REPORT ON THE BALANCE OF PAYMENTS

APRIL 2015

‘We may not always be able to do what must be done,
but we must always do what can be done.’

Letters 27
Gábor Bethlen

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In accordance with Act CXXXIX of 2013 on the Magyar Nemzeti Bank, the primary objective of the MNB is to achieve and maintain price stability and, without prejudice to its primary objective, the central bank is also responsible for maintaining the stability of the system of financial intermediation. Developments in the external balance are key to financial stability, as processes relating to the balance of payments allow for conclusions to be drawn concerning the sustainability of economic growth and relevant risks. Moreover, analysis of the balance of payments makes it possible to identify and take actions to avoid economic problems earlier, when they are developing.

To that end, on a regular basis the Magyar Nemzeti Bank carries out comprehensive analyses of trends relating to Hungary's external balance, examining a number of indicators to assess macroeconomic imbalances and identifying elements and processes of critical importance for Hungary's vulnerability.

Given the lessons learned from the financial crisis and the recent period, the balance of payments of a given country and trends therein indicating potential dependence on external financing are particularly important in the economic press. Developments in the external balance position are also closely monitored by market participants and analysts. Therefore, the primary goal of the publication entitled 'Report on the Balance of Payments' is to inform market participants – by way of this regular analysis – about developments in the balance of payments and thus provide deeper insight into the workings of the economy.

This analysis was prepared by the MNB's Directorate Monetary Policy and Financial Market Analysis under the general guidance of Dániel Palotai, Executive Director in charge of Monetary Policy. Contributors: Gergely Baksay, Zsuzsa Kékesi, Balázs Kóczián, Péter Koroknai, Rita Lénárt-Odorán, Ádám Martonosi and Balázs Sisak. It was approved for publication by Dr. Ádám Balog, Deputy Governor.

This Report is based on information for the period ending 26 March 2015.

SUMMARY

***In 2014 Q4, the four-quarter net lending of the Hungarian economy rose to 8.3 per cent of GDP, which resulted from a EUR 4.3 billion surplus both of the current account and the capital account.** At the end of the year, the high level of net lending was accompanied by a substantial decline in external debt, while the acceleration of net FDI inflows seen in the previous quarter continued. The increase observed in the external surplus at the end of the year primarily reflected the rise in corporate savings and the declining net borrowing of the general government; in addition, the stabilisation of households' financial savings at persistently high levels also contributed to the strong net lending position.*

*Hungary's external balance improved slightly throughout 2014 from last year's high level. Peaking at a historically high level in excess of 8 per cent of GDP, the surplus was made possible by a number of favourable developments. On the one hand, **the income balance deficit was further reduced** by the steady decline in external debt ratios and the drop in yields and risk premiums. On the other hand, owing to increased EU drawdowns, **the surplus on the transfer balance surged to a new historic level.** Finally, **the trade surplus remained stable**, despite the import-boosting effect of accelerated investment dynamics and the filling-up of natural gas storage capacities in 2014. The continued expansion of vehicle production and improving terms of trade were additional contributors. Meanwhile, the balance of services rose steadily throughout the year. On balance, **the export market share of Hungary improved further in 2014.***

***Financing trends show that foreign direct investment continued to flow into the economy in 2014; consequently, the high level of net lending enabled Hungary to make substantial payments on its external debt again.** In 2014, net external debt decreased by around EUR 7 billion due to transactions, to which all three sectors contributed. The outflow of funds in the banking sector continued to decelerate, possibly due to households' portfolio shifts from bank deposits towards government bonds and investment fund units, the central bank's self-financing programme and the inflow of non-residents' funds into the banking sector in relation to the conversion of the MNB bill into deposits. At the same time, these developments also contributed to the general government sector's reduced reliance on non-residents' government bond purchases, which was also reflected in the shrinking share of government debt held by non-residents. Contrary to previous years, corporations also made substantial repayments on their external debt in 2014.*

***Driven by financing flows, external debt ratios continued to fall in 2014; at the same time, GDP growth was another important contributor to the decline in Hungary's external indebtedness.** Gross and net external debt fell to around 85 and 33 per cent of GDP, respectively. In respect of the trends observed last year, it is important to emphasise that the transaction-related decline in external debt ratios was not only impeded by the weakening exchange rates, but also by diminishing yields, which increased the value of government bonds held by non-residents. The decrease of yields, however, may have a positive impact both on the net lending position and on the evolution of external debt over a longer horizon, through the decline in interest payments. The reduction of Hungary's external vulnerability was also supported by a sharp decline in short-term external debt based on residual maturity: by the end of 2014, short-term external debt shrank close to EUR 21 billion, mainly associated with general government debt. While this may also imply that the gross borrowing requirement of the Hungarian economy may be significantly lower in 2015 than in 2014, Hungary will still continue to rely on renewal of external funds.*

***Analysing the external balance from the perspective of sectors' savings, it appears that the rise in Hungary's net lending in 2014 was made possible by the further adjustment of households, the corporate sector's considerable financial savings, and the tight spending of the general government.** The net borrowing of the general government remained close to 2 per cent of GDP in 2014, partly as a result of increased revenues stemming from robust economic growth and wage dynamics and the improvement in tax collection efficiency following the installation of online cash registers. Despite the sharp rise in the sector's investment expenditures, the financial savings of corporations remained substantial, which can be attributed to their improving profitability boosted also by increasing EU transfers. The rise in households' net savings continued during the year, and the shift to government securities and mutual funds in the household portfolio also persisted, although it decelerated in the second half of the year. On the whole,*

both directly and indirectly, through purchases of mutual fund shares, households continued to increase their role in funding the state in 2014, which contributed to a further decline in foreign dependence.

The net lending and growth rate of the Hungarian economy was considerable even in EU comparison in 2014, and thus external debt ratios continued to fall. Nevertheless, despite the significant decrease, Hungary's external debt ratio remained relatively high. *Boosted by the robust net lending and possibly supported by the high absorption of EU transfers, the Hungarian economy expanded at a fast rate in 2014. Hungary recorded the highest balance of payments surplus among the countries of the region, in which the markedly high absorption of EU transfers and, via the improving terms of trade, the surplus of the trade (goods and services) balance played an important role. As for the savings of different sectors, in addition to the low budget deficit, the high savings of the private sector relative to the rest of the region contributed to a net lending position which is outstanding even in regional terms. While the net external debt of the economy is still higher than in other countries of the region, the gap narrowed further in 2014.*

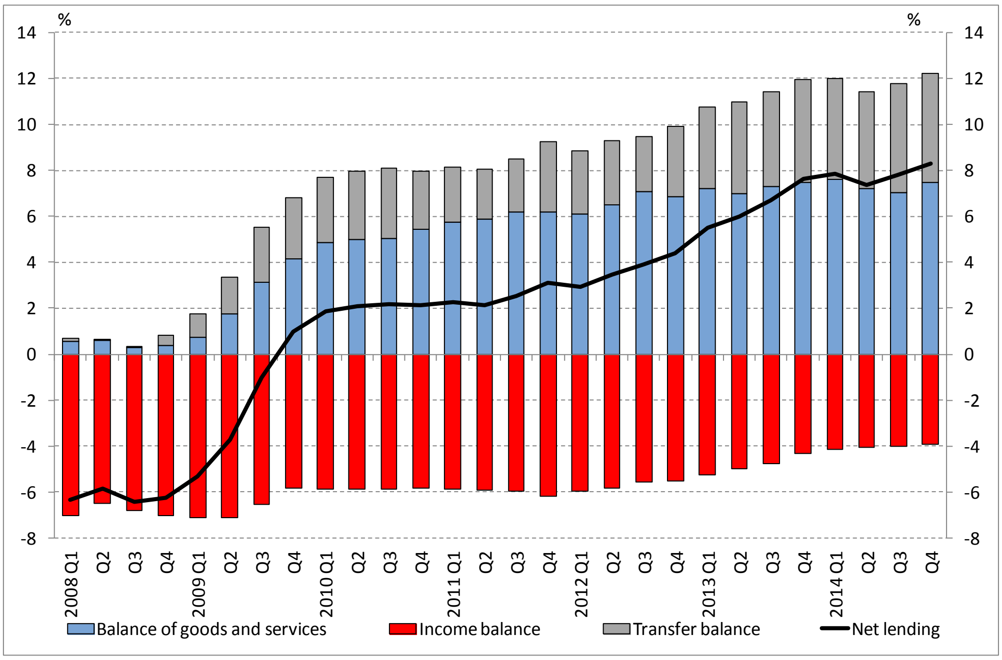
Table of Contents

1. REAL ECONOMY APPROACH

According to the real economy approach, Hungary's net lending stood at 8.3 per cent of GDP in 2014. The external position, which remained stable throughout the year, reflected the high surplus of the transfer balance and the trade balance, as well as the lower deficit of the income balance compared to previous years. Backed by the increasing use of previously accumulated vehicle industry capacities and the rising balance of services, and also supported by improving terms of trade, the trade balance consistently exceeded 7 per cent of GDP during the year. The surplus of the transfer balance rose to 4.8 per cent of GDP as drawdowns intensified towards the end of the EU budget period. Parallel to the drop in external debt ratios and the decline in yields, the deficit of the income balance continued to decrease slightly over the past year.

Based on the real economy approach, the net lending of the Hungarian economy rose to another historic peak in 2014 Q4 and exceeded 8 per cent of GDP. In Q4, seasonally unadjusted net lending based on the real economy approach amounted to EUR 2.9 billion, of which the current account balance was EUR 0.9 billion and the capital account balance was EUR 2 billion. According to four-quarter data, based on the real economy approach net lending rose to 8.3 per cent of GDP, reflecting the expansion of the trade balance – mainly associated with the balance of services – and the substantial surplus of the transfer account stemming from the EU transfers (Chart 1).

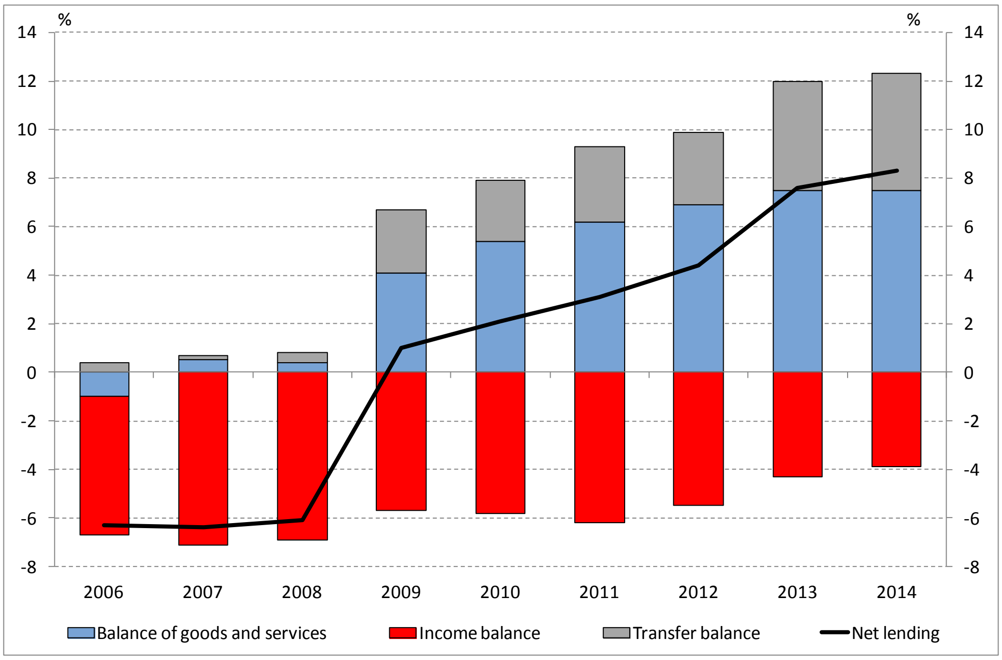
Chart 1: Developments in net lending and its components
(four-quarter values as a percentage of GDP)



All charts by the MNB unless otherwise indicated.

The moderate annual rise in net lending in 2014 was associated with an improvement in the income balance and the transfer balance (Chart 2). In part, the substantial trade surplus stemmed from the further expansion of vehicle production amid the increasing use of previously accumulated capacities, although the dynamics of the expansion slowed somewhat compared to the previous period. At the same time, the balance of goods was reduced by the sharp increase in domestic absorption, the filling-up of gas storage capacities and restrictions linked to the Russia-Ukraine conflict. The effect of the above factors, however, was offset by the rising surplus of the balance of services. The improvement in the terms of trade, in line with decreasing oil prices, was perceived to only limited degree in 2014, with a more pronounced positive effect expected for 2015. The absorption of EU transfers as a percentage of GDP increased further, owing to the concentration of payments at the end of the EU's 2007–2013 budget period. The decline in the income balance deficit is mainly due to the simultaneous fall in the balance of interests paid on foreign loans and on inter-company loans, which may be linked to the continued adjustment of external debt ratios.

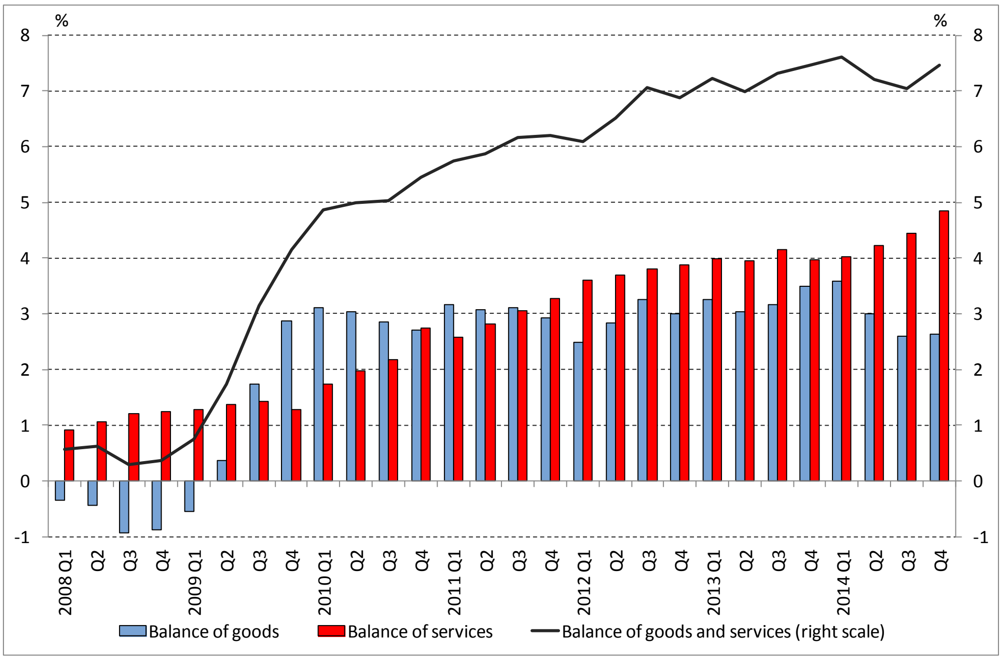
Chart 2: Developments in net lending and its components (four-quarter values as a percentage of GDP)*



1.1. Balance of trade

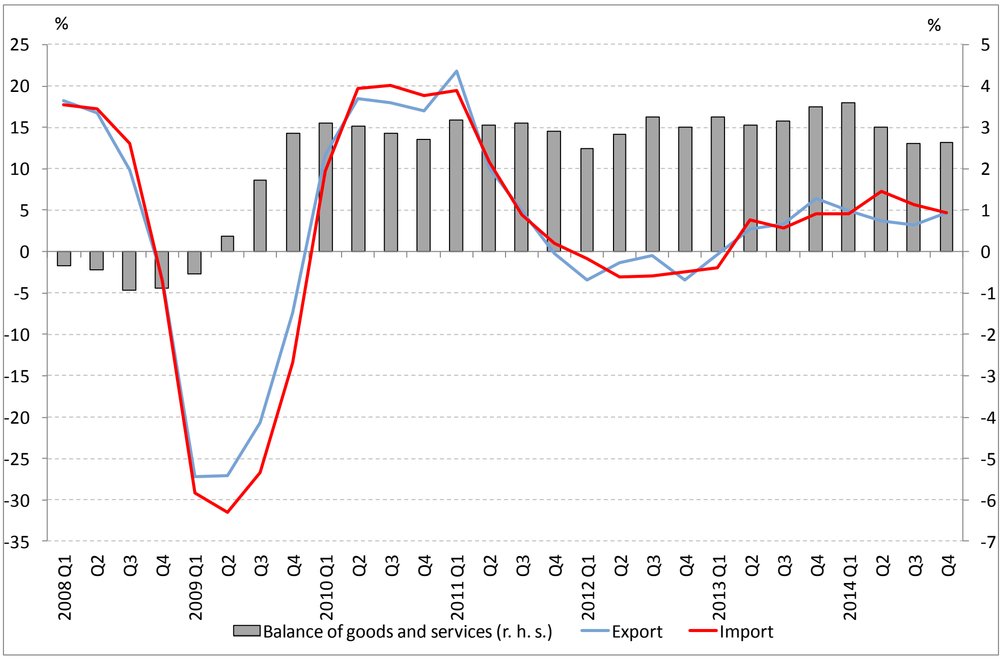
For the first time in a year, the trade surplus rose to 7.5 per cent of GDP in Q4, as a result of an increase in the balance of goods to a lesser degree, and the expansion of the balance of services to a larger degree (Chart 3). Rising domestic industrial output, in particular, vehicle production, boosted the export of goods, albeit at a slowing rate in Q4. Although imports also expanded as a result of the increase in domestic demand (including consumption), at the end of the year the four-quarter net export of goods slightly surpassed the corresponding value of the previous period. In part, this may be attributed to the decelerating dynamics of annual investment growth towards the end of the year, which may have been accompanied by a lesser increase in demand for imports. After a protracted period of stagnation, the balance of services steadily increased in 2014 as a whole, with a moderate, parallel decline in the balance of goods. As a result, the weight of the balance of services in the trade surplus increased.

Chart 3: Developments in the balance of trade and its components (four-quarter values as a percentage of GDP)



The expansion in exports of goods corresponded to the dynamics of imports once again, and thus, after two quarters of decline, the four-quarter goods surplus stabilised in 2014 Q4. The goods surplus can be attributed to the fact that the real growth in exports of goods reached the growth rate of imports again (Chart 4). Until 2014 Q3, imports increased in conjunction with recovering consumption, the filling-up of gas storage capacities and the increase in investment activity in the context of the Funding for Growth Scheme and the absorption of EU funds. Towards the end of the year, however, investment dynamics slowed, which may have dampened demand for imports as well. In addition, exports may have been buoyed by the more dynamic external activity observed at the end of the year.

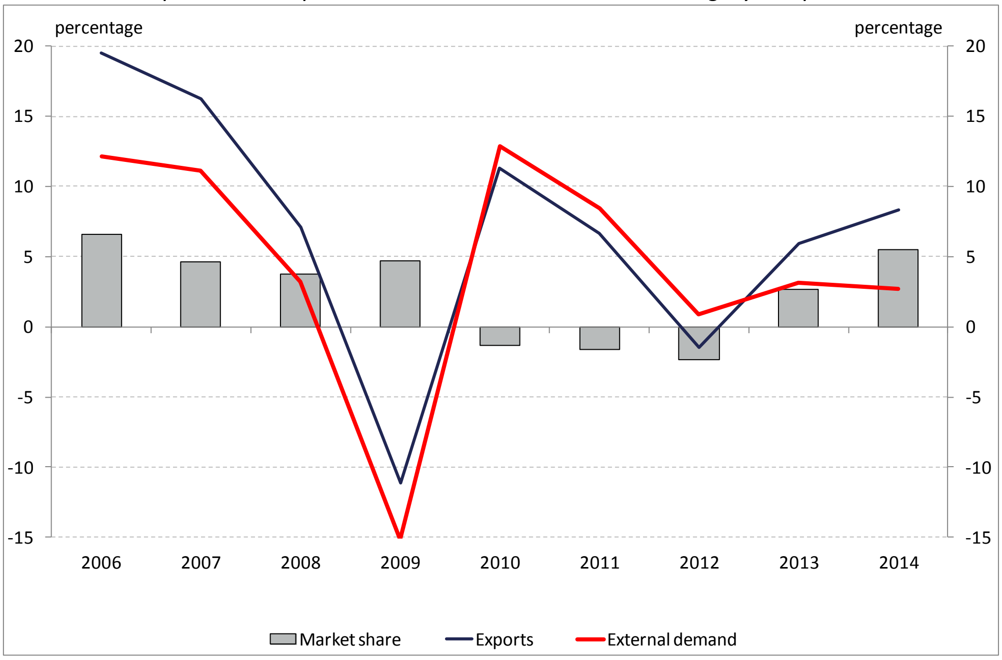
Chart 4: Change in the volume of the exports and imports of goods (annual growth rates) and the trade balance (four-quarter values as a percentage of GDP)



Source: HCSO.

Hungary's export market share increased significantly in 2014, primarily owing to a spike in vehicle production, but most industrial segments expanded also, thanks to the gradually improving external demand environment (Chart 5). The performance of Hungary's external trade was determined by external demand. Developments in external demand in 2014 were partly driven by the Russia-Ukraine crisis and the ensuing bilateral sanctions, but the restrained growth in developing countries also weakened the external demand environment for domestic exports. In Germany, Hungary's most important export partner, industrial production stagnated in the second half of 2014, which may have negatively influenced the expansion of Hungarian exports through the supplier chain. On balance, however, thanks to the dynamically increasing exports of the vehicle factories put into production in the course of 2014 and the improving international environment at the end of the year, the Hungarian economy increased its export market share in 2014 as well, closing the gap between its current and pre-crisis growth rates once again.

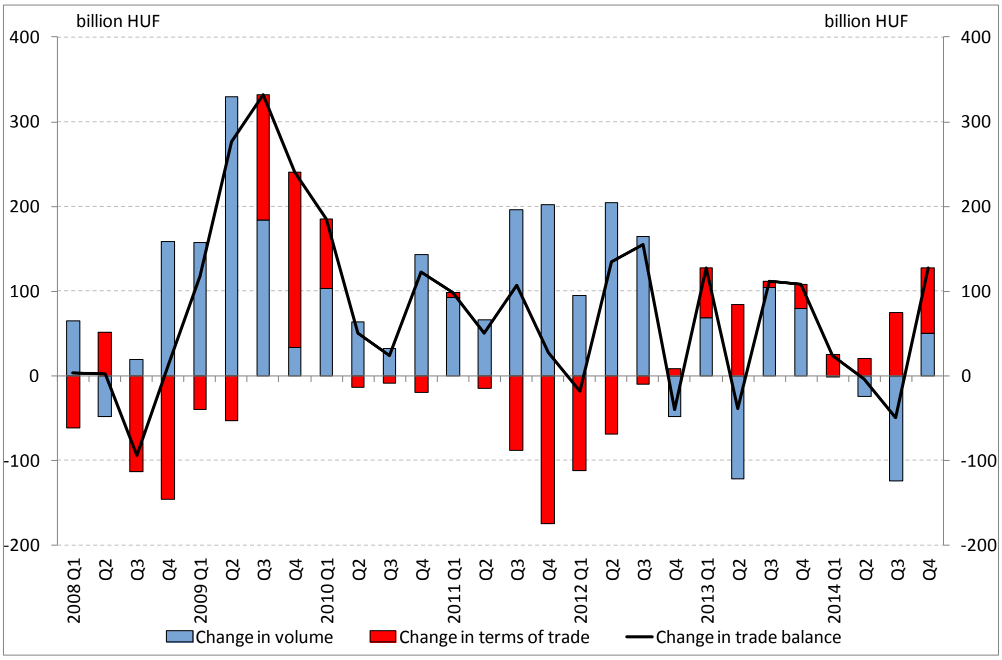
Chart 5: Developments in import-based external demand and Hungary's export market share



Source: HCSO

Besides the improvement in the terms of trade and contrary to the previous part of the year, the volume effect also contributed to the increase in the trade balance in Q4. Based on export and import price indices according to GDP, the terms of trade increased the surplus of the goods and services balance to a larger degree in the second half of the year (Chart 6). Besides low commodity prices and weak external inflation, a shift towards higher value exports may have played a role in this increased contribution. In Q4, the volume of external trade contributed positively to the balance again, partly as a result of the completion of the filling-up of gas storage capacities and the significant deceleration in investment activity at the end of the year, as well as the surge in vehicle production.

Chart 6: Developments in the balance of trade according to GDP (year-on-year)



Source: HCSO

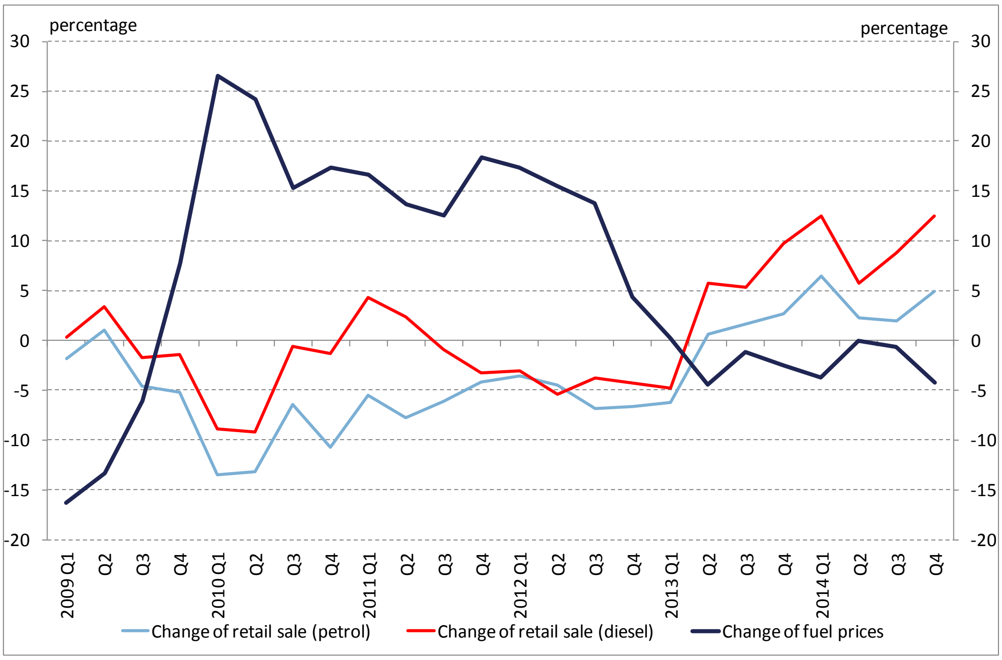
Box 1: Impact of falling oil prices on the foreign trade balance

Through its impact on import prices, the decline in oil prices may improve the terms of trade and hence, increase the trade surplus. The balance of trade may improve not only as a result of exporting more goods or services than importing them. If the price of exported goods is more favourable than the price level of imported goods, the terms of trade will improve, which can also increase the trade balance. The decline in oil prices lowers the import price index, which may have a positive impact on the terms of trade and hence, improve the trade balance. At the same time, the trade surplus increasing effect of falling oil prices is counteracted by the fact that, according to foreign trade statistics, Hungary exports a considerable part of imported crude oil derivatives (40 per cent expressed in euro). Since in this case the decline in the prices of crude oil derivatives is reflected both in the export and the import price index, its impact on the trade balance is smaller. At the same time, the expected fall in imported gas prices may improve the terms of trade.

At the same time, the impact of the significant fall in oil prices (by roughly 40 per cent) observed in recent years on the trade balance may be tempered by several factors. The decline in fuel prices in line with the fall in oil prices may lead to a surge in demand for fuel, which may reduce the trade surplus through the volume effect. In addition, increasing real wages may also point to increased demand for fuel. According to a previous study published by the MNB, the absolute value of the price elasticity of diesel oil turnover is lower, while its income elasticity is higher than 1; in other words, changes in prices have a smaller impact on fuel demand than changes in incomes.[1] In addition to the decline in fuel prices, real incomes also increased in the previous period and the two effects combined may have caused the significant increase in the retail sale of fuels in recent months (Chart 7). Consequently, we expect protracted growth in sales amid low gasoline prises, which, taken together, may dampen the favourable impact of the decline in oil prices on the trade balance. For instance, according to data on retail sales volumes, the amount spent on fuel purchases has increased even in the face of the price decline.

[1] Report on Inflation, September 2011, MNB

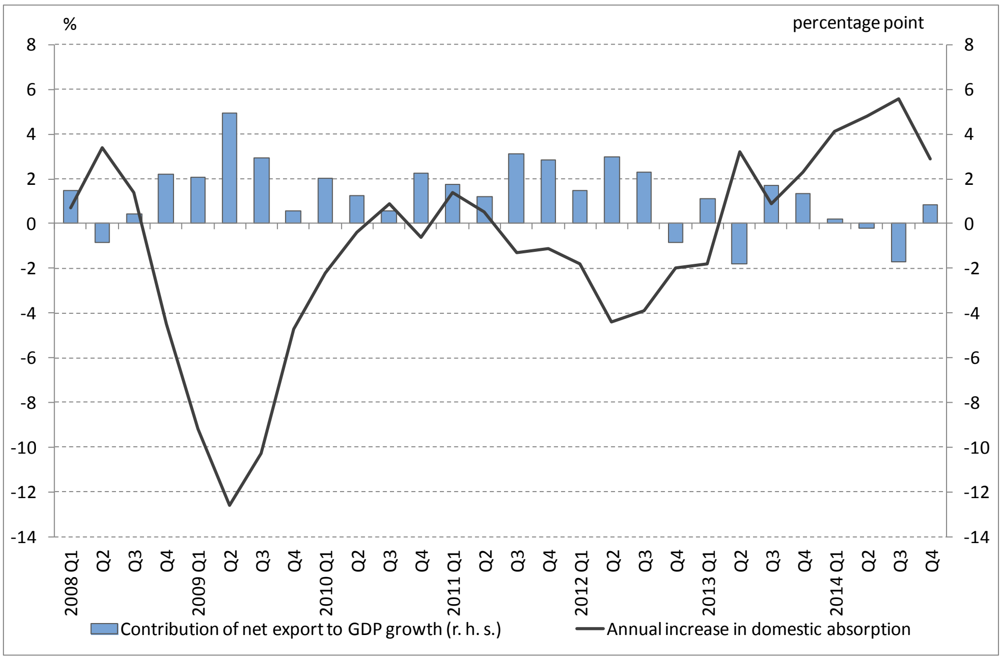
Chart 7: Quarterly average of the monthly change in fuel prices and in the retail sales of fuels



Source: HCSO, NTCA.

