REPORT ON THE BALANCE OF PAYMENTS

MARCH
2016

*‘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 financial intermediary system. 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, the Magyar Nemzeti Bank performs comprehensive analyses of trends relating to Hungary's external balance on a regular basis, examining a number of indicators to assess macroeconomic imbalances and identifying elements and processes of critical importance for Hungary's vulnerability.

Given the lessons learnt from the financial crisis and the recent period, a country's balance of payments and trends therein indicating potential dependence on external financing are particularly important in the economic media. 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 Barnabás Virág, Executive Director in charge of Monetary Policy, Financial Stability and Lending Incentives. Contributors: Anna Boldizsár, Gabriella Csom-Bíró, Orsolya Csortos, Zsuzsa Kékesi, Balázs Kóczián, Péter Koroknai, Balázs Sisak and Ákos Szalai. The Analysis was approved for publication by Deputy Governor Márton Nagy.

This Report is based on information for the period ending 24 March 2016.

SUMMARY

Hungary's external vulnerability continued to decreased in 2015 Q4. With a current account surplus of more than EUR 1 billion, the net lending of the economy rose to an unprecedented EUR 3.2 billion. With ongoing net FDI inflows at the end of the year, the external debt of the country declined significantly. Despite a slight increase, the net borrowing of the government remained moderate, which was offset by an increase in the financial savings of corporations, while the financial savings of households stabilised at high levels.

External balance indicators remained favourable throughout 2015, as economic growth continued to be backed by a sustainable financing structure. After a temporary downturn in the previous year, Hungary's external position rose to another historic peak of almost 9 per cent of GDP in 2015, supported by a number of factors. On the one hand, dynamic vehicle production, more subdued investment growth and a consistently high balance of services contributed to a significant rise in the trade surplus. Hungary's export market share grew further overall, while the expansion in net exports was supported by improving terms of trade thanks to falling energy prices. On the other hand, as Hungary's drawdowns intensified following the closure of the EU budget period, the surplus of the transfer balance rose to another historic peak. Finally, the upturn in net lending was also boosted by a modest downward shift in the income balance deficit, which was also supported by the decline in external debt in recent years coupled with lower yield levels.

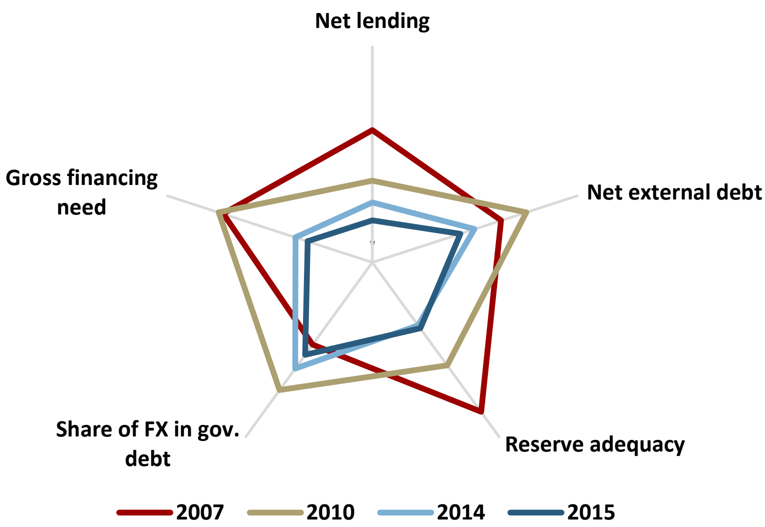
According to the financing side approach, the sectors' contribution to the reduction of Hungary's net external debt was stronger than usual in 2015, amounting to more than EUR 9 billion. In contrast to the previous years, the largest decline was registered in the banking sector. The substantial volume of new corporate deposits raised banks' funds significantly. In addition, by reducing the MNB's foreign exchange reserves, the conversion of foreign currency loans to forint slowed down the decline in the state's net external debt, while the foreign currency received lowered banks' debt. In 2015, the external debt of the state was reduced significantly by the prepayment of foreign loans, the foreign currency bond purchases of the MNB and the sale of government securities by non-residents. With regard to the latter, it is important to note that, despite exceeding the level observed at the onset of the crisis, owing to a large degree to the self-financing programme of the MNB and to heightened household demand for government bonds, non-residents' sale of government securities did not generate strains in the market of government securities, and the reliance of the state on foreign funding decreased. The corporate sector also continued the repayment of external debts. Since this process also affected intercompany loans, simultaneously reflecting state acquisitions and corporations' repayment of intercompany loans, net FDI inflows hovered around 0 per cent compared to 2.8 per cent of GDP in 2014, while equity investments – driven by reinvested earnings – even increased.

Key external debt ratios relevant to external vulnerability continued to show remarkable improvement in 2015: gross external debt amounted to 76 per cent of GDP, while net external debt dropped to 25 per cent. Thanks to the continued deleveraging of the sectors, corporations and banks scaled back net external debts further, the latter also supported by the conversion of foreign currency loans and the substantial volume of new corporate deposits. Announced mid-year, the tightening of the new foreign exchange funding adequacy ratio (FFAR) from January and the new foreign exchange coverage ratio (FECR) promoted a decline in banks' short-term external debt. As a result, by the end of 2015 the short-term external debt of the economy fell to EUR 21 billion, and thus the foreign exchange reserves of the country well exceeded the level expected by investors even after the dip caused by the conversion of foreign currency loans. Amid declining maturing debt and rising net lending, the gross financing need of Hungary dropped further and stood below EUR 13 billion. However, this also implies that the Hungarian economy still needs inflows of external liabilities, albeit to a lesser degree than before, to finance maturing external debts.

Examining the savings of individual sectors, all sectors contributed to the increase in net lending in 2015. The net borrowing of the state sank below 2 per cent of GDP which, in addition to economic growth, can be attributed to rising incomes and falling interest expenditures. The increase in the financial savings of the corporate sector resulted from lower investment activity compared to the previous year, coupled with the sector's high profitability, which was also boosted by the spike in EU transfers. Savings by households were supported by rising real wages and employment, and driven by the settlement of foreign currency loans, trends in lending also pointed to higher net financial savings. Households' intensive government bond purchases continued in 2015, further increasing the sector's role in the financing of public debt and moderating reliance on inbound capital flows.

In 2015, external balance developments in Hungary fundamentally shifted to favourable direction (Chart 1: values closer to the centre – in practical terms, the closing of the "net" – signal smaller vulnerability from the given indicator). The key indicators typically signal declining vulnerability: the net and gross financing need, net external debt and the foreign currency ratio of public debt all continued to decline. While the reserve adequacy did not change notably despite the decline in the foreign exchange reserves, the level of the foreign exchange reserves remains well above (by EUR 9 billion) the level of short-term external debt.

Chart 1: Stylised depiction of Hungary's external balance processes



The chart presents the difference of individual indicators from the long-term average scaled by dispersion; smaller values signal the strengthening of the fundamental (e.g. smaller net borrowing).

The contraction of external debt indicators of the Hungarian economy is also significant by international standards, pointing to a considerable reduction of the previously observed external imbalances. Both in comparison to the countries of the region and the Mediterranean countries, Hungary boasts the highest balance of payments surplus, predominantly driven by the trade surplus and the high absorption rate of EU transfers. Parallel to this, while the external debt of countries in the region and the Mediterranean economies was rising, Hungary showed a remarkable adjustment in external indebtedness and achieved a significant improvement in key indicators relevant to external vulnerability. For example, Hungary's net international investment position and external debt dropped to the level of Poland from the previously recorded regional peaks. At the same time, the gross external debt of the country is still high in regional terms. Importantly, however, Hungary's gross financing need based on original maturity – which had posed severe financial risks in the past – improved significantly thanks to the decreasing amortised long-term debt and the country's robust net lending, and by 2015 Hungary recorded the lowest value in the region.

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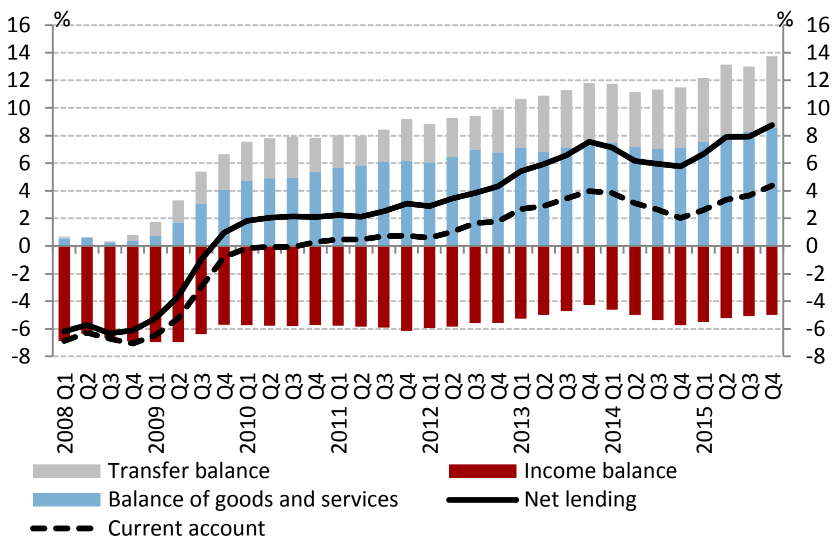
1. REAL ECONOMY APPROACH

Under the real economy approach, the net lending of the Hungarian economy rose to around 9 per cent of GDP in 2015. The improvement in the balance of payments position was continuous throughout the year, driven primarily by the increase in the trade balance and the transfer balance, but the moderate decline observed in the deficit of the income balance also pointed to a rise in net lending. The expansion in the trade surplus was accompanied by a spike in the balance of services and rising exports, on the back of higher capacity utilisation in the automotive industry and more subdued investment activity compared to the previous year. Through the improving terms of trade, net exports were also boosted by falling energy prices. The surplus of the transfer balance represents a historic peak at over 5 per cent of GDP, which is related to intensifying drawdowns after the closure of the EU budget period. The upturn in net lending was also boosted by a modest downward shift in the income balance deficit, which was also supported by the gradual decline in external debt and falling yields.

Under the real economy approach, in 2015 Q4 the four-quarter net lending of the Hungarian economy rose to the vicinity of 9 per cent of GDP (Chart 2). Seasonally unadjusted net lending amounted to EUR 3.2 billion in Q4, reflecting the contributions of the current account and the capital account surplus by EUR 1 billion and by EUR 2.2 billion, respectively. According to the combined balance of the current account and the capital account, the four-quarter net lending[1] of the economy rose to 8.8 per cent of GDP, which was supported by all three factors of the real economy approach. After a continuous increase, at the end of the year the four-quarter balance of the current account amounted to 4.4 per cent of GDP.

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



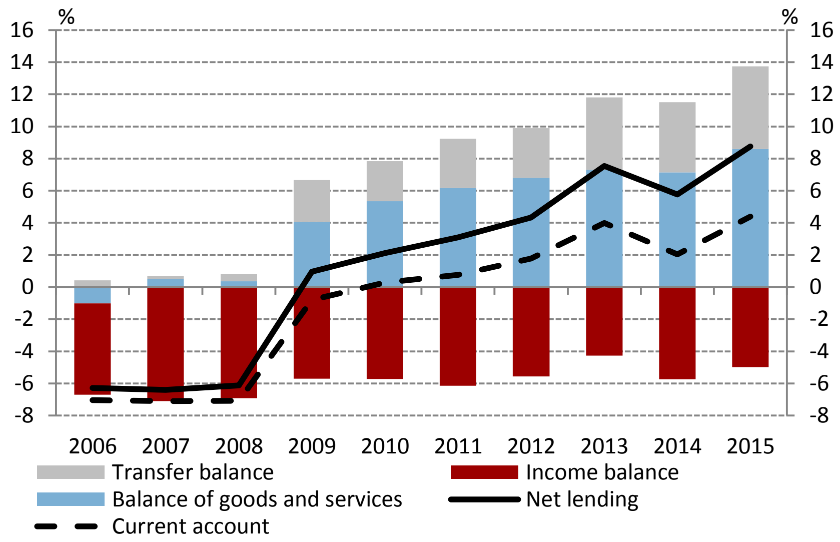
All charts by the MNB unless otherwise indicated.

In 2015 as a whole, the net lending of the Hungarian economy rose to 8.8 per cent of GDP, with the contribution of all real economy factors (Chart 3). The substantial increase can be mainly linked to the historic peak of the trade balance and the transfer balance, but the moderate decline in the income balance also pointed to an increase in net lending. The significant trade surplus emerged with rising exports of goods, which were boosted by the capacity utilisation of vehicle production that has been rising since 2013, while a decline in imports prompted by decelerating investment was also an important contributor. The surplus of the balance of goods was supported by the dynamics of exports – which surpassed the growth rate of imports – and the improvement in the terms of trade related to falling oil prices. The high transfer balance can be attributed to the fact that the absorption of EU grants peaked in 2015 as a

1 In order to adjust for seasonal effects, the MNB generally examines the four-quarter cumulated indicator, which is derived from the quarter and the cumulated amount of the previous three quarters.

result of the closure of the 2007-2013 EU budget period. The deficit of the income balance decreased in the context of declining interest payments to non-residents, which can be linked to the improvement in external debt ratios and to the low yield environment.

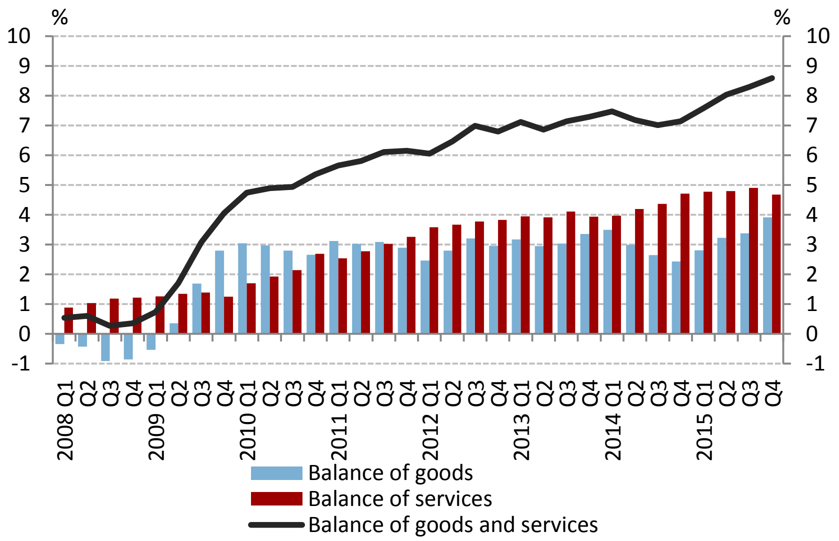
Chart 3: Developments in net lending and its components* (annual values as a percentage of GDP)



1.1. Balance of trade

The expansion of net exports can be linked to the continuous increase in the surplus on the balance of goods surplus and to the persistently high level of the balance of services (Chart 4). As a result of investment dynamics of over 10 per cent, the surplus on the balance of goods declined temporarily in 2014, but after a continuous rise in 2015, by Q4 it amounted to almost 4 per cent of GDP. This growth was driven by the expansion of Hungarian industrial production – in particular, the rising output of vehicle production – and by the improvement in the terms of trade. The surplus on the balance of goods was also supported by the fact that imports remained subdued in Q4 against the backdrop of a modest increase in investment activity, while the expansion of exports continued. The persistently high level of the balance of services continues to represent a high share in the trade surplus: the exports of services, in turn, remained dynamic in the context of the substantial income of transportation and the hospitality industry and the shared service centres established in Hungary (for more details about the factors behind the increase in the balance of services, see the June 2015 issue of the *Report on the Balance of Payments*).

Chart 4: Developments in the balance of trade and its components (four-quarter values as a percentage of GDP)

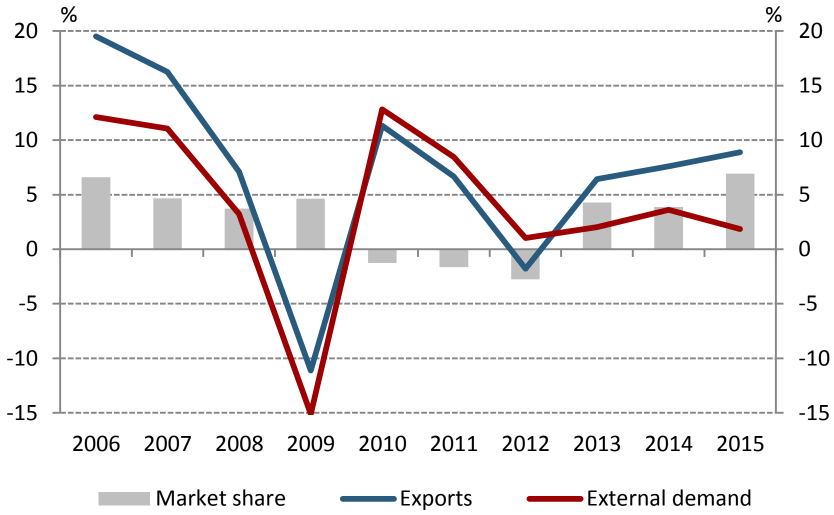


Once again, the dynamics of the exports of goods exceeded the expansion of imports in 2015, and by 2015 Q4 the four-quarter net exports of goods rose to around 4 per cent of GDP. The wedge materialising between the real growth of exports and that of imports in Q4 boosted the surplus on the balance of goods (Chart 5). In Q4, import dynamics decelerated sharply, while the expansion of exports continued in line with rising industrial production, despite the slump in external demand.

Chart 5: Change in the volume of exports and imports of goods (annual growth rates) and the trade balance (four-quarter values as a percentage of GDP)

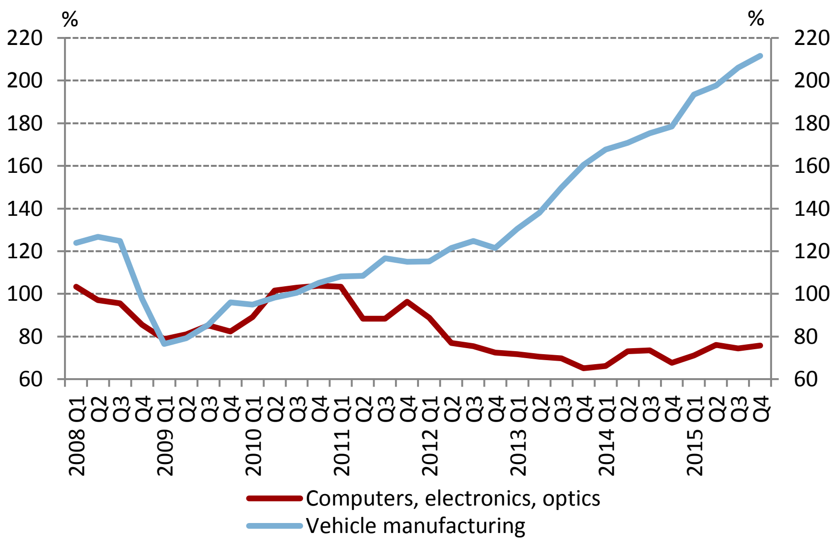
The acceleration of exports can be attributed to the fact that, despite weakening external demand, Hungary's export market share increased further in 2015, presumably as a result of the surge in production spurred by the new vehicle industry capacities added in recent years (Chart 6). After the low value recorded in 2014 in the context of the Russia-Ukraine conflict and the resulting bilateral sanctions, external demand slowed somewhat in 2015 reflecting, in addition to the ongoing sanctions, the deceleration in emerging economies. Meanwhile, the expansion seen in Germany, the most important export partner of Hungary, until the end of the summer may have benefited Hungarian exports through the supplier chain. Taken together, Hungary's export market share improved significantly in 2015, which can be attributed to the dynamically expanding exports of vehicle factories and strong exports of services.

Chart 6: Real growth of exports and external demand and developments in Hungary's export market share



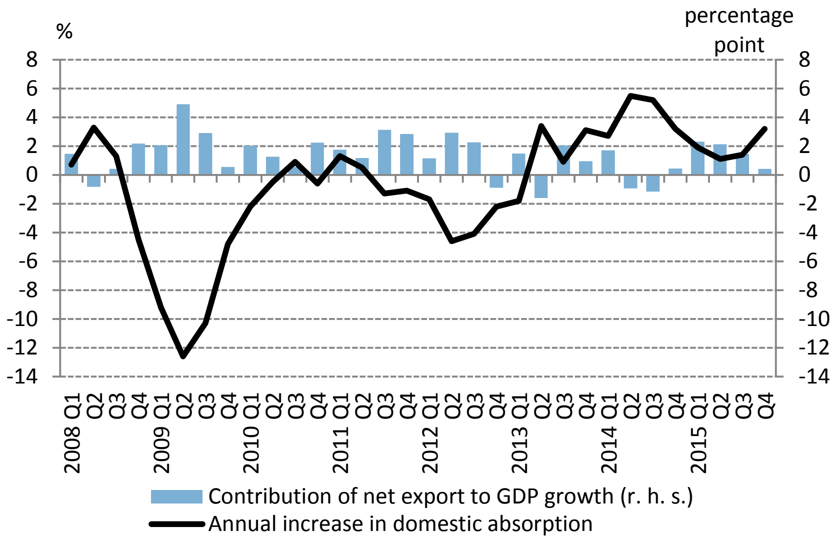
Once again in 2015, rising vehicle production played an important role in the expansion of Hungarian exports, but the performance of electronics also made a smaller contribution (Chart 7). The pronounced increase in the performance of the automotive industry continued in 2015, which can be linked to the construction of new capacities and their expanding utilisation. The gradual decline observed in electronics in recent years reversed and turned into a modest increase in 2015. As a result, the expansion of exports was strongly supported by the automotive industry and, to a lesser degree, by electronics.

Chart 7: Developments in the output of the automotive and the electronics sectors (2010 = 100)



Consistent with the substantial increase in exports and the deceleration of domestic use, the contribution of net exports to GDP growth was stronger in 2015 than one year earlier. Net exports contributed positively to GDP growth in 2015 again (Chart 8), which can be attributed to the increased utilisation of the export capacities accumulated after the implementation of high import content investment projects. The contribution of net exports to growth was boosted by falling oil prices and the fact that the dynamics of imports were restrained by the less intensive filling of gas storage capacities compared to the previous year. The increase in domestic absorption slowed somewhat at the beginning of the year, mainly as a result of the slowdown in private sector investment. At the end of the year, however, domestic absorption increased significantly, mainly as a result of robust consumption and rising public sector investment driven by EU transfers. Parallel to the upswing in more import-intensive internal demand factors, the contribution of net exports to growth in Q4 fell short of the 2015 average. With regard to these processes it should be emphasised that the remarkable improvement in net exports took place despite the fact that domestic use continued to strongly support economic growth in 2015 as well, which suggests that exports played a more prominent role than before.

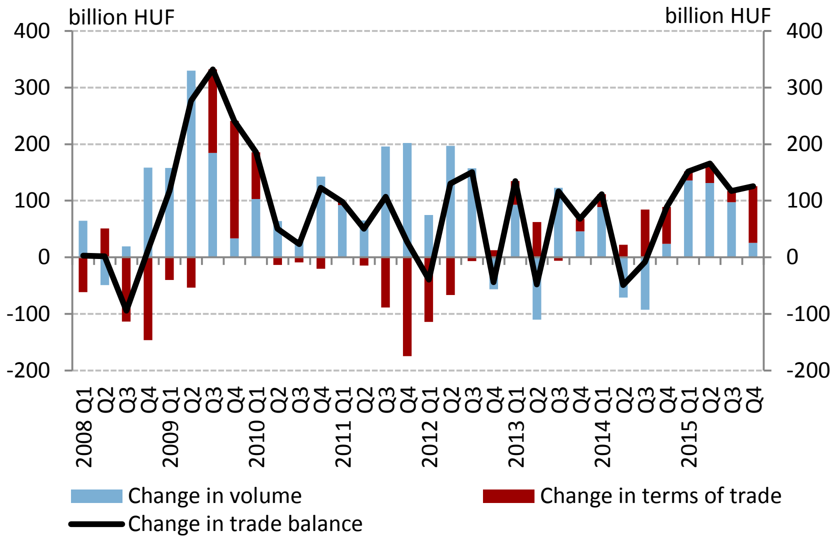
Chart 8: Annual rate of increase in domestic absorption and contribution of net exports to GDP growth



Source: HCSO

In addition to the volume effect, the rise observed in the trade balance in Q4 was more strongly supported by the improving terms of trade (Chart 9). As shown above, in Q4 the increase in the volume of external trade pointed to a continuing but more modest improvement in the trade balance. The decline in import prices exceeded the decline in export prices in Q4 as well; thus the improvement in the terms of trade contributed to the expansion of the balance of goods and services once again. The primary factor behind the dip in the price indices was the downward shift in the price of energy, which represents a higher weight in imported products.

