

Crisis Management Program of the Government

19 April 2009

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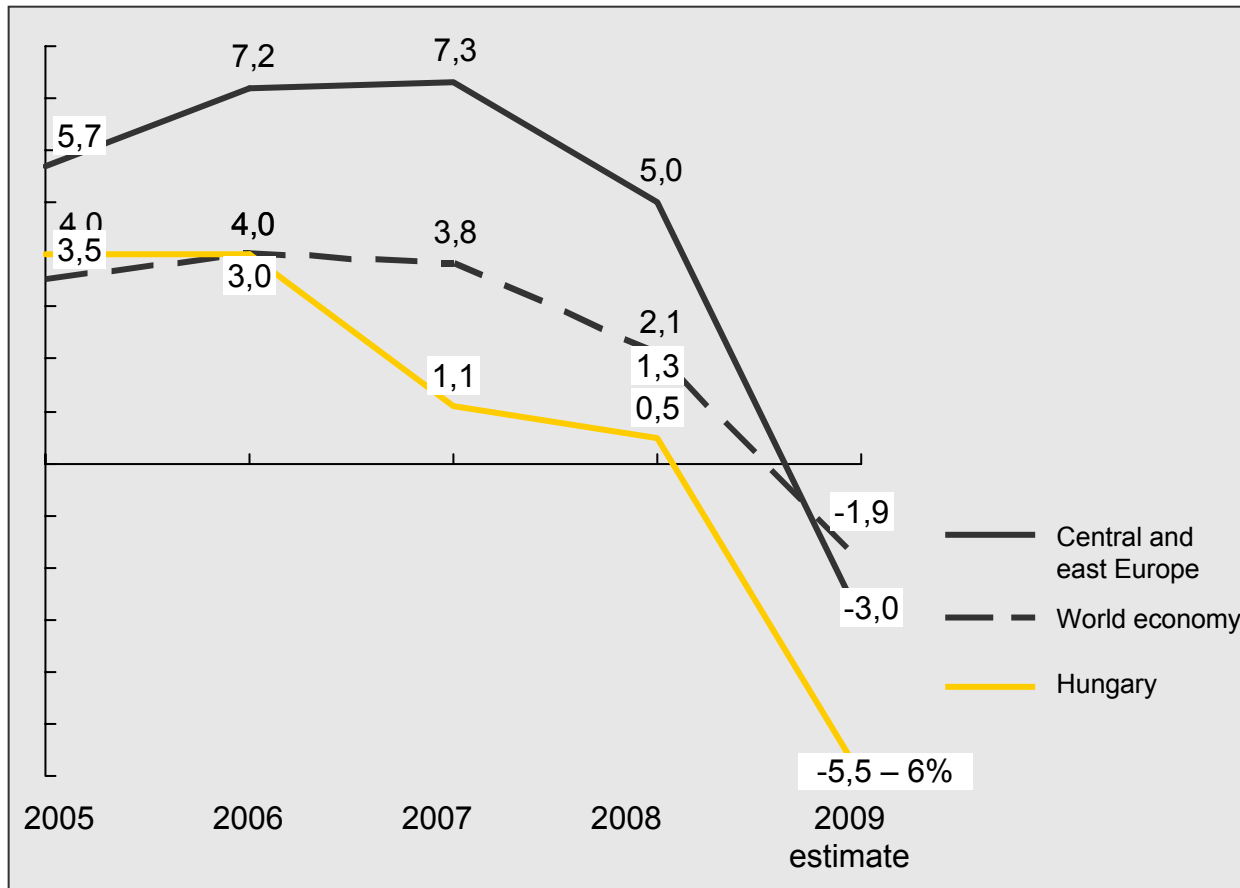
1. Description of the current situation

2. Introduction of necessary measures

3. Projected consequences of the crisis management program

The global economic recession has a much harsher effect on the Hungarian economy

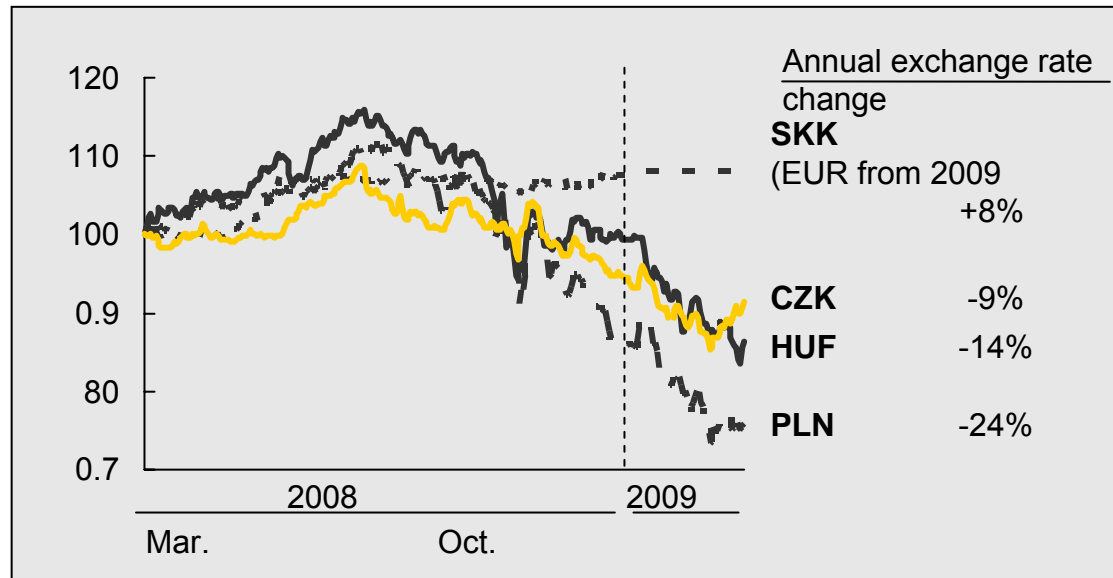
Economic growth in certain countries and regions in percent between 2005 and 2009



- According to projections, the output of the entire world economy will decline in 2009
 - The whole of international trade will also shrink in comparison to 2008
 - Hungary has been consistently performing poorer than the average of the region
 - Hungary is dependent on exports, so that the GDP also depends largely on key trade partners (e.g. Germany)
- Key German economic indices have not been this low in the last 20 years (e.g. IFO)

Credible fiscal and monetary policies are needed to fend off volatile exchange rates