External demand was restrained for the year as a whole, and import-intensive investment projects dampened the contribution of net exports to growth, while domestic absorption increased significantly. The aforementioned increase in the volume effect of the trade surplus in Q4 entailed a turnaround in the contribution of net exports to growth as well; consequently, the contribution of net exports to growth was almost neutral in 2014 after the significant contribution of recent years. Ultimately, the reason for this development is the fact that the effect of rising imports caused by the sharp increase in domestic absorption was mitigated by the spike in exports as the utilisation of vehicle industry projects completed in previous years in vehicle production increased. The increase in the volume of whole-economy fixed investment is linked to the accelerating absorption of EU funds and the Funding for Growth Scheme. At the same time, it is important to note that the slightly negative contribution of net exports to growth in 2014 emerged in the context of the filling-up of natural gas storage capacities in Q3, and may have been partly linked to the sanctions introduced in response to the Russia-Ukraine conflict; thus, without these one-off effects, the contribution of net exports to GDP growth may have remained positive even amid robust domestic absorption. According to forward-looking indicators, owing to the sharp fall in oil prices and the weakening of the euro against the US dollar, the growth outlook of the European Union may prove to be somewhat better, allowing for a further increase in domestic exports.

Chart 8: Annual rate of increase in domestic absorption and contribution of net exports to GDP growth

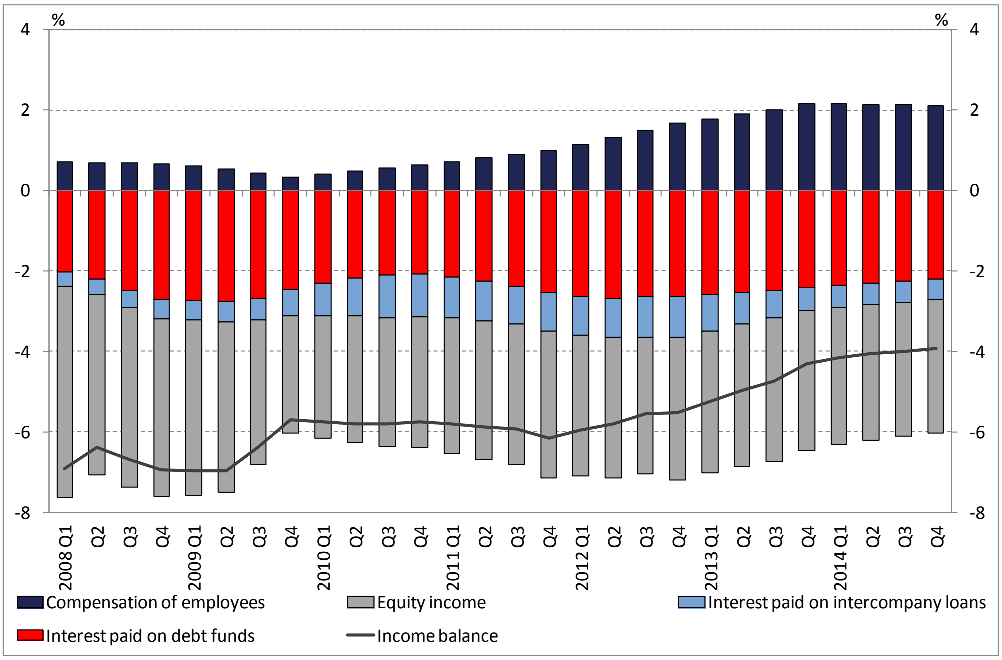


Source: HCSO

1.2. Income balance

In Q4 and in 2014 as a whole, the income balance deficit continued to decline as the balance of interest paid on foreign loans and inter-company loans decreased (Chart 9). The four-quarter deficit of the income balance amounted to 3.9 per cent of GDP, which implies a slight decline compared to the previous quarter. The decline primarily reflected a downward shift in the balance of interest paid on foreign debt and inter-company loans. This may be related to the historically low domestic and international interest environment on the one hand, and the further decline in debt ratios in line with the substantial level of net lending. Since the repricing of loans takes effect only gradually, the deficit of the interest balance may drop further. The income balance improved by 0.5 per cent of GDP in 2014 as a whole, mainly in conjunction with the decline in incomes paid for interest-bearing assets. While the deficit of the income balance was significantly reduced in 2013 by the incomes of those temporarily employed abroad, the rate of this process subsided in the course of 2014.

Chart 9: Developments in the items of the income balance (relative to GDP)

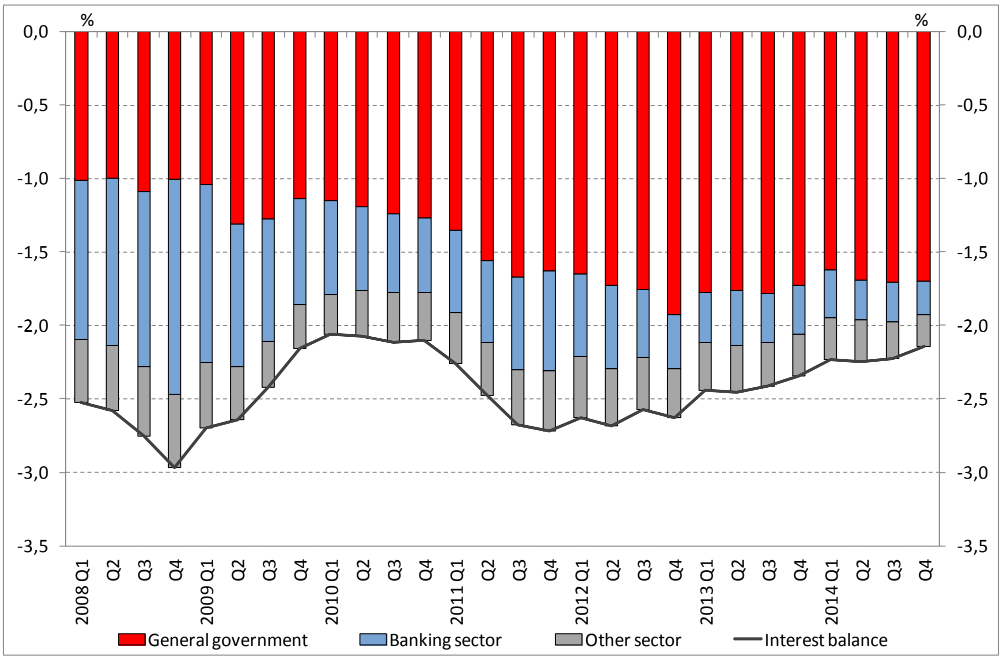


Data available on income outflows relating to shares are rather limited. Only a limited amount of quarterly data is available on the profitability of foreign-owned enterprises operating in Hungary; therefore, information on quarterly profit outflows are based on estimates for the most part.[2] As regards outflows of income in relation to shares, data are available concerning dividends, according to which Q4 dividends slightly exceeded the level warranted by seasonality. At the same time, Q4 data convey relatively limited information, as four fifths of the dividends were paid in the second quarter in 2014. Similar to the value recorded in 2013, the level of annual net dividend payments stood at around EUR 2.4 billion.

Net interest paid abroad dropped by 0.2 per cent of GDP in 2014 as a whole, mainly owing to the contribution of the general government and the banking sector. At the same time, the interest expenditures of corporations also decreased. In 2014, interest paid abroad declined in conjunction with the drop in the economy's external debt. This decline affected all sectors in line with the sectors' outflow of funds. The dip in the interest balance deficit was more or less consistent with the level of decline seen in 2013, owing to the continued decline of the interest environment. At the same time, in 2014 the conversion of the MNB bill into deposits under the MNB's self-financing programme may have generated shifts in the interest expenses of the sectors. As a result, the interest expenses of the consolidated general government may have dropped more sharply than those of the banking sector, as some of the liquidity previously held by foreigners in the MNB bill may have ended up in the banking sector. On the other hand, the reduction in corporations' interest balance may have been partly associated with a larger outflow of funds at the end of the year.

[2] For more details, see the statistics publication entitled 'Hungary's Balance of Payments and international investment position statistics, 2012'.

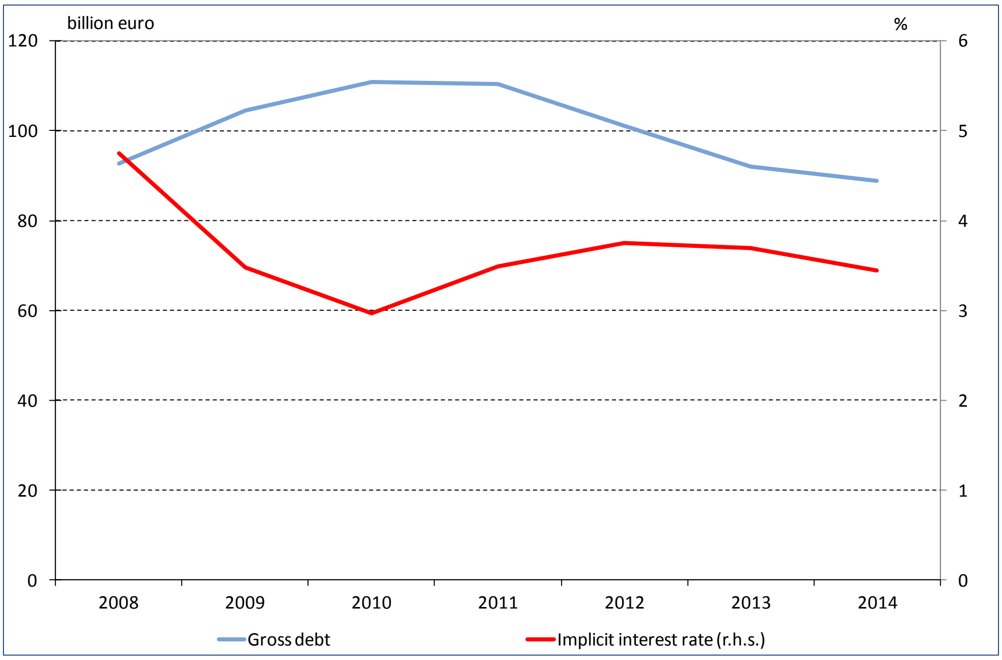
Chart 10: Developments in the interest balance and its breakdown (as percentages of GDP)



Besides the interest environment, the slight reduction of gross public debt may also have contributed to the improvement in the interest balance. In 2014, the deficit on the interest balance continued to decrease in the context of a decline in gross external debt and falling interest rates. The decline in external debt can be attributed to the continued adjustment of the sectors, the general government's lower deficit compared to the levels seen in previous years, the repayment of loans received from international organisations and the net repayments of the private sector. Moreover, the contraction in the interest balance deficit was also supported by the historically low Hungarian and international yield environment and the narrowing of risk premiums, as a result of which – provided that interest rates remain low – the implied interest rate level of the economy's external debt may continue to decrease.[3]

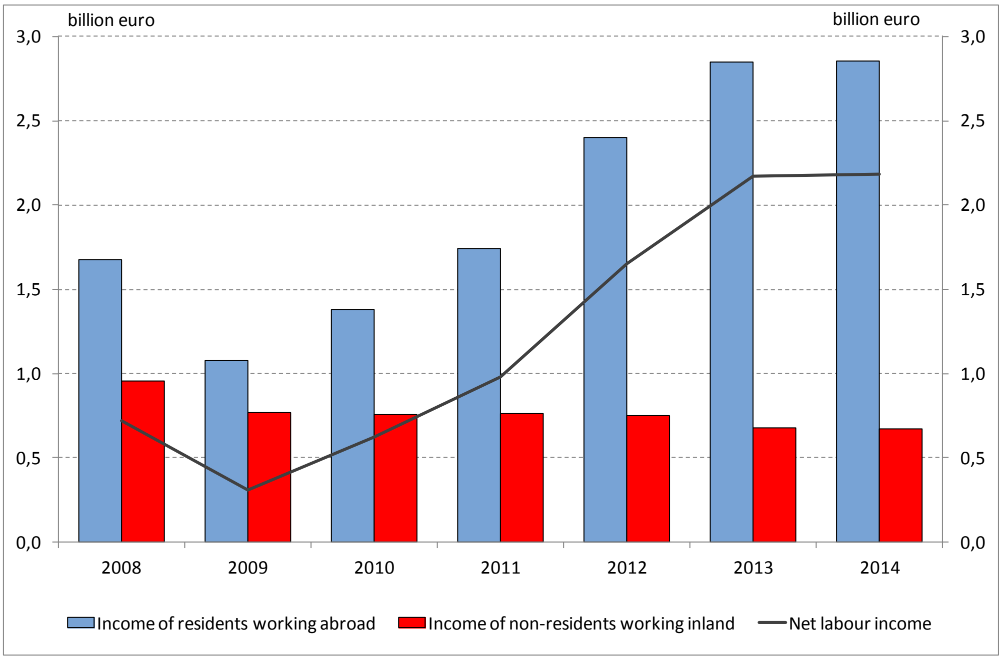
[3] Developments in the implicit interest rates (i.e. average interest paid on debt) do not necessarily reflect the changes in the current interest levels, because at present interest also needs to be paid on debt originating from earlier periods at their applicable rates (e.g. fixed interest-bearing debt); in other words, the repricing of the total debt volume with the new interest rates may prove to be a lengthy process, in view of the multiple-year average maturity period.

Chart 11: Developments in average gross external debt and its implicit interest rate



In 2014, the net income of resident employees working abroad was around EUR 2.2 billion, which is more or less consistent with the level observed in the previous year. The income of workers temporarily employed abroad has increased rapidly in recent years, with its net value reaching EUR 2.2 billion by 2013 (Chart 12). This did not change noticeably in the course of 2014; consequently, the income of workers employed temporarily – for less than 1 year – abroad lowers the deficit of the income balance significantly and hence, improves the net lending position of the economy. At the same time, workers employed temporarily abroad pay large sums of taxes on their incomes, which reduces the balance of other current transfers within the transfer balance. As a result, the impact of workers employed temporarily abroad on the net lending position may be less pronounced than in the case of the income balance.

Chart 12: Incomes of non-resident employees working abroad

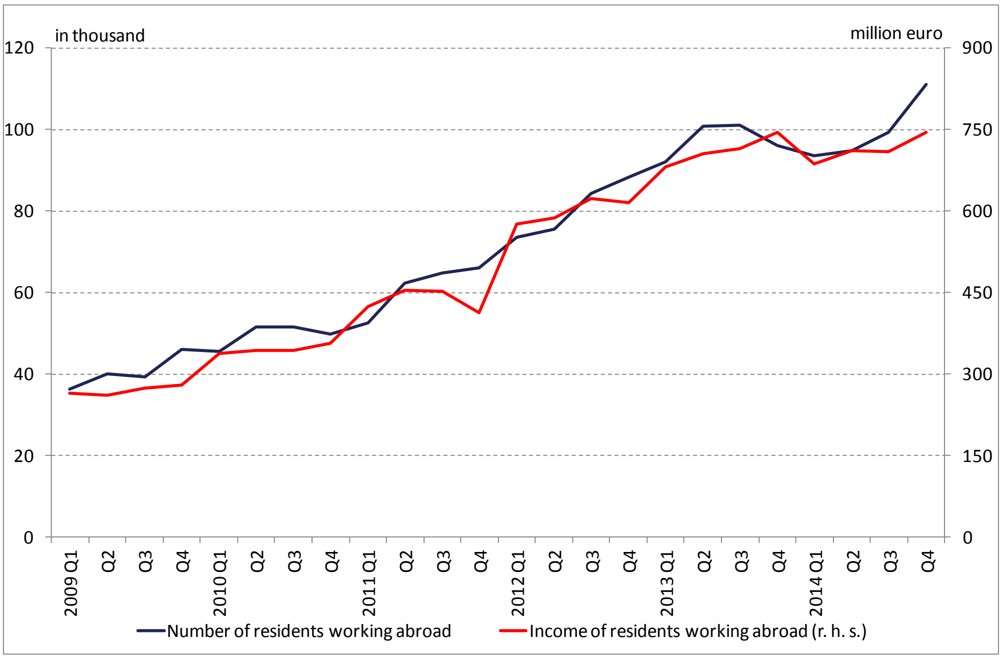


Source: HCSO, MNB.

Box 2: The extent of employment abroad

Within the income balance, the total income of resident workers employed abroad for less than a year has increased sharply since 2009. In view of the marked increase seen in recent years in the incomes of those employed abroad within the income balance, it is worth examining the background of this process. The literature distinguishes between two groups of workers employed abroad:[4] workers employed permanently and workers employed temporarily abroad. The income balance contains the incomes of people working abroad for less than a year; in practice, the wages of workers employed at foreign sites who have a residence in Hungary. By the end of 2013, the number of residents working abroad surged to 110,000, i.e. it increased more than two and a half times compared to the base in early 2009. This expansion is likely to be related to the fact that some of the destination countries (Austria, Germany) opened up their labour markets completely for migration flows from Hungary after May 2011[5] (Lakatos, 2015).

Chart 13: Income and number of resident workers employed abroad for less than a year



Source: MNB, HCSO.

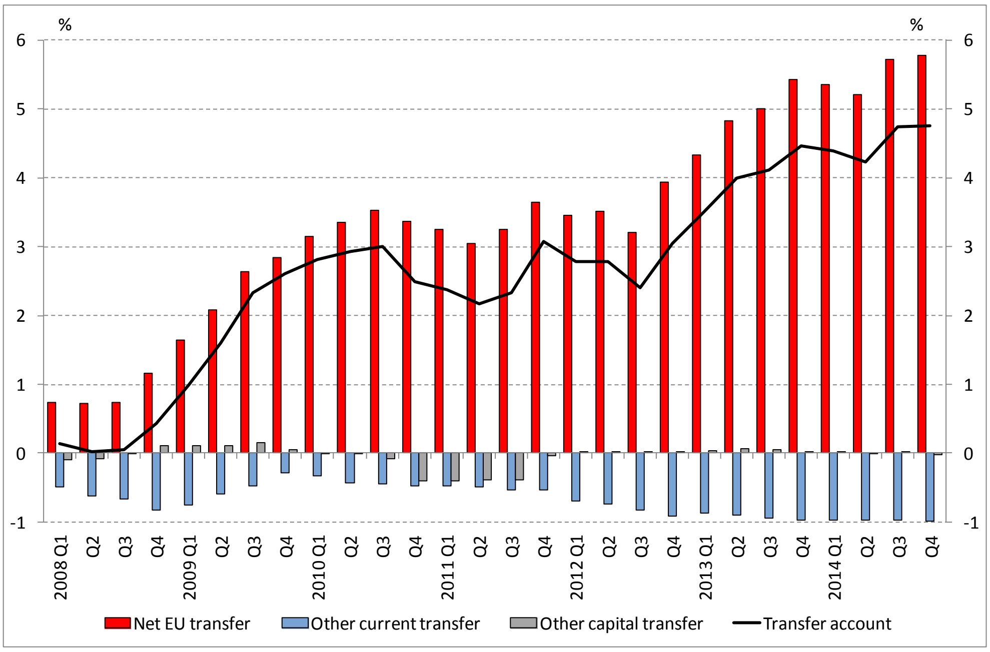
1.3. Transfers

In 2014, the GDP-proportionate annual absorption of transfers rose further from the historically high level recorded in 2013, and amounted to 4.8 per cent of GDP. The rise in the transfer account still reflects the increased absorption of EU transfers, while other current transfers continue to reduce the surplus of the transfer balance. The absorption of EU transfers continues to play the most important role within the transfer account: at around EUR 6 billion (5.8 per cent of GDP), the absorption of EU transfers in 2014 exceeded the level recorded in the previous year (Chart 14). In 2014 Q4, the absorption of EU transfers amounted to EUR 2.4 billion, surpassing even the peak observed a year earlier. Other current transfers have persistently reduced the surplus of the transfer balance in recent years, mainly as a result of the taxes and contributions paid by workers temporarily employed abroad. Since the incomes of those working temporarily abroad did not change perceivably in 2014, other current transfers also remained stable. Consequently, the incomes of people working temporarily abroad improve the current account balance overall, but to a lesser degree than the value observed within the income balance alone.

[4] Katalin Bodnár – Lajos Tamás Szabó (2014): The Effect of Emigration on the Hungarian Labour Market, MNB Occasional Papers No. 114

[5] Judit Lakatos (2015): Hungarians working abroad; foreigners working in Hungary. Hungarian Statistical Review, Volume 93, No. 2, February 2015

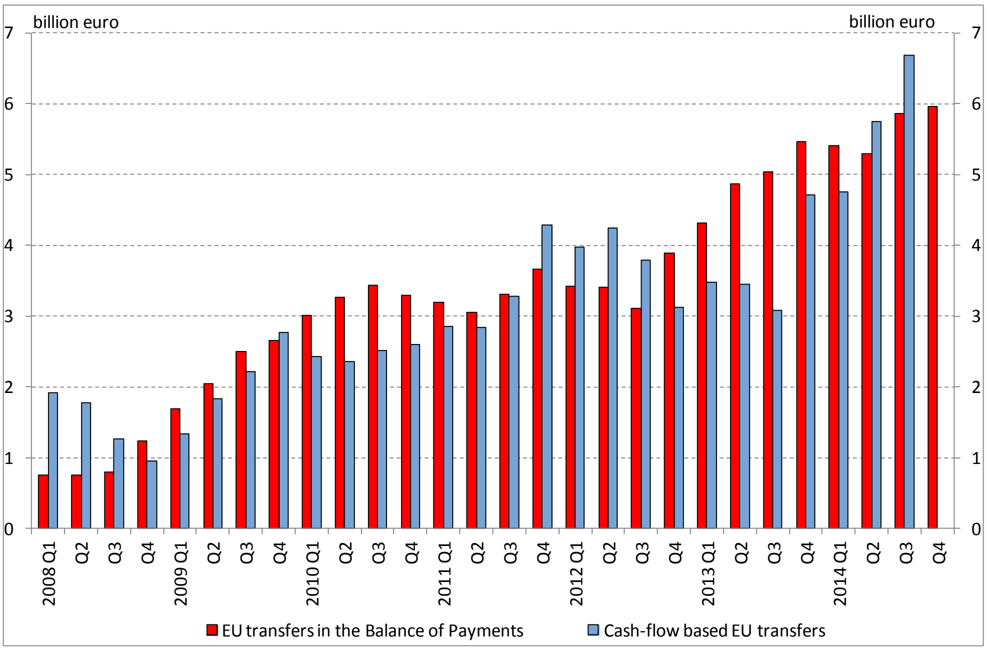
Chart 14: Developments in the transfer balance (four-quarter values as a percentage of GDP)



Box 3: Cash-based and accrual-based accounting of EU transfers

EU transfers booked in an accrual-based accounting system may differ in the short run from the amounts booked according to the cash accounting approach, but they are similar in the longer run. Towards the end of the EU's budget period, the absorption of EU funds progressively increases, which is reflected both in balance of payments data and in the amount drawn down. The amount of grants used in 2012 was already close to EUR 4 billion, and rose to EUR 5.4 billion and nearly EUR 6 billion in 2013 and 2014, respectively. At the same time, a substantial part of the transfers absorbed in 2013 had been transferred earlier; this is why the absorption of transfers at the end of 2014 exceeded the value of the transfers received. In contrast, in 2014 Q3 – with respect to the four previous quarters – the absorption of transfers fell short of the amount transferred (Chart 15), with the difference reflected in the growing debts of the state vis-à-vis the European Union. This difference decreased in Q4 as a result of the robust absorption of EU transfers, which suggests that the gap between the absorption of EU transfers and the transferred amount may have narrowed at the end of the year.

Chart 15: EU transfers according to the accrual-based and the cash-based approach (four-quarter values)



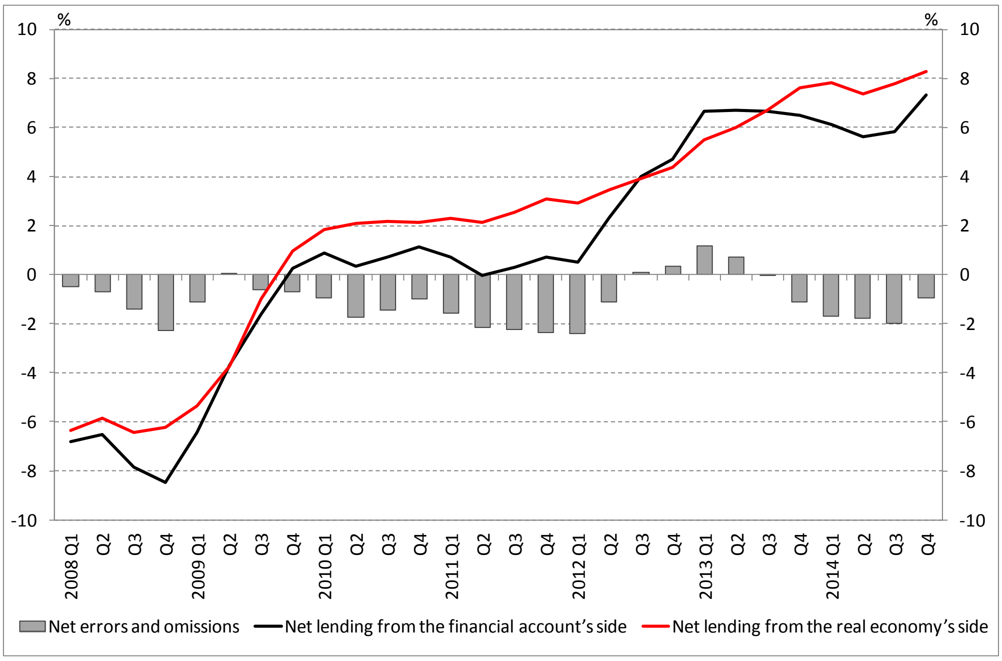
2. FINANCING APPROACH

Financing data also indicate that the economy's net lending may have increased further in 2014 Q4, due to a decline in debt liabilities and an inflow of non-debt funds. Based on the items of the financial account, 2014 was also characterised by a decline in net external debt and net FDI inflows. Net foreign direct investment showed moderate inflows in 2014, which were further weakened by the acquisition of certain foreign corporations by the government. While the nearly EUR 7 billion decline in debt liabilities is smaller compared to 2012–2013, it is still significant. Each sector continues to reduce its external debt. Based on sectoral developments in debt liabilities, similar to 2013, the declining trend of banks' external debt reduction continued. This can still be attributed to households' portfolio realignments; however, the process may have also been supported by the MNB's self-financing programme and conversion of the MNB bill into deposits. The reduction in the general government's debt liabilities was mainly linked to the foreign currency reserves boosted by the EU transfers and the declining foreign currency bond portfolio in the context of heightened domestic demand for government paper.

In addition to the analysis of real economy data, trends in the balance of payments can be also analysed from the perspective of the financial account, which includes financing items. Based on the financing approach, we can assess whether the net lending of the economy emerged amid an inflow or outflow of debt or non-debt liabilities. In respect of the post-crisis period, for instance in the case of Hungary, the financing side shows the foreign asset purchases/debt repayments on which agents of the economy have been spending their financial savings originating from the unconsumed part of their income, in light of the massive trade surpluses of recent years. Moreover, based on data derived from the financing side, changes in the external funds of individual sectors of the economy can also be analysed. While data derived from the real economy approach and the financing approach should be identical, differences are likely to arise in practice due to non-integrated data sources, incomplete observation and the different treatment of the exchange rate, as indicated by the category of "Net errors and omissions", i.e. the statistical error. Nonetheless, it should be pointed out that developments in the real economy and the financing tend to be largely similar over the long term (Chart 16).

