



REPORT ON THE BALANCE OF PAYMENTS



JULY
2017

*'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 the relevant risks. Moreover, the analysis of the balance of payments enables earlier identification of economic problems, when they are developing, and thus steps can be taken to avoid such problems.

To this end, the Magyar Nemzeti Bank regularly performs comprehensive analyses of the trends relating to Hungary's external balance, examining a number of indicators to assess macroeconomic imbalances and identifying elements and processes which are of critical importance for Hungary's vulnerability.

Given the lessons from the financial crisis and the recent period, a country's balance of payments and the 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. The primary goal of the Report on the Balance of Payments is to inform market participants about the developments in the balance of payments by way of this regular analysis, 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 and Lending Incentives. Contributors: Anna Boldizsár, Gabriella Csom-Bíró, Orsolya Csontos, Bence Gerlaki, Zsuzsa Kékesi, Balázs Kóczyán, Péter Koroknai and Balázs Sisak. The Report was approved for publication by Deputy Governor Márton Nagy.

This Report is based on information pertaining to the period ending on 21 June 2017.

SUMMARY

Hungary's **external balance position developed positively** in the first quarter of 2017 again. In addition to the **still substantial surplus of more than 5 per cent of GDP on the current account balance**, the **net FDI inflow** and the **decline in external debt** continued. The economy's **net lending still substantially outstrips the values observed in the countries of the region**.

According to the real economy approach, in the first quarter both **net lending and the current account surplus declined slightly**, primarily owing to the **fall in the trade surplus**. The decline in the goods balance was caused by the deteriorating terms of trade, as well as by the import increasing effect of the vigorous expansion in investment and consumption. At the same time, **the improvement in industrial performance bolstered growth in export dynamics**, and thus the contribution of net exports to growth, even with substantial domestic absorption, was still positive, while the trade surplus remained close to 10 per cent of GDP. Net lending is determined, in addition to the trade balance, by the income and transfer balance as well. The **transfer balance** continued to reduce Hungary's net lending to a moderate degree. In early 2017, the **income balance stabilised**, as the combined result of the decrease in the income of workers employed abroad and the improvement in the interest balance.

According to the financing side developments, **net FDI inflow continued again in the first quarter of 2017, while net external debt decreased by roughly EUR 0.7 billion (more than 0.6 per cent of GDP), as a result of transactions**. The sectoral distribution of the debt liabilities outflow changed considerably compared to the previous year: whereas in 2016 – partly due to the forint conversion of foreign currency loans – in parallel with the growth in the net external debt of the general government consolidated with the MNB, banks' net external debt decreased, **in early 2017 banks' external debt increased substantially**, due to the outstanding growth in the deposits placed with them by non-residents. At the same time, **the decrease in the government's net external debt is mostly** attributable to **falling non-residents' government securities holdings**, which was supported to a large extent by households' substantial purchase of government securities. In addition, in the first quarter **the net external debt of non-financial corporations continued to fall**.

In 2017 Q1, **the downward trend in the Hungarian economy's debt ratios, which has been lasting for several years now**, continued: Hungary's GDP-proportionate gross external debt fell to 69 per cent, while net external debt decreased to 18 per cent of GDP. The decrease in net external debt **was linked to the government and non-financial corporations, while the net external debt of the banking sector rose**, which took place in conjunction with an increase in liabilities that exceeded the ongoing growth in external assets. In spite of this, banks' stock of external assets still exceeds the sector's external debt. At the general government, it was primarily **the continuing fall in non-residents' government securities holdings** that improved the external debt ratio, while **in the corporate sector** the ratio improved **due to the rise in external assets**. The **level of foreign exchange reserves still significantly exceeded (by more than EUR 4.5 billion) the level expected and deemed safe by investors**.

In 2017 Q1, there was **also a moderate decrease in net lending according to the sectors' savings**. This was **primarily caused by the fall in the financial savings of the private sector**, the impact of which was mitigated by the decline in the government's borrowing requirement. Early in the year, the decline in the households' net financial savings continued, with this primarily linked to **rising consumption** and strengthening credit demand. As regards household savings, **government securities are still the instruments sought after** the most by households, and similarly to the previous quarters this substantially **supported the decrease in the government's external liabilities and vulnerability**.

In our special topic, in addition to Hungary's **external debt**, we present the factors that drive the **developments in its non-debt liability ratios, particularly in foreign direct investments**. The economy's **net external liability fell substantially as a result of the deleveraging that took place after the crisis**, which was reflected **primarily in the large decrease in net external debt**, but **the drop in the non-debt liabilities also contributed**. In the case of net external debt, deleveraging after the crisis was coupled with the **repayment of foreign loans**, but **the impact of this was restrained by revaluation effects**: after the outbreak of the crisis the weakening of the forint exchange rate and in recent years the decline in forint yields also pointed to a rise in external debt through the increase in prices of government securities.

On the other hand, drop in yields decreases the external vulnerability of the economy via the reduction of interest expenses. As for non-debt liabilities, **transaction data**, which reflect non-residents' investment decisions, **had shown steady net FDI inflows since the crisis**, while revaluations decisively pointed to a decline in the FDI stock. In the past years several factors influenced the net working capital stock:

- While the **stock of net direct investment rose by more than EUR 1.5 billion** in total since the beginning of 2008, due to the **growth in nominal GDP** the GDP-proportionate index fell by more than 4 percentage points.
- The slight increase in net FDIs developed in parallel with a major, almost **EUR 15 billion, inflow of funds**, based on transactions.
- The smaller rise in the stocks can be explained by the **revaluation effect**, which is mainly attributable to the fact that the **extraordinary losses** (e.g. losses related to the early repayment scheme, settlement, foreign currency borrowing) are recognised here, while the sales of equity and loan portfolios also affect the stock through the revaluation.
- The **government purchases** also pointed to the decrease in the net FDI stock (in a value exceeding EUR 4 billion, where the acquisition of MOL, E-On and Budapest Bank also had a significant role).
- The **working capital outflow of domestic enterprises** also caused a decline in the net FDI stock.

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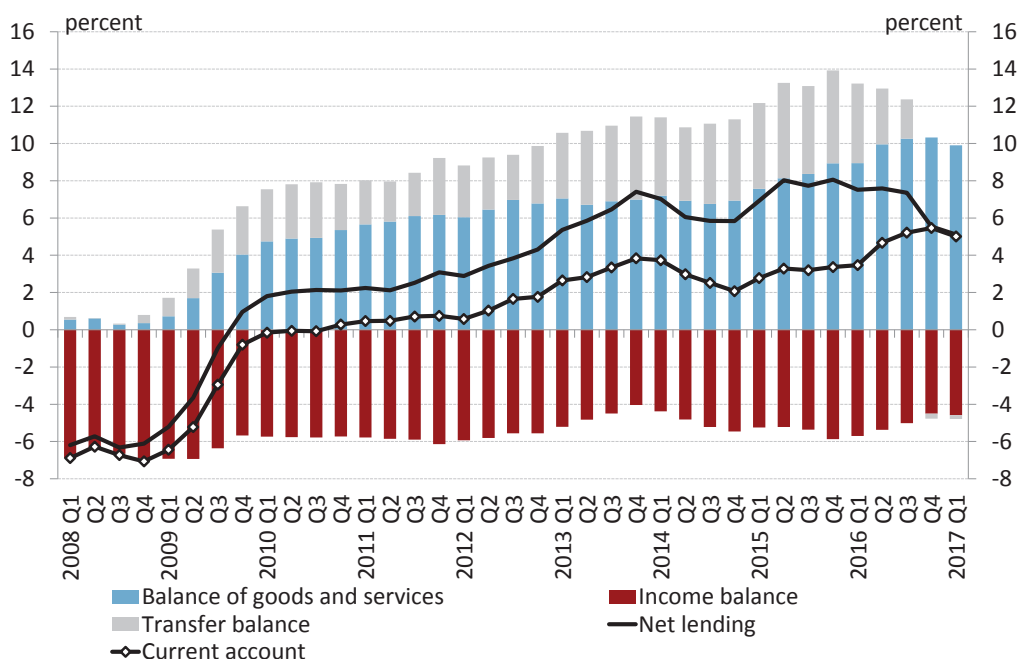
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1. REAL ECONOMY APPROACH

In 2017 Q1, according to the real economy approach, both the net lending of the Hungarian economy and the current account balance decreased slightly, although both of these indicators remain at a high level, amounting to nearly 5 per cent of GDP. The moderate decline in net lending was primarily due to the decline in the trade surplus. The fall in net exports was caused, among others, by the deteriorating terms of trade, the import consequences of rising investments and consumption, while the expansion in export dynamics was supported by improving industrial performance. The balance of trade remained high, at around 10 per cent of GDP. The transfer balance did not change significantly and continued to reduce Hungary's net lending to a moderate degree. After the trend of the previous quarters, in early 2017 the improvement in the income balance came to an end, which is primarily linked to the decrease in the compensation of employees, while the interest balance of foreign loans continued to decline.

In 2017 Q1, Hungary's four-quarter net lending and current account balance, according to the real economy approach, both fell to 5 per cent of GDP, which can still be deemed as high (Chart 1). Seasonally unadjusted net lending amounted to EUR 1.3 billion in the quarter, which was achieved with a current account surplus of EUR 1.2 billion and a capital account surplus of EUR 0.1 billion. Based on four-quarter data, Hungary's net lending decreased to 5.1 per cent of GDP. The still relatively high net lending is mostly attributable to the high current account balance, amounting to 5 per cent of GDP. As a result of the moderate absorption of EU funds, the transfer balance – similarly to the previous quarter – had a negative impact on Hungary's external balance position. In contrast to the previous periods, the deficit on the income balance did not continue to decrease.

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



* Income balance: labour income, income on equity and income on debt. Transfer balance: sum of the capital account and other primary and secondary income.

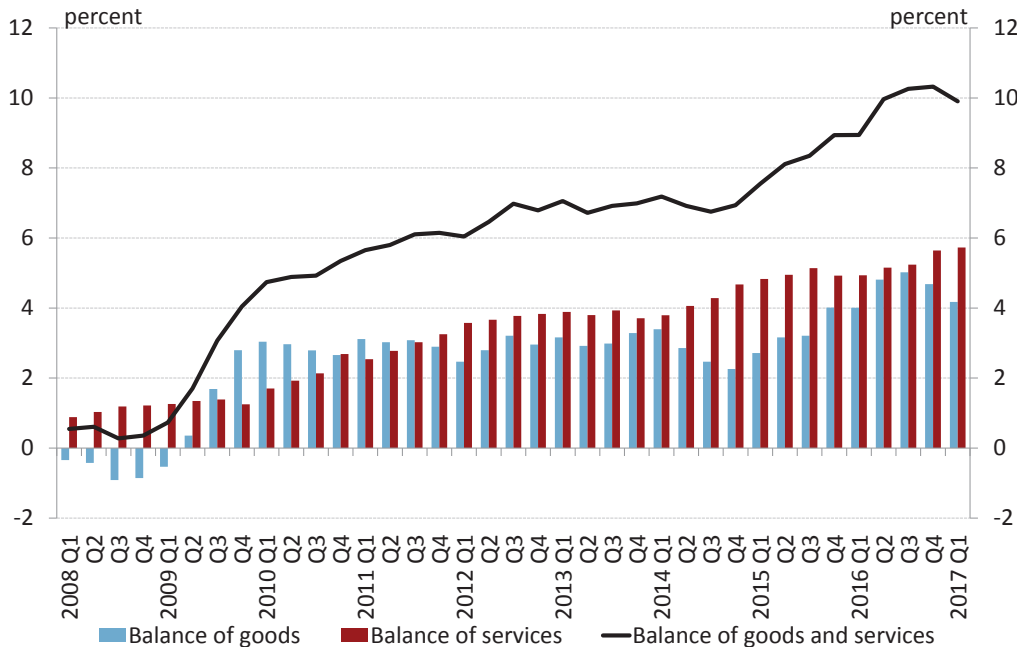
All charts by the MNB unless otherwise indicated.

1.1 Trade balance

Hungary's balance of trade declined in 2017 Q1, owing to the decline in the surplus on the goods balance (Chart 2). The Q1 value of the trade balance slightly fell short of the year-on-year value, as a result of which the four-quarter surplus of the goods and services balance fell, but remained at a high level of around 10 per cent of GDP. The decline in the trade surplus is attributable to the fall in the goods balance, which was only partially offset by the slight increase in the services balance. The goods balance surplus declined to a similar extent as in the previous quarter, which may be connected with the deterioration in the terms of trade as – in addition to rising household consumption and the

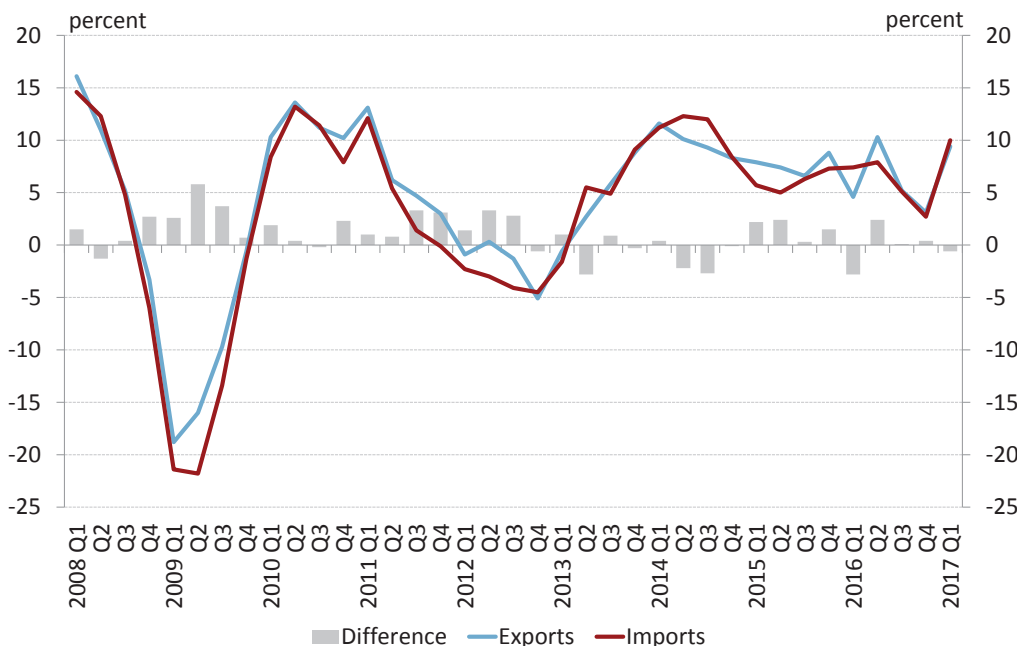
growth in import-intensive investments – exports also increased in line with the swiftly improving industrial production. The services balance surplus improved somewhat during the first quarter and thus amounted to 5.7 per cent of GDP, still supported primarily by tourism, transport services and the shared service centres. Despite the slight decrease observed during the quarter, the balance of trade is still the largest contributor to Hungary's net lending.