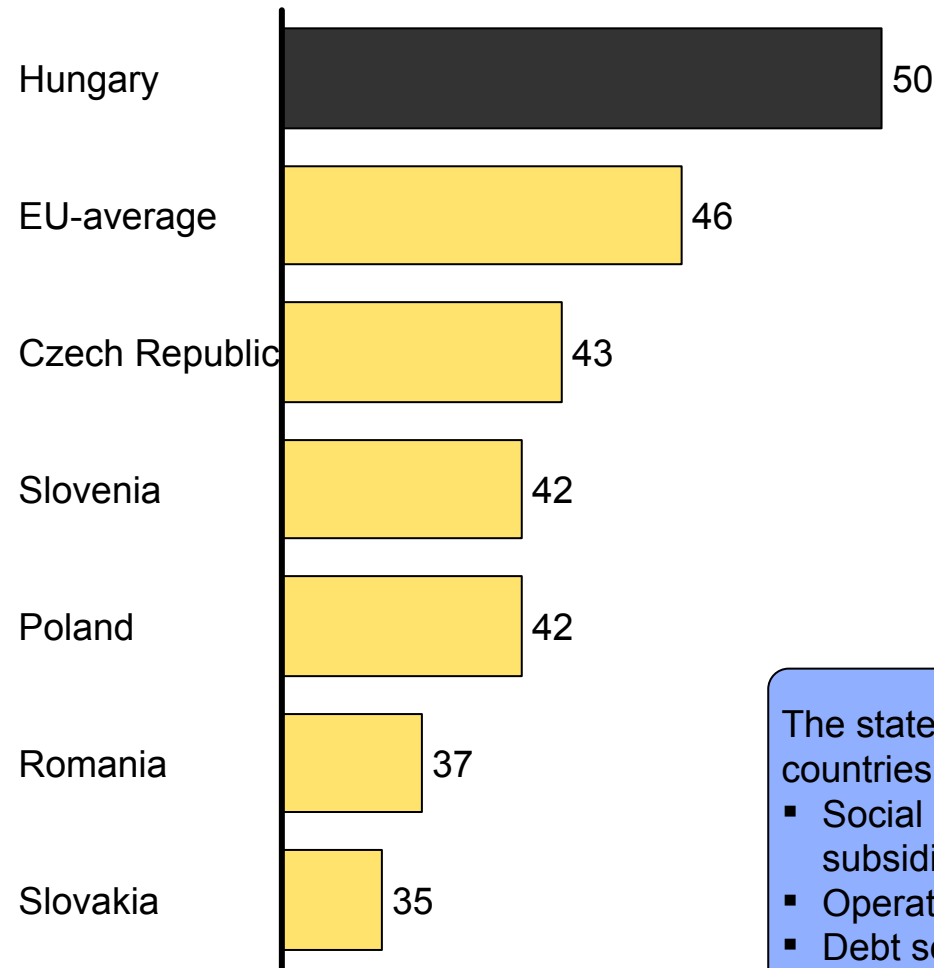
Changes in the exchange rates of Visegrád countries against the euro between March 2008 and March 2009 (exchange rate on 11 March 2008 = 100)



- The devaluation of currencies has been going on since October 2008
- Exchange rate volatility has increased substantially, which aggravates the situation of participants in the economy
- The tools of monetary policy are scarce because they only make the funding of the debts of the private sector and the state household even more difficult
- Falling budget deficit reduces devaluation pressure on the currency

The Hungarian state is inefficient, therefore it drains more money from the economy and the citizens than the majority of the countries in the region

State spending in percentage of the GDP in 2007



Problems with the high level of spending:

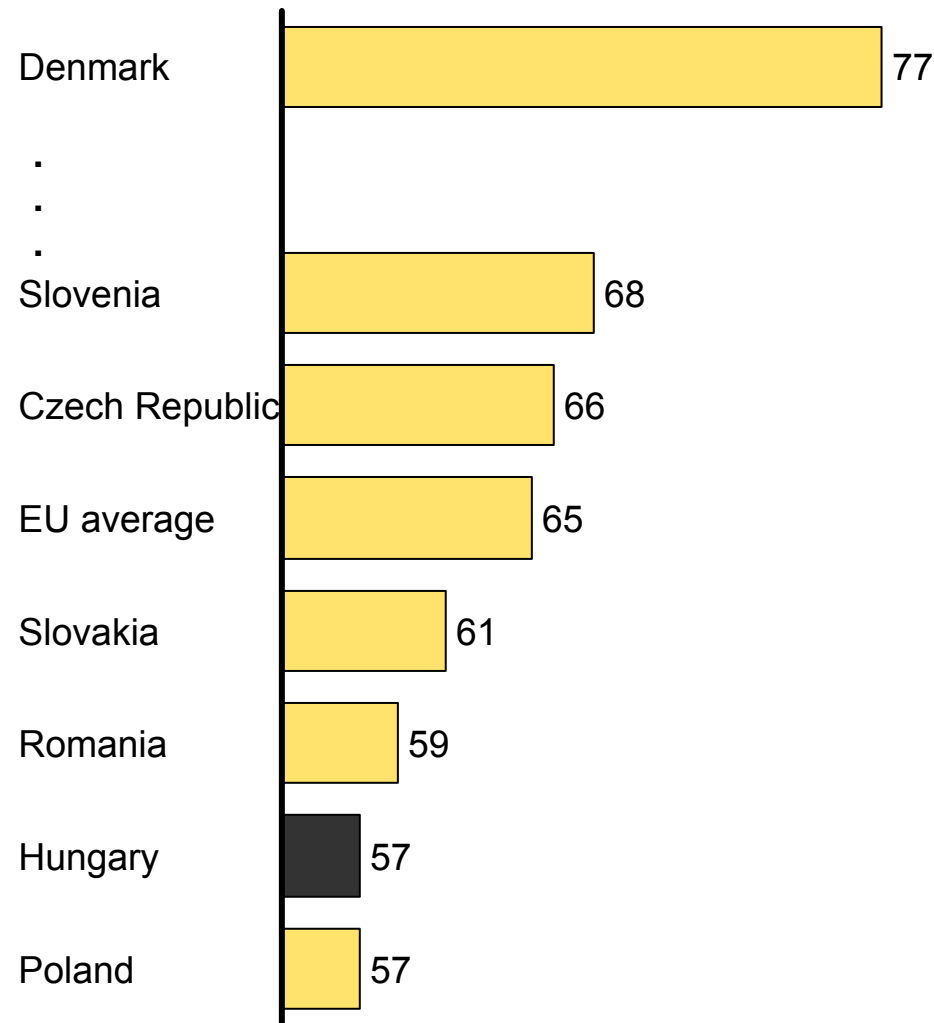
- It can only be financed with high taxes and increasing debt
- The structure of redistribution is not right, the country spends too much on social benefits
- The quality of services of public administration bodies lags behind the needs of the citizens

The state of Hungary spends substantially more than the countries in the region on the following areas:

