation of a real exchange rate variable from its trend. The trend is constructed by applying the Hodrick-Prescott filter with the smoothing parameter lambda set equal to 14400. The real exchange rate is calculated as the local currency per U.S. dollar adjusted for consumer prices (base year: 2005=100 in both the local country and the US). As a measure of reserves adequacy we examine the annual percentage change in the level of this variable. To define the respective threshold values for these two signalling indicators we take the size of critical regions from Edison (2003)[68].

The EMP index is calculated following again Kaminsky et al. (1998). Specifically, the EMP index is a weighted average of changes in the exchange rate and in international reserves. All our analysis is carried on a monthly data spanning from 1993 to 2008[69]:

$$EMP_t = \Delta e_t - \alpha\left(\Delta r_t - \Delta r_t^*\right)$$

67 For Latvia, Macedonia, Moldova, Kazakhstan, Kyrgyz Republic and Russia not all the data is available since 1993. Where it is the case, calculations start from the earliest possible date. In Tables A4.1-3 unavailable data is marked as N/A.

68 Although, Kaminsky et al (1998) execute a panel data study, Edison (2003) finds that the signal analysis proposed by those authors can be applied – with a similar degree of success - to a single country.

69 Although it is true that in the case of freely floating exchange rates, the EMP index can be simply calculated as an annual change in a monthly nominal exchange rate, it is also true that in the case of a dirty/managed floating exchange rate regime (de jure but not de facto floating), the change in the exchange rate may not sufficiently reflect the exchange rate market pressure. In this case, the attempted speculative attacks on the exchange rate will be reflected through actions taken by a central bank. To capture this, we decided to analyse the EMP index which is a combination of changes in nominal exchange rate as well as international reserves. Moreover, as Calvo and Reinhart (2002) show, many emerging economies with officially flexible exchange rate regimes often allow only minimal exchange rate movement – the "fear of floating" hypothesis. Some authors also include in the EMP index changes in the interest rate differential (Eichengreen, et al., 1996). Due to the lack of reliable data on interests rates for many countries examined, we chose not to include interest rates in our analysis.

where α, is the weight, which is the ratio of standard deviations of e_t and (r_t - r_t*). It is used to equalize the volatilities of the two components and to prevent the component with the highest volatility from dominating the index. Δ denotes a monthly percentage change.

For countries in the Euro area that do not run independent monetary policy and cannot use reserves to relief potential exchange rate pressures the EMP index was calculated as a simple change in a nominal exchange rate (national currencies/ ECU rates were used before the introduction of the Euro):

$$EMP_t = \Delta e_t$$

A crisis (or turbulent) episode is defined as an unusually rapid increase in the index, i.e., following Eichengreen et al. (1996), a crisis is defined as taking place when the EMP index exceeds its threshold value. The benchmark thresholds are set to be 1.5 standard deviations (S.D.) above the entire sample mean. Formally:

Crisis = 1 if $EMP_t > \mu_{EMP} + 1.5\sigma_{EMP}$

Crisis = 0 otherwise.

Table A3.1 presents the results for a number of identified crisis episodes using this approach.

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Table A3.1 Number of crisis signals sent by the EMP indicator in crisis and turbulent times in the period 1993M1 till 2008M12