Chart 2: Developments in the balance of trade and its components (four-quarter values as a per cent of GDP)



In 2017 Q1, annual real growth in exports and imports significantly rose (Chart 3). The Q1 growth in exports was supported a great deal by the surge in industrial production. In addition, industrial production in Germany, Hungary's key trading partner, also developed favourably for Hungary's exports in the first quarter. Similarly to the export dynamics, the annual real growth in imports also rose substantially, mostly attributable to rising investments and household consumption, as well as to the procurement of products of high import content necessary for industrial production.

Chart 3: Annual real growth of exports and imports

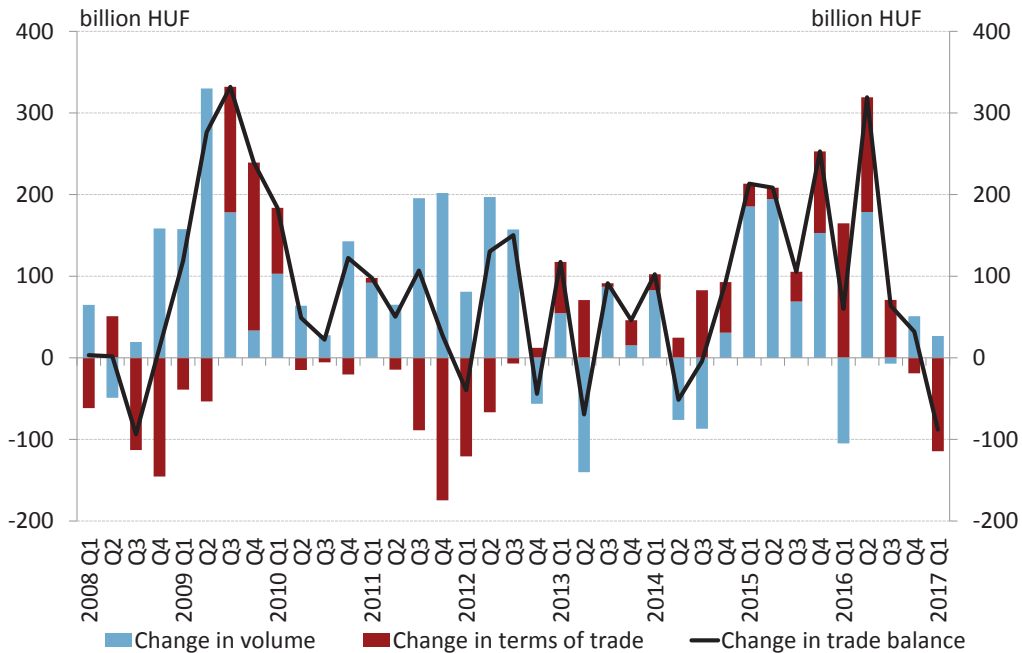


Source: HCSO, MNB

The decline in the trade surplus was caused by the deterioration in the terms of trade, which was only partially offset by the improving volumes resulting from the pick-up in industrial production (Chart 4). In the last twelve months,

with the fading impact of the decline in oil prices, the terms of trade gradually decreased, as a result of which, in the last quarter of 2016 the change in the terms of trade already contributed negatively to the trade surplus. Since the fuel prices rose in year-on-year terms in 2017 Q1, this trend continued, as a result of which the deterioration in the terms of trade substantially lowered the surplus of the goods and services balance. This was partially offset by the positive change in volumes, which mostly resulted from the expansion in industrial performance.

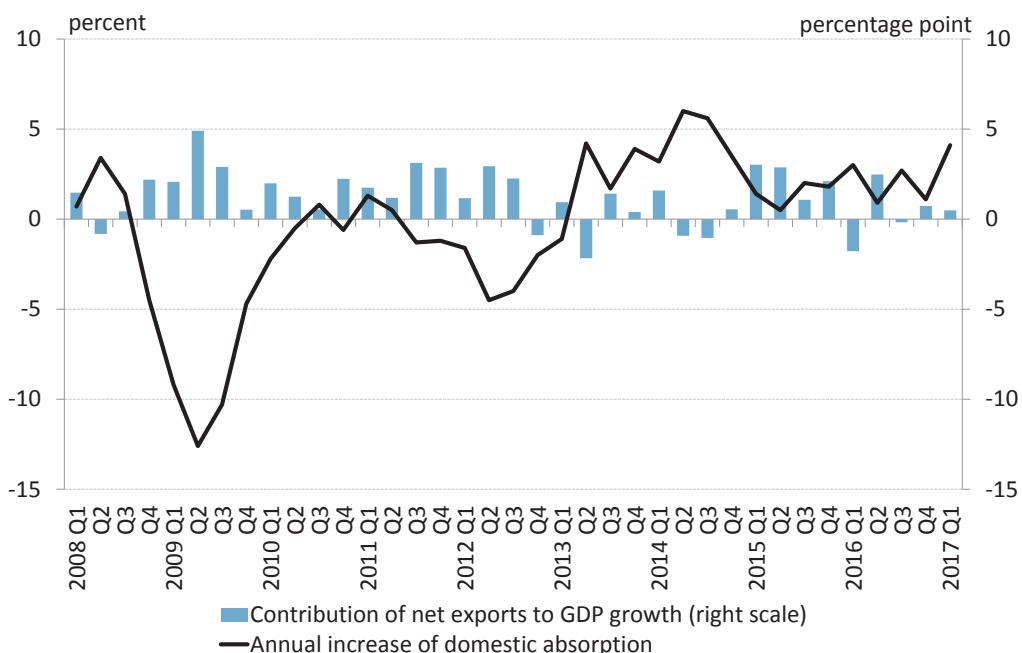
Chart 4: Developments in the balance of trade factors according to GDP (year-on-year)



Source: HCSO

In the first quarter, net exports supported growth moderately despite the fact that the annual growth rate of domestic absorption increased significantly (Chart 5). In 2017 Q1, GDP growth was realised primarily in conjunction with substantial growth in domestic absorption, which was attributable, amongst other things, to the favourable investment activity in the national economy and households' rising consumption. On the other hand, the resulting expansion in imports was offset by exports that picked up in parallel with the significant rise in industrial production and the expansion of the services balance; consequently, the contribution of net exports to growth remained positive, similarly to the previous quarters.

Chart 5: Annual growth rate of domestic absorption and contribution of net exports to GDP growth

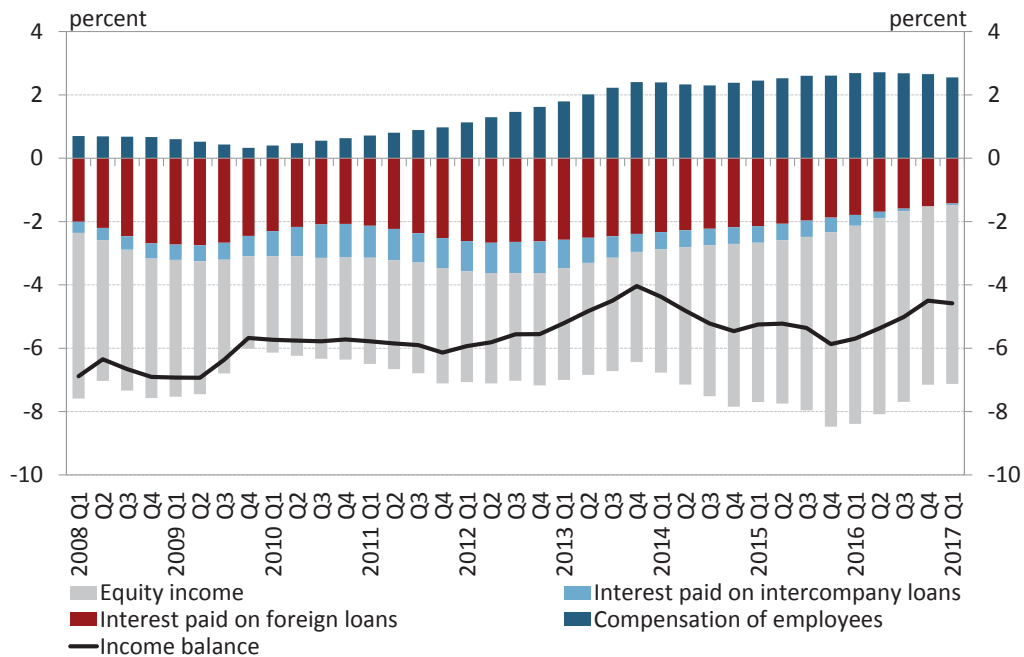


Source: HCSO

1.2 Income balance

In 2017 Q1, the four-quarter deficit on the income balance stabilised at around 4.5 per cent of GDP (Chart 6). In the first quarter, the continuous decline in the income balance deficit, which started in early 2016, changed to stagnation: the continued decline in the interest balance of foreign loans was offset by the fall in the income of employees, while the income of foreign-owned companies did not change substantially. The gradual improvement in the interest balance of foreign loans can still be linked to both the fall in gross external debt and the moderate interest environment. On the other hand, the minor decrease in the GDP-proportionate income of employees – that is the wage of residents working abroad for less than one year – pointed to a deterioration in the income balance. During the period under review, there was no substantial change in the profit of foreign-owned companies operating in Hungary, but we only have limited information in this respect.¹

Chart 6: Developments in the items of the income balance* (four-quarter values as a per cent of GDP)



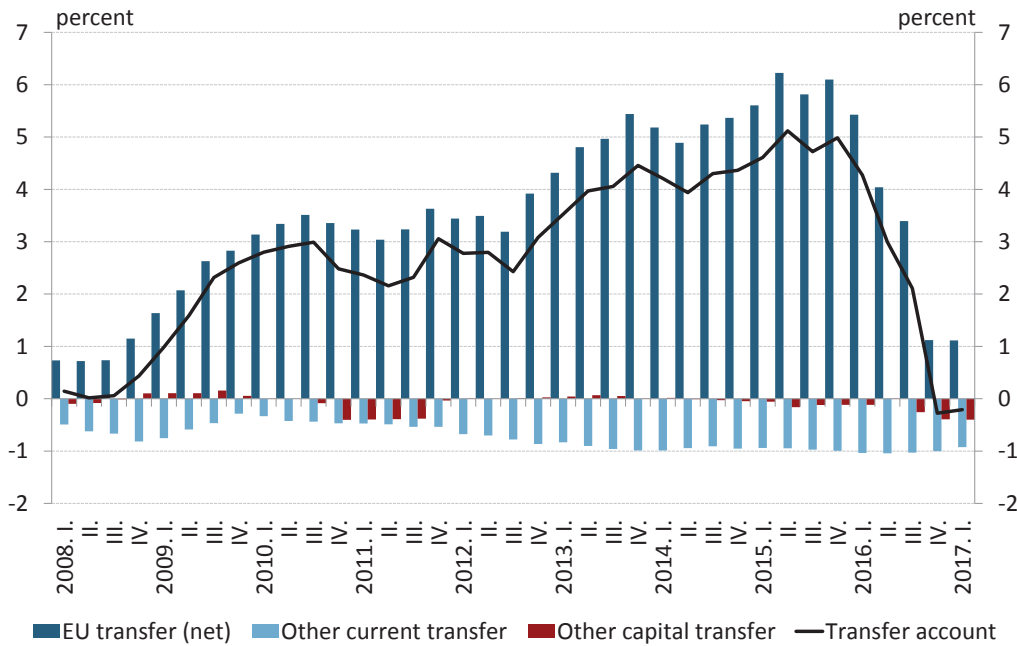
*Income balance: earned income, income on equity and income on debt.

1.3 Transfer balance

In 2017 Q1, in conjunction with the moderate absorption of funds from the new EU programming period, the transfer balance still reduced net lending (Chart 7). The absorption of EU transfers declined in 2016, after the end of the funds of the 2007-2013 programming period, which caused the transfer balance to decrease significantly. In 2017 Q1, the absorption of the funds from the 2014-2020 programming period remained at the low level seen in 2016, and thus – similarly to the previous quarter – the four-quarter value of EU transfers amounted to EUR 1.3 billion. Although payments related to EU transfers were rather high at end-2016, a large part of this was linked to prepayments, which do not appear in the balance of payments. The low level of the transfer balance was also influenced by the deficit on the other capital and current transfer balance, in addition to the moderate absorption of EU funds. In the past quarters, the current transfers – which include, for example, the tax and social insurance contribution paid in respect of the wages of employees temporarily working abroad – were relatively stable, around 1 per cent of GDP, while there was also no substantial change in other capital transfers.

¹ Until the receipt of the questionnaire data in September following the reporting year, the data in the balance of payments related to the corporate revenues of foreign-owned corporations are based on estimates, which will be replaced by the actual data calculated on the basis of the corporate questionnaires received in September.