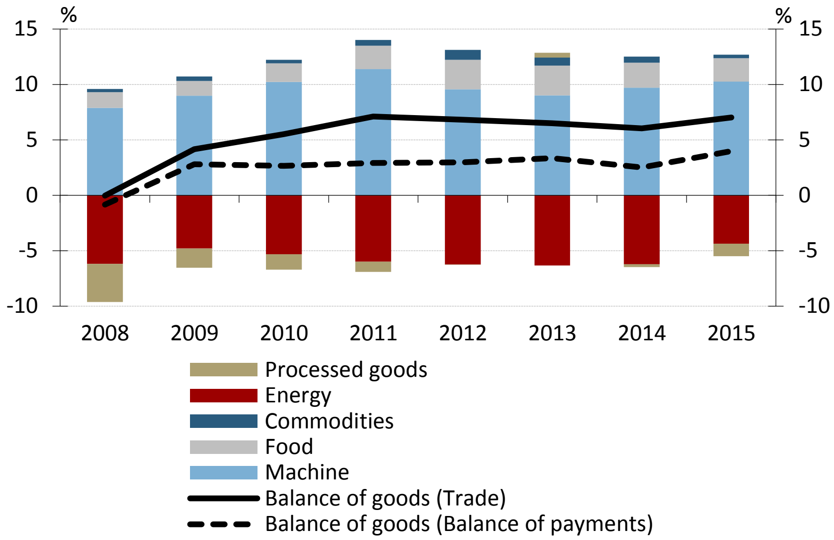
Chart 9: Developments in the balance of trade as a percentage of GDP (year-on-year)



Source: HCSO

In 2015, the increase in automotive industry exports and the decline in energy imports were the most important contributors to the rise in the balance of goods (Chart 10). As regards the components of the balance of goods, the net exports of machinery grew further in 2015, primarily as a result of the continuing expansion of vehicle exports and the more subdued dynamics of domestic machinery investment. After the stagnation typical of previous years, net energy imports faltered in 2015 and thus their negative effect on the trade balance was 2 percentage points lower than in the previous year. Net exports of food products exhibited a moderate downturn during the year against the backdrop of a pick-up in internal consumption and the less robust performance of agriculture compared to the outstanding harvest results of 2014, while the rising shortfall of processed goods might be linked to recovering consumption.

Chart 10: Net external trade in goods by main groups (as a percentage of GDP)

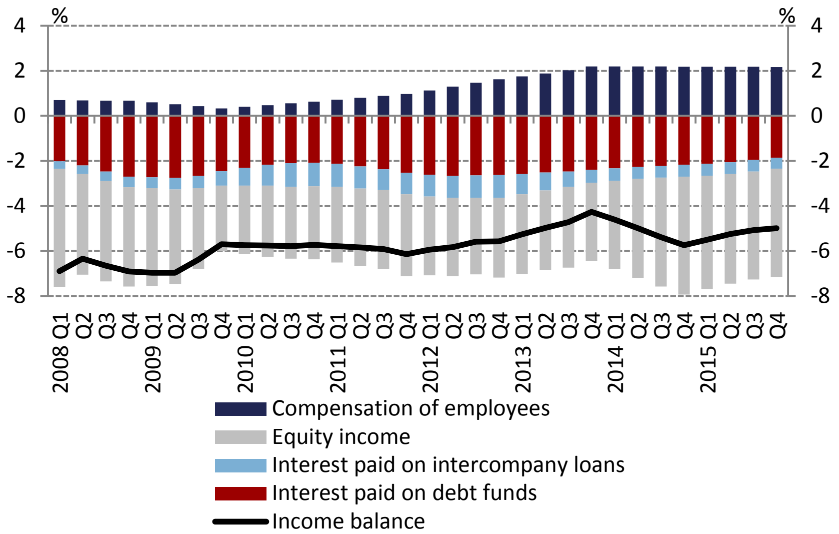


Source: HCSO, MNB The difference between the balance of goods presented in the external trade statistics and in the balance of payments stems from the lack of a detailed breakdown of VAT resident reversals and the difference in composition. At the same time, data derived from various sources have been very similar in recent years, which makes them suitable for trend analysis.

1.2. Income balance

The contraction observed in the income balance deficit since the start of the year slowed in Q4 and as a result, the four-quarter deficit amounted to 5 per cent of GDP (Chart 11). The reduction in the interest balance of foreign loans and intercompany loans contributed to the improvement of the income balance in the last quarter as well. According to estimates, following a robust increase last year, the profits of foreign-owned companies stabilised, while the incomes of employees working abroad for less than a year did not change notably. Although as a combined result of these effects the income balance deficit contracted only slightly in Q4, the deficit decreased by 0.7 per cent of GDP for the year as a whole.

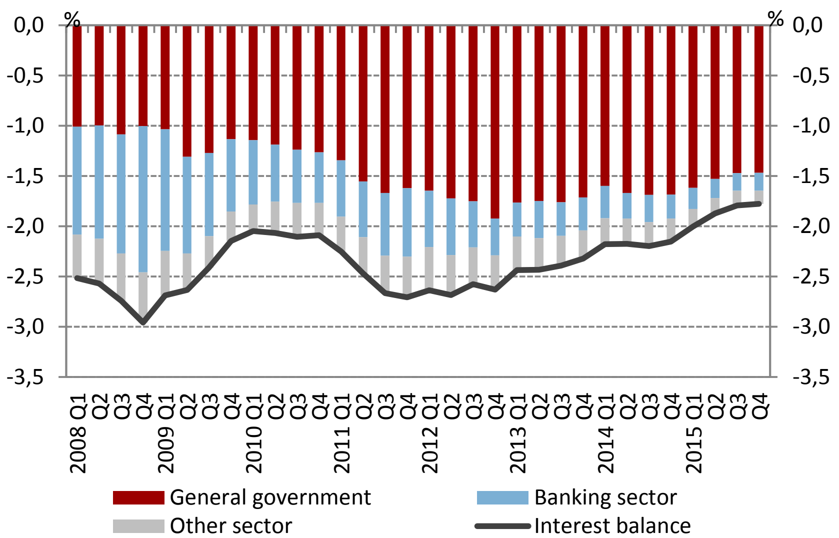
Chart 11: Developments in the items of the income balance (four-quarter values as a percentage of GDP)



Data on income outflows relating to shares are limited to estimates. Since quarterly data on the profitability of foreign-owned enterprises operating in Hungary are limited, information on quarterly profit outflows is, for the most part, based on estimates.[2] As regards **outflows of income related to shares** data are available concerning dividends, according to which net dividends for 2015 amounted to around EUR 2.6 billion and thus exceeded the amount paid last year. In this regard, however, it should be stressed that dividends are typically voted in consideration of the previous year's performance, and corporations' 2014 profit may have also been improved by ad-hoc factors (for more details, see the September 2015 issue of the *Report on the Balance of Payments*).

Surpassing the rate observed in the previous year, the deficit of the interest balance decreased by 0.4 per cent of GDP for 2015 as a whole, supported by a decline in the interest expenditures of all three sectors (Chart 12). In 2015, interest on foreign loans fell parallel to the ongoing drop of the external debt of the economy. Interest paid by market participants on foreign loans declined in line with the sectors' outflow of funds; the repricing of loans and the decline in gross outstanding debt affected all sectors.

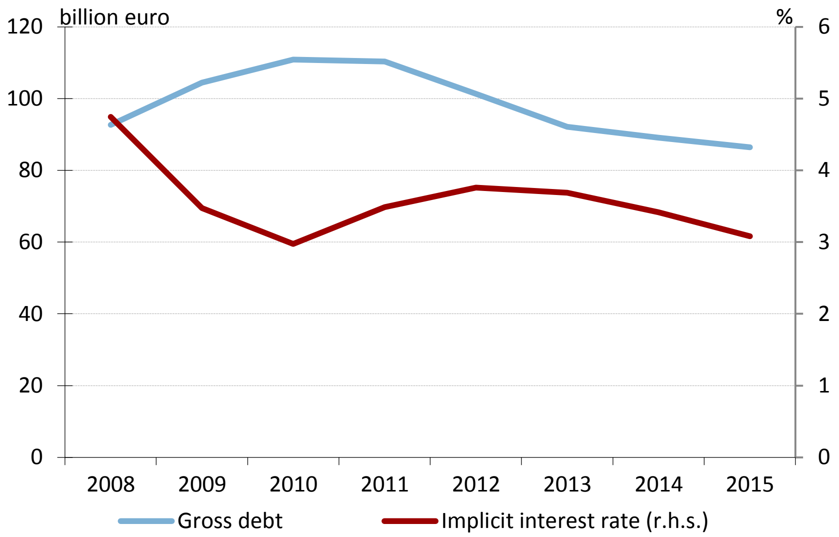
Chart 12: Developments in the interest balance and its breakdown (as a percentage of GDP)



[2] For more details, see the statistics publication "Methodological notes to the Balance of Payments and International Investment Position".

The improvement in the interest balance reflected the low international and Hungarian yield environment and the decline in gross debt. In 2015, the deficit of the interest balance amounted to less than 2 per cent of GDP, driven by the repricing of loans and the continuing decline in external debt. Gross external debt stood at EUR 86 billion on average in 2015 (Chart 13). The largest contributors to this result were the prepayment of development loans disbursed by international organisations to the Hungarian state, the decline in the government securities holdings of non-residents in line with the self-financing programme and the balance sheet adjustments of the banking sector. Consistent with the low interest environment, the repricing of debt continued and the implied interest rate of the external debt of the economy sank to the level of nearly 3 per cent.[3]

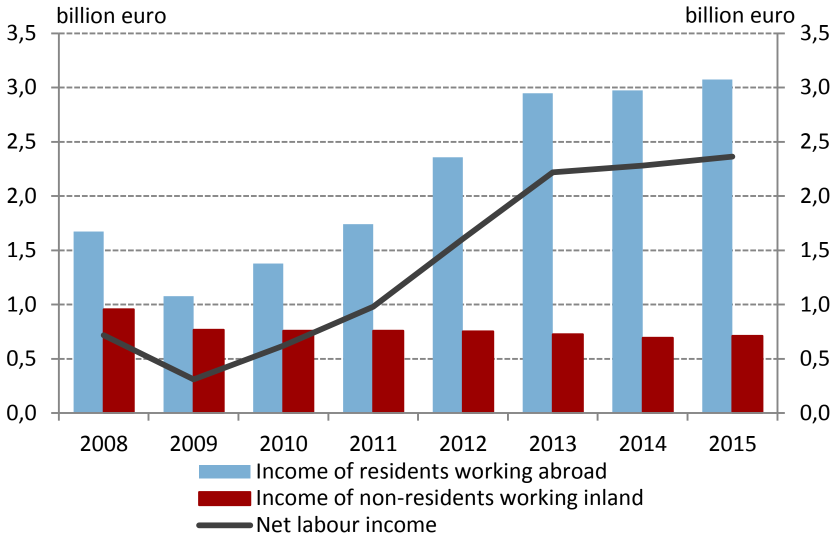
Chart 13: Developments in average gross external debt and its implied interest rates



The net income of employees working abroad did not change notably in 2015 and remained close to the EUR 2.4 billion level observed in the previous year (Chart 14). The net income of workers temporarily employed abroad rose dynamically until 2013 and then levelled off in the past two years. In 2015, the income of resident employees working abroad for less than a year amounted to EUR 3.1 billion, while non-residents employed on a temporary basis in Hungary earned EUR 0.7 billion. Consequently, the net income of non-resident employees contributed to the decline in the income balance deficit by EUR 2.4 billion overall. Besides improving the income balance, however, due to the taxes imposed on their income, workers temporarily employed abroad also exert an opposite effect on the net lending position of the economy through the transfer balance: tax payments reduce the balance of other current transfers and hence, net lending. At the same time, the remittances of workers with more permanent employment abroad improve the balance of current transfers. As a result, the incomes of workers employed abroad contribute to the increase in net lending to a lesser degree compared to their positive impact on the income balance.

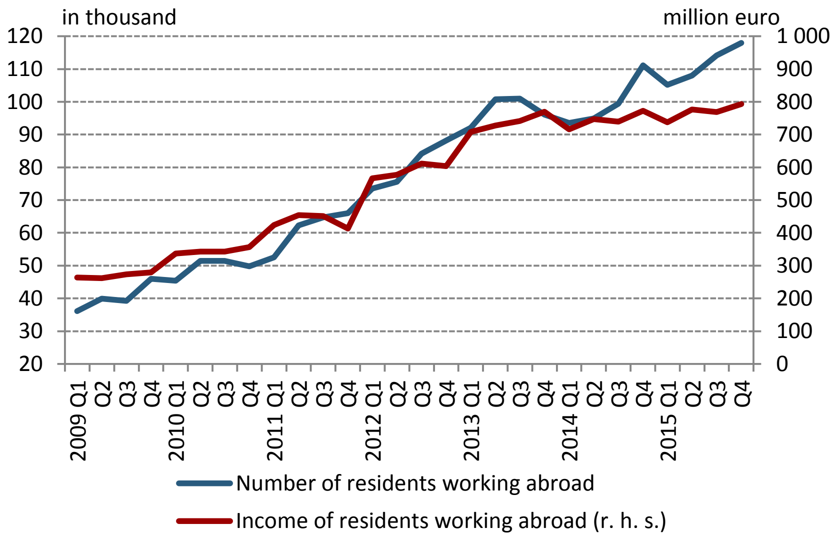
[3] Developments in the implied interest rates (i.e. average interest paid on debt) do not necessarily reflect the changes in the current interest levels, because at present interest also has to be paid on debt originating from earlier periods at their applicable rates (e.g. fixed-rate debt); in other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

Chart 14: Incomes of employees temporarily working abroad



After a temporary halt in 2013, the number of workers employed abroad for less than a year continued to rise; the income of these employees, however, did not change significantly in the past year (Chart 15). The income balance reflects the incomes of employees temporarily working abroad; this typically involves employees working in neighbouring countries, but with residence in Hungary. The opening up of Western European labour markets raised the number of commuters significantly. In 2013-2014, the increase in the number of resident commuters slowed temporarily, but in 2015 their number started to rise again. At the same time, the income of workers temporarily employed abroad increased to a lesser degree in the past year.

Chart 15: Income and number of resident workers employed abroad for less than a year

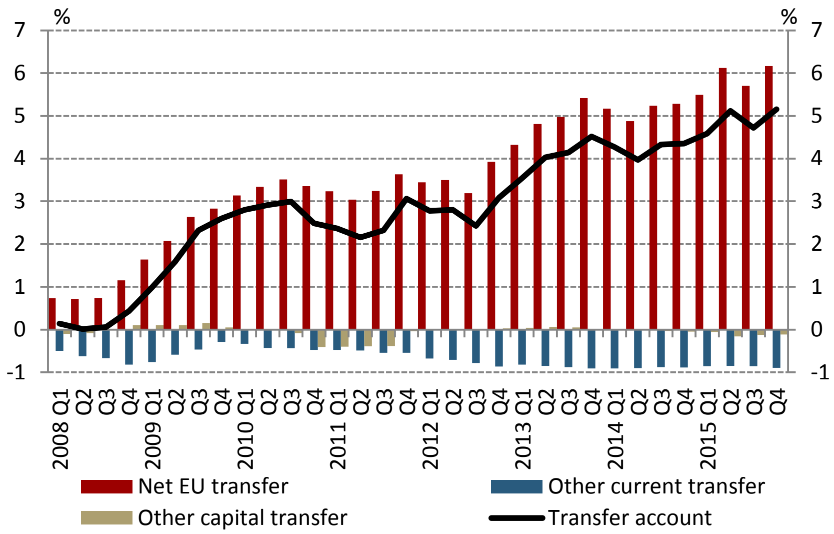


Source: HCSO, MNB

1.3. Transfer balance

In 2015, the annual transfer balance surplus rose to yet another historic peak, reaching 5.2 per cent of GDP. This spectacular rise was driven by the intensification of EU transfers due to the closure of the EU budget period (Chart 16). Composed predominantly of EU funds, the transfer balance includes current items and the capital transfers belonging to the capital balance together; therefore, it allows for the full consideration of inbound flows of foreign financing for the assessment of the balance of payments position. Current transfers typically involve low value transfers constituting a part of the income. By contrast, capital transfers are high amount, infrequent items (such as investment grants), which increase financial wealth. The remarkable increase in the transfer balance in 2015 is related to the accelerated absorption of EU funds. After the closure of the 2007-2013 budget cycle, Member States had two years to draw down the funds before losing the financing altogether; in other words, the entire allocation had to be used by the end of 2015. The lion's share of the drawdowns were concentrated in the last years, peaking in 2015 when they exceeded 6 per cent of GDP in annual terms.

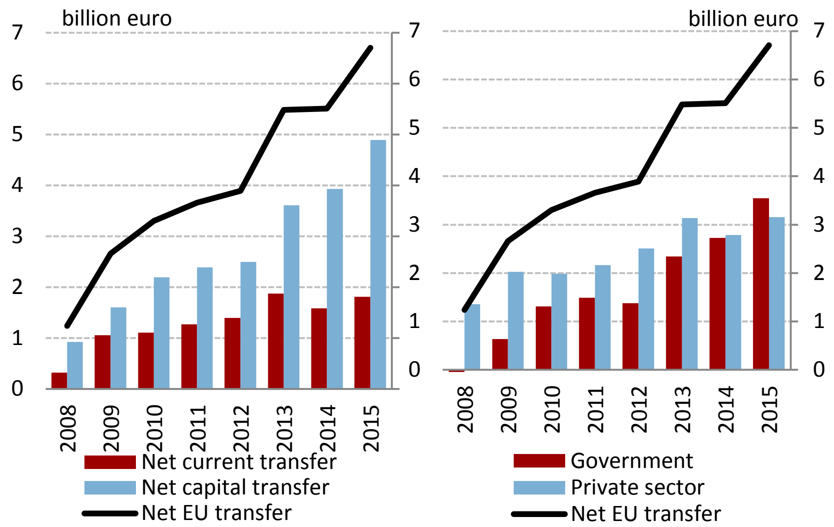
Chart 16: Developments in the transfer balance (four-quarter values as a percentage of GDP)



Once again in 2015, the positive impact of EU funds on the external balance was mitigated by the outflows of other current transfers. In addition to funds from the European Union, other current transfers, which typically point to a decline in net lending, constitute the second important component of the transfer balance. Other current transfers mainly involve transfers primarily from the private sector to non-residents without compensation (including the health insurance contributions and tax payments of workers employed abroad). Similar to the stable values of recent years, in 2015 these transfers mitigated the significant surplus generated on the transfer balance by EU funds.

At EUR 6.7 billion, the net absorption of EU transfers peaked last year, of which EUR 1.8 billion represented current transfers and EUR 4.9 billion constituted capital transfers. The revenue side of net current transfers mainly states agricultural assistance, while the expenditure side contains Hungary's contribution to the EU budget. The balance of current transfers was relatively stable in the past three years, ranging between EUR 1.5 billion and EUR 2.0 billion. Since the inflow of capital transfers – which are typically intended to finance investment projects – depends on the implemented EU projects, accelerated state absorption resulted in a substantial increase in capital transfers in 2015. As a result of the latter, public investment showed a major increase again last year.

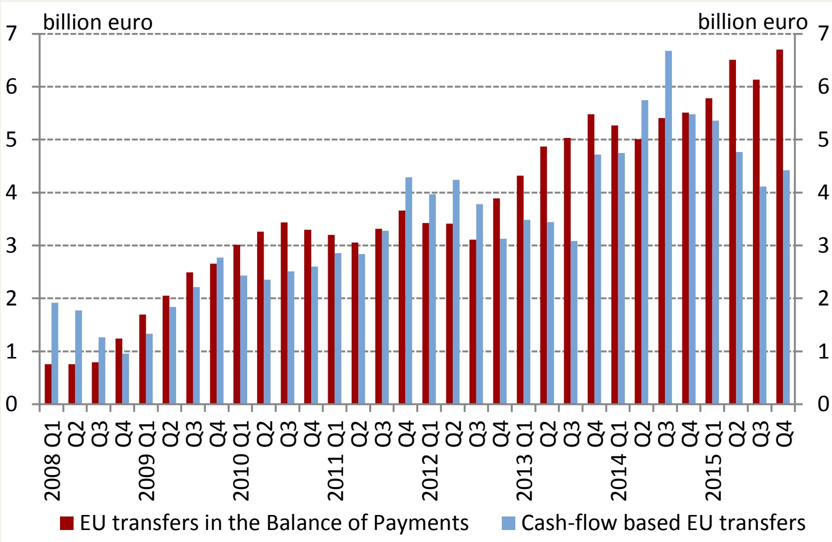
Chart 17: Developments in net EU current and capital transfers and their sectorisation (EUR billions)



Box 1: Cash-based and accrual-based accounting of EU transfers

Developments in EU transfers according to the accrual-based and the cash accounting approach diverged significantly last year, owing to advance payments by the state as required by the closure of the programming period. Upon the closure of the EU budget period, utilised EU transfers increasingly exceeded the funds transferred by the European Commission; therefore, the accrual-based absorption of EU transfers stated in the balance of payments in 2015 diverged more and more from the cash-based data affecting the foreign exchange reserves. The difference is attributable to projects pre-financed by the general government, which will be settled with the EU at a later point; therefore, the state has generated claims vis-à-vis the European Union. The amount to be disbursed by the EU had to be pre-paid by the state in order to maximise the absorption of the allocation of the 2007–2013 budget cycle at the end of the programming period. Moreover, pre-financing was also required because of the fact that the last 5 per cent of the funds will only be transferred by the EU if the inspection of the projects finds everything in order.

Chart 18: EU transfers according to the accrual-based and the cash-based approach (four-quarter values)



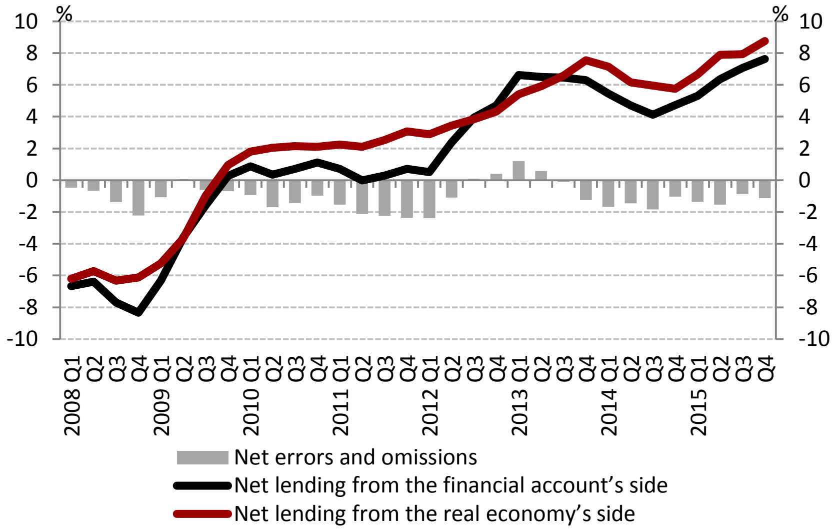
2. FINANCING APPROACH

Financing items also confirm the increase in Hungary's net lending at the end of 2015, which resulted from a significant fall in external debt and net FDI inflows. For 2015 as a whole, transactions reduced the net external debt of the economy to a larger degree than seen in previous years (by more than EUR 9 billion), while net FDI funds decreased marginally, owing to the state acquisition of Budapest Bank and the repayment of intercompany loans. Each sector continues to scale back its external debt; however, contrary to previous years, in 2015 the banking sector recorded the largest decline. The different structure of the decline in external debt reflects the conversion of foreign currency loans to forint: on the one hand, the conversion restrained the decline in net public debt through the reduction of the MNB's foreign exchange reserves; on the other hand, however, it contributed significantly to last year's decline in banks' net external debt. Besides the conversion, the surge observed in corporate deposits during the year also played a role in the reduction of banks' net external debt. The tightening of FFAR announced in July 2015 and the new FECR regulation, in turn, had a positive impact on the maturity structure of bank funds and accordingly, short-term external liabilities decreased significantly in the second half of the year. The net external debt of the consolidated general government dropped further despite the conversion-related decline in the reserves, which can mainly be attributed to the absorption of EU transfers and the decline in the government security holdings of non-residents that affected forint and foreign currency bonds alike. These developments did not generate tensions in the government securities market, as the securities sales of non-residents were counterbalanced by the purchases of domestic households and the banking sector, which were also encouraged by the self-financing programme.

In addition to analysing real economy transactions, trends in the balance of payments can also be examined from the perspective of the financial account, which includes financing items. Based on the financing approach, we can assess whether the net lending position of the economy emerged in the context of an inflow or outflow of debt or non-debt liabilities. As regards the post-crisis period, for instance, the financing side shows the foreign asset purchases/debt repayments on which economic agents have been spending their financial savings deriving from the unconsumed part of their income, in the light of the massive trade surpluses of recent years. Moreover, based on data derived from the financing side, changes in the external liabilities of individual sectors (general government, banking sector, corporations) of the economy can be also analysed. While data derived from the real economy approach and the financing approach should be identical in theory, 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. Despite this difference, developments in the real economy and in financing tend to be broadly similar over the long term.

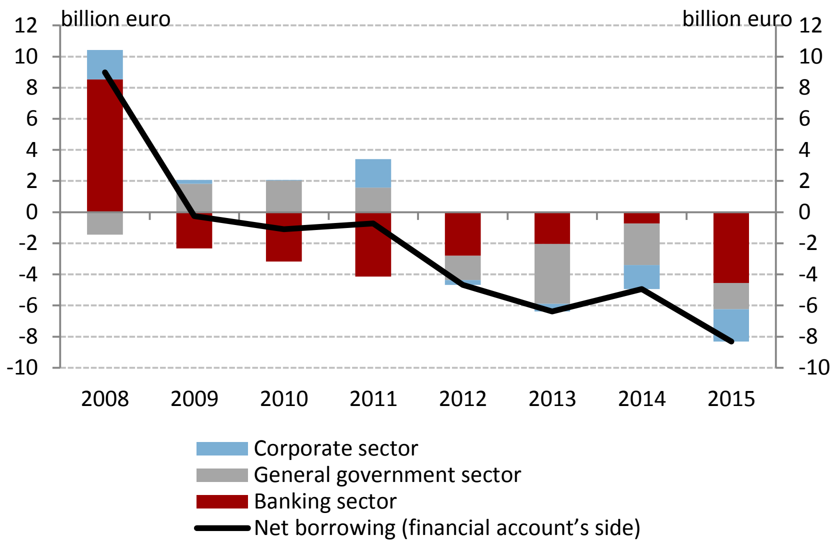
The economy's four-quarter net lending increased in 2015 Q4 under both approaches. Similarly to previous years, in 2015 net lending calculated on the basis of the real economy (8.8 per cent of GDP) exceeds the level calculated under the financing approach (7.6 per cent of GDP) (Chart 19). This means that the external debt of the country declines to a lesser degree than indicated by the amount of the current account and the capital account. The gap between the net lending figures derived on the basis of the two approaches (Net errors and omissions) increased somewhat, but nevertheless remained close to the long-term average.