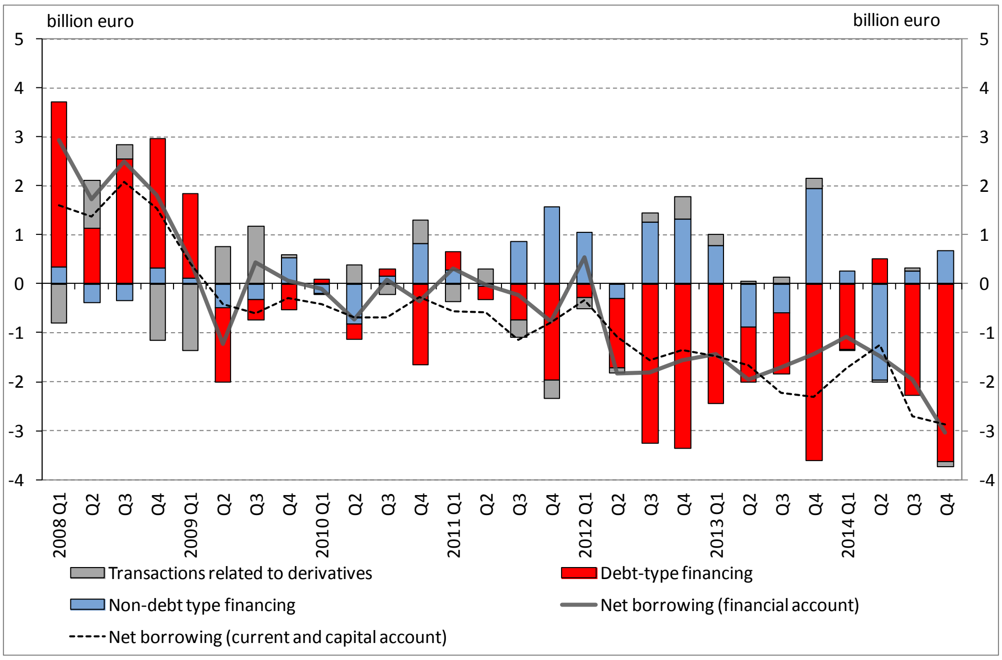
In Q4, the four-quarter net lending figure derived from financing data rose to around 7.3 per cent of GDP. Since the middle of 2013, the relationship between the net lending figure derived from the real economy approach and that computed from the financing approach has returned to its historic trend (Chart 16). This means that net lending derived from real economy transactions exceeds the figures of the financial account, which includes financing items; thus, the decline in external debt indicators derived from data on the financing side falls short of the decline that would be warranted by real economy data. Q4 saw a rise in both indicators, but the increase was lower in the case of the indicator derived from the real economy side and higher for the indicator derived from the financing side. Accordingly, the gap between the net lending figures derived on the basis of the two approaches has narrowed somewhat.

Chart 16: Two types of net lending and "Net errors and omissions" (four-quarter data as a percentage of GDP)



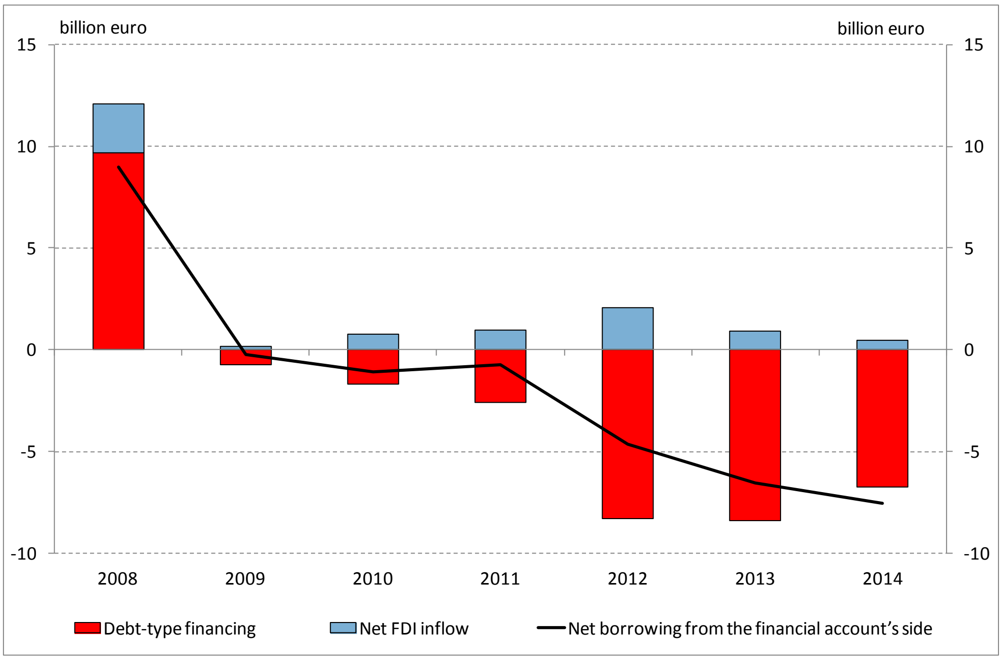
Debt liabilities decreased sharply in Q4 again, while non-debt funds increased by nearly EUR 1 billion. Seasonality reasons may explain a portion of the EUR 3.6 billion decline in the economy's debt liabilities: since 2010, end-of-year debt outflows have consistently exceeded the outflows observed in the remaining quarters of the year, which may be attributed to banks' end-of-year balance sheet adjustments. At the same time, non-debt liabilities expanded at a faster rate during the quarter in the context of a nearly EUR 1.5 billion increase in net foreign direct investment. It is still important to emphasise that, for the purposes of our analysis, due to economic considerations, inter-company loans are regarded as non-debt liabilities. The relevant reasoning is presented in detail in the Box included in Chapter 3.

Chart 17: Developments in the structure of net lending (unadjusted transactions)



With respect to type, in 2014 the outflow of debt liabilities decreased year-on-year, but the rate of the decline remains high. Meanwhile, the FDI portfolio of non-residents continued to increase slightly. In 2014, the debt-type external funds of the economy decreased by nearly EUR 7 billion, falling at a slower rate than that observed in the previous two years. That notwithstanding, the rate of the decline is still considerable. While the outflows affected all three sectors, the sectoral structure of the outflows was influenced by a number of measures (see Chapter 3.2 for more detail). The level of the outflows may have been slightly moderated by the fact that the outstanding debt of the private sector decreased to a lesser degree compared to recent years, which limited banks' funds available for the reduction of external debt. At the same time, the balance sheet adjustment of the private sector still enabled the banking sector to reduce its external liabilities, while in the case of the general government the conversion of the MNB bill and the self-financing programme resulted in a higher outflow of funds. It is also important to note, however, that some of the forint liquidity deriving from the sale of non-residents' MNB bills flowed back to the banking sector, increasing banks' external liabilities. As regards non-debt liabilities, the substantial outflows recorded in Q2 – stemming from the dividend payments of foreign corporations and state acquisitions affecting FDI – could not be offset by the inflows seen in the rest of the quarters.

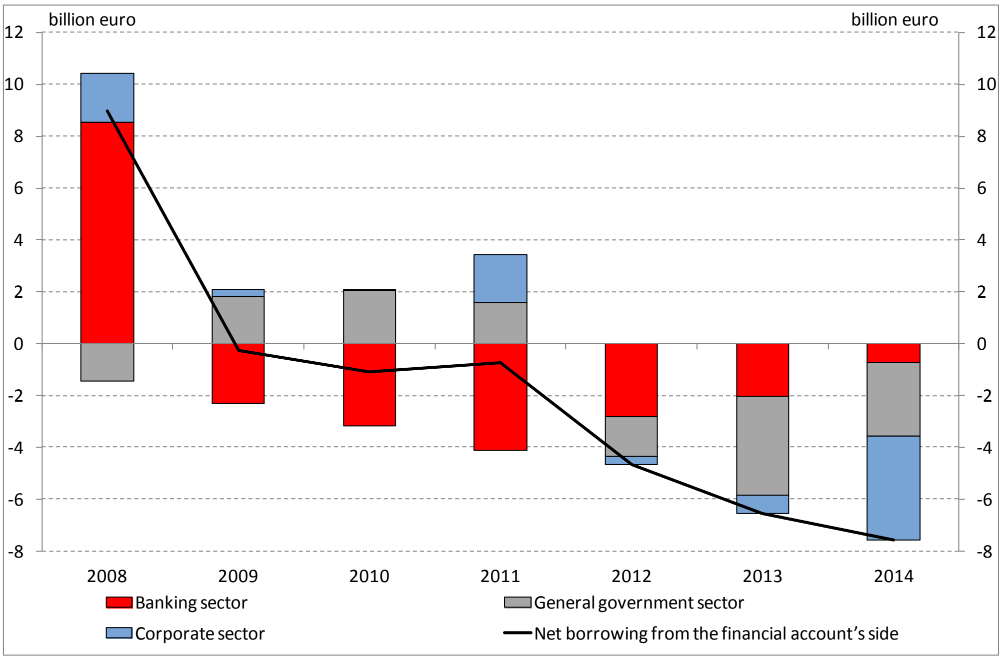
*Chart 18: Developments in foreign direct investment and debt-type financing**



** In addition to the components indicated on the chart, net external borrowing also includes the equity transactions of portfolio investments and transactions associated with derivatives.*

Looking at the sectoral breakdown of net lending in 2014, the banking sector's net outflow of funds hit the lowest level seen since the crisis (Chart 19), while corporations scaled back their net external debt at a faster rate, which may be partly attributed to households' portfolio realignments. Considering both debt liabilities and non-debt liabilities, the banking sector's net outflow of funds has declined in recent years in parallel to households' portfolio realignments. Moreover, individual capital injections (e.g. Erste, MKB, CIB) may also have restrained banks' net outflow of funds in 2014 again. Ultimately, the liquidity from the conversion of the MNB bills into deposits under the MNB's self-financing programme may also have dampened the outflow of funds in the banking sector. Since the net lending of the economy did not change markedly between 2013 and 2014, the outflow of funds increased in the rest of the sectors, in particular, in the corporate sector. At the same time, households' portfolio shifts (more precisely, households' purchases of investment fund units flowing, in part, into external assets) may also have contributed to this process. Although the general government's net outflow of funds contracted compared to 2013, it remained significant.

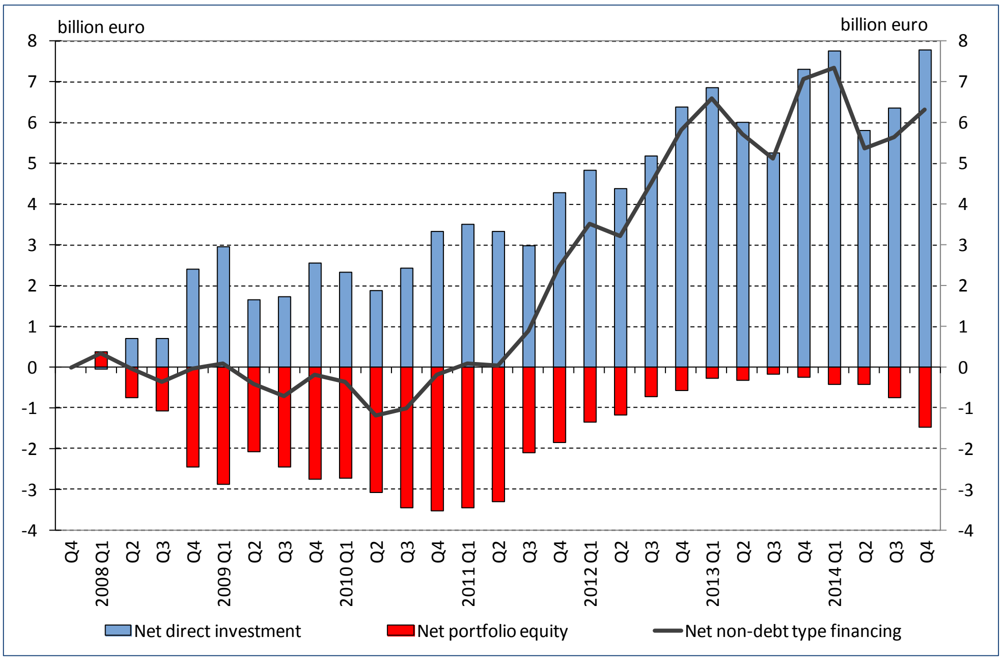
Chart 19: Net outflow of funds by sector



2.1. Non-debt liabilities

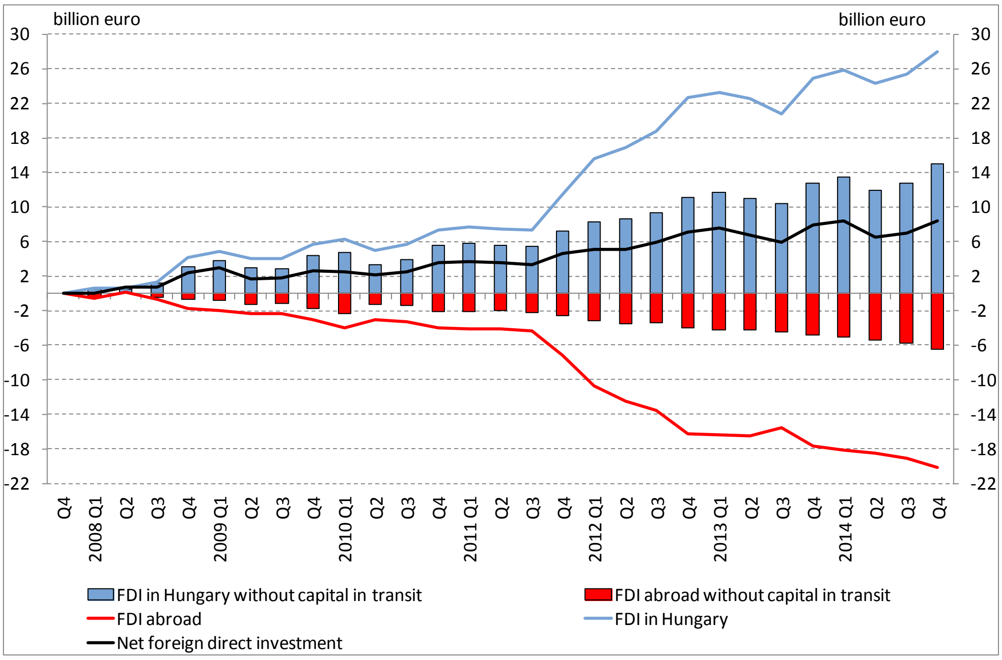
The fourth quarter saw a pronounced rise in FDI within the economy, the impact of which was offset by a decline in net portfolio equity. Foreign direct investment grew by EUR 1.5 billion in Q4, driven primarily by rising investments by non-residents in Hungary. The lion's share of the rise in investments by non-residents was linked to reinvested earnings, but the increase in shares and other equity held by non-residents amounted to EUR 0.6 billion. At the same time, foreign direct investments by residents also increased. Over the course of 2014, non-debt liabilities decreased within the economy in the wake of expanding net FDI and decreasing net portfolio-equity (Chart 20), the latter representing a break from the previous years' rising trend.

Chart 20: Developments in non-debt financing (cumulative transactions)



Within FDI, the indicators reflecting inflows and outflows are strongly shaped by capital in transit, and therefore an analysis of the net inflow of funds is warranted. Outflows of net FDI observed during the year, which are mostly tied to dividend payments and state acquisitions, were offset by substantial inflows in Q4. Thus, FDI reflecting non-resident investments in Hungary grew by over EUR 2.5 billion during the year, while the indicator factoring in foreign investments by residents expanded by nearly EUR 500 million. Capital in transit substantially shapes developments in gross FDI in Hungary. Presumably due to the idiosyncrasies of the Hungarian tax system, certain corporations only provide intercompany loans to their Hungarian affiliates for tax optimisation purposes, which are then immediately transferred abroad. This is referred to as capital in transit and has been distinguished by the MNB in its balance of payments statistics since 2008.[6] Capital in transit, however, only affects gross flows and does not distort net FDI data due to its nature. Our analyses focus solely on net indicators (Chart 21). Capital in transit also impacts the sector-based structure of FDI in Hungary. An investment in Hungary may be classified in a different sector than the purpose of the direct investment, distorting the sector-based FDI data.

Chart 21: Developments in foreign direct investment (cumulative transactions)

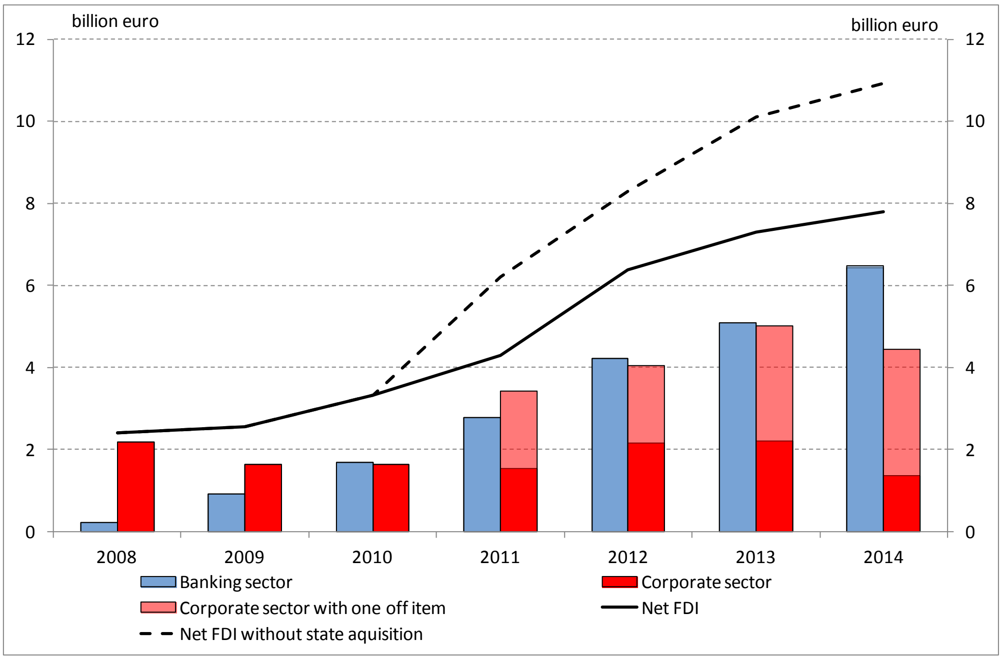


FDI rose slightly in 2014, with banks playing a pivotal role in this. While the banking system has seen a gradual rise in FDI since the crisis – partly due to the necessary capital injections – FDI to the corporate segment has largely stagnated since the crisis (Chart 22). Corporations' net inflows of foreign direct investment were also shaped by state transactions: The state acquisition of MOL in 2011, of E-On in 2013 and Antenna Hungária Zrt. and Főgáz Zrt. in 2014 offset the net FDI funds of the corporate sector. Data adjusted by state acquisitions revealed that roughly the same amount of net FDI funds flowed into the banking system and the corporate sector until 2013. In 2014, however, the rise in FDI channelled into the banking sector resulted in a slightly negative net FDI inflow to the corporate sector. Several factors linked to developments in corporate funding that may nuance trends in FDI are worth noting:

[6] In this context it should be noted that data for enterprises that have established in Hungary solely for tax optimisation purposes (special purpose entities, SPEs) are automatically listed separately in the balance of payments statistics. The operations of SPEs are, in essence, limited to raising funds (capital, loans) from abroad and immediately passing them on to other foreign undertakings, i.e. their activities have no impact on real economic processes. The total gross loan portfolio of SPEs hovered in the range of 20-40 per cent of GDP.

- For one, the dip in net FDI to the corporate sector in 2014 does not reflect a decline in net FDI inflows – which stood at around EUR 1.5 billion, similarly to the previous year – but rather a rise in the foreign investments of Hungarian corporations.
- In addition, the expansion of production capacity is not necessarily paired with inflows of FDI; for instance the Mercedes investment in Hungary was financed from substantial loans from abroad.
- Finally, another key factor in corporate FDI may be the fact that following the crisis, countries within the region saw a slower rise in FDI funds compared to the previous period (for more detail, see Chapter 5).

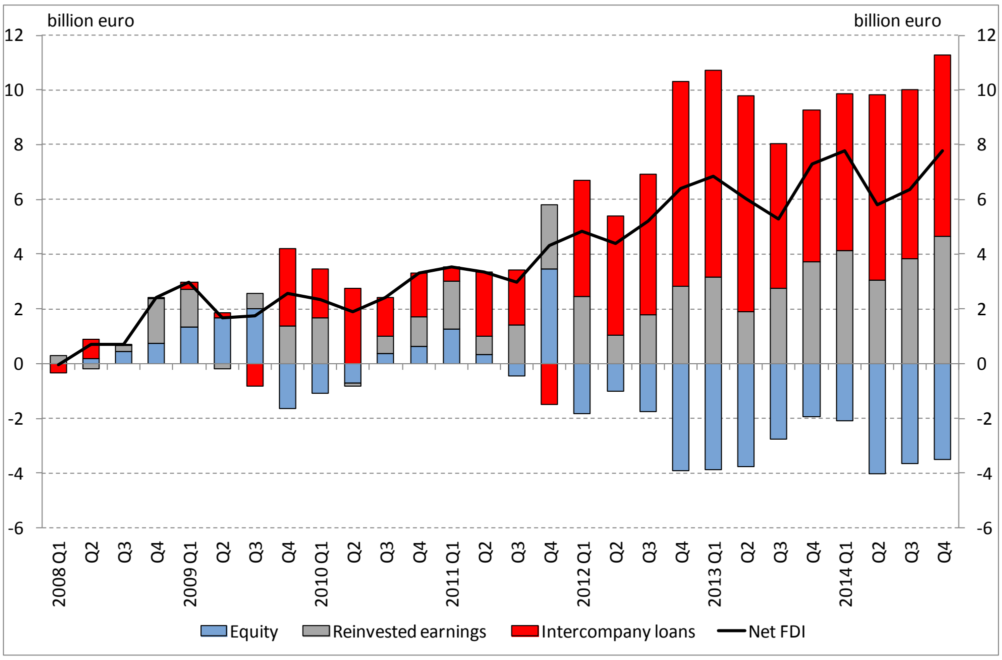
Chart 22: Developments in net FDI in a breakdown by sector (cumulative annual transactions)



The rise in FDI in recent years occurred alongside reinvested earnings and rising intercompany loans, the latter often replacing equity financing. Since the financial crisis, equity financing by non-residents has decreased, in which the portfolio restructuring of parent companies played a key role, as did the replacement of former equity financing by intercompany loans in many instances following changes in ownership (e.g. in 2012 Q4). Meanwhile, intercompany loans and reinvested earnings grew by over EUR 11 billion, contributing to an overall rise in net FDI funding of nearly EUR 8 billion since early 2008. It should also be noted that equity financing shrank sharply in 2014 Q2 due to significant dividend payments.[7] The greater inflow of equity financing towards the end of the year may have mitigated this impact.

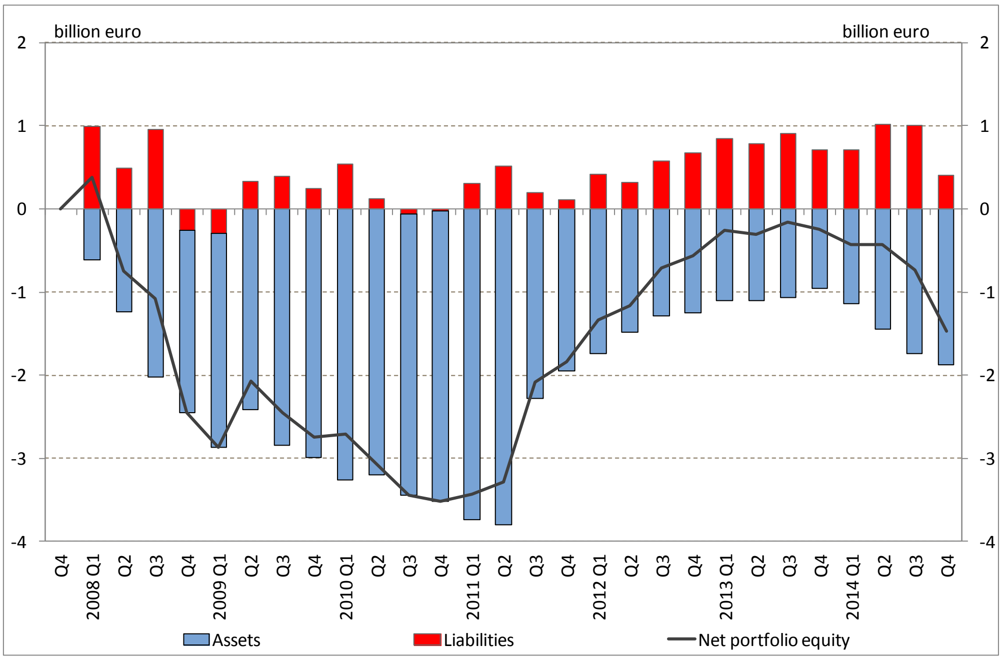
[7] In the balance of payments statistics, the distribution of extraordinary dividends is recognised as a decline in equity investment transactions – the withdrawal of capital – rather than as a decline in reinvested earnings. For more detail, see: http://www.mnb.hu/Root/Dokumentumtar/MNB/Statisztika/mnbhu_modszertanok/modszertani_atlas/Valtozasok_a_fizetesimerleg-statisztikakban__a_BPM6_modszertan_bevezetese.pdf

Chart 23: Developments in the elements of net FDI (cumulative transactions)



Net portfolio equity liabilities decreased in Q4 and portfolio equity assets by residents rose throughout the entire year in 2014, in contrast to previous years, while investments by non-residents in Hungary shrank. Earlier years were characterised by decreasing portfolio equity investments abroad by residents due to the sale of pension fund assets amongst other things, while the equity investments of non-residents in Hungary increased slightly (Chart 24). By contrast, 2014 saw a decline in non-resident equity investments in Hungary while the foreign assets of mutual funds increased in line with household portfolio restructuring. This is reflected in the rise in foreign assets held by residents which entailed an outflow of net liabilities and significantly curbed the inflow of non-debt liabilities.

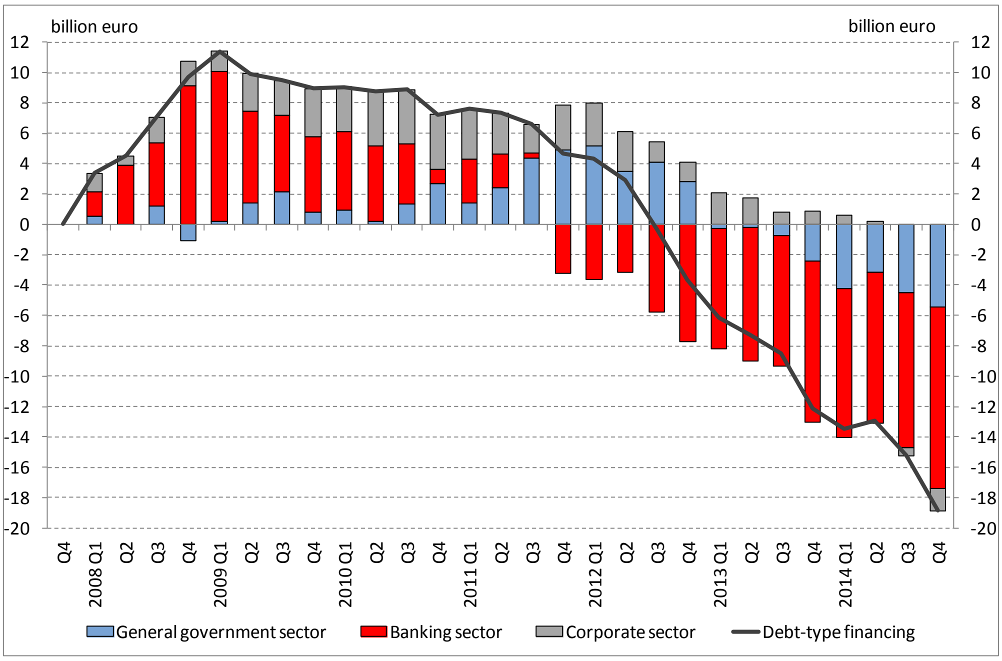
Chart 24: Drivers of changes in net portfolio investment (cumulative transactions)



2.2. Debt liabilities

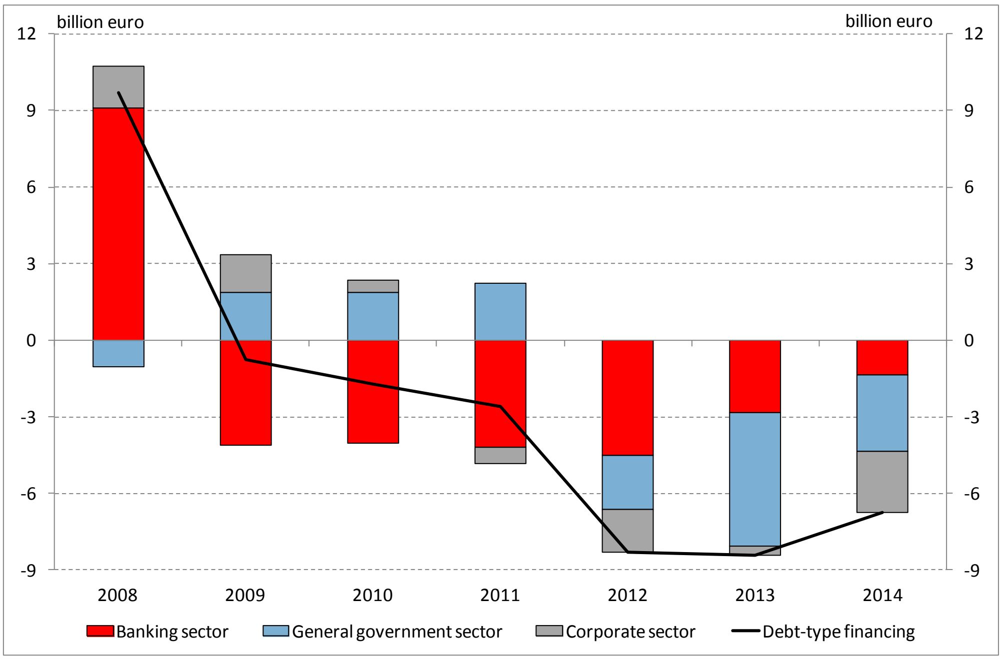
2014 Q4 saw a EUR 3.6 billion decline in the economy's net external debt, half of which was tied to the banking system; however, this is presumably part of the provisional trend typically prevailing at the end of the year. During the last quarter of the year, the banking system's net external debt generally decreases to greater extent, which may be linked to end-of-the-year window dressing by foreign banks. Corporations also continued scaling back their net external debt alongside banks (by close to EUR 1 billion), and the consolidated government sector decreased its net external debt by nearly EUR 900 million.