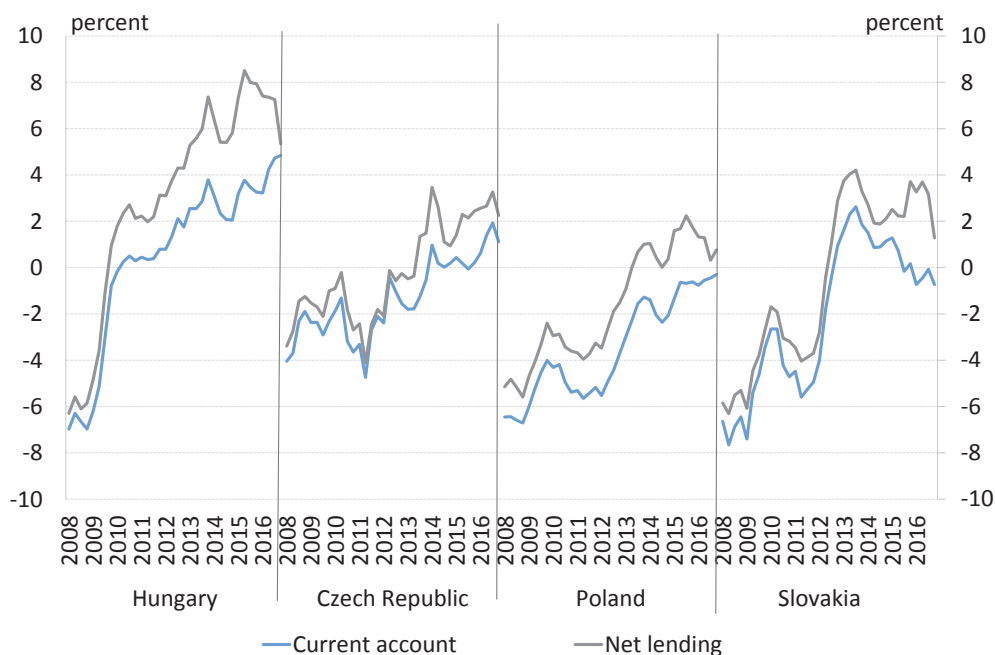
Chart 7: Four-quarter changes in the items of the transfer balance



1.4 Regional outlook

The net lending and current account balance of the Hungarian economy still substantially outstrip the values observed in the countries of the region. Before the close of the EU 2007-2013 programming period, the absorption of EU funds rose significantly in the countries of the region, as a result of which the net lending of the Visegrád countries increased substantially in 2015. However, in parallel with the end of the programming period, last year the capital account declined a great deal: the largest fall took place in Hungary, where the decrease amounted to roughly 4 per cent of GDP, but other countries in the region also observed an average decline of 1.5 – 2.0 per cent. This was due to the fact that during 2016, in Hungary the absorption of EU transfer as a per cent of GDP exceeded that observed in other countries of the region, and thus the decrease therein had a larger impact on net lending in Hungary. Despite the decline of a larger extent, Hungary's external balance position is still well above that of the regional competitors.

Chart 8: External balance position of the countries of the region (as a per cent of GDP)

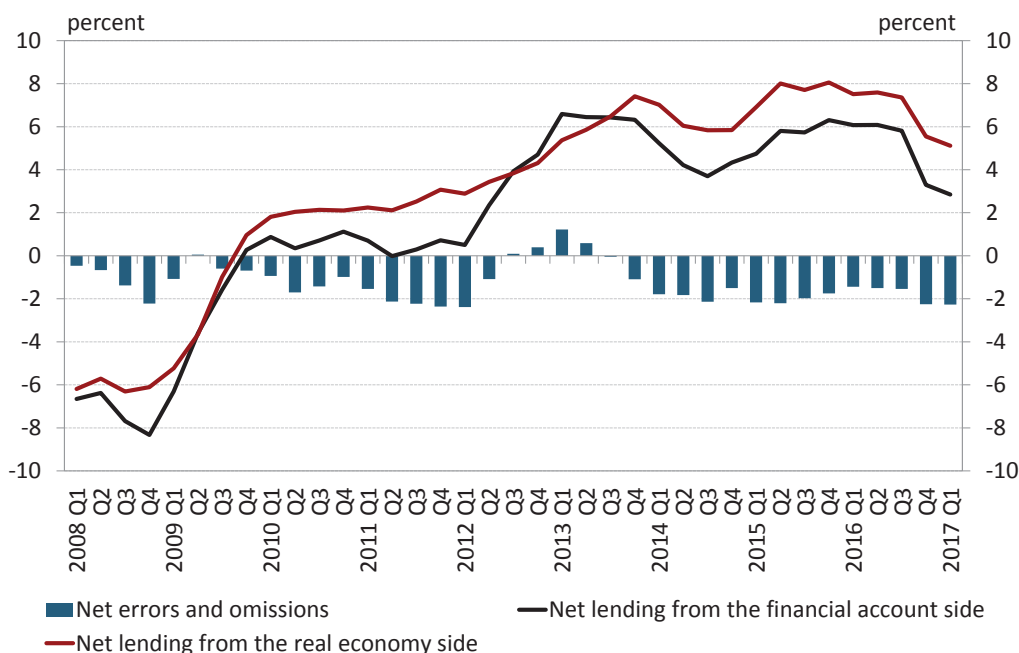


2. FINANCING APPROACH

The four-quarter value of net lending, calculated on the basis of the financial account and reflecting the financing side of the balance of payments, declined to 2.8 per cent of GDP. On a quarterly basis, similar to end-2016, the moderate outflow of funds developed in parallel with a net FDI inflow of over EUR 300 million – corresponding to the seasonal trends – and a decline in external debt in excess of that. The net outflow of debt liabilities decelerated, as usual in the first quarter, and its sectoral distribution also changed. Whereas in 2016 – partly due to the forint conversion of foreign currency loans – in parallel with the growth in the net external debt of the general government consolidated with the MNB, banks' net external debt decreased, in early 2017 banks' external debt increased substantially, due to the outstanding growth in deposits placed with them by non-residents. The fall in the net external debt of the general government is mostly attributable to the continued decline in non-residents' government securities holdings, the position of which was taken over by the banking sector participants and households. In addition, in the first quarter non-financial corporations' net external debt continued to decline.

In 2017 Q1, the four-quarter financing side net lending – which still falls about 2 percentage points short of the value calculated based on the real economy approach – amounted to 2.8 per cent of GDP (Chart 9). Accordingly, net lending calculated on the basis of the real economy data still exceeds the value calculated from the financing side, as a result of which the decrease in Hungary's debt indicators falls short – at annual level by about 2 per cent of GDP – of the value anticipated on the basis of the real economy processes.² It should be noted that this trend is typical for the Hungarian economy over the longer run as well, and a similar situation can also be observed in the countries of the region.

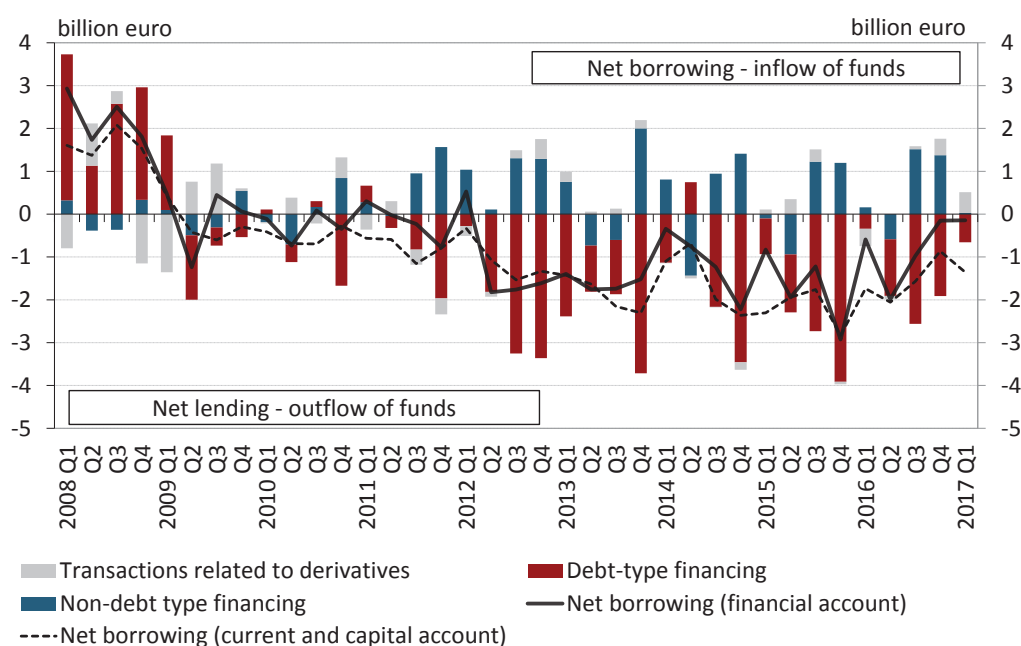
Chart 9: Two types of net lending and “Net errors and omissions”
(Four-quarter values as a per cent of GDP)



Similarly to the end of 2016, in the first quarter unadjusted net lending from the financing side amounted to around EUR 150 million (Chart 10). The moderate outflow of funds was primarily supported by the decrease in debt liabilities, which was partially offset by the inflow of funds related to foreign direct investments and derivatives.

² Trends in the balance of payments can also be analysed by examining the financing of real economy transactions. Indeed, the financial account shows what types of transactions were used by resident economic agents to finance transactions in the real economy that had an effect on net financial worth. 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 rates, as indicated by the category “Net errors and omissions”.

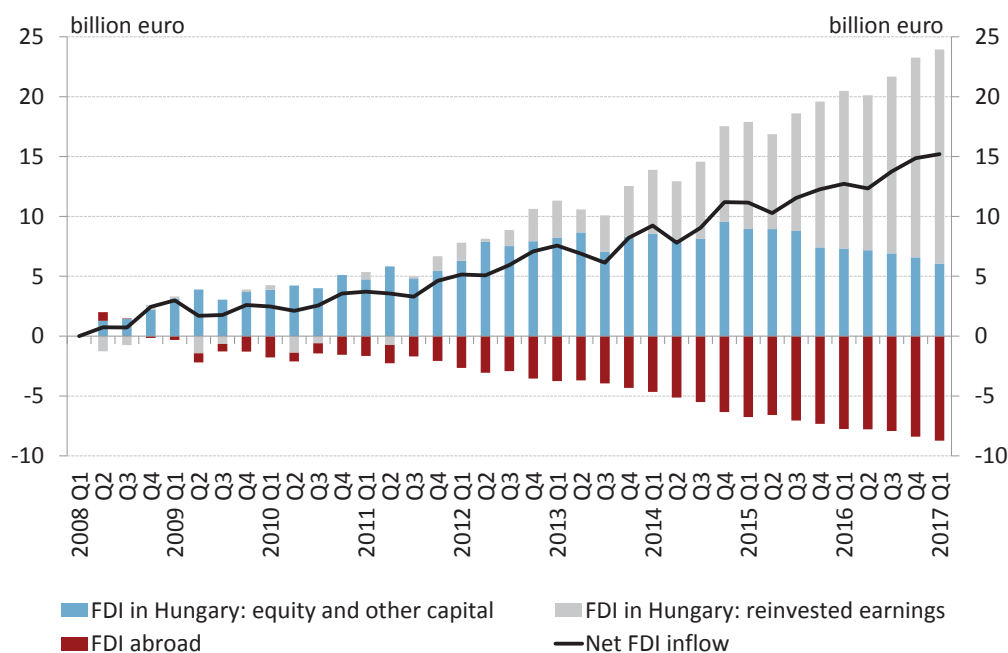
Chart 10: Structure of external financing (unadjusted transactions)



2.1 Non-debt liabilities

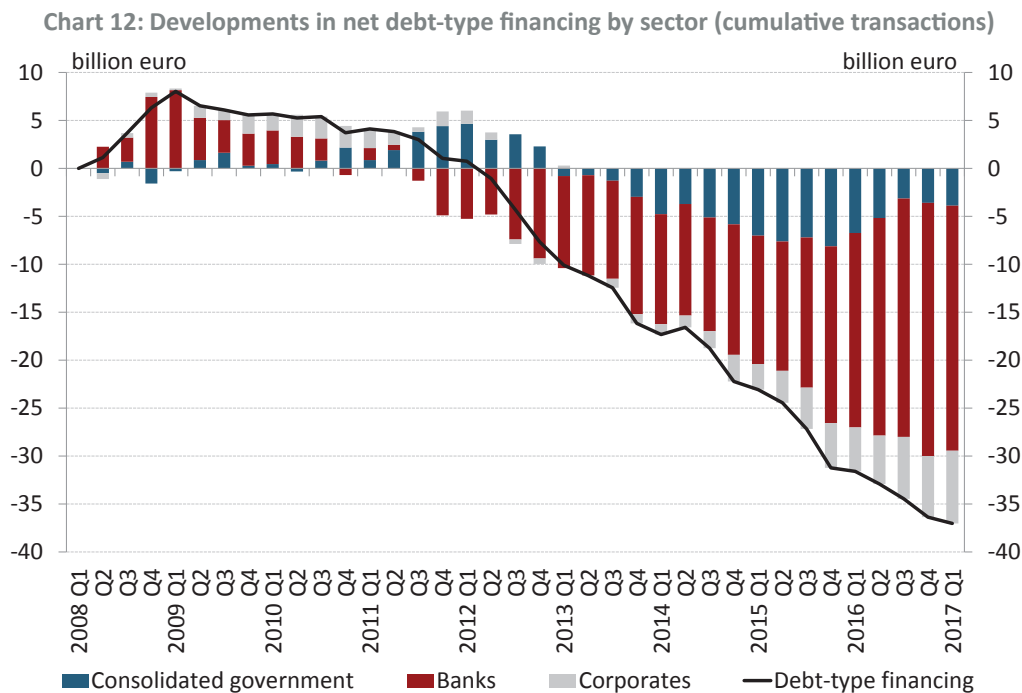
In 2017 Q1, the value of net FDI once again increased in Hungary (Chart 11). In order to eliminate the distorting effects, it is advisable to examine the values excluding capital in transit transactions and asset portfolio rearrangement. In the first quarter, the net FDI inflow amounted to more than EUR 0.3 billion, which roughly corresponds to the usual start-of-year value. The rise in non-residents' investments in Hungary is attributable to the reinvested earnings of foreign companies, while corporations – in accordance with the post-crisis deleveraging process – continued to repay their intercompany loans. In addition to the decline in intercompany loans, the continued increase in the FDI outflow of resident corporations also restrained the net FDI inflow. In early 2017, the inflow of non-debt liabilities was also reduced by changes in portfolio investments: in addition to the sale of Hungarian shares by non-residents, the purchase of foreign shares by resident actors also supported the outflow of funds.