- Social benefits and housing subsidies (e.g. family subsidies, sick pay, disability benefits)
- Operating costs of the state
- Debt service

The low level of employment is a problem the management of which requires the government to do a lot

Rate of employment of people aged 19–64 in percent in 2007

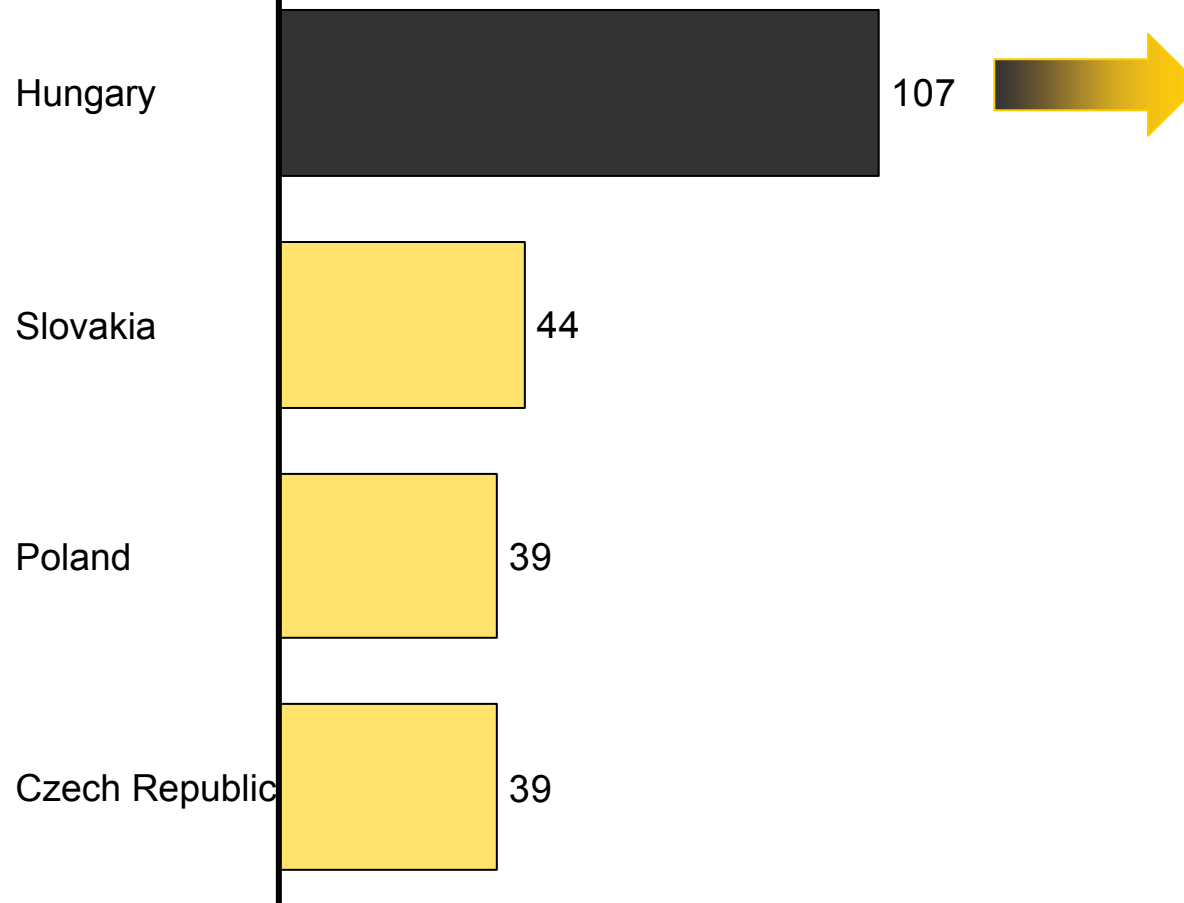


Problems with employment in Hungary:

- The low rate of employment indicates that less than necessary workers sustain the country with their taxes
- App. 1.5 million people lost their jobs in the years after the political changes. They have not been able to return to employment ever since
- It is a serious problem that certain groups have been cornered out from the labour market almost completely:
 - People with low skills
 - Women with children
 - People older than 50

The foreign indebtedness of Hungary is outstanding in the region, which gives the impression of risk about the country

Foreign indebtedness of Visegrád countries* in percent of the GDP at the end of 2008



Reasons for high indebtedness:

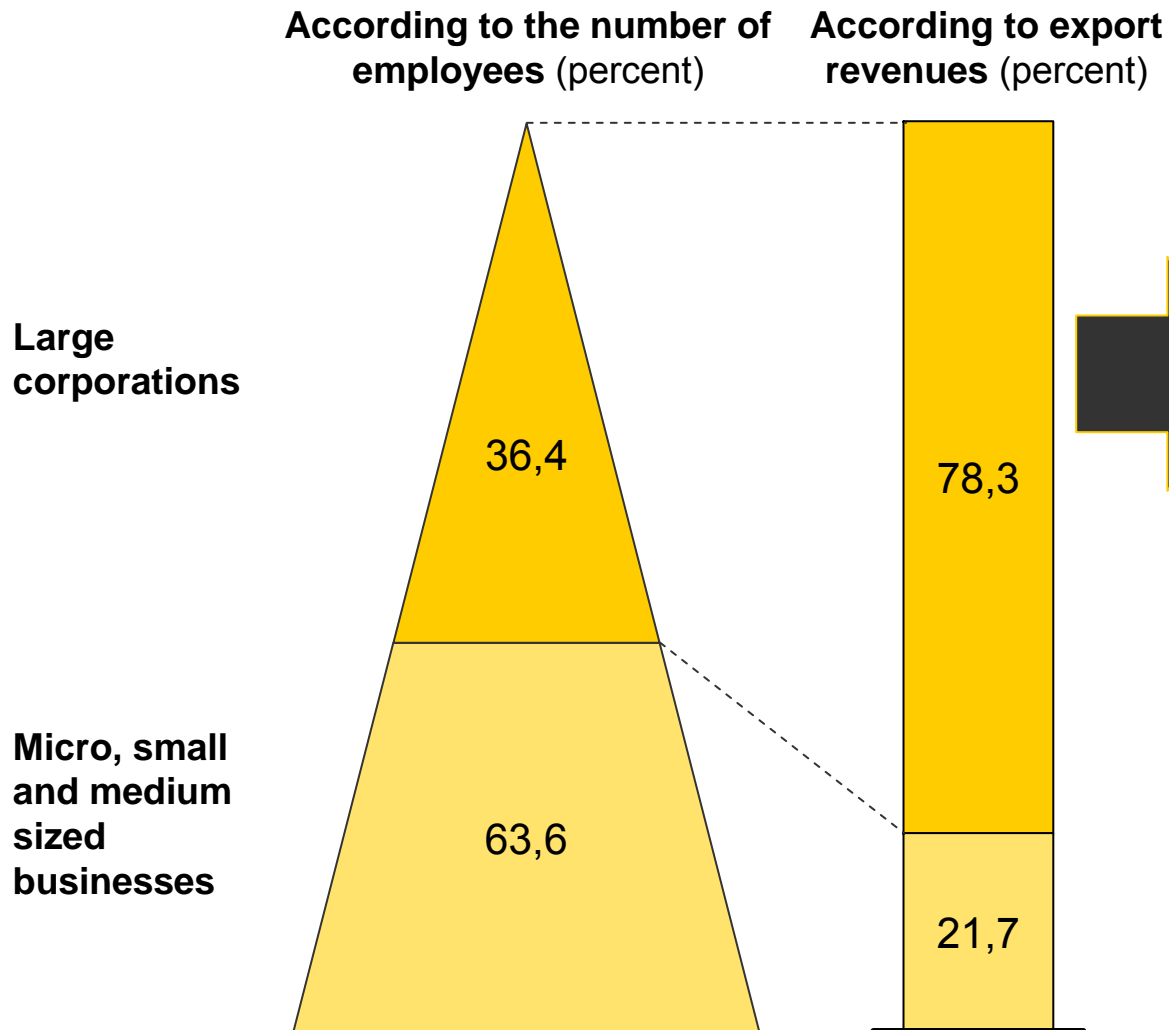
- The **state** finances the budget deficit from debt, which is a burden on the entire economy through the high level of debt service
- Due to high HUF interest rates **companies** also drew FX loans, which has increased their vulnerability
- Growth was fuelled by domestic consumption between 2000 and 2006, which also increased indebtedness mainly through an increased volume of FX loans to **retail** customers
- Foreign capital investments did not cover the entire external funding need, so that the country had to seek foreign loans