Chart 19: **Developments in the two types of net lending (four-quarter data as a percentage of GDP)**



The reduction of the external liabilities of the Hungarian economy accelerated in 2015, supported by significant outflows of funds from all three sectors (Chart 20). These outflows had been mainly linked to the banking sector in the years following the crisis, before public finances and corporations gradually stepped up their role in the downsizing of external debt from 2012. The large-scale outflow of the external funds of the economy continued in 2015: the decline in the debt of the general government consolidated with the MNB[4] primarily reflected non-residents' sales of government securities, while the reduction of corporations' debts was related to their continuing balance sheet adjustments. In contrast to the decelerating outflows seen in previous years, the external debt of the banking sector declined more substantially in 2015, which may have reflected, in addition to private sector balance sheet adjustments, changes in the legislative environment and the lower external financing need resulting from the conversion.

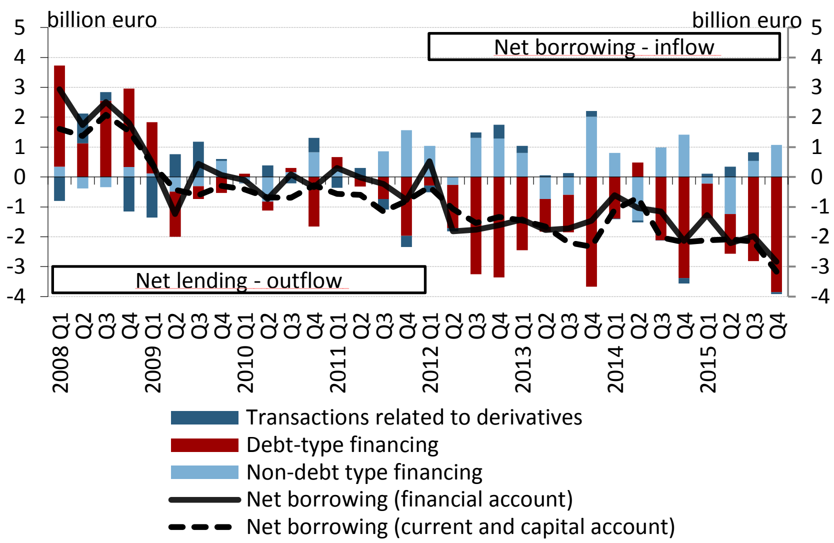
Chart 20: Net outflow of funds by sector



[4] In the structure of external financing, for analysis purposes, the sector of the general government is examined consolidated with the MNB.

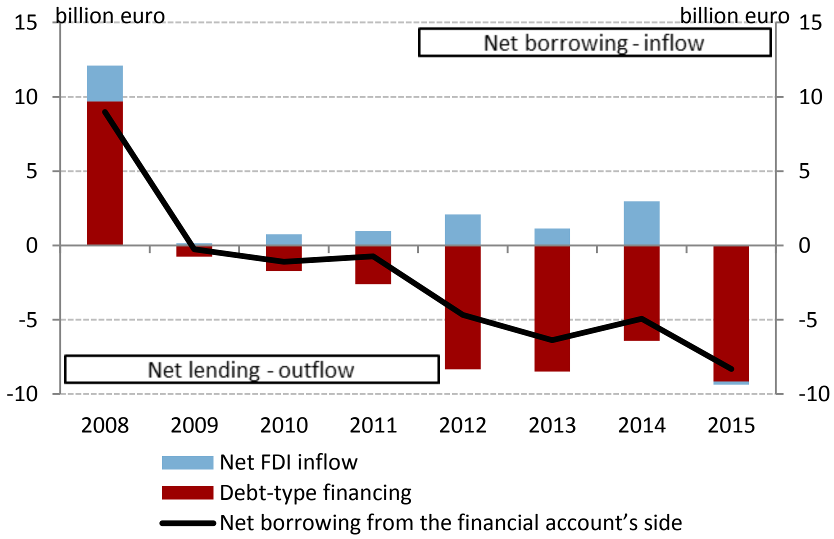
In terms of structure, developments in the outflow of funds were similar to those seen in the previous quarter: the net outflow of debt liabilities continued, while the inflow of non-debt liabilities increased. At around EUR 4 billion, the outflow of debt liabilities reached a historic high, mainly in relation to active deleveraging and deposit placements by economic agents and banks' balance sheet adjustments and optimizations at the end of the year and in response to regulatory changes. Meanwhile, the foreign non-debt liabilities of the economy increased further, as a result of the increase of net foreign direct investment and net portfolio debt. Based on financing items, in Q4 net lending surged to an unprecedented EUR 2.8 billion (Chart 21).

Chart 21: Developments in the structure of external financing (unadjusted transactions)



With respect to the nature of the outflow of funds observed in 2015, the decline in debt liabilities surpassed the levels seen in previous years, while in contrast to a robust increase last year, there were no capital inflows in the case of net foreign direct investment due to state acquisitions and the repayment of intercompany loans (Chart 22). In line with the improvement in net lending, compared to previous years the debt liabilities of the economy decreased more sharply – by more than EUR 9 billion – in 2015. The outflow of funds affected all three sectors. The balance sheet adjustments of the private sector continued to support the banking sector's reduction of external liabilities, while the outflow of funds in the public sector can be mainly attributed to the diminishing government securities holdings of non-residents. In contrast to the net inflows registered in recent years, there was a modest outflow in net FDI, partly in relation to the acquisition of Budapest Bank by the state, and partly linked to the repayment of intercompany loans.

Chart 22: Developments in foreign direct investment and debt-type financing*



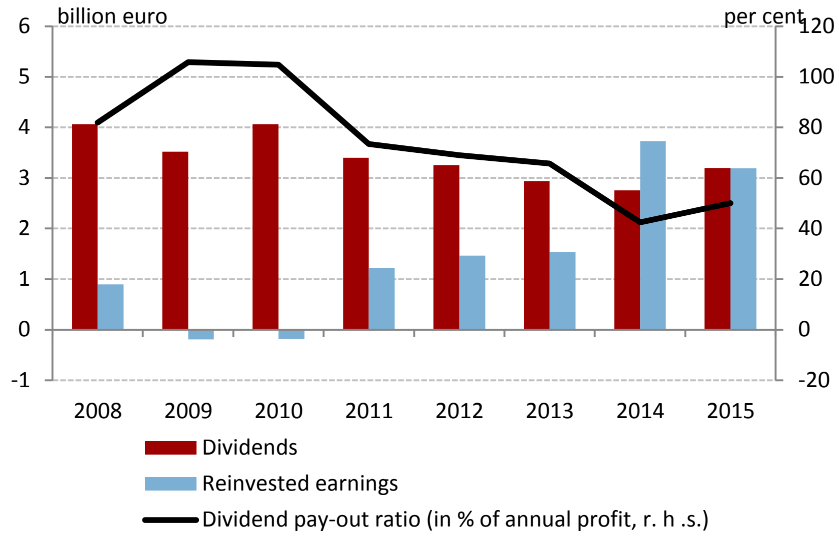
Note: * In addition to the components presented on the chart, net external borrowing also includes the equity transactions of portfolio investments and transactions associated with derivatives.

The marginal decline in net FDI is not primarily related to the increase in outflows; it rather reflects a decline in FDI inflows compared to previous years. It should be noted, however, that several factors contributed to this development:

- On the one hand, FDI was also reduced by one-off transactions which have no real economic impact otherwise. The state acquisition of Budapest Bank generated a large-scale (EUR 0.6 billion) decline in non-residents' investments, while Magyar Suzuki Zrt. carried out an almost EUR 0.2 billion equity increase (but according to the company's communication, it remains "over-capitalised" even after the transaction[5]). In addition, by selling its shares in the company, one of Richter's investors reduced its stake to less than 10 per cent, and thus the operation lowered the FDI stock of non-residents.
- On the other hand, parallel to the moderation of external debt, corporations repaid some of their intercompany loans during the year. Thanks to their substantial profits, corporations scaled back loans from their parent companies as well, which was consistent with their ongoing deleveraging process, as well as the repayment of external debts in 2015. Importantly, however, in 2015 the equity FDI of non-residents surpassed even the values recorded in the previous year.
- Finally, downward pressure on net FDI inflows was exerted by the fact that the dividend payment of corporations increased in 2015 after the declines typical in previous years, which entailed the reduction of reinvested earnings (Chart 23). It should also be noted, however, that the ratio of reinvestment to the profit of the given year is still far higher than the levels prevailing in the region (For more details, see Chapter 5 of the September 2015 issue of the *Report on the Balance of Payments*).

[5] *http://www.suzuki.hu/pages/display/corporate/news/2015/cikk:magyar_suzuki_corporation's_statement*

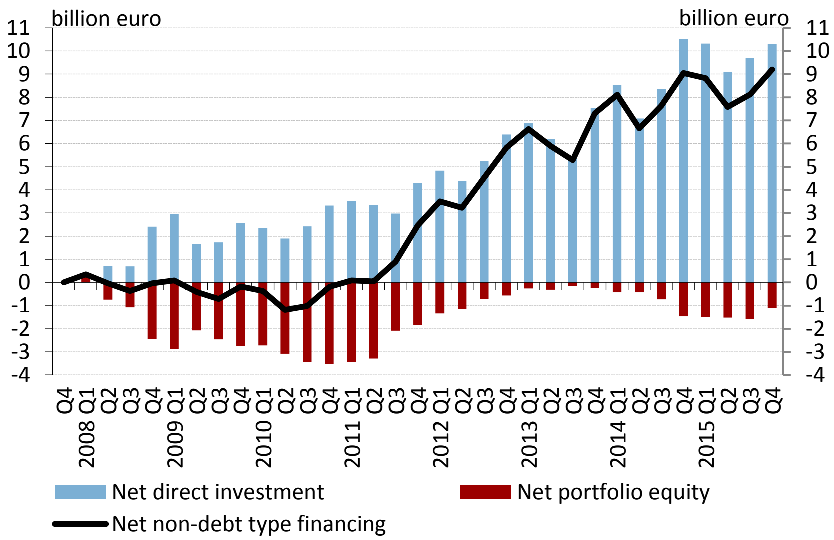
Chart 23: Distribution of profits generated by foreign-owned companies incorporated in Hungary



2.1. Non-debt liabilities

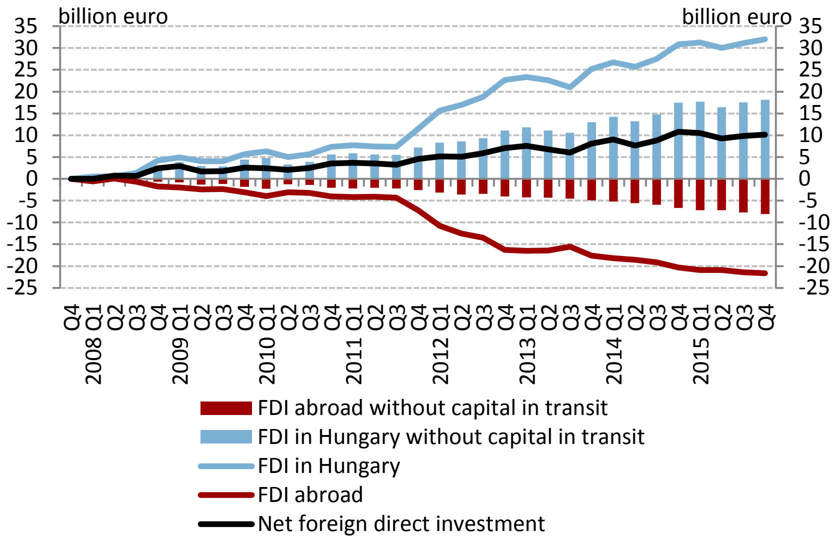
Both the FDI and portfolio equity liabilities of the economy increased in Q4. Mainly as a result of non-residents' investments in Hungary, in particular, the reinvestment of earnings, net FDI liabilities of the economy rose by EUR 0.6 billion during the fourth quarter, which were significantly offset by the decline in intercompany loans. Foreign direct investments by residents also increased, albeit to a lesser degree than in Q3. For 2015 as a whole, the non-debt liabilities of the economy remained broadly unchanged, which was the combined result of the slight decline in net foreign direct investment and the modest increase in net portfolio equity investment (Chart 24).

Chart 24: 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. Presumably owing to the special features of the Hungarian tax regime, certain companies only provide intercompany loans or capital injections to their subsidiaries in Hungary for tax optimisation purposes, which are then immediately transferred abroad; this is referred to as capital in transit, which has been listed separately by the MNB in the balance of payments statistics since 2008.[6] Capital in transit only affects gross flows and, due to its nature, does not distort net FDI data.[7] Although in 2015 the value of capital in transit fell significantly short of previous years, the MNB's analyses concentrate on net indicators (Chart 25). As a result of dividend payments, net FDI temporarily declined in Q2 before starting to rise again in the second half of the year, mainly owing to reinvested earnings.

Chart 25: Developments in direct investment (cumulative transactions)

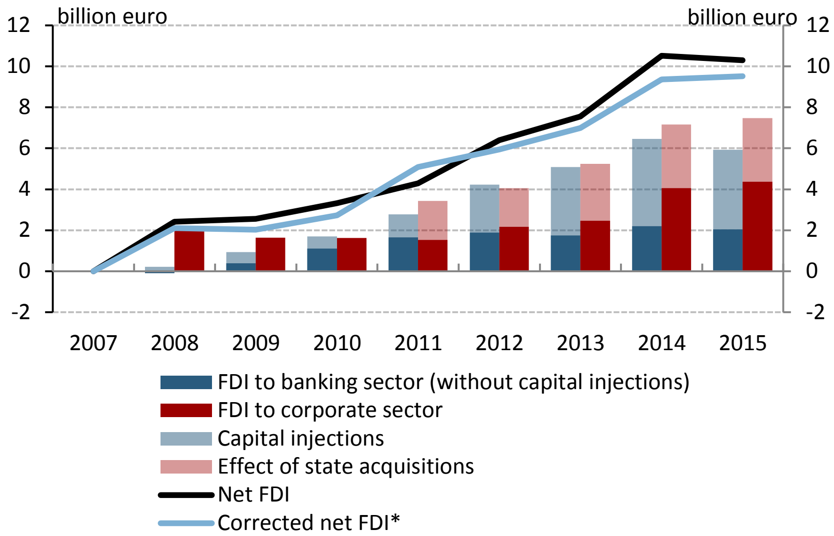


Direct investment inflows would have shown similar developments even without one-off effects in recent years and accordingly, net FDI inflows also continued on a smaller scale in 2015. Foreign direct investments in Hungary have been influenced by numerous one-off effects since the outbreak of the financial crisis (Chart 26). Without the capital injections required because of the losses sustained by banks during the crisis, net FDI inflows would have been less significant in recent years. At the same time, the inflow of funds was also affected by the state's acquisition of foreign-owned companies: corporations' FDI was reduced by the state's acquisition of MOL in 2011, of the gas business of E-On in 2013, and of Antenna Hungária Zrt. and Főgáz Zrt. in 2014. Taken together, however, both the original data (including banks' capital injections and state acquisitions) and adjusted figures show a similar magnitude of net FDI inflows – almost EUR 10 billion – in recent years. In 2015, the banking sector saw a moderate FDI outflow (mainly due to the acquisition of Budapest Bank by the state), while corporations registered a slight FDI inflow. On the whole, although raw data indicate a modest decline in net FDI in 2015, adjusted for one-off effects, FDI increased slightly owing to the inflows recorded in the corporate sector.

[6] In this context it should be noted that data for enterprises 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 has hovered in the range of 20-40 per cent of GDP in recent years.

[7] Capital in transit, on the other hand, also has a significant impact on the sectoral structure of Hungarian FDI. Indeed, an investment in Hungary may be classified in a different sector than the purpose of the direct investment, distorting the sector-based FDI data.

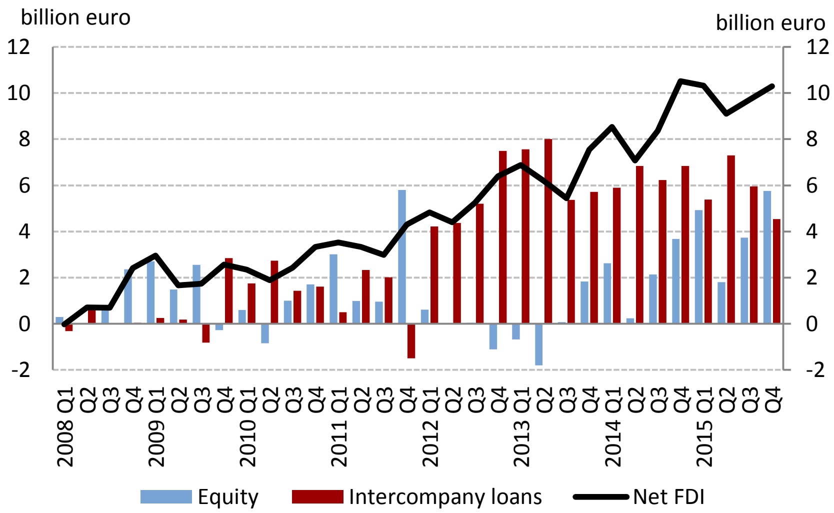
Chart 26: Developments in net FDI by sector (cumulated annual values)



Note: *Adjusted net FDI includes net foreign direct investment inflows adjusted by state acquisitions and FDI inflows to banks, excluding capital injections. The column presenting banks' capital injections also includes other one-off effects associated with the banking sector (such as the acquisition of Budapest Bank).

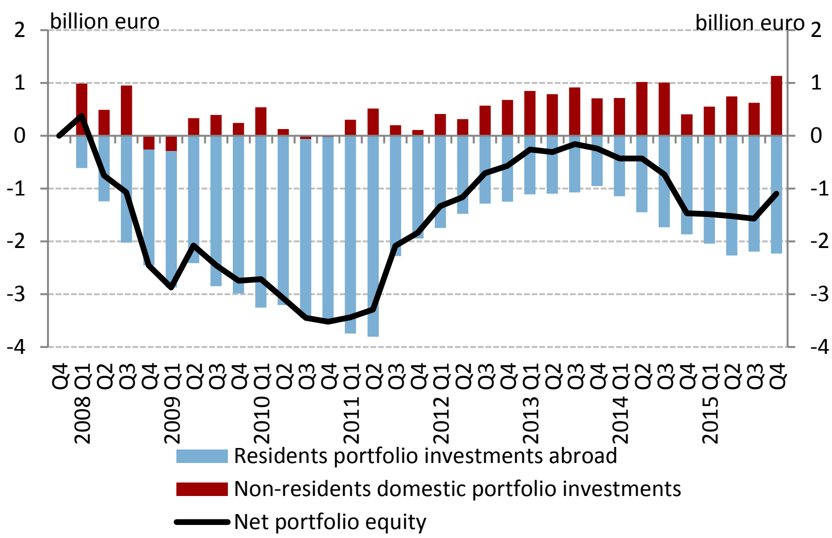
The rise in non-residents' FDI in recent years has occurred alongside a rise in equity investments and reinvested earnings and a fall in intercompany loans (Chart 27). The net FDI of non-residents has shown a relatively even increase since the crisis, and by 2015 the increase amounted to over EUR 10 billion. Examining direct investments over a longer horizon, it is apparent that equity financing by non-residents declined overall until 2013 following the crisis. This, however, can be partly attributed to parent companies' portfolio realignments and to the fact that equity financing was often replaced by intercompany loans after ownership changes. From the middle of 2013, however, equity financing rose significantly as a result of an increase in reinvested earnings, while intercompany loans declined even more substantially.

Chart 27: Developments in net direct investment (cumulative transactions)



In Q4, net portfolio equity liabilities increased, mainly owing to the rise in non-residents' Hungarian investments (Chart 28)**.** After the decline in net portfolio equity liabilities registered in 2014 due to the increase in foreign liabilities in the wake of residents' purchases of mutual fund shares, equity investments by non-residents increased overall in 2015. In the first half of 2015, the rise in residents' equity portfolio investments abroad continued at a slower pace before stopping altogether, which may be the result of the deceleration observed in households' purchases of mutual fund shares. For the year as a whole, equity investments by non-residents in Hungary increased. This can be mainly attributed to the significant, EUR 500 million increase observed in the last quarter of the year, which may also have reflected the state's sale of its stake in OTP, which, overall, contributed to a rise in non-debt liabilities.

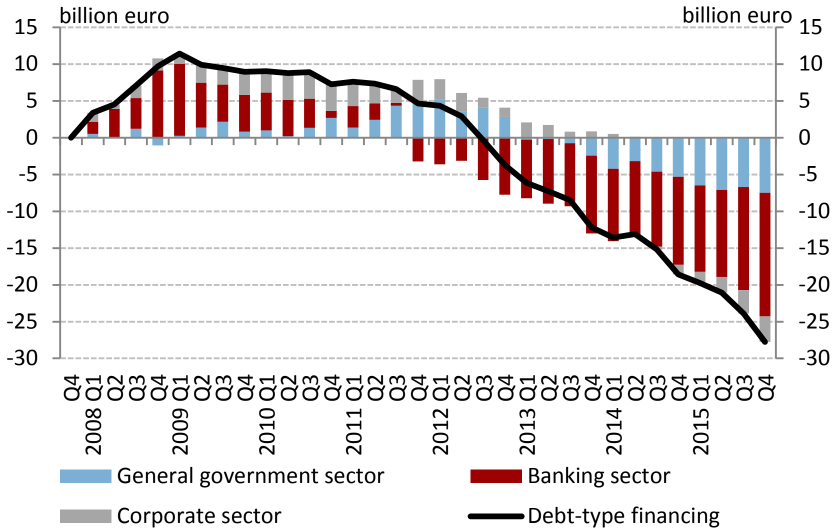
Chart 28: Drivers of changes in net portfolio investment (cumulative transactions)



2.2. Debt liabilities

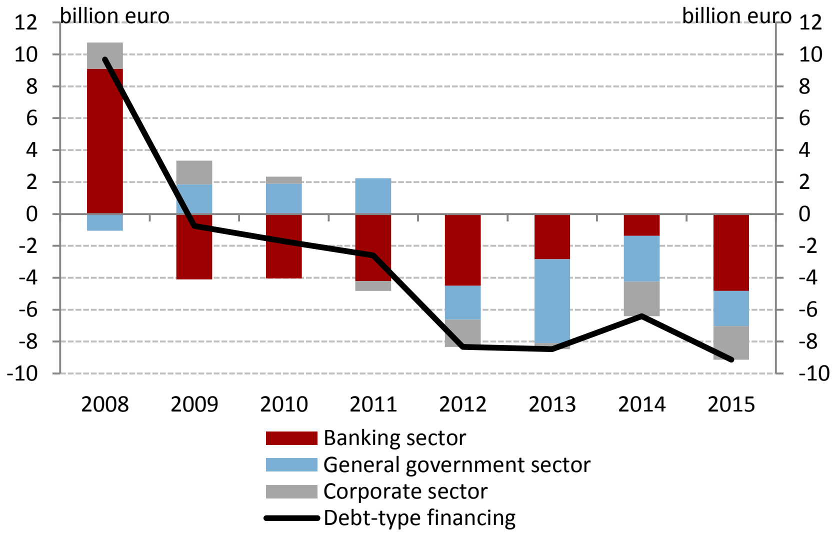
In 2015 Q4, the net external debt of the economy declined further, to a large degree, in relation to the banking sector (Chart 29)**.** In the final quarter of the year, the net external debt of the economy shrank by almost EUR 4 billion. This decline can be mainly attributed to the reduction of the net external debt of the banking sector on the back of foreign banks' end-of-year balance sheet optimisation, the conversion of foreign currency loans, and robust new deposit placements by the corporate sector. Alongside banks, corporations also continued scaling back their net external debt. In Q4, the net external debt of the consolidated general government decreased by nearly EUR 0.8 billion, in which the intensive absorption of EU transfers and hence, rising claims vis-à-vis the EU, played a dominant role.