Chart 11: Developments in FDI without capital in transit transactions (cumulative transactions)



2.2 Debt liabilities

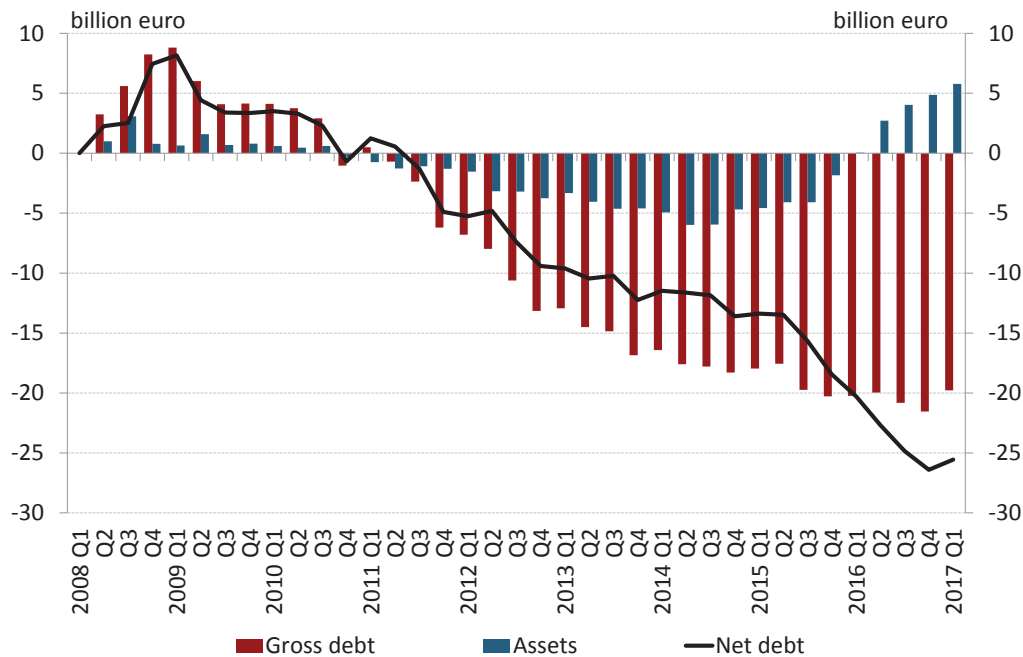
As usual in the beginning of the year, the decrease in Hungary's net external debt decelerated in the first quarter, primarily due to the increase in the banking sector's external debt, while the net external debt of the general government³ and of non-financial corporations decreased (Chart 12). In addition to the deceleration of the decline in external debt, there was also a significant change in the sectoral distribution of the decline: in 2016 – due to the transfer of foreign currency liquidity by the central bank to the banks in connection with the forint conversion of foreign currency loans – banks' net external debt decreased, while that of the general government rose in parallel with the fall in the foreign exchange reserves. By contrast, in early 2017, the net external debt of the banks rose to a larger degree and that of the general government decreased, despite the fact that foreign currency liquidity, related to the forint conversion, was provided to the banks in the first quarter as well. In addition, the net external debt of non-financial corporations continued to decrease, similar to the trends observed last year.



After the continuous decline that commenced in mid-2015, in 2017 Q1 the net external debt of the banking sector rose by almost EUR 1 billion. Similarly to the previous quarters, the banking sector's external assets continued to increase in early 2017 – the rise of almost EUR 0.9 billion may still be partly attributable to the maturities of the foreign exchange swaps related to the forint conversion of foreign currency loans. On the other hand, compared to the developments observed in 2016, one major change is that the banking sector's external liabilities rose by almost EUR 1.8 billion; hence, also considering the rise in external assets, banks' net external debt increased by almost EUR 1 billion (Chart 13). However, the strong increase in banks' external liabilities was not linked to foreign borrowing. The largest growth was recorded in deposits placed by non-residents' with Hungarian credit institutions, most of which mature within one year. In addition to the changes in the banks' Q1 foreign asset-liability structure, the sector's foreign receivables still exceed the volume of foreign liabilities, and thus banks' net external debt is still negative (for more details see the section on the developments in debt ratios).

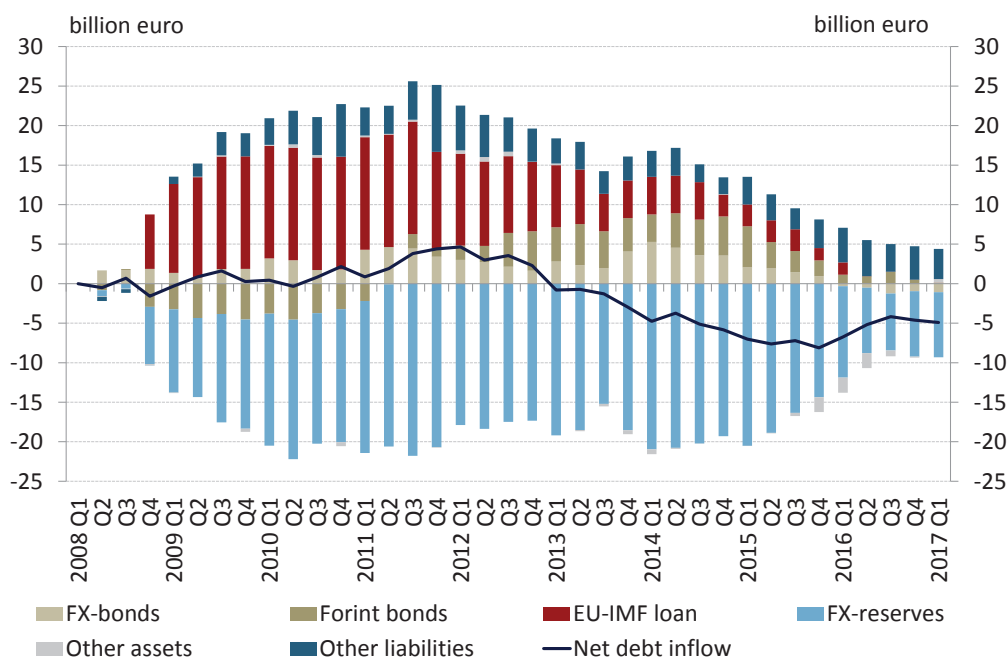
³ For the purposes of the analysis, the general government sector is consolidated with the MNB when examining the structure of external financing.

Chart 13: Developments in the banking system's external debt and receivables (cumulative transactions)



The net external debt of the general government consolidated with the MNB dropped by EUR 0.3 billion, primarily due to the continued decline in non-residents' government securities holdings (Chart Chart 14). The net external debt of the consolidated general government has fallen substantially since end-2011, followed by a moderate rise in 2016, in line with the decreasing foreign exchange reserves owing to the conversion of foreign currency loans. The swaps expiring due to the conversion of foreign currency loans, the payment of foreign currency interest and other foreign currency expenditures reduced the foreign exchange reserves in 2017 Q1 as well, but on the whole, as a result of other factors (inflow of EU transfers, sales of domestic foreign currency bonds), the foreign exchange reserves did not change (for more details, see section 3.3). Thus the decrease in the general government's net external debt is primarily attributable to the continued decline in the government securities holdings of non-residents.

Chart 14: Breakdown of net external debt of the general government consolidated with the MNB (cumulative transactions)



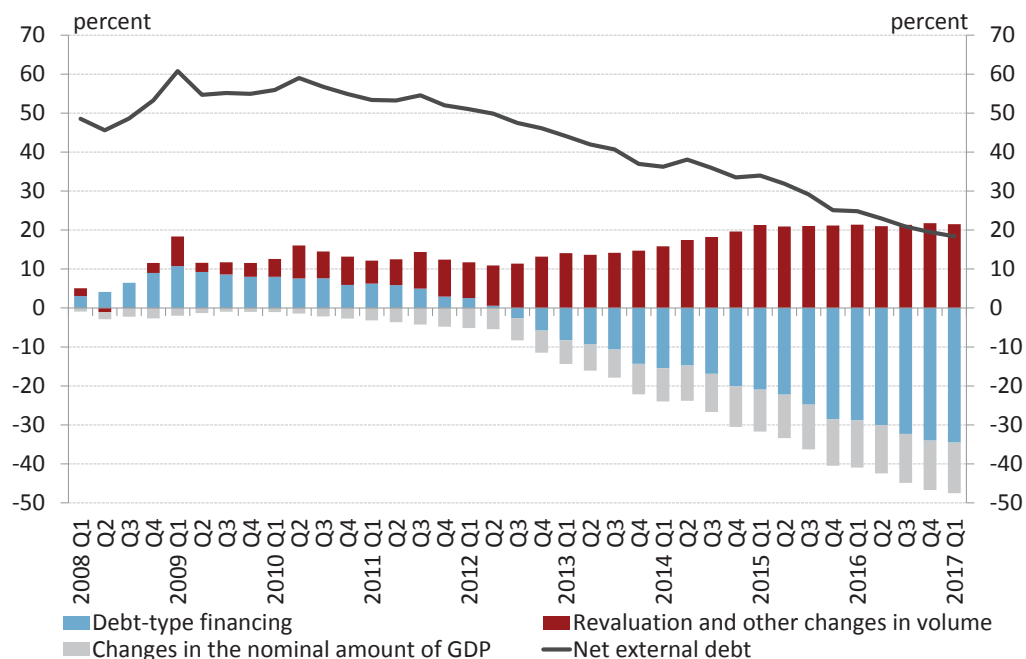
3. DEVELOPMENTS IN DEBT RATIOS

In 2017 Q1, the decline in the debt ratios of the Hungarian economy continued. After decreasing by almost 1 percentage point, net external debt amounted to 18.4 per cent of GDP, while gross external debt fell to 69 per cent of GDP. The decline in net external debt was also supported by the growth in GDP and the revaluation effects, in addition to the more moderate outflow of debt liabilities. The fall in net external debt was linked to the consolidated general government and non-financial corporations, while the banking sector's net external debt rose. Despite the rise in the debt ratio, banks' external assets holdings still exceed the sector's external debt. The decline in corporations' GDP-proportionate net external debt was achieved in parallel with a larger rise in external assets, while there was also a moderate decrease in the sector's external liabilities. In the case of the consolidated general government, it was the continued decline in non-residents' government securities holdings that reduced the debt ratio. The fall in GDP-proportionate gross external debt at the end of the first quarter was achieved in conjunction with the consolidated general government's declining gross external debt and the private sector's rising gross external debt. The level of foreign exchange reserves remained more or less steady during the quarter, and still significantly exceeds the level expected and deemed safe by investors.

3.1 Developments in net and gross external debt

In 2017 Q1, the decline in net external debt continued, supported by the growth in GDP and also by revaluation effects, in addition to the outflow of debt liabilities (Chart 15). At end-March, net external debt amounted to 18.4 per cent of GDP. Along with the more moderate outflow of debt liabilities – as usual in the beginning of the year – the growth in nominal GDP, as well as the exchange rate revaluation of outstanding stocks also contributed to the fall. However, the improvement of the debt ratio was slightly restrained by the yield-related repricing of government securities holdings.⁴

Chart 15: Components of changes in net external debt* (cumulated, GDP-proportionate values, end-2007 = 0)



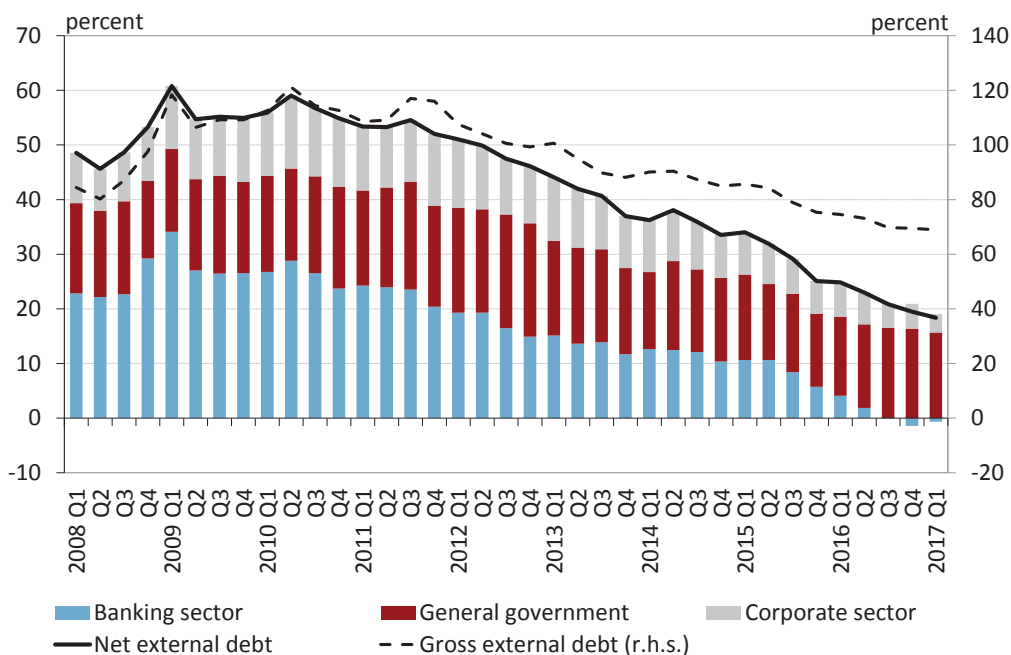
In contrast to the developments in 2016, the improvement in the debt ratio was linked to the general government and the corporate sector, while the net external debt of the banking sector increased (Chart 16). The decrease in the Hungarian economy's net external debt was linked to a larger degree to corporations: along with a larger increase in the sector's external assets, there was also a slight decrease in its external debt. In addition, it also improved the debt

⁴ The appreciation of the forint exchange rate against the euro had no material impact on net external debt, as the euro-denominated debt is roughly offset by the almost same level of euro foreign exchange reserves.

ratio that after the rise in the general government's net external debt in the previous year, this debt fell moderately in the first quarter, which was primarily attributable to the continued decline in non-residents' government securities holdings. In 2017 Q1, the downward trend in the banking sector's net external debt decelerated to a moderate increase, which took place along with a rise in liabilities exceeding the growth in external assets, and these factors resulted in a rise in Hungary's net external debt.