# of signals in 24 months before crisis	Argentina	Bolivia	Botswana	Brazil	Canada	China	Colombia	Croatia	Cyprus	Czech Rep.	Denmark	Estonia	Ethiopia	Hungary	Iceland	India	Indonesia	Israel	Jordan	Kazakhstan	Kenya	Korea, Rep.	Kyrgyz Rep.	Latvia	Lithuania
RER																									
Mexican crisis	0	2	0	1	0	9	0	0	0	0	0	0	1	0	0	2	0	2	2	4	6	0	N/A	3	8
Asian crisis	0	4	2	0	0	4	2	1	1	0	2	5	0	0	0	2	9	2	3	1	3	4	6	1	0
Russian	0	2	0	3	0	2	3	0	0	0	0	0	0	0	0	0	12	1	4	6	3	7	10	0	0
Global	**0**	5	1	3	9	3	7	5	3	7	3	4	4	6	8	12	**0**	7	6	**0**	3	1	2	7	5
RESERVES																									
Mexican crisis	0	0	0	0	3	0	1	0	0	0	3	0	0	0	7	0	0	2	0	N/A	0	0	1	N/A	0
Asian crisis	1	0	0	0	0	0	1	1	6	8	0	2	4	6	2	13	0	1	8	2	9	7	4	8	0
Russian	0	4	0	0	4	0	4	2	0	16	0	2	6	10	0	4	7	0	8	2	1	14	3	0	0
Global	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	9	**0**	**0**	**0**	2	**0**	**0**	**0**	**0**	5	1	5	**0**	2	**0**	**0**	2
EMP																									
Mexican crisis	0	4	0	12	4	1	0	5	0	0	1	0	3	0	1	1	0	2	6	6	3	0	5	0	2
Asian crisis	0	0	1	0	0	0	1	1	1	1	1	1	1	0	1	3	0	1	1	0	1	0	2	0	0
Russian	0	0	1	0	3	0	2	0	2	2	2	2	1	1	0	3	6	0	0	0	1	2	2	0	0
Global	**0**	**0**	1	**0**	**0**	2	2	**0**	2	2	2	3	2	2	2	2	**0**	1	1	**0**	**0**	**0**	**0**	1	2
	Macedonia	Malaysia	Mexico	Moldova	Morocco	Norway	Pakistan	Paraguay	Peru	Philippines	Poland	Romania	Russia	Singapore	Slovak Rep.	S. Africa	Sweden	Switzerland	Tanzania	Thailand	Turkey	Uganda	Ukraine	UK	Uruguay
RER																									
Mexican crisis	0	0	12	N/A	0	0	1	0	1	1	2	4	N/A	0	0	0	1	0	5	0	4	6	12	0	0
Asian crisis	7	14	0	1	0	1	4	0	0	7	2	0	0	6	0	1	3	4	24	11	3	2	0	0	0
Russian	1	12	3	14	0	0	0	0	7	8	0	7	17	7	0	0	1	0	24	10	0	3	7	0	0
Global	3	3	1	**0**	3	9	4	5	4	4	6	**0**	2	6	5	4	5	3	16	3	3	**0**	**0**	7	4
RESERVES																									
Mexican crisis	N/A	0	9	0	0	0	0	0	0	0	0	0	1	0	0	4	0	0	5	0	7	0	7	0	0
Asian crisis	7	2	3	0	10	0	9	0	0	1	0	4	1	0	2	11	11	0	12	4	0	0	1	3	0
Russian	7	7	0	3	0	4	6	5	0	11	0	0	6	9	4	6	18	0	1	16	0	0	1	13	0
Global	**0**	**0**	1	**0**	**0**	2	2	**0**	**0**	**0**	**0**	**0**	**0**	**0**	4	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
EMP																									
Mexican crisis	2	2	2	0	1	0	2	0	3	2	2	3	0	0	0	2	2	2	2	0	3	0	6	1	0
Asian crisis	1	1	1	0	0	2	4	0	0	1	0	2	0	0	0	2	2	2	2	2	1	1	0	0	0
Russian	2	7	0	0	1	3	5	2	0	6	0	2	2	7	0	2	4	2	1	7	0	1	0	2	0
Global	**0**	1	**0**	**0**	2	2	5	**0**	2	**0**	1	**0**	**0**	**0**	1	1	**0**	**0**	**0**	1	**0**	**0**	**0**	1	**0**

Note: Own calculation based on the IMF, IFS data. The numbers in rows RER and RESERVES indicate numbers of signals issued within 24 months prior to Mexican, Asian, Russian and Global crises. The numbers in the EMP row point to number of times when the EMP exceeds its threshold value in a given period indicating a crisis or financial turbulence. N/A indicates the lack of data.