Chart 29: Developments in net debt-type financing by sector (cumulative transactions)



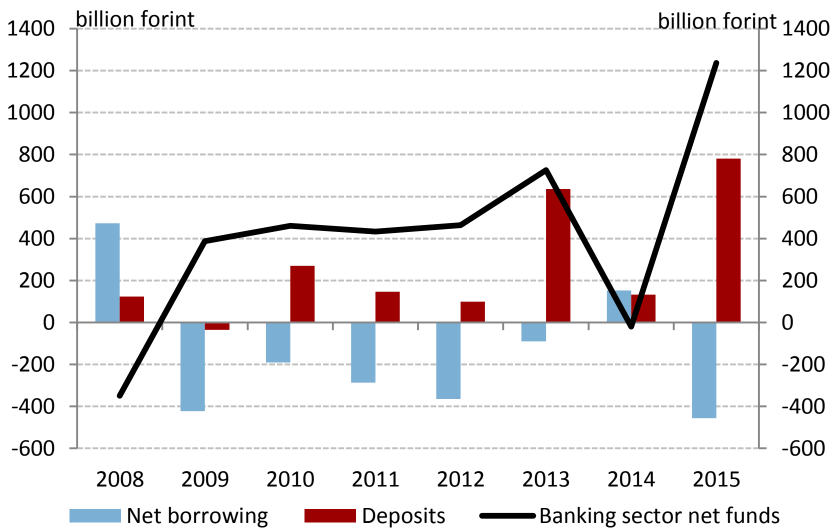
During the whole of 2015, the adjustment of the economy was larger than in previous years: as a result of transactions, net external debt decreased by more than EUR 9 billion. Overall, all three sectors continued to reduce their net external debt, but in a structure different from previous years, and the strongest contraction in 2015 was observable in the banking sector, amounting to almost EUR 5 billion (Chart 30). The decline in external debt exhibited a different structure compared to the previous years, due mainly to the conversion of foreign currency loans into forint, which on the one hand restrained the reduction of the consolidated government's external debt through the shrinking foreign currency reserves of the MNB, and on the other hand lowered banks' net external debt. In addition, the substantial volume of new deposits by the corporate sector also supported the reduction of banks' external funds. The tightening of the foreign exchange funding adequacy ratio (FFAR) and the new foreign exchange coverage ratio (FECR) regulation announced in July 2015 also influenced the structure of short-term external debt. One temporary factor also contributed to the outflow of funds: the reduction of the external debt by foreign-owned banks for balance sheet optimisation reasons, characteristic of the end-of-year period. The net external debt of the consolidated general government decreased less than in previous years, by approximately EUR 2.2 billion, which was influenced by the drop in reserves due to forint conversion, as it boosted net external debt. Year-on-year the corporate sector also reduced its net external debt by EUR 2 billion, which can be attributed to the repayment of foreign loans and the shrinking volume of outstanding commercial loans.

Chart 30: Developments of debt-type funds in individual sectors (annual transactions)



In 2015, loan repayments and new deposits by companies considerably increased the funds available to banks, which strongly supported the reduction of the banking system's external debt. New deposits by non-financial corporations expanded markedly in 2015, amounting to almost HUF 800 billion. The intensive utilisation of EU transfers, the presumably rising corporate profits on account of the decreasing oil prices and the subdued expansion of investments as compared to previous years may have all contributed to the substantial increase in deposits. Moreover, funds available to banks were also boosted by the fact that corporate credit decreased by almost HUF 400 billion during the year. However, idiosyncratic factors also played a role in the contraction of credit: in June the state took over the total outstanding debt of BKV Zrt., certain companies' bank funds were replaced by parent company financing, and banks' end-of-year portfolio cleansing also reduced corporate debt.[8]

Chart 31: Developments of non-financial corporations' bank loans and deposits

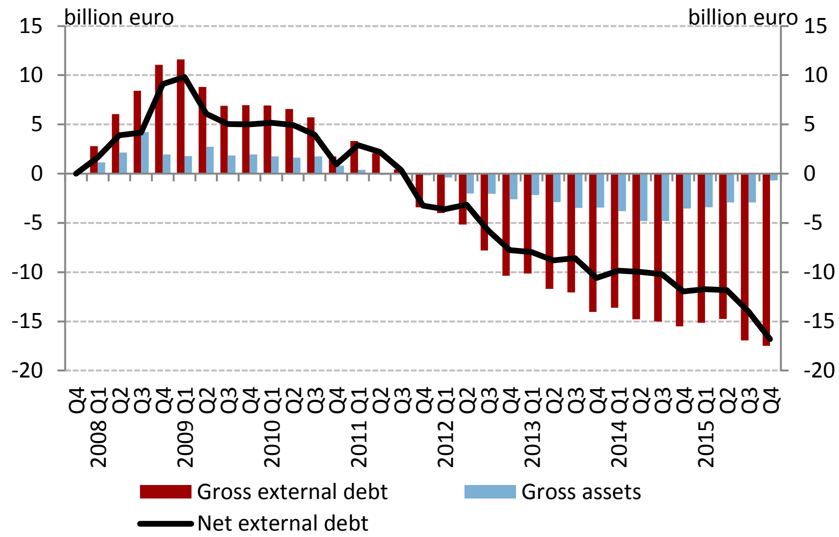


Both the drop in external liabilities and the rise in external assets played a role in the reduction of the banking sector's net external debt in 2015. In the last quarter of 2015, the sharp decline in net external debt continued, chiefly due to the considerable expansion of external assets. In 2015, the external liabilities of the banking system

[8] For more details, see the press releases of the MNB from June and December 2015 on the developments of credit institutions' consolidated balance sheet, as well as the November 2015 Financial Stability Report.

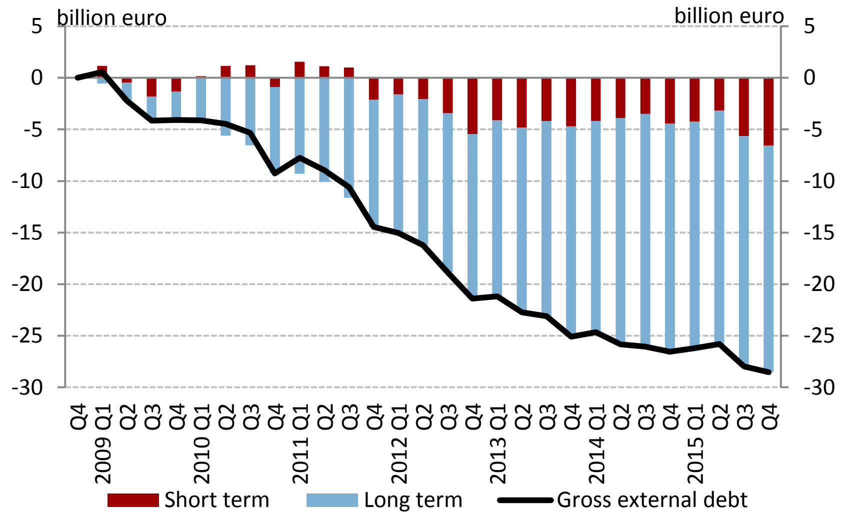
contracted by EUR 2 billion, while external assets increased, and therefore net debt was reduced by around EUR 5 billion in aggregate (Chart 32). In 2015, the shrinking of external assets – which was characteristic of the previous years and indicated deleveraging – ground to a halt, and, compared to the previous year, a significant increase was observed, amounting to EUR 2.8 billion. This process may have been influenced by the effect of the foreign currency that was received from the central bank in connection with the forint conversion, as it boosted foreign assets.

Chart 32: Developments in the banking sector's external debt and asset transactions (cumulative transactions)



The contraction of the banking system's external debt continued in the past year, which mainly entailed a considerable drop in short-term liabilities observed in the second half of the year (Chart 33). In 2015 Q4, banks decreased their gross external debt by EUR 0.5 billion, i.e. less than in the previous quarter. This happened in the context of an EUR 0.9 billion reduction of short-term debt, and an almost EUR 0.4 billion rise in long-term liabilities. Over the whole year, the outflow of funds developed favourably from the perspective of the maturity structure, as in the second half of the year short-term liabilities contracted more than in previous years. This was due, on the one hand, to the fact that the tightening FFAR rules and the new FECR regulations effective from 1 January 2016 as well as the deleveraging linked to forint conversion led to a sustained decrease in short-term liabilities. On the other hand, a temporary factor, namely the balance sheet optimisation typical of the end-of-quarter and end-of-year periods, also supported the reduction of short-term liabilities.

Chart 33: Maturity breakdown of the banking system's external debt (cumulative transactions)

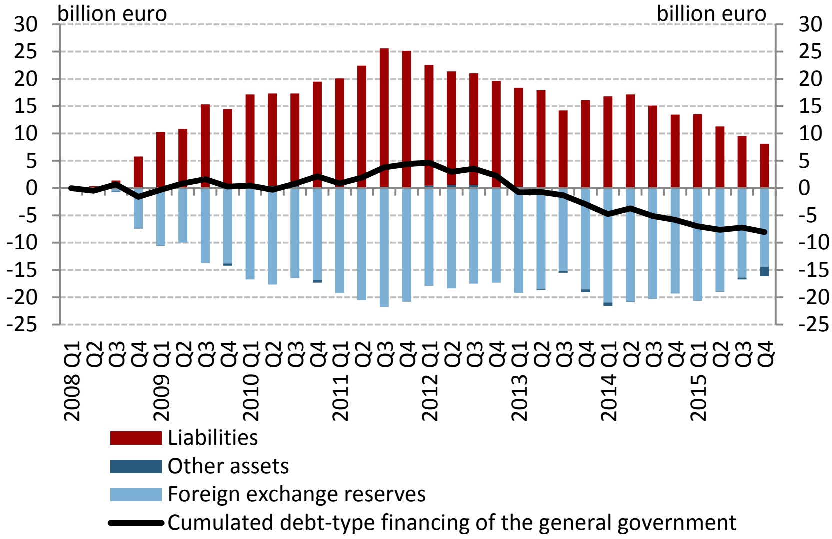


The net external debt of the general government consolidated with the MNB shrank by EUR 0.8 billion in 2015 Q4: the continued substantial utilisation of EU transfers was partly offset by the reduction in foreign currency reserves. At the end of the year, the net external debt of the government dropped further. The main factor in the sustained decrease in debt was the substantial utilisation of EU transfers amounting to over EUR 3 billion, which, partly through the increase in claims against the EU, reduced the net external debt of the general government. In addition, the fact that non-residents continued to sell their government securities also contributed to the drop in net external debt. These effects, however, were mitigated by the shrinking of the foreign currency reserves at the end of the year, which was due in part to permanent and in part to temporary reasons.

- The first cause of the end-of-year fall in foreign currency reserves was that in December a premium EUR-denominated Hungarian government bond (PEMÁK) matured, and its repayment depleted the reserves (however, as this bond was held by residents, gross external debt was not reduced).
- The second cause was the continued foreign currency conversion into forint, which banks could spend on cutting their external liabilities (and the foreign currency received may also decrease banks' net external debt by boosting external assets).
- In addition, the MNB provided foreign currency to the banking system in a swap, which temporarily reduced reserves, but manifested itself in the sharp drop in net external debt of banks.
- The reserves were further reduced by the Government Debt Management Agency's prepayment of an external development loan (this, however, did not affect net external debt, as gross external debt dropped in tandem with the reserves).

Based on transactions, the net external debt of the consolidated government decreased by EUR 2 billion during the whole of 2015, which was less than in previous years (Chart 34). The fall in the state's net (and also gross) external debt was supported by more than EUR 5 billion by the continued sale of government securities by non-residents, and the maturity of government securities held by non-residents, which concerned both forint and foreign currency-denominated bonds. A vast portion of the forint-denominated bonds sold by non-residents – partly linked to the self-financing programme – appeared in Hungarian banks' balance sheets (for more details, see the Box), while the decrease in the foreign currency bond portfolio was mainly attributable to the foreign currency bond purchases by the central bank. The state's external debts also decreased, which was partly due to the prepayment of a foreign currency development loan. (The foreign currency liquidity for the reduction of foreign currency liabilities was provided from the central bank reserves, and thus these transactions had no impact on the consolidated government's net external liabilities.) However, the drop in debt on account of the sale of government securities by non-residents was offset, in part, by the substantial decrease in foreign currency reserves (as this also considerably reduced the state's external claims). The drop in foreign currency reserves was influenced on the one hand by the foreign currency liquidity provision linked to forint conversion, and on the other hand by the aforementioned factors (e.g. the repayment of the maturing PEMÁK bond), as well as the state acquisition of Budapest Bank. Owing to the latter, the government's net external debt increased as the reserves fell, and the economy's FDI debt was also reduced; therefore, the transaction did not affect the net international investment position, although it caused a realignment within its structure.

Chart 34: Breakdown of net external debt of the general government consolidated with the MNB (cumulative transactions)

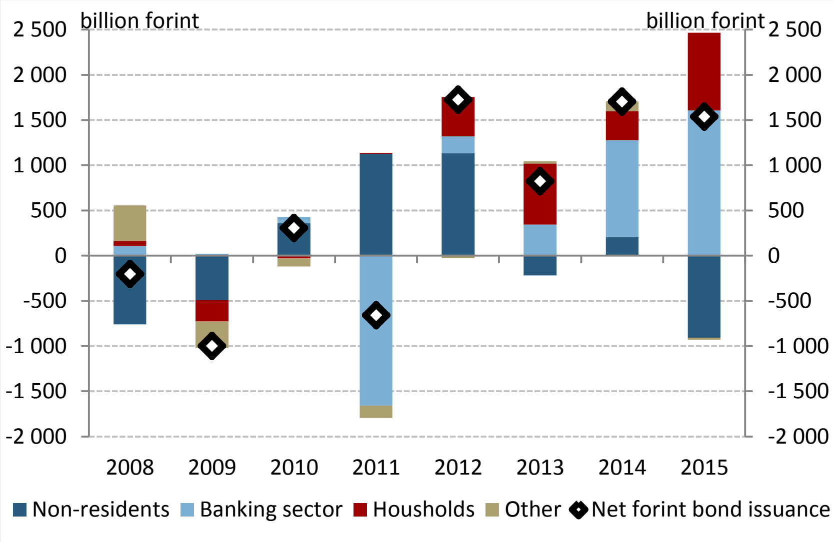


Box 2: Government securities market developments

Supported by the self-financing programme, the reduction in the government securities holdings of non-residents contributed to the improvement in the country's external vulnerability. The total volume of (foreign currency and forint-denominated) Hungarian government securities held by non-residents fell sharply, by more than EUR 5.6 billion (HUF 1,700 billion), in 2015. As a result, almost 15 per cent of the government securities position held by non-residents was eroded, which caused a significant realignment within the investor structure of the Hungarian government securities market: the proportion of non-residents in the total Hungarian government securities portfolio fell from 53 to 46 per cent. Non-resident investors primarily sold HUF-denominated bonds, thereby reducing their position, which decreased by almost HUF 1,000 billion. The sales by non-residents coincided with the surging demand – due, inter alia, to the self-financing programme launched by the central bank – by domestic credit institutions, i.e. the forint-denominated government securities position of non-residents was partly taken over by the domestic banking system, the position of which rose by more than HUF 1,500 billion. Similar to the domestic banking system, households' government securities holdings also expanded dynamically, rising by approximately HUF 900 billion, which also contributed to the reduction of the state's net external debt (Chart 35). The huge government securities demand of the two sectors enabled the state to pay back a substantial amount of maturing foreign currency debt in 2015 without issuing foreign currency bonds (for more details, see Chapter 4.1).

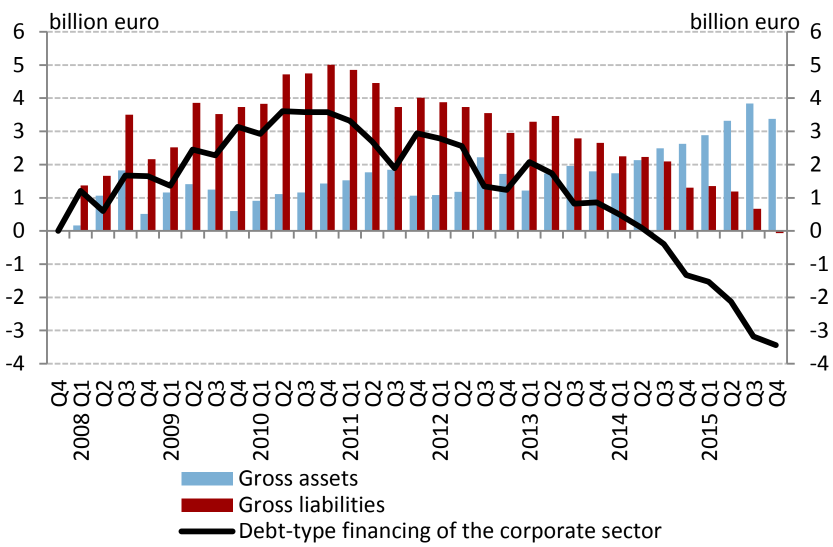
Non-residents' sale of government securities did not cause market turbulences or a rise in yields despite being greater in volume than in 2008, which was favourable. This may have been due to the fact that in 2015 the stability of the government securities market was ensured by domestic sectors. The more balanced supply and demand supported the slight decrease in government securities yields in Hungary as compared to the beginning of the year. These shifts in government securities market yields may indicate the market-stabilising role of the self-financing programme, and that Hungary's external vulnerability was mitigated as the domestic sectors started playing a more central role. Financing the maturing foreign currency bonds from forint funds may reduce vulnerability even further.

Chart 35: Changes in the volume of forint-denominated government securities by sectors



In 2015 Q4, the fall in companies' external debt continued, which can be attributed to the more marked reduction of debt against non-residents (Chart 36). In year-on-year terms, the dynamic decline in companies' external debt since 2014 progressed further in 2015, amounting to EUR 2.1 billion overall. Although assets against non-residents dropped in the last quarter, the decline in liabilities and the rise in assets against non-residents both supported the fall in external debt in annual terms.

Chart 36: Developments in companies' net debt-type funds (cumulative data)



3. DEVELOPMENTS IN DEBT RATIOS

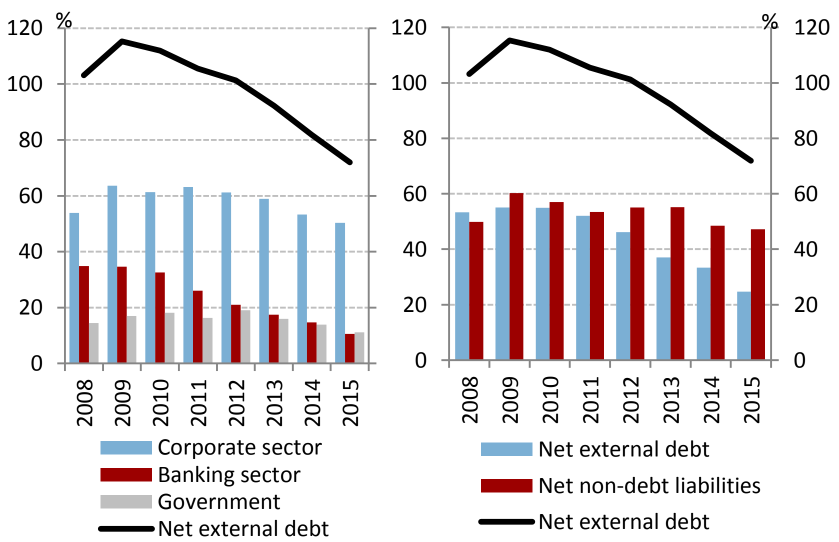
The adjustment of the key external debt indicators from the perspective of the country's vulnerability continued in 2015. Net external debt fell to below 25 per cent of GDP, and gross external debt fell to below 76 per cent of GDP. The adjustment of external debt indicators was primarily attributable to the outflow of funds and the rise in nominal GDP, while developments in the forint exchange rate hampered this process slightly. On account of deleveraging, the net external debt of both the banks and corporations continued to decrease, which in the case of the banks was further strengthened by forint conversion and the adjustment to the changes in the regulatory environment. The net external debt of the consolidated general government also dropped substantially, which was mainly influenced by the fall in debt to non-residents supported by the self-financing programme. The short-term external debt based on residual maturity – following a temporary mid-year rise in the originally long-term debt – sank back to around EUR 21 billion by the end of 2015. The level of foreign currency reserves – despite the diminishing trend due mainly to the MNB's programmes – continued to substantially exceed the level expected by investors. The gross financing need of Hungary continued to contract owing to the country's increasing net lending, however, the Hungarian economy is still dependent on the rollover of external liabilities.

The external vulnerability of the country is not only influenced by so-called flow variables (such as the current account balance or the net lending), since the external debt of the economy and its composition is also essential. Although the changes in debt indicators can usually be inferred from the developments in the financial account, we can only obtain a clear picture of developments in stock variables by taking into account the shifts in foreign currency and securities prices and nominal GDP.

3.1. Net external liabilities

The net external liability of the country continued to decrease in 2015 and was around 72 per cent of GDP at the end of the year (Chart 37). When examining the vulnerability of a country, one should not only analyse external debt indicators but also the developments in external liabilities, which also include non-debt-type liabilities (foreign direct investments and portfolio shares) in addition to debt. The net external liability of Hungary decreased at the same pace in 2015 as in previous years, i.e. by almost 10 per cent of GDP: the external liabilities of the banking system, the consolidated general government and companies all decreased. While after 2010 the contraction of net external liabilities was mainly attributable to the drop in debt-type liabilities, non-debt-type liabilities also decreased over the past two years, which was principally due to the rise in domestic companies' foreign assets. In parallel with the outflow of debt-type funds, the adjustment of the net external debt continued in 2015.

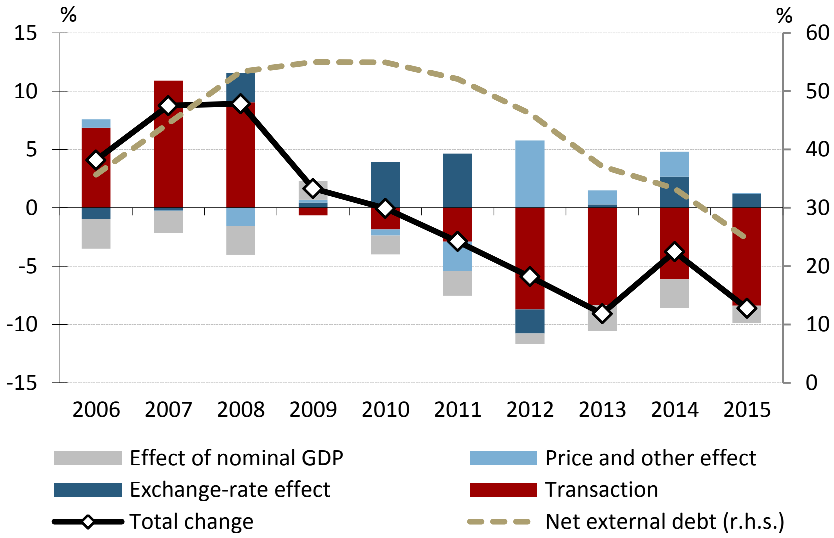
Chart 37: Developments in net external liabilities (end-of-period values relative to GDP)



3.2. Net external debt

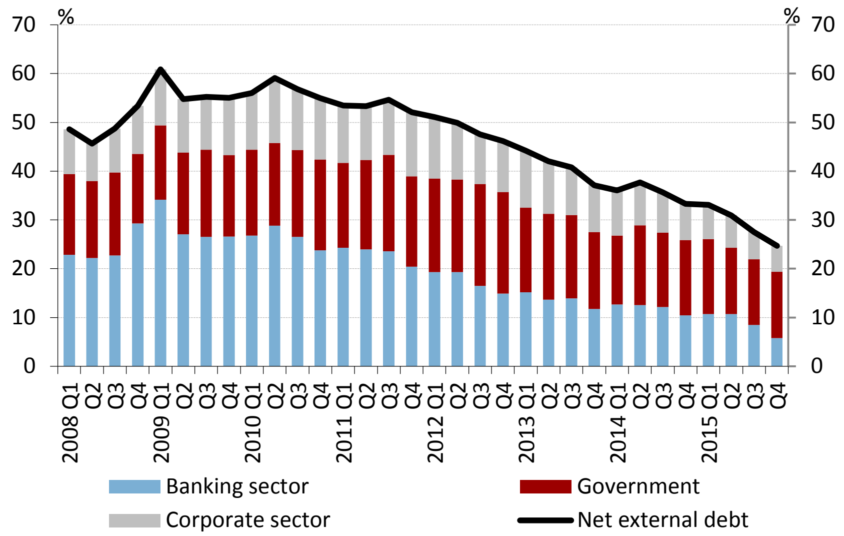
The fall in net external debt continued in 2015 mainly on account of transactions and changes in GDP, and was slightly hampered by the depreciation of the forint exchange rate (Chart 38). In the years leading up to the crisis, net external debt relative to GDP rose mainly due to net borrowing by the banking system, and then, in parallel with the adjustment of the sectors, the outflow of debt-type funds started. During the crisis years, the drop in nominal GDP and the depreciation of the forint contributed to the rise in the debt ratio, which was offset by changes in several factors. Later, in parallel with the continued debt reduction, the net external debt of the Hungarian economy plunged by 30 percentage points between 2010 and 2015. The annual improvement of the debt ratio of almost 9 percentage points in 2015 was once again helped by the outflow of debt-type funds and GDP growth, which was somewhat offset by the depreciation of the forint against foreign currencies decisive from the perspective of external debt (euro, dollar, Swiss franc). In 2015, prices of government securities did not change substantially, so the corresponding price effects did not exert a marked influence on net external debt.

Chart 38: Decomposition of net external debt changes (relative to GDP)



Net external debt fell to below 25 per cent of GDP at the end of 2015, which was mainly due to the decrease in banks' debt (Chart 39). In the fourth quarter, net external debt shrank by almost 3 per cent of GDP, primarily due to the drop in the external debt of the banking system, but the net debt of the corporate sector also decreased slightly. The main factors behind the contraction in banks' external debt were the forint conversion, the end-of-year deleveraging, the tightening of FFAR rules and the new FECR regulation announced in July 2015, as well as the substantial amount of new deposits by the corporate sector. The net external debt of the general government did not change considerably in the fourth quarter, as external debt-type assets (primarily foreign currency reserves) and liabilities both decreased. Net external debt dropped considerably in the whole of 2015, falling by almost 9 per cent of GDP, more than half of which was observed in the banking system, while the consolidated general government and companies also reduced their external debt. After the crisis the shrinking debt and the substantial amount of new deposits by the private sector enabled banks to significantly cut their external liabilities. This process continued in 2015: the deleveraging of the private sector and the foreign currency provided to banks by the MNB during forint conversion both contributed to the further decrease in banks' net external debt. Mainly in connection with deleveraging, companies also reduced their net external debt further in 2015. The net external debt of the consolidated general government also dropped by 2 per cent of GDP. This was mainly reflected in the fall in debt to non-residents, which was primarily supported by the self-financing programme.