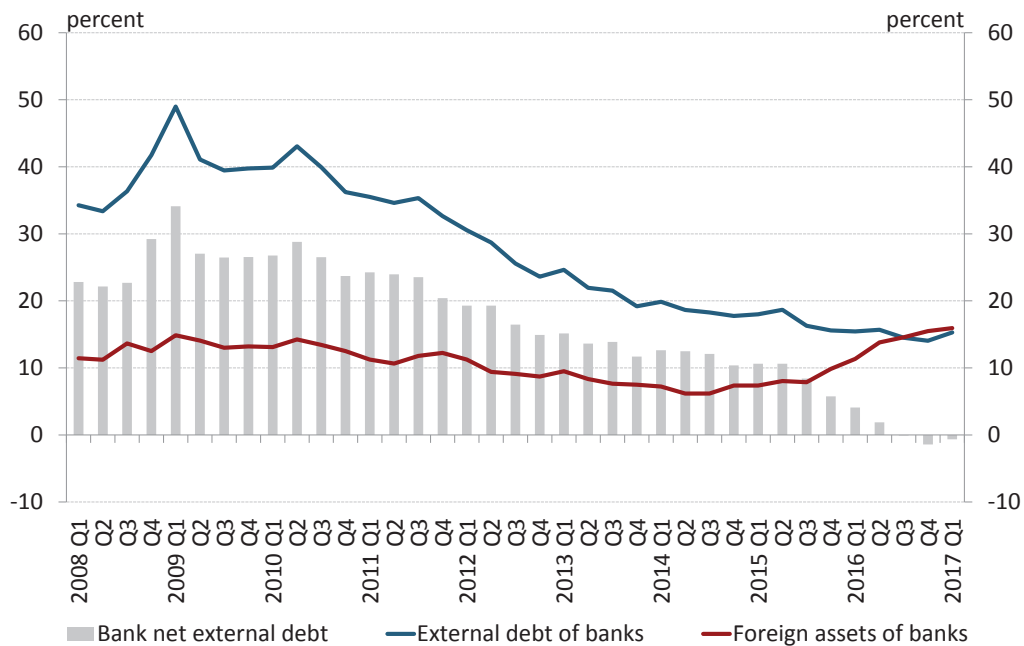
Gross external debt decreased to a lesser degree than seen in the case of the net ratio, falling to 69 per cent of GDP at the end of 2017 Q1 (Chart 16). The decline in the GDP-proportionate gross external debt observed in 2017 Q1 took place along with an increase in the stock as a result of transactions, which was offset by the effect of the growth in GDP and appreciation of the forint exchange rate against the euro. As regards the sectors, the gross external debt of the consolidated general government declined by more than 1 per cent of GDP, while that of the private sector – due to the banking sector – moderately rose.

**Chart 16: Net external debt in a sectoral breakdown and gross external debt
(as a percentage of GDP, excluding intercompany loans)**



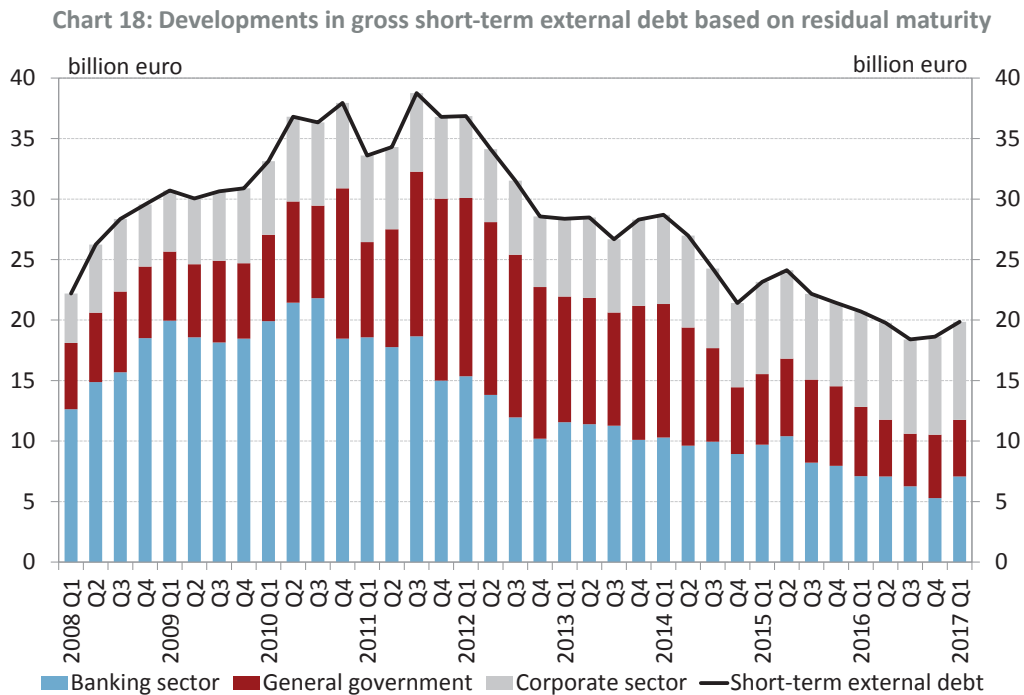
The banking sector's net external debt increased in 2017 Q1, while the external assets still exceed the level of external debt (Chart 17). The gradual decrease in the banking sector's net external debt switched to a rise during the first quarter: the increase in gross debt exceeded the rise in external assets, continuing at slower rate. The increase in the banking sector's foreign currency assets was primarily supported by the expiry of the foreign exchange swaps linked to the forint conversion of the households' foreign currency loans, while the larger increase in external liabilities was attributable to the rise in the deposits placed by non-resident actors with Hungarian banks. The rise in banks' GDP-proportionate net external debt as a result of transactions was partially offset by the increase in GDP and the appreciation of the forint exchange rate against the euro. Despite the rise in the debt ratio, the sector's net external debt was negative at the end of 2017 Q1, that is, banks' stocks of external assets still exceed external liabilities. Under the negative net external debt, the sector's gross external debt amounts to EUR 17 billion (15 per cent of GDP), EUR 7 billion of which expires within twelve months.

Chart 17: Developments in the banking sector's external assets and debt (as a percentage of GDP)



3.2 Developments in short-term external debt

Hungary's short-term external debt rose to nearly EUR 20 billion in 2017 Q1, which was primarily linked with the growth in the banking sector's debt (Chart 18). Hungary's short-term external debt increased by EUR 1.2 billion in the first quarter. The increase in the banking sector's short-term external debt also contributed to this rise in the debt ratio, while the debt ratio of the consolidated general government improved slightly and that of non-financial corporations remained more or less steady. The banking sector's short-term external debt based on original maturity rose by nearly EUR 1.3 billion, while its amortising debt on account grew by EUR 0.5 billion. The growth in the banks' short-term external debt based on original maturity reflected the debt increasing effect of the short-term bank deposits placed by non-residents. The rise of EUR 0.3 billion in non-financial corporations' short-term external debt based on original maturity – which was partially attributable to the growth in commercial loans – drove an increase in the debt ratio, which was offset by the decline in the sector's amortising debt on account to a similar extent. On the other hand, the debt ratio was improved by the EUR 0.6 billion decline in the consolidated general government's short-term external debt during the quarter. The general government's short-term external debt based on original maturity, along with the decrease in the margin accounts – hedging the US dollar exposure to euro – decreased by about EUR 0.4 billion, while due to the decrease in the non-residents' government securities holding, as a result of the expiry of foreign currency bonds, the amortising debt on account fell short of the end-2016 level by EUR 0.2 billion.



3.3 Developments in foreign exchange reserves and reserve adequacy

In 2017 Q1, there was no change in the level of foreign exchange reserves; the largest item which increased reserve was represented by EU transfers, while the maturity of swaps related to the forint conversion of households' foreign currency loans was the largest item which decreased reserves. At the end of March 2017, international reserves amounted to EUR 24.4 billion, which was almost at the same level as at the end of 2016. Changes in the foreign exchange reserves were influenced by a number of factors, from which the key items increasing the reserve were the following:

- EU funds increased the reserves by almost EUR 0.6 billion.
- Related to the MNB's quantitative restriction on the three-month deposit instrument, the MNB holds foreign currency swap tenders providing HUF liquidity since October 2016, to manage uncertainties related to liquidity developments. The impact of swap instruments generated a surplus of almost EUR 0.5 billion in 2017 Q1.
- As a result of the Government Debt Management Agency's net foreign currency financing, foreign exchange reserves rose by roughly EUR 0.2 billion, which is linked to the domestic foreign currency bonds (PÉMÁK) issued during the quarter, whereas the general government had no maturing foreign currency bonds.
- The revaluation resulting from the depreciation of other currencies against the euro increased foreign exchange reserves by about another EUR 100 million.

On the other hand, the rise in the level of reserves was fully offset by several items which decreased reserve; some of these are related to the MNB's programmes:

- In March 2017, the maturity of the swap instruments related to the conversion of households' foreign currency loans reduced foreign exchange reserves by almost EUR 0.6 billion.
- The reserve-reducing effect of loans granted under the foreign currency pillar of the third phase of the Funding for Growth Scheme amounted to more than EUR 60 million in the first three months of the year.
- The foreign currency transactions of the Government Debt Management Agency and the Hungarian State Treasury reduced the reserve level by EUR 0.7 billion in total. More than half of these expenditures related to the coupon payment due in the first quarter, related to several government bonds issued USD and EUR,

accounting for more than one-third of the annual interest payments belonging to the foreign currency-denominated government bonds.

At end of March 2017, the foreign exchange reserves significantly exceeded the level expected by investors. Based on the Guidotti-Greenspan rule, which is particularly followed by both the central bank and investors, the foreign exchange reserves of EUR 24.4 billion at the end of March 2017 exceed the level of short-term external debt, which amounts to EUR 19.9 billion. Changes in the foreign currency reserves were greatly influenced by the payment of EU funds, as well as by the MNB's foreign currency swap transactions of monetary policy purpose, the effect of which was fully neutralised by the Government Debt Management Agency's foreign currency transactions and the maturity of the foreign exchange swaps related to the forint conversion of foreign currency loans. The rise in short-term external debt is mostly related to the increase in the banking sector's debt, while in the case of the general government a small decrease was observed. Accordingly, there is still plenty of room for manoeuvre over the Guidotti rule, amounting to roughly EUR 4.5 billion in 2017 Q1, which still represents a safe reserve level (Chart 19).

Chart 19: Short-term external debt and the stock of foreign exchange reserves of the Hungarian economy



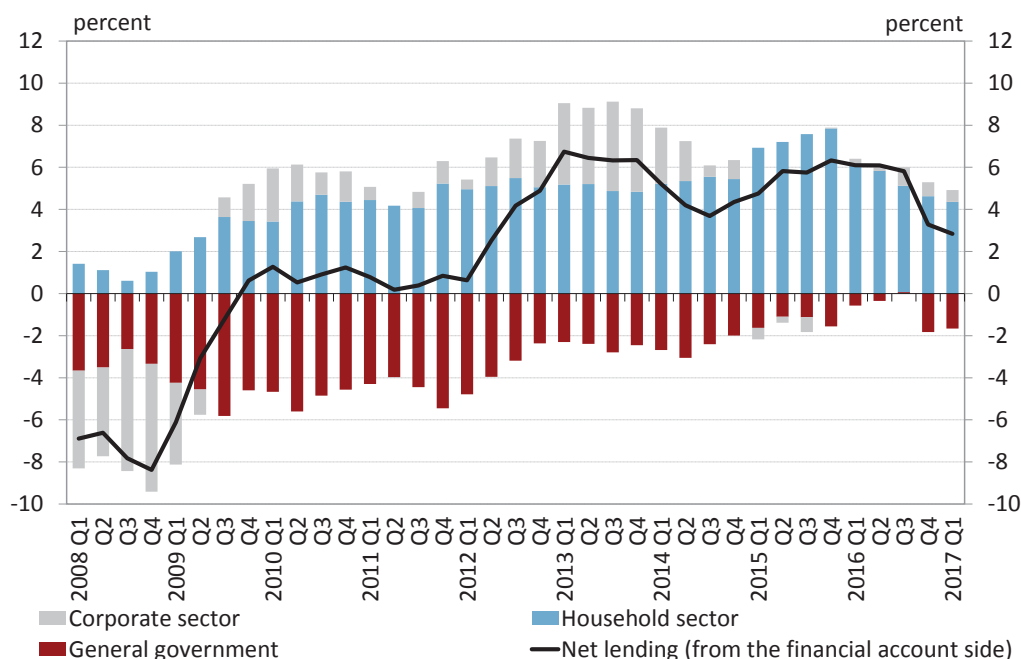
* Guidotti rule: short-term external debt based on residual maturity.

4. SECTORS' SAVINGS APPROACH

In 2017 Q1, net lending according to economic sectors' savings amounted to 2.8 per cent of GDP after a further moderate decrease. This was primarily caused by the fall in the financial savings of the private sector, the impact of which was mitigated by the decrease in the general government's net borrowing. Households' net financial savings once again declined in the first quarter, which is essentially attributable to the rising consumption and credit demand. As regards households' savings, government securities are still the instruments sought after the most by households, which – similarly to the previous quarters – significantly supported the decrease in the government's external liabilities and external vulnerability. In contrast to the previous quarters, households' demands for government securities shifted from short-term papers towards longer-term instruments, which also reduces the economy's vulnerability as it decreases the rollover risk.

According to the sectors' savings, the Hungarian economy's net lending in 2017 Q1 slightly decreased further, mostly attributable to the fall in the private sector's financial savings, while the general government's net borrowing was lower compared to the previous quarter (Chart 20). The moderate net borrowing of the consolidated general government can be explained by the rising fiscal revenues linked with the expansion of consumption and higher employment, as well as decreasing interest expenses. However, the impact of these was slightly offset by the fact that in the first quarter the expenditures related to EU transfers rose, while the EU funds received in December 2016 still have not been recognised as fiscal revenue. In the beginning of 2017 households' four-quarter net lending fell below 4.5 per cent of GDP, with further growth in consumption volume and increasing net new borrowing. The net lending of the corporate sector slightly decreased further, which can be attributed to a moderate decline in incomes and the increase in investments and stock accumulation.