Table A3.2 Correlations of EMP indices between Hungary and a country indicated

$EMP=\Delta NER+\alpha(\Delta r-\Delta r^{*})$	Argentina	Bolivia	Botswana	Brazil	Canada	China	Colombia	Croatia	Cyprus	Czech Republic	Denmark	Estonia	Ethiopia	Hungary	Iceland	India	Indonesia	Israel	Jordan	Kazakhstan	Kenya	Korea, Rep.	Kyrgyz Republic	Latvia	Lithuania
Correlation	0.0	0.0	0.3	0.1	0.2	-0.1	0.1	0.2	0.5	0.4	0.5	0.5	0.1	**1.0**	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.4	0.3
>=0.2	0	0	1	0	1	0	0	1	1	1	1	1	0	**1**	1	0	0	0	0	0	0	0	0	1	1
>=0.4	0	0	0	0	0	0	0	0	**1**	**1**	**1**	**1**	0	**1**	0	0	0	0	0	0	0	0	0	1	0
>=0.5	0	0	0	0	0	0	0	0	**1**	0	**1**	**1**	0	**1**	0	0	0	0	0	0	0	0	0	0	0

$EMP=\Delta NER+\alpha(\Delta r-\Delta r^{*})$	Macedonia, FYR	Malaysia	Mexico	Moldova	Morocco	Norway	Pakistan	Paraguay	Peru	Philippines	Poland	Romania	Russian Federation	Singapore	Slovak Republic	South Africa	Sweden	Switzerland	Tanzania	Thailand	Turkey	Uganda	Ukraine	United Kingdom	Uruguay
Correlation	0.3	0.1	0.1	0.1	0.5	0.4	0.1	0.0	0.1	0.1	0.4	0.2	0.1	0.2	0.5	0.3	0.4	0.3	0.0	0.1	0.1	0.1	0.0	0.1	0.0
>=0.2	1	0	0	0	1	1	0	0	0	0	1	1	0	1	1	1	1	1	0	0	0	0	0	0	0
>=0.4	0	0	0	0	**1**	**1**	0	0	0	0	1	0	0	0	**1**	0	**1**	0	0	0	0	0	0	0	0
>=0.5	0	0	0	0	**1**	0	0	0	0	0	0	0	0	0	**1**	0	0	0	0	0	0	0	0	0	0

$EMP=\Delta NER$	Austria	Belgium	Croatia	Germany	Estonia	Spain	Finland	France	Greece	Ireland	Italy	Luxemburg	Malta	Holland	Portugal	Slovenia	Slovak Republic	Bulgaria	Czech Republic	Denmark	Romania	Turkey	Poland	Latvia	Lithuania
Correlation	0.8	0.8	0.7	0.8	0.8	0.8	0.7	0.8	0.8	0.7	0.8	0.8	0.8	0.8	0.8	0.7	0.8	0.2	0.8	0.8	0.5	0.3	0.7	0.6	0.6
>=0.2	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	0	1	1	1	0	1	1	1
>=0.4	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	0	1	1	1	0	1	1	1
>=0.5	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	0	1	1	1	0	1	1	1

Note: Own calculation based on the IMF IFS data. “0” indicates no or very week (below 0.2) correlation between individual countries’ EMP indices and the index for Hungary.

Table A3.3 Countries with the largest trade (export) exposure to Hungary (2007 exports to Hungary as % of country's 2007 GDP)

Main Partners in 2007	Slovak Republic	Montenegro	Czech Republic	Slovenia	Austria	Bosnia and Herzegovir	Romania	Uzbekistan	Ukraine	Poland	Germany	Croatia	Netherlands
Export to Hungary (%GDP)	**3.83**	**3.25**	**1.94**	**1.81**	**1.55**	**1.28**	**1.21**	0.89	0.89	0.88	0.76	0.75	0.52

Note: Own calculation based on COMTRADE UN data base and IMF World Economic Outlook, Sep 2011 database.