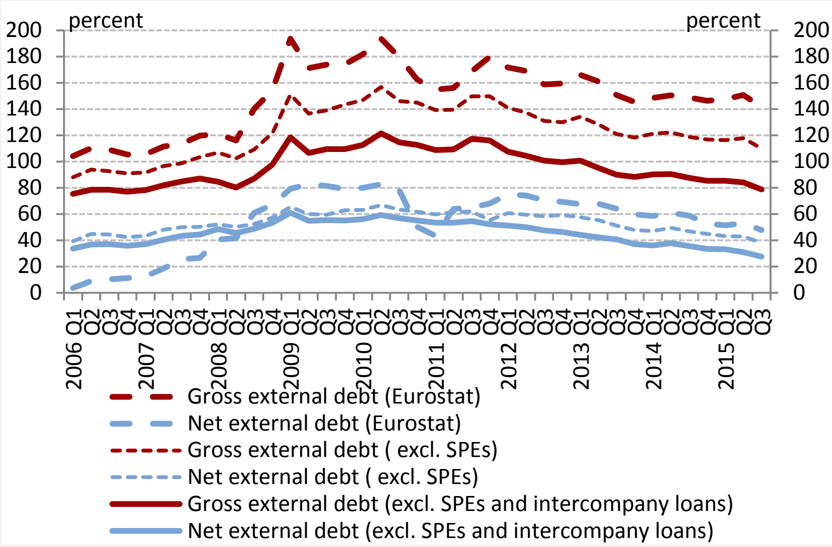
Chart 39: Breakdown of net external debt by sectors (relative to GDP, without intercompany loans)



Box 3: On various external debt indicators

Based on economic considerations, our analysis uses debt indicators adjusted for SPEs and intercompany loans. All European Union Member States' nominal as well as net and gross external debt relative to GDP is available in Eurostat. The indicators in the database, however, contain several factors that should not be taken into account when examining underlying trends. One such factor is the external debt of special-purpose entities (SPEs). Special-purpose entities do not perform actual, real economy activities on the territory of a given economy, but, primarily for tax considerations, "pass their capital through" the country. Therefore, they have a major impact on the economy's gross external liability indicators, but practically no effect on the country's net investment position. Nevertheless, these transactions may influence the level of net external debt due to the different inflow and outflow of debt-type and non-debt-type funds, as can be seen in the case of Hungary (Chart 40); therefore, time series also containing the liabilities of SPEs show greater fluctuations. In addition, intercompany loans may also significantly modify the debt shown in statistics. However, we have pointed out in our earlier analyses that intercompany loans carry much lower rollover and interest rate risks than bank lending, and according to our observations, they should be considered non-debt-type funds rather than debt-type funds (for more details, see the April 2014 and 2015 Reports on the Balance of Payments). Thus one should use indicators adjusted for this when analysing external debt indicators. From the perspective of underlying trends, the case of Hungary also shows that both gross and net external debt are lower than in the case of the indicator also containing intercompany loans and SPEs. Yet we should also underline that there has been a steady and substantial adjustment in the case of all indicators over the past years.

Chart 40: Developments of net and gross external debt (relative to GDP)

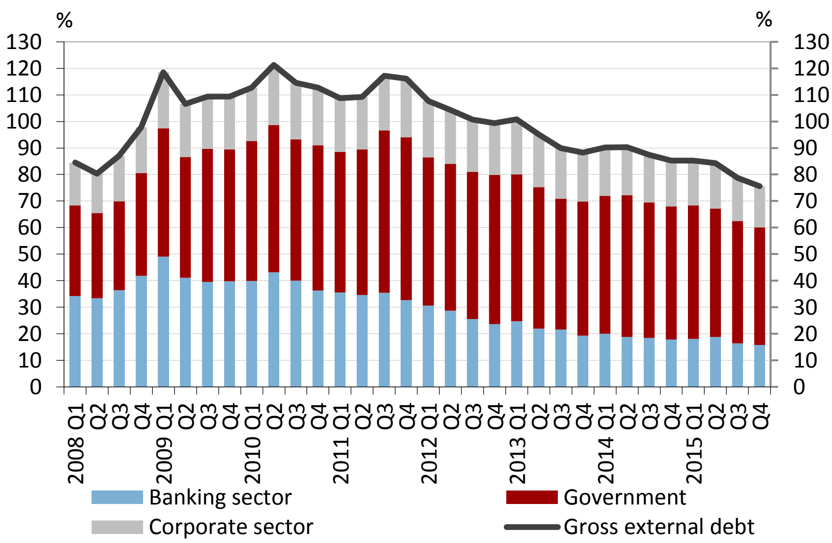


Source: Eurostat, MNB

3.3. Gross external debt

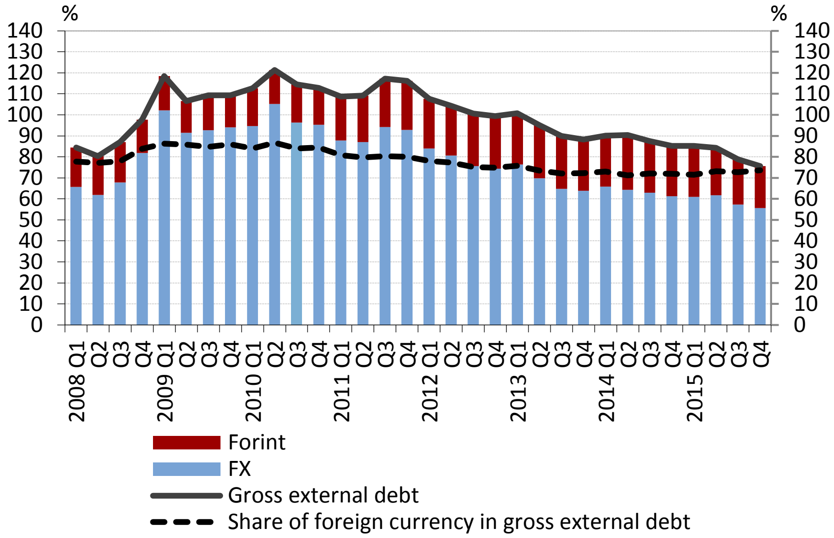
In line with the downward trend in recent years, gross external debt fell to below 76 per cent of GDP by the end of 2015. After the outbreak of the crisis, gross external debt peaked at 120 per cent of GDP, but then decreased considerably in recent years thanks to deleveraging. All sectors contributed to the reduction of the gross external debt in 2015, and the greatest contraction in gross external debt was exhibited by the general government. The gross external debt of the general government dropped significantly as the government securities holdings of non-residents fell, which was also supported by the self-financing programme of the MNB by raising the demand of the banking system for government securities, and households' government securities purchases also contributed to the mitigation of the sector's foreign dependence. In addition, the banking system's gross external debt was also markedly reduced, which may have been due to the continued deleveraging, and the adjustment on account of the forint conversion and the tightening regulations.

Chart 41: Breakdown of gross external debt by sectors (relative to GDP, without intercompany loans)



Similar to recent years, the foreign currency ratio within gross external debt was slightly above 70 per cent in the whole of 2015. When analysing external vulnerability, one should also examine the distribution of gross external debt by denomination, as in the case of a high foreign currency ratio the foreign currency liquidity requirement of repayments is substantial, and the indicator is also more sensitive to the revaluation caused by the exchange rate. In 2015, gross external debt decreased, but the proportion of foreign currency debt did not change significantly. The EUR-denominated foreign currency debt of the general government fell compared to the end of 2014, but the foreign currency ratio of the general government's external debt rose slightly, to around 65 per cent due, in part, to the drop in non-residents' holdings of HUF-denominated government securities. The external debt of the private sector is mostly denominated in foreign currencies (only the banking system has substantial HUF-denominated debt), and its foreign currency ratio, amounting to 85 per cent, hardly changed in 2015.

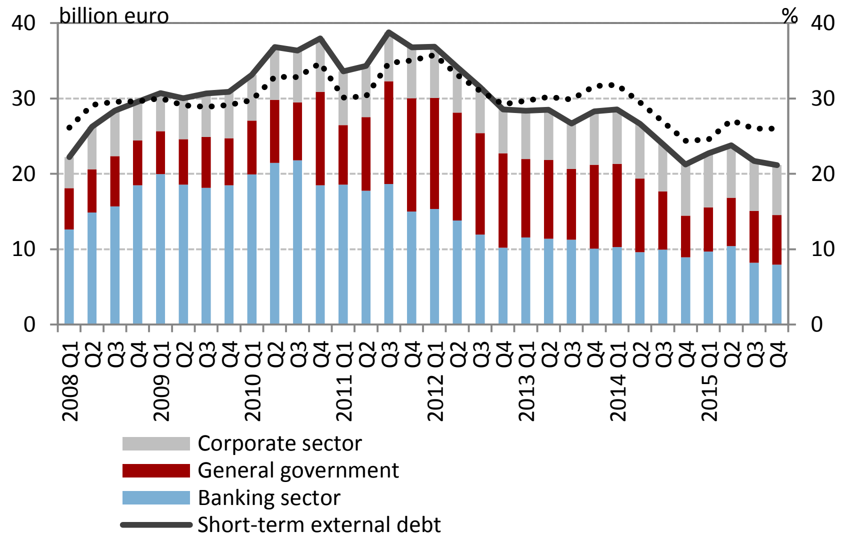
Chart 42: Breakdown of gross external debt by denomination (values relative to GDP)



3.4. Short-term external debt and gross financing need

Following a temporary rise early in the year, short-term external debt based on residual maturity decreased again in the second half of 2015, and therefore at the end of the fourth quarter it reached EUR 21.2 billion, i.e. the same level as at the end of 2014. Short-term external debt is an important indicator of the level of reserves expected by investors; therefore the EUR 17 billion drop in the past four years – in line with the steadily positive net lending – is vital from the perspective of the economy's positive perception. At the end of 2015, short-term external debt stood at around the same level as in December 2014, however, a minor adjustment could be observed at the sector level. The short-term external debt of the general government increased by almost EUR 1 billion as compared to the end of 2014, which was mainly due to the rise in amortising debt on account of the last instalment of the EU loan. Overall, the government's short-term external debt amounted to EUR 6.6 billion at the end of 2015, which was considerably less than the peak of EUR 15 billion observed at the end of 2011 (linked to the concentrated maturity of the international loans taken out at the onset of the crisis). The small increase observed at the general government was offset by the decrease in the short-term external debt of the banking system and companies. The decrease in the banking system's originally short-term debt – which was mainly linked to the changes in regulation – considerably exceeded the rise in the sector's amortising debt, and therefore the banking system's short-term external debt dropped by almost EUR 1 billion. After a temporary surge, the short-term external debt of companies was lower at the end of 2015 than in December 2014. The proportion of short-term debt within total external debt rose slightly in 2015 after a temporary spike in early 2015, but remains below the level typical before the crisis.

Chart 43: Developments in gross short-term external debt based on residual maturity



The decline in the short-term external debt of the economy continued in Q4 2015. Short-term external debt fell by almost EUR 600 million, which was influenced by the general government and the banking system in almost equal measure.

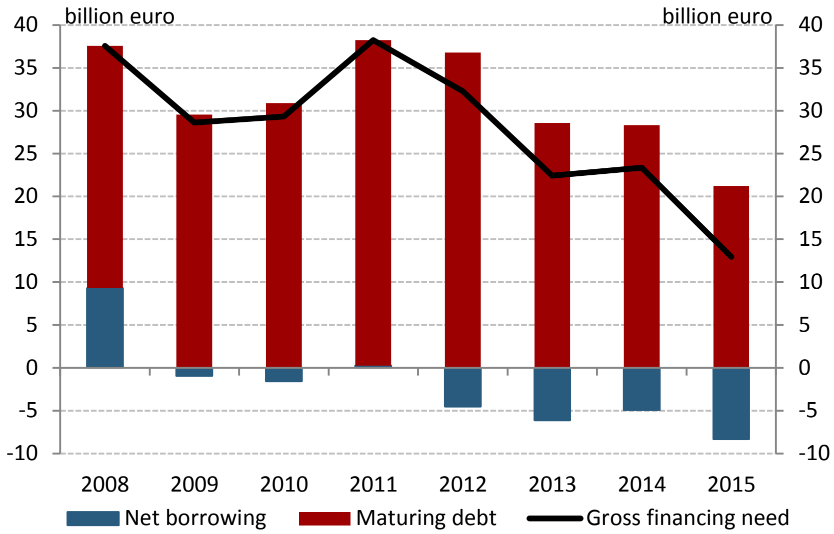
- The decrease in the short-term external debt of the *consolidated general government* was supported by the fall in both the originally short-term debt and in originally long-term debt. The short-term external debt of the sector based on original maturity decreased by almost EUR 170 million, primarily due to the drop in the Treasury bill holdings of non-residents. Amortising debt was also lower than at the end of the third quarter, which was basically due to the Government Debt Management Agency's prepayment of a development loan from an international organisation. Overall, the originally short-term external debt of the general government decreased to the level observed before the crisis.

- The short-term external debt of the *banking system* based on residual maturity fell below EUR 8 billion in the fourth quarter, which has been unprecedented since 2005. The decrease was mainly due to the originally short-term debt, which was slightly offset by the expansion of the sector's amortising debt. The tightening of FFAR rules and the introduction of the FECR regulation on 1 January 2016, the adjustment due to the forint conversion and banks' deleveraging may have all played a part in the fall in banks' short-term external debt.

- The short-term external debt of the *corporate sector* did not change significantly in the fourth quarter and stood at the same level at end of the year as in previous years.

The gross external financing need of the country dropped below EUR 13 billion, which was influenced by the continued decrease of the maturing debt and the strong net lending (Chart 44). The debt maturing in 2015, amounting to around EUR 21 billion, was lower than in previous years, which has been unprecedented since the start of the crisis. The marked contraction of maturing debt in recent years reduced the dependence on external funds, and thereby also external vulnerability. In addition, the net lending of the economy also increased to over EUR 8 billion, therefore the difference between the two, i.e. gross financing need dropped to below EUR 13 billion. Although gross financing need has fallen by almost EUR 25 billion since 2011, it still indicates a dependence on the inflow of external funds, which may pose a risk in case of a potential future liquidity shortage.

Chart 44: Developments in the gross financing need



3.5. Reserve adequacy

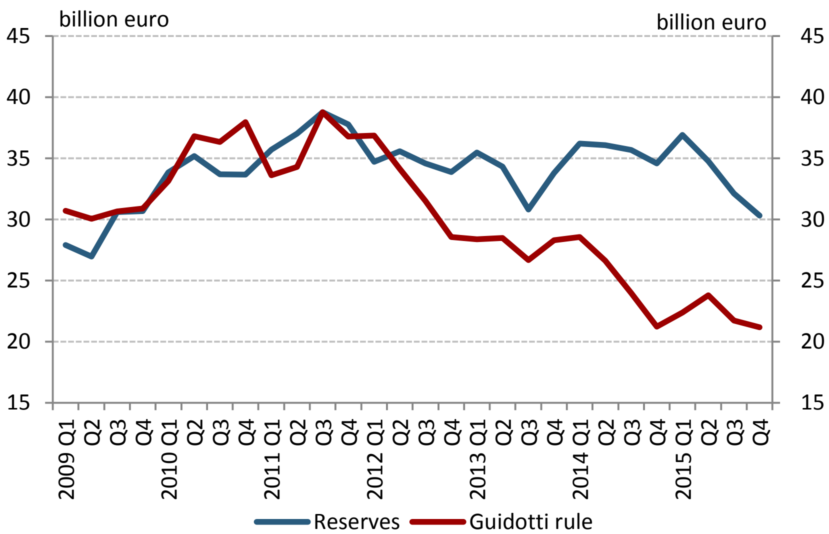
Foreign currency reserves decreased in 2015 Q4, primarily due to the Government Debt Management Agency's foreign currency transactions and the drawdown of swap instruments in connection with the conversion of households' foreign currency loans. At the end of 2015, international reserves amounted to EUR 30.3 billion, representing a decline of EUR 1.8 billion compared to the level in September 2015. The inflow of EU transfers amounting to EUR 1.7 billion contributed to the increase in reserves, but this only partially offset the reserve-reducing impact of several factors.

- The main reason behind the fall in foreign currency reserves was the repayment by the Government Debt Management Agency of its foreign currency debt, which reduced reserves by EUR 1.3 billion overall. The foreign currency operations of the Government Debt Management Agency other than a loan repayment were linked to the maturity of the PEMÁK bonds.
- The maturing foreign currency swap transactions linked to the forint conversion of household foreign currency loans also reduced reserves.
- In addition, the foreign currency spent in the conversion of foreign currency consumer loans also depleted foreign currency reserves.
- The MNB's foreign currency bond purchase also contributed to the decrease in foreign currency reserves.
- Finally, the level of foreign currency reserves was also influenced by several minor factors: the foreign currency expenditure of the Hungarian State Treasury, the one-week foreign currency swap instrument of the MNB announced at the end of the year and providing EUR liquidity to banks, as well as repayment of the MNB's foreign currency bond debt.

Mainly due to the MNB's programmes reducing foreign currency reserves, reserves fell by almost EUR 4 billion over the course of 2015. The swap maturities of the unconditional instrument linked to the phase-out of household foreign currency loans, the termination tenders held in connection with the unconditional instrument, and the drawdown of the foreign currency rolled over in one-week transactions within the framework of the conditional instrument reduced the level of reserves by EUR 3.2 billion during the year. Since the end of August 2015, the MNB has held several Swiss franc sale tenders in connection with the conversion of foreign currency consumer loans other than mortgage loans. By the end of 2015, banks used up most of the foreign currency acquired at the tenders, which amounted to EUR 0.5 billion. The self-financing programme of the central bank announced in 2014 continued in 2015. Banks responded strongly to the measures linked to the transformation of the policy instruments, and as a result their forint-denominated government securities holdings increased substantially. The steady demand for HUF-denominated government securities enabled the Government Debt Management Agency to shift its focus towards forint financing, which also contributed to the decrease in foreign currency reserves through the reduction of the government's foreign currency debt.[9] The Government Debt Management Agency repaid foreign currency debt in the amount of almost EUR 4 billion in 2015 without a bond issuance on international markets. The stronger-than-expected forint issuance also enabled the reduction of foreign currency debt quicker than planned, and therefore the Government Debt Management Agency prepaid both foreign currency loans and foreign currency bonds during the year. The combined effect of forint conversion and the self-financing programme was close to EUR 8 billion. Moreover, the other foreign currency transactions of the Government Debt Management Agency and the Hungarian State Treasury amounting to EUR 2 billion also reduced reserves during the year. The main factor offsetting the MNB's programmes and boosting reserves was the inflow of EU funds.

In addition to the decrease in foreign currency reserves, short-term external debt also declined, and therefore the volume of foreign currency reserves still substantially exceeds the level expected by investors (Chart 45). Based on the Guidotti–Greenspan rule (focusing on external debt maturing within a year), which is strictly followed by both investors and the central bank, the volume of foreign currency reserves of close to EUR 30.3 billion at the end of 2015 significantly exceeds the level of short-term external debt amounting to EUR 21.2 billion. Short-term external debt decreased by EUR 0.6 billion in the fourth quarter, which was primarily linked to the decrease in the short-term external debt of the banking system and the general government. Foreign currency reserves significantly exceed the level expected by investors from the perspective of other reserve indicators as well (for example the import rule or the reserve indicator closely monitored by the IMF).

Chart 45: Developments in foreign currency reserves and the Guidotti indicator



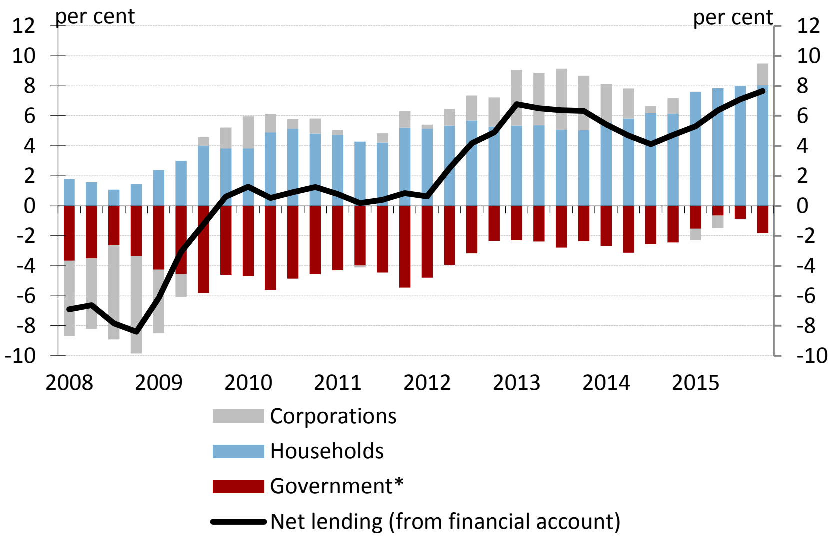
[9] In order to repay its foreign currency debt, the Government Debt Management Agency bought foreign currency from the central bank from its rising forint deposits.

4. SECTORS' SAVINGS APPROACH

The strengthening net lending in 2015 was mainly linked to the rising financial savings of the private sector, but the state's net borrowing also decreased year-on-year. Net savings of the private sector reached a historic high in the fourth quarter, which was attributable to the increasing income of households, the continued dominance of the precautionary motive, the sluggish loan demand and the subdued investment activity of companies. The net lending of the general government rose slightly at the end of the year, but the figure of below 2 per cent for the four quarters can still be considered exceptionally favourable. The low net borrowing of the general government was due to the rising tax revenues and decreasing interest expenses, in parallel with the expansion of the real economy.

According to the savings approach, the net lending of the economy grew slightly in 2015 Q4, influenced by the expansion of companies' net savings and the slight increase in the general government's net borrowing which exerted the opposite effect (Chart 46). As the aggregate savings of the domestic sectors are reflected in the financing of non-residents, the sum of the financial savings of domestic sectors equals external net lending. The four-quarter net lending of households reached a historic high of above 8 per cent of GDP at the end of 2015, which was achieved in the context of subdued borrowing and the substantial expansion of financial assets, in addition to the one-off effect of the settlement. The net borrowing of the consolidated general government rose at the end of the year, but remained below 2 per cent of GDP. The fairly low net borrowing was supported mainly by rising fiscal revenues linked to the expansion of consumption and higher employment, as well as decreasing interest expenses. After a mid-year slump due to the one-off impact of foreign currency loan settlements, the corporate sector contributed significantly to the financing of the country once again, which was attributable to incomes stabilising at a high level and the slowdown of investments.

Chart 46: Net lending of the individual sectors (four-quarter values relative to GDP)

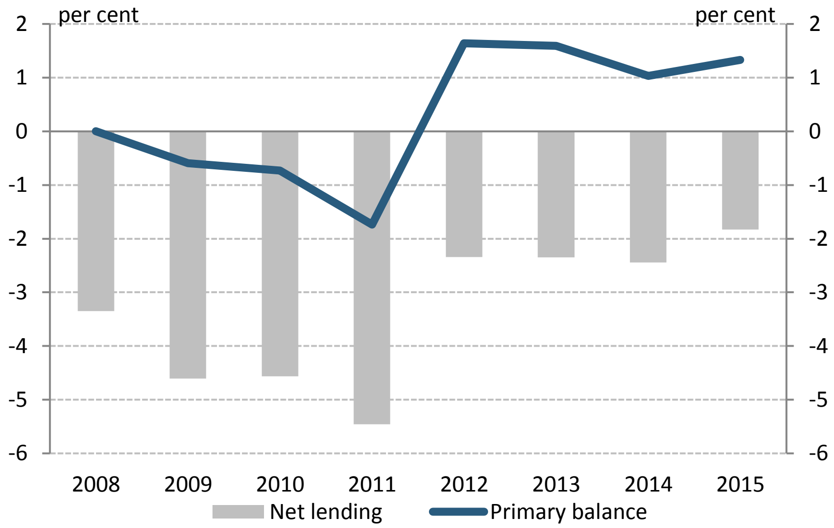


Note: * "General government" represents the net borrowing of the government according to the financial accounts. "Corporate" was determined on the basis of the residual principle.

4.1. General government

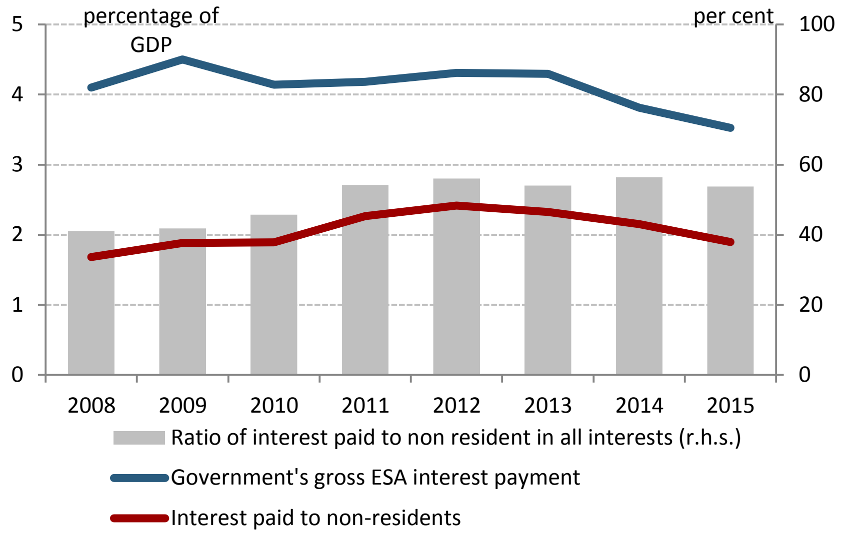
In 2015, the net borrowing of the general government remained at the historically low level characteristic since 2012 (Chart 47). The budget deficit declined slightly more in 2015 than in previous years, and the 1.8 per cent figure achieved was the lowest deficit relative to GDP since the political transition. The improvement in the general government balance was chiefly due to falling interest expenses, dynamically rising revenue and disciplined budget management on the expenditure side. With the increasing wage outflows and the rising consumption spending of households, the expansion of the real economy boosted the tax base and the contribution base, and thus the revenue side of the budget. On the expenditure side, the value of financial transfers relative to GDP continued to decline in 2015, which was principally due to the GDP-proportionate reduction in pension expenditures, which however increased in terms of purchasing power. The volume of EU subsidies reached its highest level ever in 2015, which increased both budget revenue and expenditure, and affected the balance to the extent of the state's own contribution (and indirectly through the tax revenues generated by stimulating the economy).

