REPORT ON THE BALANCE OF PAYMENTS

2018
APRIL

‘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 for Monetary Policy and Economic Analysis. Contributors: Dániel Babos, 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 Márton Nagy, Deputy Governor.

This Report is based on information pertaining to the period ending 23 March 2018.

Summary

The external vulnerability of the Hungarian economy declined again in 2017. While the current account surplus dropped to below 3 percent of GDP mainly due to strong domestic demand, the economy's net and gross external debt ratios continued to decline significantly, in the context of strong growth in EU transfers and the persistently large inflow of foreign direct investment. Despite the decline in the trade surplus, Hungary's net lending remains sizeable and exceeds the values registered by the other countries in the region.

According to the real economy approach, the decrease in the current account surplus was accompanied by rising absorption of EU transfers. This curbed the decline in net lending, which thus still reached a high level, exceeding 4 percent of GDP. The decrease in the net saving position is mostly attributable to the lower goods surplus, stemming from the rise in import-intensive investment, an increase in consumption and deterioration in the terms of trade owing to higher oil prices. It should be noted that – in the context of strong import growth – Hungarian exports accelerated significantly in 2017, contributing to the improvement in the export market share. Despite the decline registered in most countries of the region, the Hungarian trade surplus remains high and is a major factor behind the favourable external balance position. The current account balance was also reduced by the higher profit of companies in foreign ownership, while the increase in the income balance deficit was restrained by the decrease in interest paid abroad (in parallel with the decrease in external debt). After a temporary decline, the absorption of funds from the new programming period of the European Union rose substantially in 2017 and exceeded 2.5 percent of GDP.

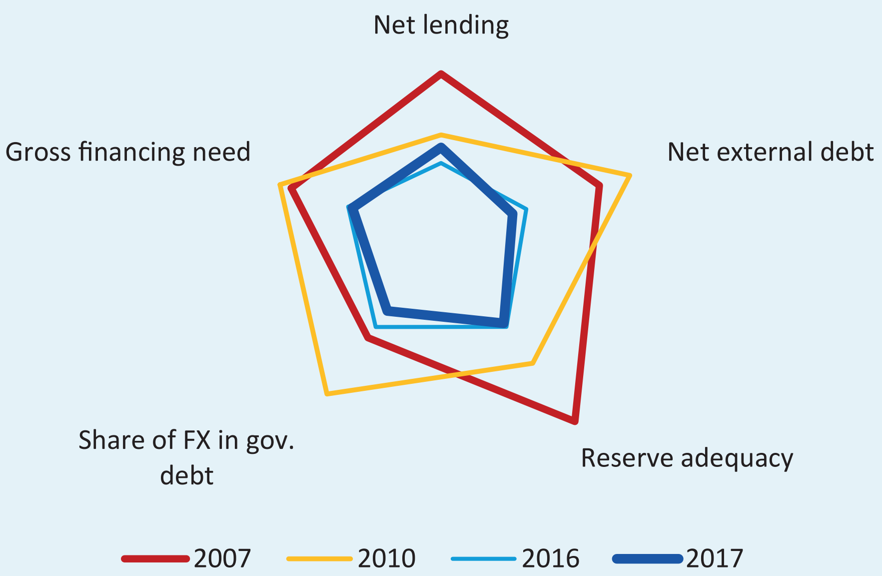
According to the financing side of the balance of payments, in 2017 the outflow of funds was lower than in the previous year. Net external debt remains high. The decline of more than EUR 5 billion in net external debt was supported by net foreign direct investment, which was similarly high as in the previous year and amounted to almost EUR 2 billion, in addition to net lending. Following the decrease observed in previous years, the net external debt of the banking sector rose modestly in 2017, while the net external debt of the consolidated general government fell to a larger degree and that of the corporate sector contracted to a smaller degree. In addition to the absorption of EU transfers, the substantial drop in the general government's net external debt was attributable to lower non-residents' government securities holdings, while transactions did not lead to change in foreign exchange reserves, as the combined result of the foreign currency requirement of self-financing, the EU transfers and the foreign currency liquidity related to the central bank's fine-tuning instrument. Similarly to the previous year, the decline in the private sector's net external debt as a result of transactions was mostly caused by higher external assets, while the repayment of foreign loans only contributed to the decline to a lesser degree, i.e. the decline in external liabilities is already much less typical and it is more the growth in reserves accumulated in external asset that is driving the decline in net external debt. The rise in bank liabilities affected long maturities, and thus the maturity structure of the sector remains favourable.

In parallel with the still significant level of net lending, the external debt ratios of the Hungarian economy continued to drop in 2017, further reducing the country's external vulnerability (developments in the external balance are summarised in Chart 1, where values closer to the centre – practically the closing of the “net” – indicate lower vulnerability in relation to the ratio in question). Net external debt fell to 13 percent of GDP, while gross external debt dropped to nearly 60 percent of GDP, representing one half of the level observed in 2010, with this development supported by the outflow of funds, the revaluation and the rise in nominal GDP. The adjustment in net external debt seen in 2017 was mostly related to the fall in the general government's net external debt, and to a smaller degree to the decrease in that of corporations. Gross external debt fell faster than net external debt, mainly due to the fact that revaluation (related to the depreciation of the US dollar) reduced both external liabilities and receivables, partially offsetting each other in the net ratio. The decline in Hungary's external vulnerability was strongly supported by the fall of almost EUR 2 billion in the economy's gross borrowing requirement in 2017 and by the fact that by the end of the year short-term external debt also fell to a historic low, approaching EUR 16 billion. Considering the Guidotti-Greenspan rule – which is also closely followed by the central bank and investors – the end-2017 foreign exchange reserves of EUR 23.4 billion exceed the volume of short-term external debt, which amounted to EUR 16.4 billion.

According to the sectors' saving approach, net lending declined in 2017 as the combined result of contrasting processes: corporations' net position turned into a net borrowing requirement, also accompanied by a moderate increase in the

general government borrowing requirement, while the financial savings of the household sector rose. The continuous rise in corporate investment activity and the slow increase in housing investments by households both made important contributions to reducing the private sector's net lending. Nevertheless, in the second half of the year – owing to the fast-growing wages – households materially boosted their net savings, a development which was also supported by weaker credit demand after a temporary growth spurt. The general government's net borrowing improved modestly to stay below 2 percent of GDP in 2017 Q4, facilitated by higher budget revenues in parallel with wage growth, rising consumption and lower interest expenditures. The private sector still generated substantial demand for government securities, and thus the decrease in the foreign currency ratio of the government debt and in the government's dependency on external liabilities continued.

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



Note: The chart presents the deviation of individual indicators from the long-term average scaled by dispersion; smaller values indicate the strengthening of the fundamental position (e.g. lower borrowing requirement).

In the special topic in this issue of the report, we compare the changes in Hungary's external balance indicators to developments in the region. Despite declining, Hungary's net lending exceeded the average of the countries in the region (and the European Union) in 2017 again, mainly due to the savings rate being higher than generally seen in the region. Similarly to Hungary, in most of the countries in the region the current account balance decreased due to the decline in the balance of goods, but the underlying reason for this in several countries (in contrast to Hungary) was primarily higher consumption rather than the investment spending. In addition, following the improvement in the terms of trade observed in previous years, the oil price rise typically reduced the external trade balance of the countries in the region. While in Hungary the fall in the current account surplus was partially offset by the inflow of funds belonging to the new EU programming period, in other countries in the region (with the exception of Poland) no improvement was recorded in the transfer balance. The outstanding net lending of Hungary was supported by the high savings – even in a regional comparison – of the private sector, while the budget deficit was in line with the level observed in the region. In parallel with this, in 2017 Hungary's external vulnerability continued to decrease, as a result of which the country's net external debt fell below the level observed in Poland and Slovakia, while the gross external debt dropped close to the average of the region.

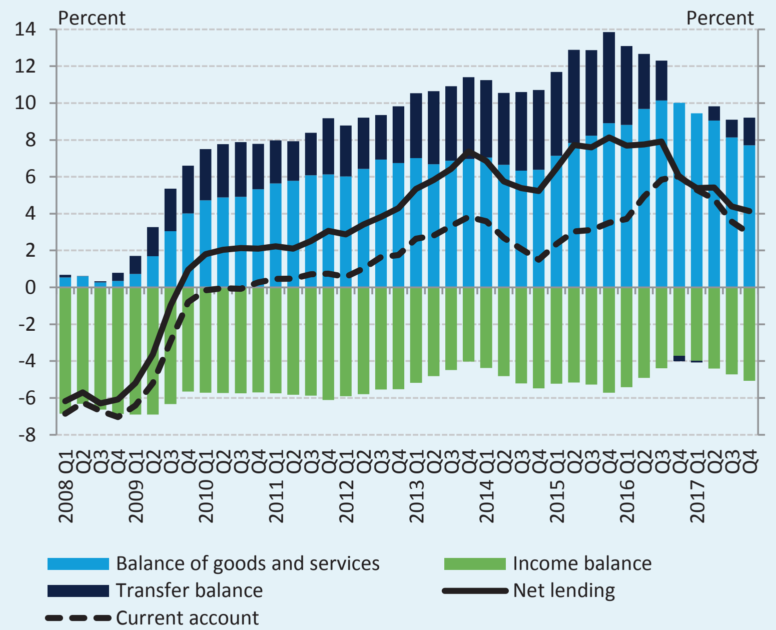
Content

1 Real economy approach

Calculated according to the real economy approach, Hungary's net lending amounted to 4.1 percent of GDP in 2017. The current account balance fell by one half from its historic high recorded at the end of 2016, dropping to 2.9 percent of GDP by the end of 2017. During the year, developments in the trade balance and the income balance fostered a fall in the external balance position, but this was more or less offset by the rise in the transfer balance resulting from the higher absorption of EU funds. The decrease in the balance of goods and services was primarily due to a rise in import-intensive investment, with growing consumption also contributing to this. Despite declining, the trade surplus continues to be the key factor behind Hungary's favourable external balance position. The improving performance of the service sector was also reflected in the balance of services, which – in contrast to the balance of goods – rose moderately in the final quarter of the year to reach 5.8 percent of GDP. In contrast to previous years, the surplus on the balance of goods and services was no longer significantly supported by the change in the terms of trade. Due to the rise in the EU funds belonging to the new 2014–2020 programming period, the transfer balance surplus rose according to the four-quarter data and at the end of 2017 it amounted to 1.5 percent of GDP. The profit of non-resident companies rose during the year, which entailed an increase in the income balance deficit, but this was partially curbed by the decrease in interest paid abroad.

Based on the real economy approach, in 2017 Q4 the four-quarter net lending of the Hungarian economy fell to 4.1 percent of GDP (Chart 2). According to the seasonally unadjusted figures, net lending in the fourth quarter amounted to EUR 600 million, with surpluses of almost EUR 200 million and EUR 400 million on the current and capital accounts, respectively. Based on the four-quarter data, net lending fell to 4.1 percent of GDP, owing to the simultaneous deterioration in the trade balance and in the income balance, but this was partially mitigated by the improvement in the transfer balance. The lower balance of goods and services was attributable to higher domestic absorption, while the growth in services exports had a positive effect. The underlying reason for the sharp improvement in the four-quarter transfer balance was the absorption of EU funds, which amounted to almost EUR 1 billion in the fourth quarter.

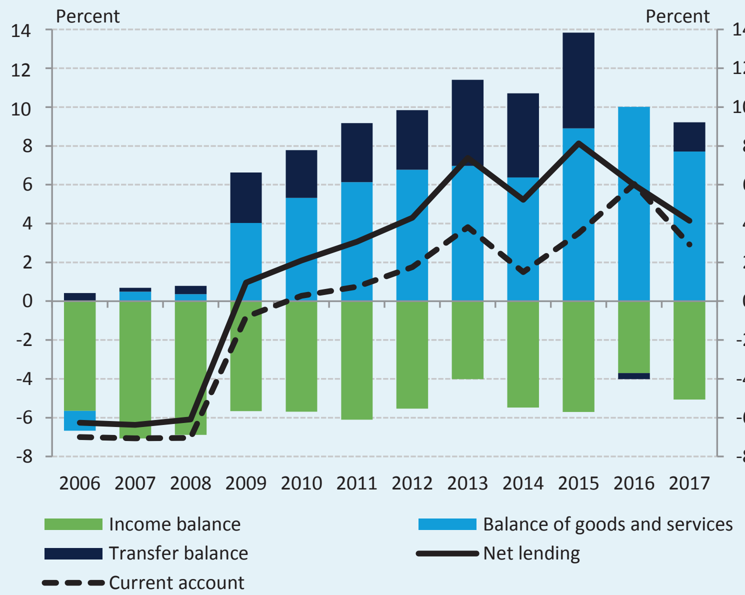
Chart 2: Developments in net lending and its components*
(four-quarter values as a percentage of GDP)



Source: All charts by the MNB unless otherwise indicated.

In 2017, net lending contracted to a smaller degree than the current account surplus (Chart 3). Hungary's external balance position decreased compared to the 2016 level, as the combined result of the lower current account balance and the improvement in the transfer balance stemming from the inflow of EU funds. The current account surplus fell to 2.9 percent of GDP from its historic high of 6 percent measured in 2016, primarily due to the lower trade surplus and to a lesser degree to the higher income balance deficit. The decline in the balance of goods and services in 2017 was accompanied by higher import-intensive investment and consumption increasing at a lower rate, while the income balance deficit was primarily driven by the higher profit of foreign-owned companies. In 2017, the transfer balance surplus amounted to 1.5 percent of GDP, which substantially exceeds the level observed in the previous year, but still falls short of the inflow of funds observed at the end of the previous EU programming period, which amounted to 3–5 percent of GDP in annual terms.