* Public and private sector total

2

The poor shape of the real economy is mostly reflected in the situation of SMEs

Distribution of companies operating in Hungary in 2007



Consequences

- The performance of the economy is largely exposed to the export of large companies, which is strongly dependent on international business cycles
- The majority of SMEs does not participate in international trade, and they are not competitive at the moment for the following reasons:
 - Typically small, family businesses
 - High tax burden
 - Administration is more difficult through extensive bureaucracy

Events of the last few months have made the challenges that the government is facing even harder

Impacts of the first quarter of 2009

The decline of the Hungarian economy may be larger than expected, mainly due to the performance of key export markets → - 5.5 – 6%

The impact of measures already announced in 2009 is much smaller than necessary according to market assessments. Such a program leaves the impression that the government has a wrong assessment of the weight of the problems

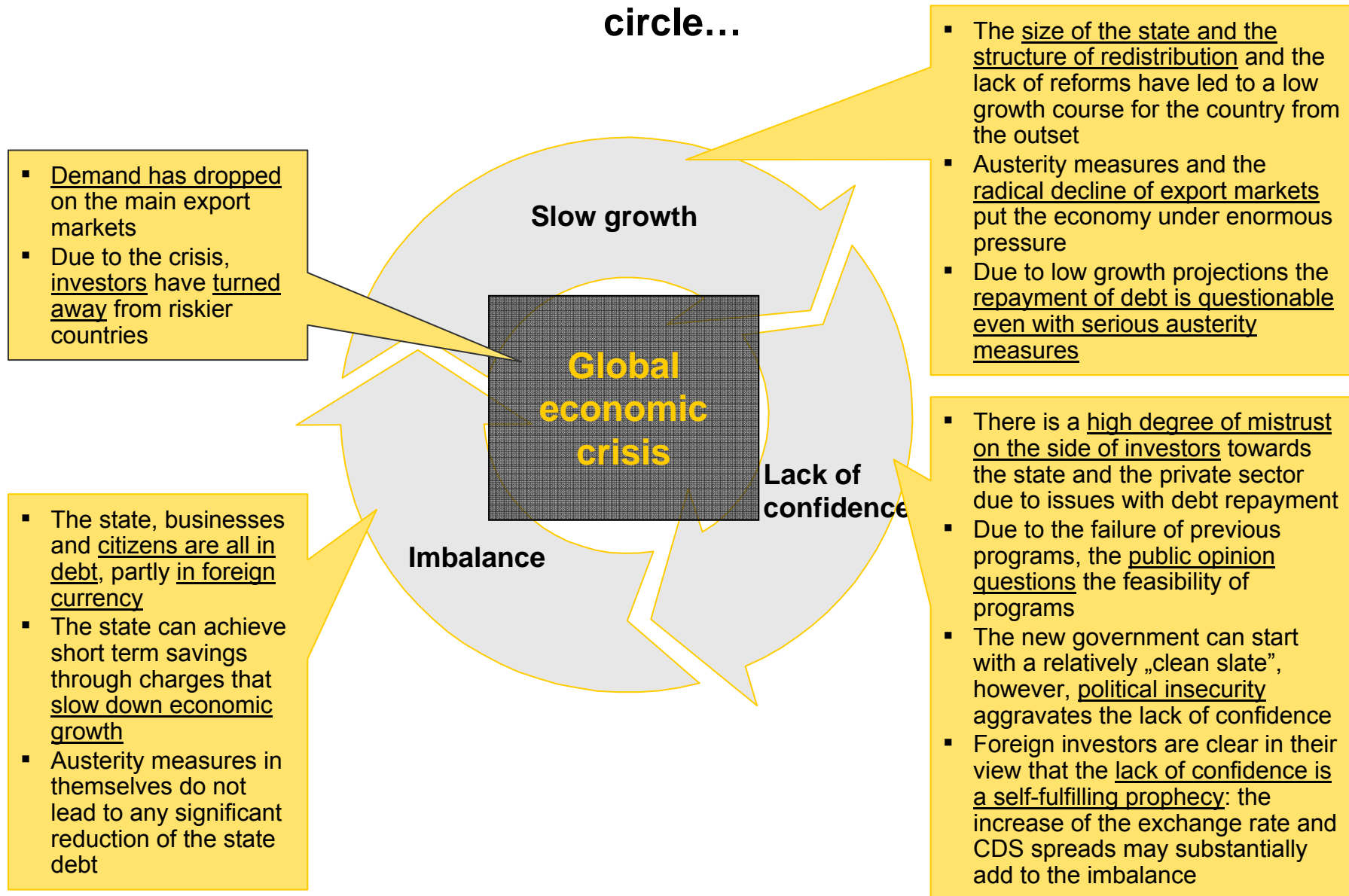
The feasibility of the announced measures is questionable as the confidence of markets is lacking

There is a consensus among analysts that this trap cannot be left except through fuelling growth



The last 3 months have made it even clearer that this double clench can only be overcome if the attainment of the equilibrium and the intensification of growth are done in parallel

The current situation traps the performance of the country in a vicious circle...



