REPORT ON THE BALANCE OF PAYMENTS

2018
JANUARY

‘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 developments 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 for Monetary Policy and Economic Analysis. Contributors: Eszter Balogh, Anna Boldizsár, Gabriella Csom-Bíró, Orsolya Csortos, Bence Gerlaki, Zsuzsa Kékesi, Balázs Kóczián, Péter Koroknai and Balázs Sisak. The Report was approved for publication by Deputy Governor Márton Nagy.

This Report is based on information for the period ending on 21 December 2017.

Summary

In 2017 Q3, **the current account surplus declined due to strengthening domestic demand**, while net lending fell more slightly as a result of the rising absorption of EU transfers. The sustained high level of net lending **reduced Hungary's external indebtedness**, helping to **mitigate the economy's external vulnerability**. In the third quarter, the current account surplus amounted to 3.9 percent of GDP, which **still substantially exceeds the values observed in the countries of the region.**

Net lending according to the **real economy approach fell to 5.2 percent of GDP** in the third quarter. The underlying reasons for this decline included the **decrease in the trade surplus** and the **rise in the income balance deficit**, which was slightly offset by the **moderate increase in the transfer balance surplus**. The significant decline in the balance of goods surplus stemmed partly from **rising imports due to stronger domestic absorption**, and partly from the **deceleration in exports due to summer factory stoppages**, while the **services balance surplus** also continued to **decrease**. In the past quarter, **growth in the absorption of EU transfers continued**, but it still falls short of the level observed in earlier years.

In the third quarter, net lending **declined in terms of financing as well: in parallel with a major decrease in net external debt, net FDI inflow** amounted to more than EUR 0.7 billion. The **substantial outflow of debt liabilities** was supported by the banking sector to a larger degree and by the corporate sector to a smaller degree, while the general government's external debt and receivables fell at a similar rate. In line with these developments, **external debt ratios as a percentage of GDP continued to decline in 2017 Q3 as well**: net and gross external debt both fell by almost 2 percentage points (with net external debt dropping to 14.1 percent of GDP and gross external debt down to 63.8 percent). **In a breakdown by sectors, the banking sector's net external debt decreased to the largest degree,** as this sector's external assets exceeded its stock of external liabilities again, owing to the substantial increase in external receivables. **Hungary's short-term external debt** – which is primarily linked to the general government – **fell to EUR 18.7 billion, and thus the foreign exchange reserves** of EUR 22.2 billion **still significantly exceed the level expected** and deemed safe **by investors**.

According to the **sectors' saving approach, the sharp decline in net lending** was attributable to the fall in the private sector's net lending, while the general government's net borrowing remained moderate. The **government's** low net borrowing is primarily attributable to **increasing revenues** from rising consumption and higher employment. In the third quarter, **households' holdings of government securities** once again **increased** dynamically, which has a **favourable impact on the economy's external vulnerability**.

In the **special topic** presented in this report, we examine the factors underlying the **decrease in the trade balance in 2017**. The fall in the current account surplus observed in 2017 was linked to a decline in the trade surplus, **mainly in the goods balance** and to smaller degree in the services balance. The deterioration in the terms of trade due to higher commodity prices contributed to narrowing the trade balance, but **the decline** can be mostly attributed to **volume** changes. The decrease in the balance of goods resulted primarily from the **stronger import growth**, while in the case of services it was due to the fact that export growth lagged behind GDP growth. The decline in the four-quarter balance was mainly caused by the decrease in net machinery exports, and in particular by the larger rise in machinery imports, attributable to the **growth in imports of machinery for investment purposes**. Thus, on the whole, due to the higher import demand from the expansion of domestic demand, net exports made a negative contribution to growth in 2017. On the other hand, in recent quarters the **balance of goods decreased** not only in Hungary, but **also in the other countries in the region**, which was attributable to the expansion of domestic demand in most of the countries.

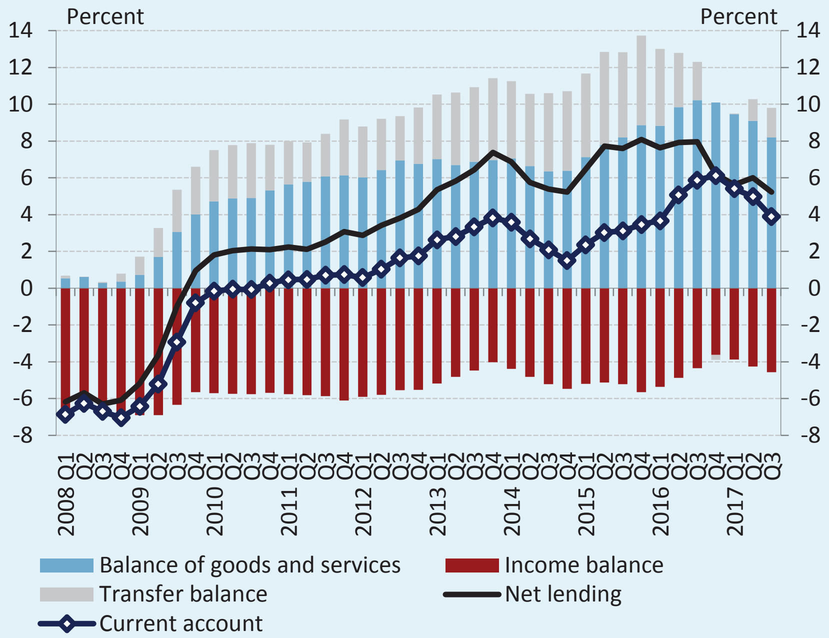
Contents

1 Real economy approach

In the real economy approach, the net lending of the Hungarian economy fell to 5.2 percent of GDP in 2017 Q3, while the current account surplus fell to 3.9 percent of GDP. The decline in net lending was primarily due to the lower surplus on the goods and services balance, while this was partially offset by the improvement in the transfer balance. The lower trade balance was mostly linked to the expansion of domestic consumption and gross fixed capital formation. In parallel with this, amidst increasing absorption of EU funds, the improvement in the transfer balance fostered a rise in net lending. Similarly to previous periods, the deficit on the income balance continued to rise, owing to higher profits of non-resident companies and slightly lower compensation of employees.

In 2017 Q3, according to the real economy approach, Hungary's four-quarter net lending fell to 5.2 percent of GDP, while the current account surplus fell to 3.9 percent of GDP (Chart 1). According to the seasonally unadjusted figures, net lending in the third quarter amounted to EUR 1.1 billion, as the combined result of surpluses of EUR 0.8 billion and EUR 0.3 billion on the current account and the capital account, respectively. The decline in the four-quarter value of the external balance indicators can be explained by similar development as in the previous quarter: the trade surplus decreased and the deficit on the income balance continued to rise, while the impact of these changes was mitigated by a slight improvement in the transfer balance. The decrease in the surplus on the goods and services balance was mostly linked to the rise in domestic absorption items, while the improvement in the transfer balance mainly related to the stronger absorption of EU funds.

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

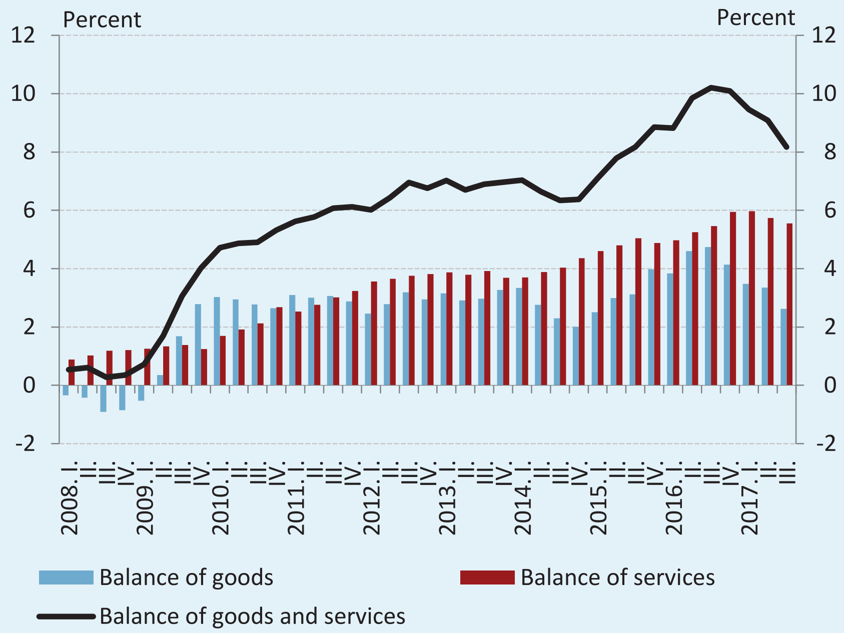


** Income balance: labour income, income on equity and income on debt. Transfer balance: sum of the capital account and other primary and secondary income.*
All charts by the MNB unless otherwise indicated.

1.1 Trade balance

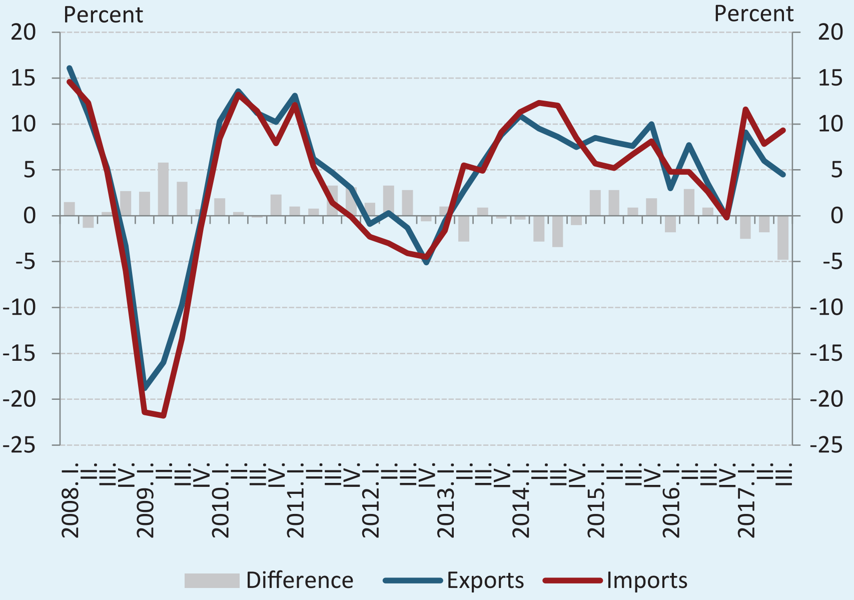
Similarly to the situation in the second quarter, the decline in the trade surplus can be attributed to the lower goods and services balance (Chart 2). The steady decline in the trade surplus, which has been seen from mid-2016, continued in the third quarter as well. Initially, this decline was linked to the decrease in the goods surplus, but in the past two quarters developments in the services balance surplus also lowered the trade balance. Despite the decline, at the end of the period under review, the goods and services balance was still high, amounting to 8.2 percent of GDP, which is well above the values observed in the post-crisis years. The decline in the balance of goods in the third quarter was also attributable to the summer stoppages at the vehicle factories, which was partially offset by a surge in the manufacturing of machinery and metal industry products. In addition, due to the expansion of manufacturing capacity, goods imports rose substantially, which also contributed to the lower balance of goods. The services balance decreased at a similar rate as in the previous quarter, but its level remains high, at around 5.6 percent of GDP.

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



Similarly to the previous quarter, the annual real growth rate of exports fell in 2017 Q3, and the rate was significantly exceeded by the annual growth in imports due to the expansion of domestic demand items (Chart 3). In parallel with capacity expansions in Hungary, the absorption of imports by investments rose in the third quarter, which contributed to faster annual real growth in imports. In addition, the stable rise in household consumption, which affected both semi-durable and durable goods, also fostered real growth in imports in the period under review. By contrast, similarly to the dynamics observed in the previous quarter, export growth declined further, which was partly due to the moderate vehicle manufacturing output resulting from summer factory stoppages.