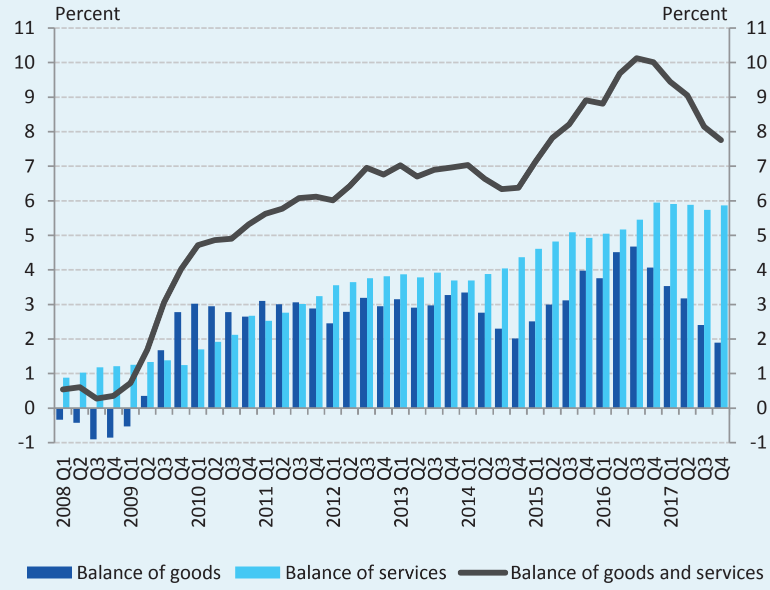
Chart 3: Developments in net lending and its components (annual values as a percentage of GDP)



1.1 Trade balance

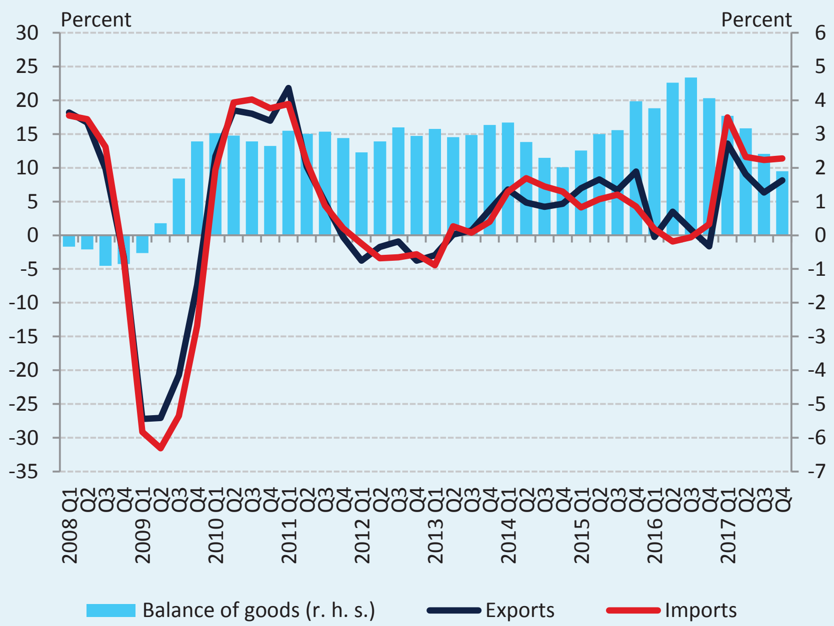
In 2017 Q4, the trade balance of the Hungarian economy – similarly to the trend observed throughout the year – declined further and amounted to 7.7 percent of GDP (Chart 4). The dynamic growth in the surplus of the balance of goods and services which had lasted since 2014 stopped at the end of 2016 and subsequently weakened gradually in 2017. The trade surplus continued to decline in the fourth quarter, shrinking at a slower rate than observed in the previous quarter, which was accompanied by a decrease in the balance of goods and modest improvement in the balance of services. Robust household consumption and the expansion of import-intensive investment in both the government and private sectors reduced the balance of goods, while the improving exports, resulting from the acceleration of industrial production, increased the balance of goods. Overall, the surplus on the goods balance dropped below 2 percent of GDP at the end of the year. In contrast to the developments in the goods balance, the surplus on the services balance rose moderately in the last quarter and amounted to 5.8 percent of GDP. In addition to tourism, the services balance surplus is mainly due to shared service centres operating in Hungary and to the surplus in transportation.

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



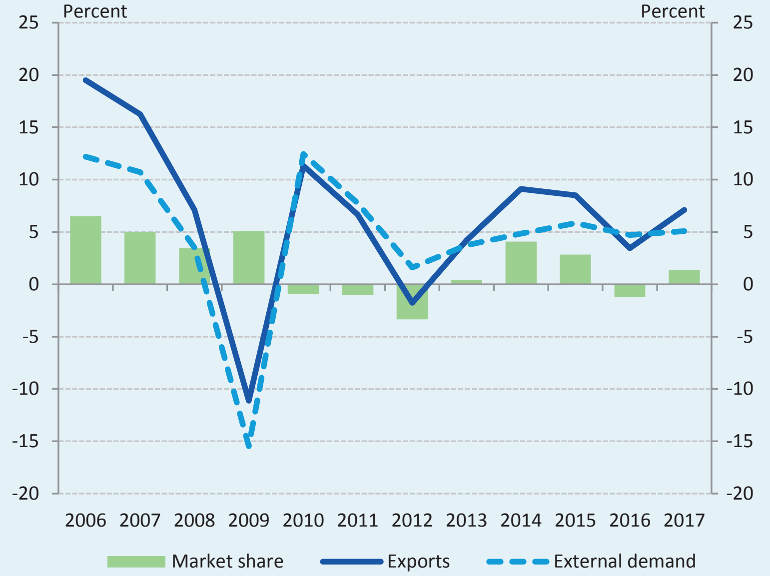
In 2017 Q4, the annual growth rate of goods imports still exceeded the growth rate of goods exports, albeit to smaller degree (Chart 5). In previous years, the annual growth rate of imports usually lagged behind that of exports, as a result of which the goods balance surplus reached a record high level by mid-2016. However, in 2017, in line with the rise in domestic demand items, growth in imports exceeded the export growth rate, as a result of which the goods balance dropped to below 2 percent of GDP. At the end of 2017, the difference between the growth rate of goods imports and exports narrowed, as a result of the improving output of the engineering and chemical industries, among other things.

Chart 5: Annual growth in goods export and import and the goods balance (four-quarter values as a percentage of GDP)



After a temporary, modest decrease in 2016, Hungary's export market share improved in 2017, driven by faster export growth (Chart 6). With the deceleration in annual real export growth, Hungary's export market share decreased in 2016. However, stable external demand was accompanied by faster export growth in 2017, mainly supported by the economic situation in the region and in Germany, within the broader context of robust international economic activity. As a result of this, Hungarian exports expanded at a faster rate than Hungary’s export markets, leading to an increase in export market share.

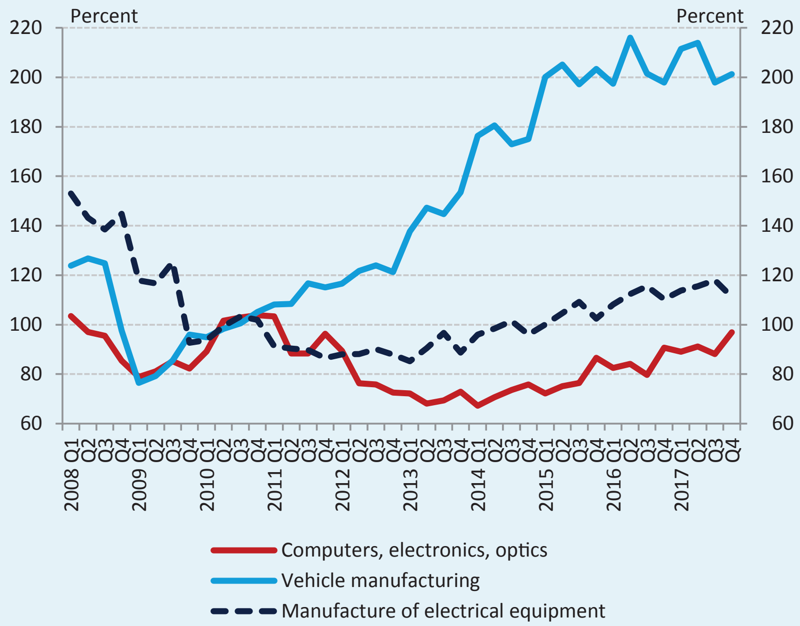
Chart 6: Real growth in exports and external demand* and developments in Hungary's export market share



**Weighted by export markets.*

The output of the electronics industry supported Hungarian exports to a larger degree in 2017, while vehicle manufacturing contributed more modestly. The surplus on the goods balance rose substantially between 2015 Q1 and mid-2016, mostly due to the export market sales of the production of vehicle manufacturing, plastic, rubber and non-metallic mineral products. In 2017, the output of industries with a higher weight rose only moderately, and the faster export growth observed in the fourth quarter in manufacturing was mainly supported by the better performance of the electronics industry.

Chart 7: Industrial production in key sectors (2010 = 100)

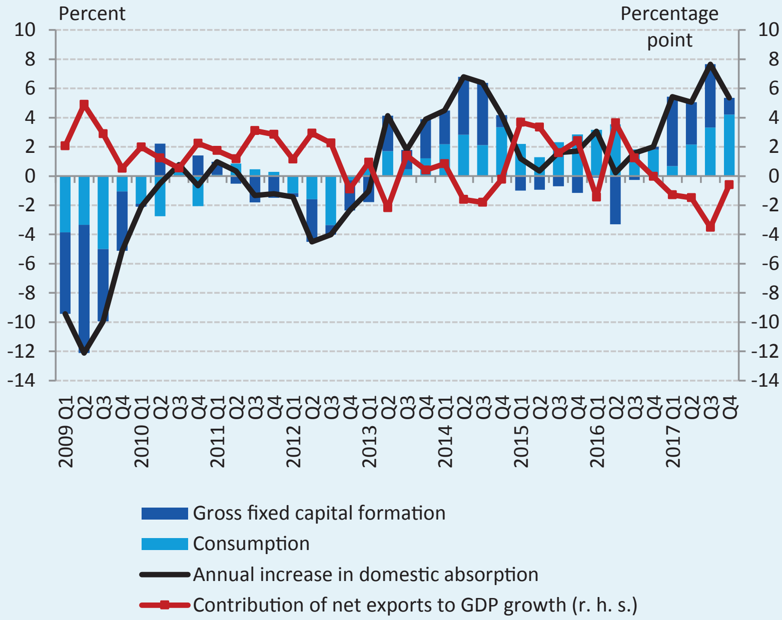


Source: HCSO.

In 2017, the annual growth rate of domestic absorption rose substantially, whereas net exports curbed growth (Chart 8). Strong GDP growth during the year was mostly linked to the rising investment level and household consumption. Annual investment growth amounted to almost 17 percent in 2017, involving both the general government and the private sector. The annual change in households' consumption expenditures reached the highest post-crisis level in 2017, and the rise in the consumption of durable and semi-durable products – with high import content – was also high. On the other hand, the weight of durable consumer goods within consumption and imports did not change significantly (for more details, see the

January 2018 report), which may be linked to the moderate increase in the prices of these products. In 2017, net exports made a negative contribution to economic growth in all quarters, which is mostly attributable to the increase in domestic demand for import-intensive items.

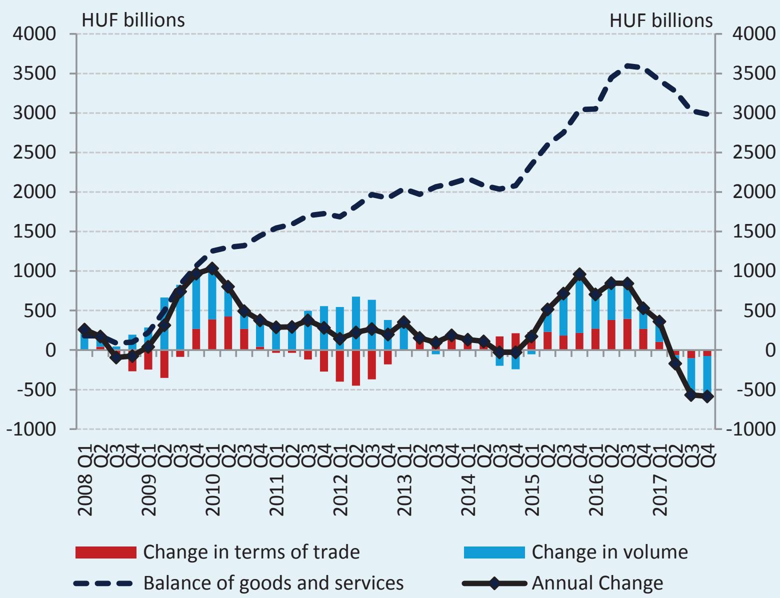
Chart 8: Annual growth rate of domestic absorption and the contribution of net exports to GDP growth



Source: HCSO.

The trade balance decreased in 2017, mainly due to volume changes, but the change in the terms of trade also contributed to the decline to a minor degree. In the period between 2013 and 2016, the improvement in the terms of trade contributed strongly to Hungary's rising trade balance, but in 2016 Q4 – in line with rising commodity prices – the terms of trade resulted in a deterioration in the balance of goods and services. In the first half of 2017, in addition to the volume effect, the change in the terms of trade also had a negative impact on the trade surplus. In the second half of the year, higher fuel prices still resulted in a deterioration of the terms of trade, while the relative price changes of export products may have offset this. Overall, the change in the terms of trade slightly reduced the trade balance in 2017.

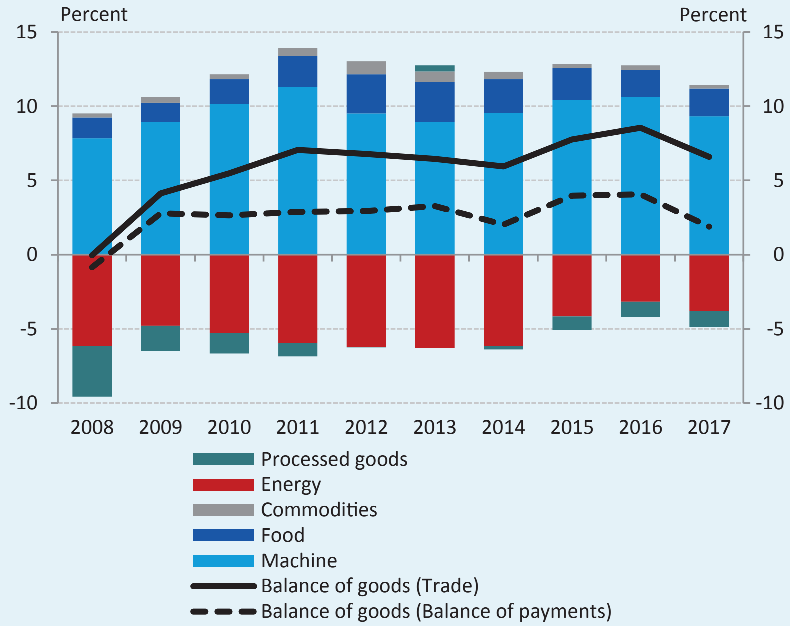
Chart 9: Developments in the balance of trade factors according to GDP (year-on-year)



Source: HCSO.