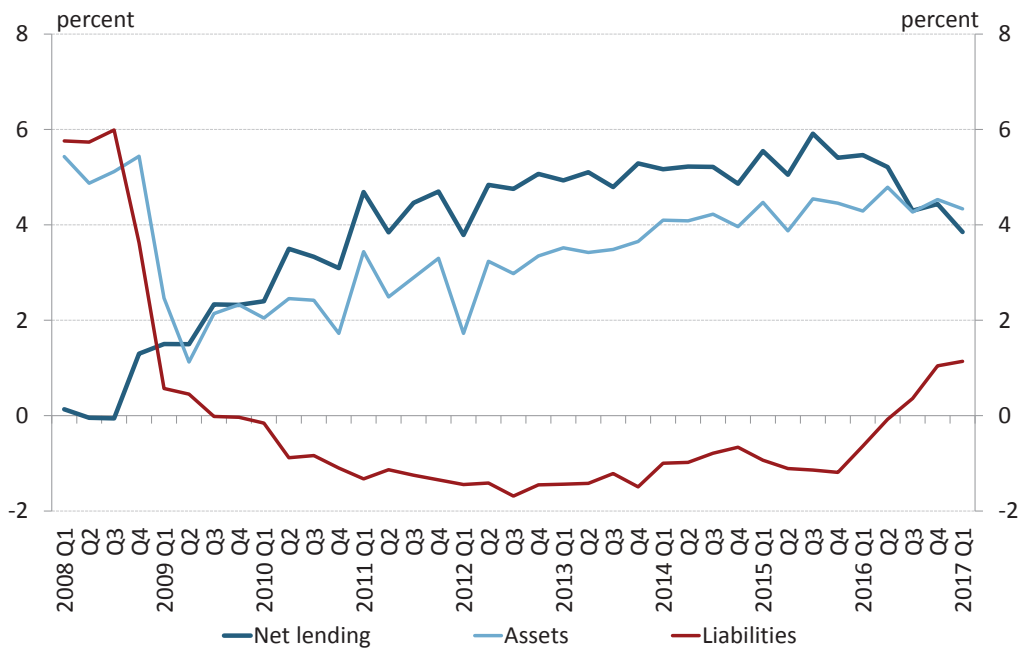
Chart 20: Net lending of the individual sectors (four-quarter values as a percentage of GDP)



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

According to the underlying trends, households' net financial savings decreased again in the first quarter, which took place in parallel with rising borrowing and declining asset accumulation (Chart 21). In 2017 Q1, the net lending of households amounted to approximately 4 per cent of GDP according to the underlying trends based on seasonally adjusted data. The seasonally adjusted net new borrowing in the first quarter of 2017 exceeded 1 per cent of GDP, which is attributable to the fact that, in an environment of steady growth in the household housing loan portfolio, the stock of other loans – mostly due to the FGS and land purchase loans granted to the self-employed – also rose significantly. In parallel with that, although the accumulation of financial assets declined to some extent, it is still relatively high, at around 4-5 per cent of GDP.

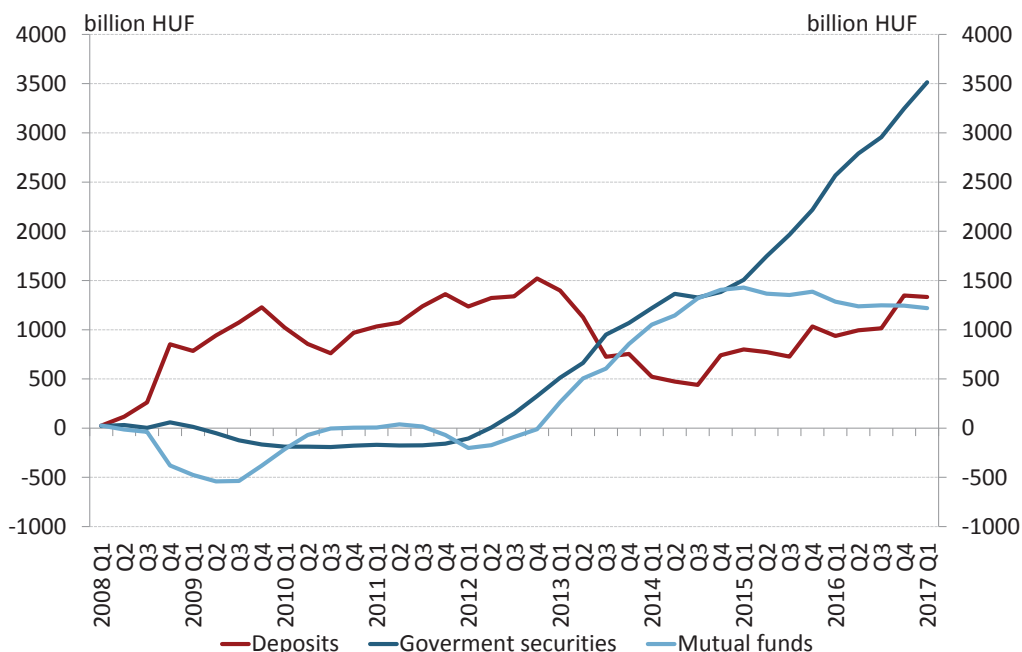
Chart 21: Net lending of households (seasonally adjusted revised* values, as a percentage of GDP)



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. Time series are adjusted separately.

The dynamic growth in the volume of households' government bond holdings continued in 2017 Q1, which – via the financing of the general government from internal funds – supports the lowering of the general government's external vulnerability (Chart 22). The uninterrupted growth in households' government securities holdings, which has been seen since 2012, continued in 2017 Q1 as well, which is primarily due to the major yield advantage realisable in the low yield environment, in contrast to other forms of investments. As a result of this, households' government securities holdings amounted to almost HUF 4,500 billion in March. Contrary to the previous quarters, households' demands for government securities shifted from short-term papers towards longer-term instruments, as a result of which the average residual maturity of the households' government securities portfolio rose. After the rising trend of the past period, in the first quarter – in line with start-of-year seasonality – no major change was recorded in households' cash and deposit holdings.

Chart 22: Developments of households' key financial assets (cumulative transactions)



5. FACTORS DETERMINING THE CHANGES IN EXTERNAL DEBT INDICATORS

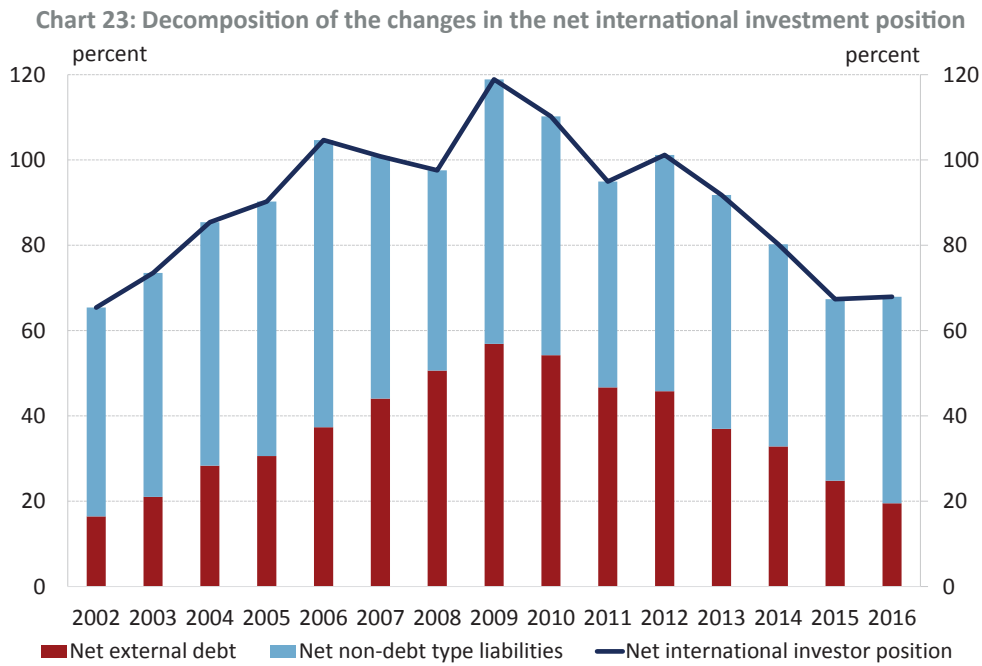
In this special topic, we present the factors that determine the developments in Hungary's external liability indicators. Whereas in the past we usually focused on net external debt, this analysis presents non-debt external liabilities, mainly the changes in foreign direct investment, in detail. As a result of the adjustment since the crisis, the net external liabilities of the Hungarian economy declined considerably, starting from a historical high of 120 per cent of GDP to close to 65 per cent, which was mainly reflected in the significant drop in net external debt, with the decrease in non-debt liabilities also contributing to this. In the case of net external debt, the adjustment following the crisis was coupled with the repayment of foreign credit. At the same time, the relevant impact was restrained by revaluation effects: the depreciation of the exchange rate following the outbreak of the crisis and the decline in yields in recent years also resulted in a rise in external debt. As for non-debt liabilities, transaction data, which reflect non-residents' investment decisions, had shown steady net FDI inflows since the crisis, while revaluations clearly pointed to a decline in FDI stock. On the whole, the stock of foreign direct investment decreased in the case of banks and increased in the case of non-financial corporations. In recent years, however, various factors influenced the net FDI stock:

- While the stock of net FDI liabilities had increased by more than EUR 1.5 billion in total since early 2008, nominal GDP growth reduced the net FDI stock as a proportion of GDP by more than 4 percentage points.
- The smaller increase in the stock of net FDI was accompanied by a large inflow of FDI, amounting to almost EUR 15 billion.
- The smaller increase in the stock – compared to inflow of funds – is mostly due to revaluations, which are mainly attributable to the fact that one-off losses are recorded here (e.g. losses related to repayment and settlement of FX loans, and losses related to FX loans), and the selling of equities and outstanding loans also affect revaluations.
- Acquisitions by the state also resulted in a decline in net FDI stocks (in a value of more than EUR 4 billion, in which the purchase of MOL, E-ON and Budapest-Bank played a significant role, among others).
- Hungarian companies' FDI investments abroad also entailed a decline in the net FDI stock.

5.1 Changes in Hungary's external liabilities

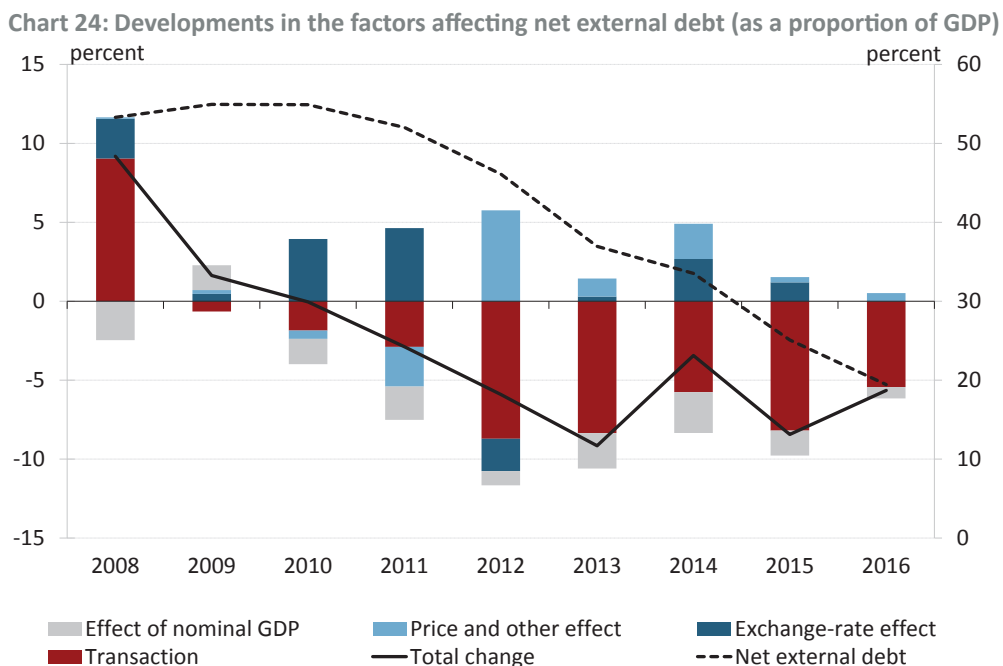
Until end-2009 Hungary's net international investment position showed significant growth, whereas since then the external liabilities of the economy have declined considerably, in parallel with debt repayment and the growth in nominal GDP. Prior to the crisis the Hungarian economy accumulated significant external liabilities, which grew to nearly 120 per cent of GDP by 2009, but the net international investment position as a proportion of GDP then declined to somewhat more than 65 per cent by end-2016. This decline was mainly attributable to nominal GDP growth, which in itself reduced external liabilities as a proportion of GDP by more than 10 percentage points. A considerable portion of the decline was reflected in the decrease in net external debt, although non-debt liabilities were also down slightly (Chart 23). Various recent studies and articles⁵ called attention to these latter developments and to the complexity of the factors that influence changes in the FDI stock. According to type of liability, the net international investment position is fundamentally affected by the changes in net external debt and non-debt liabilities. Therefore, we also provide a detailed review of the changes in these two items.

⁵ For example, Gábor Oblath (2016): Működőtőke-áramlás, újrabefektetett jövedelem és a nettó külföldi vagyon változása Magyarországon – Statisztikai adatok, módszertani kérdések és értelmezési buktatók (FDI flows, reinvested earnings and the changes in net foreign assets in Hungary – Statistical data, methodological questions and difficulties of interpretation); Statisztikai Szemle, Vol. 94, Nos 8–9; pp. 821–855.