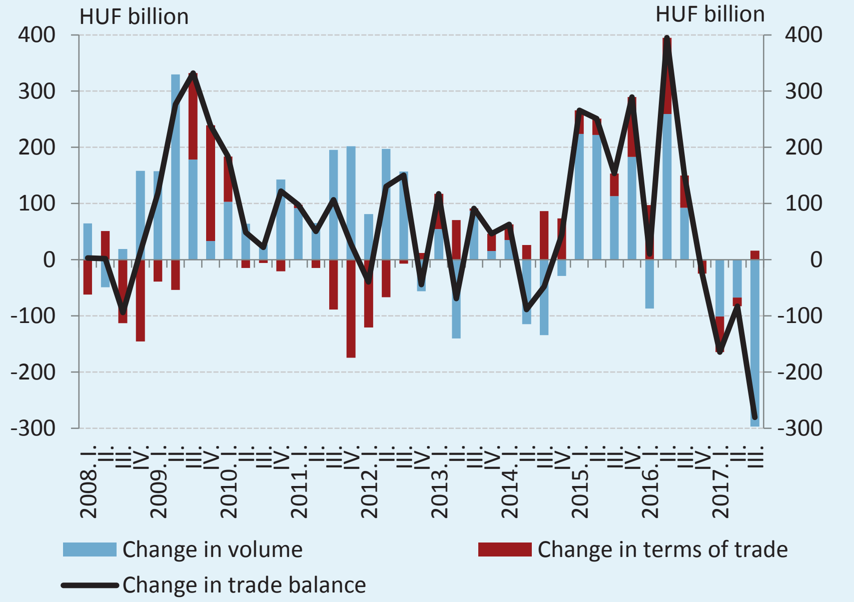
Chart 3:
Annual real growth of exports and imports



Source: HCSO, MNB.

In line with the import growth, the volume change substantially reduced the trade surplus, while the change in the terms of trade moderately increased the surplus (Chart 4). Due to the strong growth in domestic demand items and moderate vehicle manufacturing output, the volume change substantially reduced the surplus on the goods and services balance in the third quarter. On the other hand, the evolution of the terms of trade had a moderately favourable impact on the trade balance, as the combined result of the rise in commodity prices and the price change of machinery equipment, which have a higher weight in exports. For more details on developments in the trade balance, see the special topic in this report.

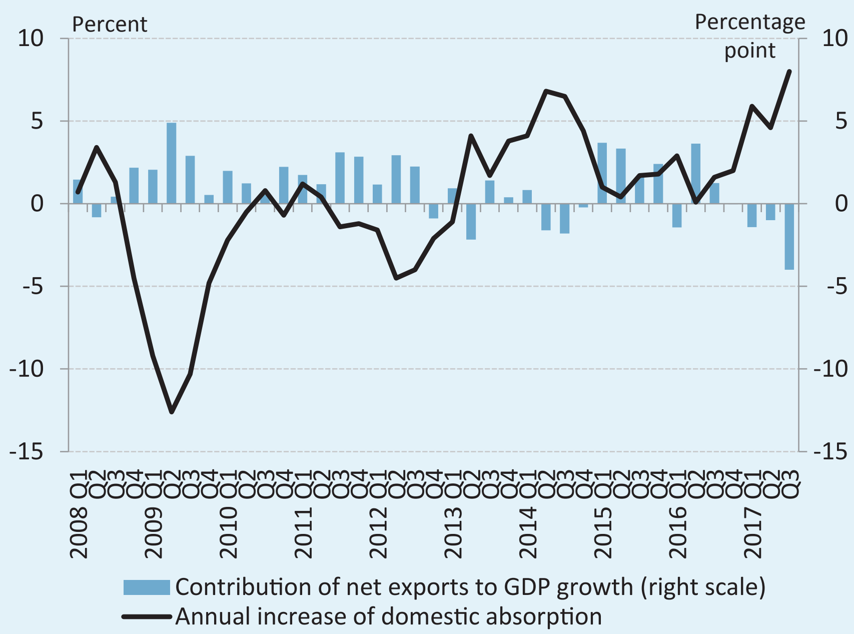
Chart 4:
Developments in balance of trade factors according to GDP (year-on-year)



Source: HCSO.

In the third quarter, the significant expansion of domestic absorption supported GDP growth, while net exports restrained growth (Chart 5). Higher household consumption and the rising level of gross fixed capital formation both made a positive contribution to Hungarian economic growth in the third quarter. The dynamic growth in gross fixed capital formation is partly attributable to public investment supported by EU funds, and partly to private sector investment, which rose in parallel with manufacturing capacity expansions. As a result of stronger domestic demand, net exports curbed GDP growth significantly.

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

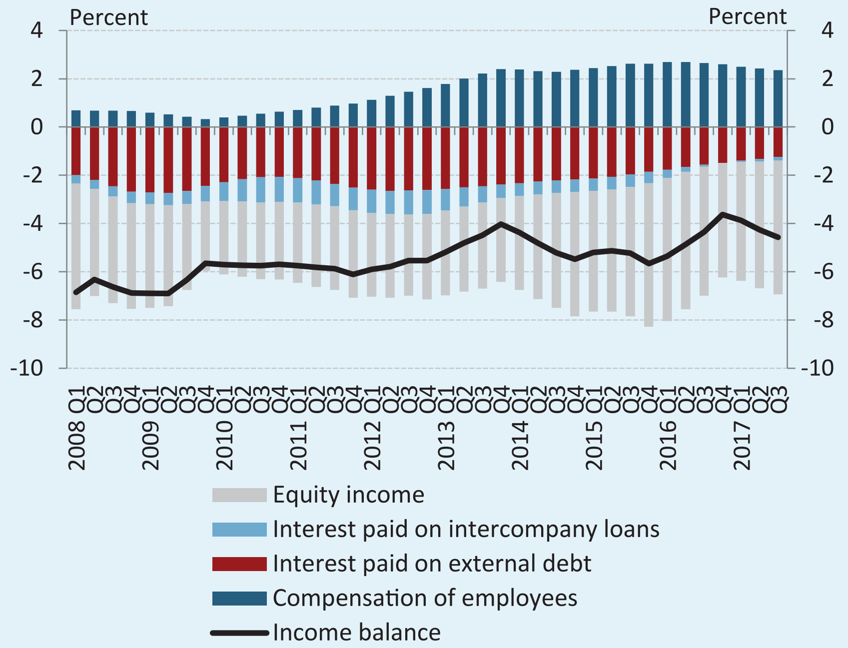


Source: HCSO.

1.2 Income balance

Similarly to the previous periods, the four-quarter deficit on the income balance continued to increase, reaching 4.6 percent of GDP (Chart 6). In the third quarter, the gradual rise in the income balance deficit, which lasted from the end of last year, continued as the combined result of several factors. In the period under review, the higher income balance deficit was attributable to a larger degree to the rising profit[1] of foreign-owned companies, and to a smaller degree to the decrease in the compensation of employees working abroad for a period shorter than one year. This was partly offset by a small improvement in the interest balance of foreign loans, primarily due to the low yield environment and lower gross external debt.

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



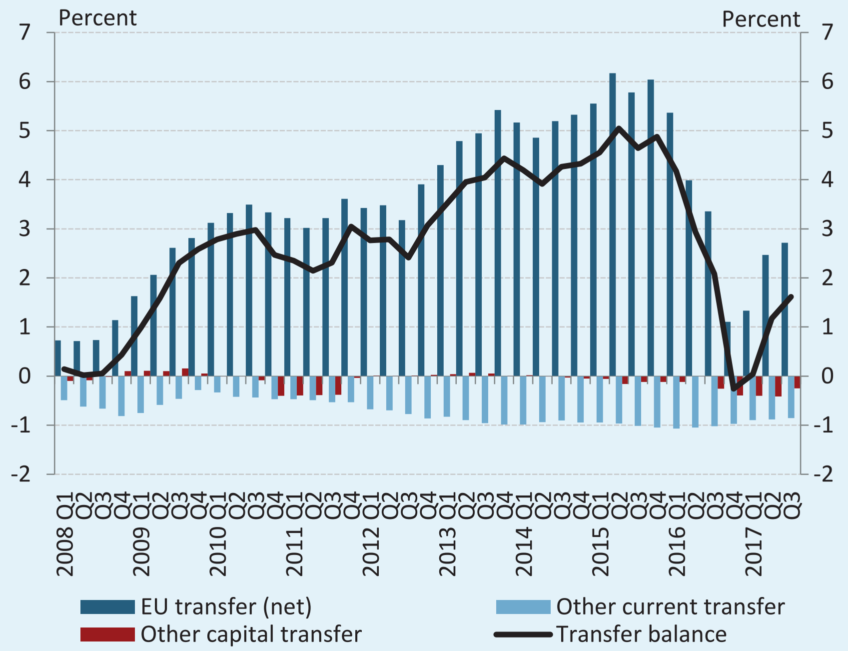
** Income balance: labour income, income on equity and income on debt.*

[1] The profits of foreign-owned companies, as well as the reinvested income shown in the income balance, are based on an estimate for 2017, which will be replaced by actual figures based on corporate surveys together with the publication in September 2018.

1.3 Transfer balance

In the third quarter, as a result of higher inflows of EU transfers, the transfer balance continued to improve (Chart 7). The absorption of EU transfers declined substantially last year, as the 2007-2013 programming period ended. Consequently, at the end of the fourth quarter of 2016, the transfer balance caused a decrease in net lending. However, from the second quarter, due to the inflow of funds from the new programming period, the transfer balance improved substantially. In the third quarter, the four-quarter value of the net capital transfer inflow from the EU amounted to EUR 1.9 billion, while the inflow of net current transfers was EUR 1.4 billion. In addition to the higher absorption of EU funds, the lower deficit of other capital transfers also contributed to improving the transfer balance in the period under review, while the balance of other current transfers did not change significantly.

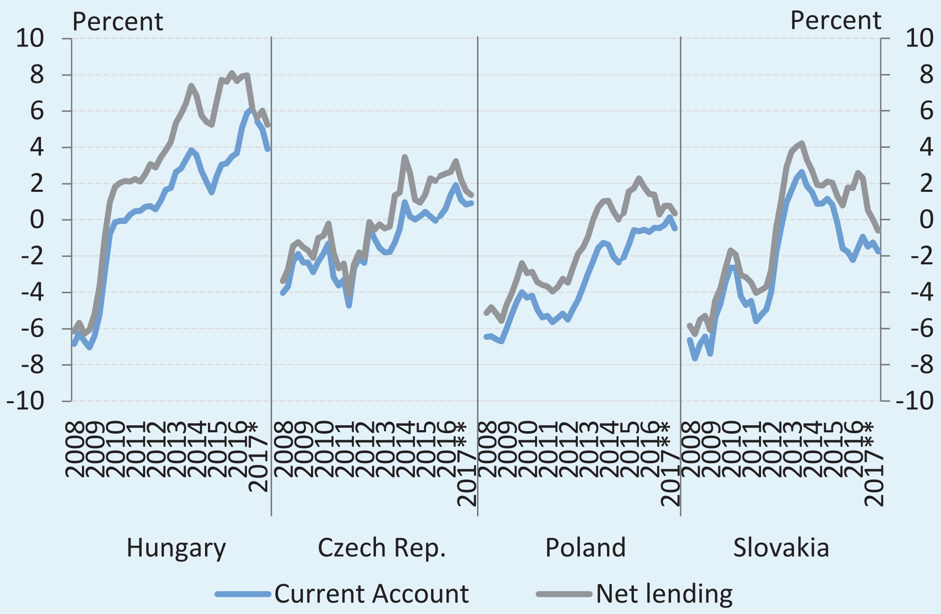
Chart 7:
Four-quarter changes in the items of the transfer balance (as a percentage of GDP)



1.4 Regional outlook

Similarly to Hungary, in the past quarters net lending has decreased in all of the countries of the region, in part due to the decrease in the balance of goods and in part to the moderate developments in the capital account (Chart 8). With the end the EU's 2007-2013 programming period, the absorption of EU funds by the countries in the region declined substantially, contributing to the drop in their net lending. The largest fall was observed in Hungary and Slovakia, as these countries had previously recorded the highest inflows of EU funds. In addition, in the past quarters there was also a slight decrease in the balance of goods in the countries of the region (for more details, see the special topic). Despite the fall, Hungary's net lending and current account still exceed the level observed in the countries of the region.