The reduction in the goods balance was primarily driven by rising fuel imports and falling net exports of machinery (Chart 10). In contrast to the previous two years, net imports of fuel increased in 2017, with the rise in the oil price playing a key role in this regard. However, it should be noted that net fuel imports still fall substantially short of the level typical of the period before 2014. In addition, net exports of machinery also declined, due in part to the higher machinery imports from investment growth and in part to more moderate growth in vehicle manufacturing. Despite the decline, net machinery exports are still a key item in the development of Hungary's goods balance. In addition to machinery, net food exports also contribute to the surplus on the goods balance, but the level of these exports did not change significantly in the period under review.

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

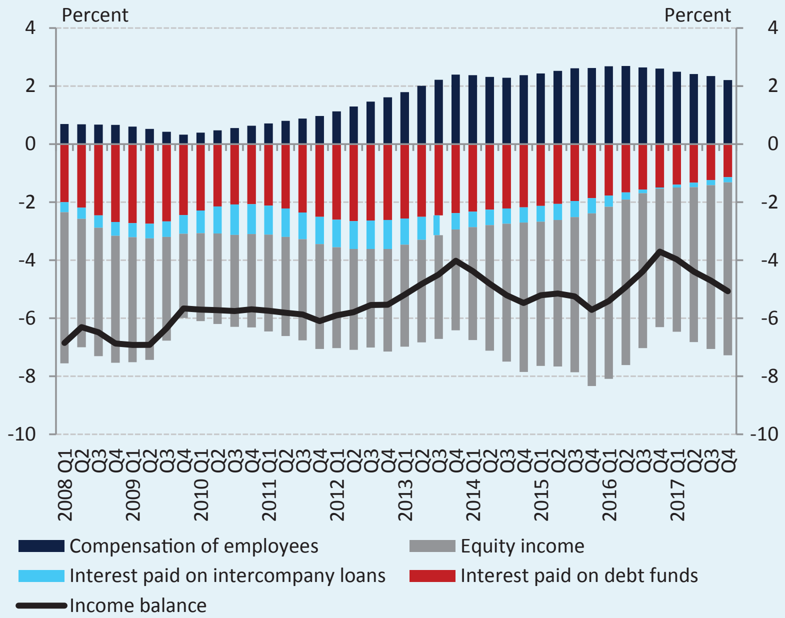


The difference between trade in goods based on external trade and the balance of payments depends on the different requirements of the methodologies and the content of the data sources. We obtain the trade in goods figures of the balance of payments by means of adjustment factors derived from the external trade statistics (for more details, see the publication on the methodology of compiling the balance of payment statistics). The data derived from various sources were similar in recent years, which makes them suitable for trend analysis.
Source: HCSO, MNB.

1.2 Income balance

In the fourth quarter, the deficit on the income balance rose further as the profit of non-resident companies increased and the compensation of employees declined; at the end of 2017 the deficit amounted to 5.1 percent of GDP (Chart 11). At the end of 2016, the income balance deficit fell to its lowest post-crisis level, i.e. to 3.7 percent of GDP, but in 2017 it gradually increased accompanied by a rise in the profit of foreign-owned companies operating in Hungary and a moderate fall in the compensation of employees. The increase in the deficit was slightly curbed by the favourable trend in the interest balance of loans borrowed from abroad, which is related to the low yield environment and the continued decrease in external debt ratios, in line with the substantial net lending.

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



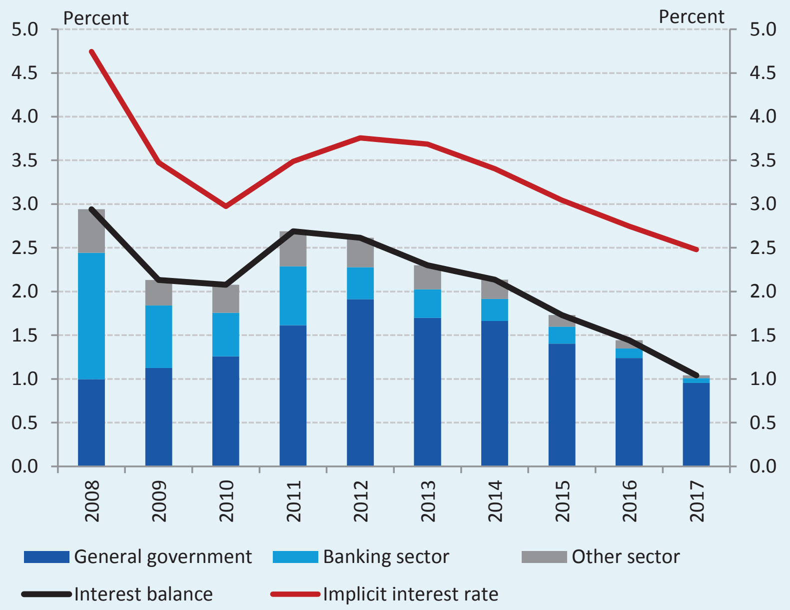
Income outflow figures related to equity are based on estimates. We only have limited quarterly data on the profitability of foreign-owned companies operating in Hungary, and thus information on profit outflows are essentially based on estimates.[1] As regards expenditures related to equity, we have data on dividends, according to which in 2017 the annual net dividend payment fell slightly short of last year's value and amounted around EUR 2 billion. However, it should be also noted that the vote on dividends is usually related to the performance one year earlier (for more details, see Balance of Payments Report of October 2016).

The net interest balance continued to decline in 2017, similarly to previous years, reaching around 1 percent of GDP at the end of the period. The decline in the interest paid by Hungary abroad seen since 2012 also continued in 2017, supported by the drop in outstanding external debt and the low interest environment (the implicit interest rate on external debt was 2.5 percent during the year[2]). The breakdown by sectors shows that the GDP-proportionate value of the net interest balance of banks and other sectors (mostly non-financial corporations) was close to zero. The net interest expenditure amounting to 1 percent of GDP is almost completely related to the interest balance of the general government.

1 For more details, see the statistical publication "Methodological notes to the Balance of Payments and International Investment Position".

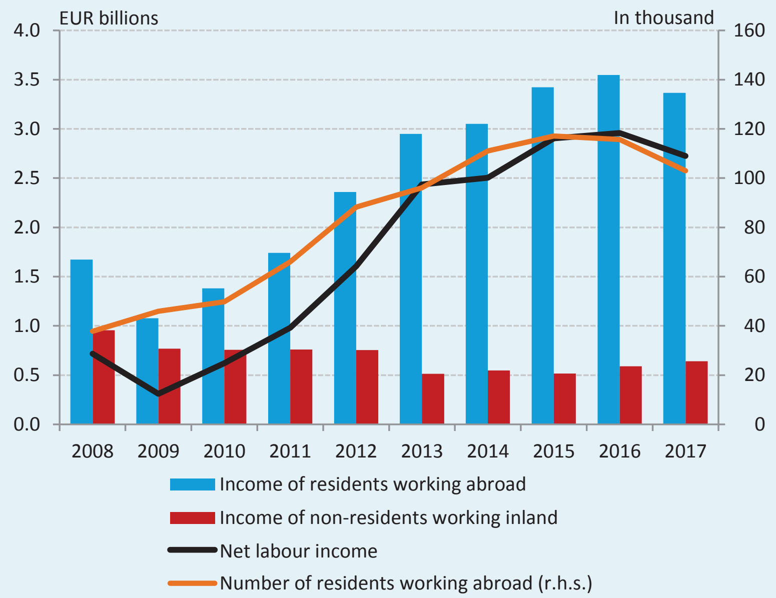
2 Developments in the implicit interest rates (i.e. average interest paid on debt) do not necessarily reflect the changes in the current interest levels, because at present interest must also be paid on debt originating from earlier periods at the applicable rates (for example, fixed-rate debt); in other words, the repricing of the total debt volume to the new interest rates may prove to be a lengthy process in view of the multi-year average maturity.

Chart 12: Changes in net interest expenditure (as a percentage of GDP) and in the implicit interest rate



In contrast to previous years, the rise in the net income of employees temporarily working abroad did not continue in 2017, which made a minor contribution to the deterioration in the income balance (Chart 13). After the crisis, the income of resident economic agents working abroad rose dynamically, which helped improve the income balance deficit. However, in 2017 the net balance of the foreign compensation of employees decreased slightly, in the context of a moderate increase in the income of employees working in Hungary for a period shorter than 1 year and a decrease in the income of Hungarian citizens working abroad. At the beginning of 2016, the rise in the number of employees working abroad halted, possibly owing to the strong growth in Hungarian average wages – partly due to the wage agreement concluded in 2016 – and to moving abroad permanently (those working abroad for more than one year already belong to a different statistical category). The fall in the number of employees working abroad was especially pronounced in the second half of 2017.

Chart 13: Incomes of employees temporarily working abroad



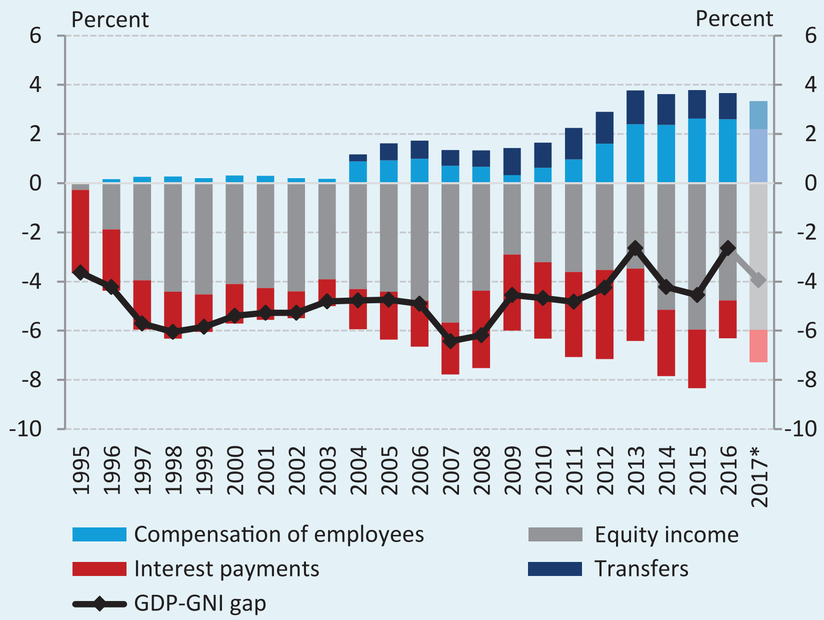
Source: HCSO, MNB.

1. Box: GDP-GNI gap

The gap between the gross domestic product and the gross national income is very important, as the difference between the two ratios shows the balance of income flows vis-à-vis the non-resident sector, and thus it approximates the effective disposable income of resident actors better than GDP. At present the indicator most often used in economics for measuring the economic development of a country is the gross domestic product (GDP), but there are a number of other indicators that may provide a more accurate picture of a nation's income position. One of these is gross national income (GNI), which – in contrast to GDP – is closer to the resident sector's disposable income. The aspect in which it effectively differs from GDP is that while the gross domestic product measures the income generated by the resident economic agents within the territory of a country, GNI also considers the income of non-resident owners from the respective country, as well as the income of resident economic agents from abroad. Such incomes include the items stated in the balance of payments under primary incomes: net income of employees temporarily working abroad, capital and interest income and current transfers related to products and production, which in the case of Hungary are mostly represented on the income side by the agricultural subsidies received from the EU. During the economic convergence of a country, it is a natural phenomenon that as a result of the capital income paid abroad GDP exceeds GNI, but above a certain level this may reflect external vulnerability and dependence on foreign funds and may even hinder convergence.

In Hungary, the GDP-GNI gap tended to decrease after the crisis, but in recent years it usually fluctuated at 2–4 percent of GDP. In the pre-crisis period, the gap between the gross national income and the gross domestic product amounted to around 5 percent of GDP. However, partly due to the surge in interest expenditures resulting from external indebtedness before the crisis, it rose to a historic high, i.e. over 6 percent of GDP. In the post-crisis years, the decline in the profit of foreign-owned companies and the rise in the net income of temporary employees reduced the GDP-GNI gap. In recent years, in parallel with the decline in external vulnerability, the interest expense paid abroad significantly reduced the GDP-GNI gap, while the rise in the profit of foreign-owned companies resulting from the favourable business conditions raised the GDP-GNI gap. Consequently, similarly to other countries of the region, the outflow of funds from Hungary mostly related to the outflow of income linked to equity participations in 2016–2017, while interest expenditure amounted to roughly 1 percent of GDP.