... which we must break out from, otherwise we face a serious social and economic crisis that concerns everyone

What do we risk if we don't intervene?

- **In the macro-economy:**
 - Long term recession, lagging behind other countries in the region
 - Quickly growing level of state debt
 - Devaluation of the forint
- **In the entire country:**
 - A wave of company bankruptcies
 - Several hundreds of thousands of jobs at risk
 - Several hundreds of thousands of home and car owners with foreign currency loans can be at risk
 - The value of pensions and family allowances is jeopardized



- Avoiding the crisis is the **primary interest of the country**
- This requires the following:
 - Rapid correction of the debt trajectory
 - Improvement of the potential growth rate of the economy
- Hungary has contractual **undertakings** towards international institutions (IMF, EU):
 - Crisis management measures should not deteriorate the equilibrium of the state household
 - The state debt must switch to a course of reduction as soon as possible

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Objectives of the crisis management program

➤ Tackling the impacts of the global economic crisis

➤ Stimulating economic growth

Slow growth
▪ Economic output
▪ Employment

Global economic crisis

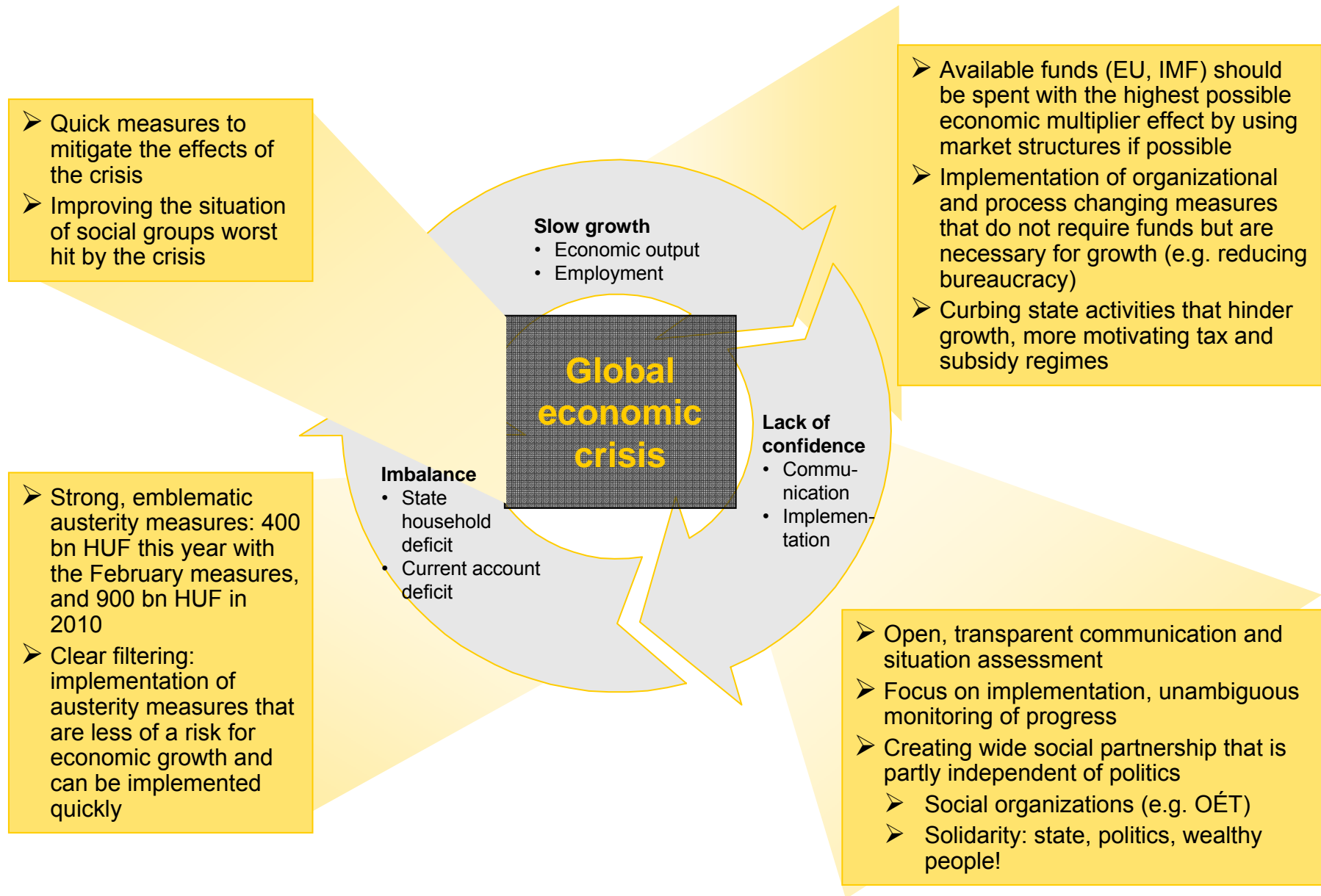
Lack of confidence
▪ Communication
▪ Implementation

Imbalance
▪ State household deficit
▪ Current account deficit

➤ Creating equilibrium

➤ Restoring confidence

The new government must tackle all elements of the vicious circle



Tackling the effects of the global economic crisis

Stabilization of the financial system

- Agreements with international institutions
- Measures to help people with foreign currency loans
- Securing the stability of the exchange rate
- Stimulating lending by banks
- Strengthening the banking supervision and consumer protection
- Reviewing the role of the Treasury

Programs facilitating the financing of SMEs

- Expanding the activity of MFB / involving new funding
- Preferred financing loan programs: MFV Business Development Loan, New Hungary Micro, Working Capital and Investment Loans
 - Expanding lending without the banking system (involvement of Local Enterprise Promotion Foundations and the Leader Group)
- Capital programs for SMEs
- Guarantee programs

Retaining jobs and helping those who loose their jobs

- Topping up the 4 days of work – 1 day of training program with EU funds
- Stimulating part-time employment
- Supporting employment with a new employer (wage support)
- Complex service package to help downsized workforce
- Passing the law on orderly employment relations
- Continuation of EKD subsidies, speeding up job creation tenders within the GOP

Speeding up the use of EU funds

- Speeding up advance payments
- Adjustment to the exchange rate
- Participation in providing co-financing
- Replacing the requirement of increasing sales revenues with job retention
- Speeding up decisions on subsidies

The measures to improve the equilibrium will result in app. 1,300 bn HUF savings in the state household in 2009 and 2010