Chart 8:
Four-quarter net lending of the countries of the region (as a percentage of GDP)



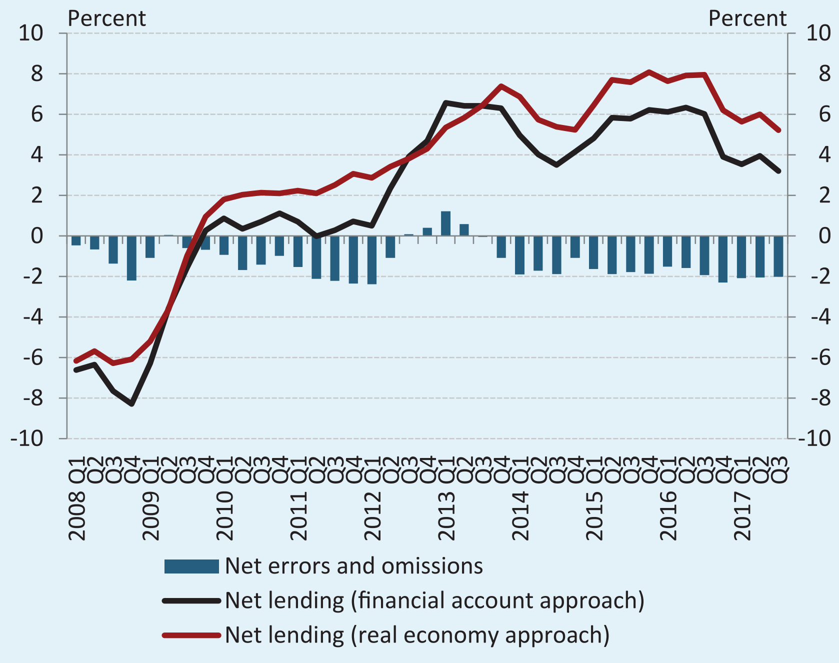
** Data related to Hungary are up to the third quarter of 2017.*
*** Data for the countries of the region are available up to the second quarter of 2017.*

2 Financing approach

Calculated on the basis of the financial account, net lending fell to 3.2 percent of GDP in the third quarter, as the combined result of the substantial decline in net external debt and larger inflows of non-debt liabilities, reflecting a significant rise in foreign direct investment. The substantial outflow of debt liabilities was driven by the banking sector to a larger degree and by the corporate sector to a smaller degree, while on the basis of transactions, the consolidated general government's net external debt did not change significantly. The decrease in the banking sector's net external debt was achieved in parallel with a significant increase in external assets, which may still have been attributable to the rising volume of the private sector's foreign currency deposits.

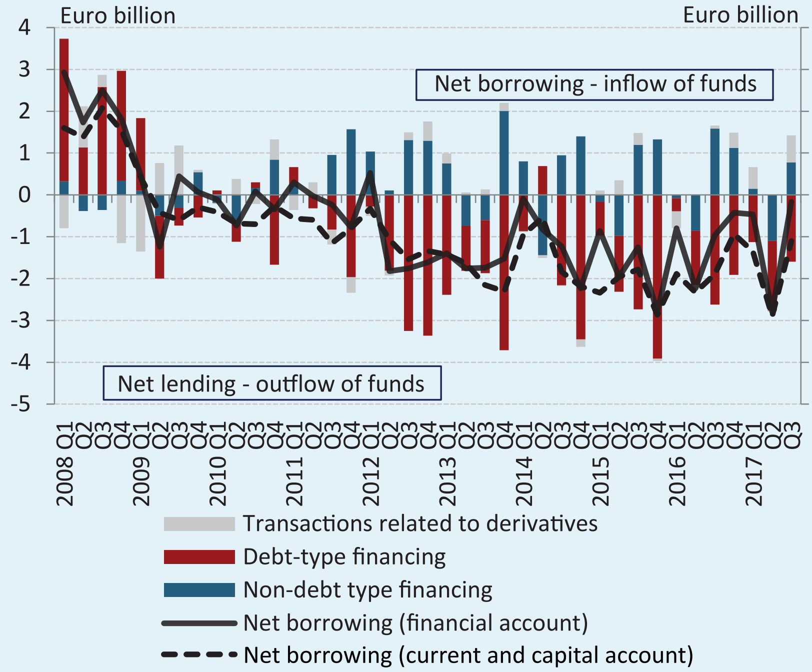
In 2017 Q3, according to the financing approach, four-quarter net lending fell short of the real economy approach and amounted to 3.2 percent of GDP (Chart 9). In addition to net lending calculated on the basis of the real economy approach, the indicator using the financial account also decreased to a similar degree in the period under review, and thus the difference between the two ratios did not change substantially. Net errors and omissions remained slightly above the long-term average, at around 2 percent of GDP.

Chart 9:
Two types of net lending and "Net errors and omissions" (four-quarter values as a percentage of GDP)



In the third quarter, net lending calculated according to the financing approach declined significantly, falling to EUR 0.2 billion (Chart 10). An outflow of funds was observed only in the case of debt liabilities: Hungary's net external debt shrank by EUR 1.6 billion as a result of transactions. On the other hand, non-debt liabilities rose by EUR 0.8 billion in the third quarter, owing to the increase in foreign direct investment. In addition, in the period under review, the inflow of funds related to derivative transactions amounted to EUR 0.6 billion, accompanied by a larger increase in receivables.

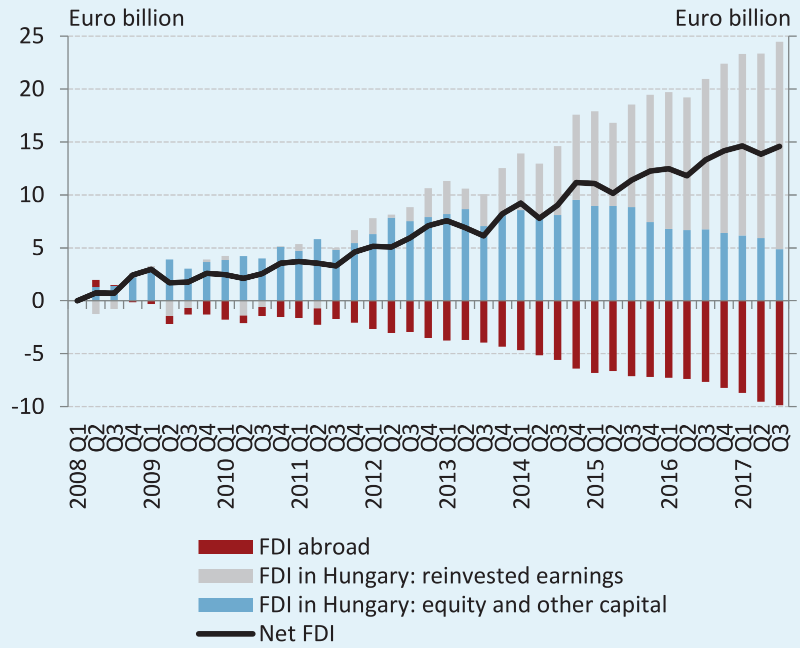
Chart 10:
Structure of net lending (unadjusted transactions)



2.1 Non-debt liabilities

In 2017 Q3, the value of net FDI increased again in Hungary (Chart 11). In order to eliminate the distorting effects, it is advisable to examine the data net of capital-in-transit transactions and the restructuring of the asset portfolio. Based on these data, in the third quarter – in contrast to the second quarter – the net FDI stock in Hungary rose by more than EUR 700 million based on transactions, with the increase in the investment of foreign-owned companies partially offset by the growth in outward investment by resident companies. The FDI inflow of foreign-owned companies was linked almost completely to the large increase in reinvested earnings (partially due to seasonal effects), which was partially offset by the significant decline in inter-company loans.

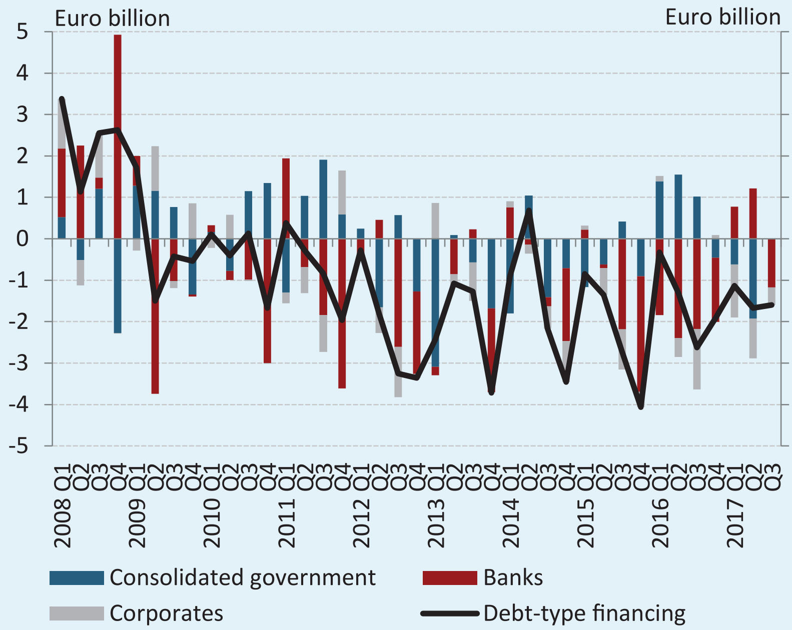
Chart 11:
Developments in FDI without capital-in-transit transactions (cumulative transactions)



2.2 Debt liabilities

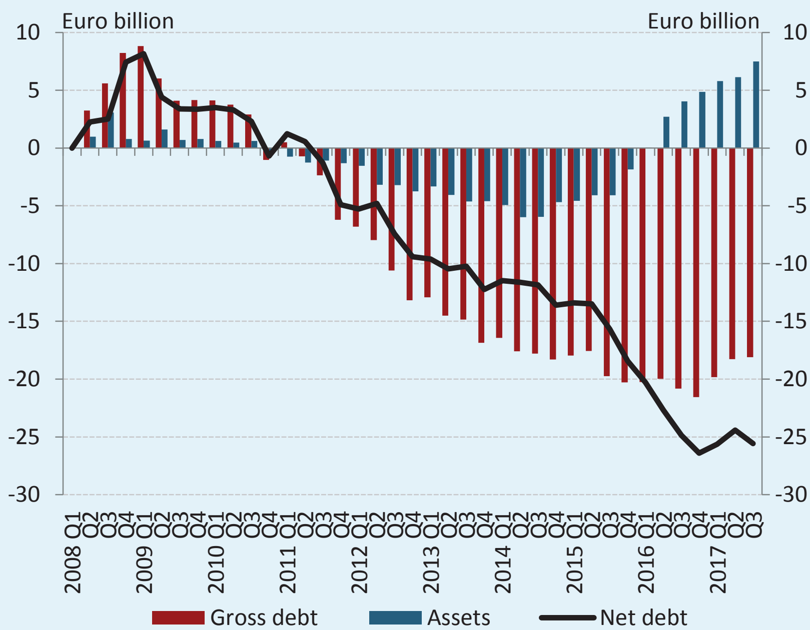
In the third quarter, the outflow of debt liabilities accelerated, mostly due to the decrease in the banking sector's net external debt, while developments in corporate sector debt also reduced the debt ratio (Chart 12). In contrast to the trends observed in previous quarters, the banking sector's net external debt increased as a result of transactions in the first two quarters of this year, followed by a decrease of almost EUR 1.2 billion in the third quarter, primarily due to a sharp rise in external assets. In addition, corporations' net external debt, which fell short of the level observed in earlier periods, decreased by EUR 0.4 billion, which was linked in full to the rise in the sector's external assets. On the other hand, the net external debt of the consolidated general government did not change during the quarter: the significant decrease in the sector's external liabilities was offset by the decrease in foreign exchange reserves.