Table A3.4 Banking linkages: Parent Country Exposure to Daughter Countries

Parent country	Austria	Germany	Italy	France	Belgium	Sweden	Netherlands	Switzerland	Portugal	Spain
Relative exposure to Hungary[1]	**11.896**	**7.697**	**11.169**	2.461	**10.071**	0.300	1.988	0.400	1.385	0.321
Relative exposure to the CESE region[2]	91.607	48.110	86.847	37.151	68.029	89.332	30.433	23.127	44.682	2.524
Absolute exposure to Hungary[3]	**3.296**	0.391	0.732	0.150	**1.001**	0.032	0.200	0.043	0.073	0.029
Absolute exposure to the CESE region	25.379	2.443	5.692	2.261	6.762	9.602	3.068	2.506	2.362	0.226
Exposure to CESE, % of lenders' GDP (approx.)	70	6	9	5	25	20	10	10	5	1

Note: End-Dec 2007 data, in millions of US dollars; Bolded countries are countries with the largest exposure to Hungary;

“1” - Foreign claims of a Western European country on a Hungary as a share of its total claims vis-à-vis all developing countries, in percent;

“2” - Foreign claims of a Western European country on CESE countries (Poland, Russia, Czech Republic, Hungary, Romania, Croatia, Turkey, Slovakia, Ukraine, Latvia, Estonia, Lithuania, Bulgaria, Serbia, Bosnia and Herzegovina, Albania, Belarus, Montenegro, Moldova and Macedonia) as a share of its total claims vis-à-vis all developing countries, in percent;

“3” - Foreign claims of a western European country on a CESE country as a ratio to the Western European country's banking sector assets, in percent.

Source: Arvai et al, 2009.

Table A3.5. Banking linkages : asset exposure

Bank	OTP Bank	MKB	K&H	Erste Bank	CIB	Raiffeisen	Unicredit	Budapest Bank	FHB Mortgage Bank	Citibank Hungary
Value of assets in Hungary (in billion of Euros)*	36.2	11.5	11.3	10.7	10.2	8.8	4.2	3.4	2	N/A
Relevant Subsidiary	Bulgaria, Croatia, Romania, Serbia, Ukraine, Slovakia, Montenegro, Russia	Hungary	Hungary	Hungary	Hungary	Hungary	Hungary	Hungary	Hungary	Hungary
Headquarter (Parent)	**Hungary**	Germany	Belgium	Austria	Italy	Austria	Italy, Austria, Germany	US	**Hungary**	US

Note: Sourced from banks' internet sites. "*" as of December 2009, gathered by Seeking Alpha.

Annex 4 Results from Delphi Questionnaire

EX-POST EV. BOP SUPPORT OP. HUNGARY NOV 08: DELPHI QUESTIONNAIRE

To assess the impact of the BOP assistance on the macroeconomic situation and its contribution to the implementation of structural reforms in Hungary, you are kindly asked to complete the questionnaire below. Please note that the questionnaire refers to both EU and IMF BOP assistance if it states “BOP assistance”. The questionnaire is sent to a selected group of experts that have witnessed the developments related to the BOP assistance in Hungary. It will be implemented in two rounds. If you participate, the anonymous consolidated responses of all experts will be returned to you. In line with the Delphi-methodology, you will be given the opportunity, if the responses of the other experts induce you to do so, to amend your initial responses.

Part 1: Macroeconomics and external sustainability

1. 1. In the case that Hungary would not have received the joint EU / IMF BoP assistance, could you indicate the likelihood of the following scenarios?
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
The government of Hungary would not have been able to service its debt and would have defaulted.	19	
The government of Hungary would have used a mix of its reserves, expenditure cuts and revenue raising measures to service its debts until the end of 2008. By then, the existing Gyurcsány (or a new) government would have re-gained sufficient confidence to return to the capital market.	19	
The government of Hungary would have used a mix of its reserves, cutting expenditures and revenue raising measures to service its debts until the end of 2008. By then, the government would not have gained sufficient confidence to return to the capital market and would have either defaulted or requested EU/IMFsupport.	19	
Average: 2,69 — Median: 3		

1. Very unlikely
2. Unlikely
3. Likely
4. Very Likely
- Don’t know

2. 2. Can you elaborate on the macro-economic and fiscal consequences for Hungary of the most likely scenario in the lack of EU/IMF assistance (based on the most likely scenario that you selected in the previous question, or any other not mentioned option)?
(Each respondent could write a single open-ended response of maximum 2000 characters.)