Chart 25: Developments in net debt-type financing per sector (cumulative transactions)



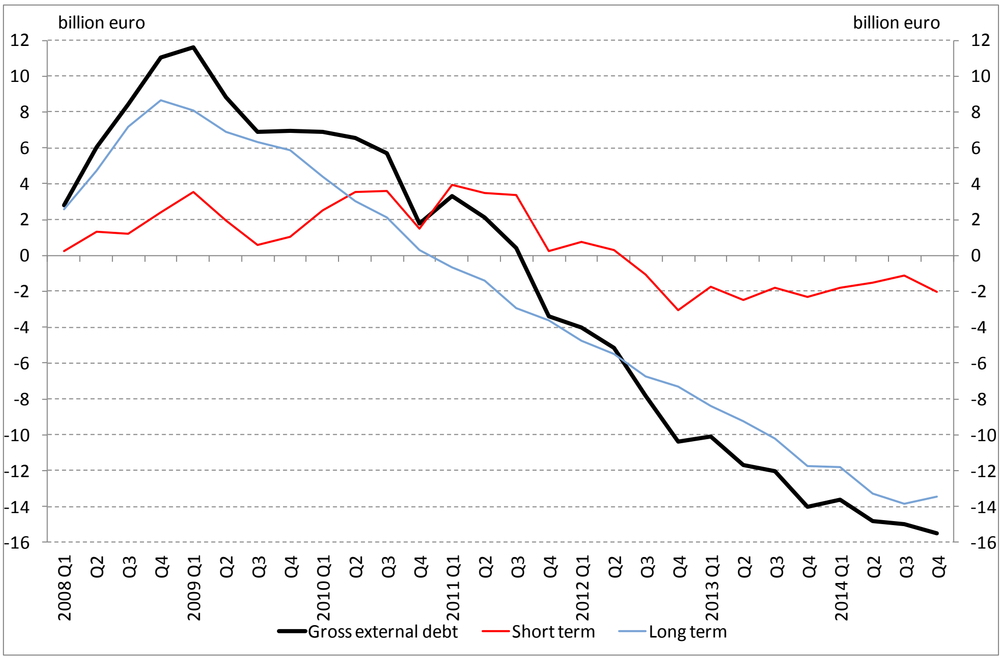
The adjustment of the economy's external debt indicators continued throughout 2014, with net external debt contracting by EUR 6.7 billion based on transactions. Similarly to the previous year, the greatest decline in 2014 occurred within the consolidated general government, in which the MNB's measures may have played a role, alongside government security purchases by households and the reserve-boosting impact of EU transfers. The economy's shrinking net external debt in 2014 was driven primarily by the net outflow of state debt in the amount of EUR 3 billion. The outflow of funds was reinforced by the central bank's self-financing scheme, and specifically the conversion of MNB bills to deposits. As a result, some of the released funds may have been channelled into the banking system, thereby restraining the outflow of funds from the sector. Additionally, the further reduction of household savings held in the form of bank deposits, albeit at a slowing rate, may have also played a role in the weaker scaling back of debt by banks, while the sector's net repayments also shrank. The substantial net outflow of state funds were still fostered by continued purchases of government securities by households (see Chapter 4.2 for more detail), as did the significant influx of EU transfers, also expanding foreign exchange reserves. It should be noted that the contraction in net external general government debt is also reflected in the diminishing ratio of non-residents holdings within government debt (see Chapter 4.1 for more detail). The corporate sector scaled back its net external liabilities by EUR 2.4 billion at an annual level.

Chart 26: Developments in net debt-type liabilities of individual sectors (annual transactions)



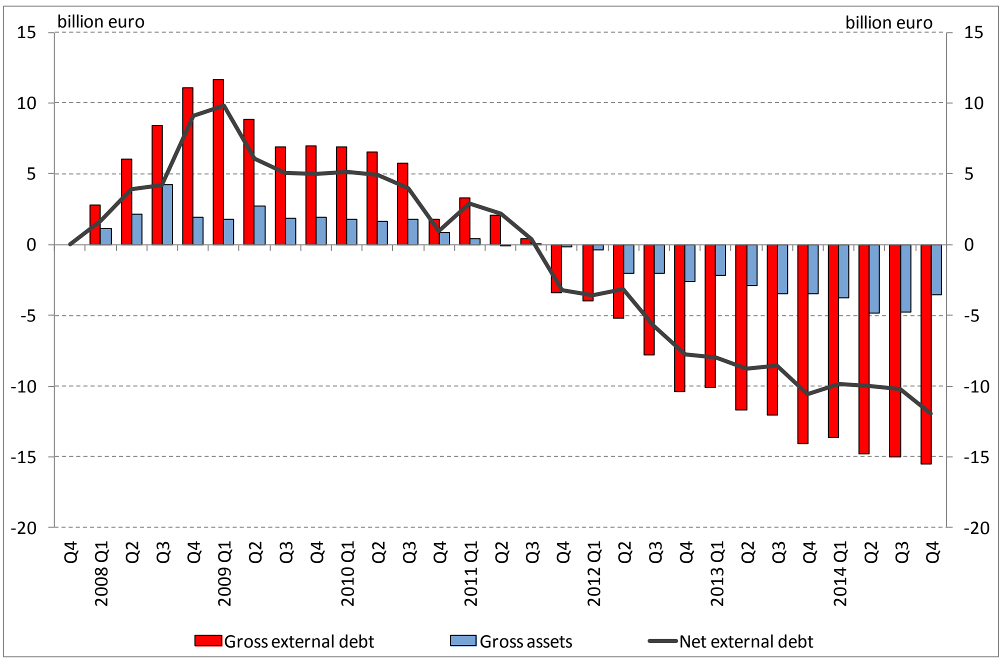
The decrease in the banking system's external debt in the past year chiefly affected long-term liabilities, while short-term debt has remained essentially unchanged over the past two years. In 2014 Q4, banks scaled back their debt to greater extent, with short-term debt decreasing by nearly EUR 1 billion and long-term liabilities rose by over EUR 400 million. Over the course of 2014, the decline in long-term liabilities continued at a slower pace, which on the one hand may be linked to lower net repayment of loans in the private sector than previously, and to household portfolio restructuring contributing to the slower decrease in banks' liabilities, on the other hand. The conversion of MNB bills to deposits in the context of the self-financing scheme towards the middle of the year may have contributed to a material rise in banks' short-term debt, as a portion of the forint liquidity held by non-residents may have wound up within the banking system in the form of deposits. Although the deposit conversion took place in Q3, the adjustment may have started in the preceding months.

Chart 27: Developments in the banking sector's gross short-term and long-term debt transactions (cumulative transactions)



The banking sector's shrinking net external debt in 2014 was only slightly slowed by the decline in the sector's foreign assets. In 2014, the banking system's foreign liabilities fell by over EUR 1.4 billion, the net impact of which was mitigated by a net EUR 100 million decline in external assets (Chart 28). The decline in external assets was also prevalent in previous years, linked to deleveraging in other countries as well. This may also mean that the banking system in part funded the repayment of its external debt by selling off external assets.

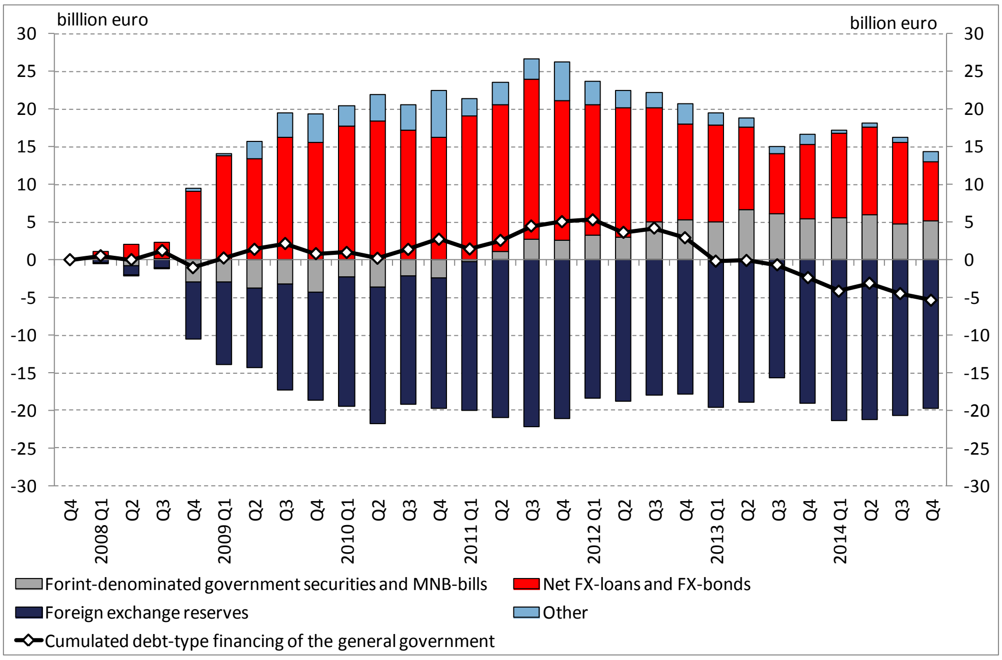
Chart 28: Developments in the banking sector's gross external debt and asset transactions (cumulative transactions)



Net external debt of the general government consolidated with the MNB decreased by nearly EUR 0.9 billion in Q4, mainly driven by the absorption of EU transfers. The decline in net external general government debt emerged in conjunction with substantial absorption of EU transfers. In Q4, the repayment of the EU loan substantially shaped both the gross debt and reserves. External general government debt shrank by close to EUR 2 billion as a result, while foreign exchange reserves declines by a similar amount, with the latter offset by the reserve-boosting impact of EU transfers.

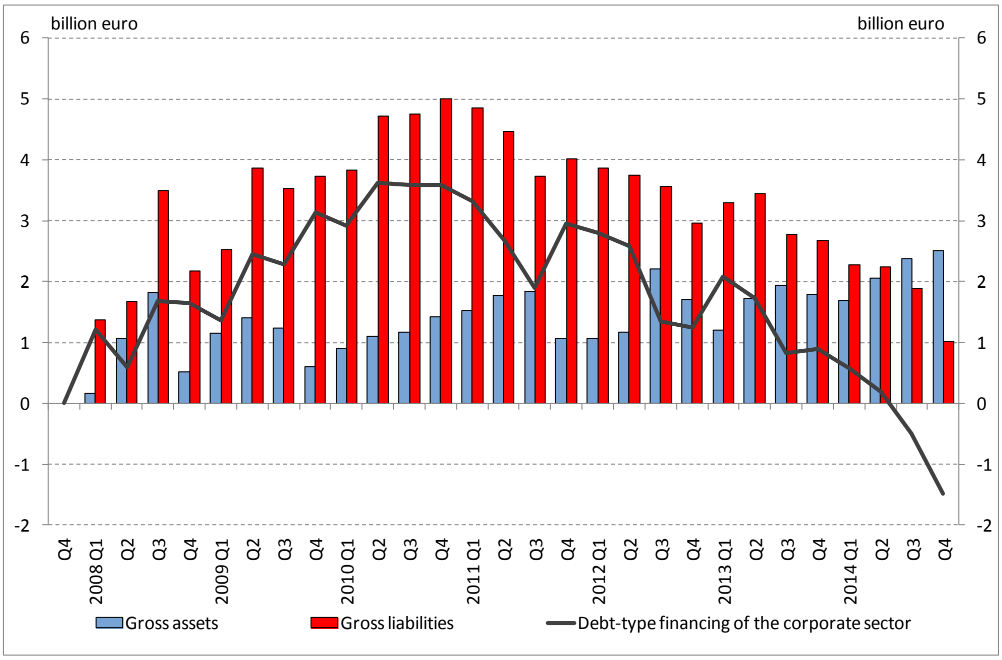
Net external debt of the consolidated government shrank by EUR 3 billion based on transactions, which falls short of the decline observed in 2013 (Chart 29). Similarly to previous years, the influx of EU transfers, which increased foreign exchange reserves, played a significant role in the net decline in general government debt. During the year, the decline in general government debt was also shaped by the conversion of MNB bills to deposits in the context of the MNB's self-financing scheme, which increased the outflow of state funds through a reduction in the volume of MNB bills held by non-residents (while increasing the banking system's external liabilities). At the same time, the state's gross external debt has decreased markedly in past years on account of the repayment of loans granted by international organisations. Their repayment, however, was accompanied by a similar utilisation of reserves, which resulted in the consolidated government's net external debt remaining unchanged.

Chart 29: Breakdown of net external debt of the general government consolidated with the MNB (cumulative transactions)



Corporations' external debt shrank further in Q4, mainly driven by the decrease in external liabilities, specifically foreign loans and trade credits. The decline in the net external debt of non-financial corporations accelerated in 2014 compared to previous years, amounting to EUR 2.4 billion. The rise in external assets also exacerbated the impact of this greater deleveraging of external debt. In addition, the loans disbursed in the context of the Funding for Growth Scheme may have also contributed to scaling back the external debt of corporations, with domestic liabilities replacing loans taken out abroad.

Chart 30: Developments in the corporate sector's net external debt type financing (cumulative data)



3. DEVELOPMENTS IN DEBT RATIOS

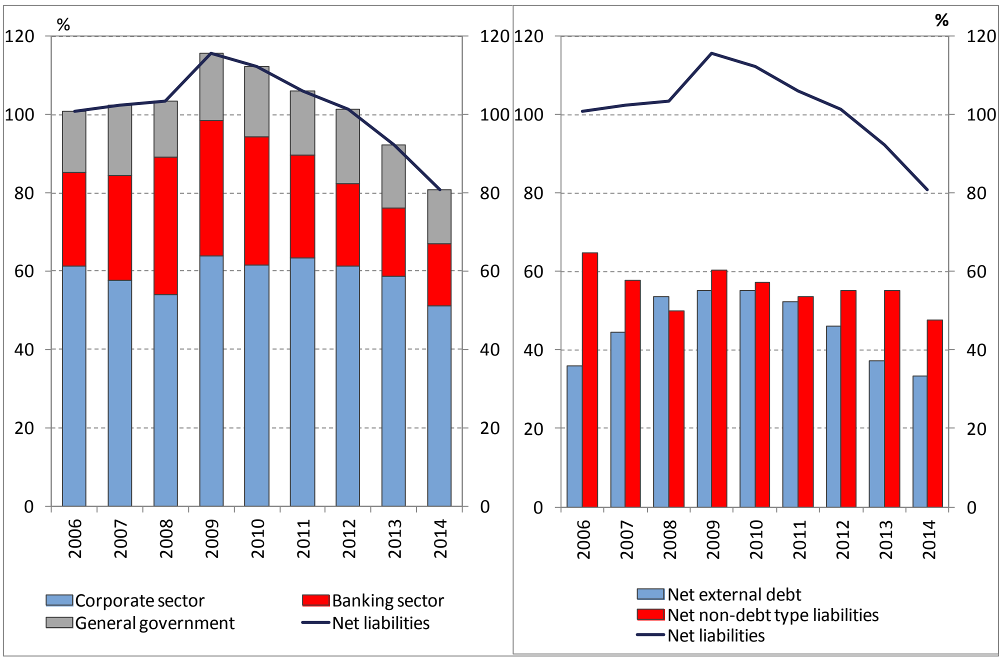
A significant reversal in external debt indicators emerged from mid-2010, primarily linked to the outflow of funds and rising nominal GDP. Concerning the trends prevailing in 2014, it is important to note that the decline in external debt indicators from transactions was restrained by both the decline in yields and the weakening exchange rate. Net external debt shrank from 60 per cent in early 2009 to close to 33 per cent of GDP. Deleveraging has substantially lowered the net external debt of the banking system and corporations compared to the levels prevailing at the start of the crisis. The net external debt of the consolidated general government remains close to the early-2009 levels, despite the continuous decline in the recent period. Gross external debt has exhibited a major correction, along with the net indicator. The decline in Hungary's external vulnerability was fostered by the sharp decline in its short-term external debt based on residual maturity: short-term external debt sank to near EUR 21 billion by late 2014. This might mean that the Hungarian economy's gross external borrowing in 2015 may be substantially lower than the preceding year's figure, although Hungary remains dependent on the influx of external funding despite its net lending.

In addition to transaction-based indicators, balance of payments statistics also contain stock indicators. In terms of a country's external vulnerability, the level and composition of external debt are also decisive factors, along with net lending or external borrowing. Developments in financing trends are generally a good indication of trends in debt ratios, but stock indicators also reflect the impact of changes in exchange rates and prices of securities.

3.1. Net external liabilities

In 2014 Q4, Hungary's net external liabilities fell to its lowest point since the crisis, at 80 per cent of GDP (Chart 31). A country's external liabilities also contain non-debt liabilities (primarily FDI), in addition to external debt. In Hungary, the fall in external liabilities in 2014 was most prominent in the corporate sector, while net external liabilities within the banking system remained essentially unchanged. Meanwhile, net external debt of the consolidated government also shrank in 2014. The reduction in net external liabilities in recent years has primarily affected debt liabilities, while 2014 also saw a decline in non-debt liabilities as well, driven for the most part by the investments abroad of resident non-financial corporations, and to a smaller extent by the purchase of foreign shares of investment service providers. The banking system’s non-debt liabilities remained essentially unchanged. Despite the outflow of debt liabilities in 2014, net external debt only shrank to a small degree due to the revaluation stemming from the depreciation of the forint exchange rate and declining yields.

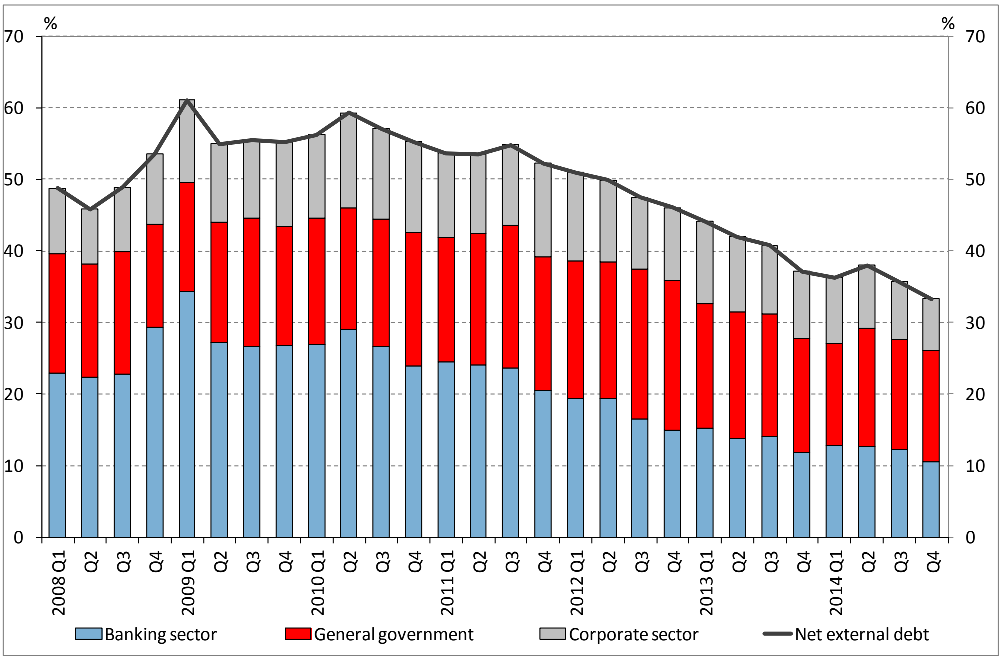
Chart 31: Developments in net external debt (period-end values as a percentage of GDP)



3.2. Net external debt

Hungary's net external debt shrank further in 2014, falling to 33 per cent of GDP (Chart 32). The decline in net external debt in 2014 took place in all three sectors: along with the banking sector, corporations' net external debt shrank to greater degree, while general government external debt only shrank to a smaller degree. In the wake of deleveraging, banks' net external debt now falls substantially short of the levels prevailing in 2008. A continued decline in net external general government debt was seen in 2014, albeit at a slower rate. The stock indicator exhibited a slight reversal in 2014 compared to the transaction-based indicator, primarily linked to revaluation effects. The reversal in the general government indicator was slowed by the revaluation stemming from falling yields in accordance with the easing cycle, coupled with the weaker forint. In terms of the trends prevailing in Q4, the decline in the indicator is primarily linked to the deleveraging of banking system liabilities: banks' net external debt in Q4 shrank by close to 2 per cent of GDP, in which the year-end window dressing of banks played a significant role. The scaling back of corporations' net external debt also continued, chiefly explained by the deleveraging of external liabilities. At the same time, there were no material changes in the general government's external debt: the decline based on transactions was offset by the revaluation of the stock.

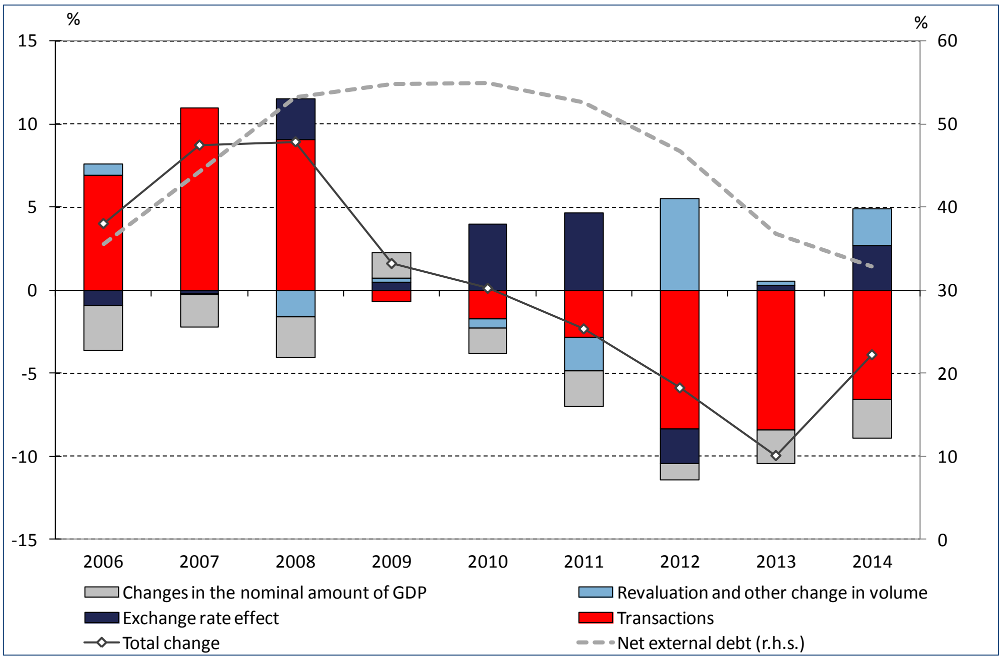
Chart 32: Breakdown of net external debt by sector (as a percentage of GDP, without intercompany loans)



The reversal of net external debt in recent years was driven by the impact of changes in GDP, in addition to transactions. The change in the net external debt figure as a percentage of GDP can be broken down into transactions, price effects and the impact of changes in GDP (Chart 33). According to this breakdown, the more than 20 per cent decline in net external debt that materialised between 2010 and 2014 was driven for the most part by the outflow of debt liabilities, due to deleveraging across sectors. In addition, nominal GDP growth also contributed significantly to reducing Hungary's net external debt. However, revaluation effects pushed the debt ratio upwards. Price effects (changes in the price of shares and government securities) have resulted in an expansion of net external debt by over five percentage points since 2009, mainly owing to the revaluation linked to declining government securities yields.[8] The increase in external liabilities by 10 per cent since 2009 was also driven by the depreciation of the forint against currencies relevant to external debt (EUR, USD, CHF). In terms of developments in non-transaction effects shaping volumes, it should be noted that while in previous years, the price and the exchange rate exerted an opposite effect on external debt, in 2014 both impacts increased the external debt ratios.

[8] In the balance of payment statistics, securities are registered at market prices; by contrast, securities are taken into account at nominal value in EU public debt statistics.

Chart 33: Breakdown of changes in net external debt by components (as a percentage of GDP)



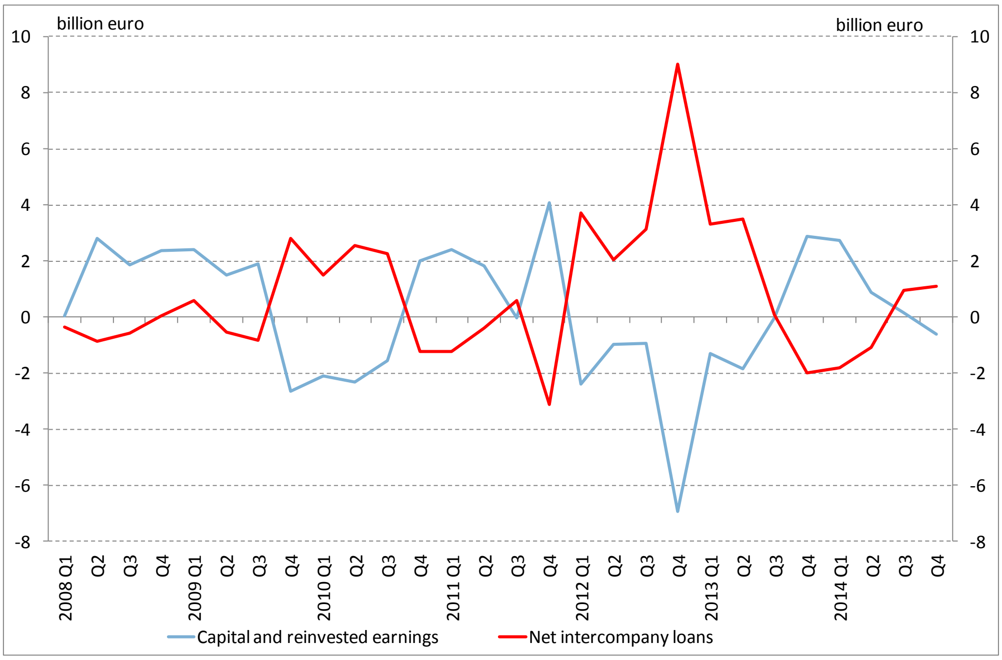
Box 4: Various external debt ratios

The underlying trend in external debt is best illustrated by the indicator exclusive of intercompany loans and special purpose entities. Ratios exclusive of special purpose entities (SPEs) should be considered when looking at external debt. These corporations generally do not engage in real economic activities, and serve financial intermediary functions for their foreign owners, transferring the funds received from abroad to another foreign destination and thus inflating the gross flows, with no impact on economic developments (Koroknai – Lénárt-Odorán, 2010 MNB).[9] Based on economic considerations, intercompany loans should also be distinguished along with SPEs when analysing the external debt ratio. This is warranted by the fact that in recent years, intercompany loans and FDI funds have exhibited opposite trends, in other words corporations often replaced their equity funds with intercompany loans (Chart 34). Based on experience, the interoperability between intercompany loans and direct equity investment is relatively simple and can take place without any fundamental reason and with no impact on market developments. Additionally, intercompany loans carry far lower risk compared to other foreign loans, as in their case renewal, foreign exchange and interest rate risk is far lower compared to bank loans of similar amounts and maturities. Recently, foreign analysts have also started to distinguish intercompany loans from external debt.[10]

[9] Péter Koroknai–Rita Lénárt-Odorán (2011): The role of special purpose entities in the Hungarian economy and in statistics, MNB Bulletin, October 2011.

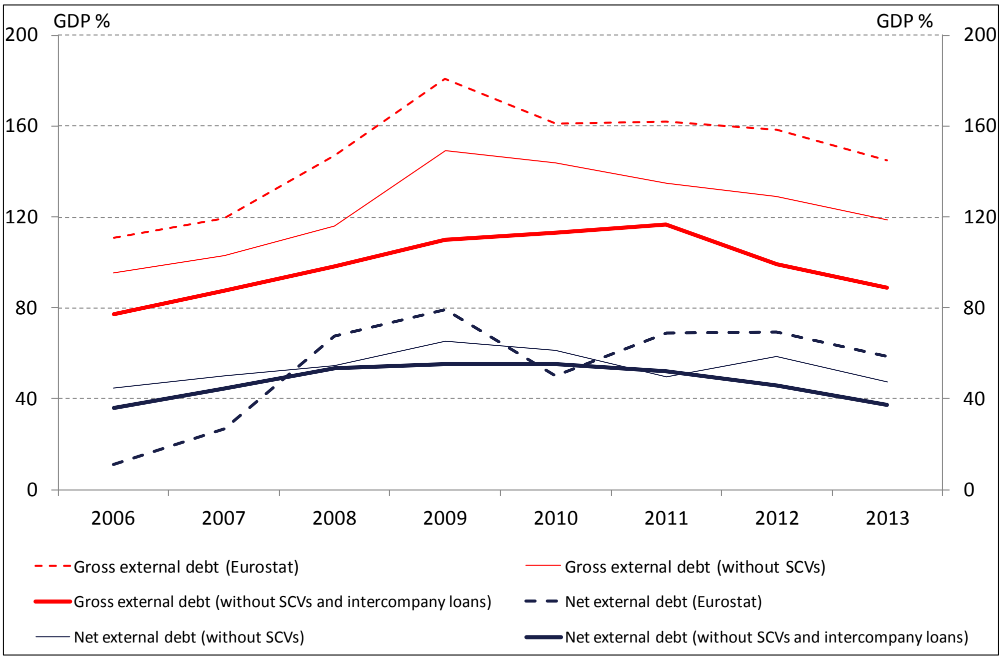
[10] For more detail, see the analysis entitled "Should We Worry about External Debt?" published by Morgan Stanley on 4 November 2013.