Chart 14: Changes in the GDP-GNI gap in Hungary

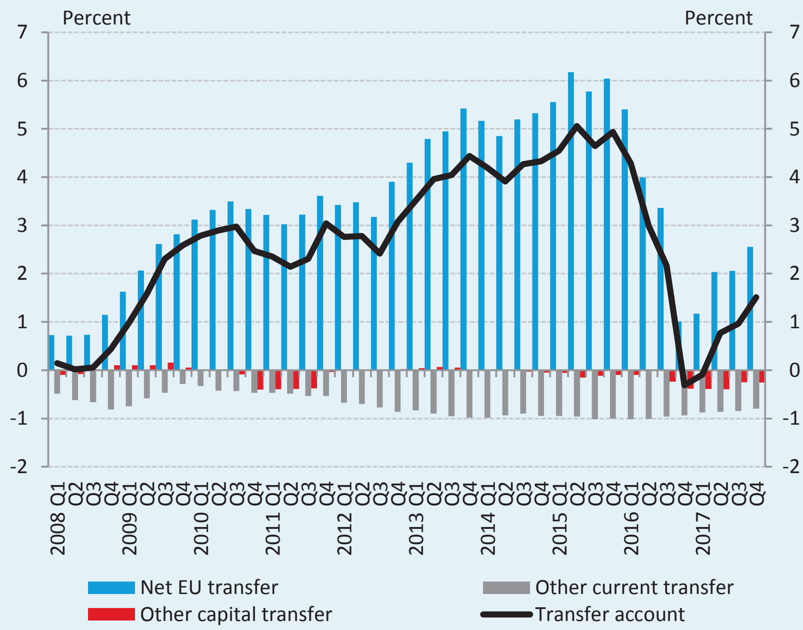


At present, no official GNI data (published by HCSO) related to 2017 is available, the 2017 figure was calculated from the balance of payments data release primary incomes(without SPEs, and the profit of foreign-owned companies is only an estimate for the time being).

1.3 Transfer balance

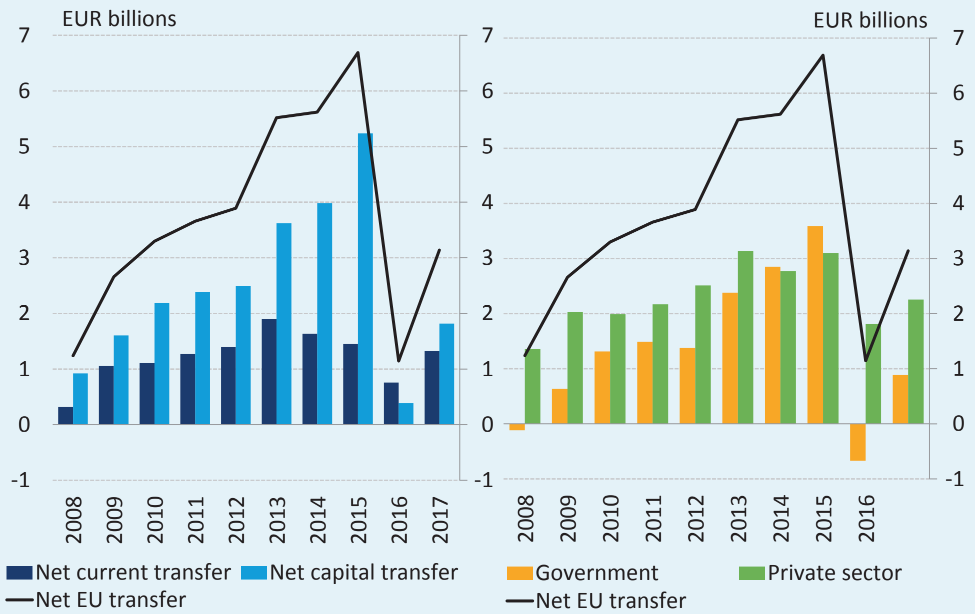
Accompanied by the rising absorption of funds from the EU's new programming period, the transfer balance rose to 1.5 percent of GDP, which curbed the decline in net lending (Chart 15). At the end of 2016, with the end of the 2007–2013 programming period and the moderate inflow of funds from the new programming period, the transfer balance lowered net lending slightly. However, in 2017 – particularly from the second quarter – the inflow of EU transfers rose substantially, which had a positive impact on Hungary's external balance position. Based on the 2017 four-quarter data, at the end of the fourth quarter the inflow of EU funds amounted to 2.5 percent of GDP, which substantially exceeds the values registered in the previous twelve months, but still falls short of the level measured at the end of the previous programming period. In addition to the EU funds, the moderate decrease in the transfer balance deficit, which primarily involves other current transfers, also generated a rise in the transfer balance. On the whole, at the end of 2017, the transfer balance rose to 1.5 percent of GDP, with the inflow of EU transfers remaining as the key factor.

Chart 15: Developments in the transfer balance (four-quarter values as a percentage of GDP)



The absorption of EU funds rose to EUR 3.1 billion in 2017, which had a similar effect on the current account and capital account. In 2016, in line with the end of the previous EU programming period, net current and capital transfers fell from the previous level of EUR 6.7 billion to close to EUR 1 billion, which was primarily reflected in the lower capital transfer balance. The decline in capital transfers, mostly financing investments, was accompanied by a significant drop in government transfers. In 2017, due to the inflow of funds from the new programming period, the net absorption of EU transfers rose strongly as the combined result of capital transfers in the amount of EUR 1.8 billion and current transfers of EUR 1.3 billion. The absorption of EU funds, which substantially exceeded the inflow of EU transfers in the previous year but still fell short of the average level from earlier years, primarily affected the private sector in 2017.

Chart 16: Developments in net EU current and capital transfers, and the breakdown thereof by sectors

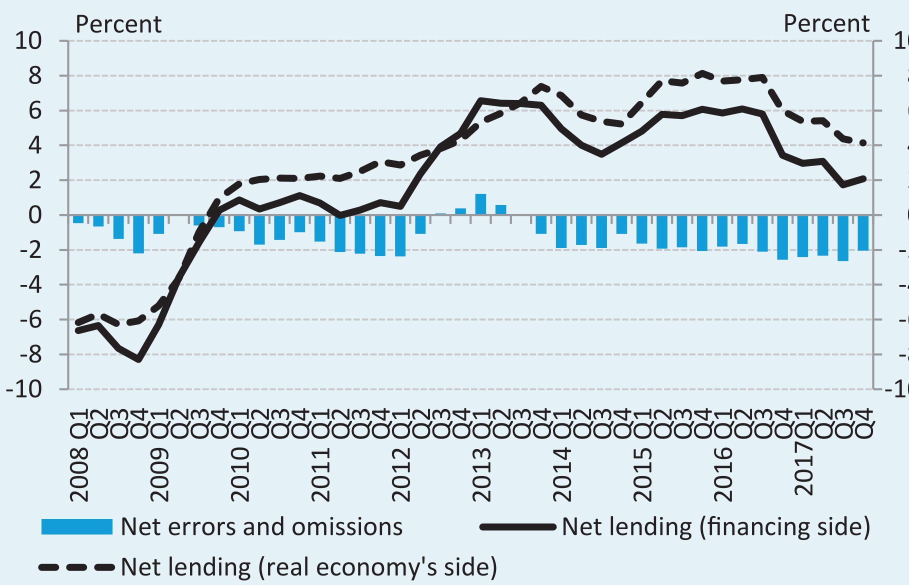


2 Financing approach

In 2017 Q4, net lending based on financing items was similar to the ratio calculated on the basis of the real economy items, in an environment characterised by a large outflow of debt liabilities and a substantial inflow of foreign direct investment. Throughout 2017, the outflow of funds fell short of the level registered in 2016, which is due to the decline in net portfolio equity investments and the fall in debt liabilities, the rate of which was lower than last year, but was still considerable. On the other hand, the value of net foreign direct investment rose at a rate similar to what was registered in the previous year, increasing by roughly EUR 2 billion. In 2017, the net external debt of the banking sector increased slightly, while the net external debt of the consolidated general government contracted to a larger degree, and the net external debt of the corporate sector fell to a smaller degree. The large drop in the general government's net external debt was attributable to the decrease in the government securities holding of non-residents with the absorption of EU transfers as an additional factor, while the foreign exchange reserves – as the combined result of the foreign currency requirement of the general government, the EU transfers and the foreign currency liquidity related to the central bank's fine-tuning instrument – did not change as a result of transactions. Non-residents' government securities holdings declined by a smaller degree than in previous years, while the domestic private sector continued to generate strong demand for government securities, and thus the government's dependency on external liabilities continued to decrease. Similarly to the previous year, the private sector's net external debt fell as a result of transactions: this was mostly attributable to the increase in external assets, with the decline in external debt contributing to this only to a lesser degree. The rise in bank liabilities affected long maturities, while the short-term external debt of the sector essentially remained unchanged in 2017.

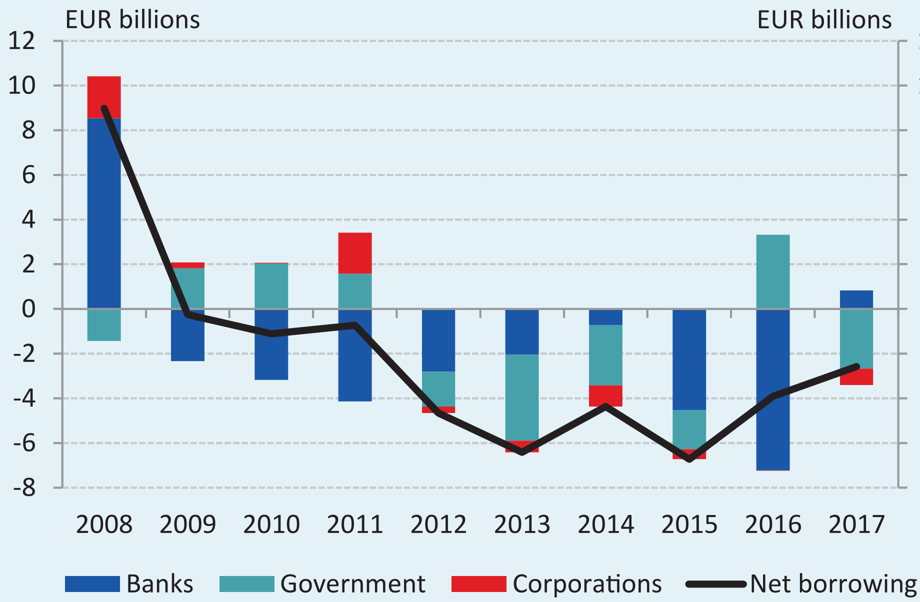
The economy's net lending under the financing approach rose moderately in 2017 Q4, in contrast to the declining value calculated according to the real economy approach. Four-quarter net lending calculated based on real economy data fell to 4.1 percent of GDP, and in parallel with this, the indicator calculated from the financing side rose to 2.1 percent of GDP (Chart 17). The difference between the two indicators, i.e. net errors and omissions, shrank to 2 percent of GDP, and remained within the band typical for the countries in the region (for more details, see Section 5).

Chart 17: Developments in the two types of net lending (four-quarter data as a percentage of GDP)



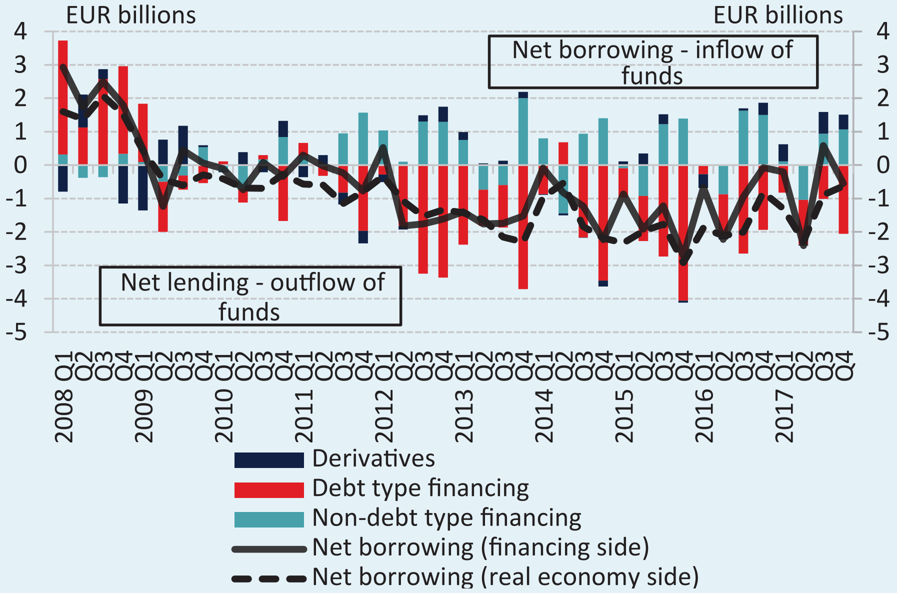
In 2017, the decline in the Hungarian economy's external liabilities continued at a slower pace than in the previous years, mostly driven by the consolidated general government and to a smaller degree by the corporate sector, while the banking sector's net external liabilities rose moderately. After the crisis, the banking sector continuously reduced its net external liabilities (in line with deleveraging by the private sector), which was also supported by the foreign currency assets received as a result of the forint conversion in 2015–2016; due to the foreign currency liquidity provided by the central bank in connection with that process, the gradual deleveraging of the general government consolidated with the MNB, which had been ongoing since 2012, temporarily switched over to an increase in debt in 2016. In 2017, the rate of decline in the economy's external liabilities slowed down compared to the previous year, and the structure of the outflow of funds also changed (Chart 18). After the decline registered in the previous year, the net foreign liabilities of the banking sector rose modestly in 2017. The increase in the sector's external assets was lower than the rise in external liabilities and this was partly attributable to the foreign exchange swap instruments of the central bank providing forint liquidity. The general government's net external debt fell significantly, due to the rise in the absorption of EU transfers and the decline in non-residents' holdings of government securities, along with the impact of the aforementioned swaps providing forint liquidity, which boosted foreign exchange reserves.