More efficient public sector

- Freezing nominal gross salaries for 2 years
- Revision of salary top-ups for the second half of 2009
- Elimination of 13th month salary, introduction of a general incentive
- Reducing subsidies for local governments

Strengthening the sustainability of the pension system

- Advancing the increase of the retirement age
- Rescheduling pension adjustment for 2009
- Elimination of pension adjustment for 2010
- Cancellation of the 2nd installment of the 13th month pension for 2009
- Elimination of the 13th month pension, introducing a pension premium pegged to the GDP
- Advancing the introduction of penalty system in case of early retirement

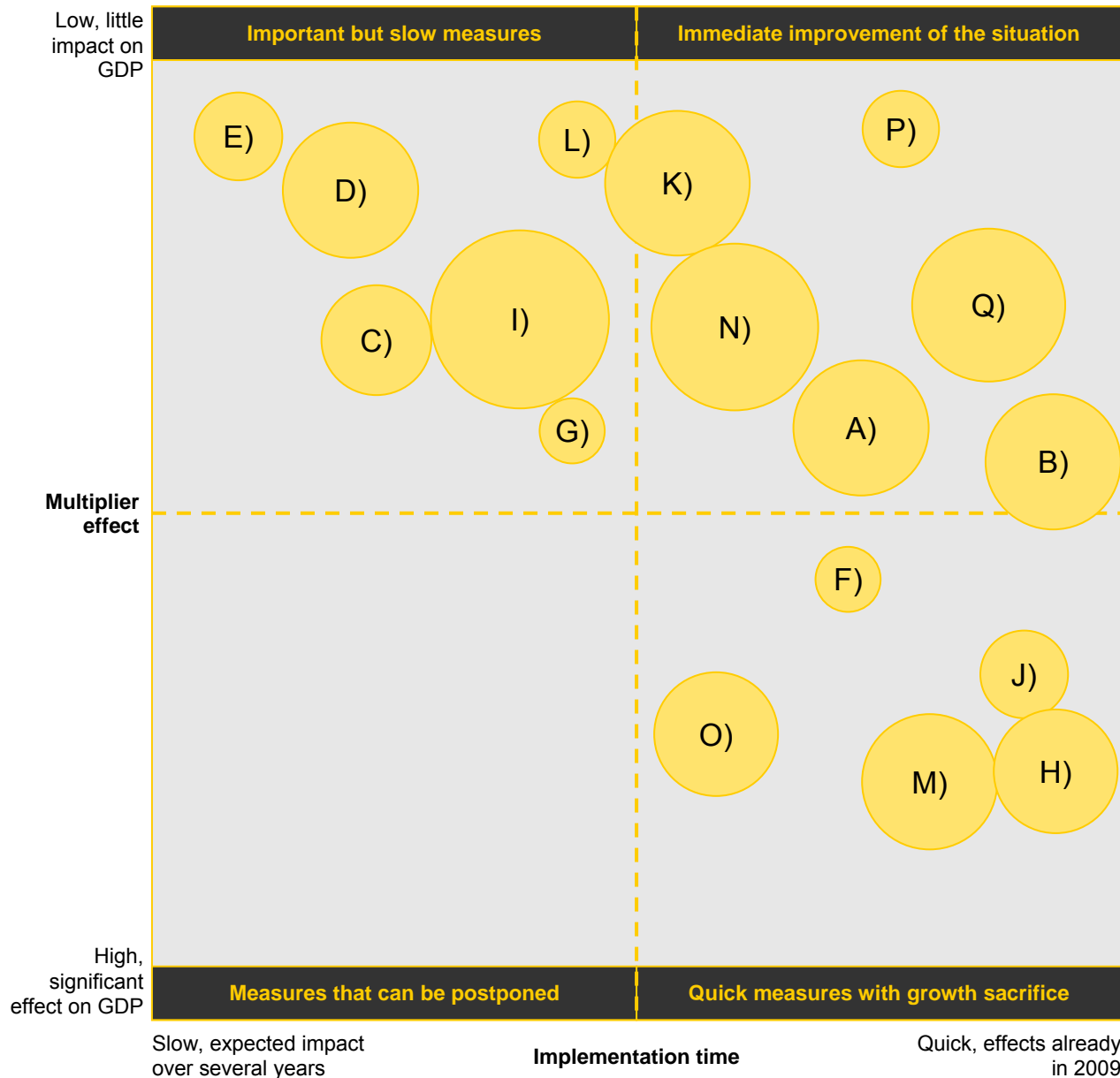
Developing a more targeted social system

- Cutting sick pay by 10 percentage points (from 70% to 60%, and from 60% to 50%)
- Freezing the family allowance for 2 years, reducing the age of eligibility from 23 to 20 years of age.
- Setting a cap for the duration of maternity subsidy and maternity pay with nursery and kindergarten programs, more flexible rules for tending to children
- Suspension of housing subsidies
- Reduction and gradual phasing out of gas and distance heating compensation pays

Other measures

- Cutting subsidies for community transport through reorganization, and revision of transport benefits and allowances
- Reducing subsidies to public media
- Cutting the national top-up of community agricultural subsidies (in 2010)

The measures to improve equilibrium have an effect on short term, while slightly curbing growth



- A. Freezing nominal wages for 2 years
- B. Revision of wage top-ups for the 2nd half of 2009
- C. Elimination of 13th month pay, introduction of general incentive
- D. Reduction of local government subsidies
- E. Accelerating the increase of retirement age
- F. Rescheduling pension adjustment for 2009
- G. Cancellation of pension adjustment in 2010
- H. Cancellation of both installments of 13th month pension in 2009
- I. Cancellation of 13th month pension, introduction of pension allowance pegged to the GDP
- J. Reduction of sick pay to 60%
- K. Freezing of family allowance for 2 years, reduction of eligibility to 20 years of age
- L. Capping the term of maternity and child care leaves
- M. Suspension of housing subsidies
- N. Reduction and gradual phasing out of gas and distance heating subsidies
- O. Reducing the subsidy of community transport
- P. Reducing the subsidy of public media
- Q. Reducing top-up subsidies

TAX REGIME

Group of measures

Actual measures

2009

2010

Reducing the burdens on labour

- Cutting employer contributions by 5% up to 2× the amount of the minimum wage
- Raising lower PIT band to 1.9 mHUF

- 5% cut of employer contributions after the entire income
- Elimination of EHO
- Total grossing-up: Tax base is the gross wage plus social contributions
- Rates will reduce: to 15-17% and to 33-35%
- Lower band limit: 4-5 million HUF

Fighting tax evasion

- Extending taxes to income and wealth kept in tax havens
- Adjusting the contribution base to the real value of the activity

Securing funding and taxes on consumption

- **Increasing VAT to 25%**,
- **Preferred rate:** 18% → milk, dairy products, bread, bakery pr., distance heating
- Increase of excise tax by 5-6% on average

Introduction of general real property tax, elimination of current taxes

- The general value-based real property tax remains unchanged in case of properties with smaller value – progressive and equitable system

Simplification

- Unified corporate income taxation, elimination of surtax
- Limitation of tax allowances and tax exemptions
- Simplification of duties etc.