Chart 34: Changes in intercompany loans and FDI (four quarterly transactions)



According to the international statistical methodology, intercompany loans are loans within foreign direct investment and as such, they represent debt-type financing. Accordingly, Eurostat indicators currently include intercompany loans and SPEs, and thus external debt indicators do not necessarily reflect fundamental economic developments. Prior to the introduction of the new balance of payments and external debt ratio methodology (BPM 6th edition), Eurostat published data series exclusive of SPEs, but following the transition, Eurostat now publishes new data series that include SPEs. The new publication substantially distorts external liability and debt ratios, in particular for Hungary. Gross external debt exclusive of intercompany loans and SPEs providing a more accurate indication of underlying developments compared to the data published on Eurostat – featuring the smoothest time profile during this period – was lower by 56 per cent of GDP, while net external debt was lower by 21 per cent of GDP in late 2013 (Chart 35).

Chart 35: Developments in external debt indicators (as a percentage of GDP)

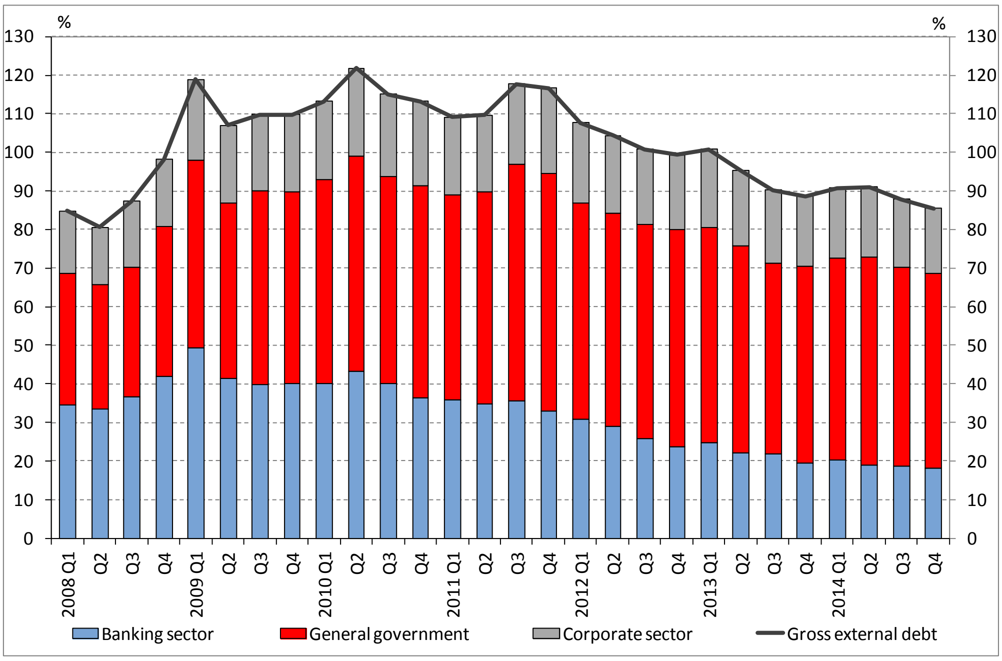


Source: Eurostat, MNB

3.3. Gross external debt

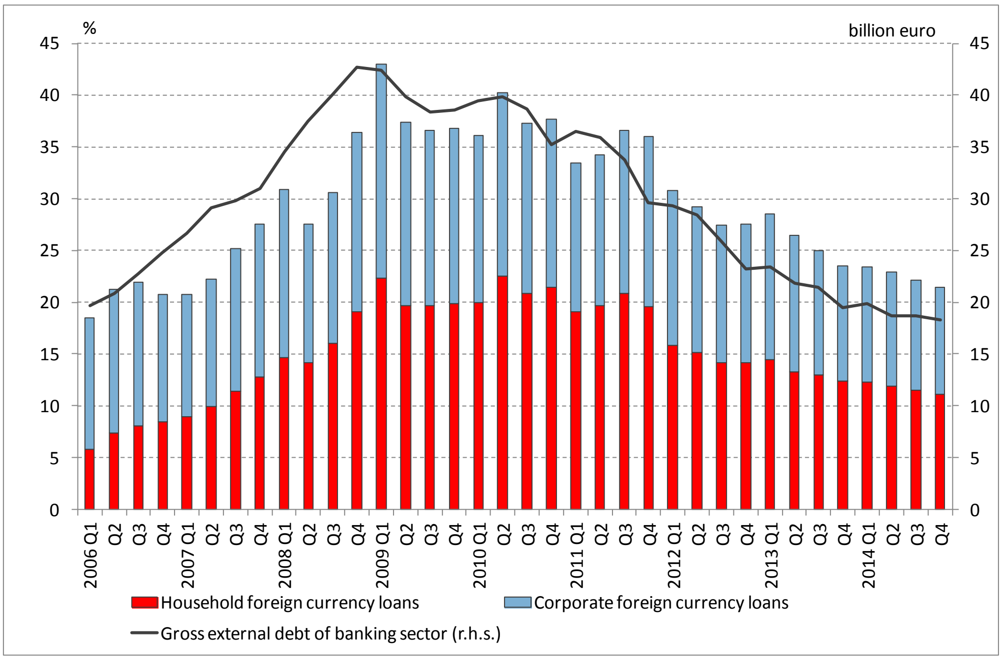
Gross external debt stood at 86 per cent of GDP in 2014 following a substantial decrease in recent years. Hungary's gross external debt rose to 120 per cent of GDP following the start of the crisis, but then fell significantly thanks to deleveraging across sectors and was less than 86 per cent of GDP in late 2014. The fall in gross external debt in 2014 was observed across all three sectors, but most prominently in the banking system and the corporate sector, while gross external debt of the consolidated government only shrank to a smaller extent.

Chart 36: Breakdown of gross external debt by sector (as a percentage of GDP, without intercompany loans)



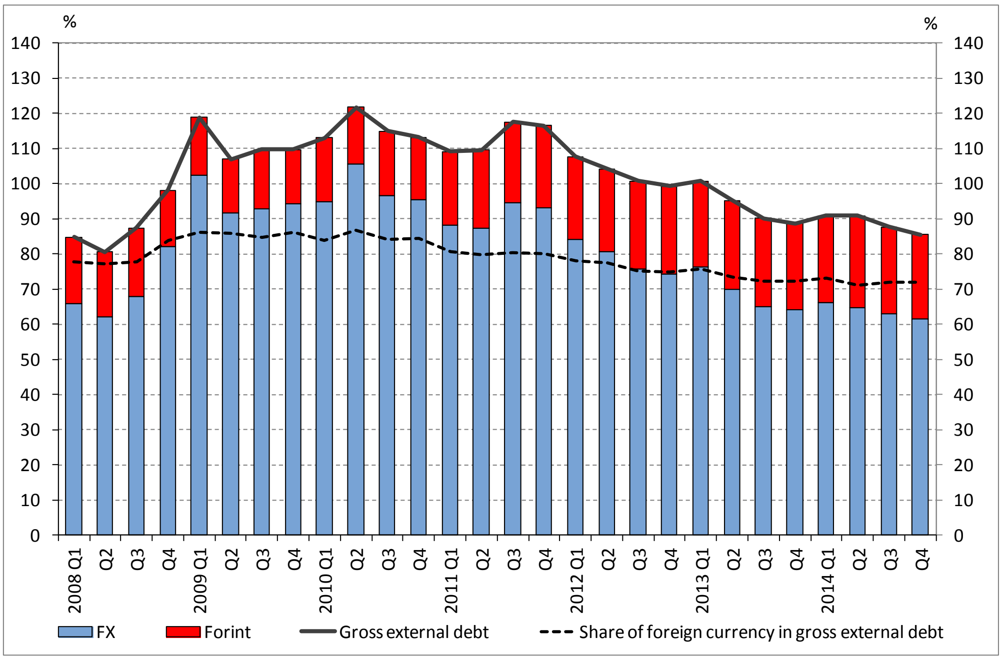
Overall, by late 2014 banks' gross external debt was lower by 31 per cent of GDP compared to early 2009, in line with the contraction in the volume of foreign currency loans in the private sector (Chart 37). Corporations' gross external debt also shrank by over 1 per cent of GDP in 2014. Gross general government external debt, however, only decreased to a smaller extent: the reversal in the indicator was held back by the issuance of foreign exchange bonds early in the year, coupled with declining yields and a depreciating exchange rate. Despite the MNB's self-financing scheme fostering the reduction in external general government from mid-2014, the general government continues to have the highest gross external debt. The reversal in banks' gross external debt was slowed by the greater revaluation of gross external liabilities due to the depreciating exchange rate.

Chart 37: Private sector foreign currency borrowing as a percentage of GDP and banks' external debt



The share of foreign currency in gross external debt remains above 70 per cent. The breakdown by currency is particularly important in case of gross external debt. Although Hungary's external vulnerability is generally assessed based on total external debt, the currency ratio may contain relevant information for investors: countries with a high foreign currency ratio also have high foreign currency liquidity needs in relation to their repayments, and the ratio is also more sensitive to revaluations stemming from the exchange rate. The ratio of gross debt denominated in foreign currency within total gross debt stagnated at above 70 per cent in late 2014, and thus did not decrease despite shrinking gross external debt in 2014. The share of foreign currency within the consolidated general government increased in early 2014, due to the issuance of foreign exchange bonds, and then gradually declined from Q2, partly due to the MNB's self-financing scheme. In the case of the general government, the share of foreign currency in external debt remains lower than in the private sector, at around 60 per cent, for the most part due to the significant holdings of forint government securities by non-residents. The private sector's external debt is characteristically denominated in foreign currency, and only the banking system tends to hold debt in forint. The share of foreign currency within the private sector decreased somewhat throughout 2014, which may have been driven by the conversion of the MNB's main policy instrument into deposits (as the conversion resulted in forint liquidity kept by non-residents in the banking system).

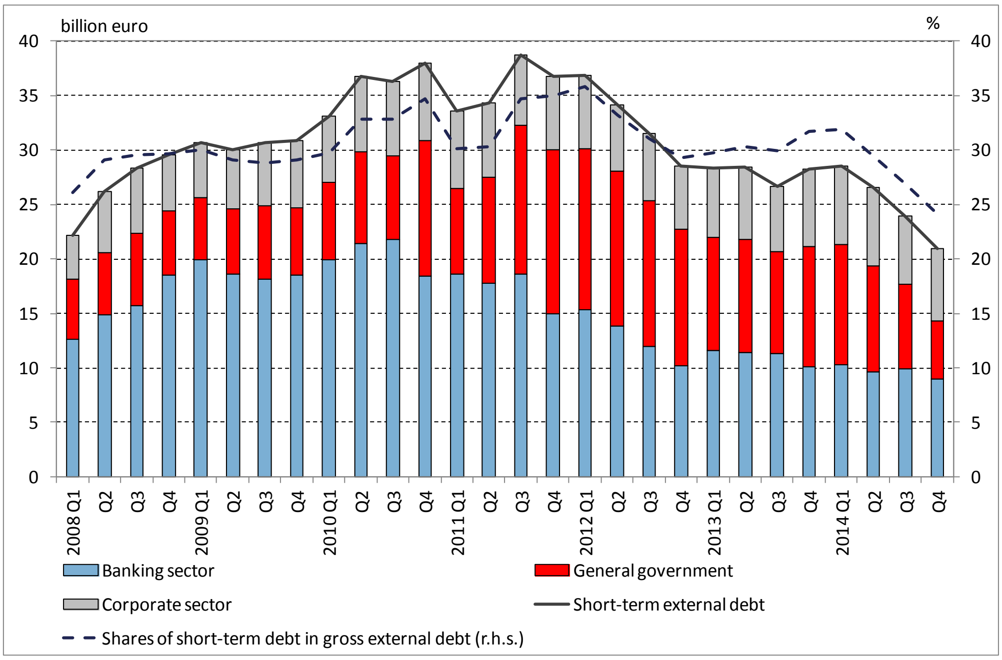
Chart 38: Currency structure of gross external debt (as a percentage of GDP)



3.4. Short-term external debt

Following stagnation in 2013, short-term external debt based on residual maturity continued to decline, reaching EUR 21 billion in late 2014. Short-term external debt is one of the most important indicators of the reserve level expected by investors, and this item has seen a large decrease of nearly EUR 17 billion over the past three years, in accordance with the economy's sustained external balance surplus. Over EUR 7 billion of this decline was registered in 2014, driven primarily by the reduction in short-term debt of the general government. The decline in short-term government debt consolidated with the MNB was reflected for the most part in the repayment of amortised long-term debt (foreign exchange bonds, forint government securities held by non-residents and EU loan instalments), while less debt was amortised in 2014 compared to earlier years. The consolidated general government's external debt with original short-term maturity shrank mainly in the wake of the conversion of the MNB main policy instrument to deposits. Overall, short-term debt of the government amounted to only EUR 5 billion in late 2014, far lower than the EUR 15 billion peak in mid-2011. The decline in the banking system's external debt continued: the decline in amortised long-term debt was only partially offset by a minimal rise in originally short-term debt. Short-term external debt also decreased slightly in the corporate sector. The decline in the economy's short-term debt was achieved in line shrinking short-term debt within total external debt, which fell below 25 per cent by late 2014 and thus dropped below the pre-crisis level.

Chart 39: Developments in gross short-term external debt based on residual maturity

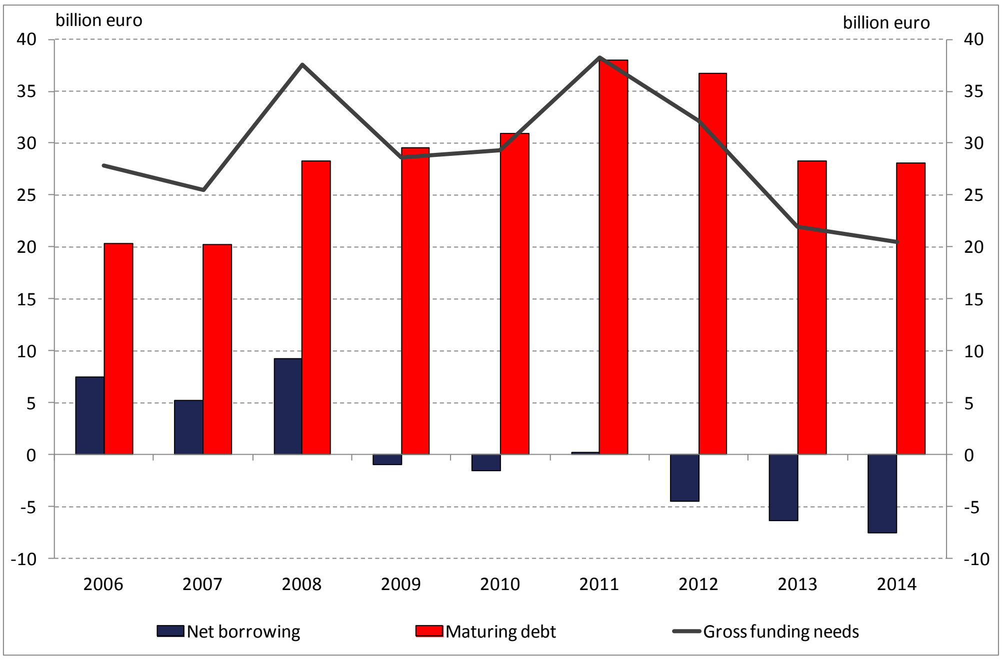


Short-term net external debt decreased by nearly EUR 3 billion in Q4. The modest rise in corporations' short-term external debt was more than offset by the decline in the short-term external debt of the general government and the banking system, thus yielding a significant decline overall.

- In the period under review, the short-term external debt of the *general government* shrank by EUR 2 billion on account of the repayment of the EU loan instalments falling due. In addition to amortised external debt, the decline may also be associated with the prepayment of the assumed municipal debt. At the same time, there were no major changes in the general government's short-term debt based on original maturity.
- Following a temporary increase in the previous quarter, banks' short-term external debt based on original maturity decreased once again in Q4, dropping by close to EUR 1 billion to reach a historical low of nearly EUR 8 billion. This end-of-the-year decline was only temporary, according to preliminary January data, and was presumably linked to banks' year-end window dressing.
- The short-term external debt of the *corporate* sector increased by about EUR 0.4 billion during the quarter, but the level of short-term debt is still lower than in late 2013.

Although gross external debt has declined materially since 2010, it still remains elevated, and consequently gross external financing of nearly EUR 20 billion was necessary in 2014. Maturing debt amounted to EUR 28 billion in 2014, roughly on par with the amount registered one year earlier. Due to Hungary's net lending in excess of EUR 7 billion, external financing in the amount of EUR 20 billion was necessary to finance the remaining maturing debt in 2014, which is roughly on par with the figures observed in 2013. Due to the gross borrowing requirement, which has been continuously shrinking since 2011 but nonetheless remaining high, dependence on external funding remains substantial, which may lead to deteriorating investor sentiment and represent a source of risk if liquidity starts to dry up. It should be noted, however, that in the wake of the decline in short-term external debt, "only" EUR 21 billion in maturing external debt will have to be renewed in 2015, representing a far lower gross borrowing requirement of around EUR 13 billion assuming that net lending remains stable.

Chart 40: Developments in the gross borrowing requirement

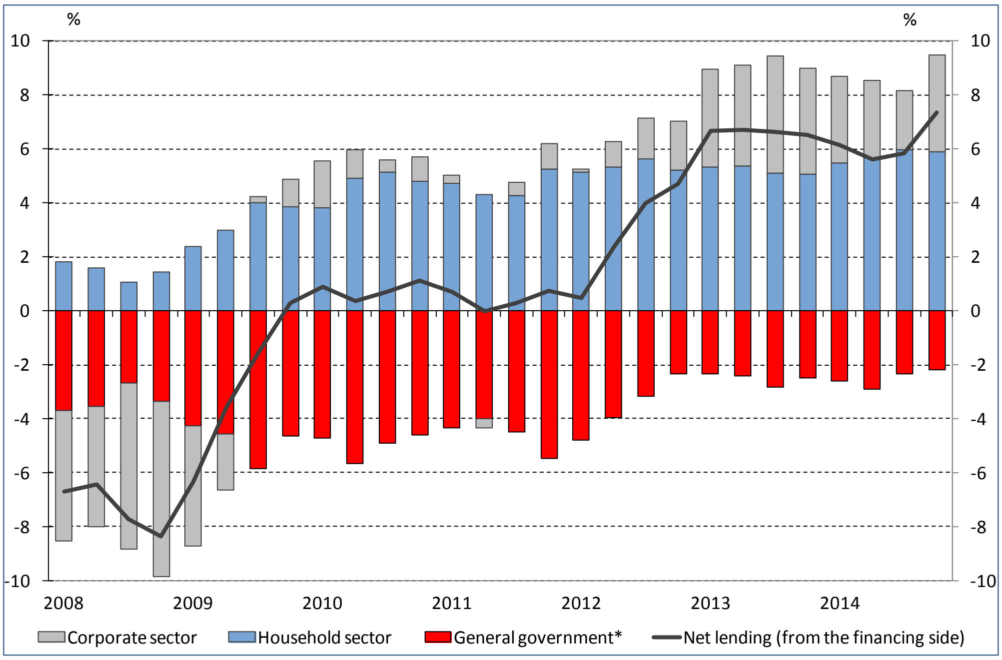


4. SECTORS' SAVINGS APPROACH

Last year, Hungary's external saving position stabilised at a high level with contributions from all sectors. With regard to the private sector, the tight financing opportunities, the still dominant precautionary motives and deleveraging meant that the net saving position of both the corporate and household sectors remained substantial. In addition, the low net borrowing requirement of the government also contributed to the maintenance of the external balance.

Based on the sector's savings approach, net lending increased substantially in 2014 Q4, mainly due to the improvement of corporate net savings and the decrease in general government borrowing requirements (Chart 41.)**.** Since the net savings of resident sectors ultimately appear in the funding of the non-resident sector, the sum of the sectors' net savings and net lending based on the financing approach are identical. At the end of 2014, the four-quarter value of households' net savings stabilised at a high level, around 6 per cent of GDP, which is still attributable to the modest borrowing and the considerable growth in financial assets. The consolidated general government's borrowing requirement in 2014 continued to be favourable, at around 2.2 per cent of GDP, which may primarily be related to increased consumption, the decrease in the GDP-proportionate weight of cash benefits and the surplus revenue generated by the more efficient collection of VAT, thanks to online cash registers. The net savings of the corporate sector contributed to Hungary's financing by 3.6 per cent of GDP in Q4, which was achieved with an increase in investments and, presumably, incomes as well. The significant saving in terms of funding may also be related to the fact that the corporations' willingness to borrow outside the Funding for Growth Scheme is rather low.

Chart 41: Net lending of specific sectors (four-quarter data as a percentage of GDP)

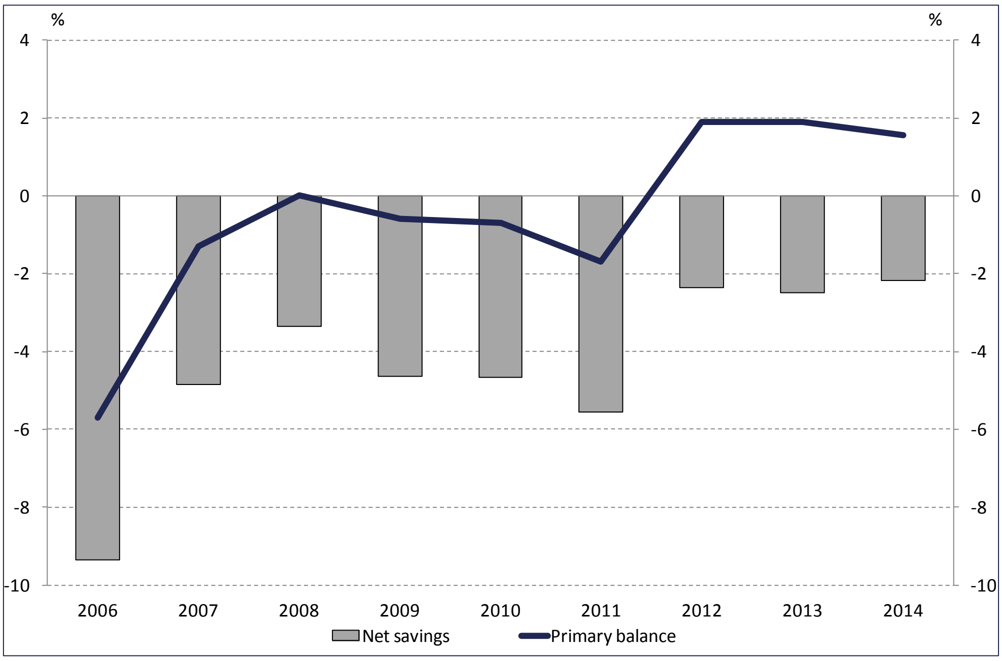


**Under general government, we present the borrowing requirement by financial accounts, adjusted in 2011 with the transfer of the private pension fund assets. The corporate sector is derived on the basis of the remainder principle.*

4.1. General government

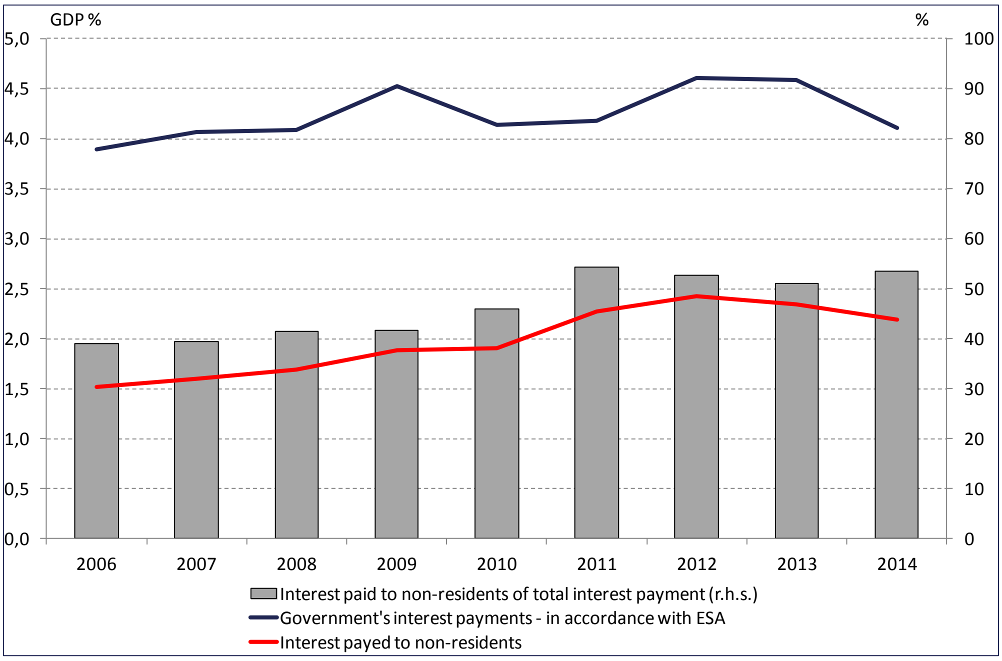
Similarly to the previous two years, the general government's net borrowing was low again in 2014. Net borrowing accounted for 2.2 per cent of GDP and developed under similar budgetary processes as in the previous years, as no new measures with a significant impact on the structure of the budget were taken. As a result of higher-than-expected economic growth and high wage dynamics, revenues developed favourably. In addition, the increase in VAT revenues was also supported by the improved efficiency of tax collection due to the installation of online cash registers. On the expenditure side, the value of certain transfers increased in real terms, because inflation was lower than calculated in the budget, but at the same time there was actually a slight decrease in GDP-proportionate pension expenditures as a result of the earlier measures, the impacts of which started to appear gradually (e.g. the raising of the retirement age starting from 2014). Government wage expenses increased as a result of the introduction of the teacher career path model and expansion of the public labour programme. The value of the EU transfers reflected in the budget peaked in 2014, which increased both government revenues and expenditures, while the balance was affected up to the amount of the own resources, and the primary balance (without interest payments) also deteriorated roughly by the amount of own resources.

Chart *42: Changes in net savings of the general government (as a proportion of GDP)*



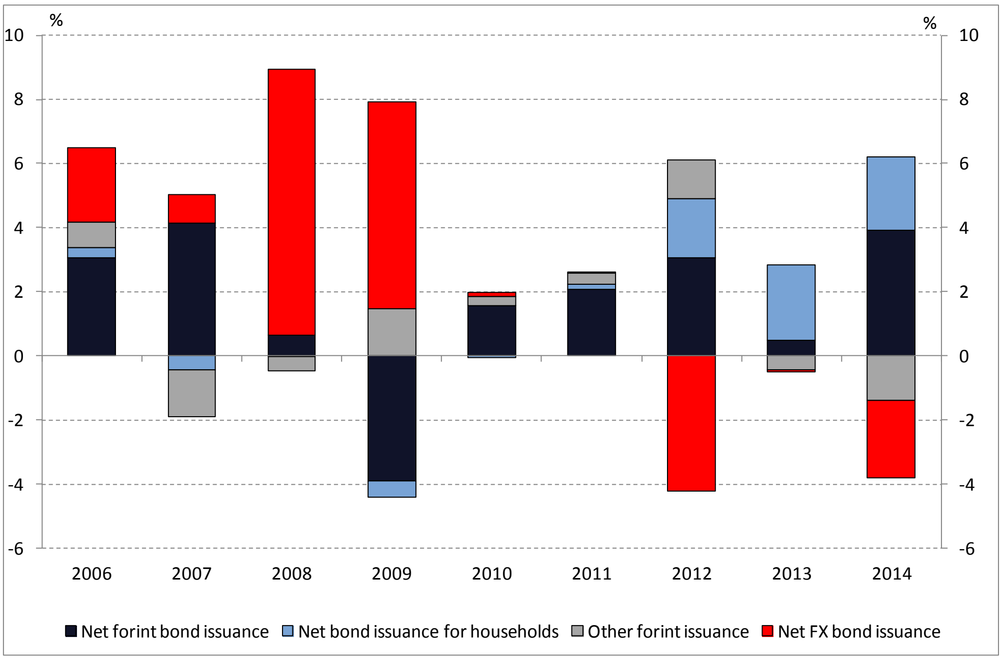
The interest expenses paid on government debt substantially decreased in 2014, contributing significantly to the development of a low budget deficit. Compared to the pre-crisis years, GDP-proportionate government interest expenses had previously exhibited an increasing trend, as a result of the increasing government debt until 2011 and also due to the soaring risk premiums. However, in 2014 the interest burden calculated on an accrual basis fell by 0.4 per cent of GDP, due to the continued decrease in government securities market yields since 2012. The decrease in yields was mostly attributable to the falling risk spread and decreasing inflation, but the central bank's easing cycle also contributed. However, the change in yields only appears in the change in actual interest expenses with a time lag, due to the gradual repricing of government debt. This partially explains that yields, which increased during the crisis, resulted in higher government interest expense in subsequent years as well. The total interest expenditure decreased in 2014, but within that the share of interest paid to non-residents (which also affects the balance of payments) increased slightly, despite the fact that the ratio of non-resident ownership fell within the total government debt. This apparent contradiction may be attributable to the fact that the composition of the debt has changed and the weight of the forint government securities, which offer higher interest, increased in non-resident ownership. On the other hand, Hungarian foreign currency yields fell to a lesser extent than forint yields. Thirdly, the average EUR/HUF exchange rate compared to 2013 was almost 3 per cent weaker in 2014.