Chart 18: Net outflow of funds by sector



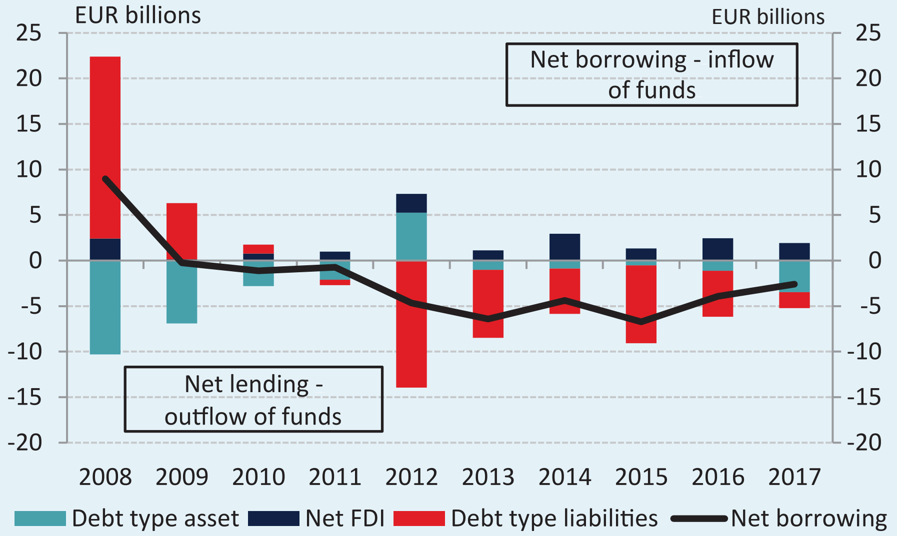
The modest rise in the economy's net lending according to the financing side at the end of 2017 occurred in conjunction with a large outflow of debt liabilities and an inflow of non-debt liabilities. As a result of the strong growth registered in the fourth quarter, which corresponds to the usual seasonality, the outflow of debt liabilities exceeded EUR 2 billion, which was primarily attributable to the private sector's continuing deleveraging. This development was reflected both in the reduction of the country's external debt and the rise in external assets. By contrast, the economy's foreign non-debt liabilities rose by roughly EUR 1 billion in the fourth quarter, which was linked completely to foreign direct investment, while portfolio investment ebbed slightly during the final quarter. On the whole, after a moderate increase, the economy's net lending in the fourth quarter amounted to roughly EUR 550 million (Chart 19).

Chart 19: Structure of net lending (unadjusted transactions)



In 2017, accompanied by modestly lower net lending, the outflow of debt liabilities accelerated, while the inflow of foreign direct investment tapered off to a small degree (Chart 20). In 2017, the economy's debt liabilities dropped by more than EUR 5 billion, falling slightly short of the value registered in the previous year. Compared to developments in previous years, one important change is that the rise in external assets made a strong contribution to the decline in net external debt, while the decline in external liabilities decelerated. Foreign direct investment remained relatively steady: the inflow of roughly EUR 2 billion registered in 2017 fell slightly short of the value observed in the previous year.

Chart 20: Developments in foreign direct investment and debt liabilities*

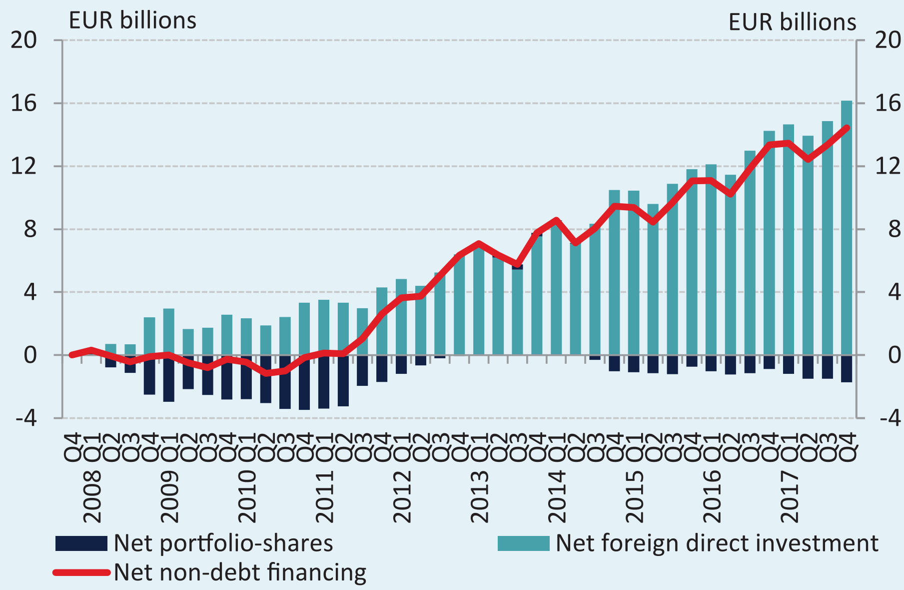


**In addition to the components presented in the chart, net external borrowing requirement also includes the equity transactions of portfolio investments and transactions associated with derivatives.*

2.1 Non-debt liabilities

In 2017 Q4, non-residents' net foreign direct investment rose substantially, accompanied by a decline in net portfolio equity investment. Net foreign direct investment by non-residents exhibited the growth typical at year-end and exceeded EUR 1.3 billion in 2017 Q4. Similarly to previous periods, the inflow was mostly linked with the reinvested earnings of foreign companies, but there was also a slight increase in the equity of non-resident companies. A decrease in net FDI was fostered by the outward investments of resident companies which increased significantly, based on data net of capital-in-transit transactions. Throughout 2017, the economy's non-debt liabilities rose by roughly EUR 1.1 billion in net terms, resulting from the significant foreign direct investment by non-residents, but curbed by the outflow linked to portfolio investment (Chart 21).

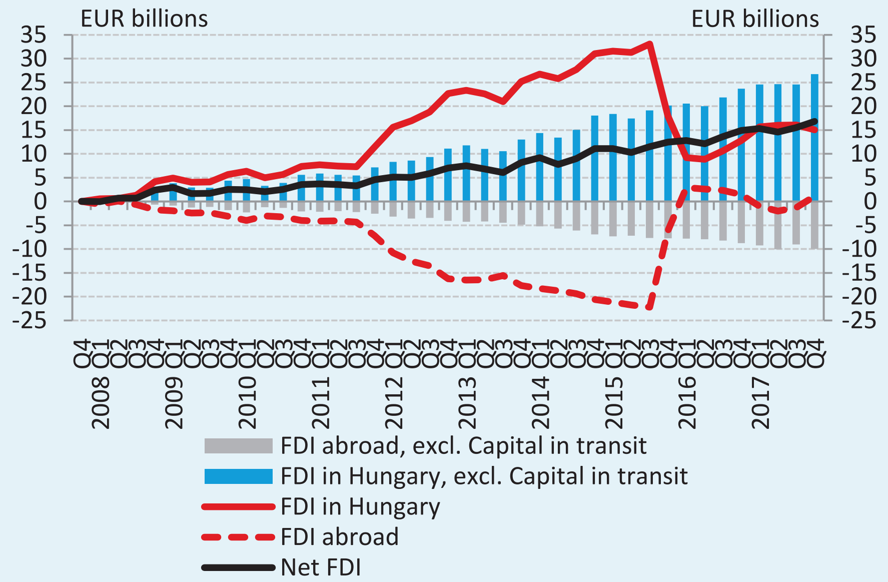
Chart 21: Changes in non-debt liabilities (cumulative transactions)



Transactions associated with capital in transit and the rearrangement of the asset portfolio strongly influence the gross legs of direct investment, and thus it is worth analysing the net inflow of funds. Starting from 2008, the balance of payments statistics present capital flows net of capital in transit separately. This is necessary, because some non-resident companies grant intercompany loans or capital to their Hungarian subsidiaries presumably for tax optimisation purposes, which are transferred by these subsidiaries abroad. The capital-in-transit flows impact the gross legs, i.e. the inflow and outflow data, and have no impact on the net foreign direct investment data.[3] In 2015, capital-in-transit transactions had a major impact, while in 2016 and 2017 they only had a smaller effect on the gross legs of foreign direct investment. The importance of separating capital-in-transit transactions is also demonstrated by the fact that – according to the original data – the net growth in foreign direct investment in 2017 Q4 was attributable to lower outward investment (while FDI inflow even decreased in Hungary), while according to the data net of capital in transit it is attributable to the growth in gross FDI inflow (Chart 22).

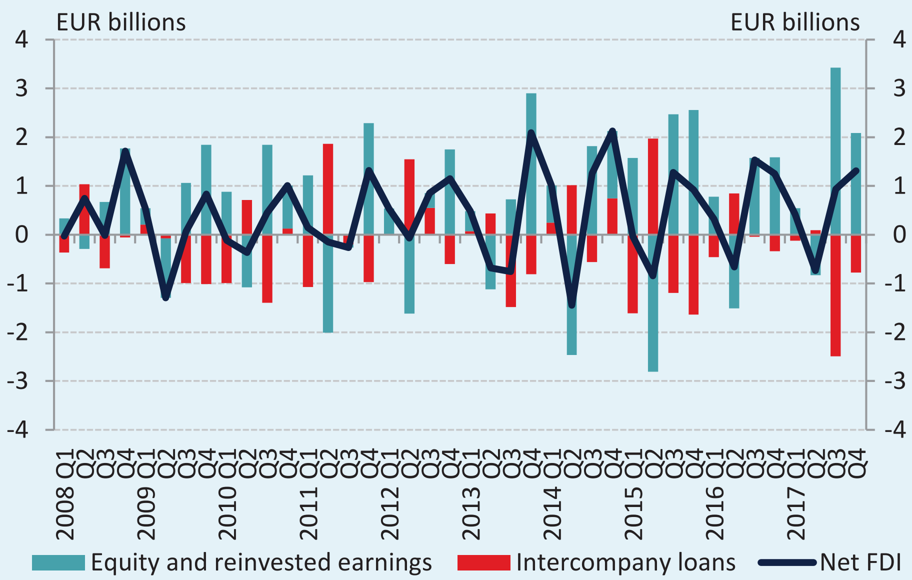
3 However, capital in transit also has a significant impact on the structure of Hungarian FDI by sectors, because it can happen that the investment in Hungary belongs to a different sector than the ultimate purpose of the direct investment, and hence the FDI data by sectors is also distorted.

Chart 22: Developments in foreign direct investment (cumulative transactions)



In past years, the rise in net foreign direct investment was linked with the growth in reinvestment, while intercompany loans decreased (Chart 23). After the slight decrease observed in the first half of the year, in 2017 H2 the inflow of net foreign direct investment accelerated, which was fully attributable to the reinvested earnings of non-resident companies. After the crisis, the net FDI inflow slowed down substantially, and the change in equity participation and intercompany loans often offset each other. However, in the past few years, the inflow of reinvestment type funds accelerated, while intercompany loans decreased. The decrease in equity participations is partially explained by the FDI-reducing effect of state acquisitions (MOL, E-On, Antenna Hungária Zrt., Főgáz, Budapest Bank), while the fall in intercompany loans may have been linked to deleveraging in the corporate sector (entailing the repayment of domestic and foreign loans). Despite the state acquisitions and the rising outward investment by residents, the FDI stock rose on the whole, which shows that overall FDI by the non-resident sector is increasing in Hungary. In 2017 Q4, similarly to the previous period, the growth in reinvestment[4] was outstanding, while the repayment of intercompany loans continued at a slower pace.

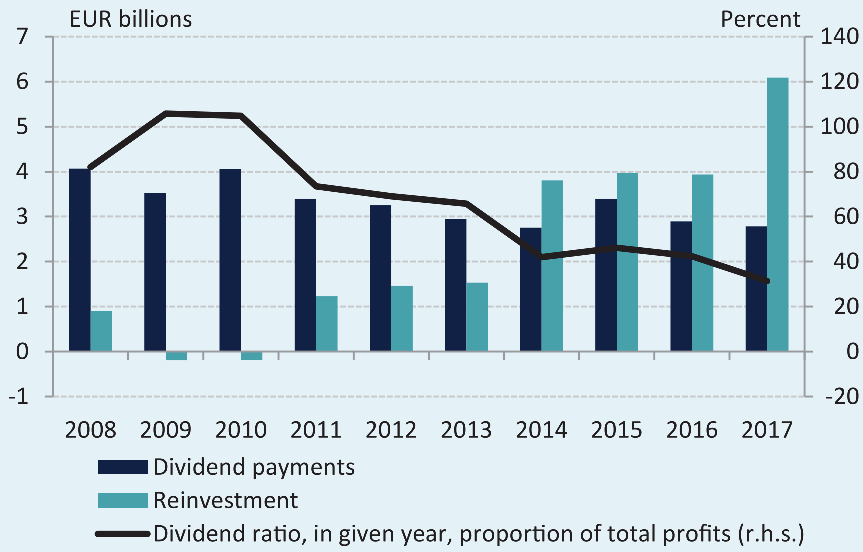
Chart 23: Developments in net direct investment (net of capital in transit)



4 The foreign direct investment income and thus the value of reinvestments is based on estimate until the release of the actual figure next September.

The rise in the profitability of foreign-owned companies was accompanied by constant dividend payments, which resulted in a substantial growth in reinvested earnings. The profitability of foreign-owned companies gradually improved in the post-crisis years, with profit rising to nearly EUR 7 billion in the period of 2014–2016 and already approaching the level of EUR 9 billion in 2017. [5] Meanwhile, the dividends paid remained more or less constant, hence the increasing profit led to higher foreign direct investment through reinvested earnings (Chart 24). As a result of the foregoing, the dividend payment relative to the annual profit, i.e. the dividend ratio, dropped to nearly 30 percent, which falls well short of the value typical in the region (for more details, see Section 5.6 of the Report on the Balance of Payment of October 2017). As part of the deleveraging, which continued in 2017 as well, foreign-owned companies repaid part of their intercompany loans, which curbed FDI inflow.