Chart 47: Developments in the net lending of the general government (relative to GDP)



In parallel with the decrease in the government's interest expenses, interest paid to non-residents declined. The fall in the general government's gross interest expenses that started after 2013 continued last year, dropping to 3.5 per cent in 2015 – well below the approximately 4 per cent observed before the 2008 global crisis on the financial markets – thereby improving the budget balance (Chart 48). The central bank's programmes (rate-cutting cycles, self-financing programme), the stable domestic macroeconomic situation and falling government securities market yields on account of the accommodating international environment all contributed to the reduction in gross interest expenses. The interest expenses of the state follow the fall in yields slower, as longer-term debt is only gradually repriced to a lower interest rate level. From the perspective of the income balance in the balance of payments, it is worth noting that the share of interest paid to non-residents by the state within all state interest payments declined further in 2015, reflecting the change in the ownership structure of government debt. Non-residents' holdings of HUF-denominated government securities decreased by HUF 900 billion, while foreign currency-denominated government securities dropped by HUF 300 billion in 2015, and as a result the proportion of foreign ownership within total debt sank to below 50 per cent. Due to all of the above, the interest paid to non-residents dropped to below 2 per cent of GDP overall, marking the lowest figure since 2010 and contributing to the improvement of the current account.

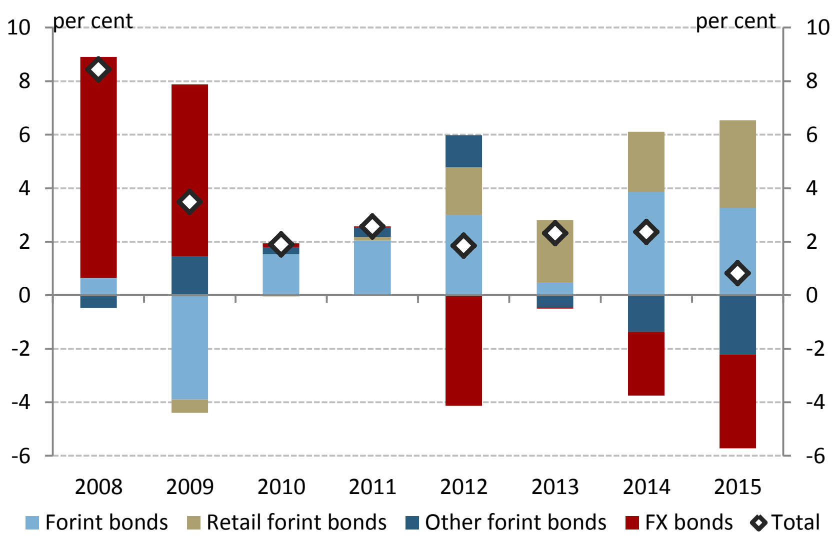
Chart 48: Developments in the interest expenses of the general government



Note: Data do not contain the imputed interest expenses incurred since 2012 on account of the pension system reform.

The debt issuance of the state was historically low in 2015, while the weight of domestic sources of financing within the financing structure of the general government continued to grow substantially, which reduced the dependence on non-residents (Chart 49). The role of HUF-denominated retail securities in financing has increased considerably since 2012. The net issuance of retail securities between 2006 and 2011 was negative on an annual average, i.e. their volume decreased. However, in 2012 issuance jumped dynamically, and the annual increase in their stock reached 3.3 per cent of GDP by 2015. In parallel, the role of HUF-denominated bonds also increased, due to demand by foreign investors and later by the banking system, partly on account of the MNB's self-financing programme. The stable expansion of forint liabilities provided increasing coverage for financing the annual government deficit and higher repayment of the maturing foreign currency debt. Since the majority of foreign currency bonds is in the hands of non-residents, increasing forint financing also considerably reduces the foreign share of government debt.

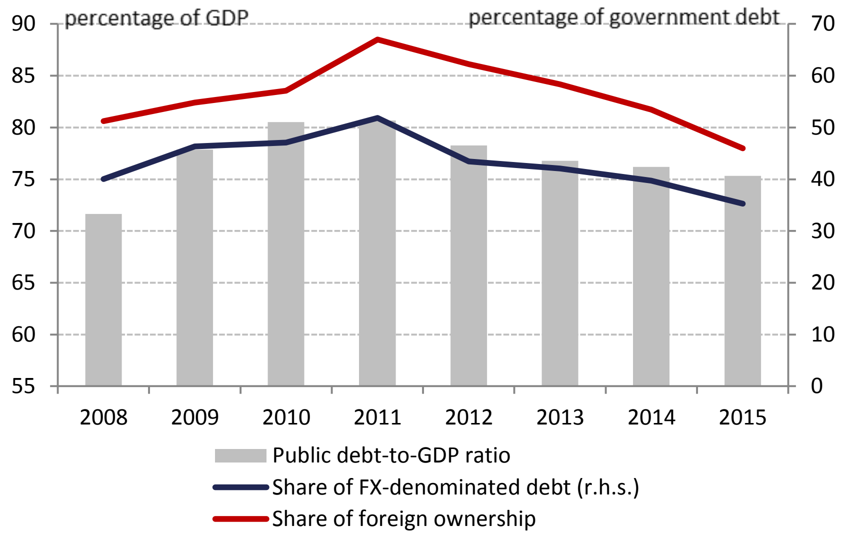
Chart 49: Structure of the Government Debt Management Agency's annual net debt issuance (relative to GDP)



The downward trend in gross government debt relative to GDP and within that the foreign currency ratio, as well was the proportion of foreign ownership within government debt observed since 2011 continued last year (Chart

50). By the end of 2015, gross government debt relative to GDP had dropped to 75.3 per cent. Thus, the Hungarian debt ratio declined by 5.5 percentage points compared to the end of 2011 (while the average government debt ratio of EU Member States increased by a similar figure, amounting to 87 per cent). The key driver behind the structural change in government debt in the recent years was the growing demand for government securities by households and the domestic banking system. As a result, the proportion of foreign ownership within government debt decreased substantially, dropping from 67 per cent at the end of 2011 to 46 per cent by the end of 2015, i.e. below the level before the 2008 global crisis. Meanwhile, the foreign currency ratio, which was also at a historic peak at the end of 2011, sank by 17 percentage points to around 35 per cent by the end of 2015. Last year marked the fourth year in the downward trend of foreign ownership and foreign currency ratio, which plays a vital role in the steady decrease in Hungary's external vulnerability.

Chart 50: Developments in gross government debt and the proportion of foreign ownership and foreign currencies within that

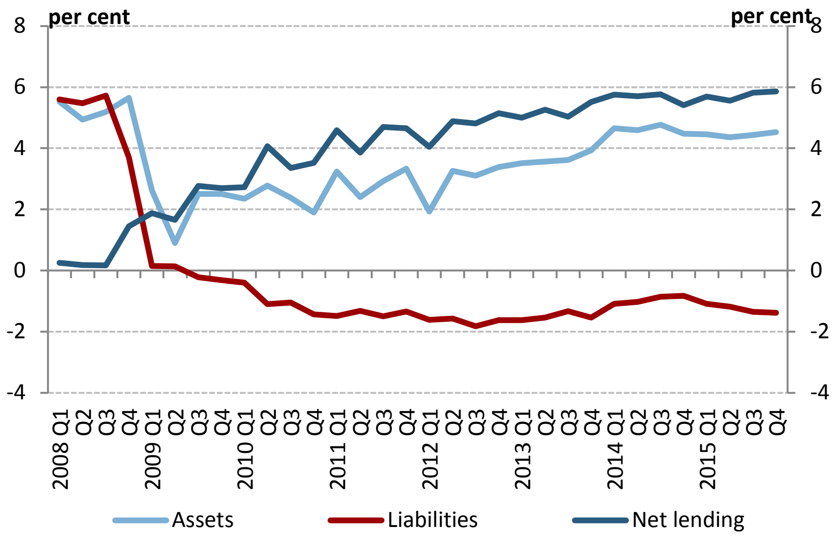


Note: The proportion of foreign ownership in 2015 is an MNB estimate.

4.2. Households sector

Based on underlying trends (without the settlement), the net lending of households stabilised at a high level, at around 6 per cent of GDP in 2015 Q4 (Chart 51). The high level of net savings was achieved because the seasonally adjusted asset accumulation and net borrowing remained practically unchanged. Net repayment in 2015 Q4 amounted to 1.4 per cent of GDP, which was attained in the context of higher gross borrowing and similarly increasing repayment as compared to the same period of the previous year. In connection with the forint conversion of vehicle loans at the end of the year, the lending facilities were modified: the so-called bullet loans (in which a major part of the principal is paid back on maturity) had to be converted into annuity loans, which entailed a rise in the repayment of principal. With respect to the underlying trends, the expansion of financial assets has been steadily massive since 2014 – amounting to 4.5 per cent of GDP in the fourth quarter – which continues to be supported by the rise in employment and wages. The gradual recovery in consumption in the context of substantial financial savings is enabled by rising incomes.

Chart 51: Net lending of households (seasonally adjusted revised* values, relative to GDP)

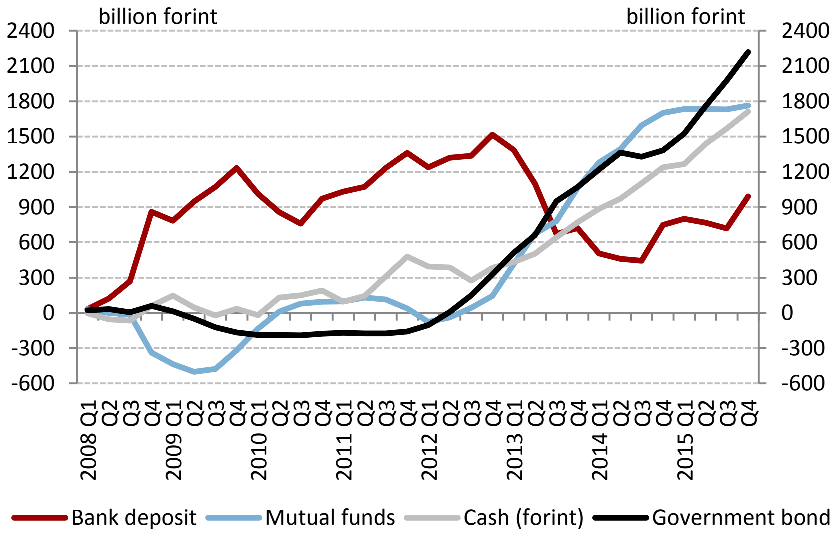


Note: Figures showing underlying trends, adjusted for the impact of pension savings, the early repayment scheme and real yield payment, the indemnification of the depositors at liquidated savings cooperatives as well as the forint conversion and settlement.

Throughout 2015, households' financial savings were affected by impact of the settlement and the conversion into forint. Based on underlying trends, the net savings of households amounted to 5.7 per cent of GDP, similar to the previous year. Despite the fact that gross borrowing by households has steadily been on the rise since 2013, the volume of loans gradually contracted in 2015, which was attributable to more intensive repayments. During the course of the whole year, the value of gross repayments was substantially influenced by the transformation of vehicle loans and settlement: the declining volume of credit exerted a mitigating impact on the size of the principal repayments by households, but the drop in interest rates entailed a rise in the proportion of principal within the instalments – and thus in repayments – and this was stronger than the previous effect. Holding financial institutions accountable for the unfairly charged costs and the forint conversion of consumer loans at preferential rates reduced total credit, and thereby improved the net lending. Taking into account the effects of the measures, the net annual financial savings of households reached 8 per cent of GDP.

The composition of households' financial assets was primarily shaped by the government securities purchases from new savings, which, coupled with the MNB's self-financing programme, contributed significantly to reducing the foreign dependence of the state (Chart 52). The structural change in households' financial asset portfolio was mainly influenced by new savings, but a slight realignment of bank deposits and government securities was observed in 2015. Mainly due to seasonal effects, the volume of bank deposits rose at the end of the year after a slight decrease in the first three quarters, while government securities holdings expanded dynamically during the whole year. The heightened demand for government securities in the context of low interest rates may have been supported by the continued yield spread compared to bank deposits, as well as a rapid rise in income and the expansion of financial savings on account of the settlement. Following its rise since 2012, the volume of investment fund units stabilised in early 2015 at a high level, which may be linked to the termination of the rate-cutting cycle. The demand for investment fund units shifted towards bond funds due to the higher potential gains during the rate-cutting cycle, which after the termination of the cycle – on account of the deceleration of government securities' price increases – became a less attractive investment opportunity, and therefore purchases of investment fund units slackened. The upward trend in households' cash holdings continued in the whole of 2015, which was attributable to the environment of low inflation and low yields, as well as the expansion of consumption.

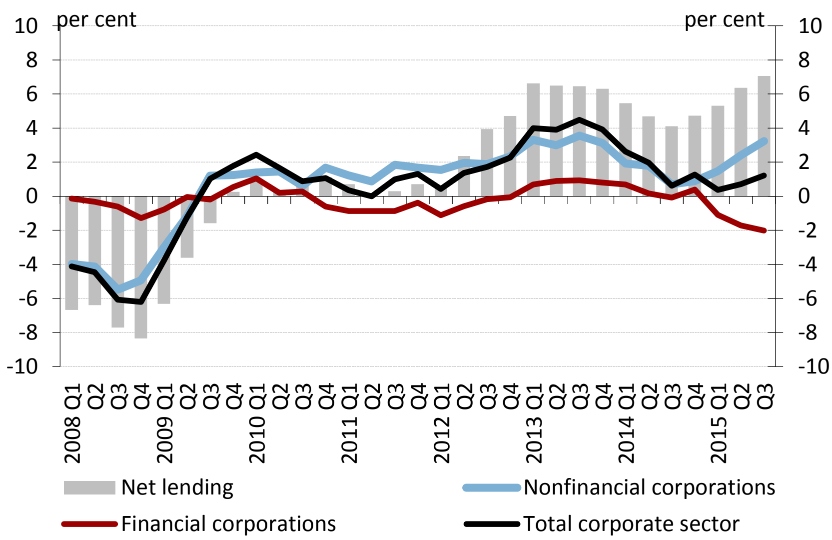
Chart 52: Developments of households' key financial assets (cumulative transactions)



4.3. Corporate sector

Although the external net lending calculated from the financing side substantially expanded again in 2015, the financial savings of companies had a moderate impact on this. The net lending of the whole corporate sector grew from 0.4 to 1.2 per cent of GDP until the third quarter, which was the result of the conflicting processes observed in the case of financial and non-financial corporations (Chart 53). The slight increase in the net lending of non-financial corporations may have been supported on the one hand by the decline in corporate investments, and on the other hand by favourable income trends, which were partly due to EU transfers. The net lending of financial corporations is well below zero, which is characteristic of the sector over the longer term, and this may be due to the one-off impact of the foreign currency settlements that primarily emerged in Q1.[10]

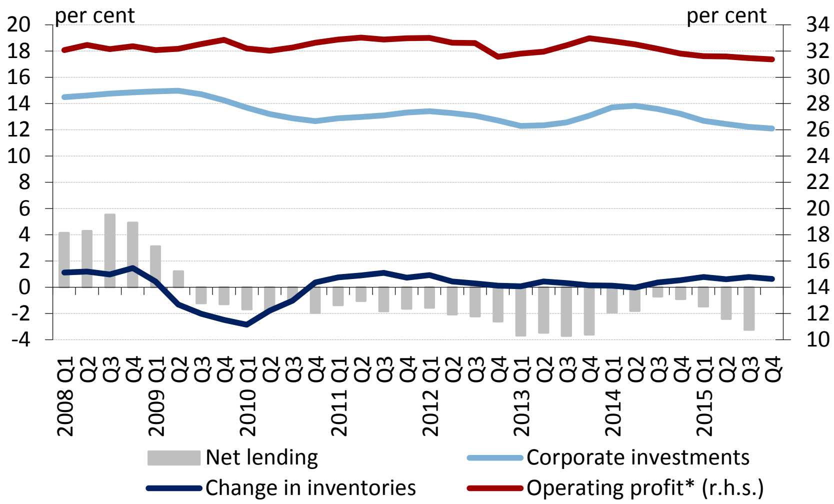
Chart 53: Net savings of corporations and net lending (four-quarter values relative to GDP)



[10] The net lending of financial corporations is mainly influenced by the profits or losses of the sector, and the change in their non-financial assets (e.g. properties). However, in addition to these, the crisis and later the losses incurred during the early repayment scheme and the foreign currency settlements also substantially influenced the position of the sector: the difference between the market rate and the fixed exchange rate, and the foreign currency settlements as a capital transfer provided to the household sector reduced the net lending of banks, while at the same boosting households' net financial savings.

The net lending of non-financial corporations increased substantially once again during the year, to over 3 per cent of GDP, which was primarily attributable to the slowdown in investment dynamics and the presumably rising profitability. In Q3, similar to earlier in the year, the investment performance of companies producing for the domestic and the external markets was both subdued (Chart 54). Investments in manufacturing may have been dampened by the earlier realisation of large automotive industry investments. Meanwhile, agricultural investments also fell, which may have been influenced by the expiry of the Funding for Growth Scheme. In addition, muted inventory investment also contributed to higher financial savings. In parallel, the operating results of non-financial corporations capturing income developments remained more or less stable in 2015. However, the considerable rise in corporate tax revenues collected by the state suggest favourable income developments in the sector. The expansion of EU transfers and the reduction of corporate interest expenses due to decreasing indebtedness and interest rates all pointed towards the higher profitability of the sector, and thus towards rising financial savings.

Chart 54: Non-financial corporations' net borrowing as a percentage of GDP and the main underlying real economy factors (four-quarter values calculated from national accounts)

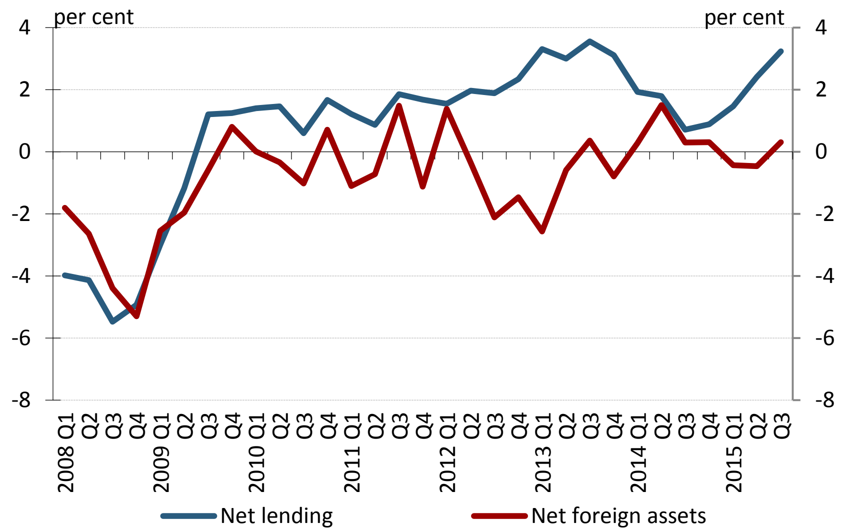


Note: * Indicator adjusted for companies' interest and property income.
Source: HCSO, MNB

In a financing approach, the rise in net corporate savings was achieved in the context of external financing hovering around zero. The substantial decline in corporate debt typical in the first half of the year continued in Q3 as well, due to more intensive loan repayments and the decrease in commercial loans.[11] The inflow of equity-type funds decelerated in the first three quarters of the year owing to higher dividend payments and reinvested earnings, the value of which was slightly below the amount observed in the previous year, but from the perspective of external financing, the drop in companies' external debt was offset anyway (Chart 55). The increase in corporate net lending was therefore mainly attributable to the expansion of domestic deposits and domestic repayments.

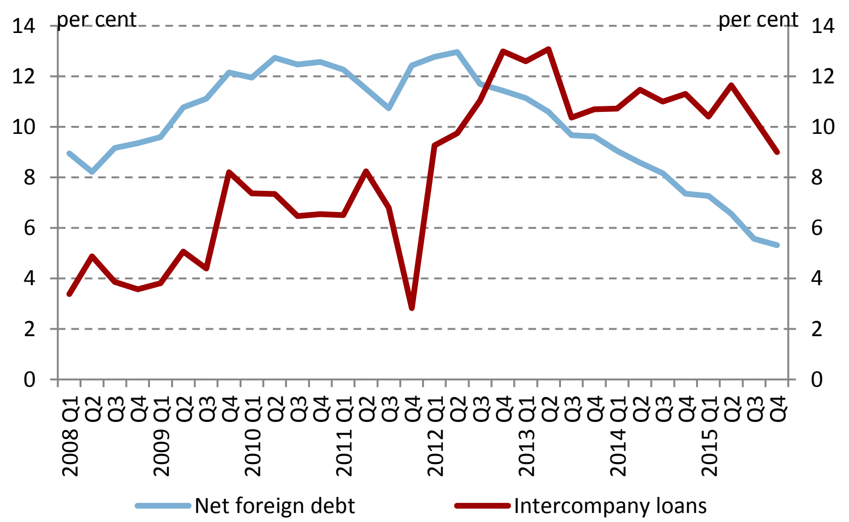
[11] Since foreign-owned companies often pass substantial amounts of funds through their subsidiaries in Hungary, and since companies often considerably rearrange their portfolio, only the net transactions in external assets and liabilities are worth examining.

Chart 55: Net lending and net external transactions of non-financial corporations (four-quarter values relative to GDP)



The decrease in the proportion of foreign loans within companies' external liabilities continued, while at the end of 2015 the net volume of intercompany loans also fell. Intercompany loans provided stable funds for foreign companies after the crisis. While debt-type funds steadily decreased from 2012, the indicator capturing intercompany loans provided by the parent company relative to GDP stabilised at a high level. In this respect, there was a change at the end of 2015, as net intercompany loans decreased to 9 per cent of GDP. At the same time, the adjustment in companies' net foreign loans observed in recent years continued: the volume of net foreign loans – in the context of a smaller decline in assets and a greater drop in liabilities – fell further.

Chart 56: Volume of foreign and intercompany loans of non-financial corporations (relative to GDP)



5. INTERNATIONAL COMPARISON

In 2015, the net lending and growth rate of the Hungarian economy remained considerable compared to the EU countries. Among the countries of the region, Hungary has the highest current account surplus, mainly driven by the high absorption rate of EU transfers and the foreign trade surplus arising from new industrial capacities and improving terms of trade. In parallel with this, as the outflow of debt liabilities significantly surpassed the levels seen across the region, Hungary's substantial adjustment continues. In addition to the persistently low budget deficit, significant private sector savings also contributed to the robust net lending position. The resulting decline in the external debt ratios of the economy also points to a marked moderation of the previously observed external imbalances. This assumption is supported by the significant improvement in several key indicators relevant to external vulnerability: for example, Hungary's net international investment position and external debt dropped to the level of Poland from the previously recorded regional peaks. At the same time, the gross external debt of the country is still high in regional terms. Importantly, however, by 2015 Hungary's gross financing need based on original maturity – which had posed severe financial risks in the past – had improved significantly, with Hungary recording the lowest value in the region.

Examining Hungarian balance of payments data in an international context, this chapter mainly focuses on comparing Hungary with other countries in the region, briefly noting some of the processes that set Hungary apart from the rest of the countries. The external balance developments of Hungary are best captured by making comparisons with two groups of countries. One of these groups comprises countries whose accession to the European Union coincided with Hungary's entry, which have thus faced similar challenges in recent decades as Hungary. On the other hand, a comparison with Southern European economies may also be useful as Hungary's vulnerability at the outbreak of the crisis – owing to its significant indebtedness – was comparable to that experienced in Southern European countries, which, in theory, could have prompted them to carry out similar adjustments. In reality, however, while Hungary reduced its external debt to a large degree during the post-crisis adjustment, the debt ratio of Mediterranean countries either stagnated or in fact increased (which may have partly resulted from the use of the single currency, which impeded the adjustment of Mediterranean countries). Thanks to the gradual adjustment of external debt indicators, by the third quarter of 2015 Hungary's net international investment position as a percentage of GDP declined to the levels observed in Poland and in Slovakia. This development confirms that Hungary's external balance should be compared to that of its Visegrad peers as, in many regards, they bear more similarities to Hungary than any other countries in Europe.