Chart 43: Changes in general government interest expenditures



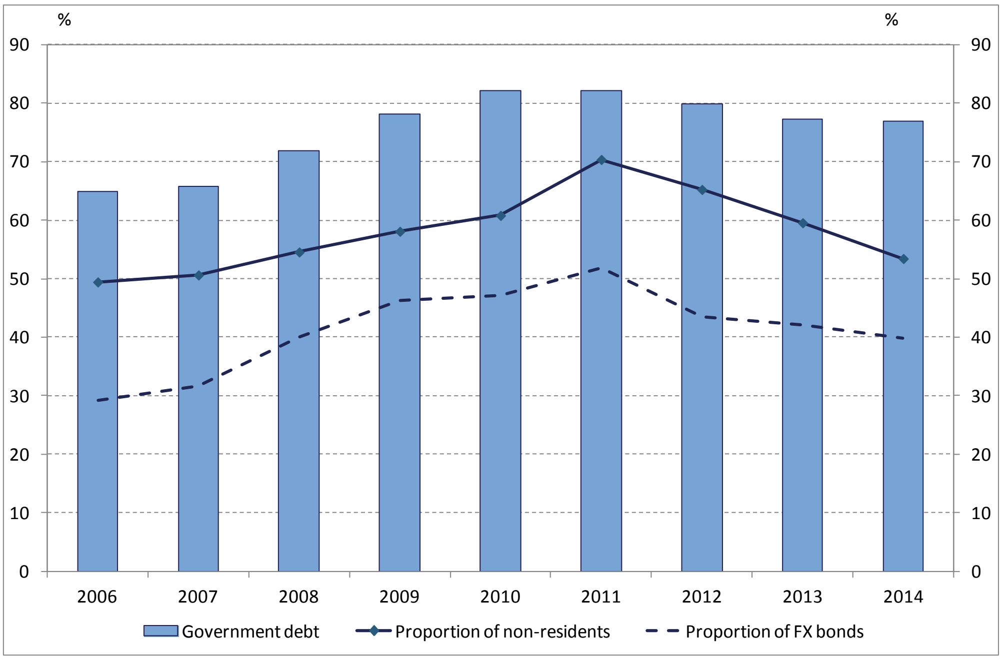
In recent years, debt management has gradually reduced the foreign currency ratio in government debt, which fell below 40 per cent by the end of 2014. The foreign currency ratio soared in 2008 as a result of the loans taken from international organisations, followed by additional foreign currency bond issues and depreciation of the forint exchange rate pushing it above 50 per cent of the total debt by the end of 2011, which was well above the optimal ratio for Hungary in terms of debt management. In recent years, the Government Debt Management Agency has made strong efforts to reduce the foreign currency debt. In 2011-2012, this was supported by non-residents' robust demand for forint government securities, and following the stagnation therein, by households' purchases of government securities. In 2014, the Government Debt Management Agency issued less foreign currency government debt than the expiring portfolio, as a result of which the foreign currency ratio of the government debt fell from the previous year's 42 per cent to below 40 per cent (Chart 45). The largest foreign currency repayment was the instalment of EUR 2 billion on the loan from the European Commission in November (the last instalment in the amount of EUR 1.5 billion falls due in April 2016).

Chart 44: Structure of the Government Debt Management Agency's annual net issue of debt (proportion of GDP)



In terms of the owner distribution of government debt, the trend observed since 2011 continued, as the ratio of non-resident ownership within government debt decreased considerably in 2014 as well. At end-2011, around 70 per cent of government debt was owned by non-residents, while at this ratio was only 53 per cent end-2014, with the current value thus approaching the pre-crisis value of around 50 per cent. The change in 2014 was mainly the result of three factors: new issue of foreign currency bonds in a lower volume than the expiring portfolio, favourable household demand for government paper and rising levels of government bond assets at banks. This household demand stems from the conscious debt management programme of recent years, which diversified government securities and made them more attractive for households compared to other forms of investment. Obviously, the growth in households' financial assets was another key factor behind this. The MNB launched the self-financing programme in April 2014 the purpose of which was to strengthen the financing of government debt from internal, domestic funds and to mitigate the external vulnerability of the economy. The conversion of MNB bills into deposits boosted banks' demand for government bonds, due to the fact that as opposed to the central bank bills the central bank deposit is not eligible collateral in the case of the MNB's loan assets, and its liquidity classification is also less favourable; thus, demand for other more liquid assets, primarily government bonds, increased. In line with the objectives of the self-financing programme, the government bond portfolio of resident financial institutions expanded by HUF 830 billion, i.e. by 21 per cent in 2014.

Chart 45: Development of government debt and the ratio of external funding (in proportion to GDP and government debt)



Note: The ratio of foreign ownership is calculated from a non-uniform database, in part based on estimations.

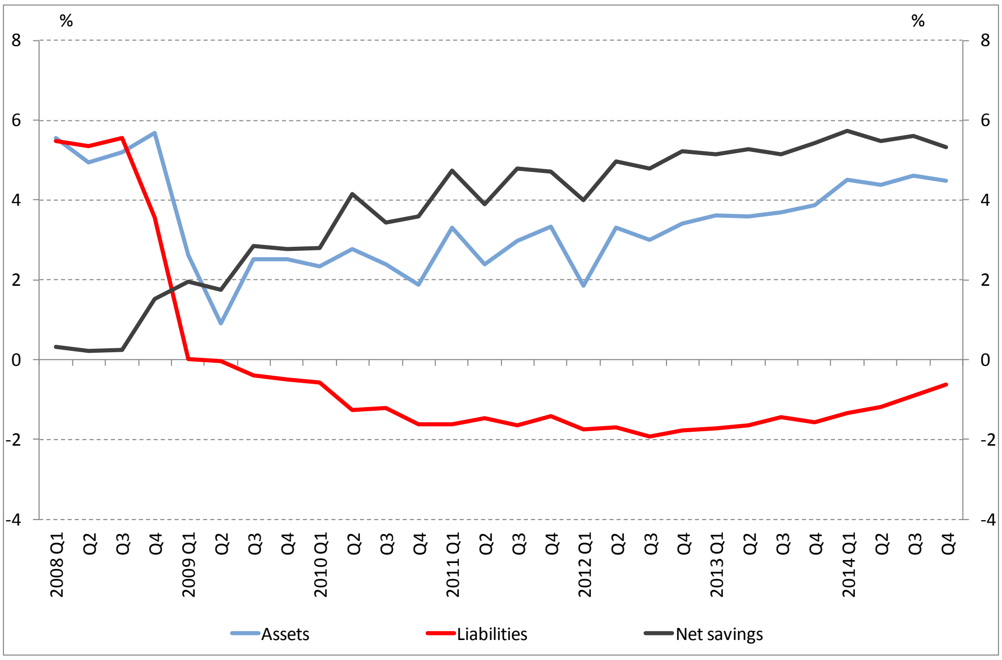
4.2. Households

Households' net savings fell a bit in 2014 Q4, but remain high, at over 5 per cent of GDP (Chart 46). The moderate decrease in net savings results from the fact that there was no material change in the seasonally adjusted growth rate of financial assets, while the decrease in net new borrowing decelerated. Although the households are still repaying more loans than they borrow, the continuous contraction of outstanding borrowing – net of revaluation – is gradually decelerating.[11] The adjustment on the liabilities side, which started as a result of the crisis, decreased compared to 2013 and the fall in the GDP-proportionate loan repayments was attributable to the fact that, from the middle of the year, forint-denominated borrowing for housing purposes exceeded loan repayments.

Following the substantial increases seen in earlier years, the GDP-proportionate index of financial asset growth only increased to a minor extent in 2014. This may suggest that households' accumulation of financial assets reached its maximum level last year. In parallel with this, the reallocation of the household portfolio from bank deposits to securities came to a halt by the end of 2014. With the expected recovery in consumption, growth in financial assets may slow down along with an increase in net new borrowing, which points to a gradual decrease in net savings.

[11] The decline in borrowing may have been attributable to the moving of the working days at the end of the year.

Chart 46: Net savings of households
(seasonally adjusted revised values, as a percentage of GDP)*



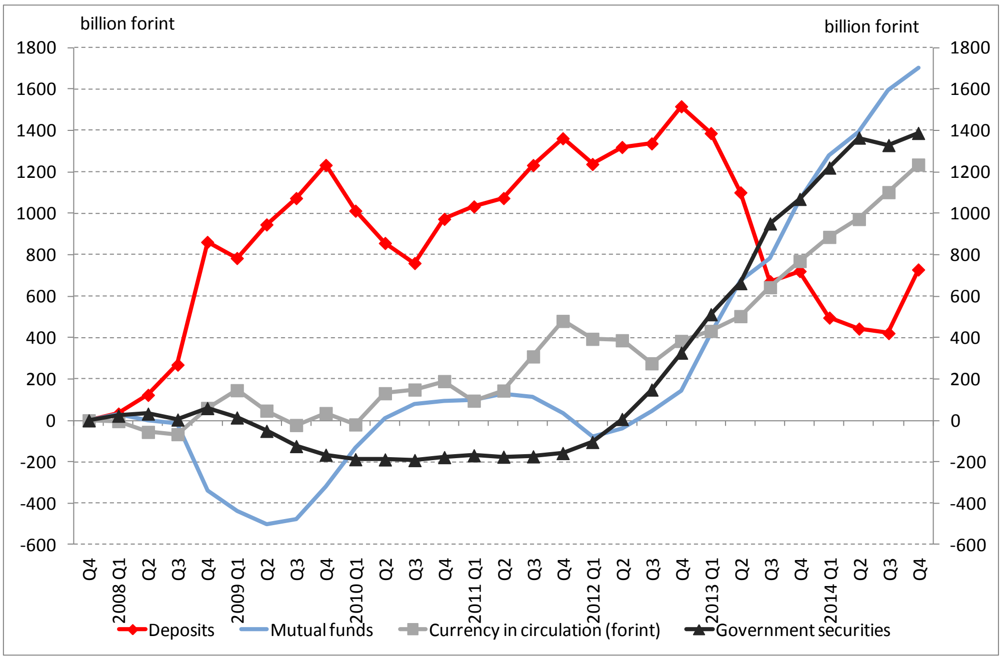
**Revised values, reflecting the underlying values, adjusted for pension fund savings, early repayment, the disbursement of real yields and the indemnification of the deposit-holders of the liquidated cooperative banks*

The restructuring of the household portfolio seen since the start of the easing cycle – i.e. the flow of funds from bank deposits into securities – came to a halt in 2014 (Chart 47). Starting from the second half of 2012, the low yields on bank deposits encouraged households to invest their savings in government securities offering significant yield premiums and mutual fund shares, which retrospectively showed relatively high returns. This process decelerated considerably in early 2014, and stopped by the end of the year.[12] In the second half of the year, no major shift was seen between individual items in the household portfolio; the structure of the portfolio was mainly influenced by new savings. The portfolio of mutual fund shares continued to increase throughout the year, due to the difference between bank deposits and the retrospective yields and to the fact that the mutual fund shares are regarded as a liquid form of savings. Savings in government securities reached its current value by the middle of the year. One of the most important reasons for the stagnation is that by now a large volume of government bonds should be rolled over to maintain the portfolio at the current level. On the other hand, in the second half of the year, the decline in deposit rates also stopped, and thus falling deposit rates no longer motivated households to reallocate their funds. As a third factor, it may also be an important consideration that the government bond holdings of households reached an extremely high level by international standards.[13] At the end of the year, when investing in government securities households preferred the purchase of long-term papers, while holdings of short-term securities shrank. However, the financing of the general government by households increased in the second half of the year as well, indirectly via bond funds. At the same time, the rise in households' holdings of mutual fund shares may have been reflected in the increase in the sector's foreign receivables, such as, for example the growth in foreign equity investments of mutual funds (see Chapter 2). The trend-like increase in cash holdings, which was seen throughout 2014, may still be related to the low yield environment, the negative inflation and the recovery in consumption.

[12] At the same time, the growth in bank deposits at the end of the year was also attributable to the early wage payment due to the moving of the working days in January 2015, as well as to seasonal growth.

[13] Kékesi Zsuzsa – Kóczián Balázs – Sisak Balázs: Role of the household portfolio shift in the financing of the government - Credit Institution Bulletin, March 2015

Chart 47: Changes in the key financial assets of households (cumulative transactions)

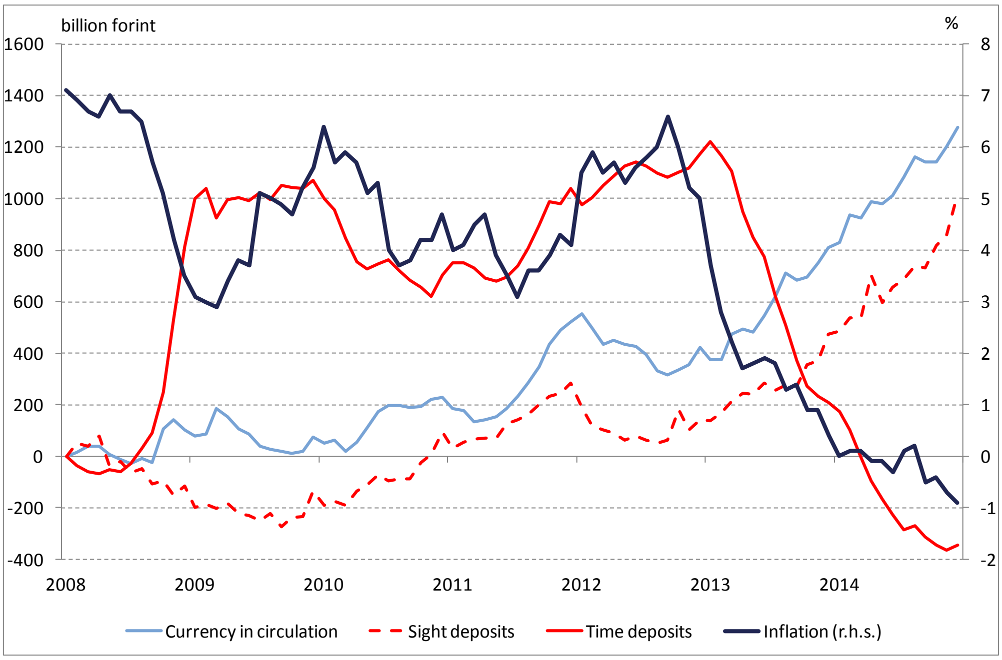


Box 5: Impact of decreasing inflation on household savings

The MNB's easing cycle implemented in parallel with decreasing inflation resulted in a spectacular restructuring of household savings. In recent years, households made considerable reallocations in their savings. On the one hand, the decline in yields in line with falling inflation encouraged households to place their savings in investment vehicles offering higher interest, and on the other hand an increasing volume of funds flowed into non-interest bearing assets or assets offering very low interest, such as sight deposits and cash. The latter is attributable to the fact that in a low yield environment the interest loss that one may suffer on non-interest bearing assets or low-interest assets is also negligible, which – considering the liquidity of these assets – boosted the cash and sight deposit portfolio. In addition, demand for cash and sight deposits may have also increased as result of rising consumption.

As a result of falling yields, the cash and sight deposit portfolio started to increase. The portfolio of non-interest bearing investment instruments started to increase in the second half of 2012, simultaneously with the decrease in the cash holding cost, i.e. inflation. By the end of 2013, cash holding costs had practically fallen to zero, and thus households realised no loss on keeping their savings in cash. The so-called opportunity cost compared to the yield of alternative investment instruments remained in place, but fell significantly. However, it can be assumed that households kept the cash and sight deposit funds in order to preserve their liquidity, rather than for the purpose of investment. The increase in cash holdings may have also been fostered by the introduction of the transaction duty. As a result of all of this, the portfolio of non-interest bearing assets reached its historic peak by December 2014.

Chart 48: Relation of inflation and household deposits (cumulative transactions)



As a result of the easing cycle, demand for mutual fund shares and government securities, which offer a yield premium over bank deposits, increased significantly. The non-investment purpose portion of the funds released from time deposits flowed into non-interest bearing assets, while savings for investment purposes were invested in mutual fund shares and government securities. The rising demand for government securities was also supported to a great degree by the government's strategy (e.g. new sales channels, increased marketing spending). Households' savings held in government securities reached the current level by 2014 Q2 and have not changed materially since then. As a result of these processes, the direct household financing as a percentage of the central budget debt exceeded 9 per cent in 2014 Q3. From the second half of 2014 the increase in households' financing of the general government materialised indirectly, via bond funds, as the increase in holdings of mutual fund shares, and particularly of bond fund shares, continued in 2014 as well. For household investors, the advantage of indirect financing of the general government, i.e. bond funds compared to direct purchases of government securities is that it represents a weaker commitment, along with a significant yield premium.[14] In 2014 Q3, the ratio of indirect financing by households as a percentage of the central government debt exceeded 11 per cent. Thus, in total households' debt financing amounted to 20 per cent within the debt of the central government, as a result of which households increased the rate of internal financing and reduced the rate of the external indebtedness, thereby also contributing to the decrease in the government's net external debt.

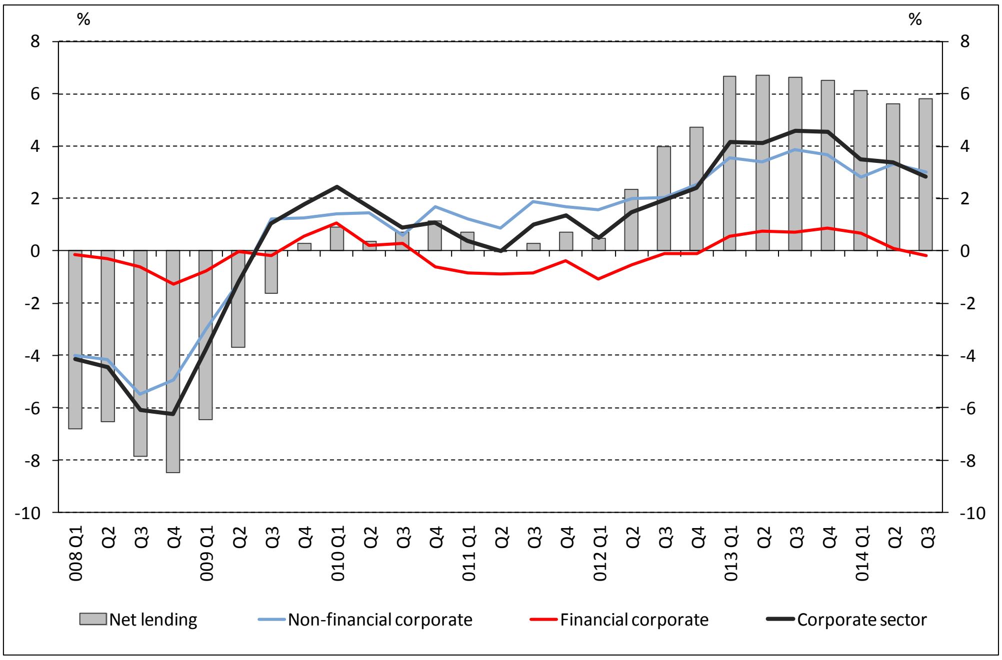
4.3. Corporate sector

While the increase in corporations' financial savings during the crisis was a dominant factor in the strong improvement of net lending, calculated from the financing side, starting from 2012 the position of the corporate sector has lagged behind the total economy's net lending at an ever increasing rate (Chart 49). The decline in the net lending of the corporate sector as a whole until Q3 was primarily due to financial corporations, while the financial savings of non-financial corporations have been fluctuating around 3-4 per cent of GDP for almost two years. The financial corporations – being part of the financial intermediary system – essentially do not perform any real economy activity and the vast majority of the monetary transactions performed by them affects both their financial assets

[14] Kékesi Zsuzsa – Kóczián Balázs – Sisak Balázs: Role of the households' portfolio shift in the financing of the government - Credit Institution Bulletin, March 2015

and liabilities.[15] Accordingly, in 2014 the net savings of financial corporations returned to the close to zero level that had previously characterised the sector over the longer run.

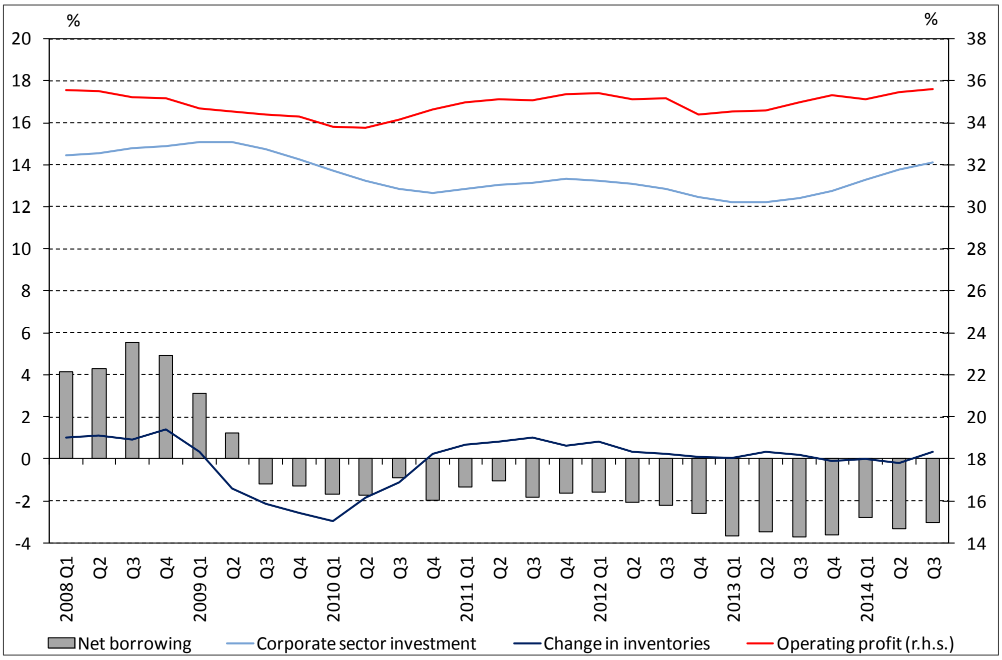
Chart 49: Net lending of corporations and external surplus (four-quarter GDP-proportionate figure)



On the real economy side, the net lending of non-financial corporations remained at a high level along with the considerable growth in investment spending in recent quarters, which may be attributable to growth in companies' revenues, also supported by rising EU transfers. Within investments, in parallel with the recovery in domestic demand, the investments of industries producing for the domestic and the external market increased at similar rates. Manufacturing (particularly suppliers related to the automobile industry's major investments) still plays a key role in the growth of investments, while the funds provided by the Funding for Growth Scheme may have also supported investment growth. At the same time, the GDP-proportionate value of operating profit, which is a key variable for the revenue processes of non-financial corporations, remained roughly at the same level: in parallel with the acceleration in annual GDP growth, the annual real growth of corporations' operating surplus may have exceeded the 2013 level. The year-on-year rise in EU transfers may have also increased corporations' disposable income to a minor degree, while corporations’ interest expenses may have also decreased, in conjunction with decreasing indebtedness and the falling level of interest rates.

[15] The net lending of financial corporations is primarily influenced by the profit or loss of the sector, as well as the change of their non-financial assets (e.g. real properties). However, in addition, first the crisis and later the losses realised as a result of the final early repayment scheme had a considerable impact on the sector's position: the difference between the market and the fixed exchange rate as a capital transfer granted to the household sector – in addition to increasing the households' net financial savings – reduced banks’ net lending.

Chart 50: GDP-proportionate borrowing requirement of non-financial corporations and the related key real economy factors (four-quarter figures calculated from the national accounts)



Source: HCSO.

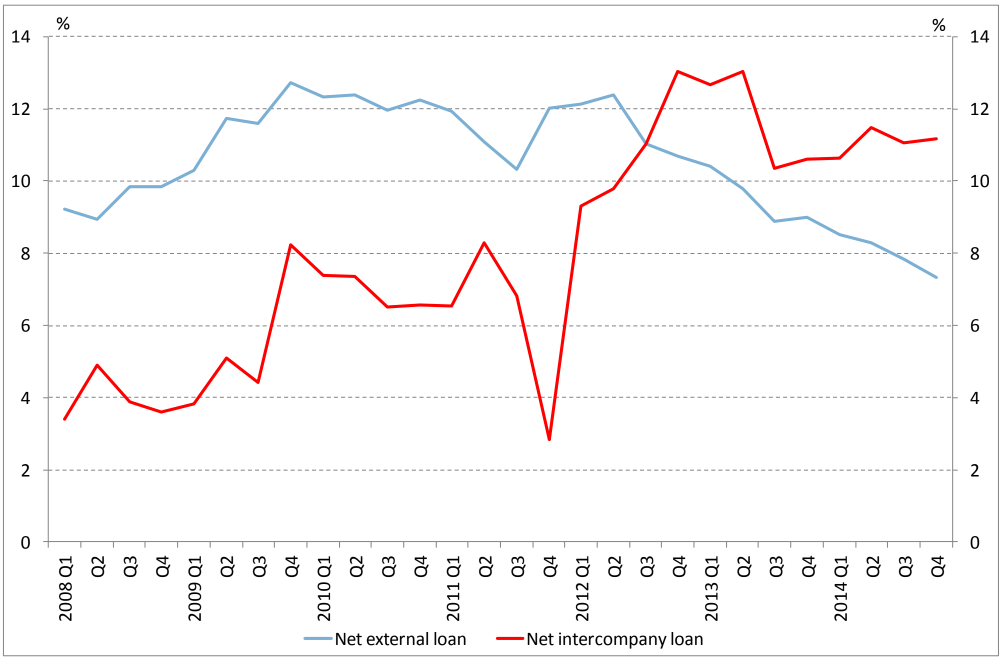
On the funding side, the stagnation in the net savings of non-financial corporations took place in conjunction with extremely low financing. In 2014, non-financial corporations' debts showed the same small rate of increase seen since the outbreak of the crisis, and thus the net savings of the sector was predominantly driven by the accumulation of financial assets, which roughly approximated the pre-crisis level. Within liabilities, in past years the decline in foreign and domestic credits was offset by the increase in non-residents' equity-type funds. At the same time, until 2014 Q3, as a result of the relatively high profit transfer in Q2 and state acquisitions, the decrease in foreign credits was exacerbated by the fall in the non-resident sector's equity investment (See details in the Financing approach chapter). In part, this is the reason that the corporations' net foreign assets[16] once again increased to a larger extent and thus their development over the longer run caught up with the sector's net savings (Chart 51).

[16] Since foreign-owned companies often run large volume of funds through their Hungarian subsidiaries, and the companies frequently restructure their portfolios significantly, only the net transactions of the foreign assets and liabilities should be examined.

Chart 51: Net lending and net foreign transactions of non-financial corporations (four-quarter values as a percentage of GDP)

Within the foreign liabilities of corporations, outstanding foreign borrowing decreased further in 2014 as well, while there was no further increase in intercompany loans, in contrast to the upward trend seen during the post-crisis period so far. Following the outbreak of the crisis, it appeared that intercompany loans would represent more stable funding compared to other debt components. Experience also shows that when the market environment becomes unfavourable, it is the debt-type funds that flow out first. This could be observed in the case of Hungary as well: while the foreign loans of corporations have been decreasing since 2010, intercompany loans remained relatively stable after the increase.

Chart 52: Non-financial corporations' foreign and intercompany loan portfolio (as a percentage of GDP)



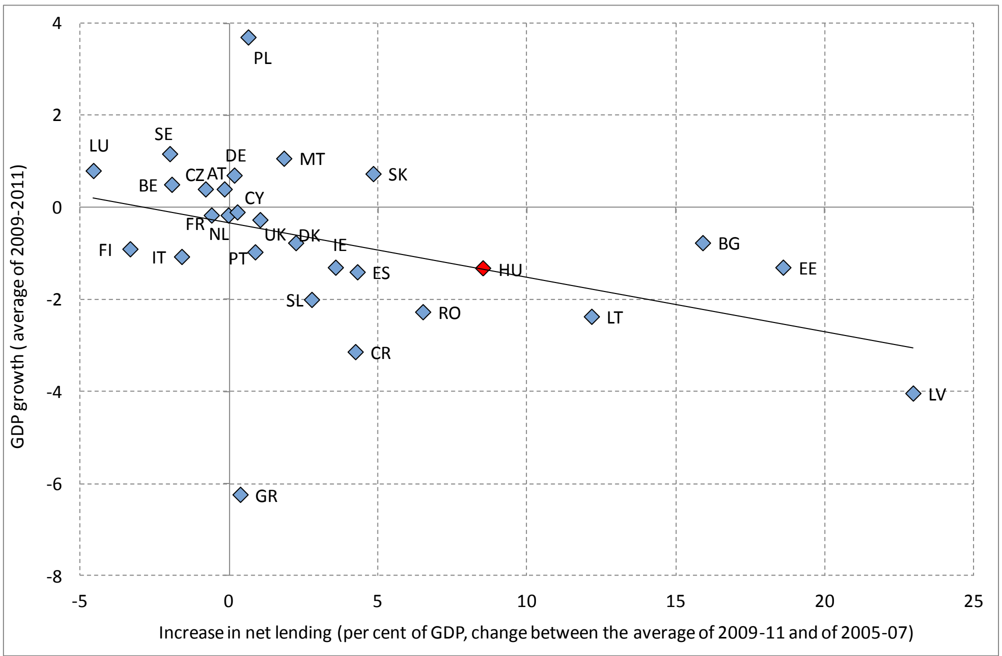
In comparison with the European Union, the Hungarian economy's net lending and growth rate was high in 2014. Accordingly, the improvement in external debt indicators continued. However, Hungary's external debt ratio remains relatively elevated, despite a substantial decrease. *In 2014, Hungary's economy expanded rapidly, along with elevated net lending. The high utilisation rate of EU transfers may have contributed to this. Within the region, Hungary boasts the highest balance of payments surplus, driven by the balance of goods and services surplus stemming from the high absorption of EU transfers and improving terms of trade. As for the savings of different sectors, in addition to the low budget deficit, the significant savings of the private sector may have also contributed to net lending that is salient even in regional terms. The economy's net external debt remains higher compared to other countries within the region, but the difference has become smaller.*

Presenting the data on the Hungarian balance of payments in an international context, this chapter mainly focuses on a comparison with other countries in the region, while briefly touching upon some of the processes that, in some regards, set Hungary apart from the other countries. In order to assess the changes in Hungary's balance of payments in an international comparison, it makes sense to compare the Hungarian data to similar countries. Therefore, comparison with the Visegrad countries seems relevant, since the economies of the region have faced similar challenges in past decades and all acceded to the European Union at the same time.