Chart 12:
Developments in net debt-type financing by sector



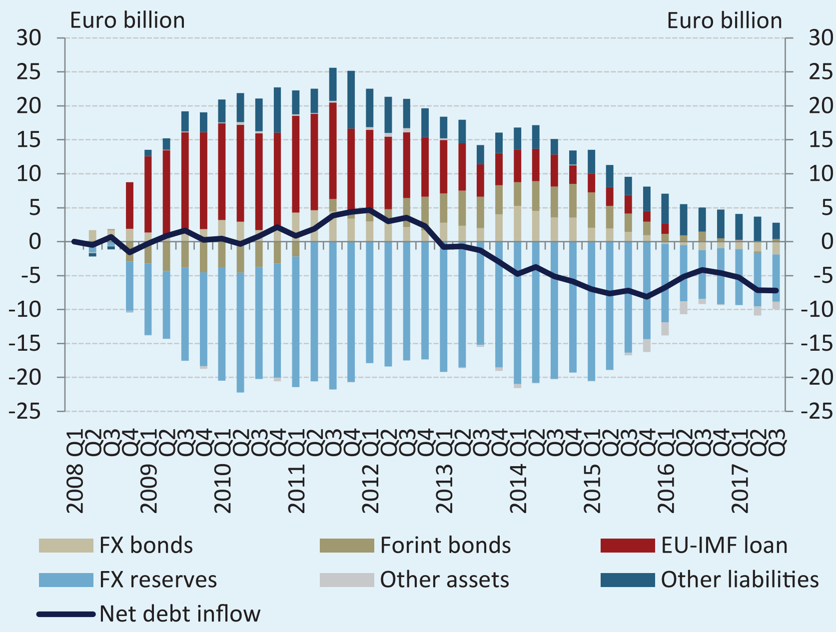
Similarly to the trends observed in 2016, banks' net external debt declined in the third quarter, due to the significant increase in external assets (Chart 13). The rise in the banking sector's external assets exceeded the value observed in the previous quarter, while liabilities increased only to a small degree. As a result of this, the sector's net external debt declined by EUR 1.2 billion, following the increase observed in the previous two quarters. The expansion of external assets in the third quarter may have been supported, amongst other things, by the increasing foreign currency deposits of the private sector. Following the significant growth observed in the previous two quarters, the external liabilities of banks rose only moderately, increasing by EUR 0.2 billion in the third quarter, which appeared in full in the sector's long-term liabilities.

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 did not change significantly in the third quarter (Chart 14). During the period, repayment of the general government's net external debt dropped to almost zero, falling well short of the decrease of almost EUR 2 billion registered in the previous quarter. In Q3, the decline in the general government's external liabilities corresponded to that in assets. The substantial fall in liabilities is primarily attributable to the decline in the margin accounts, which also entailed a drop in foreign exchange reserves, and hence had no effect on net external debt. The absorption of EU transfers reduced the accrual-based liabilities to the EU. On the other hand, the decrease in liabilities was partly offset by a small increase in non-residents' government securities holdings, which occurred in parallel with a rise in forint government securities and the repayment of foreign currency bonds. The drop in foreign currency assets was attributable almost in full to the decline in foreign exchange reserves, mostly resulting from the maturity of a foreign currency bond in July, in addition to the already mentioned margin accounts.

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



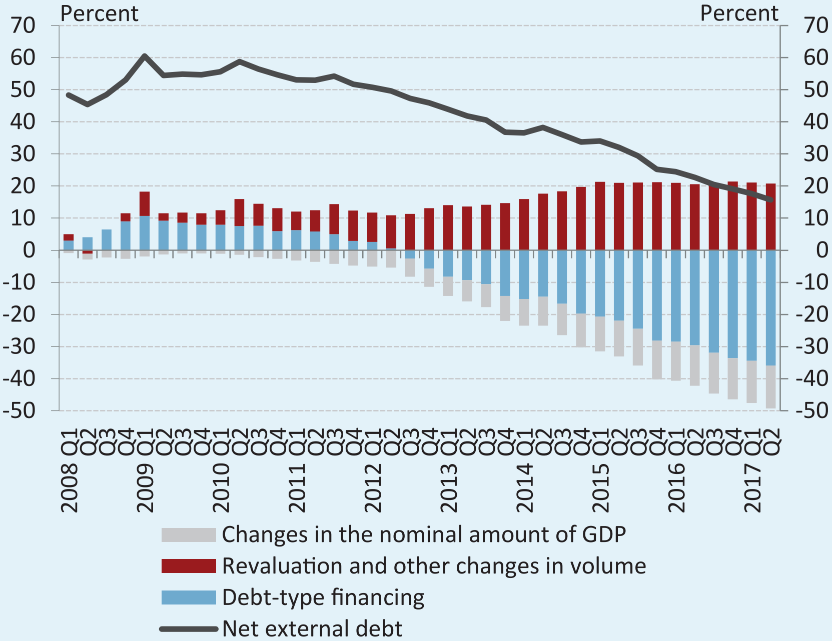
3 Developments in debt ratios

In 2017 Q3, the debt ratios of key importance for the assessment of Hungary's external vulnerability continued to decline. Net and gross external debt fell by 1.6 and 2.1 percentage points, respectively, and thus the net ratio amounted to 14.1 percent of GDP, while gross external debt amounted to 63.8 percent of GDP at the end of the quarter. The decline in net external debt occurred amidst a more substantial outflow of debt liabilities, but the growth in GDP also supported the reduction of this ratio. In a breakdown by sectors, the net external debt of the banking sector shrank substantially, while the net external debt of the consolidated general government and non-financial corporations decreased to a smaller degree. As a result of the substantial rise in the banking sector's external assets, the sector's external assets once again exceed banks' stock of external liabilities. In the case of corporations, the change both in liabilities and assets resulted in a decrease, while for the general government, with an almost identical decrease of liabilities and assets, the growth in GDP contributed to the decline in the indicator. As regards gross external debt as a percentage of GDP, the larger part of the decrease related to the consolidated general government, but the gross external debt of the private sector also declined to a small degree. Hungary's short-term external debt fell by EUR 1 billion to EUR 18.7 billion, which is fully explained by the decrease in the consolidated general government's short-term external debt. Even with the decrease in foreign exchange reserves to EUR 22.2 billion, short-term external debt still substantially exceeds the level expected and deemed safe by investors.

3.1 Developments in net and gross external debt

In 2017 Q3, Hungary's net external debt decreased to 14.1 percent of GDP, due to the outflow of debt liabilities, as well as GDP growth (Chart 15). Net external debt – a ratio which is of key importance in terms of the country's external vulnerability – dropped to 14.1 percent of GDP by the end of September. Of the three factors taken into consideration, the decrease in the debt ratio was primarily supported by the outflow of debt liabilities, but the growth in nominal GDP also contributed to the decline to a smaller degree; on the other hand, the revaluation of outstanding stocks had no significant impact on the whole: the stock-increasing effect of the yield decrease was offset by the appreciation of the forint against the US dollar.

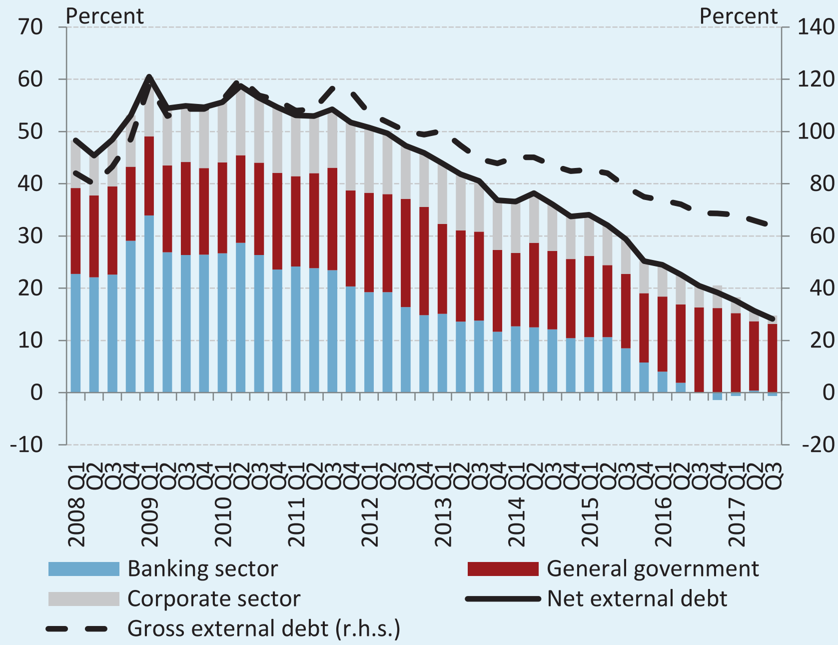
Chart 15:
Components of changes in net external debt* (cumulated, GDP-proportionate values, end-2007 = 0)



All sectors contributed to the substantial decrease in net external debt in the third quarter as well (Chart 16). In the banking sector, the decrease in the debt ratio was caused by the significant increase in assets, in the case of corporations, the change both in liabilities and assets resulted in a decrease, while for the general government, amidst an almost identical decrease in liabilities and assets, the growth in GDP contributed to the decline in the indicator. The decrease in the general government's external assets was primarily caused by transactions, in particular by the lower foreign exchange reserves, while the decline in debts is attributable to the decrease in liabilities, linked to the absorption of EU transfers and to the maturity of a foreign currency bond.

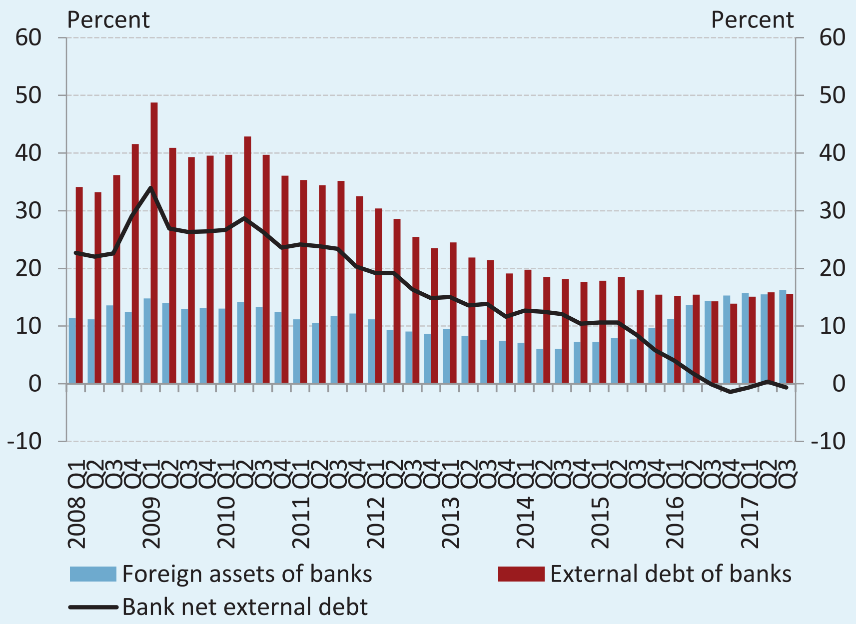
In 2017 Q3, gross external debt continued to fall, declining by more than 2 percentage points to reach 63.8 percent of GDP. The lower debt ratio was mostly supported by the outflow of debt liabilities, but as a result of the denominator effect, GDP growth and the appreciation of the forint exchange rate against the US dollar also contributed to the decline. In a breakdown by sectors, the consolidated general governments gross external debt as a percent of GDP fell by 1.6 percentage points, while that of the private sector fell by 0.6 percentage point, with the decrease in the gross external debt of corporations and the banking sector amounting to 0.4 and 0.2 percentage point, respectively.

Chart 16:
Net external debt by sectors and gross external debt (relative to GDP, excluding intercompany loans)



In the third quarter, the banking sector's net external debt once again moved into negative territory: as a result of the substantial growth in assets, the sector's external receivables exceed its external liabilities (Chart 17). The fact that the banking sector's net external debt became negative is primarily attributable to the rise in assets, but gross external liabilities also showed a minor decline. The rising foreign currency deposits of the private sector made a major contribution to boosting the banking sector's external receivables. As a result of the growth in external assets, the sector's net external debt became negative, i.e. the banks' external assets once again exceed the external liabilities of the sector.