Response	Total	% of total respondents	%
Open answer	19		100%
Total respondents: 19 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

3. 3. Please indicate the likelihood of the following scenarios, in case the EU would not have participated in the BoP support programme:
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
IMF would not have provided BoP assistance either	19	42 37 11 11
IMF would have raised the amount of their assistance	19	16 16 47 16
IMF would have provided the same amount of assistance	19	11 32 32 11 16
Average: 2,24 — Median: 2		

- 1. Very unlikely
- 2. Unlikely
- 3. Likely
- 4. Very Likely
- - Don’t know

4. 4. Hungary was able to tap into financial markets in the second half of 2009. Without BOP assistance, when would Hungary have been able to access domestic and international financial markets?
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Domestic financial markets	19	16 11 32 11 16 16
International financial markets	19	11 11 11 11 26 26
Average: 4,07 — Median: 3		

1. Q3 2009
2. Q4 2009
3. Q1 2010
4. Q2 2010
5. Q3 2010
6. Q4 2010
7. Later

- Don't know

5. 5. Without BOP assistance, how much would yields on government bonds have risen at the end of 2008 compared to what they were? Long-term interest rates for debt securities Hungary (10-yr) Month/yearJul08Aug08Sep08Oct08Nov08Dec08Jan09Apr09Jul09Oct09 Interest rates8.117.777.999.579.418.318.7610.638.817.45
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Bond yields would have risen by	18	17 17 17 28 17
Average: 4,53 — Median: 4,50		

1. 0
2. 0-2 points
3. 2-4 points
4. 4-6 points
5. 6-8 points
6. Above 8 points

- Don't know

6. 6. Without BOP assistance, how much would the real effective exchange rate of the forint have depreciated at the end of 2008 compared to what it was? Month/year Jul08 Aug08 Sep08 Oct08 Nov08 Dec08 Jan09 Apr09 Jul09 Oct09 Interest rates 66.5 67.9 69.5 74.6 76.4 75.3 79.1 81.3 73.2 72.6 CPI-based, Index, 2000 level =100

(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Real effective exchange rate would have depreciated by	18	
Average: 5,07 — Median: 6		

1. 0-3 points
2. 3-5 points
3. 5-8 points
4. 8-10 points
5. 10-15 points
6. Above 15 points

- Don't know

7. 7. Without BOP assistance, how much would lending to private sector have decreased at the end of 2008 compared to what it was? Month/year Jul08 Aug08 Sep08 Oct08 Nov08 Dec08 Jan09 Apr09 Jul09 Oct09 Household lending 115.7 115.4 116.1 116.4 115.6 114.7 113.9 108.7 101.6 97.3 Non-financial corporations 107.4 106.6 107.8 105.6 104.9 102.8 101.8 98.4 92.5 89.8 Real growth index based on transactions, in %

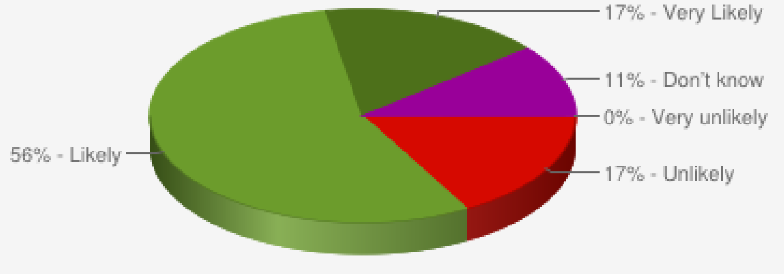
(Each respondent could choose only ONE response per sub-question.)