EXPECTED OUTCOME OF TAX MEASURES

**Tax wedge reduces by 5-7%
at average wages**

**Employer contributions
drop by app. 8% on the
level of the minimum wage,
and by 6% for the average
wage**

**90% of taxpayers fall under
the lower tax rate**

**The level of marginal tax
burden (currently 45%),
which influences the level
of activity, reduces
substantially**

Increasing the level of activity

Groups of measures

Actual measures

Transforming the system of child rearing subsidies

- Continuation of the nursery and kindergarten development program (acceleration and expansion of funding)
- Revision of child care regulations (family day-schools etc.)
- Implementing more targeted measures in complex employment programs to allow the return of women to the labor market

Increasing the level of activity of the elderly

- Gradual increase of the retirement age (from 2012)
- Increasing the age focus of retirement (penalty)
- Tightening the conditions for retirement on disability
- Subsidies on the employment of the elderly will be strengthened e.g. through contribution allowances to employers

Subsidy policy measures

- Helping persons in a disadvantaged situation to return to the labor market
- Supporting the job finding of people with lower skills, career starting individuals, elderly employees and those who return to the labor market after working as a caregiver to a relative
- Launching programs that aim at sustaining the working ability of persons who became unemployed after September 2008
- Contribution allowance aimed at the employment of persons in disadvantaged situation
- Continuation of the Path to Work Program

The government will use a number of measures beyond the budget to stimulate the economy

Groups of measures Actual measures

Strengthening market acquisition

- Export development program
- Supporting access to domestic markets
- Launching supplier program
- Foreign economic policy offensive

Simplification of administration

- Cutting bureaucracy
- Fighting chain debts
- Accelerating the licensing of high value private investments
- Implementation of the Acceleration II program

Working out sector strategies

- Working out development strategy for sectors of particular importance for the national economy (automotive, logistics, IT, pharmaceuticals and bio-tech)
- Labor intensive sectors: food industry, tourism, construction
- Adapting the vocational training to industry needs
- Stimulating research and development

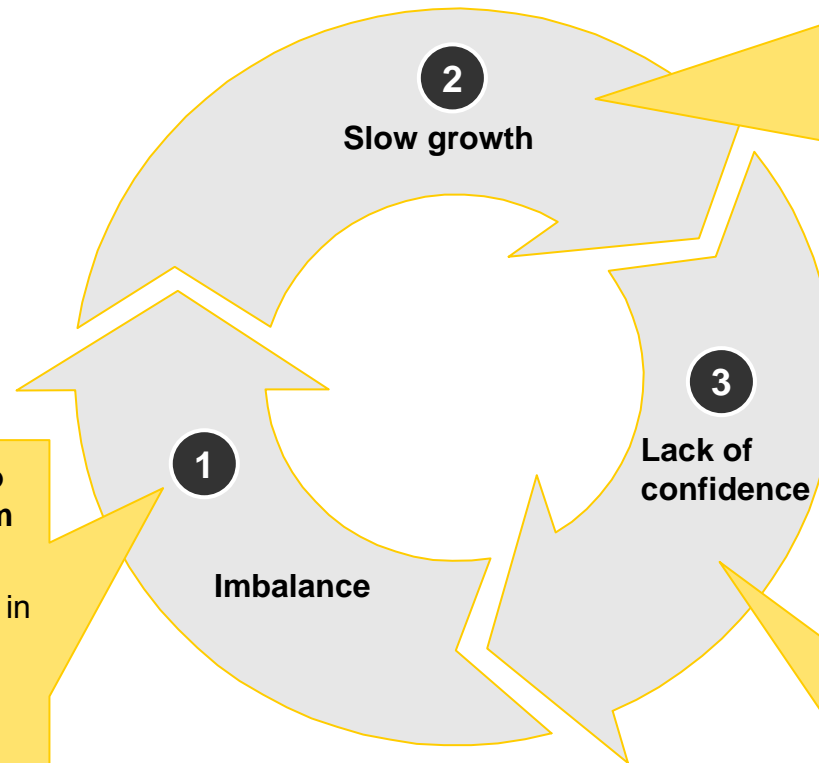
Development of human and real economic infrastructure

- Regionalization of community transport and introduction of electronic ticket control
- Introduction of electronic toll collection
- Education: higher education, vocational training, training of skilled workers

Improvement of energy efficiency

- Stimulating energy efficiency
- Revenues from the sale of CO2 quotas should be spent on energy efficiency programs
- Green Public Procurement System

A number of additional government measures will improve the living conditions of citizens



Additional measures to improve the equilibrium

- Helping foreign currency loan debtors in trouble
- Stronger enforcement of the means based principle in social benefits
- Recapitalization of banks and securing their stability if ended up in a difficult situation due to the crisis

Additional measures to stimulate growth

- Implementation of environmental and agricultural developments
- Improving the quality of higher education through the introduction of a more efficient financing system
- Helping mothers to find jobs through launching new nursery development and teacher re-training programs

Additional measures to boost confidence

- More support to the police for significant improvements in public safety
- Securing the value stability of savings kept in pension funds through introduction of more risk averting investment regulations

The commitment of the government is confirmed by setting the right objectives and measures that guarantee implementation

Fundamental problem with managing the double crisis: in addition to actual targets investors should also see guarantees for implementation

Economic objective

- Equilibrium: primary surplus of 3-4% by 2010
- Growth: 2% above EU average sustainably
- Confidence: compliance with Maastricht criteria

Independent supervision

- Agreements with the IMF and the EU guarantee independent oversight over the implementation of the program

Long term inception program

- The establishment of a project office will guarantee that the implementation plan is carried out

Anti-corruption, law and order and public safety

- Protection of persons reporting to police, code of conduct, police and other law enforcement organizations to be strengthened, amendment of the Criminal Code

Solidarity

- State, politics and wealthy individuals

Communication

- Regular information on the achievements to guarantee transparency

Everybody has something to contribute to solidarity

SOLIDARITY

State

- Cutting the salaries of ministers by 15%
- Cutting per diems of ministers and state secretaries by 50% when traveling abroad
- Radical cut of remuneration for board or supervisory board membership in majority state owned companies
- Capping the salaries of managers of majority state owned companies