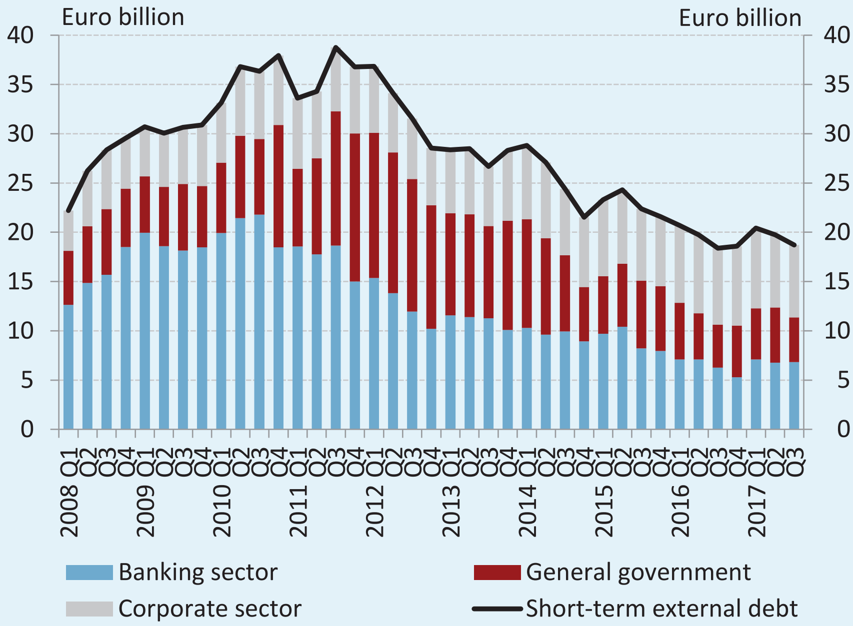
Chart 17:
Developments in the banking sector's external assets and debt (as a percentage of GDP)



3.2 Developments in short-term external debt

After falling by roughly EUR 1.1 billion, short-term external debt amounted to EUR 18.7 billion at the end of the third quarter of 2017 (Chart 18). The decrease in short-term external debt can be attributed almost completely to the consolidated general government, while the private sector's short-term external debt did not change significantly: the modest decline in corporations' debt was offset by the rise in banks' debt. In the third quarter, the short-term external debt of the consolidated general government fell by EUR 1.1 billion, which was caused by a large decrease in short-term external debt based on original maturity and by a smaller decline in amortising debt, mostly attributable to the decline in margin accounts and the maturity of a foreign currency bond held by non-residents.

Chart 18:
Developments in gross short-term external debt based on residual maturity



3.3 Developments in foreign exchange reserves and reserve adequacy

In 2017 Q3, the level of foreign exchange reserves decreased, mostly due to the net FX financing need of the government, the change in the margin deposit portfolio related to the Government Debt Management Agency's hedging swap transactions, as well as the foreign currency expenditures of the Government Debt Management Agency and the Hungarian State Treasury. At the end of September 2017, international reserves amounted to EUR 22.2 billion, reflecting a decline of EUR 1.2 billion compared to the level at the end of June 2017. Changes in the foreign exchange reserves were influenced by a number of factors, of which the key reserve-increasing items were as follows:

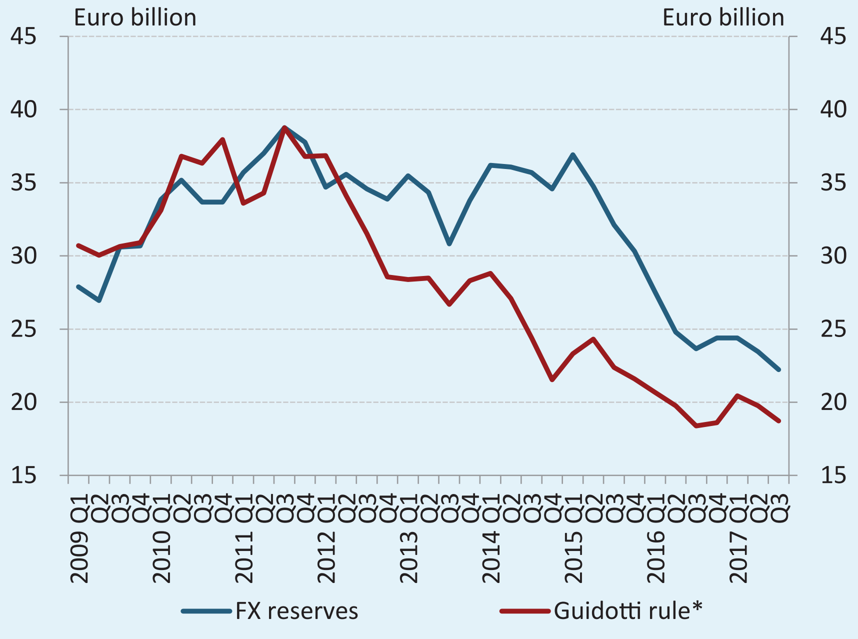
- The net FX financing need of the Government Debt Management Agency reduced the reserves by roughly EUR 700 million. In July, a EUR-denominated foreign currency bond expired in the amount of EUR 760 million; the reserve-reducing effect of this was offset in the amount of almost EUR 130 million by the issuance of the onshore yuan-denominated Panda bond at the end of July. Hungary is the first foreign issuer to issue renminbi bonds both in the domestic market and in the (Hong Kong) foreign market. In the quarter under review, the repayment of foreign currency loans amounted to more than EUR 220 million, while the issuance of the retail foreign currency bonds raised reserves by almost EUR 110 million.

- The margin deposit, linked to the Government Debt Management Agency's hedging swap transactions, the foreign currency deposits placed by the domestic credit institutions at the MNB, and the rollover of the cross-currency swap transactions reduced the reserves by slightly more than EUR 300 million.

- Other foreign currency expenditures of the Hungarian State Treasury and the Government Debt Management Agency represented another reserve-decreasing item, which reduced foreign exchange reserves by more than EUR 500 million in total. The reserve-reducing effect of the revaluation resulting from the depreciation of other currencies against the euro was close to EUR 300 million.
- The September maturity of the swap facilities related to the conversion of households' FX loans into forints and the loans granted within the framework of the FX pillar of the third phase of the Funding for Growth Scheme reduced the reserves by EUR 65 million and nearly EUR 40 million, respectively.
- Contrary to the items reducing the reserves, the EU funds of almost EUR 230 million, received in the third quarter, as well as the rise of almost EUR 500 million in the stock of forint liquidity providing foreign exchange swaps, resulted in an increase in reserves.

In addition to the decrease in foreign exchange reserves, short-term external debt also declined substantially by the end of the third quarter, and thus the volume of foreign exchange reserves still considerably exceeded the level expected by investors (Chart 19). In addition to the lower level of foreign exchange reserves compared to the end of last quarter, short-term external liabilities also declined, and thus considering the Guidotti-Greenspan rule – which is closely followed by the central bank and the investors – the foreign exchange reserve of EUR 22.2 billion, recorded at the end of the third quarter of 2017, exceeds the volume of short-term external debt, which amounted to EUR 18.7 billion. The room for manoeuvre over the Guidotti-Greenspan indicator was roughly EUR 3.5 billion at the end of the third quarter, which is still a safe level.

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



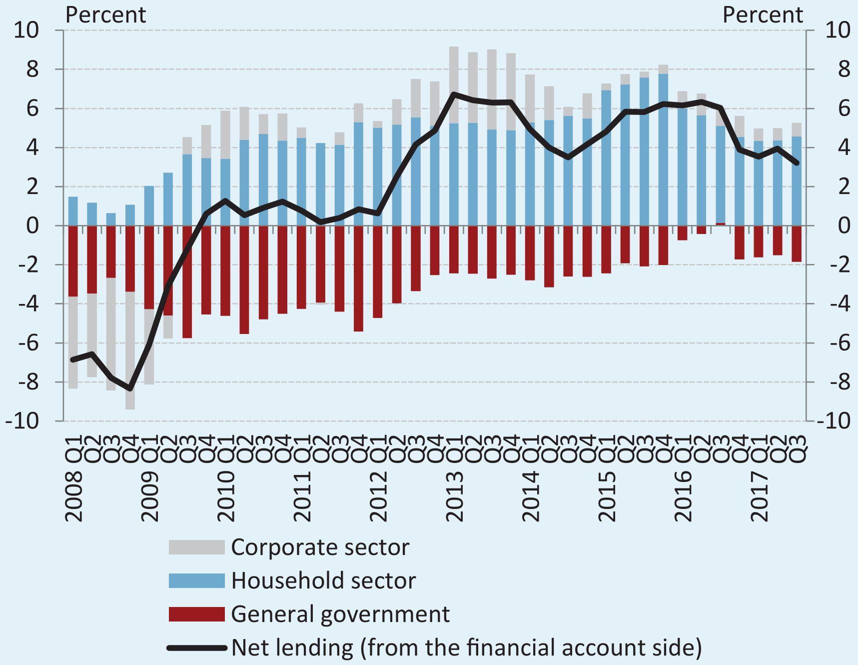
** Guidotti rule: short-term external debt based on residual maturity.*

4 Sectors' savings approach

In 2017 Q3, four-quarter net lending according to the economic sectors' savings dropped to 3.2 percent of GDP. The general government borrowing requirement – the level of which, similarly to the previous periods, was moderate, but increased slightly compared to the second quarter – and the decrease in the net lending of the private sector together resulted in a substantial fall in net lending. Based on the seasonally adjusted data, households' outstanding borrowing increased at a similar rate as in the previous quarter, while the accumulation of financial assets decreased slightly. Despite the maturity of a large volume of household government securities, households continued to expand their government securities portfolio, and the shift towards longer-term securities continued. The rise in the average maturity of household government securities caused a decrease in rollover risk, and thereby a decline in the vulnerability of the economy.

Based on the sectors' saving, in 2017 Q3 the four-quarter net lending of the Hungarian economy fell to 3.2 percent of GDP (Chart 20). The general government's borrowing requirement was moderate in the third quarter as well, which can be explained by the rising tax revenues resulting from higher consumption and employment. The net lending of the corporate sector, which fell short of the level observed in the previous year, can be attributed to the rise in investments: as a result of the continuing growth in investments, corporations' net lending decreased to 0.5 percent of GDP in the third quarter. The four-quarter net financial savings of households was around 4.5 percent of GDP in the past quarter, which – as a consequence of the outstanding borrowing that has been on the rise for more than a year now – falls short of the pre-2016 level, but still significantly exceeds the pre-crisis values.

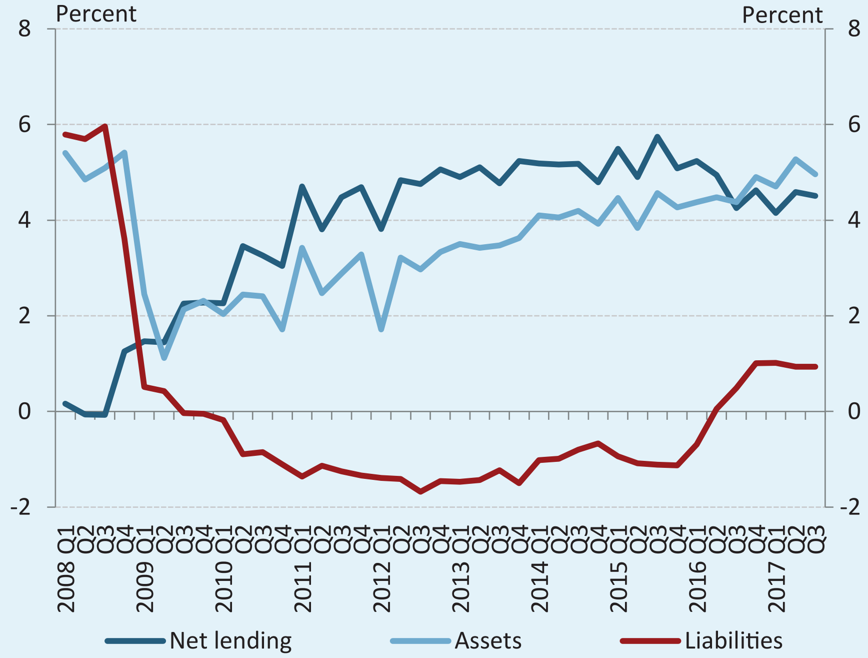
Chart 20:
Net lending by sectors* (four-quarter data relative to GDP)



** Under general government, we present the borrowing requirement according to the financial accounts. Corporate was determined on the basis of the residual principle.*

The underlying trends show that the households' seasonally adjusted net financial savings amounted to 4.5 percent of GDP in the third quarter (Chart 21). In the third quarter, the households' seasonally adjusted net new borrowing was around the level of the previous quarter, which is attributable to the steady growth in the housing loan portfolio and to the rise in the FGS and land purchase loans granted to the self-employed. On the other hand, there is still no significant growth in consumer loans. The sector's gross financial instruments rose substantially, increasing by around 5 percent of GDP, in the third quarter as well, which is primarily attributable to the large increase in securities, but the current account deposits and cash holdings also increased substantially.