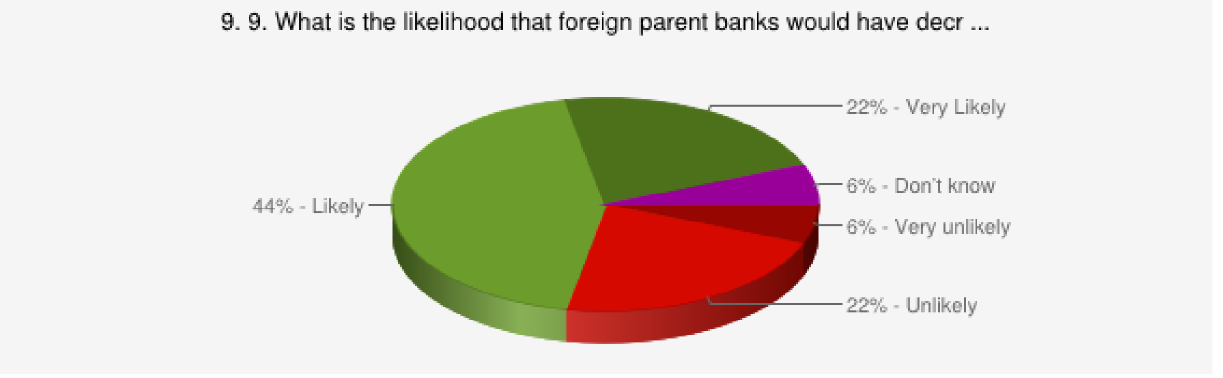
Sub-questions	Resp.	% of responses
Private sector lending would have decreased by	18	
Average: 4,38 — Median: 4,50		

1. 0-2 points
2. 2-4 points
3. 4-6 points
4. 6-10 points
5. 10-15 points
6. Above 15 points

- Don't know

8. 8. In case Hungary would have defaulted, what is the likelihood tha ...





Part 2: Structural Reform Part

10. How do you assess the relative importance of these reforms at the time they were proposed?

10. Conditionality: Fiscal governance reform
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Adoption of reform, appointment of Fiscal Council, and preparation of budget in line with new fiscal framework	18	
Adoption of new government regulation on the general rules of public finance administration	18	
Average: 3,15 — Median: 3		

1. Not important, and diverting focus

2. A minor, hardly relevant issue

3. A fairly important issue

4. Very important issue and top priority

\- Don’t know

11. Conditionality: Financial sector supervision and regulation
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Introduction of support package for the domestic banking sector	18	11 / 39 / 39
Adoption of measures to carefully monitor banks' funding needs	18	22 / 50 / 22
Strengthen financial sector supervision	18	11 / 72 / 11
Take measures to further strengthen the HFSA's and MNB's capacity to assess and address solvency and liquidity concerns in banks in a timely manner	18	11 / 56 / 28
Revision of the Financial Stability Act, in line with agreed EU principles	18	22 / 56 / 11
The Hungarian Financial Sector Authority (HFSA) will take measures to strengthen its consumer protection arm in line with the Draft HFSA Law	18	17 / 33 / 28 / 17
Average: 2,93 — Median: 3		

1. Not important, and diverting focus
2. A minor, hardly relevant issue
3. A fairly important issue
4. Very important issue and top priority
- Don't know

12. Conditionality: Structural reforms
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Adoption of Pathway to work, moving from passive to active labour market policies	18	44 / 39 / 11
Improve the financial sustainability of the pension system	18	22 / 67
Improve the financial sustainability of the social assistance system	18	61 / 33
Adoption of revenue-neutral tax reforms aimed at reducing the tax wedge on labour and bolstering economic growth	18	17 / 28 / 50
Implement durable savings in the area of long-distance public transport	18	11 / 28 / 39 / 22
Average: 3,13 — Median: 3		

1. Not important, and diverting focus
2. A minor, hardly relevant issue
3. A fairly important issue
4. Very important issue and top priority
- Don’t know

11. How do you assess progress in the following topics until May 2010 in comparison with the situation at the end of 2008?

13. Conditionality: Fiscal governance reform

(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Adoption of reform, appointment of Fiscal Council, and preparation of budget in line with new fiscal framework	18	
Adoption of new government regulation on the general rules of public finance administration	18	
Average: 3,11 — Median: 3,50		

- 1. No progress
- 2. Some progress
- 3. Completed
- 4. Completed but policy shift after 2010
- \- Don’t know