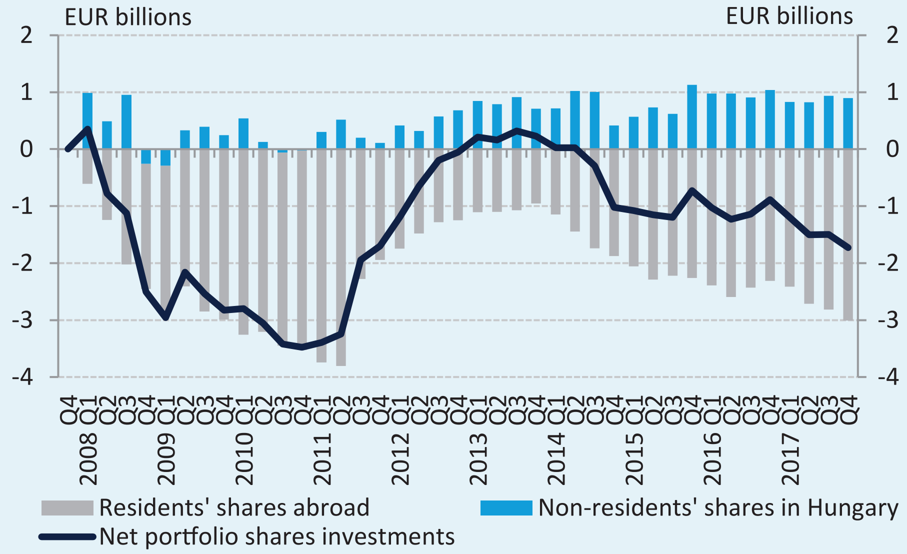
Chart 24: Distribution of profits generated by foreign-owned companies in Hungary



In 2017 Q4, a considerable net portfolio equity outflow was registered, which was linked to a minor fall in investment by non-residents in Hungary and a larger rise in investment by residents abroad (Chart 25). In 2014, a rapid rise commenced in the purchase of foreign mutual fund shares by resident actors, which significantly reduced the net portfolio equity stock. Although purchases by residents abroad continued in 2015 as well, the impact of this was mitigated by non-residents' increasing demand for domestic instruments. Throughout 2017 – and in the fourth quarter – resident actors' holdings of foreign instruments rose once again. Within this, households and mutual funds purchased foreign mutual fund shares, while non-residents' domestic instruments hardly changed, and thus net portfolio equity investment fell sharply.

5 Profit 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.

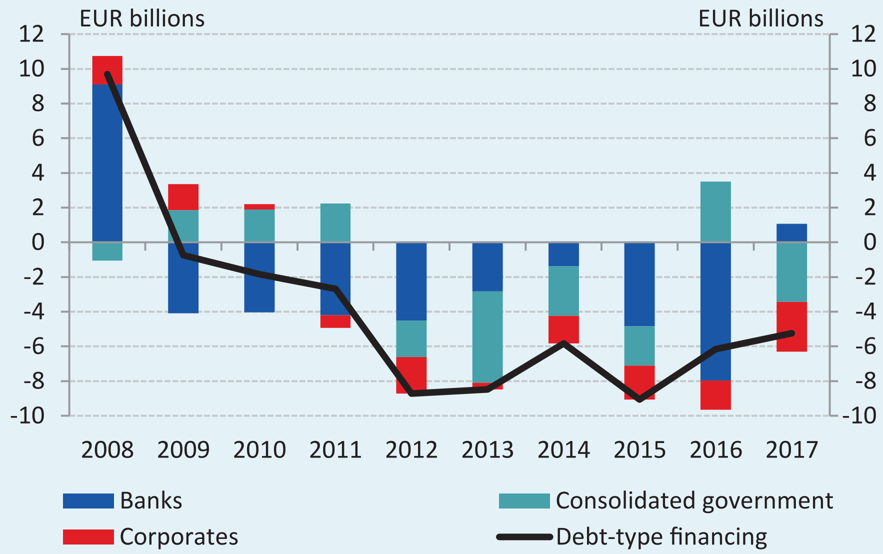
Chart 25: Factors of changes in net portfolio equity (cumulative transactions)



2.2 Debt liabilities

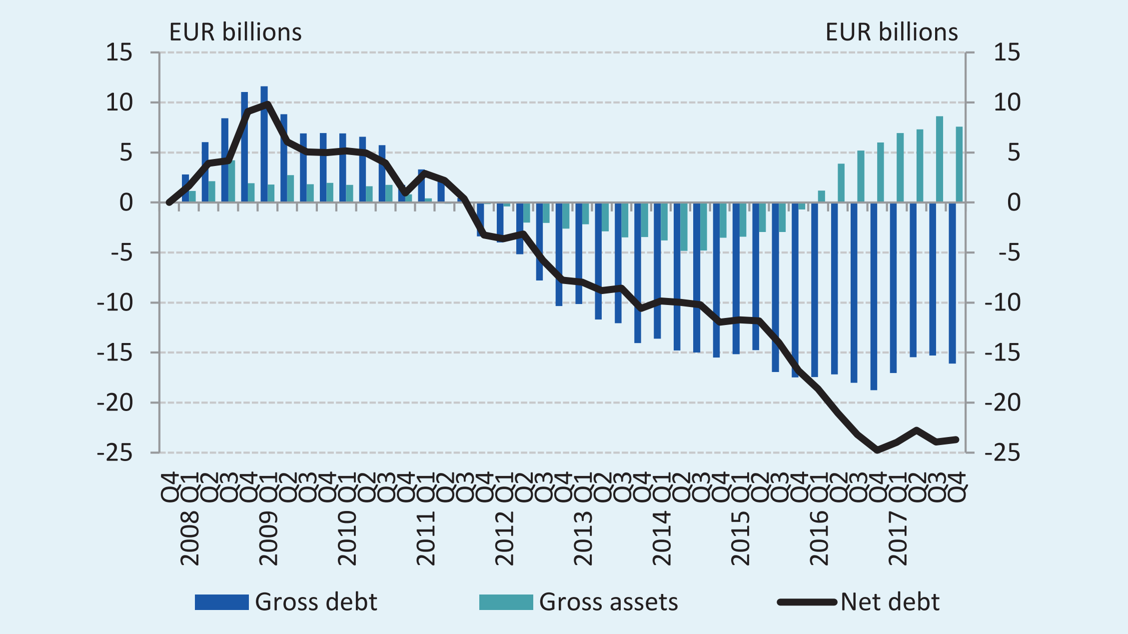
The economy's net external debt declined by EUR 2 billion in the fourth quarter, and by more than EUR 5 billion in the entire year – this was mostly driven by the general government in both periods, and to a smaller degree by the corporate sector, while the banking sector's net external debt rose moderately. In 2017, the adjustment of the economy related to external debt decelerated somewhat: the fall of almost EUR 5 billion in net external debt as a result of transactions was slightly smaller than the decline registered in the previous year. On the other hand, there was a major change in the breakdown of the decline in external debt by sectors. In 2016, due to the forint conversion, the central bank provided the banking sector with substantial foreign currency liquidity, which – as a result of the fall in foreign exchange reserves – led to a rise in the general government's net external debt and a decrease in banks' net external debt (Chart 26). By contrast, in 2017 developments in the structure of external debt were dominated by the central bank's fine-tuning forint liquidity providing swap instruments: partly as a result of this, the banking sector's external assets rose to a smaller degree than its external liabilities, while the net external debt of the consolidated general government, after the rise registered in 2016, once again declined substantially, falling by more than EUR 3 billion in 2017. In addition to the effect of the central bank's fine-tuning instrument which increased foreign exchange reserves, the rising absorption of EU transfers and the declining government securities holdings of non-residents also played a role in this process. In annual terms, the decline in the net external debt of the corporate sector accelerated, amounting to roughly EUR 3 billion.

Chart 26: Changes in the debt liabilities of individual sectors (annual transactions)



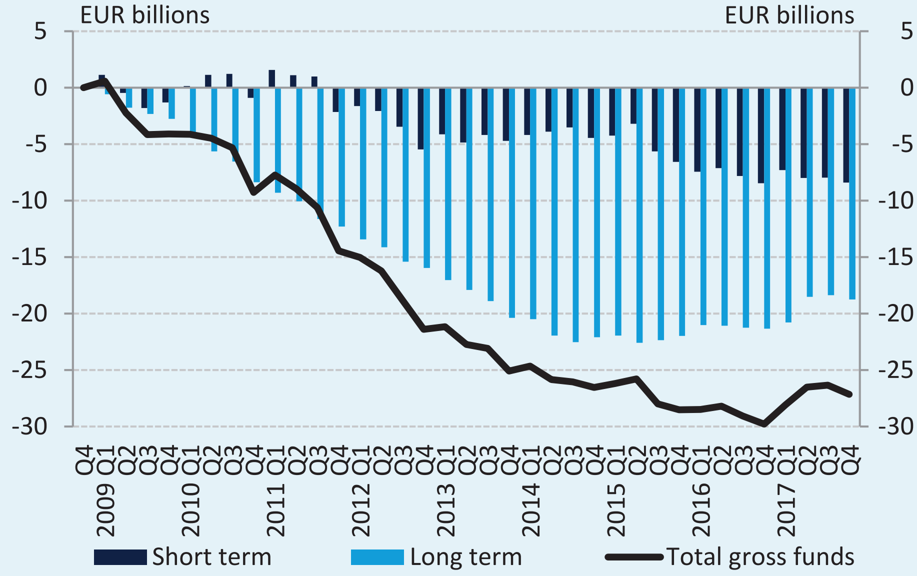
In 2017, the banking sector's net external debt increased moderately, due to the larger rise in gross external debt as compared to the rise in external assets. After registering growth in the first three quarters, banks' external debt and assets both decreased significantly in 2017 Q4 (Chart 27). The fall in liabilities mostly affected short-term external debt, which implies year-end balance sheet optimisation by the banks. Taking 2017 as a whole, the rise in the banking sector's external liabilities was presumably attributable to the fact that some banks financed their external assets with external liabilities. However, the smaller growth in external assets compared to liabilities may have been linked to the foreign currency liquidity reducing effect of the central bank's fine-tuning instrument. Summarising all these effects, in 2017 the banking sector's external assets and external liabilities rose by EUR 1.6 billion and EUR 2.6 billion, respectively, and thus banks' net external debt rose to a small degree, by roughly EUR 1 billion. It should be noted that the growth in the banking sector's external liabilities took place despite the fact that the private sector's deposits still significantly exceeded borrowing. The rise in the banking sector's external liabilities may be partly attributable to the fact that some banks finance the growth in their external assets with external liabilities.

Chart 27: Developments in the banking sector's external debt and receivable transactions (cumulative transactions)



In 2017, growth in the banking sector's gross external debt primarily involved long-term liabilities, while the stock of originally short-term liabilities hardly changed as a result of transactions. In the fourth quarter, the banking sector's total external debt fell by EUR 0.8 billion, due to the decrease in long-term debt to a smaller degree and to the fall in short-term debt to a larger degree (Chart 28). Although banks' external debt rose in 2017, this was almost completely driven by long-term liabilities exclusively, while the level of short-term debt hardly changed during the year. The unchanged level of banks' short-term debt can be regarded as a positive factor in terms of external vulnerability.

Chart 28: Maturity breakdown of the banking sector's external debt (cumulative transactions)

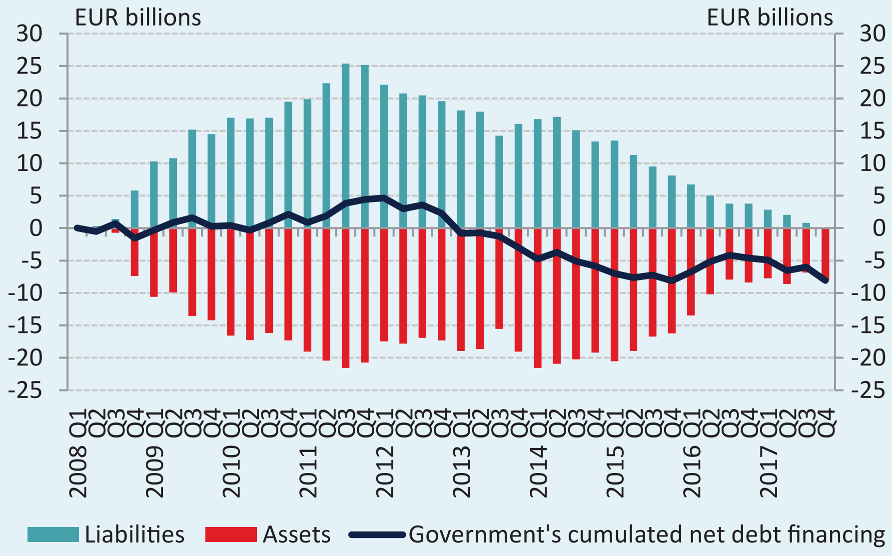


In 2017 Q4, the evolution of the net external debt of the general government consolidated with the MNB was a good reflection of the developments that took place throughout the year: the general government's external debt declined substantially as the combined result of several factors. The government's external debt was influenced by the following key items.

- The government's net external debt declined as non-residents reduced their forint government securities holdings by almost EUR 0.6 billion for 2017 as a whole and by EUR 0.5 billion in the last quarter. Partly due to transformation of the central bank's monetary policy instruments, banks substantially increased their government securities holdings, accompanied by a rise in households' government securities portfolio, and thus non-residents were replaced by resident sectors in the financing of the government.
- The absorption of EU transfers lowered net external debt significantly during the year as a whole and in the fourth quarter as well.
- The central bank's fine-tuning FX swap transactions, providing banks with forint liquidity in exchange for foreign currency liquidity, also resulted in lower net external debt (EUR 3.4 billion in the entire year, EUR 2 billion in the fourth quarter). On the other hand, the currency swaps linked to the forint conversion and the government's foreign currency expenditures reduced foreign exchange reserves.
- In 2017, net external debt also increased (via lower foreign exchange reserves), due to the April expiration of a foreign currency bond (P€MÁP) held by the domestic sectors.

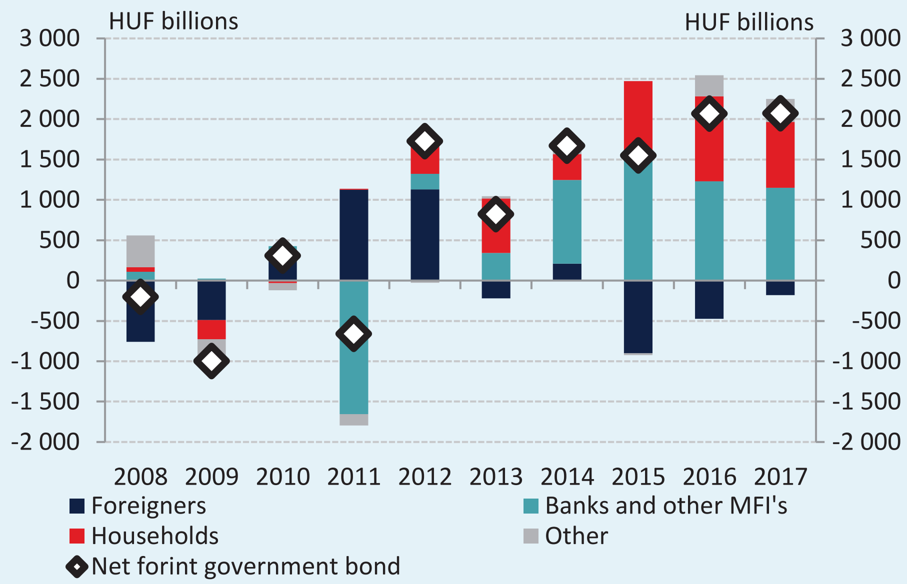
As a combined result of these factors, the decrease in the general government's net external liabilities was mostly the result of the larger fall in liabilities (Chart 29), as foreign exchange reserves remained constant.