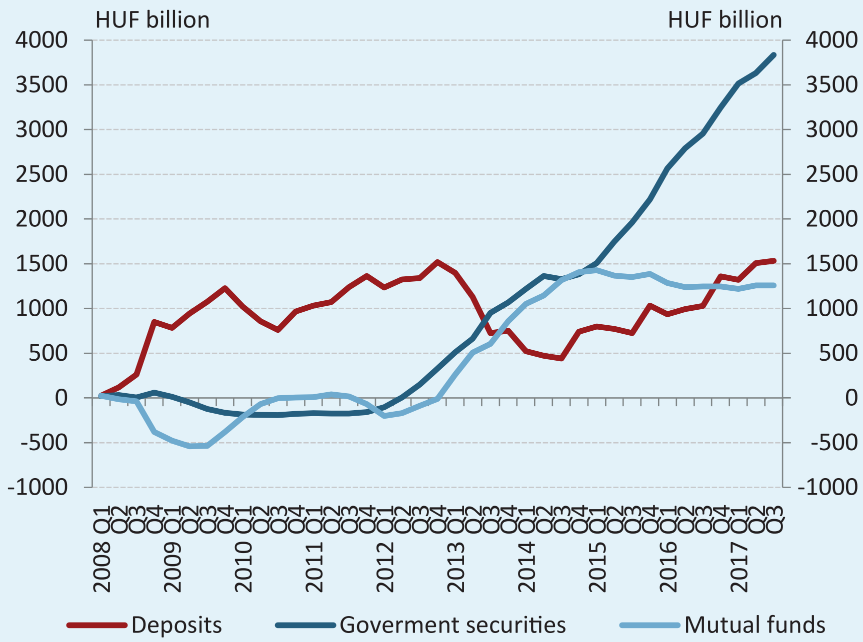
Chart 21:
Net lending of households (seasonally adjusted revised* values, as a percentage of GDP)



** 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.*

In the third quarter, households' government securities holdings once again grew dynamically, which thus continues to provide substantial support for the internal financing of the general government (Chart 22). As a result of the continuous growth in households' holdings of government securities for almost five years, the portfolio came close to HUF 4,800 billion by 2017 Q3. Despite the large volume of expiring government securities, the portfolio continued to increase, which suggests that households are not only rolling over their existing government securities holdings, but are also investing a large part of their new savings in government papers. Households continued to show preference for long-term instruments, but – in contrast to the previous quarter – there was a small increase in the short-term securities of the central government as well. The positive change in the maturity structure of the households' government securities portfolio reduces rollover risk, thereby decreasing the vulnerability of the economy. Although the rise in the forint current account deposits fell short of the value observed in the previous quarter, cash holdings once again rose substantially, and thus on the whole it can be stated that in terms of non-securities instruments, households still show preference to liquid forms of investments.

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

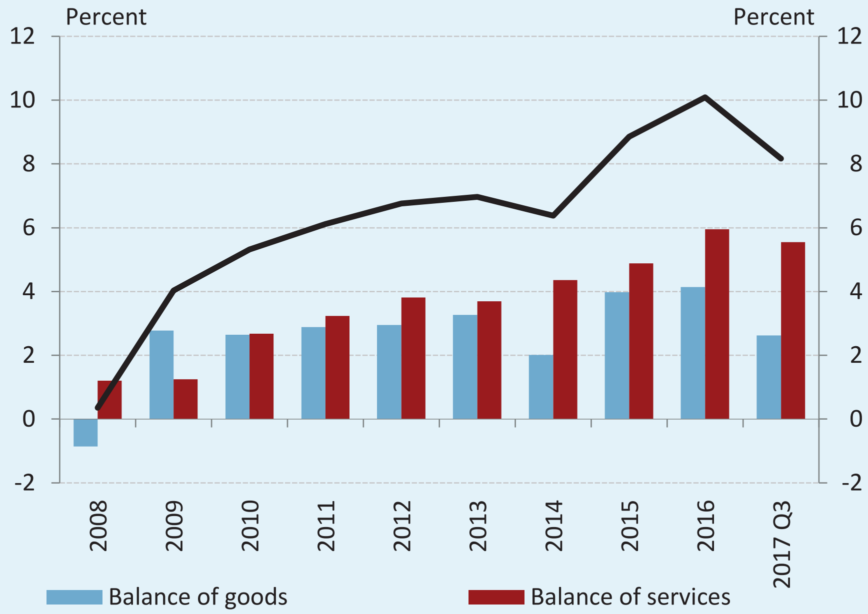


5 Special Topic: What is the underlying reason for the decrease in the trade surplus?

Calculated on the basis of the four-quarter data, the trade surplus of the Hungarian economy remains high, but following the significant increase observed in the past years it slightly declined in 2017. Nevertheless, it still substantially exceeds the values observed in the countries of the region, i.e. in the Czech Republic, Poland, Slovakia and Romania. The decline in the balance observed in the past quarters was attributable to a larger drop in the balance of goods and to a smaller reduction in the balance of services. The decline in the surplus is partly attributable to the fact that – after a lasting improvement – in parallel with the rise in commodity prices, the terms of trade slightly worsened the balance starting as early as the second quarter of 2017. Developments in the volumes also drove the decrease in the balance: while the decline in the balance of goods was primarily caused by the stronger growth in goods imports, which exceeded exports, the decrease in the balance of services was mostly due to the deceleration of exports. In terms of industries, the decline in net goods exports can primarily be explained by the decrease in the surplus from machinery exports, in addition to a minor drop in fuels: from the end of 2016, the growth in machinery imports, particularly that of road vehicles, substantially accelerated, while the growth rate of machinery exports slowed down. The decrease in the external balance may essentially be attributable to the growth in imports of machinery for investment purposes. Due to the moderate price developments, stronger consumption of consumer durables had no significant effect in terms of the deterioration of net goods exports, despite its positive contribution to growth. International comparison shows that the trade balances of the countries in the region also declined in the past quarters. In most of the countries, imports of goods, which rose in parallel with the growth in consumption and import-intensive investments, as well as the deterioration in the terms of trade were the key contributors to the decline. In a breakdown by country, we found that the decrease in Hungary's balance of goods, which occurred in the past one year, can be linked roughly half-and-half to the net exports to the euro area and to regions outside the EU, while the balance against the other EU member states has not changed.

The decrease in the four-quarter value of the current account balance observed in 2017 was linked with the decline in the trade surplus, which was contributed to by a larger drop in the balance of goods and by a smaller drop in the balance of services (Chart 23). In the past quarter, the current account surplus gradually decreased from the historical high in 2016, which primarily reflected the impact of the decline in the trade balance. Since the end of 2016, the trade balance as a percentage of GDP has declined by roughly 2 percent, three-quarters of which was attributable to the decrease in goods export, and one-quarter to that in the balance of services. Although the balance of goods already declined in the second half of 2016, the increase in the balance of services curbed the decrease in trade surplus until as late as the first quarter of 2017. However, from the second quarter of 2017 the decline in the balance of services also fostered a decrease in net exports, which accelerated the decrease in the current account surplus. In the next section, we examine the factors underlying the decrease in the trade surplus – among others, we present in more details the developments in the Hungarian balance of goods and services and in the main components of those, and also touch upon the processes observed in the region.

Chart 23:
Developments in the balance of trade components (as a percentage of GDP)*

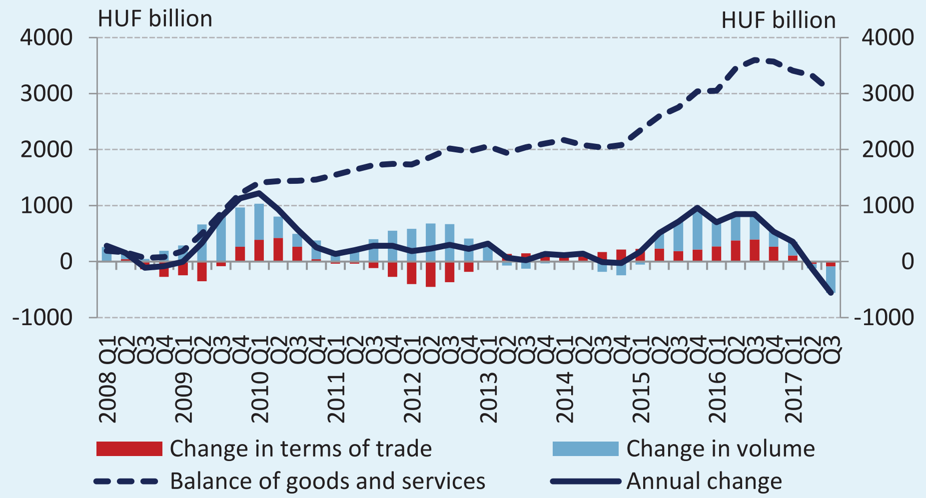


** The 2017 Q3 data are four-quarter values.*

5.1 Impact of prices and volumes

The decrease in the four-quarter surplus is partly due to the fact that, after a lasting improvement, the terms of trade already deteriorated slightly starting from the second quarter of 2017; however, the deterioration in the balance is mostly attributable to the change in volumes. After 2013, the moderate fuel prices and the favourable developments in export prices caused the terms of trade to improve, which contributed to the rise in Hungary's trade surplus (Chart 24). However, from the second half of 2016, in parallel with the rise in commodity prices, the change in the terms of trades pointed to a decline in the trade balance. This impact was partially offset by the change in the relative price of export products (machinery and transport equipment). In addition, it is also clear that while in the past the volume effect net of the price effects typically raised the trade surplus, in 2017 – similarly to the period of investment growth in excess of 10 percent observed in 2014 – it substantially deteriorated the trade surplus. On the other hand, the decrease in volumes may be attributable to both the decline in exports and the increase in imports.

Chart 24:
Impact of the change in the terms of trade and in volumes on the trade balance (four-quarter balance)

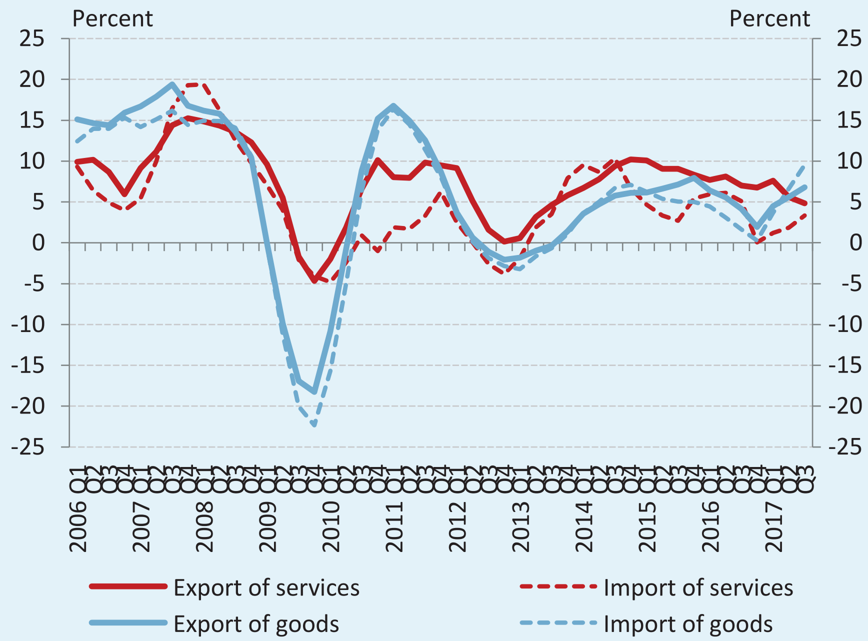


Source: HCSO.

5.2 Impact of exports and imports

While the decline in the balance of goods was primarily caused by the stronger growth in goods imports, which exceeded exports, the decrease in the balance of services was mostly due to the deceleration of exports. The decrease in the surplus of the balance of goods in the second half of 2016 was linked to slower growth in goods exports resulting from the temporary factory stoppages and declining industrial production due to the model change, while in 2017 it can be more attributed to higher goods imports resulting from the vigorous domestic demand (Chart 25). The growth in exports was supported by the rise in external demand in 2017 as well, while from the second quarter goods import, rising at an accelerating rate in 2017, already exceeded the growth in goods exports. The decrease in the balance of services was attributable to the fact that the deceleration in the growth of services export, which has lasted since 2015, continued more steeply in 2017, while after the decline observed at the end of 2016, the rise in services import commenced again.