5.1. General overview

The years after the crisis were characterised by substantial adjustment across the majority of European Union countries, which may have contributed to weaker growth. The adjustment following the start of the financial crisis is reflected in a sharp rise in the net lending of economies. Greater adjustment typically went hand-in-hand with weaker growth. This held true for Hungary: average net lending improved by nearly 9 per cent of GDP compared to the pre-crisis years. After the start of the crisis, the average growth rate of the economy turned markedly negative, in line with the substantial adjustment of economic sectors and subdued consumption and investment activity.

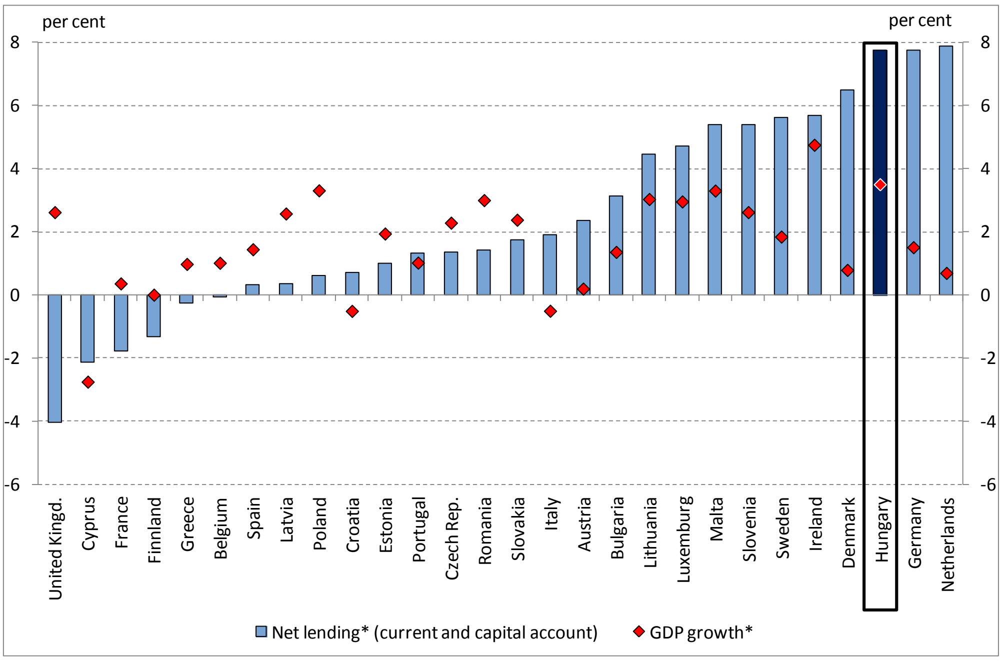
Chart 53: *Adjustment following the financial crisis and growth rates of different economies*



However, this adjustment no longer restrained growth in the latest period: in 2014, Hungary's high net lending among European Union countries was coupled with rapid economic growth (Chart 54). Among the mutually reinforcing domestic impacts of the two variables, EU transfers are worth noting, along with a host of other factors. In 2014, Hungary's current account balance and net lending outstripped previous years and was noteworthy even among the European Union's 28 member states. Consequently, its economic growth was among the highest in Europe. This may suggest that while the past adjustment came at the cost of a substantial sacrifice in growth, the further expansion of net lending in 2014 no longer restrained economic growth.

- The balance of goods and services surplus was pivotal to economic growth. The balance of the trade surplus in export growth has boosted economic growth in recent years and contributed substantially in 2014 to offsetting the growth impact of a spike in import-intensive investments (2014 also saw the balance of trade temporarily weighed down by the filling of natural gas storage capacities, which nevertheless had a neutral impact on economic growth due to rising inventories).
- In addition, the high surplus of EU transfers to Hungary contributed significantly to elevated net lending, which may have fostered relatively high economic growth through increased state investments. The external adjustment of the economy vis-à-vis the rest of the world – which remained substantial – occurred concurrently with a significant decline in debt indicators and an accelerating pickup in economic growth in 2014. It should be noted that both MNB and European Commission forecasts suggest that in years to come the economy's net lending may remain at levels similar to those seen in 2014, along with a rising trade surplus and significant absorption of EU transfers.
- Finally, the improvement in the income balance may drive economic growth, as incomes transferred abroad decline in parallel with the external debt ratios decreasing in response to net lending, which may boost the domestic sectors' disposable income.

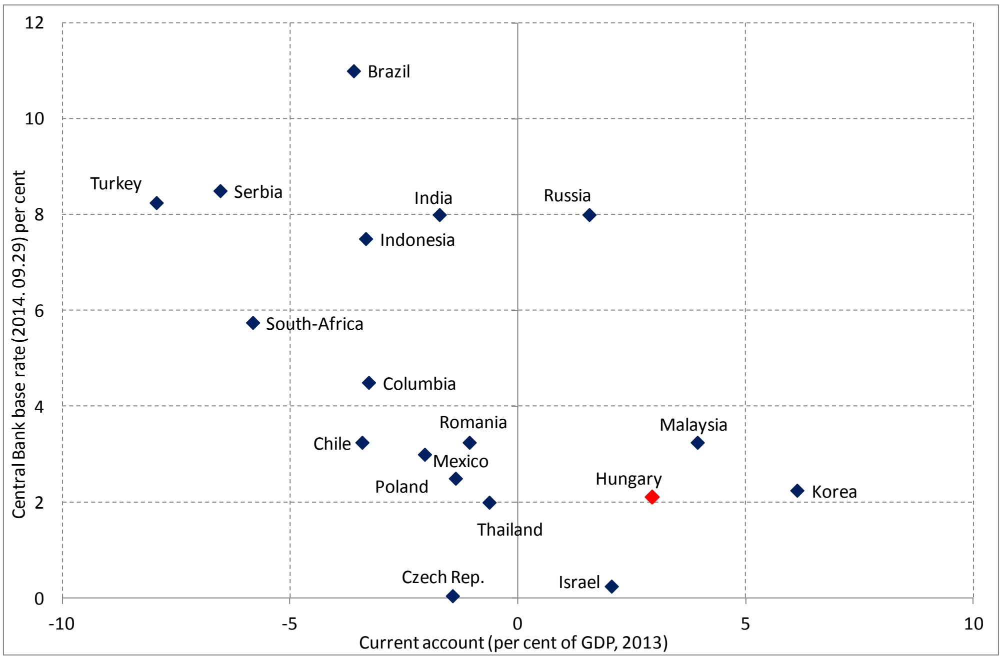
Chart 54: Developments in net lending and economic growth in 2014



*Source: Eurostat; *based on the European Commission's forecast*

The surplus on the current account may have contributed to the success of the Hungarian key policy rate cut. The quantitative easing implemented by the major central banks in recent years has created substantial excess liquidity in financial markets. As a result, the central banks of the emerging countries have also cut their key policy rates. At the same time, the rate of easing may have influenced developments in the current account and the external balance of certain countries: the data show that when the balance of payments surplus is higher, central banks can achieve lower interest rates (Chart 55). Changes in risk premia have also played a role, as the higher current account may have signalled that the financing of the country in question was less risky, which was then potentially reflected in lower risk spreads. Lower interest rate levels may have also been driven by greater focus on the current account over the past one to one-and-a-half years. In Hungary, therefore, the substantial current account surplus may have amongst other things fostered an easing of monetary conditions, and the lower key policy rates may have driven accelerating economic growth and lower interest expenses – and thus contributed to growing out of one of the key risk factors prevailing before the crisis (i.e. high indebtedness) over the long run.

Chart 55: Current account balance and the key policy rate



Source: Matolcsy (2015)[17], IMF WEO, Bloomberg

The following section presents in detail the real economic factors (changes in export performance, competitiveness and terms of trade) which shaped net lending in countries in the region with similar levels of change as the Hungarian economy. In addition, in keeping with the structure of the Report on the Balance of Payments, we present the financing changes of countries in the region and changes in their external debt and outstanding debt.

5.2. Net lending and its factors

Hungary's four-quarter net lending as a percentage of GDP remains elevated, while the recent net lending surplus in countries in the region already started to decline in 2014 (Chart 56).[18] In Q3, the four-quarter balance of the payments position was the strongest in Hungary, rising above 8 per cent as a percentage of GDP, while it hovered at far lower levels of around 1 per cent of GDP in the other countries and exhibited a declining tendency at the end of the year.

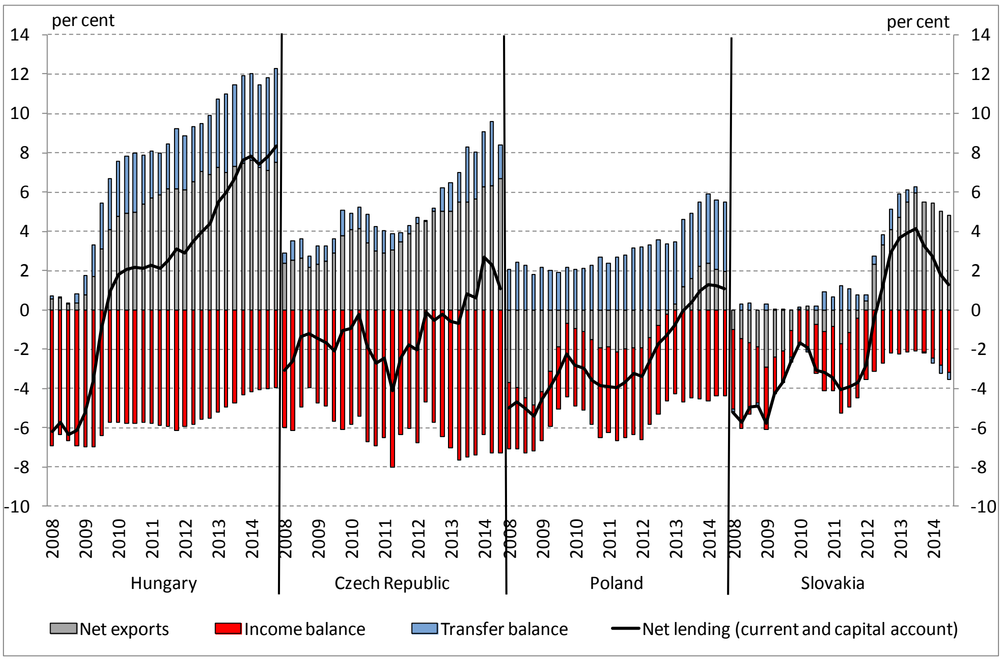
- The *balance of goods and services* surplus as a percentage of GDP was the highest in Hungary in a regional comparison. The Czech Republic saw its balance of trade improve substantially over the past year, due to growth in exports, which fostered its recovery from the slump. Although the balance of goods and services decreased somewhat in Slovakia, the trade surplus remains elevated, materially contributing to the country's economic growth. Poland exhibited the lowest balance of trade as a percentage of GDP, stemming from rapidly expanding investment and household consumption in the Polish economy, which in turn led to import growth surpassing exports.
- The *income balance* has followed different trajectories in recent years across the various countries in the region. In Hungary, the decline in the income balance has stemmed from a concurrent decrease in the profit and interest balance. In the Czech Republic, high profits from FDI have been the driver of a relatively elevat-

[17] Matolcsy György (2015): Egyensúly és növekedés, Kairosz Kiadó
[18] Data are available until Q4 for Hungary and until Q3 for the other countries.

ed income balance in a regional comparison. In Slovakia, the rising income balance deficit in recent years has been primarily associated with the after-tax profits of non-resident corporations.

- The *transfer balance* substantially boosted net lending in every country with the exception of Slovakia, in connection with higher absorption of EU transfers.

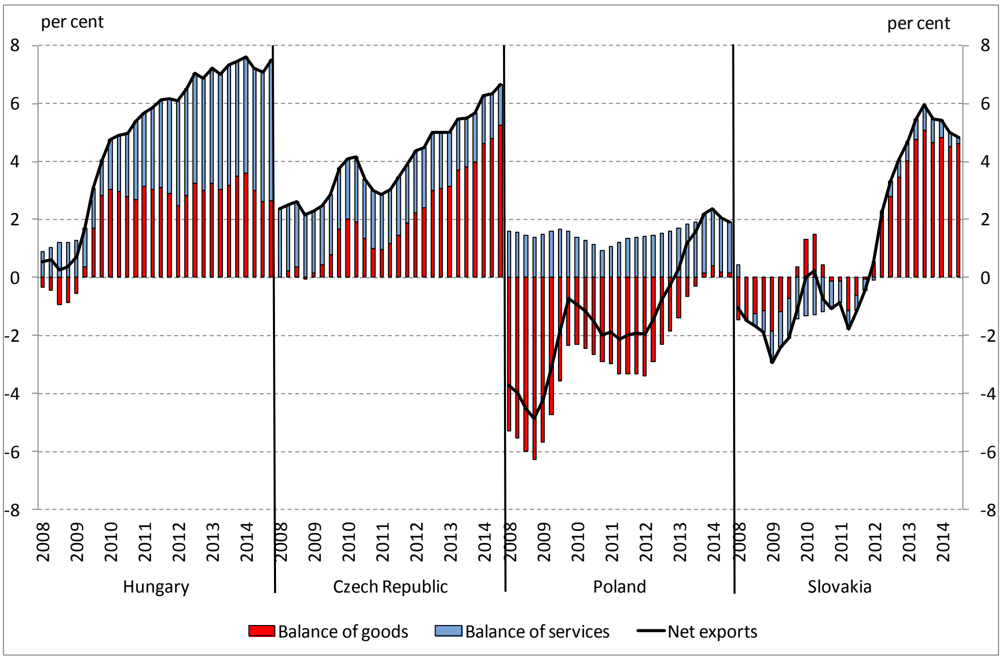
Chart 56: Current accounts and capital accounts of Visegrad countries (four-quarterly data as a percentage of GDP)



Source: Eurostat, national central banks

The balance of goods and services across the region contributes to net lending to different extents: while the balance of goods remains relatively stable in Hungary and the balance of services is improving, countries in the region are instead exhibiting greater improvements in their balance of goods. Accordingly, the balance of goods and services contributed roughly equally to Hungary's surplus balance of trade in 2014, with the balance of goods and services surplus arising mainly from the balance of tourism and transport services. The steadily rising goods surplus is coupled with a stable services surplus in the Czech Republic, with the latter driven by tourism and telecommunications. The Polish trade surplus has been associated with the service sector in recent years, specifically transport. In Slovakia, the goods surplus has accounted for most of the trade surplus in past years. Meanwhile, it should also be noted that while the net exports of the Hungarian economy are the highest in the region, their expansion in the past three years was slower than in the Visegrad countries; the dip seen in Poland and Slovakia in 2014 brought a change in this regard. Another key difference is that the countries under review were characterised by an additional significant improvement in the balance of goods following 2011, whereas Hungary's balance of goods has remained largely stable.

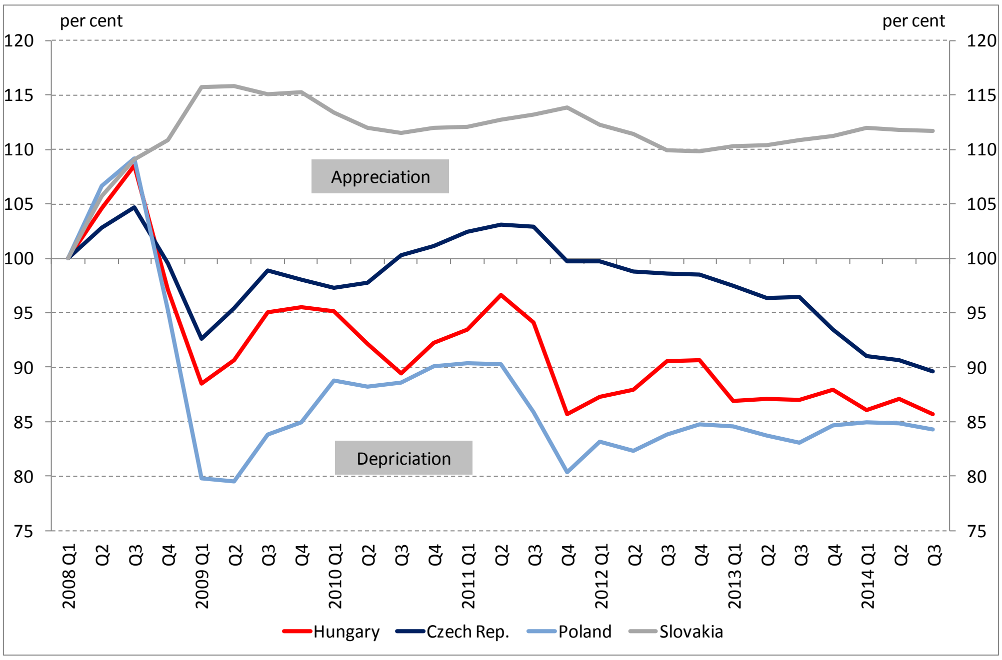
Chart 57: Distribution of the balance of goods and services in Visegrad countries (four-quarter values as a proportion of GDP)



Source: Eurostat

In terms of the competitiveness of the Hungarian export sector, the exchange rate depreciation during the period that followed the crisis may have bolstered the competitiveness of the Hungarian export sector. During the crisis, the Hungarian real exchange rate depreciated sharply compared to other countries in the region, but this development has levelled out over the past two years. This also holds true for other countries in the region, with the exception of the Czech Republic (which has continued to see depreciation of its real exchange rate due to the Czech central bank intervening to keep the Czech koruna from moving below EUR/CZK 27). The diverging developments in Slovakia's real exchange rate relative to the region is fundamentally tied to the introduction of the euro. The real economic impact of exchange rate fluctuations may increase going forward in the wake of the conversion of the substantial volume of household foreign currency debt, which has buffered positive impacts in the past. In addition, developments in the USD/EUR exchange rate may remain pivotal in terms of Hungarian exports. The European Central Bank's quantitative easing may weaken the euro, which could be beneficial for the export sector of the euro area, specifically that of Germany, thus stimulating Hungarian exports thanks to the close trade relations.

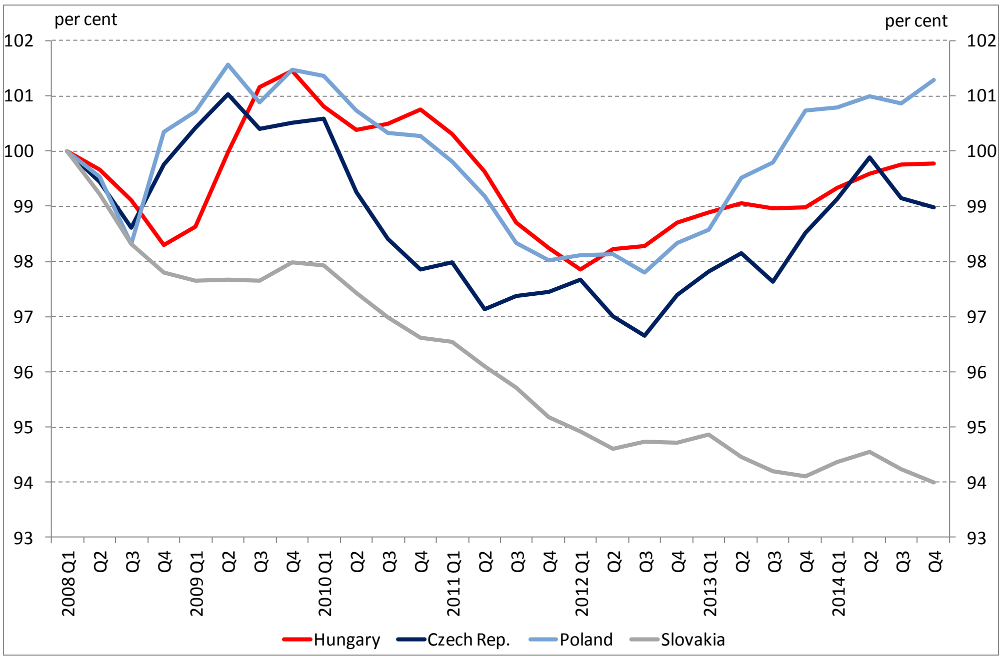
Chart 58: Changes in labour costs based on real exchange rate (2008 Q1 = 100)



Source: European Commission

Hungary's terms of trade improved slightly in 2014, similarly to other countries in the region. The globally low inflation environment and falling commodity prices have slightly improved the terms of trade of Hungary and its neighbouring countries. The strong decline in oil prices in late 2014 was only reflected to a limited extent in terms of trade, with the bulk of the impact expected to be felt in 2015. Due to the large scale of energy imports, the trade balances of the countries in the region may be increased by the improving terms of trade due to falling oil prices. In the case of Slovakia, the appreciation of the euro versus the US dollar may deteriorate its terms of trade, particularly in terms of energy.

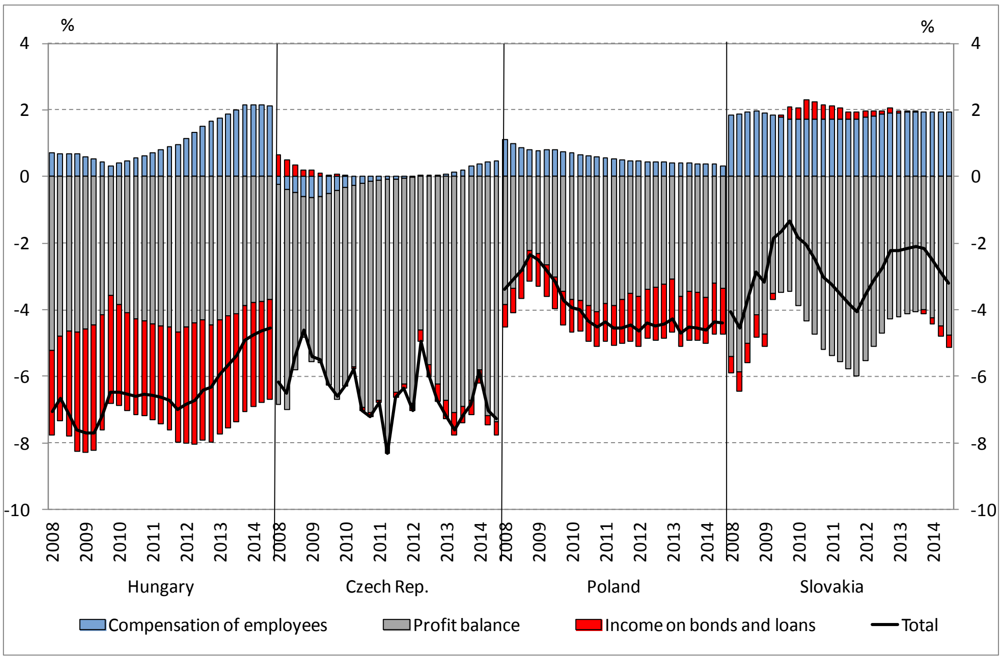
Chart 59*: Changes in the terms of trade in the region (2008 Q1 = 100)*



Source: Eurostat

In a regional comparison, despite the elevated external debt ratio, incomes transferred abroad from the Hungarian economy were average on the whole. The components of the income balance show that in connection with the elevated net external debt ratio, the Hungarian economy's interest balance deficit was the highest. Net interest expenses on loans and bonds accounted for roughly 3–4 per cent of GDP in recent years, compared to less than 2 per cent in Poland's economy and a negligible figure in the Czech Republic and Slovakia. The other characteristic of FDI is that while the Czech Republic, Slovakia and Hungary share similar volumes of net FDI of around 60 per cent of GDP, the profits realised by non-resident owners diverge substantially. The elevated profit balance in the Czech Republic (around 7 per cent of GDP) and a volume of FDI similar to that of Hungary jointly suggest that Czech corporations are more profitable and, therefore, non-resident owners derive higher profits.

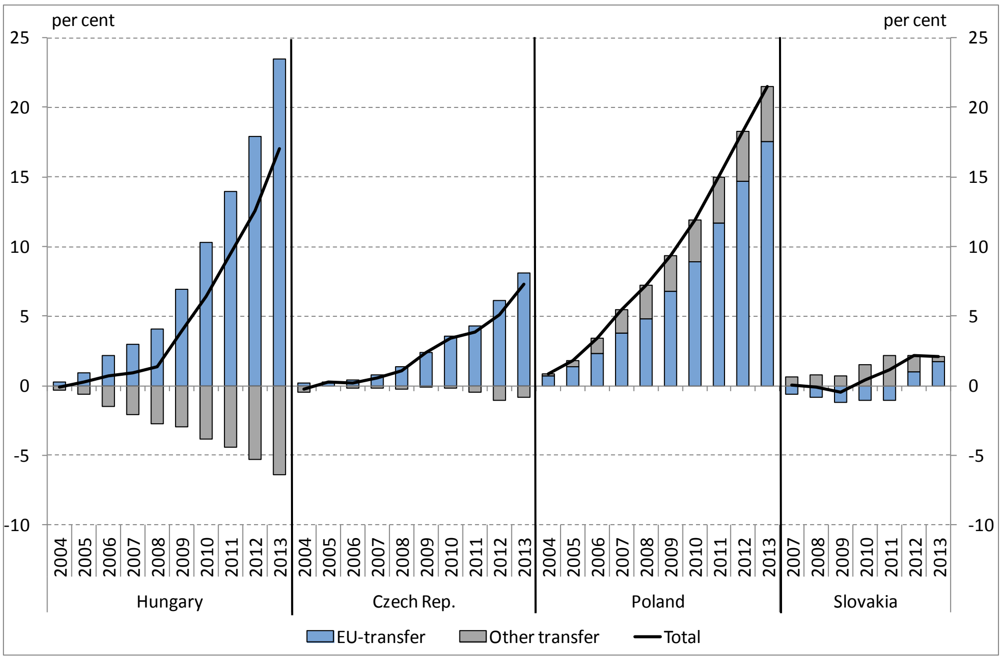
Chart 60: Developments in components of the income balance (four-quarter values as a percentage of GDP)*



*Source: national central banks; *indicators exclusive of foreign exchange reserve incomes*

The available data show that Hungary absorbed the most European Union funding among the Visegrad countries that joined the EU in 2004. Of the countries in the region, Hungary and Poland absorbed the highest amounts of EU transfers between 2004 and 2013. However, while absorption rose steadily in Poland, Hungary's absorption of EU transfers only rose significantly from 2009 onwards, largely contributing to the post-crisis adjustment. While Hungary absorbed nearly 25 per cent of its GDP on aggregate in EU funding between 2004 and 2013, Poland only absorbed around 17 per cent, while the Czech Republic only absorbed around 8 per cent of its GDP. It is important to note, however, that the transfer balance in Hungary only contributed to a slightly lower extent to net lending, compared to Poland, as the income-decreasing impact of taxes paid by workers temporarily employed abroad was set off against this item (as mentioned in the section on the Hungarian income balance).