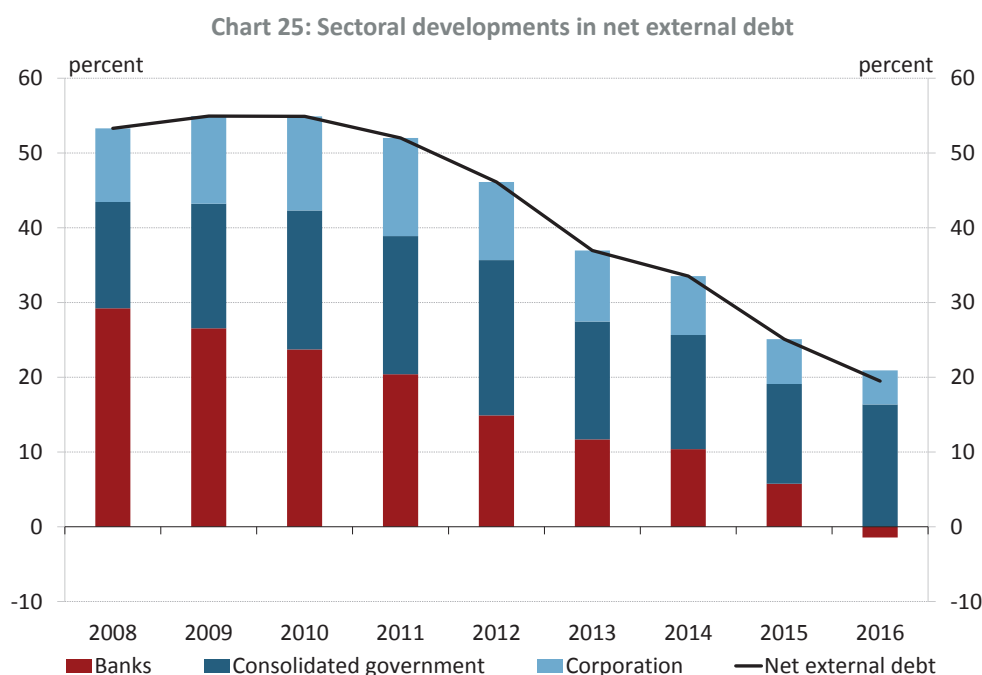


5.2 Developments in net external debt

The decline in net external debt evolved in parallel with domestic sectors’ sharp adjustment, the impact of which was significantly attenuated by the depreciation of the forint. Prior to the crisis, against the background of a high budget deficit and an upturn in households’ FX loans, the external debt ratio increased dynamically. Following the crisis, in parallel with the declining deficit and balance sheet adjustment by the private sector, net external debt started to move on a downward trend. In addition to the developments in transactions, revaluation effects occurring with the changes in bond prices and foreign exchange rates – as a result of shifts in yields – also have a major impact on the value of outstanding debt. The decline in net external debt was mainly attributable to the accumulation of financial assets and the repayment of previously borrowed FX loans and to a lesser extent to the increase in nominal GDP (by more than 10 percentage points), but exchange rate and price effects decelerated the process by some 20 per cent of GDP (Chart 24). In this respect, it is worth emphasising that although both the depreciation of the exchange rate of the forint and the yield decline added to net external debt, in spite of the stock-increasing effect, the lower yields reduced the external vulnerability of the economy by reaching the low yield level and interest payment.



The decline in net external debt is primarily attributable to the private sector. The balance sheet adjustment following the crisis was coupled with a decline in the corporate sector's external debt as well as an increase in households' financial claims and the repayment of their bank loans. Banks spent the ensuing household and corporate funds on repaying their previously borrowed foreign credit, which was also reflected in a spectacular fall in banks' external debt (Chart 25). Meanwhile, following the outbreak of the crisis, the net external debt of the state rose due to borrowing from the EU/IMF and non-residents' significant government securities purchases, and started to decline only as of 2013, following households' major government securities purchases and the launching of the self-financing programme. In 2016, the maturity of the bank swaps related to the conversion of FX loans into forints significantly affected the sectoral developments in net external debt: banks' debt declined further, while the net external debt of the consolidated general government including the MNB increased. This was because upon maturity of the swaps, the foreign exchange received from the central bank increased banks' foreign assets (as a result of which banks' net external debt became negative by end-2016), while the net external debt of the general government grew in relation to the decline in FX reserves.



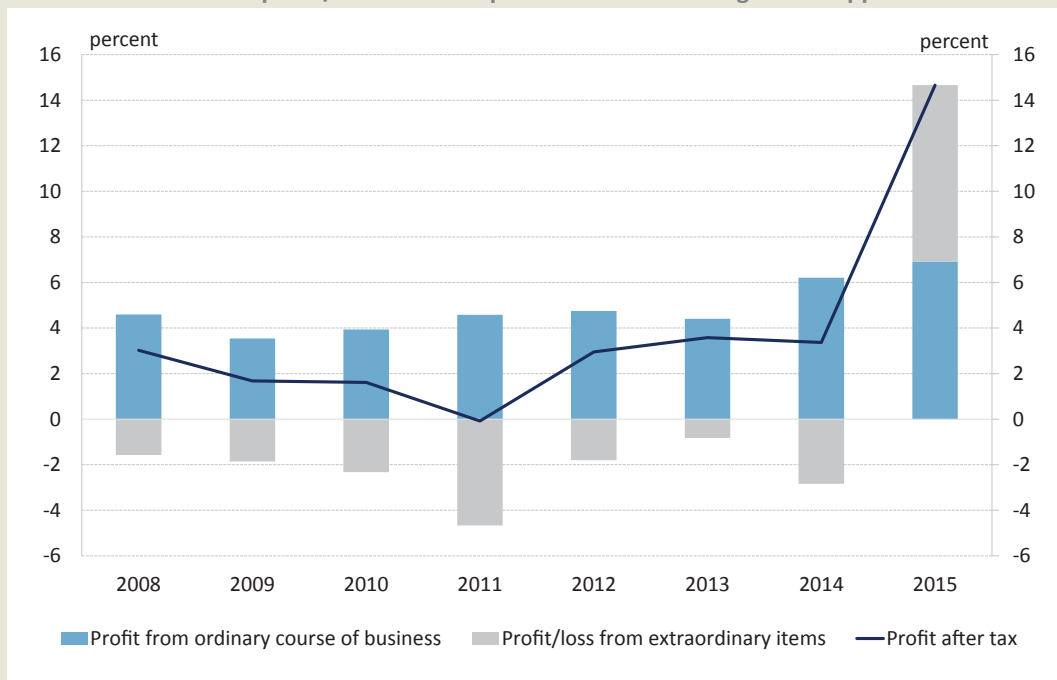
5.3 Changes in non-debt liabilities

The next chapter provides a more detailed presentation of the non-debt liabilities of the corporate sector (within that, banks and non-financial corporations) that is foreign-owned or is of foreign interest. Among non-debt liabilities, foreign direct investment and shares within portfolio investments are usually concentrated on. Although portfolio equity investments increased in the past two years, which was mainly attributable to a rise in equity prices and not to transactions, its degree is still well below that of foreign direct investments. Therefore, in the following we focus on the analysis of the changes in FDI. As consistent time series, which contain COPC adjustments (see the box for more details), are available only starting from 2008, our analyses also focus on this period. At the same time, this also allows a presentation of the developments that have taken place since the outbreak of the crisis. When analysing foreign direct investment, due to the significant capital in transit transactions observed in Hungary, it is worth focusing on the net balance of fund inflows and outflows, or filtering out capital in transit transactions. For a transparent evaluation of holdings, the holdings in EUR billion presenting the impacts net of nominal GDP growth are examined below.

Box 1: On the profit/loss according to the current operating performance concept

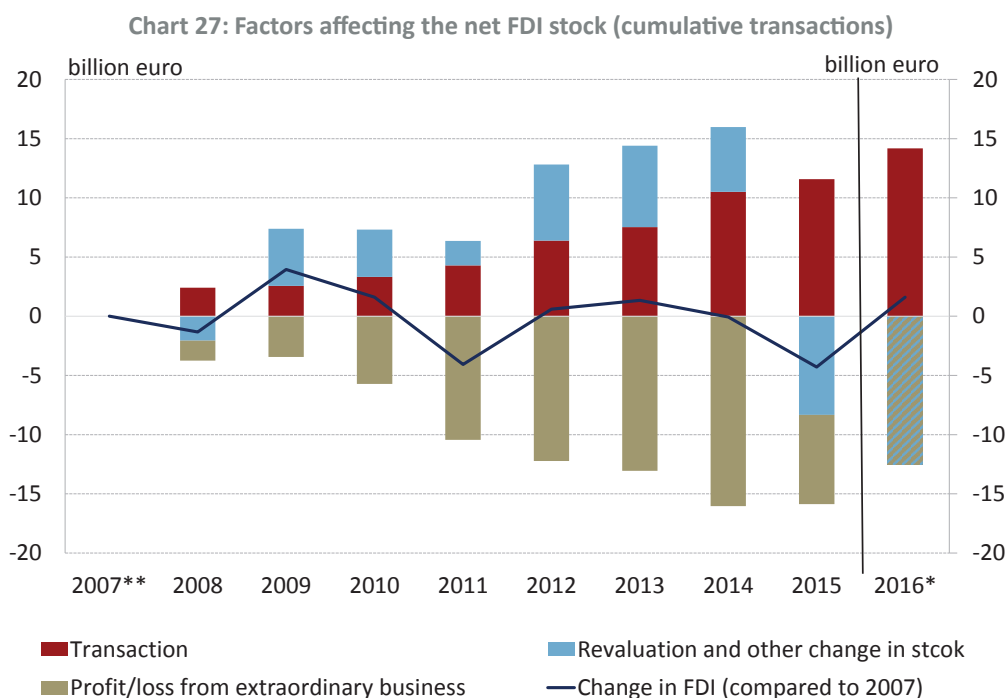
The transactions shown in the balance of payments reflect companies' profit/loss according to the current operating performance concept,⁶ while stocks are influenced by the total profit/loss that also contains the effects on profit/loss originating from unusual one-off events and revaluation. The balance of payments transactions reflect companies' profit/loss according to the current operating performance concept (COPC). Accordingly, extraordinary profits/losses are basically stated in the stock data of the balance of payments as revaluation. In the case of the data for the period before 2008 no distinction was made between the profit/loss according to the current operating performance concept and extraordinary profit/loss, and thus earlier income data contained both types. Therefore, our analyses focus on the examination of the data for the period since 2008, and thus consistent time series are presented. This is also corroborated by Chart 26, which shows that profits/losses according to the current operating performance concept is more stable for the entire time series.

While in previous years extraordinary corporate profits were negative, an extremely high positive value was observed in 2015, but profits 'from the normal course of business' shown in the balance of payments continued to be relatively stable. Since the crisis extraordinary items reduced corporate profits, whereas in 2015 – largely due to the sale of a business branch of a multinational company – a significant one-off extraordinary profit evolved at foreign-owned companies operating in Hungary (Chart 26). Accordingly, the after-tax profit of companies significantly exceeded the values observed in previous years. As a result of this one-off item, the correction item according to normal course of business changed signs. Namely, while in the previous years the net profit/loss effect had reduced the net foreign direct investment stock, it increased the latter significantly in 2015. Accordingly, the profit/loss according to the current operating performance concept excluding one-off items (blue column in the chart) was much more stable than companies' after-tax profits.

Chart 26: Net profit/loss of the corporate sector according to two approaches

⁶ MNB (2014): Hungary's balance of payments and international investment position statistics. Page 52: 'Pursuant to international statistical standards, only profits from the *normal course of business* (current operation) of an enterprise should be recorded as direct investment income. Any elements arising outside the normal course of business, as a result of 'extraordinary' factors, are to be excluded. The removal of extraordinary elements is necessary to allocate changes in the net worth of the company statistically correctly between income, revaluation and other stock changes.'

The net FDI stock has increased slightly since 2007, by nearly EUR 15 billion on the basis of transactions. The difference is partly attributable to extraordinary losses and partly to other revaluations. The slight expansion in the net FDI stock observed after the crisis is mainly related to inflow of funds (Chart 27), which is mitigated by one-off losses. According to transactions, as a result of capital investments and reinvested earnings,⁷ the value of foreign investments increased considerably. While prior to 2015 extraordinary losses significantly reduced and revaluations increased the stock of foreign direct investment, in 2015 a considerable amount of extraordinary profit was generated, which reduced the previous years' losses considerably. (This may have been largely attributable to a multinational company operating in Hungary that – following a minor loss in 2014 – attained extremely high profits exceeding EUR 10 billion in 2015.) Simultaneously with that, however, the invested stock declined considerably due to revaluation.



*Data for extraordinary profit/loss for 2016 are not yet available. Accordingly, the factors related to revaluation are not broken down.

**The 2007 data contain the 2008 opening stocks. Therefore, the time series does not contain the difference between the end-2007 closing and 2008 opening stocks.

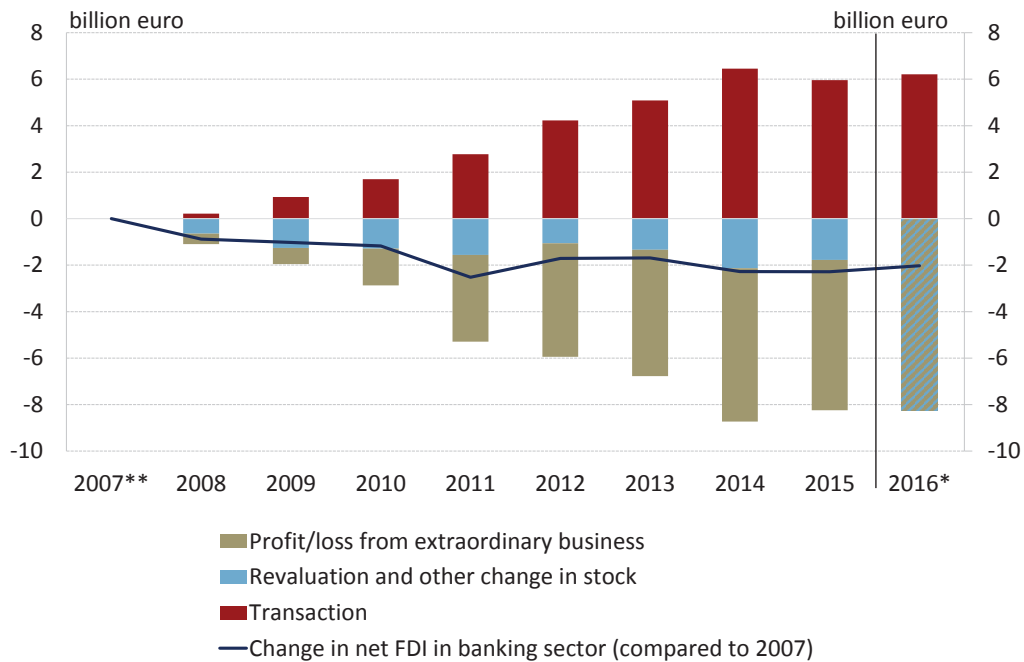
5.3.1 The banking sector

In the case of the banking sector, extraordinary losses and revaluations were the main sources of the decline in foreign direct investments, while owners' investments added to the net FDI stock – partly in relation to the capital injection due to the losses suffered. The amount of FDI flowing into the banking sector started to increase significantly from end-2008, i.e. starting from the outbreak of the crisis. Transactions rose because banks reinvested an increasing portion of the profits produced in order to offset the increasing losses related to the foreign currency loans granted, while from end-2011 the capital injections due to the losses entailed by the early repayment and the settlement already necessitated fresh FDI inflows as well. However based on currently available data, banks' profit was significant in 2016. Part of this has materialised at banks owned by domestic actors and thus is not represented in the balance of payments. Furthermore, it is noteworthy that this larger profit is partly due to a one-off effect (Financial Stability Report, May 2017), which according to the manual on the balance of payments is not represented in the transactions, while – similarly to losses of previous years, but with a different sign – it increases the stocks. In addition, banks' losses are reflected in the changes in the banking sector's FDI stock as well: banks' net FDI stock at end-2016 was below the level typical prior to the crisis in spite of the fact that nearly EUR 6 billion was invested in the meantime (Chart 28). If, in addition to the transactions, the extraordinary profit/loss (COPC adjustment) is also taken into account, it is observed that compared to the end-2007 level no FDI inflow took place on the basis of the transactions cumulated to

⁷ The expansion in reinvested earnings is also partly related to the separation of extraordinary profit.

the banks either, and developments better approximating the stock values are seen. In addition, banks' FDI stock was reduced by other changes in stock as well. Accordingly, on the whole, the extraordinary profit/loss and other changes in stock resulted in the fact that at end-2016 the FDI stock was below the level observed upon the outbreak of the crisis.