Chart 25:
Annual change in goods and services trade*



** Growth rates calculated from the EUR-denominated data of the balance of payments.*

The decline in the balance of services is mostly attributable to the decrease in services exports observed in several sectors (Chart 26). Before the crisis, in an environment of similar growth in services exports and imports, the balance of services was around 1-1.5 percent of GDP. The dynamic growth which commenced after the crisis reflected the rise in incomes, while imports as a percent of GDP have not changed materially – thus, the surplus in the balance of services rose to almost 6 percent of GDP. In a breakdown by sectors, the main contributors to growth included the surplus in hired labour services, other business services (e.g. legal and accounting services) and transport services (Chart 27). The decrease in the GDP-proportionate balance observed in the past two quarters took place amidst a nominal increase in exports, i.e. the decline is attributable to the fact that the growth in services exports fell short of GDP growth. The decrease was observed in a wide range of sectors: with the exception of transportation, the surplus of all sectors decreased moderately.

Chart 26:
Developments in the balance of services (four-quarter values as a percentage of GDP)

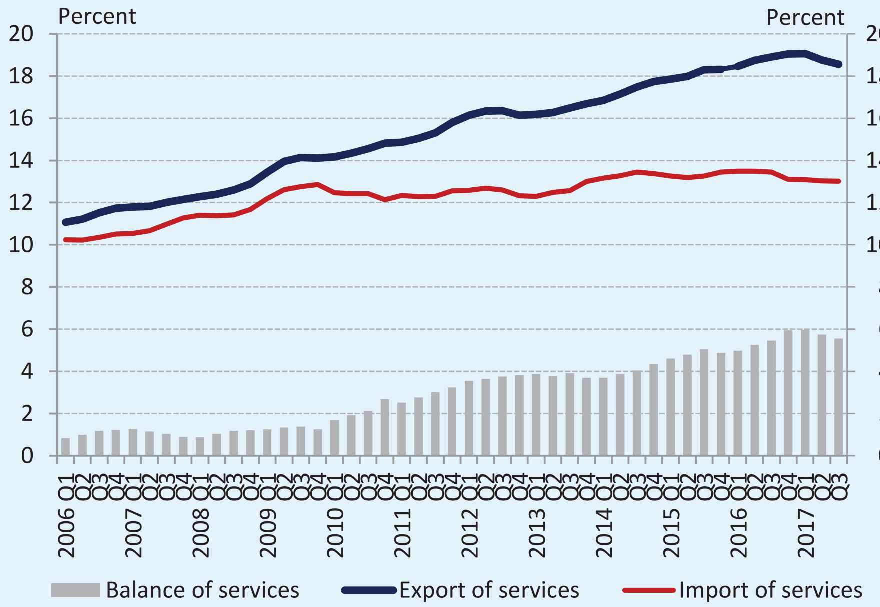
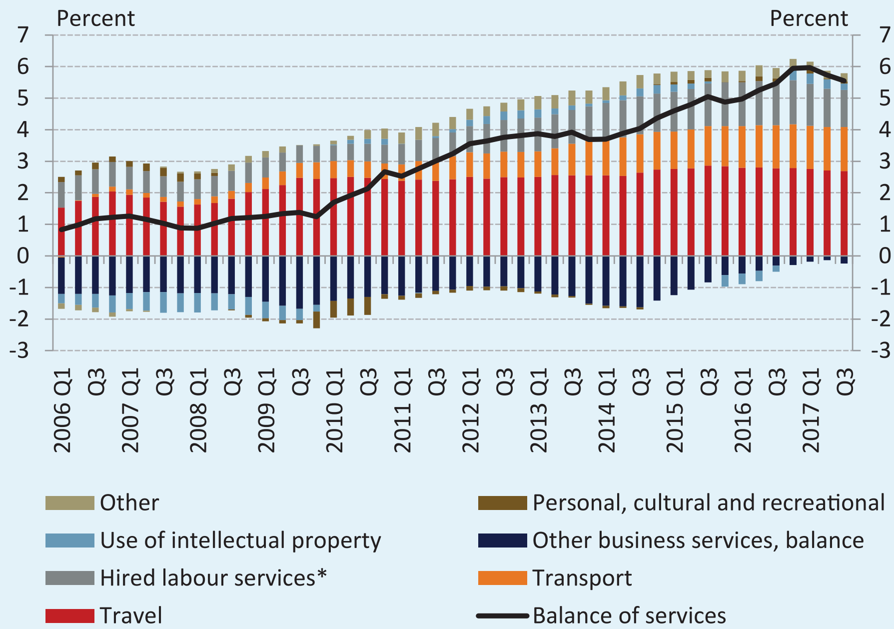


Chart 27:
Developments in the components of the balance of services (four-quarter values as a percentage of GDP)

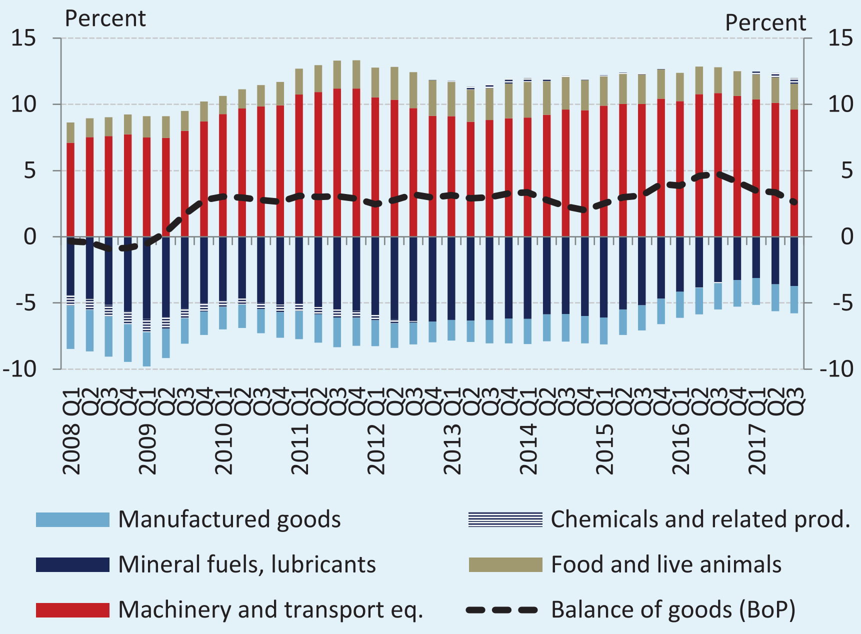


*Manufacturing services on physical inputs owned by others

5.3 Industry factors

In addition to a minor decline in fuel exports, the decrease in the balance of goods is primarily due to the decline in net machinery exports and within that to a larger increase in machinery imports. Machinery exports play a key role in the change in the balance of goods, as this item has the highest weight within the balance of goods. The increase in the balance of goods which commenced in 2014 was also primarily supported by the growth in the manufacture of machinery (Chart 28). The net machinery exports continued to rise in 2016, linked to vehicle production to a smaller degree and to the rising manufacture of electric and electronic equipment to a larger degree. However, from the end of 2016, machinery imports accelerated considerably, while the growth rate of machinery exports did not slow down, i.e. the decrease is presumably the result of domestic developments (see later). Hence, the growth in imports, which outpaced exports, resulted in a decrease in net machinery exports, which was also reflected by the decline in the balance of goods. Due to the moderate fuel prices, net goods exports rose in 2015-2016, whereas in 2017 the higher import of mineral fuels caused the balance of goods to decrease due to the deterioration in the terms of trade. In addition, the net imports of processed products also rose, which is presumably attributable to the increase in households' consumption. On the other hand, in the period under review, the decline in the balance of goods was curbed by higher net exports of chemical products.

Chart 28:
Net external trade in goods by main product groups (as a percentage of GDP)

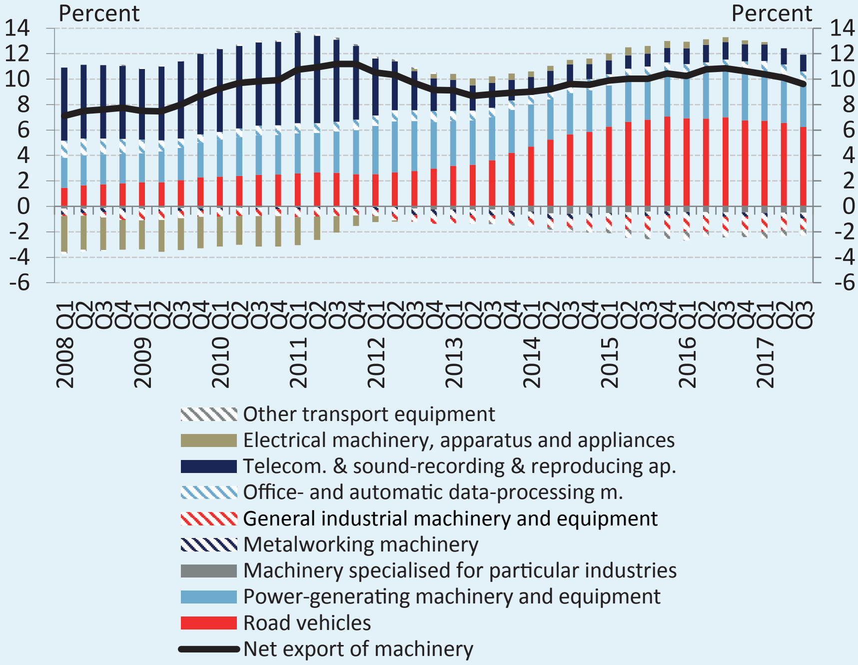


Note: The difference between trade in goods based on external trade statistics and the balance of payments is subject to the different requirements of individual methodologies and the content of data provided by the available data sources. Accordingly, we arrive at the trade in goods figures of the balance of payments by means of adjustment factors derived from the external trade statistics.[2] At the same time, data derived from various sources have been similar in recent years, which makes them suitable for trend analysis.
Source: HCSO

[2] For more details on this see the following publication (p. 8): https://www.mnb.hu/letoltes/bop-meth-notes-bpm6-en.pdf

Examining the decline in net machinery exports in a more detailed sectoral breakdown, we find that this decline was primarily due to a rise in imports of road vehicles (Chart 29). Looking at the developments in Hungary's net machinery exports in a sectoral breakdown, it can be seen that in the post-crisis years the surplus in machinery exports was primarily supported by the net exports of telecommunication, sound recording and player equipment, while after 2012 – in line with the expansion of motor vehicle industry investments – it was supported by net exports of road vehicles. At the same time, in the fourth quarter of 2016, in connection with the rising imports of road vehicles, the stable growth in net machinery exports, which had been going on since 2013, halted and then started to decrease gradually in 2017. However, despite the decrease, net machinery exports remain at a high level.

Chart 29:
Developments in the components of machinery exports (as a percentage of GDP)

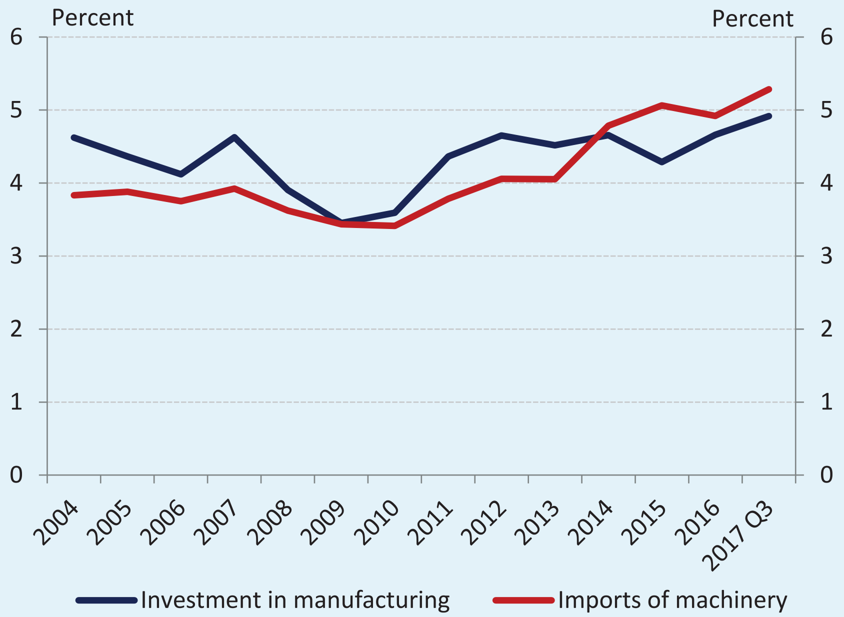


Source: HCSO.