Chart 61: EU transfer absorption among Visegrad countries between 2004 and 2013 (cumulative values as a percentage of GDP)

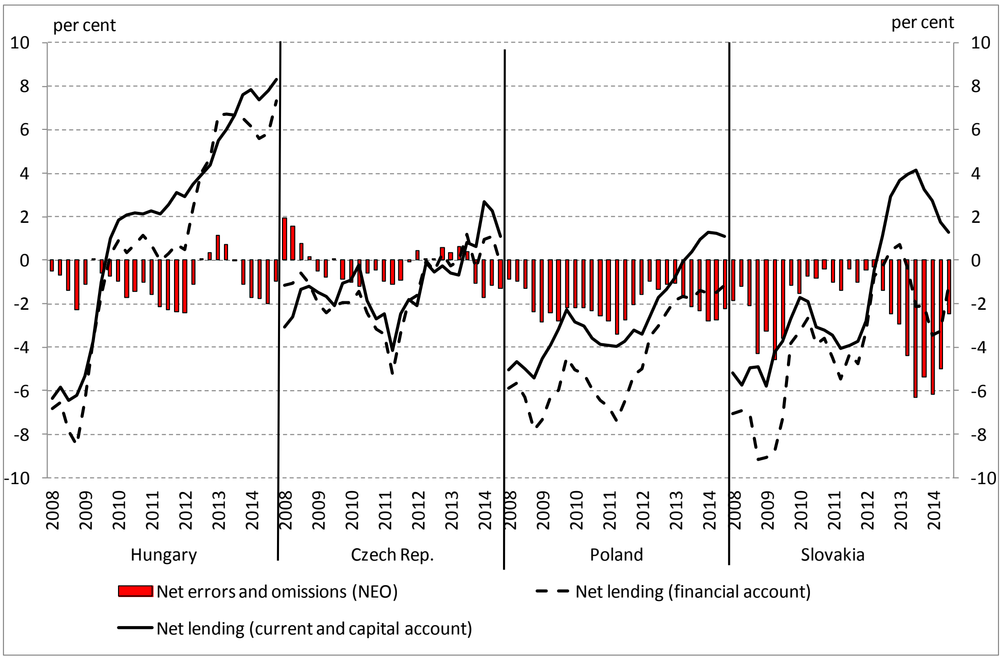


Source: Eurostat, BPM 5 data

5.3. Financing-side developments

Net lending calculated from the financing side broadly falls short of net lending calculated from the real economic side across the countries in the region. Meanwhile, the statistical error "Net errors and omissions" (NEO) remained relatively low in Hungary. "Net errors and omissions" shows the difference between net lending based on the financing side and net lending based on the current and capital accounts. For Hungary, both indicators show substantial net lending, while the difference between the two indicators is less than 2 per cent of GDP, which is considered low in a regional comparison (Chart 62). Regarding the sign of the error, it should be noted that the financing-side external position falls short of the real economic side figure in all countries in the region. This means that the external debt of certain countries is declining at a slower rate than indicated concurrently by the current and capital accounts in Hungary and the Czech Republic. The situation is even more idiosyncratic in Poland and Slovakia; due to diverging data sources, while the current and capital accounts showed a surplus in 2014, the external debt of the latter two countries rose nevertheless. In addition, the divergence between the two indicators in Slovakia was in excess of 6 per cent of GDP in early 2014.

Chart 62: Balance of errors and omissions in Visegrad countries (four-quarterly data as a percentage of GDP)

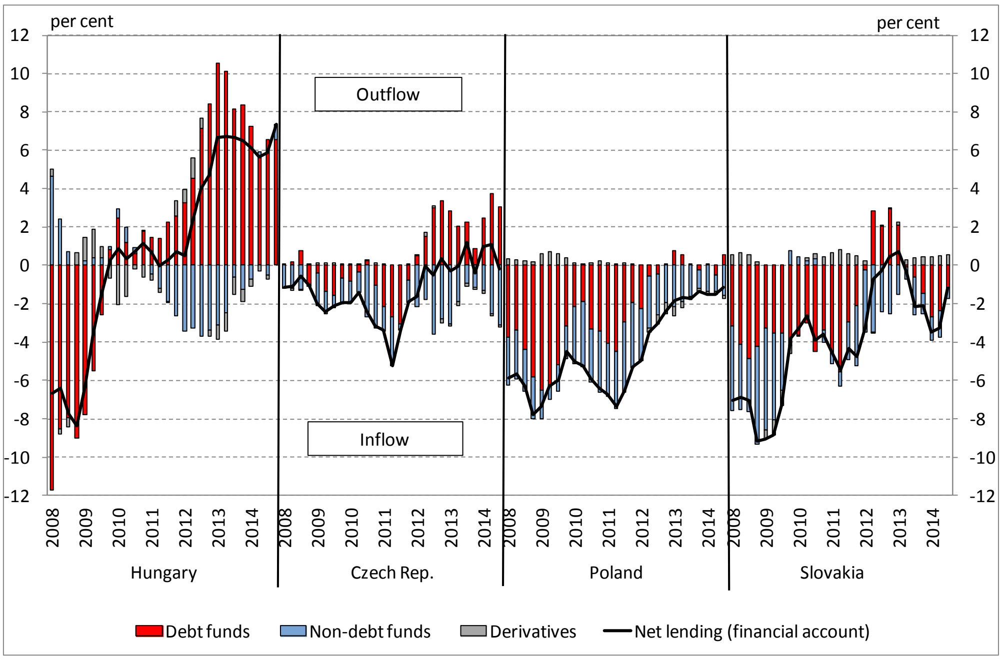


Source: Eurostat, national central banks

In 2014, the Czech Republic also scaled back its net external debt, along with Hungary, while net external debt remained the same in Poland and rose slightly in Slovakia (Chart 63). Due to Hungary's elevated external debt indicators, in particular the level of net external debt, a more pronounced adjustment was observed following the crisis, compared to the other Visegrad countries. As a result, Hungary is making substantial repayments on its external debt, while among the other countries in the region only the Czech Republic is reducing its net debt liabilities.[19] It should be noted that the influx of non-debt liabilities to Hungary has continuously waned over the past years, but remained stable in Poland and the Czech Republic; this may stem primarily from the slowdown in the sale of non-resident holdings of the nationalised private pension fund assets.

[19] The Czech central bank may have also played a role in this in the form of continuous market interventions since November 2013 in an effort to weaken the Czech koruna, which resulted in a substantial increase in central bank reserves. In addition, in 2014 Q2 the Czech Republic and the corporate sector made substantial repayments on bonds issued abroad, followed by significant repayment of foreign credits and commercial loans by the corporate sector in Q3.

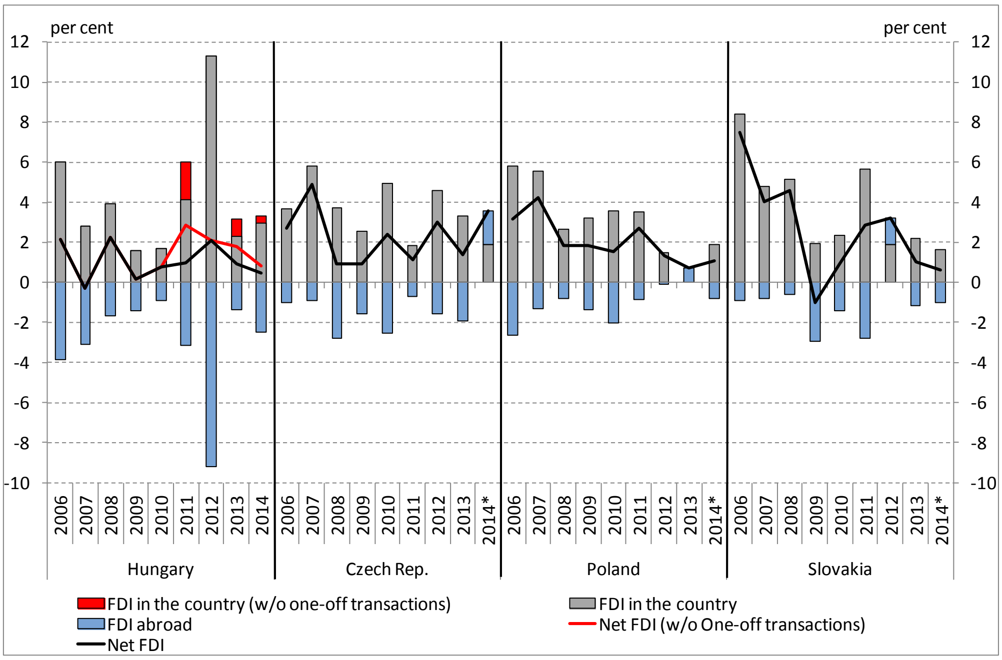
Chart 63: Net lending of Visegrad countries (four-quarterly data as a percentage of GDP)



Source: national central banks, Eurostat

The influx of net FDI faltered across the region in the wake of the financial crisis. The influx of FDI has slowed in Hungary in recent years. It should be noted, however, that following the start of the financial crisis, all of the countries in the region saw a decline in the influx of FDI compared to earlier; hence, the slower rise in investments in Hungary may be associated with this trend. With regard to the Hungarian data, it should also be noted that changes in net FDI are strongly distorted by public sector purchases: the increased equity stake in MOL and the acquisition of E-On decreased the influx of FDI, and the "underlying trend" excluding these factors would have yielded a higher inflow of FDI.

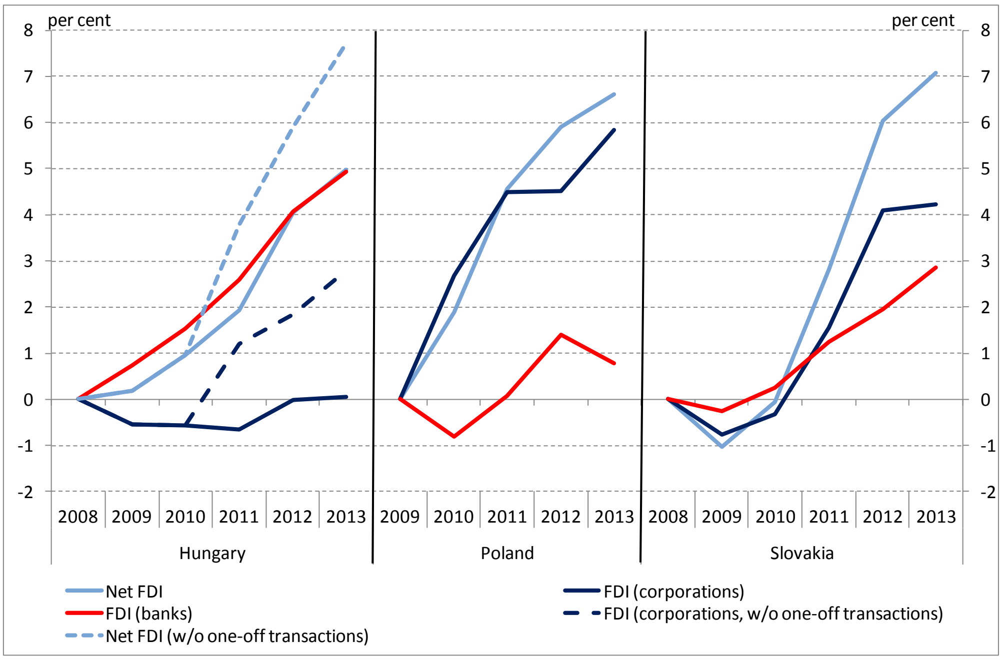
Chart 64: Net FDI inflows in the region (as a percentage of GDP)



*Source: national central banks; *four-quarter data until 2014 Q3*

In terms of the structure of FDI funds, the banking sector was dominant in Hungary, due to the substantial need for capital stemming from the significant bank losses in recent years. In Poland, the funds were directed towards the corporate sector, while in Slovakia these two sectors attracted similar volumes of FDI. In recent years, Hungary's banking sector attracted more FDI, which in many cases was linked to capital injections called for in the wake of losses. The foreign currency indebtedness of households in the years leading up to the crisis may have been instrumental in this, as the sharply weakening exchange rate, coupled with deteriorating income conditions stemming from the crisis (and the government bailout of foreign currency borrowers), created substantial losses for the banking system. The 15 per cent ratio of non-performing loans in Hungary in 2014 attests to this, compared to a ratio of around 5 per cent in the other two countries. In the corporate sector, if the major state purchases of recent years are taken into account in Hungary (e.g. MOL, E-On), then the inflow of net FDI is significantly higher, broadly on par with the regional average. In Slovakia, the banking system and the corporate sector received similar volumes of FDI. This is linked to Slovakia being part of the euro area; therefore, the depreciation of currency and foreign currency loans represents far less of an issue for the private sector. In Poland, limits on foreign currency lending were implemented before the financial crisis,[20] greatly lessening the impact of the financial crisis and rendering the banking system less reliant on capital injections. As a result, capital inflows in these countries remained far lower.

Chart 65: Distribution of net FDI funds across various sectors in countries in the region (cumulative transactions as a percentage of GDP)



Source: national central banks; note that data on changes in volume for Poland are only available from 2010, and there is no sectoral breakdown of the Czech Republic

5.4. Savings-side developments

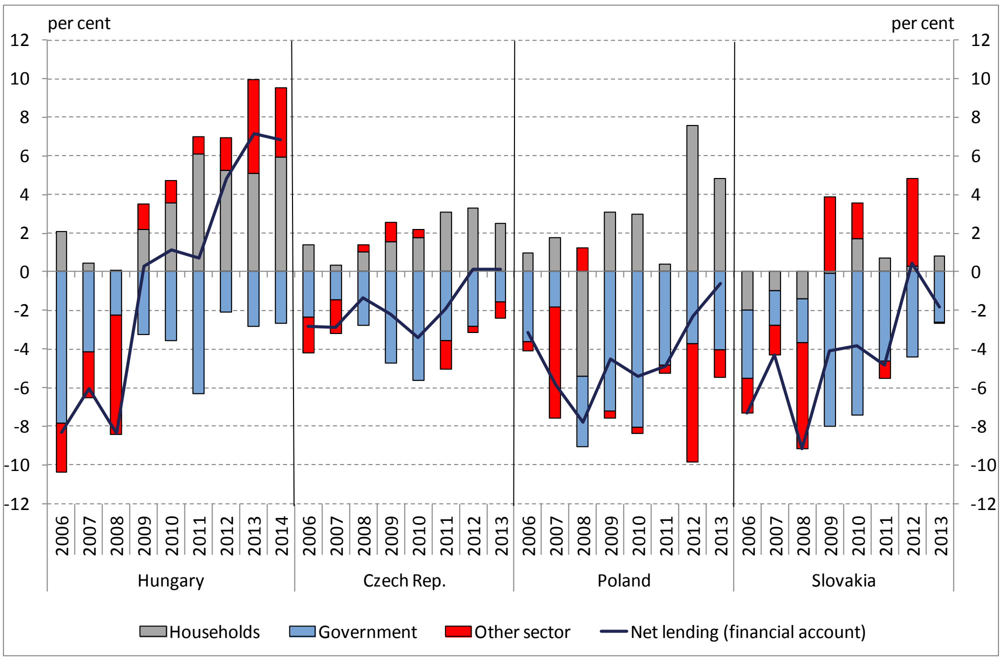
Net lending based on the savings of sectors accounted for over 6 per cent of GDP in Hungary in 2013 (and nearly 7 per cent in 2014), while hovering close to 0 per cent or showing a slightly negative value in the region:[21] the underlying cause of a higher balance of payments position is substantial financial savings by the private sector, mainly corporations. In Hungary, the corporate sector is also a net saver, along with households, and the general government borrowing requirement is also relatively low; therefore, net lending calculated on the basis of the financial account is salient in a regional comparison. The elevated net lending of households in 2013–2014 was related to the accumulation of financial assets and deleveraging. The corporate sector's net lending remains elevated despite the

[20] https://www.knf.gov.pl/en/Images/report_of_polish_banks_2007_tcm81-30053.pdf

[21] No data on countries within the region are available for 2014, and therefore it is only provided with respect to Hungary.

fact that the decline in the volume of corporate loans was halted in 2014 by the Funding for Growth Scheme, with a slight expansion registered in Q4. In Poland and the Czech Republic, the net household savings position was on par with the borrowing requirements of the corporate and public sectors, which resulted in near-equilibrium net lending in 2013. While investment and consumer credit rose in Poland due to growing demand, lending activity remained subdued in the Czech Republic. Although the general government borrowing requirement in Slovakia rose substantially in 2013, the private sector's saving position declined primarily as a result of the pick-up in retail lending, which created net borrowing.

Chart 66: Net lending of the economy in a sectoral breakdown (as a percentage of GDP)



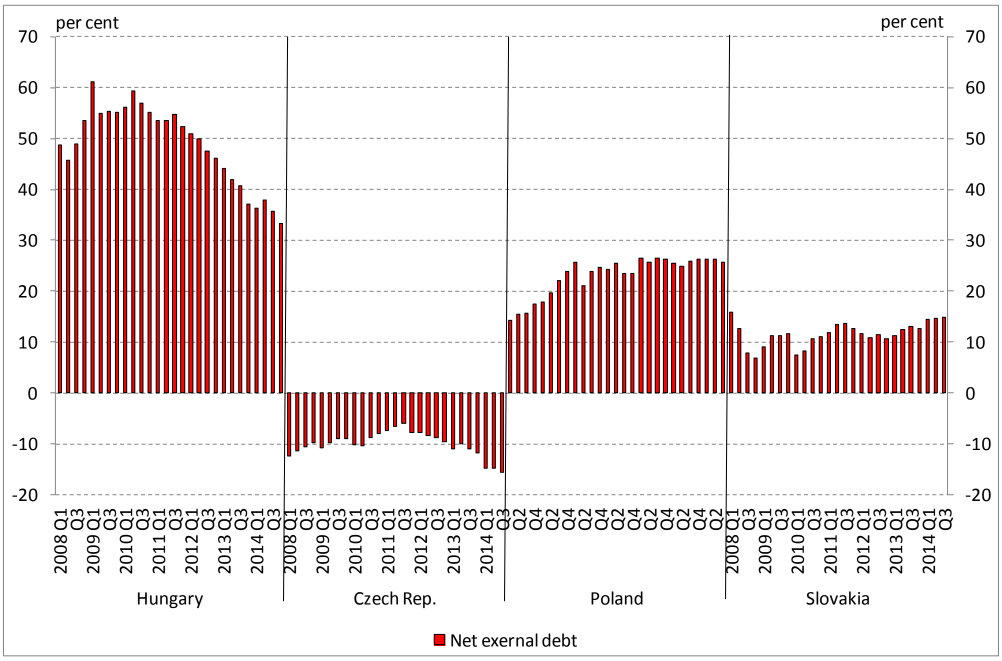
Source: national central banks

Changes in the saving positions of corporations and households in the region were also reflected in lending trends: while Hungary's net lending increased in conjunction with a decline in outstanding borrowing following the crisis, the other countries in the region did not experience any significant adjustment, which was synonymous with more active lending and a lower savings position. While the stock of household loans in Hungary has been substantially reduced since the crisis, other countries in the region show an opposite trend. This may stem from the fact that households were less indebted in the other countries in the region and were indebted in far less risky local currencies. Consequently, the ratio of defaulting loans has remained low in the region, and there was no need for adjustment entailing deleveraging. As a result, net household saving in Hungary has generally surpassed the regional average since the crisis. In terms of corporate loans, the reduction in the loan volume since October 2008 has been the most pronounced and prolonged in the region. Other countries in the region saw a slight corporate adjustment after the crisis, with Poland even experiencing a significant increase linked to rising investments over the past years. Accordingly, the Polish corporate sector secured substantial funding in 2012–2013. Stagnating corporate lending in 2013 kept corporate savings near equilibrium in Slovakia and the Czech Republic. In 2014, the Funding for Growth Scheme stopped the decline in outstanding borrowing; nevertheless, corporate net savings has remained elevated, due partly to rising profitability and partly to EU transfers to corporations.

5.5. External debt indicators

The net external debt of Hungary and the Czech Republic shrank further in 2014 and remained the same in the other Visegrad countries, along with lower debt indicators (Chart 67). In the region, net external debt decreased further in 2014 in Hungary and the Czech Republic. In Hungary, this stemmed from the fact that its trade surplus far outstrips that of other countries in the region, as does the inflow of EU transfers. In terms of net lending, the net repayment of debt liabilities is the highest in Hungary. In the case of the Czech Republic (as alluded to above), the rise in central bank reserves and the repayment of foreign loans also contributed to a reduction of net external debt. It should be added, however, that the adjustment of economic agents and the repayment of external debt is most direly needed in Hungary. The sectoral changes in net lending in the economy attest to this, with private sector net savings being the highest in Hungary in a regional comparison.

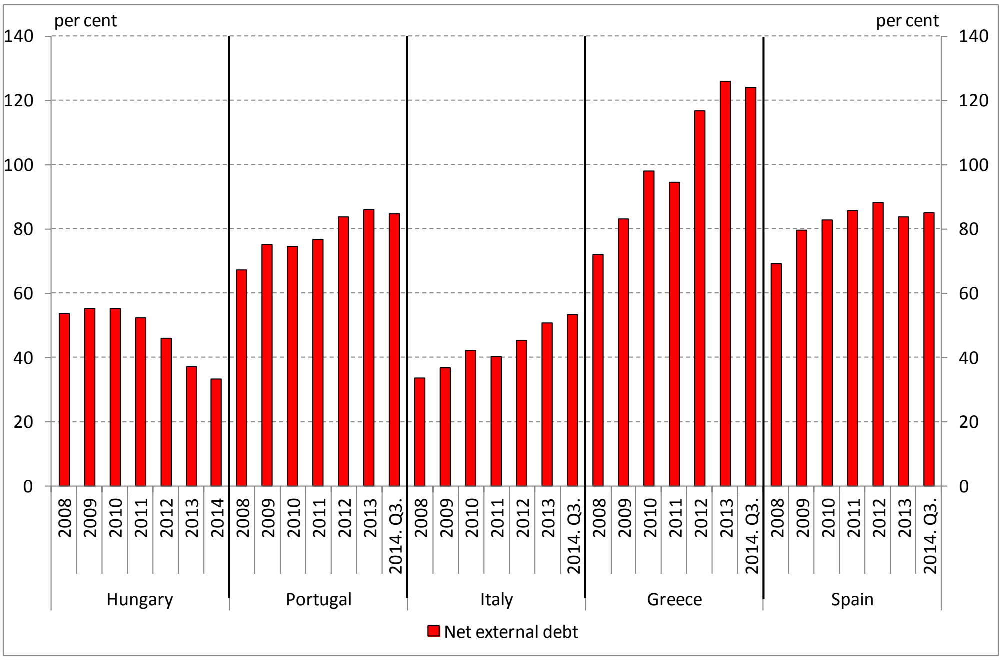
Chart 67: Net external debt of Visegrad countries (as a percentage of GDP, without intercompany loans)



Source: national central banks, Eurostat

In 2014, Mediterranean countries with significant external debt, similarly to Hungary, saw a slight decline in their net external debt. However, the volume of net external debt continues to exceed pre-crisis levels. Countries in the region were in a far better position in terms of external debt than Hungary when the crisis hit; therefore, developments in Hungary should be assessed in light of an evaluation of trends prevailing in countries already indebted prior to the financial crisis. For instance, net external debt in Mediterranean countries only slightly exceeded that of Hungary when the financial crisis erupted, but the absence of adjustment caused their external debt ratios to rise until 2013. Contrary to countries in the region, Mediterranean countries were still seeing adjustments in their net external debt in 2014, which led to a slight decline in net external debt.

Chart 68: Net external debt of Hungary and Mediterranean countries (as a percentage of GDP, without intercompany loans)

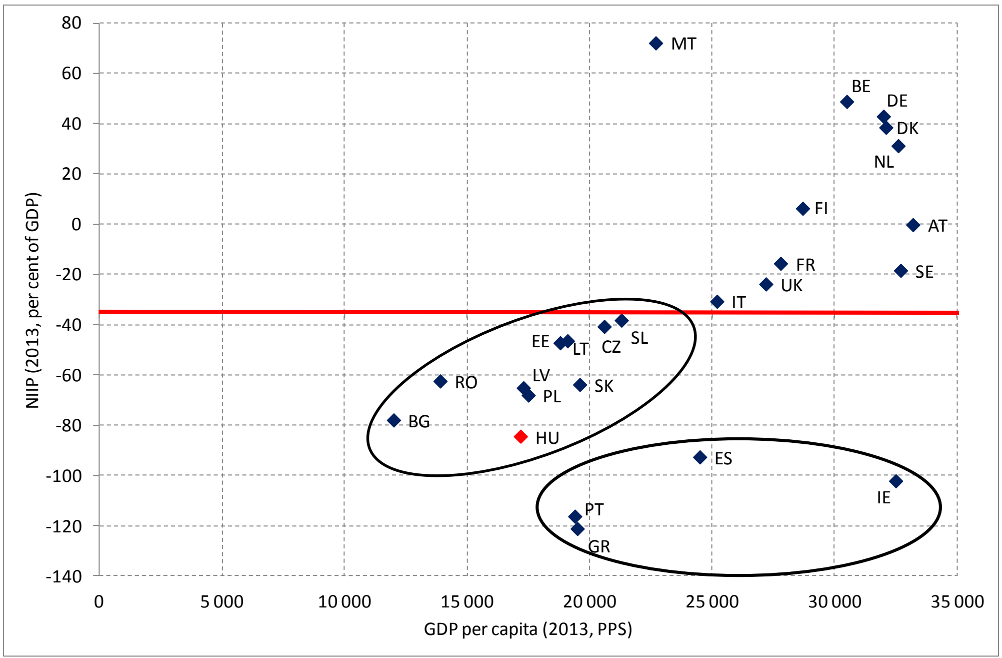


Source: national central banks, Eurostat

Box 6: Level of net external debt in a European context

The international investment position is fundamentally shaped by the level of development of a country's economy. While more developed countries make more international investments, their developing and emerging peers are the destination for international investments. Based on a macroeconomic imbalance threshold defined by the European Commission, the international investment position should not surpass -35 per cent of GDP. In other words, if the net external debt of a country exceeds 35 per cent of its GDP, the indicator signals an imbalance. It should nevertheless that the NIIP indicators of emerging countries with lower per capita income exceed this threshold without exception, while only more advanced economies with higher per capita income are situated below the threshold. It should be added that the international investment positions of the Mediterranean countries (plus Ireland) falling short of the threshold was in fact a reliable indicator of their imbalances. However, it should be emphasised that the degree by which they fell short is striking, compared to their level of development.

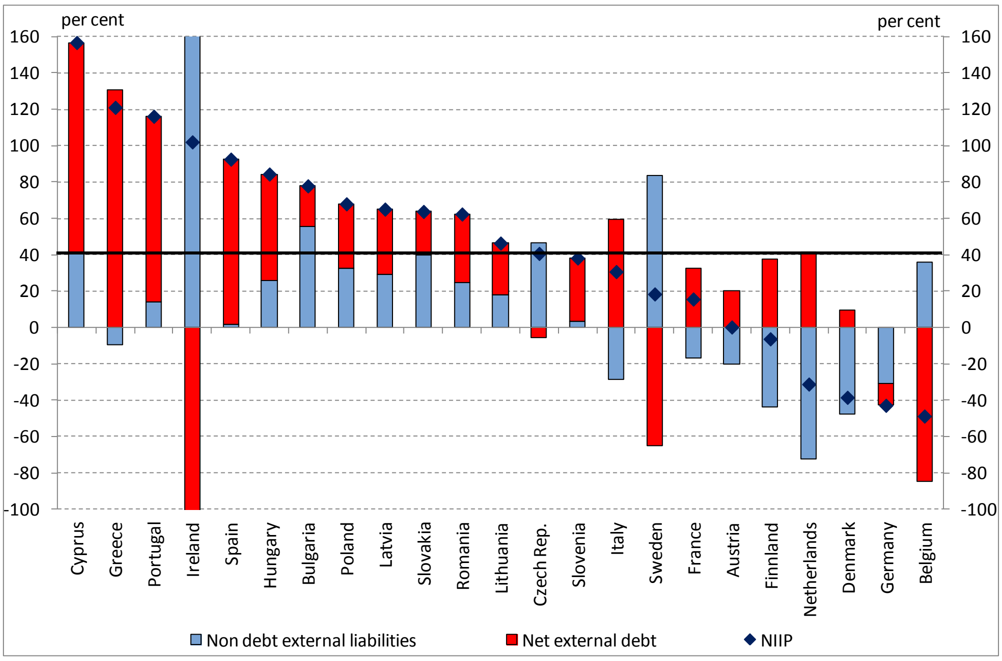
Chart 69: Net international investment position of EU member states and changes in GDP per capita (2013)



Source: Eurostat

Only countries with substantial foreign assets boast an international investment position below 35 per cent of GDP. The indicators examined under the European Commission's Macroeconomic Imbalance Procedure include the net international investment position. The indicator's threshold stands at 35 per cent of GDP. Within the European Union, only countries with substantial foreign assets exhibit a figure below this threshold – typically originators of FDI due to their greater capital stocks, and a negative net external debt for some countries.

Chart 70: Breakdown of net external debt



Source: Eurostat, debt indicator inclusive of SPEs and intercompany loans

Gábor Bethlen

(15 November 1580 – 15 November 1629)

Prince of Transylvania (1613–1629), elected King of Hungary as Gábor I (1620–1621), one of the most prominent personalities of 17th century Hungary. At the beginning of his career he loyally served the Princes of Transylvania Zsigmond Báthory, Mózes Székely, István Bocskai and Gábor Báthory. When Gábor Báthory contemplated alliance with the Hapsburgs, he turned against him and got himself elected to the throne of the principality. During his reign, he consolidated the position of Transylvania setting both the economy and the cultural life of this part of Hungary on a path of development later generally referred to as the 'golden age of Transylvania'.

The twenty-five years preceding the rule of Bethlen were heavy with external and internal wars leaving the population considerably thinned out. Bethlen set out to stabilise the domestic situation, to consolidate his power and to rebuild Transylvania with great patience. He established a centralised state apparatus and concurrently sought to strengthen the financial status of the principality. He ordered an accurate statement of treasury revenues, had the lands and properties granted since 1588 reviewed and ratified only those which had been awarded in recognition for service to the country.

To promote industry and trade, Bethlen encouraged an economic policy of mercantilism and settled foreign craftsmen in the country. Instead of taxation, he relied on the more rational utilisation of other means deriving from his status as prince in building his rule. He developed precious metals mining, invited renowned specialists from abroad and strove to boost trade. Gábor Bethlen minted coins of a stable value and regulated the multidirectional trade in goods by prohibiting exports of key merchandise.

Gábor Bethlen attempted to form an international anti-Hapsburg coalition among western and eastern European countries. In order to strengthen his ties with the Protestant Powers, on 1 March 1626 he wed the sister of George William Elector of Brandenburg, Catherine of Brandenburg, and in 1626 he joined the Westminster alliance of the Protestant Powers.

REPORT ON THE BALANCE OF PAYMENTS

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