5.1. Net lending and growth

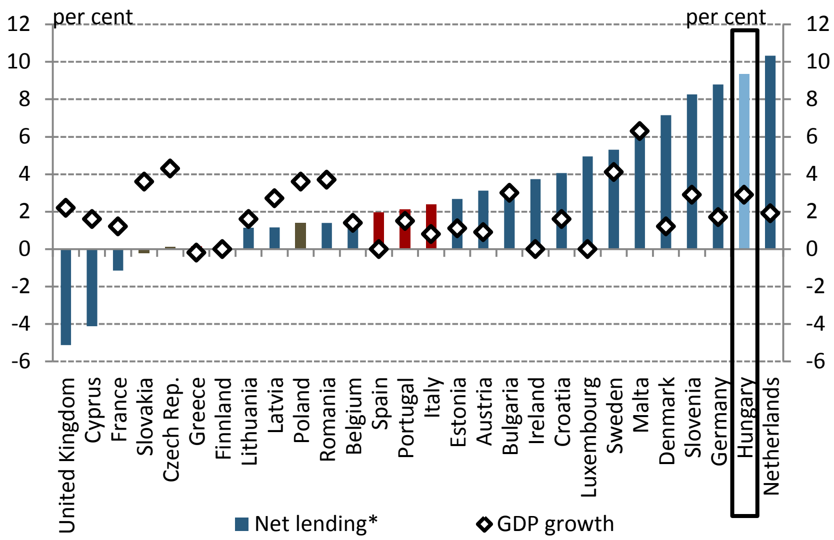
In 2015, Hungary recorded one of the highest net lending levels in the European Union, while the growth of the economy remained relatively dynamic (Chart 57). Hungary's net lending continued to rise throughout 2015, and thus reached one of the highest values among the 28 Member States of the European Union. From the side of the real economy, the rise in Hungary's net lending can be mostly explained by a further improvement in the balance of trade and the accelerated utilisation of EU transfers, which, on the financing side, was accompanied by a decline in external debt. Economic growth slowed somewhat compared to the outstanding value of the previous year, but still remained above the European Union average. The high net lending and economic growth show the following linkages:

- Boosted mainly by the surplus on the balance of goods, the foreign trade surplus was one of the key drivers of net lending and economic growth. Exports already surpassed imports in 2014, not only in volume but also in dynamics, as decelerating investment restrained import growth. As a result, the contribution of net exports to growth remained strong. The foreign trade surplus was further boosted by the improvement in the terms of trade in the context of falling oil prices.

- In addition, the further expansion of the transfer balance (in particular, the accelerating absorption of EU funds), also made a sizable contribution to the high net lending. While EU transfers played a significant role in the expansion of government investment, after the robust growth of previous years, private investment did not increase perceivably; thus, overall, the contribution of investment activity to economic growth was far less pronounced in 2015 than before.

- As regards the financing side, the repayment of foreign loans was remarkably dynamic in 2015. Reflecting the conversion of foreign currency loans and regulatory changes, debt reduction was particularly pronounced in the banking sector. In addition, firms continued to reduce their debt even in the face of the increase observed both in profitability and reinvested earnings in recent years. This may suggest that – partly driven by the settlement of foreign currency loans – the adjustment of banks and companies is still in progress, and in the context of repaying inter-company and foreign bank loans they are restraining their investment activity.
- Overall, however, the continued external adjustment of the economy and the steep decline in liabilities vis-a-vis the rest of the world coincided with economic expansion in 2015 as well.

Chart 57: Net lending and economic growth in 2015



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

The next section provides a more detailed description of the real economic factors that shaped net lending in regional economies with a similar level of development as Hungary (export performance, competitiveness, terms of trade). 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 liabilities and external debt.

5.2. Net lending and its real economic factors

Hungary's net lending as a percentage of GDP increased further last year and now significantly exceeds the levels recorded by its peers in the region (Chart 58).[12] In Q3, Hungary's four-quarter net lending continued to rise and stood at around 9 per cent of GDP; thus, as was the case in previous years, the Hungarian indicator well exceeded the values recorded in the region (1 to 3 per cent).

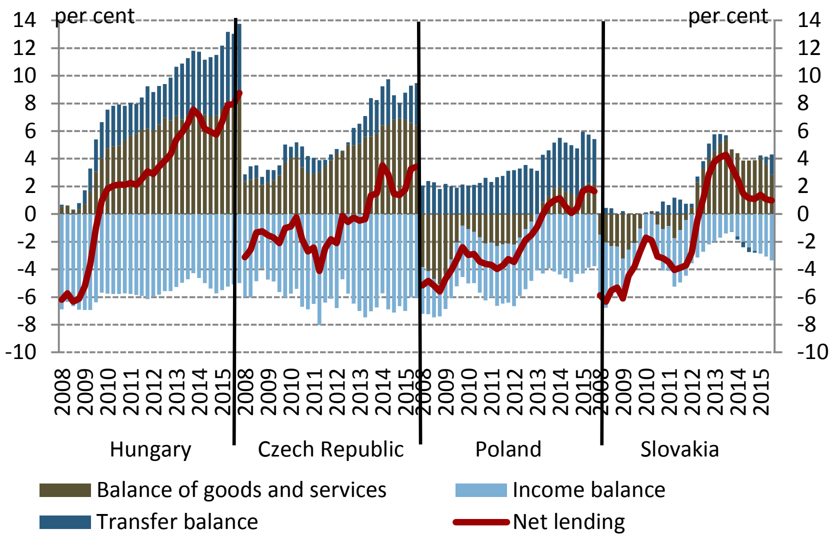
- Hungary registered the highest surplus on the *balance of goods and services* in the region, amounting to nearly 9 per cent of GDP at the end of 2015. In the region, only the Czech Republic achieved a comparable result with a GDP-proportionate foreign trade surplus of 6-7 per cent, which made a significant contribution to the improvement in the external position of the Czech economy. Similarly, in Slovakia positive net lending was mainly attributable to the trade balance surplus, but its level gradually declined during the year. This

[12] Data are available until Q4 for Hungary and until Q3 for the rest of the countries.

may reflect the share of the automotive industry, which is comparable to its weight in Hungary: relative to exports, Slovakia and the Czech Republic record the highest value added in the sector. Despite a gradual improvement, Poland continued to report the lowest foreign trade surplus in the region as a percentage of GDP.

- The Czech Republic and Hungary continued to face the largest *income balance* deficits in the region. The Czech deficit essentially resulted from the high profit of at least partly foreign-owned companies (for more details, see the September 2015 *Report on the Balance of Payments)*, while Hungary also saw a significant increase in this factor in 2014, although the interest paid on external debt is also relatively high.
- Approaching the end of the EU's 2007–2013 budget cycle, the *transfer balance* rose in every country in the region. There is no perceivable difference between the countries of the region in terms of the efficiency of the drawdown of the cohesion funds. At the same time, Hungary and Poland exhibit the highest absorption levels, which may be partly due to the favourable allocation amount. In the region, Hungary and Poland are expected to utilise the funds allocated in the budget cycle in full and avoid a loss of funding, while the Czech Republic is likely to face a minor, and Slovakia a more significant loss of funding (to be discussed in more detail later in the Report).

Chart 58 Current accounts and capital accounts of Visegrad countries (four-quarter data as a percentage of GDP)

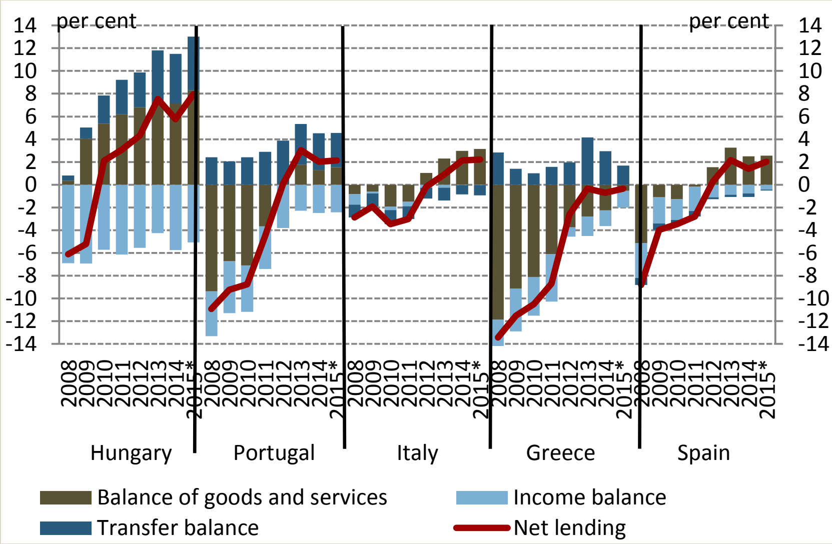


Source: Eurostat, national central banks

Box 1: Developments in the balance of payments in the Mediterranean countries

Hungary's net lending exhibited a significantly higher surplus than the corresponding value in Mediterranean countries. Adjustment was more dynamic in Hungary after the outbreak of the crisis, and thus the current account showed a surplus as early as 2010. By contrast, it was only around 2012 that net lending turned positive in Mediterranean countries, possibly because – due to the sovereign debt crisis – resident participants were forced to make adjustments only later. In most countries, it was the surplus on the balance of goods and services that contributed to the greatest extent to the net lending (only Greece recorded a deficit); this surplus, however, falls significantly short of the Hungarian foreign trade surplus. The transfer balance exhibits a surplus both in Greece and Portugal, mainly owing to EU transfers. It should be noted that the deficit on the income balance is far higher in Hungary, despite the fact that its net external debt level is well below the levels recorded in Mediterranean countries, which probably reflects the previously prevailing extremely low interest rates and the positive income effects of FDI investments abroad.

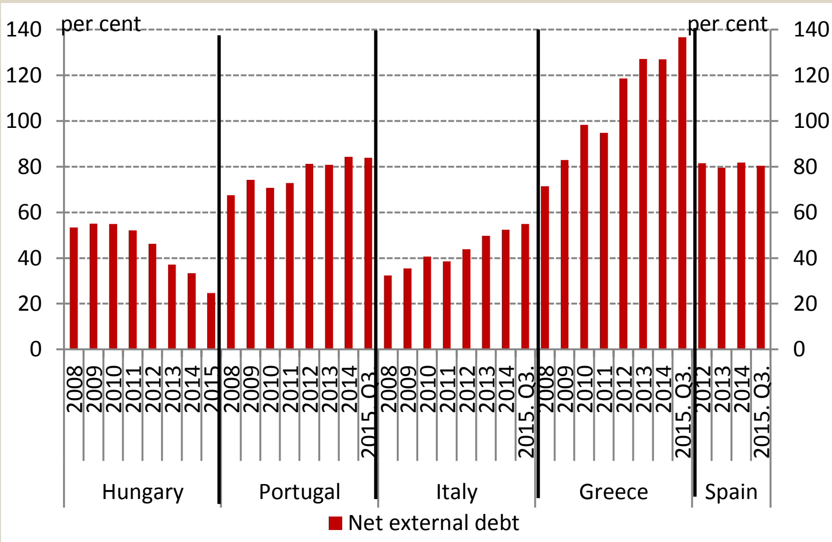
Chart 59: Current accounts and capital accounts of Mediterranian countries (as a percentage of GDP)



Note: * Values for 2015 reflect four-quarter values calculated up to the third quarter.
Source: national central banks, Eurostat

In contrast to Hungary's declining external debt, the more severely indebted Mediterranean countries typically saw an increase in net external debt after the crisis. At the onset of the crisis, the outstanding external debt of Mediterranean countries was comparable to that of Hungary, but there was no adjustment in these countries after the crisis; in fact, their external indebtedness rose sharply for a few years after the sovereign debt crisis. As a result, the developments in Hungary's external debt ratios were very different from those seen in Mediterranean countries: while Hungarian net external debt was scaled back to 25 per cent of GDP by 2015, it was around 80 per cent of GDP in Portugal and Spain and nearly 140 per cent of GDP in Greece. The diverging trend of net external debt in the Mediterranean countries relative to Hungary may also be the result of the fact that, since they were part of the euro area at the outbreak of the crisis, adjustment through the devaluation of the exchange rate was not an option for these countries. At the same time, it is also true that they were able to avoid the revaluation of external liabilities.

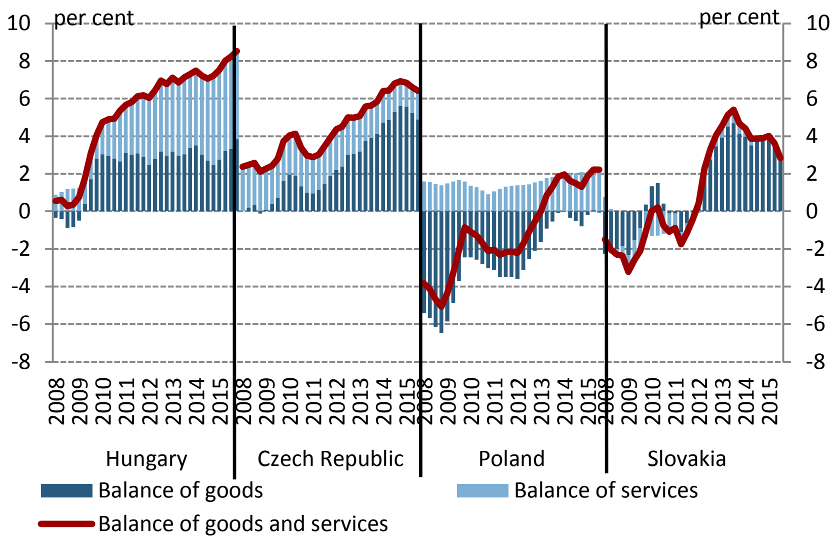
Chart 60: Net external debt of Hungary and the Mediterranean countries (as a percentage of GDP, without intercompany loans)



Source: national central banks, Eurostat

The high, rising value of Hungary's balance of services stands out in the region, while the increase recorded in the balance of goods in its peers may be related to the more restrained growth of high-import content investments. In the Czech Republic and Slovakia, where the automotive industry accounts for a relatively large share in industrial production, the surplus of the balance of goods is considerably higher than that of the balance of services. By contrast, in addition to the balance of goods, the surplus on the balance of services has made an increasingly large contribution to the net lending of the economy in recent years. To a large degree, this can be attributed to transportation, the continuing boom in tourism and the shared service centres established in Hungary. In Poland, the foreign trade surplus is essentially driven by the net exports of services, while the deficit of the balance of goods has decreased gradually since 2012 amid decelerating import dynamics stemming from the restrained growth of investment activity. In general terms, investment activity in Hungary has been more dynamic in recent years compared to its peers in the region: Investment growth exceeded the rate observed in other countries in the region by 9-10 per cent in 2013 and by 5-6 per cent in 2014 which, owing to its import content, may have contributed to the fact that the Hungarian balance of goods did not change notably.

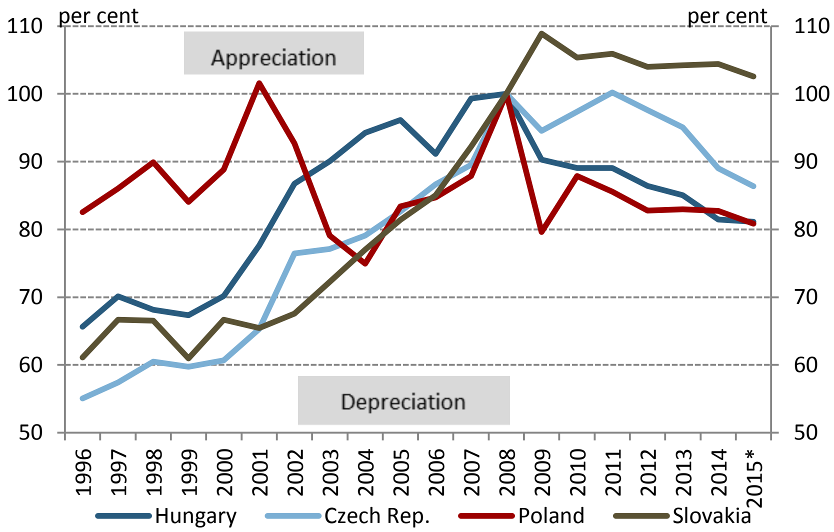
Chart 61: Distribution of the balance of goods and services of Visegrad countries (four-quarter values as a percentage of GDP)



Source: Eurostat

The labour cost-based real exchange rate points to a sharp devaluation in Hungary since 2008 (Chart 62). From the middle of the 1990s, the labour cost-based real exchange rate in the region tended to exhibit a gradual appreciation, which may partly reflect the productivity and hence, wage boosting effect of the substantial inflow of capital to the region. After the financial crisis, this trend reversed and real exchange rates started to depreciate, for the most part, in line with the depreciation of regional exchange rates. The real exchange rate of Slovakia diverged from the trend observed in its peers, which can be essentially explained by its accession to the euro area. During the years since the crisis, real exchange rates in Hungary and Poland continued on a downward slope, while the Czech real exchange rate initially strengthened after the crisis, but then depreciated significantly in the past few years. The decline can be mainly attributed to the fact that since November 2013 the Czech central bank has used the exchange rate of the Czech koruna as an additional monetary policy instrument to ease monetary conditions, and due to the decline in real wages in the Czech private sector in 2013 and 2014, as confirmed by Eurostat data.

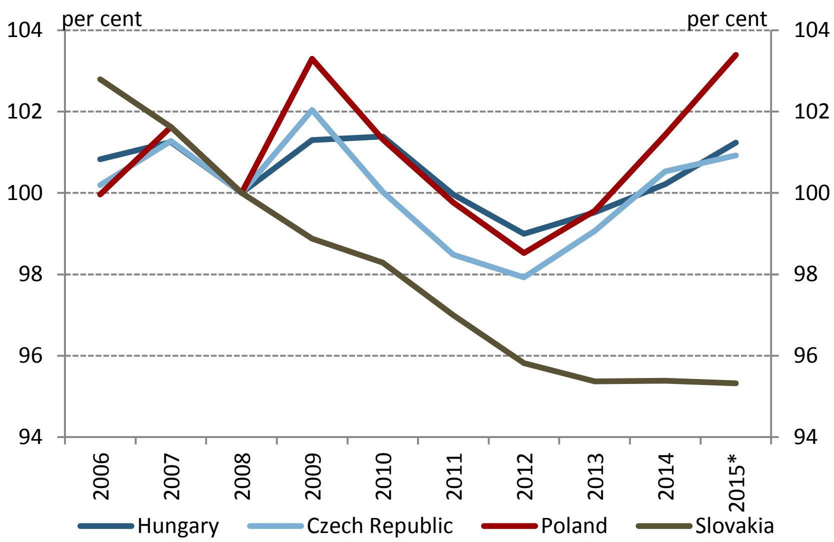
Chart 62: Changes in labour cost-based real exchange rate (2008 = 100; vis-à-vis 37 countries)



Note: *2015 value is based on the European Commission forecast.
Source: European Commission

As is the case in other countries with national currencies in the region, Hungarian terms of trade continued to improve last year. The globally low inflation environment and falling commodity prices have moderately increased the terms of trade in Hungary and its neighbouring countries in recent years. Because of robust energy imports, the improving terms of trade stemming from falling oil prices may already have increased the foreign trade balances of countries in the region, which may continue in view of the continued decline observed in commodity prices at the end of 2015.

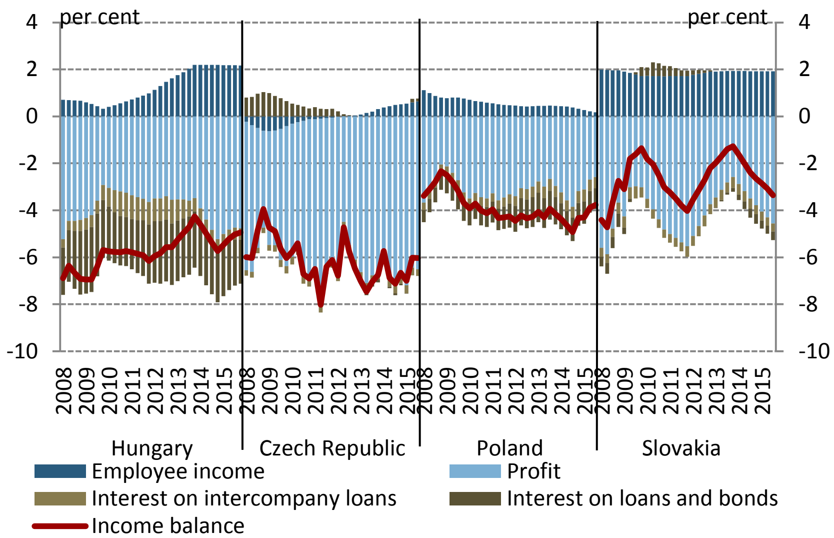
Chart 63: Changes in the terms of trade in the region (2008 = 100)



Note: *2015 value is based on the European Commission forecast
Source: European Commission

In a regional comparison, the net income paid abroad from the Hungarian economy was lower than the Czech value, but higher than the values observed in Poland and Slovakia. Although the net external debt of the Hungarian economy is gradually declining and starting to approach the level of Poland, the deficit on the interest balance is still significantly higher than the corresponding values in the rest of the region, including Poland. The higher deficit can therefore probably be linked to the protracted repricing of debt and higher gross public debt. Profits generated by the foreign direct investments of non-residents are still far higher in the Czech Republic, despite similar FDI volumes as in Hungary, which suggests the higher profitability of Czech companies. The incomes of workers temporarily employed abroad are similar in Slovakia and Hungary, while Poland records lower values, presumably because of the higher number of longer and more permanent relocations abroad.

Chart 64: Developments in components of the income balance* (four-quarter values as a percentage of GDP)



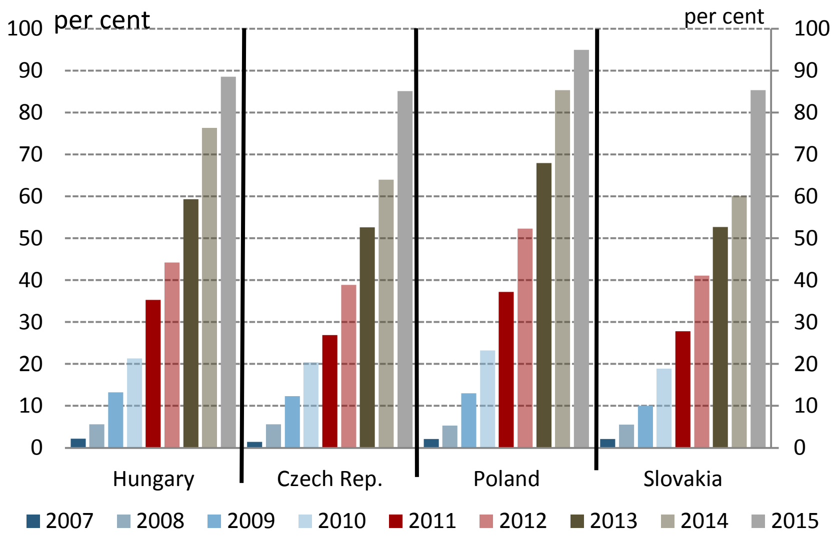
Source: national central banks

The absorption of cohesion funds is similar in the countries of the region, and most of the countries have already drawn down a major part of their cohesion funds (Chart 65)**.** According to the figures of the European Commission, Hungary's position in terms of the drawdown of cohesion funds is favourable among the Visegrad countries, as by the end of 2015 the European Commission had transferred 90 per cent of the funds.[13] Among the Visegrad countries, only Poland's absorption rate is higher: to date Poland has already drawn down more than 90 per cent of the allocation. The high absorption rate may reflect the considerable degree of infrastructure investment and the fact that, according to the State Audit Office, the distribution of EU funds is controlled by an efficient institutional system. With respect to the drawdown of cohesion funds, Slovakia lags behind the region, and the fact that the EU has cancelled several major public investment projects and project payments due to fraud and suspected corruption is likely to have played a significant role in this regard.[14] Although there are some suspended grant amounts in the case of Hungary as well, the state has a sufficient number of paid invoices to ensure the full absorption of EU funds even in case of a potential negative decision.

[2] The absorption rates show the amount transferred by the European Commission from the available allocation to the given Member State rather than the effective use of the EU transfers. The EU does not transfer the last 5 per cent of the grants to the Member State until the completion of the full review of the given grant (in relation to the 2007-2013 programming period the Commission is expected to make the payment in 2017-2018). Moreover, grants are generally transferred only after the submission of the last invoice on utilisation.

[14] State Audit Office of Hungary (2015): Study on the overview and evaluation of EU transfers to Hungary in the 2007-2013 EU budget period.

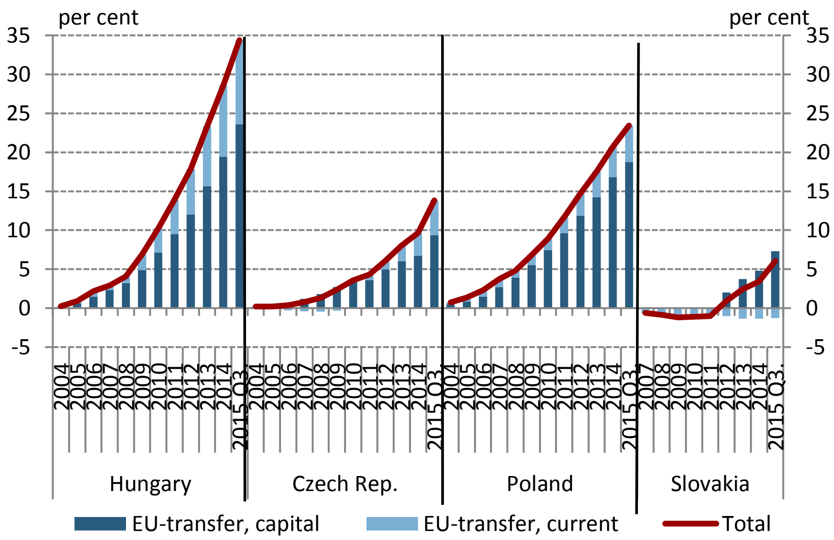
Chart 65: Absorption rate of cohesion funds in the region (as a percentage of the total allocation)



Source: European Commission, EU Cohesion Funding

Of the Visegrad countries, Hungary recorded the highest GDP-proportionate utilisation rate of EU funds until 2015 Q3 (Chart 66). Despite the fact that the absorption of cohesion funds was similar in the region, in Hungary the utilisation of the received EU resources in proportion to GDP considerably exceeded that of other countries of the region. In Slovakia, the utilisation of EU transfers remained relatively low by the end of the cycle, presumably because of substantial payments and the suspension of funds due to suspected fraud. In the Czech Republic, however, by 2015 Q3 the GDP-proportionate value of EU transfers was close to 15 per cent. The absorption of EU transfers was much higher in Poland, at 25 per cent, which was also reflected in the high drawdown of cohesion funds. GDP-proportionate indicators, however, demonstrate that the highest absorption rate of funds allocated in the previous EU budget cycle was recorded by Hungary: it was close to 35 per cent of GDP in 2015 Q3 and may have increased further at the end of the year. The higher GDP-proportionate utilisation can be partly explained by the fact that Hungary had a larger allocation amount from the previous EU budget cycle than its peers in the region which, based on the data available, may be true for the next cycle as well.