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



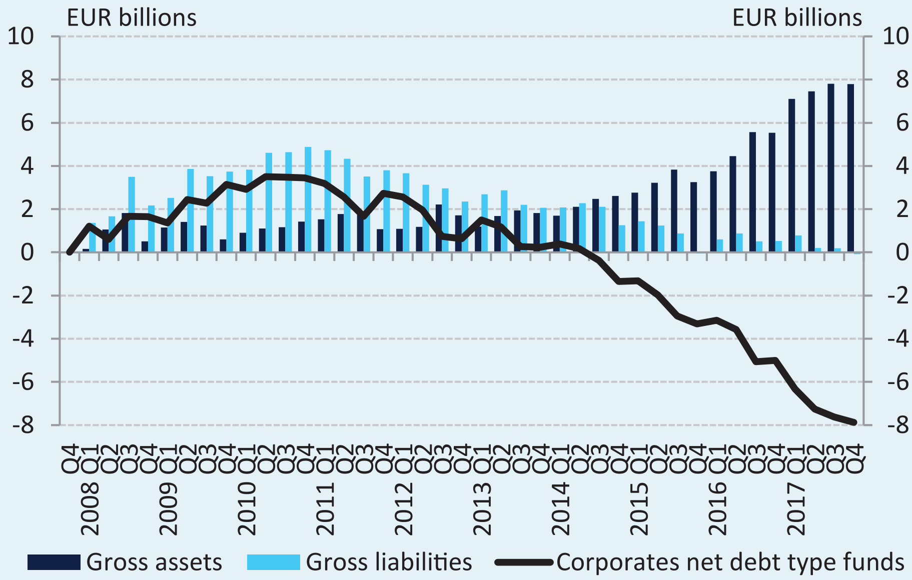
The shift towards the domestic actors within the financing of the government continued in 2017 as well, helping to reduce Hungary's external vulnerability. Overall Hungarian government bond holdings of non-residents (denominated in foreign currency and in forint) fell by more than EUR 1.5 billion (nearly HUF 500 billion), and thus the share of non-residents within total Hungarian government bond holdings fell from 38 percent registered at the start of the year to 33 percent. The sale of government bonds by non-residents involved a decline of HUF 300 billion and HUF 150 billion in foreign currency and forint government securities, respectively (Chart 30). The role of non-residents in the financing of the government was taken over by resident private sectors in 2017 as well. The banking sector's forint government securities holdings rose by almost HUF 1,200 billion, partly due to the transformation of the MNB's set of monetary policy instruments. In addition, households also made a stable contribution to the financing of the government from internal funds, by roughly HUF 800 billion. The two sector's remarkable demand on the government securities market contributed to the decrease in the foreign currency proportion of the government debt, and supported the reduction of Hungary's external vulnerability.

Chart 30: Changes in the forint government securities portfolio by sectors



The next external debt of companies continued to decrease in 2017 Q4, driven by the fall in liabilities to the non-resident sector (Chart 31). However, analysing the development of net external debt of companies at the annual level, we find that – similarly to the banking sector – the main factor was the growth in external assets, while the decrease in liabilities only played a smaller role. Since 2015, liabilities declined only by EUR 1 billion, while external assets rose by more than EUR 5 billion. In 2017, the net external debt of the corporate sector fell by a total of almost EUR 3 billion.

Chart 31: Developments in companies' net debt liabilities (cumulative data)



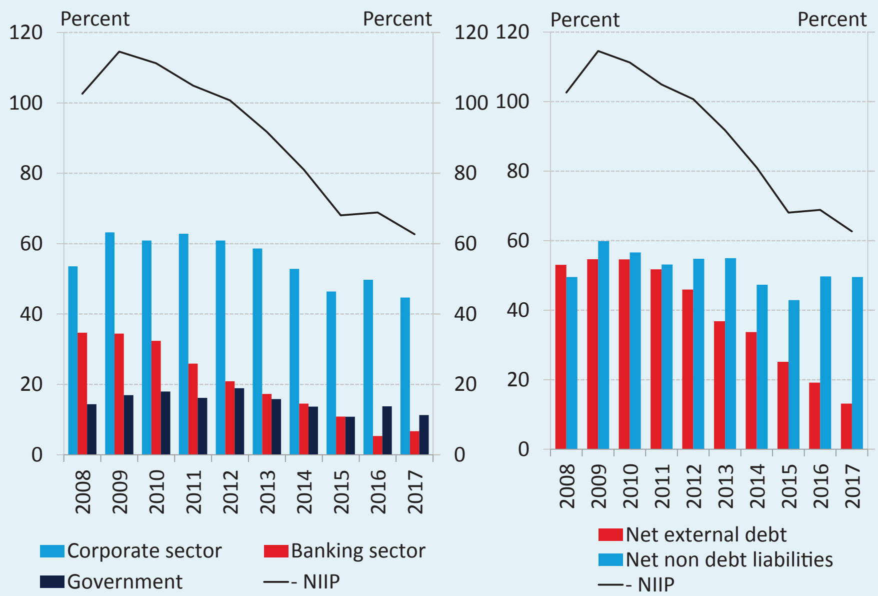
3 Developments in debt ratios

External liability indicators, which bear outstanding significance in terms of the vulnerability of the economy, continued to improve in 2017 and fell to a historic low. The decline in net external liabilities developed in the context of a steady level of non-debt liabilities and a larger decrease in net external debt. Net external debt fell to 13 percent of GDP, while gross external debt declined to nearly 60 percent of GDP, mainly due to the outflow of funds, exchange rate-related revaluation and nominal GDP growth. In 2017, the continued adjustment of net external debt was attributable to a larger degree to the general government and to a smaller one to the corporate sector, while the net external debt of banks increased slightly. The decline in the net external debt of the consolidated general government was supported by the continued decrease in non-residents' government securities holdings, the absorption of EU funds and the effect of the central bank's fine-tuning swap instruments which increased foreign exchange reserves. The decline in the corporate sector's net external debt was achieved in conjunction with rising external assets and decreasing liabilities, while in the banking sector the growth in liabilities fostered a rise in the debt ratio. Gross external debt fell faster than net external debt, mainly due to the fact that revaluation – related to the depreciation of the US dollar – reduced both external liabilities and assets, which partially offset each other in the net ratio. The decline in Hungary's external vulnerability was strongly supported by the fact that short-term external debt according to residual maturity dropped to a historic low of close to EUR 16 billion by the end of 2017. The Hungarian economy's gross financing need decreased by almost EUR 2 billion in 2017 to approach EUR 16 billion. Foreign exchange reserves still significantly exceed the level expected by investors.

3.1 Net external liabilities

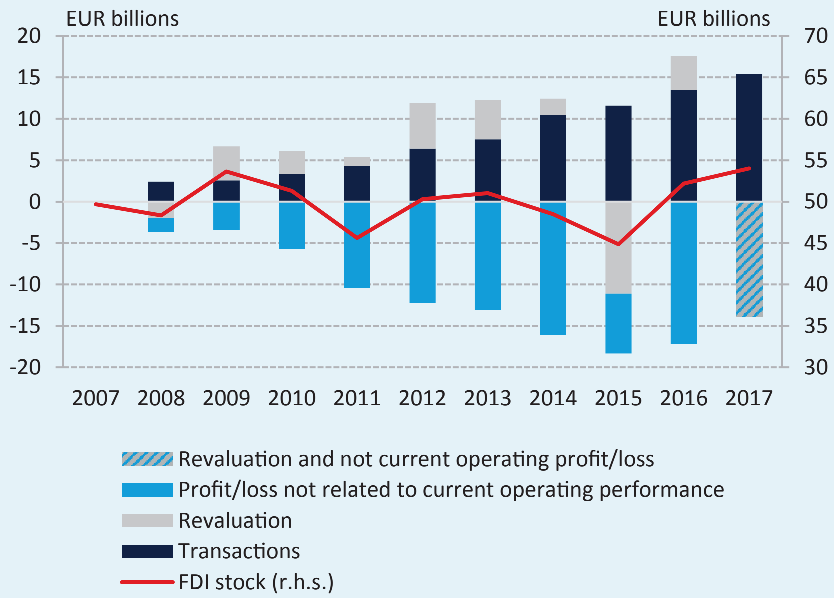
In 2017, Hungary's net external liabilities continued to fall, as part of the deleveraging process (Chart 32). The net external liabilities of the Hungarian economy – which also contain external debt and non-debt liabilities (foreign direct investment, portfolio equity and derivative liabilities) – fell below 63 percent of GDP by the end of 2017. The decrease in Hungary's net external liabilities since the crisis – as a result of the upward drift in foreign direct investment – was temporarily interrupted in 2016, but then continued in 2017. Non-debt liabilities remained constant, while debt liabilities declined in 2017 as well, resulting in a 6.2 percentage point decrease in net external liabilities. The larger part of the decline was linked to the corporate sector, while to a smaller degree it was attributable to the general government, which was partly offset by the rise in banks' external liabilities.

Chart 32: Developments in net external liabilities (period-end values as a percentage of GDP)



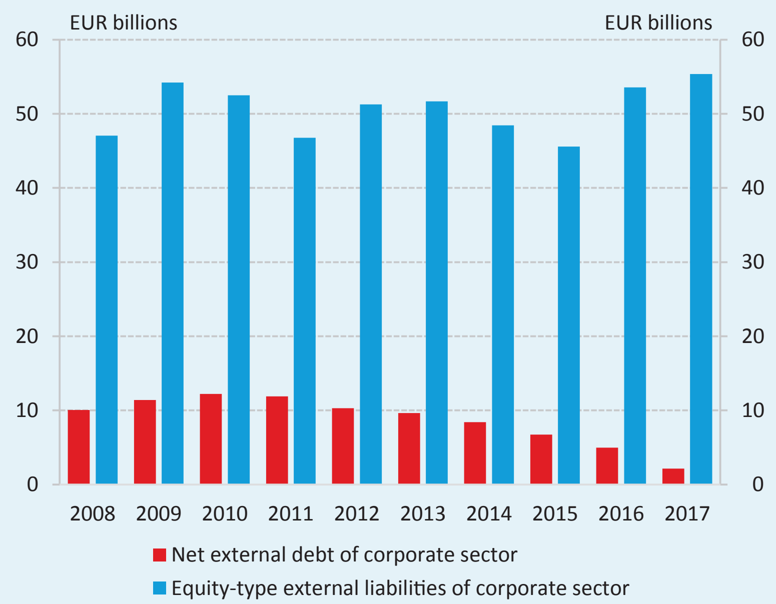
The growth in the net FDI portfolio linked to inflows of foreign direct investment was essentially reduced by companies' losses not related to the normal course of business. There was a gradual inflow of foreign direct investment transactions in the past year, but the net FDI stocks of non-residents rose to a smaller degree than that. The underlying causes of this mainly included the losses not linked to the usual course of business and the change in the portfolio resulting from revaluation. Until the end of 2017, these items reduced the foreign direct investment portfolio by almost EUR 15 billion in total (for more details on the extraordinary profit/loss, see the October 2017 issue of this Report).

Chart 33: Breakdown of the change in net FDI stock



The decline in non-financial corporations' net external liabilities was related to the repayment of external debt in 2017 as well, while the stock of foreign direct investment did not change significantly (Chart 34). Net repayment by non-financial corporations was also reflected by the decline in the external borrowing of companies: while the net stock amounted to EUR 10 billion after the outbreak of the crisis, by the end of 2017 it fell below EUR 2 billion. On the other hand, the equity participation liabilities of companies (mostly foreign direct investment) did not change materially and have fluctuated around EUR 45–55 billion since 2008. Thus, the decline in companies' net external liabilities can still be tied to net debt repayment by companies, while direct investment liabilities have not changed substantially.

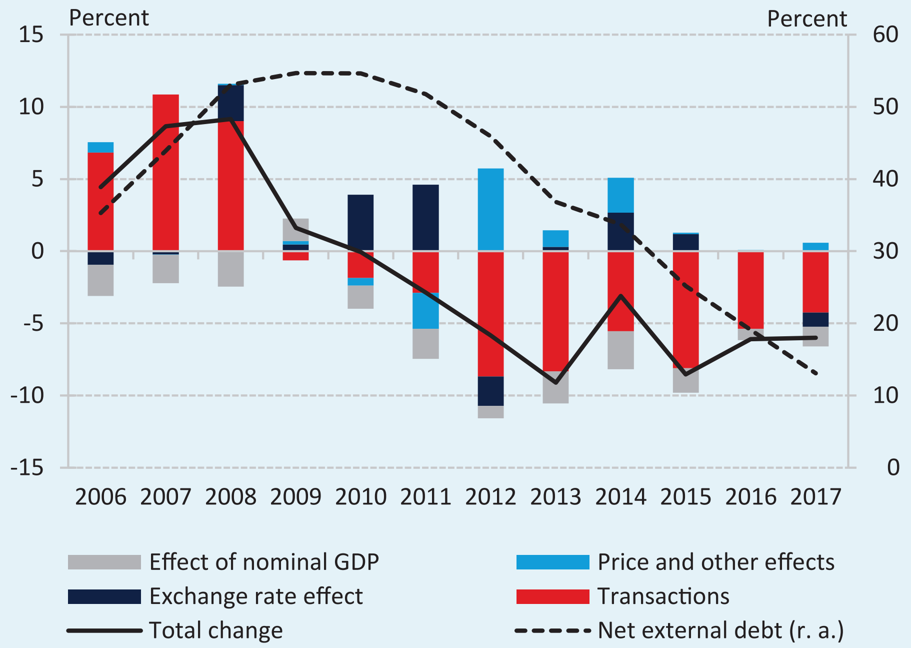
Chart 34: Changes in the net external liabilities of non-financial corporations



3.2 Net external debt

The decline in net external debt in 2017 was attributable mostly to transactions and the rise in nominal GDP, and to a smaller degree to the appreciation of forint (Chart 35). The decline in the debt ratio in recent years was primarily driven by the outflow of debt liabilities. After the outbreak of the crisis, the adjustment of net external debt was curbed in 2009 by the decline in nominal GDP, and later on by the depreciation of the forint. Hence, the adjustment of the debt overhang observed in the pre-crisis years was only able to start from 2011: in connection with the outflow of debt liabilities, net external debt fell by more than 42 percentage points, which was also supported to a smaller degree by the increase in nominal GDP. In 2017, Hungary's net external debt fell by almost 6 percentage points, which was primarily attributable to the outflow of debt liabilities and GDP growth, and to a lesser degree to the appreciation of the forint against other currencies.