14. Conditionality: Financial sector supervision and regulation
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Introduction of support package for the domestic banking sector	18	78 · 11
Adoption of measures to carefully monitor banks' funding needs	18	11 · 72 · 17
Strengthen financial sector supervision	18	39 · 44 · 11
Take measures to further strengthen the HFSA's and MNB's capacity to assess and address solvency and liquidity concerns in banks in a timely manner	18	44 · 28 · 17 · 11
Revision of the Financial Stability Act, in line with agreed EU principles	18	22 · 39 · 11 · 28
The Hungarian Financial Sector Authority (HFSA) will take measures to strengthen its consumer protection arm in line with the Draft HFSA Law	18	28 · 44 · 17 · 11
Average: 2,78 — Median: 3		

1. No progress
2. Some progress
3. Completed
4. Completed but policy shift after 2010
- Don't know

15. Conditionality: Structural reforms
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Adoption of Pathway to work, moving from passive to active labour market policies	18	39 17 17 22
Improve the financial sustainability of the pension system	18	11 22 11 39 17
Improve the financial sustainability of the social assistance system	18	11 28 17 17 28
Adoption of revenue-neutral tax reforms aimed at reducing the tax wedge on labour and bolstering economic growth	18	39 33 22
Implement durable savings in the area of long-distance public transport	18	56 17 22
Average: 2,46 — Median: 2		

1. No progress
2. Some progress
3. Completed
4. Completed but policy shift after 2010
- Don't know

12. What, if any, was the contribution of the conditionality attached to BoP assistance to the progress in the following areas?

16.1. Conditionality: Fiscal governance reform

- Adoption of reform, appointment of Fiscal Council, and preparation of budget in line with new fiscal framework

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	2		11%
2 Speeded up the reform process	12		67%
3 Shaped the contents of reform	4		22%
- Don't know	2		11%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

16.2. Conditionality: Fiscal governance reform

- Adoption of new government regulation on the general rules of public finance administration

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	6		33%
2 Speeded up the reform process	8		44%
3 Shaped the contents of reform	1		6%
- Don't know	4		22%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

17.1. Conditionality: Financial sector supervision and regulation

- Introduction of support package for the domestic banking sector

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	8		44%
2 Speeded up the reform process	5		28%
3 Shaped the contents of reform	3		17%
- Don't know	2		11%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

17.2. Conditionality: Financial sector supervision and regulation

- Adoption of measures to carefully monitor banks’ funding needs

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	9		50%
2 Speeded up the reform process	5		28%
3 Shaped the contents of reform	2		11%
- Don’t know	2		11%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

17.3. Conditionality: Financial sector supervision and regulation

- Strengthen financial sector supervision

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	4		22%
2 Speeded up the reform process	7		39%
3 Shaped the contents of reform	6		33%
- Don’t know	1		6%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

17.4. Conditionality: Financial sector supervision and regulation

- Take measures to further strengthen the HFSA’s and MNB’s capacity to assess and address solvency and liquidity concerns in banks in a timely manner

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	6		33%
2 Speeded up the reform process	6		33%
3 Shaped the contents of reform	5		28%
- Don’t know	1		6%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

17.5. Conditionality: Financial sector supervision and regulation

- Revision of the Financial Stability Act, in line with agreed EU principles

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	6		33%
2 Speeded up the reform process	7		39%
3 Shaped the contents of reform	3		17%
- Don't know	2		11%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

17.6. Conditionality: Financial sector supervision and regulation

- The Hungarian Financial Sector Authority (HFSA) will take measures to strengthen its consumer protection arm in line with the Draft HFSA Law

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	6		33%
2 Speeded up the reform process	8		44%
3 Shaped the contents of reform	2		11%
- Don't know	2		11%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

18.1. Conditionality: Structural reforms

- Adoption of Pathway to work, moving from passive to active labour market policies

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	5		28%
2 Speeded up the reform process	8		44%
3 Shaped the contents of reform	2		11%
- Don't know	3		17%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

18.2. Conditionality: Structural reforms

- Improve the financial sustainability of the pension system

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	4		22%
2 Speeded up the reform process	4		22%
3 Shaped the contents of reform	5		28%
- Don't know	5		28%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

18.3. Conditionality: Structural reforms

- Improve the financial sustainability of the social assistance system

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	3		17%
2 Speeded up the reform process	7		39%
3 Shaped the contents of reform	4		22%
- Don't know	5		28%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

18.4. Conditionality: Structural reforms

- Adoption of revenue-neutral tax reforms aimed at reducing the tax wedge on labour and bolstering economic growth

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	3		17%
2 Speeded up the reform process	7		39%
3 Shaped the contents of reform	5		28%
- Don't know	4		22%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

18.5. Conditionality: Structural reforms

- Implement durable savings in the area of long-distance public transport

(Each respondent could choose MULTIPLE responses.)