Politics

Wealthy individuals

- Introduction of real property tax
- Maintaining the surtax of private individuals until 31 December 2010
- Increasing the rate of the weight-based car tax

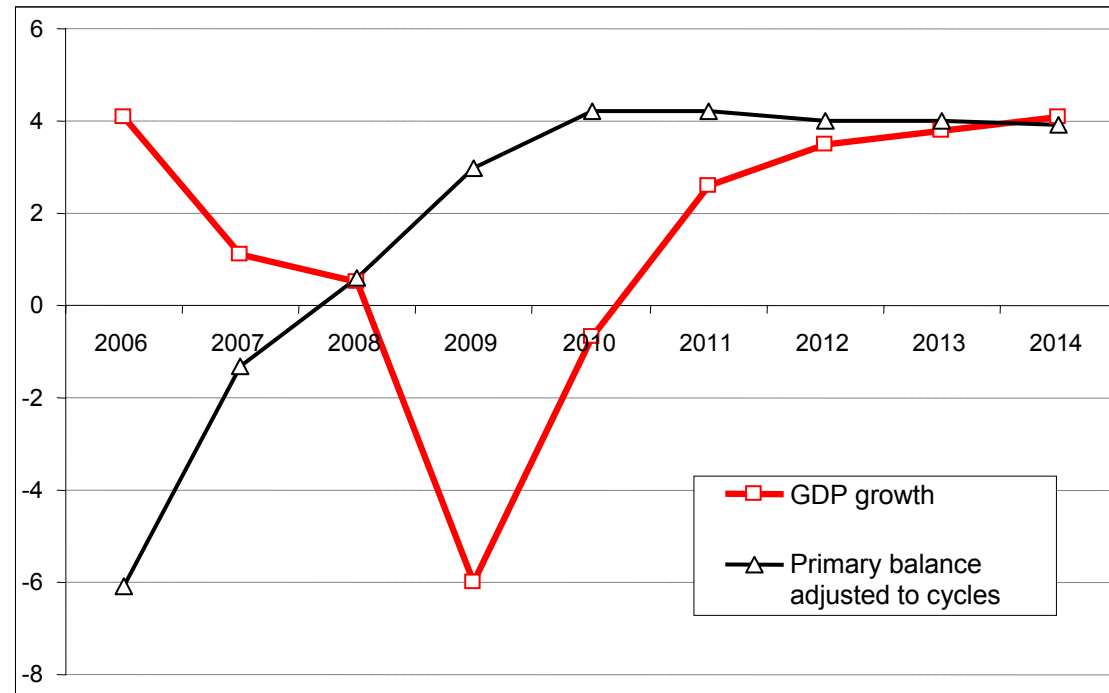
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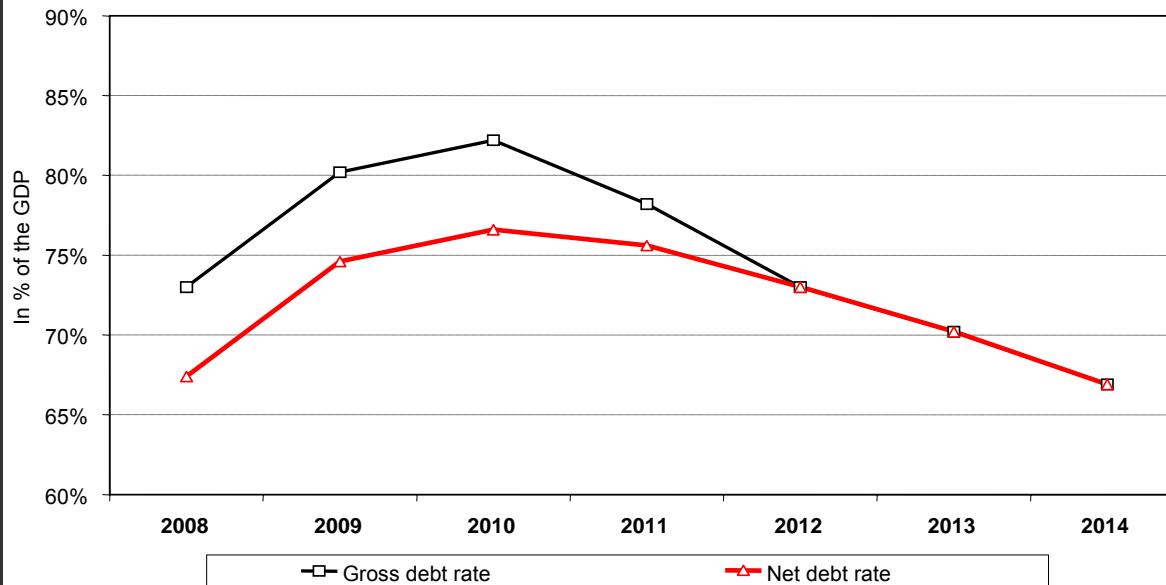
**3. Projected consequences of the crisis
management program**

Changes of macro-economic indices as a consequence of measures

The primary balance to the GDP adjusted structurally will improve significantly, by 2 percentage points already in 2009 and will reach 3%, while GDP growth will improve spectacularly by 2011.



Debt ratio changes



Debt trajectory – falling funding need of the state, more air for the economy to breathe

Long term sustainability improves

State debt on a course of reduction

The program will perceivably improve the situation of certain groups

Key beneficiaries	Which measures are good for them?	Which measures are bad for them?
Employees	<ul style="list-style-type: none"> ▪ Net salary increases because less PIT payable ▪ Lower social costs make jobs safer 	<ul style="list-style-type: none"> ▪ VAT increase makes living costs slightly more expensive ▪ Some subsidies will be reduced or phased out
Businesses	<ul style="list-style-type: none"> ▪ Social costs drop, total wage cost will be lower as a consequence ▪ General tax burden on businesses drops, too 	<ul style="list-style-type: none"> ▪ Cuts in budget expenditures will temporarily curb retail consumption
Families	<ul style="list-style-type: none"> ▪ Burdens on salaries reduce, more money is left with families ▪ Targeted programs for women to return to work ▪ More places in kindergartens and nurseries ▪ Family tax allowance retained 	<ul style="list-style-type: none"> ▪ VAT increase makes living costs slightly more expensive ▪ The amount of the family allowance will not increase for two years
Future pensioners	<ul style="list-style-type: none"> ▪ Future pensions retain their purchase power 	<ul style="list-style-type: none"> ▪ Increased age of retirement
Foreign currency loan debtors	<ul style="list-style-type: none"> ▪ Exchange rate risks reduce 	

The final outcome of the program is coming out of the crisis, restoring the honor of work, enforcing the principle of fair pay for fair work and securing the sustainable prosperity of the country

Crisis Management Program of the Government

19 April 2009