5.4 Expenditure side factors

The faster growth of machinery imports is partly triggered by the rise in imports of investment machinery. The economic growth observed in recent quarters was supported by domestic demand, and in particular by the robust growth in investments. This growth in investments was attributable to expansion in a wide range of sectors. The growth in the investments of corporations producing for external markets, and thereby the growth in imports, was primarily supported by manufacturing, which has a high weight (Chart 30). In addition, investment in the public sector and in the sectors closely related to the public sector also expanded considerably, supported by projects implemented from the 2014–2020 EU cycle (in addition to the low base), as well as investment implemented from own funds. The import content of these investments is typically very high, and thus the growth in investments may have also contributed to the rise in investment machinery imports, and thereby to the decline in the trade balance, because – on the whole – net exports made a negative contribution to growth in 2017, as a result of the rise in the import demand resulting from the increase in domestic demand.

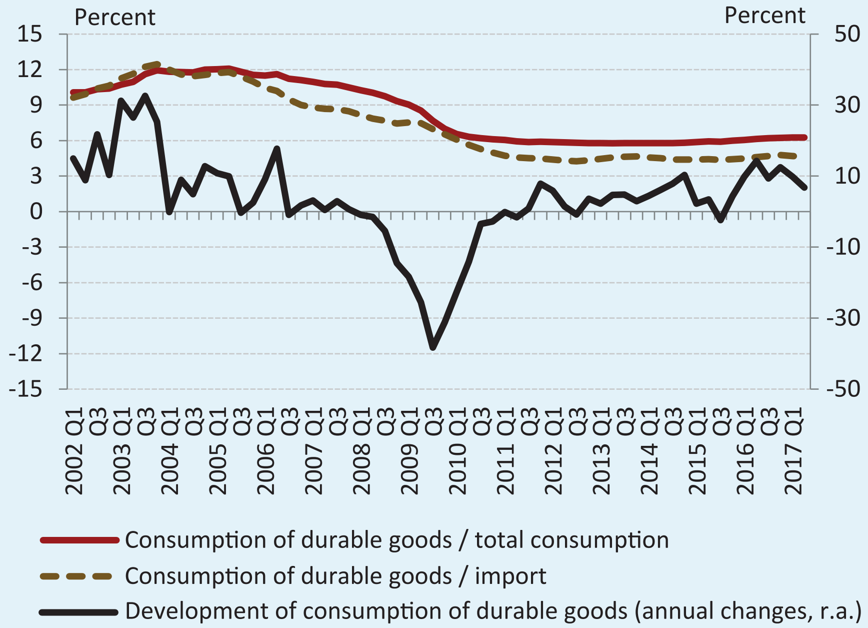
Chart 30:
Developments in investment machinery imports* and manufacturing investment (as a percentage of GDP)



**The 2017 Q3 data are estimates.*
Source: HCSO.

Meanwhile, compared to total consumption and to total imports, the ratio of durables consumption has only risen slightly (and still well falls short of the pre-crisis level), and thus the increase in the procurement of durables only made a minor contribution to the rise in machinery imports. In Hungary, in the early 2000s, in parallel with the improving financial conditions of households, the consumption of durables[3] rose significantly both as a percent of total consumption and of imports, and then declined from the mid-2000s, partly due to the austerity measures (Chart 31). In the years of the crisis, the ratio of durables dropped to a larger degree, followed by a stabilisation at around 6 percent of total consumption. In the past years, with net financial worth reaching historic highs, a recovery in confidence and a rise in net wages, the consumption expenditures of households increased, but this was not reflected by an increase in the weight of consumer durable goods. This is partly also due to the fact that in the period under review the prices of durable goods decreased, and thus the growth in the consumption of consumer durables did not necessarily entail a rise in expenditures. Accordingly, the rise in durable consumption – despite the fact that it made a positive contribution to growth – did not have a major negative effect on net goods exports.

Chart 31:
Developments in the consumption of durables



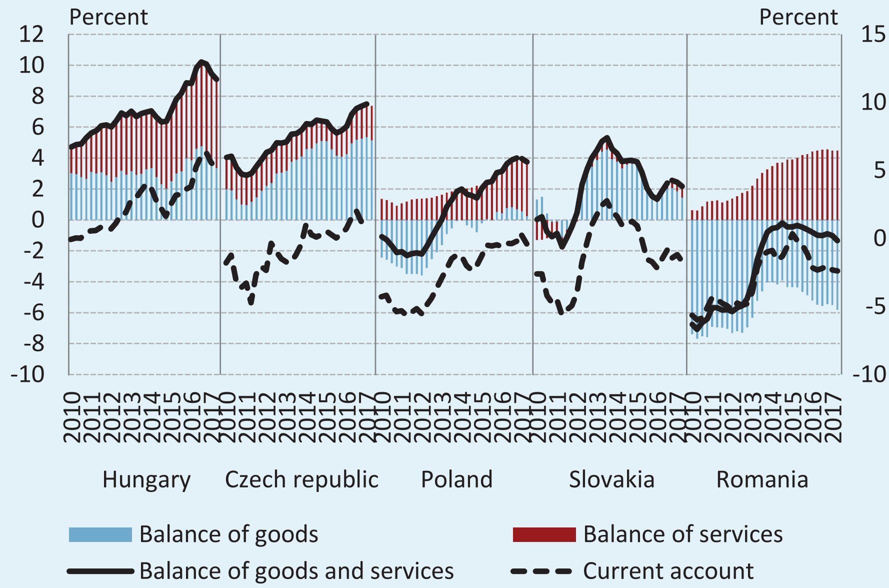
Source: HCSO.

[3] Durable products: primarily motor vehicles and vehicle parts and accessories, furniture and appliances, and other merchandise

5.5 Regional comparison

The balance of goods and services declined not only in Hungary, but also in other countries of the region in the past quarters (Chart 32). Since the end of 2016, the trade balance declined in all of the countries in the region, and in all of the countries this was due to declines in the surplus on the balance of goods. In most of the countries, imports of goods – which rose in parallel with the growth in consumption and import-intensive investments – was the key contributor to the decline. The balance of goods surplus decreased to the largest degree in Hungary, as a result of which the trade balance dropped to 9.1 percent of GDP, from the historic high of 10.2 percent, measured in the third quarter of 2016. However, despite the decline, Hungary's trade balance – primarily due to the extraordinary surplus in services – is still high and significantly exceeds the values observed in the neighbouring countries.

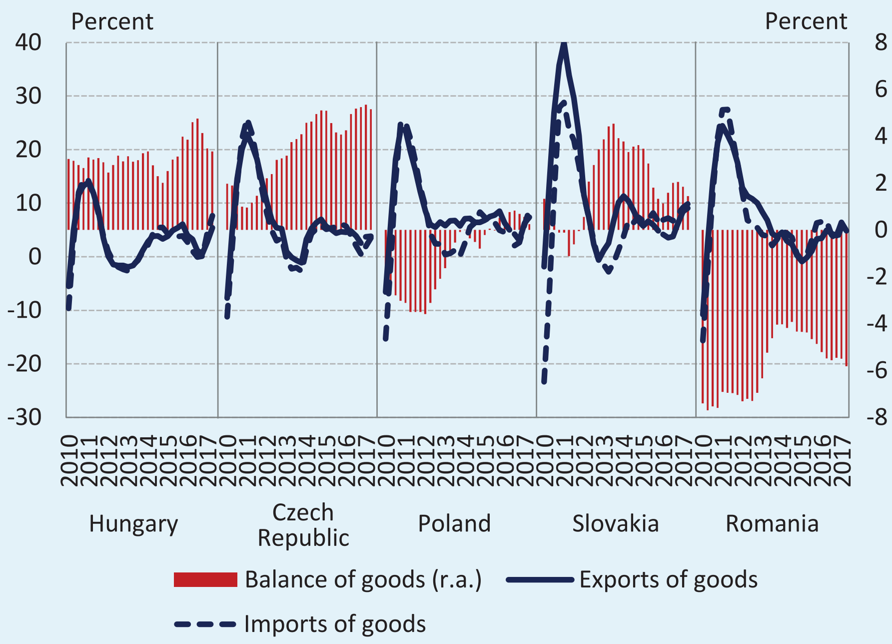
Chart 32:
Developments in the balance of goods and services in the region



Source: Eurostat.

In the countries of the region, the growth in imports in excess of exports, was linked with the volume increase related to the recovery of domestic demand and to the deterioration in the terms of trade. The rise in the balances of goods observed in 2016 in the region is mostly the result of the decline in domestic demand, primarily attributable to the drop in the EU transfers, due to the new budget cycle. However, in early 2017 the rise in goods exports and imports in the region accelerated, which typically impacted all sectors, but was linked to the highest degree with the chemical industry and machinery manufacture. As a result of the pick-up in investments of higher import content and in consumption, the rise in imports exceeded that in exports (Chart 33). The decline in the balance of goods was supported primarily by the rise in imports of processed goods in the Czech Republic, and of chemical goods in Poland, Romania and Slovakia, while in the countries of the region the growth in machinery imports was offset by the rise in machinery exports. In addition, the increase in fuel prices, observed in 2017, fostered a rise in goods import in all of the countries in the region via the deterioration of the terms of trade.

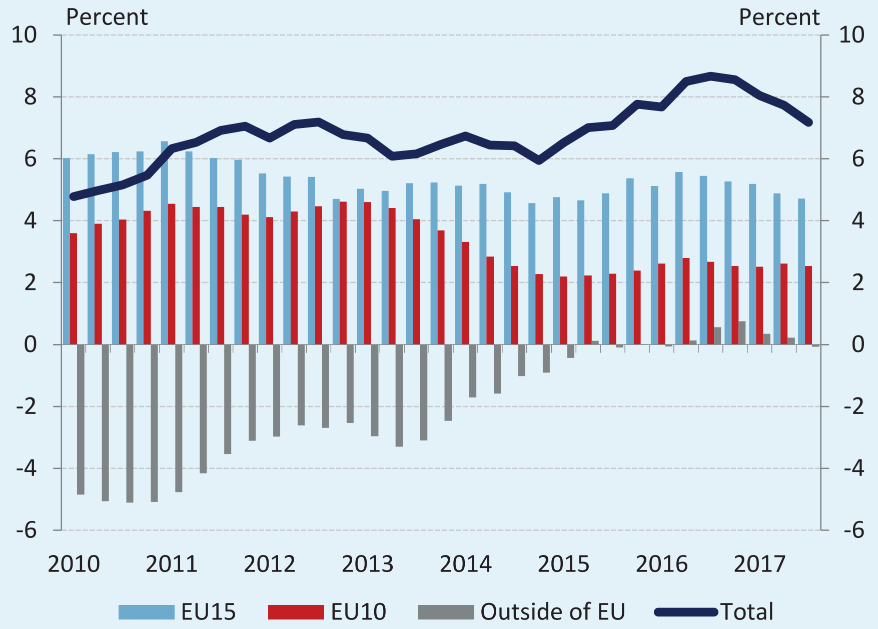
Chart 33:
Annual change in goods exports and imports



Source: Eurostat.

The decrease in Hungary's balance of goods, which occurred in the past one year, can be linked roughly equally to the net exports to the euro area and to outside the EU. The balance outside the EU deteriorated in all of the countries of the region, while a decline in the German surplus was only observed in Slovakia. The breakdown by countries shows that this is partly attributable to the decrease in the surplus versus the euro area, and in particular versus Germany, and partly to the deterioration in the balance versus the non-EU countries, particularly versus the United States and, due to the rising oil prices, Russia (Chart 34). Similarly to the aggregated data, both groups of countries were dominated by a rise in imports exceeding that in exports. However, it should be pointed out that the decrease in the surplus versus Germany, which plays a key role in exports, was observed only in Slovakia, in addition to Hungary. The general trend in the region was the decrease in the non-EU balance, with different country structure in the individual countries: in the Czech Republic the balance vis-à-vis Russia, the USA and China deteriorated, while in Poland the rise in the deficit vis-à-vis China is no longer offset by the improvement in the balance versus Russia.

Chart 34:
Developments in Hungary's balance of goods vis-à-vis the most important groups of countries



Source: HCSO.

List of charts

Gábor Bethlen

(15 November 1580 – 15 November 1629)

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

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

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

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

REPORT ON THE BALANCE OF PAYMENTS

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