Response	Total	% of responses	%
1 Raised the issue in the policy agenda	7		39%
2 Speeded up the reform process	6		33%
3 Shaped the contents of reform	3		17%
- Don't know	5		28%
Total respondents: 18 Skipped question: 0		0 % 20 % 40 % 60 % 80 %	

13. What would have happened to the following request for policy action if the BoP assistance operation had not taken place?

19. Conditionality: Fiscal governance reform
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Adoption of reform, appointment of Fiscal Council, and preparation of budget in line with new fiscal framework	18	28 44 11 17
Adoption of new government regulation on the general rules of public finance administration	18	28 44 22
Average: 2,41 — Median: 3		

1. Would have been incorporated in IMF programme
2. Would have been incorporated in WB programme
3. Would have become part of Gov't agenda anyway
4. Would have been totally neglected

- Don't know

20. Conditionality: Financial sector supervision and regulation
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Introduction of support package for the domestic banking sector	18	39 50 11
Adoption of measures to carefully monitor banks' funding needs	18	44 44 11
Strengthen financial sector supervision	18	61 28
Take measures to further strengthen the HFSA's and MNB's capacity to assess and address solvency and liquidity concerns in banks in a timely manner	18	61 22 11
Revision of the Financial Stability Act, in line with agreed EU principles	18	22 44 28
Measures taken by the Hungarian Financial Sector Authority (HFSA) to strengthen its consumer protection arm in line with the Draft HFSA Law	18	22 61 11
Average: 2,10 — Median: 3		

1. Would have been incorporated in IMF programme

2. Would have been incorporated in WB programme

3. Would have become part of Gov't agenda anyway

4. Would have been totally neglected

- Don't know

21. Conditionality: Structural reforms
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
Adoption of Pathway to work, moving from passive to active labour market policies	18	22 50 22
Improve the financial sustainability of the pension system	18	22 56 11
Improve the financial sustainability of the social assistance system	18	17 11 61 11
Adoption of revenue-neutral tax reforms aimed at reducing the tax wedge on labour and bolstering economic growth	18	22 56 17
Implement durable savings in the area of long-distance public transport	18	28 44 11 17
Average: 2,47 — Median: 3		

1. Would have been incorporated in IMF programme
2. Would have been incorporated in WB programme
3. Would have become part of Gov't agenda anyway
4. Would have been totally neglected
- Don't know

Part 3: Value Added Part

22. 14. Please indicate your view on the added value of the EU Balance of Payments assistance by providing your view on the following hypotheses?
(Each respondent could choose only ONE response per sub-question.)

Sub-questions	Resp.	% of responses
The BOP assistance added value as it further supported procedures under the Stability and Growth Pact (e.g. EDP)	17	24 47 18
The BOP assistance added value as it facilitated communication between DG ECFIN and other DGs and institutions of the European Union	17	41 24 24
Without the BOP assistance, the Vienna Initiative would not have been established	17	35 41 18
The BOP assistance added value as it allowed for a more meaningful dialogue between the EC and Hungary as compared to prior to the BOP assistance	17	29 47 12 12
The BOP assistance added value as it strengthened the confidence of investors, private sector and others in the country's economic development	17	82 12
Other, please specify:	7	14 14 71
Average: 1,82 — Median: 2		

1. Fully agree
2. Agree
3. Disagree
4. Fully disagree
- Don't know

Do NOT click on Finish, but close this window so you will be able to modify you answers later on!

P.O. Box 4175
3006 AD Rotterdam
The Netherlands

Watermanweg 44
3067 GG Rotterdam
The Netherlands

T +31 (0)10 453 88 00
F +31 (0)10 453 07 68
E netherlands@ecorys.com

W www.ecorys.nl

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