Chart 66: EU transfer use among Visegrad countries between 2004 and 2015 Q3 (cumulative values as a percentage of GDP)

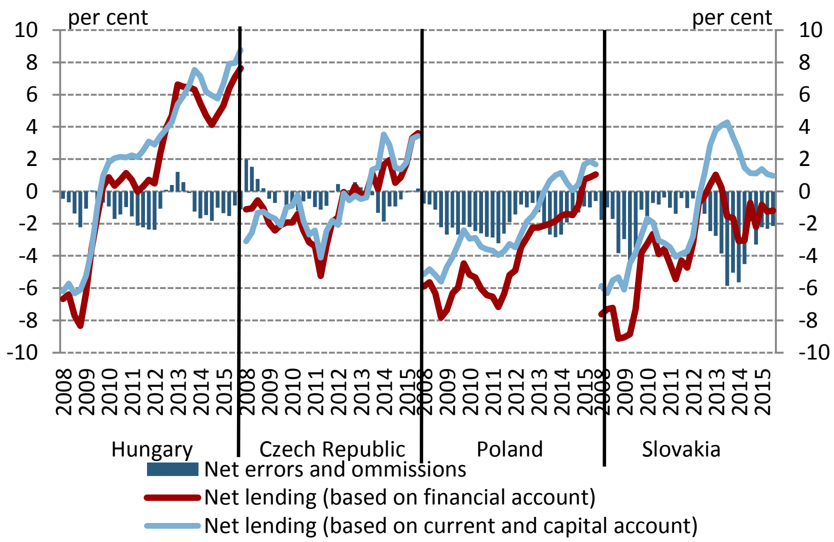


Source: Eurostat

5.3. Financing side developments

In the Visegrad countries, net lending calculated from the financial account side is generally lower than net lending calculated from the current and capital account side. "Net errors and omissions" show the difference between net lending based on the financial account side and net lending based on the current and capital accounts; therefore, this item indicates the difference between the statistics collected from different sources. For Hungary, both indicators point to a high, rising level of net lending, while the difference between the two indicators shrank to around 1 per cent of GDP, a value considered average in regional terms (Chart 67). Net lending calculated from the financial account is lower than net lending calculated from the current and capital account in all Visegrad countries. This means that the external liabilities of individual countries decline to a lesser degree than indicated by the amount of the current account and the capital account. The only major exception is Slovakia, where the current account and capital account balance showed a surplus in 2015, while the items of the financial account pointed to an increase in liabilities – in other words, despite the surplus on the current account and the capital account, the external debt of the country has increased in recent years.

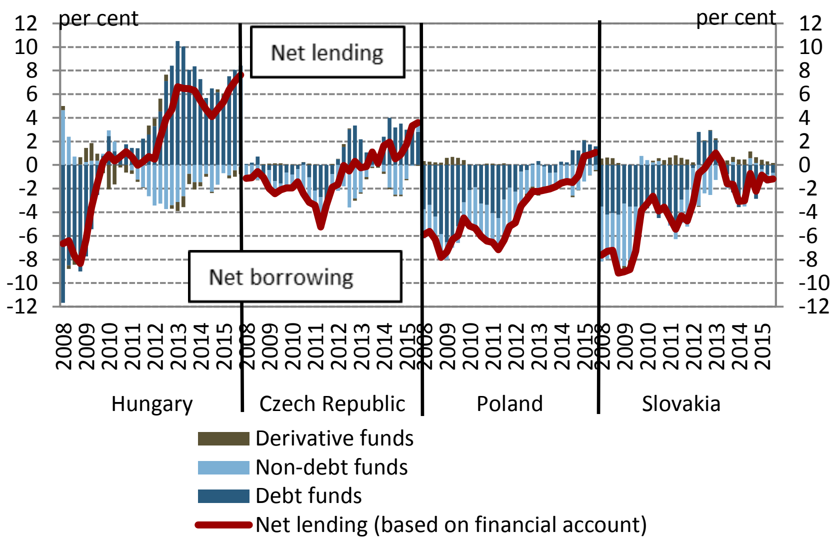
Chart 67: Net errors and omissions in Visegrad countries
(four-quarter data as a percentage of GDP)



Source: Eurostat, national central banks

Based on financing data, as in previous years, Hungary registered the highest outflow of debt-type liabilities. Except for Slovakia, all other Visegrad countries scaled back their external debt, and nearly all of them reported a declining inflow of non-debt type liabilities (Chart 68). In line with its very high net lending, Hungary's ongoing substantial adjustment in debt-type liabilities continues and as a result, the outflow of debt-type liabilities significantly surpassed the levels seen in the region. In Hungary, the decline in debt-type liabilities amounted to more than 9 per cent of GDP, while this ratio was in the range of 2-3 per cent of GDP in the Czech Republic and Poland. In the case of the Czech Republic, the contraction in net external debt may have been supported by the Czech central bank's measures: in an effort to ease monetary conditions further, it has maintained an exchange rate cap against the euro since November 2013 in order to weaken the Czech currency by selling koruna. As a result, the reserves of the Czech central banks grew by around EUR 16 billion, contributing to the decline in net external debt. It is important to note, however, that due the central bank's measures, the short-term external debt of the banking sector increased in parallel with the increase in reserves, as non-residents placed the koruna purchased from the central bank within the sector. By contrast, in Slovakia, debt-type liabilities rose slightly in 2015. The inflow of non-debt liabilities generally subsided in Visegrad countries in 2015, and by the end of the third quarter, it diminished to negligible values across the region.

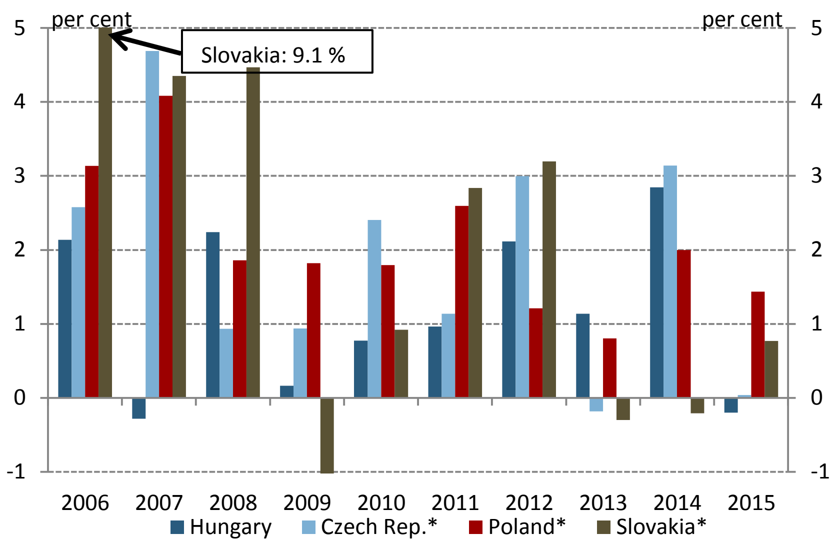
Chart 68: Net lending of Visegrad countries (four-quarter data as a percentage of GDP)



Source: national central banks, Eurostat

The inflow of FDI decreased significantly in all Visegrad countries in the wake of the financial crisis and has shown a similar trend in recent years. During the years preceding the financial crisis, all countries in the region saw significant inflows of FDI. These inflows, however, declined after the outbreak of the crisis, which also affected Hungary. As regards inflows of FDI in recent years, a similar downward trend appears to have taken hold. This may indicate that investors have a similar view of all countries in the region regarding the underlying trends, even in the face of country-specific factors that may still influence the FDI inflows of individual countries.

Chart 69: Net FDI inflow in the Visegrad region (as a percentage of GDP)



Source: Eurostat. *Four-quarter data up to 2015 Q3

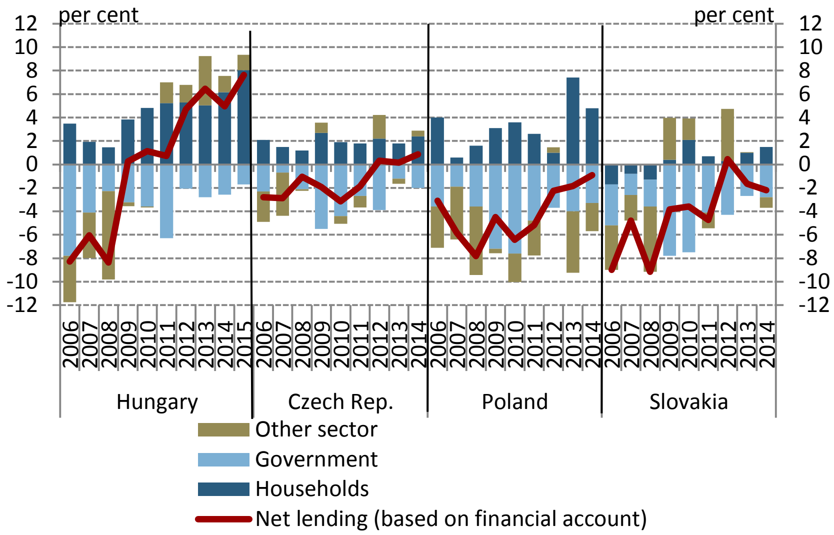
5.4. Savings side developments

Net lending based on financial account data is close to 0 per cent in the region, except in Hungary, which continues to record values far higher than the rest of the countries.[15] **Hungary's remarkable net lending can be attributed to the higher net savings of the private sector.** In addition to households, the corporate sector is also a net lender in Hungary and since the net borrowing of the general government is also relatively low, net lending calculated on the

[15] As data are not available for countries in the region for 2015, they are only provided with respect to Hungary.

basis of the financial account is outstanding by regional standards. The high net lending of households in recent years has been related to households' accumulation of financial assets and deleveraging. In 2015, the saving structure of the private sector was influenced by the settlements related to the foreign currency loans of households and the conversion of the loans to forint. The net lending of the corporate sector is still considerable: owing to the FGS programme the contraction in lending halted, and the SME sector has even experienced an expansion. In the Czech Republic, the net lending of corporations nearly coincided with the net borrowing of the general government, resulting in slightly positive net lending in 2014. Although in Poland the rapid growth of household consumption and investment exerted downward pressure on household savings, their level is still high and the net borrowing of the country may decline further. The low net lending position of households in Slovakia is unable to cover the funding needs of corporations and the general government and thus the economy relies on external funds.

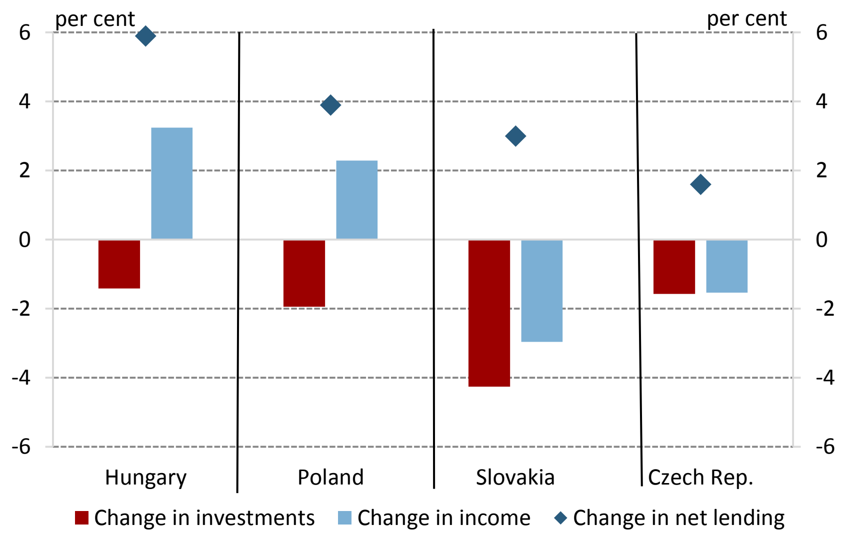
Chart 70: Net lending of the economy in a sectoral breakdown (as a percentage of GDP)



Source: MNB, HCSO, Eurostat

Hungary reported the highest increase in the net lending of non-financial corporations in the region, which reflects, for the most part, an increase in income and, to a lesser degree, slackening investment (Chart 71). Since the onset of the crisis, the net lending of non-financial corporations has improved considerably even by regional standards, which can be mainly attributed to deleveraging motivated by the sector's significant indebtedness. As regards financing processes based on the real economy approach, changes in the net lending of Hungarian corporations can be largely attributed to an increase in incomes and to a lesser degree to the deceleration of investment between 2008 and 2014. The downturn in the GDP-proportionate volume of investment had a positive effect on net savings throughout the region, but it raised the net lending of corporations most strongly in Slovakia. GDP-proportionate incomes raised the net lending of corporations both in Hungary and Poland, but reduced the sector's net lending in Slovakia and the Czech Republic. In part, this may be explained by the extremely high GDP-proportionate income of corporations in the latter two countries during the year of the crisis.

Chart 71: Factors in the net lending of non-financial corporations *(difference between 2014 and 2008 as a percentage of GDP)



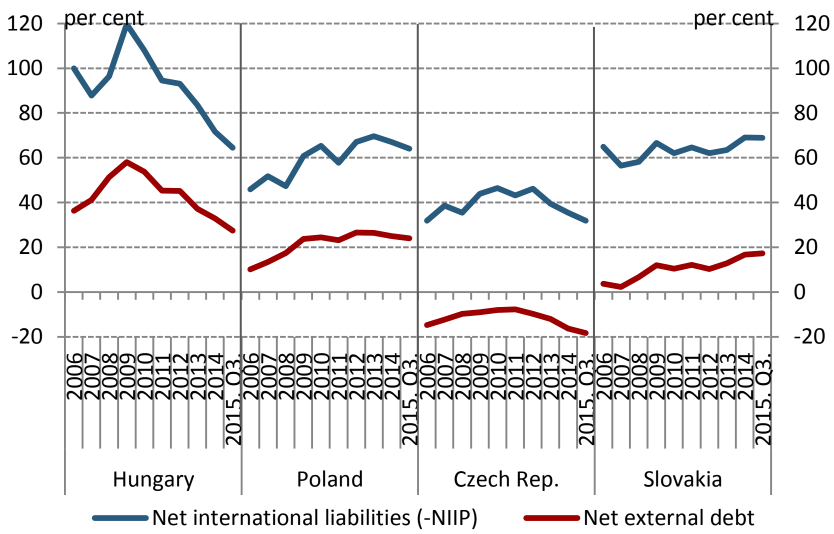
Note: *The difference between net savings and the change in investment and income can be attributed to inventories and to the difference between financial and non-financial accounts.
Source: Eurostat.

5.5. External debt indicators

The net external debt and net international investment position of Hungary have decreased dynamically since the crisis, pointing to a sizable decline in the previously observed external imbalances (Chart 71). After the outbreak of the crisis, Hungary recorded the highest net international investment position and external debt in the region, but after peaking in 2009, the indicators began to decline dynamically. In the Czech Republic and Hungary, the decline in external debt indicators was broadly in line with high net lending and a fall in debt-type liabilities. Converging with the other countries in the region, in 2015 the net international investment position indicator of Hungary (NIIP) stood at around 60 per cent of GDP, similar to the levels recorded in Poland and Slovakia. In addition, parallel to the net outflow of debt-type liabilities, the net external debt of Hungary fell. Hungary saw the steepest decline in net external debt and as a result, the net external debt of the economy converged to the value of Poland and at the end of the year it stood at around 25 per cent of GDP. The increase in the reserves of the Czech central bank (as shown above) may have boosted the net external financial assets of the Czech Republic, which currently amount to nearly 20 per cent of GDP. As regards Slovakia, even after a slight increase, net external debt remains below 20 per cent of GDP. In other words, the international investment position indicators of the region reflect substantial net lending which, overall, may point to the moderation of imbalances and the improvement in external vulnerability.

Chart 72: Net external debt and net international investment position in Visegrad countries

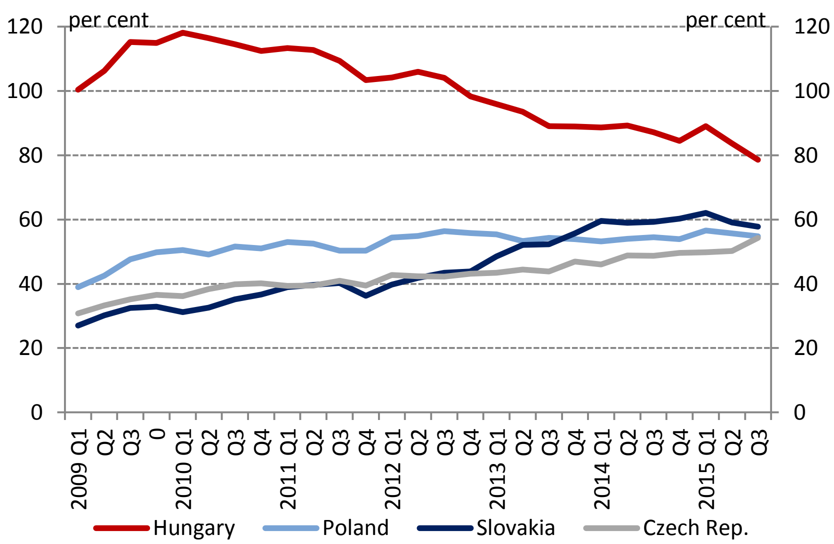
(as a percentage of GDP, net external debt without intercompany loans)



Source: national central banks, Eurostat

Consistent with the country's substantial net lending, the level of gross external debt continued to fall in Hungary but still exceeds the levels observed in the rest of the region. Hungary has demonstrated a sizable adjustment even with respect to gross external debt which by 2015 Q3 had gradually declined to below 80 per cent of GDP from its very high previous level in excess of 120 per cent of GDP. Nevertheless, the gross external debt of Hungary's peers in the region is generally far below this level, typically ranging between 50-60 per cent of GDP in 2015. It should be noted, however, that in contrast to the dynamic decline in Hungary's gross external debt, a continuous increase has been observed since 2009 in the rest of the region.

Chart 73: Gross external debt in the region (as a percentage of GDP, without intercompany loans)

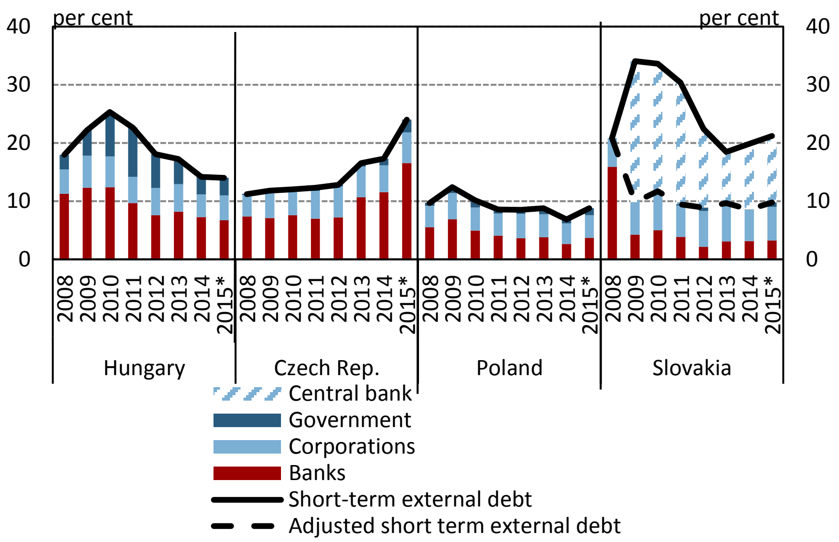


Note: *In the case of Slovakia, the technical debt incurred due to the TARGET system was excluded.
Source: Eurostat

Consistent with the higher level of gross external debt, the level of short-term external debt is also higher in Hungary compared to other countries in the region. However, owing to the favourable developments of recent

years, the Hungarian economy's short-term external debt based on original maturity continues to decline. Thanks to substantial adjustments in recent years, the short-term debt of Hungary is no longer considered extreme compared to other countries in the region. While the short-term external debt of Poland and Slovakia[16] amount to around 10 per cent of GDP, the short-term external debt of the Czech Republic rose sharply last year, reaching a level close to 25 per cent of GDP. The rise in Czech short-term external debt can be primarily linked to the banking sector: the ratio of banks' external liabilities to the balance sheet total has dynamically increased since 2013. The interventions of the Czech central bank in relation to the exchange rate cap may have also played a role in this: the korunas paid in exchange for the foreign currency purchased by the central bank may have shifted to non-resident actors who, in turn, may have deposited a substantial amount of the currency in the banking sector as short-term funds. By contrast, the short-term external debt of the Hungarian banking sector has decreased in recent years. With respect to the sectoral breakdown, the short-term external debt of Hungarian corporations appears to be comparable to the values recorded in the rest of the region. At the same time, the short-term external debt of the public sector is typically higher, which at present can be mainly attributed to the increase in the margin stock involved in the foreign currency swap transactions of the state (previously the indicator was also boosted by the substantial discount Treasury bill stock and the short-term external debt related to the settlement of EU transfers).

Chart 74: Short-term external debt based on original maturity (as a percentage of GDP)



Note: *Based on data as at 2015 Q3

Source: World Bank

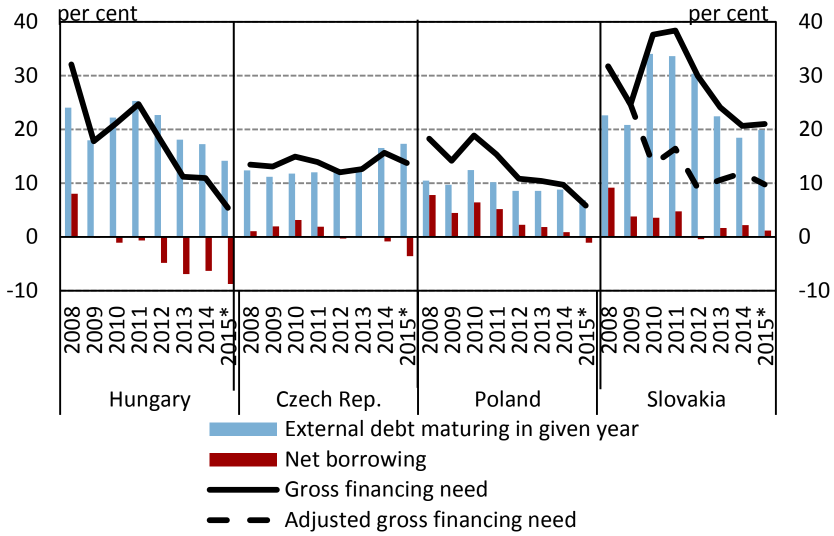
With a substantial amount of short-term external debt and also in consideration of Hungary's high net lending, the reliance of the Hungarian economy on external funds sharply decreased: calculated on the basis of the country's short-term external debt based on original maturity, Hungary's gross financing need has dropped below the values observed in the region. In assessing a country's external balance, the picture suggested by the current account and net lending position should be explored further. In addition to the net lending, gross financing need also considers short-term external debt maturing during the given year.[17] Partly owing to the MNB's Self-Financing Programme, Hungary's short-term external debt based on original maturity has declined significantly in recent years; thus, in addition to the increase in net lending, the dip in maturing debt also pointed to a decline in gross financing need. Taken together, the gross financing need of Hungary sank to around 5 per cent of GDP. With respect to the rest of

[16] The short-term external debt of Slovakia is significantly higher; however, the original value should be adjusted by the short-term external debt of the central bank. This is because following Slovakia's accession to the euro area, banks placed their surplus liquidity in the interbank market: Slovakian banks transferred excess liquidity to other banks in the euro area through the TARGET system, which meant that the Slovakian central bank incurred liabilities (i.e. short-term external debt) in the TARGET system.

17 For the calculation of the gross financing need, the net borrowing of the given country is adjusted for maturing external debt. As a result, the indicator will show the additional amount of external funds needed by the given country to cover its maturing debts.

the region, only Poland's gross financing need is comparable to the low level recorded in Hungary (which can be mainly attributed to its moderate short-term external debt rather than to its net lending). Slovakia's high gross financing need, again, is mostly related to the technical item associated with its accession to the euro area, but even excluding this item, Slovakia's gross financing need is higher than that of Hungary. The Czech Republic saw a rise in its gross financing need despite the fact that it had become a net lender. This is mainly due to a significant increase (5 per cent of GDP) in its short-term external debt in recent years. Thus, with the rise in its short-term external debt, its gross financing need is far higher than the Hungarian value.

Chart 75: Gross financing need (short-term external debt based on original maturity,[18] as a percentage of GDP)



Source: Eurostat, World Bank

[18] For the sake of comparability, gross financing need was calculated by using short-term external debt based on original maturity.

LIST OF CHARTS AND TABLES

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.

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