Chart 28: The banking sector's net FDI stock compared to January 2008

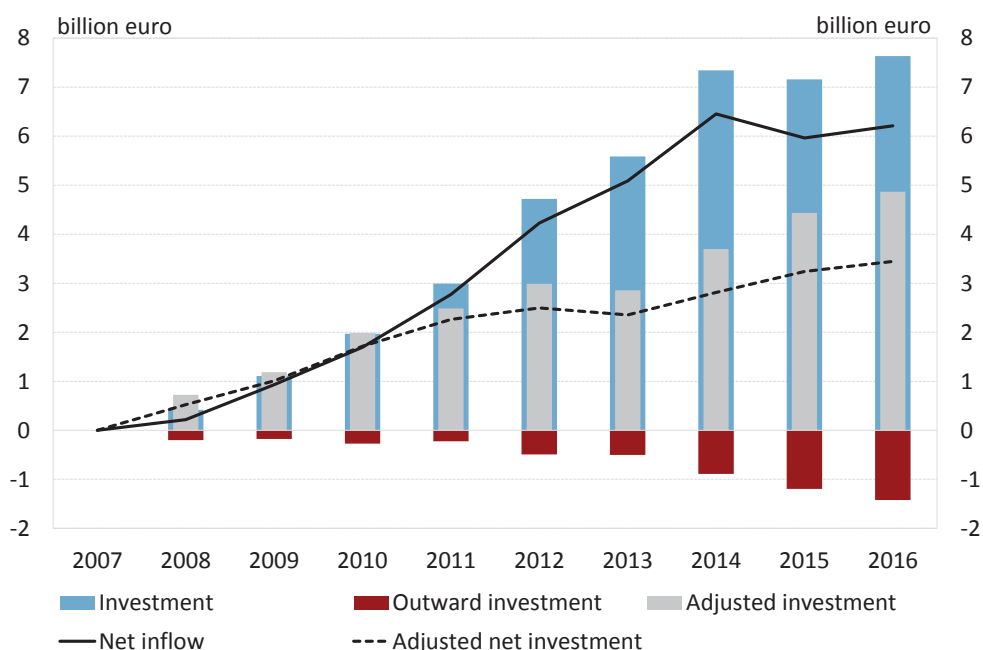


*Data for extraordinary profit/loss for 2016 are not yet available. Accordingly, the factors related to revaluation are not broken down.

**The 2007 data contain the 2008 opening stocks. Therefore, the time series does not contain the difference between the end-2007 closing and 2008 opening stocks.

In the case of banks, the value of foreign direct investment is reduced by the rise in foreign investments observed in the past years and acquisitions by the state, while foreign-owned banks' capital increases add to it. In the case of the banking sector, at the transaction level, it was mainly non-residents' investments in Hungary that contributed to the significant net FDI inflows which have taken place since 2007, while domestic actors' disinvestments slightly offset these. However, in the case of transactions it is important to call attention to two factors, which had contrasting impacts on fund inflows. While in the years following the crisis the capital increases carried out in connection with one-off losses considerably enhanced net FDI inflows, the acquisitions of – previously foreign-owned – banks (MKB Bank and Budapest Bank) by the state reduced them. With these factors taken into account, on the whole, net foreign direct investment would have been lower (Chart 29).

Chart 29: Gross components of banks' net FDI inflows according to raw data as well as adjusted for capital increases and for acquisitions by the state (cumulative transactions)

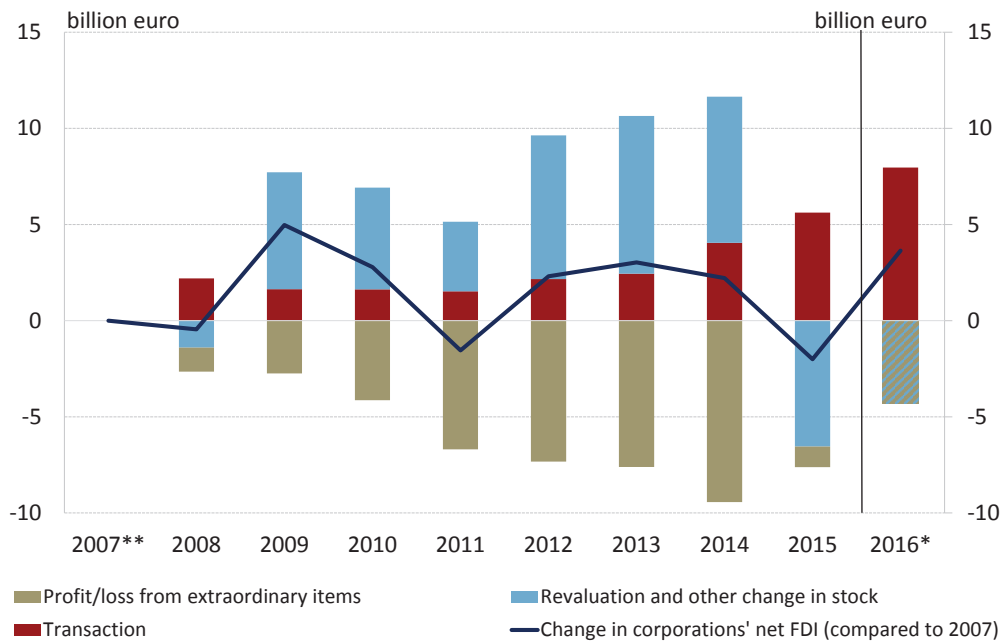


5.3.2 Corporate sector

The corporate sector's net FDI funds have expanded by nearly EUR 5 billion since the outbreak of the crisis. In the case of companies, the increase in funds was a result of an expansion in FDI funds in the corporate sector, which was moderated by the value reducing effect of the losses resulting from the crisis and of the revaluations.

- The revaluation is also partly related to the fact that companies' market value cannot be observed in the case of unlisted companies. If upon selling a company the negotiated price is different from the book value, this difference is reflected in the revaluation.
- Between 2008 and 2014, the total value of extraordinary losses was still high (nearly EUR 10 billion), but as a result of a significant one-off corporate profit in 2015, the cumulative impact on the net FDI stock declined close to 0. At the same time, in 2015 a significant revaluation effect reduced the stocks, and thus the aggregate impact of revaluations and extraordinary items remained practically unchanged. Looking at individual sectors of non-financial corporations, extraordinary losses were primarily observed in the trade sector.

Chart 30: Changes in the corporate net FDI stock (cumulative transactions)

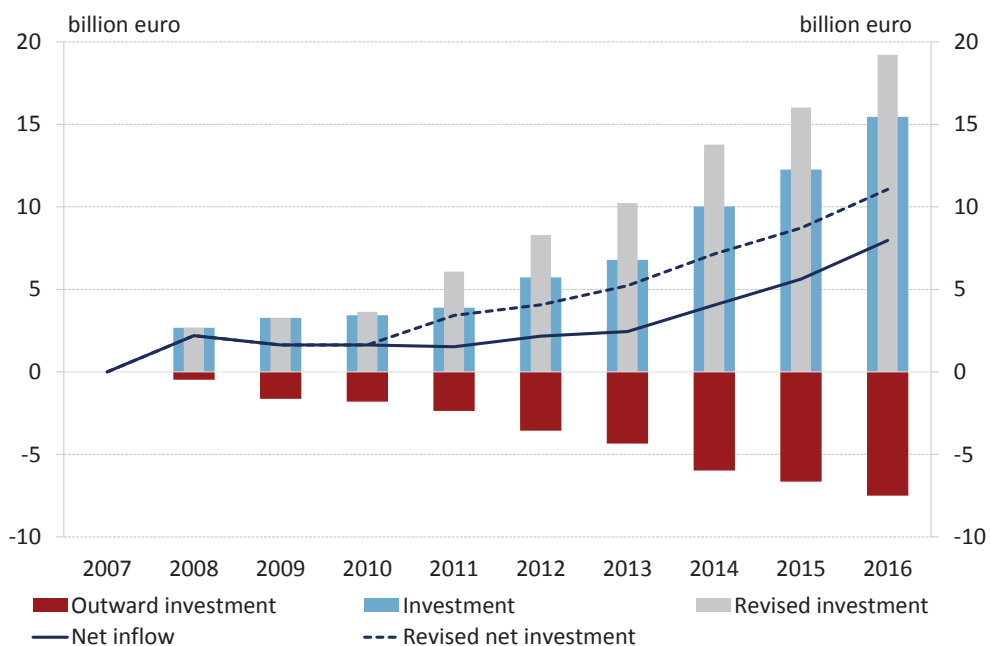


*Data for extraordinary profit/loss for 2016 are not yet available. Accordingly, the factors related to revaluation are not broken down.

**The 2007 data contain the 2008 opening stocks. Therefore, the time series does not contain the difference between the end-2007 closing and 2008 opening stocks.

In past years, corporate foreign direct investments were reduced by more than EUR 3 billion by acquisitions by the state. However, the related decline does not reflect the foreign companies' investment decisions. Most of the external liabilities related to non-financial corporations are composed of non-debt FDI funds. After the crisis, in addition to the gross components of investments abroad and investments in Hungary, net inflows also followed a rising trend (Chart 31). When analysing foreign direct investment, it is expedient to examine the net inflows, as this is what in fact may have an impact on economic developments. At the same time, after 2010 a gradual increase was already observed in the net inflows adjusted for acquisitions by the state, which have a reducing effect on net inflows. Adjusted net inflows mean data excluding the acquisitions by the state of companies such as MOL, E-On, Főgáz or the lower-value Antenna Hungária.

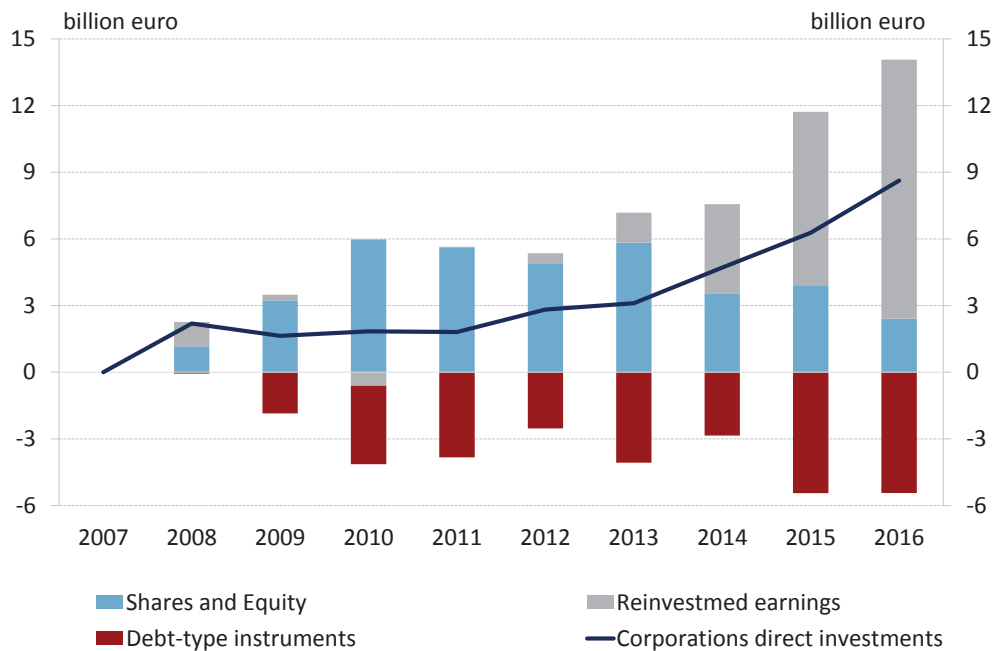
Chart 31: Gross components of corporate net FDI inflows net of capital in transit, excluding raw data and acquisitions by the state (cumulative transactions)



It is assumed in our analysis that capital in transit transactions affect companies.

Following 2012, the expansion in companies' cumulative net FDI funds evolved mainly against the background of an increase in reinvestments and a decline in equities. These developments are attributable to acquisitions by the state and superdividend disbursements. In the past years, net FDI inflows were mainly related to the increase in reinvested earnings, while equity financing declined slightly starting from 2013 according to the data shown in the balance of payments. This is partly attributable to the aforementioned acquisitions by the state, which reduced companies' equity financing by nearly EUR 3 billion. At the same time, superdividends also contribute to the restructuring between reinvestment and equity-type 'fresh' FDI inflows. This is because since 2013, if a foreign-owned company pays more dividends than its annual profits, i.e. votes for dividend payment to the debit of the retained profits, the dividend disbursement is a transaction that reduces shares and other equity, and not reinvested earnings. As a result of such superdividend disbursements, non-residents' shares and other equities turnover has declined by nearly EUR 4 billion in cumulative terms since 2013, roughly corresponding to the cumulative fall in equities that has taken place since 2013. Finally, it is worth calling attention to the decrease in the debt within FDI (aka intercompany loans): since the outbreak of the crisis, companies have repaid not only their loans from domestic and foreign banks but have also repaid more than EUR 5 billion of the loans previously received from their owners.

Chart 32: Net FDI inflows excluding capital in transit in the corporate sector (cumulative transactions)



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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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