Chart 35: Decomposition of the change in net external debt (as a percentage of GDP)



At the end of 2017, net external debt amounted to 13.1 percent of GDP, down by almost 6 percentage points compared to the end of the previous year (Chart 36). The improvement in the debt ratio was mostly related to the general government and to a smaller degree to the corporate sector, while the net external debt of the banking sector rose slightly (but remained negative). The 1-percentage point rise in the banking sector's net external debt as a percentage of GDP was attributable both to the decrease in external assets and the rise in liabilities. A decrease in the banking sector's external assets was also fostered by the central bank's fine-tuning currency swap instrument, related to the quantitative restrictions, as a large volume of foreign currency liquidity was transferred from the banking sector to the central bank, which was offset only partially by bank's external asset increasing effect of the foreign currency liquidity provided for the forint conversion. The government's net external debt fell by almost 4 percent of GDP in 2017, driven by the rising absorption of EU transfers, in addition to the central bank's fine-tuning currency swap instrument – which curbed the decrease in foreign exchange reserves – and by the lower government securities holdings of non-residents. The net external debt of non-financial corporations decreased by 2.9 percent of GDP, mostly relating to the fall in the sector's external liabilities (Chart 37).

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

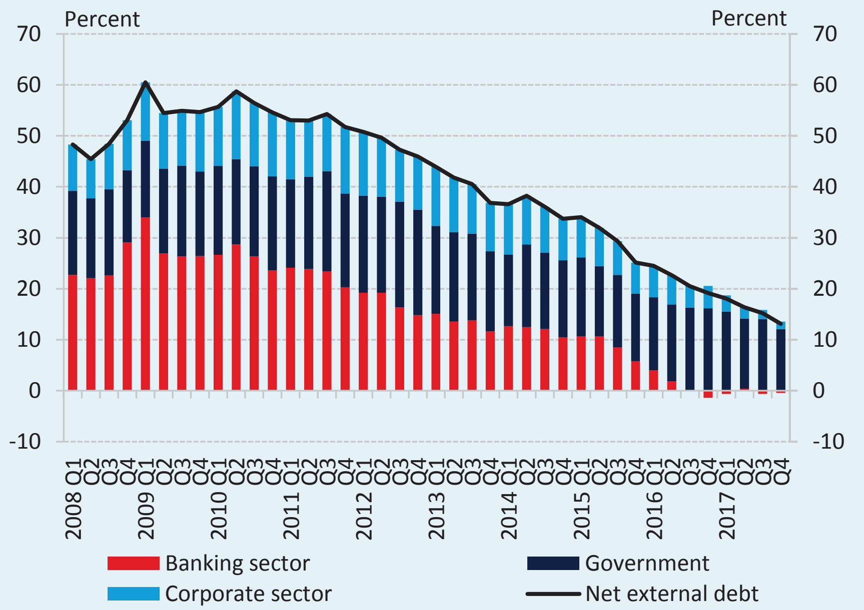
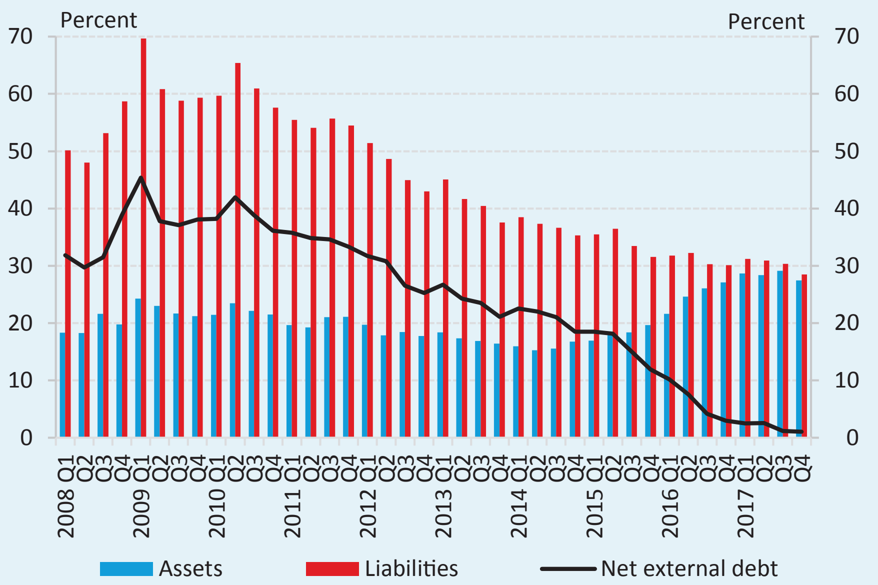


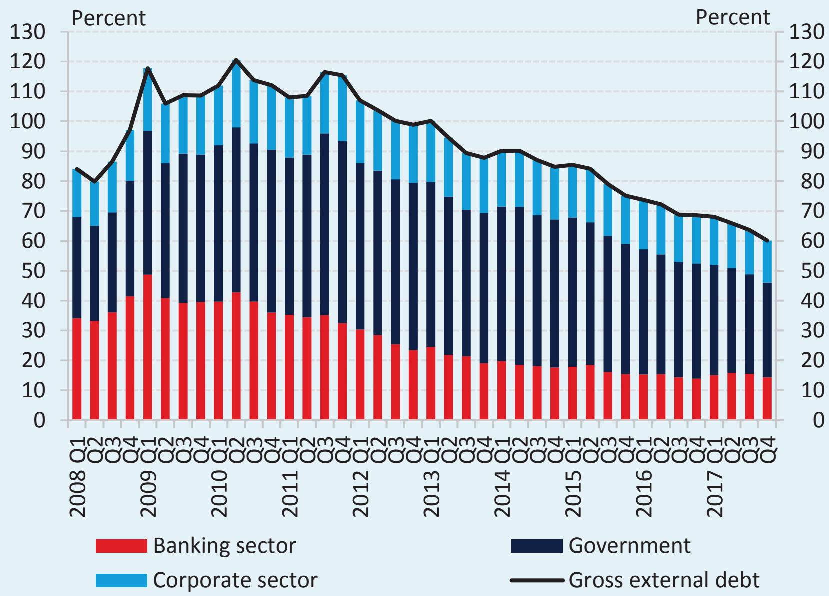
Chart 37: Developments in the private sector's external assets and liabilities (as a percentage of GDP)



3.3 Gross external debt

As a result of the continued fall in the general government's external financing, Hungary's gross external debt approached 60 percent of GDP (Chart 38). The 2017 decline in gross external debt exceeded 8 percent of GDP, and thus by the end of the year it fell to half of the level observed in 2010. The improvement in the debt ratio in 2017 was mostly tied to the general government and to a smaller degree to the corporate sector. The gross external debt of the general government was reduced by the continued decrease in non-residents' government securities holdings, in parallel with the rising role of domestic sectors in financing, the decrease in the margin portfolio related to the general government's FX-swap transactions, which was mostly attributable to the depreciation of the US dollar against the euro, and the financing of the expiring foreign currency bonds predominantly from forint funds. The corporate sector also contributed to the adjustment of the gross debt ratio, while the reduction of the banking sector's external liabilities, observed in previous years, halted in 2017, followed by an upward drift in the sector's gross external debt. Hungary's gross external debt declined more than its net external debt, as revaluation effects linked to the depreciation of the US dollar against the euro reduced both external liabilities and assets in 2017. While the revaluation due to the currency effect caused a sharp decline in gross outstanding debt, the effect of this factor in the net ratio was partly offset by the decline in external assets.

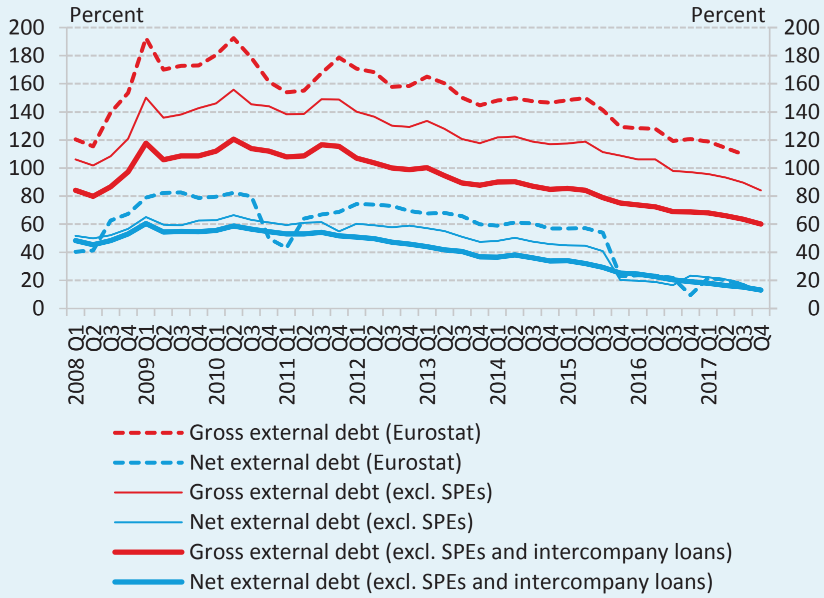
Chart 38: Breakdown of gross external debt by sectors (as a percentage of GDP, at market value, without intercompany loans)



2. Box: Developments in external debt

Net external debt, which contains SPEs and intercompany loans, also fell below 20 percent of GDP, while gross external debt still substantially exceeds the ratio calculated according to the underlying trends. Based on economic considerations, in its analyses and publications the MNB shows debt ratios excluding SPEs (special purpose entities) and intercompany loans. However, the Eurostat database only contains ratios calculated together with these factors. The SPEs do not pursue real economy activity, and their activity has no impact on the country's net external liabilities, but they have a strong influence on the gross legs. On the other hand, the intercompany loans may be regarded as non-debt liabilities rather than debt (for more details, see the April 2014 Report on the Balance of Payments). External debt containing both SPEs and the intercompany loans has dropped sharply in recent years, falling to less than 20 percent of GDP and approaching the ratio according to the underlying trends. While the net external debt ratio including the intercompany loans and SPEs shows no material deviation from the time series based on the underlying trends not containing the intercompany loans, there is still a substantial difference between the gross ratios. However, it should be noted that in the past years the gross ratios also declined continuously and significantly (Chart 39).

Chart 39: Developments in the net and gross external debt (as a percentage of GDP)



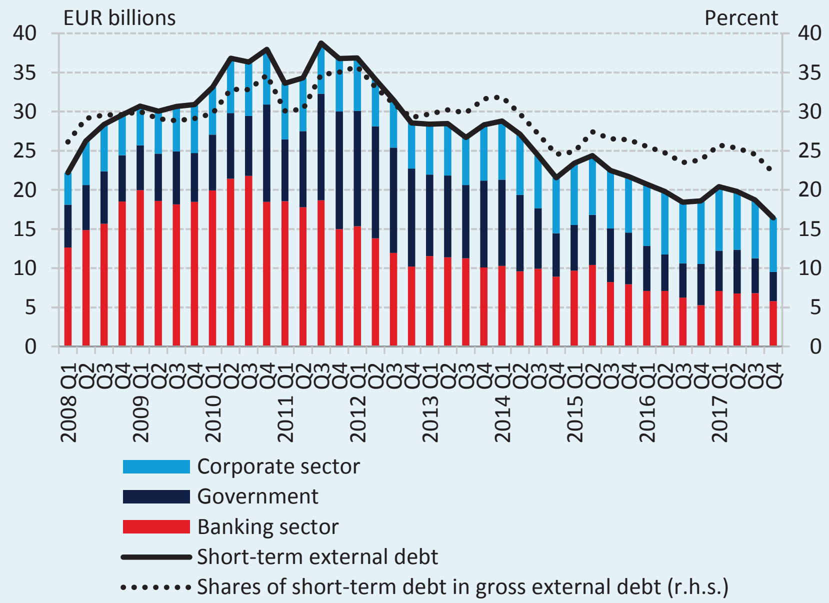
Source: Eurostat, MNB.

3.4 Short-term external debt and gross borrowing

In 2017, Hungary's short-term external debt declined further, reaching a historic low of EUR 16.4 billion at the end of the year. The last time that short-term external debt, which has key importance in terms of the assessment of the economy by investors and its external vulnerability, was lower than this was in 2004. In 2017, the ratio declined by EUR 2 billion, which can be explained by the fall in the short-term external debt of the consolidated general government and corporations, which was partially offset by the rise in the short-term external debt of the banking sector. The short-term external debt of the general government dropped by EUR 1.5 billion compared to the end of 2016, which is related in full to the short-term external debt based on original maturity, and particularly to the margin liabilities of the State Debt Management Agency. Companies' short-term external debt fell by EUR 1 billion compared to the value registered one year ago, which is linked to the decline in amortising debt. Corporate short-term external debt has stagnated at roughly between EUR 7 and 8 billion since 2014. The impact of the decline observed in these two sectors is somewhat mitigated by the rise of EUR 0.5

billion in the banking sector, linked to the increase in amortising debt. Despite this increase, the indicator for the banking sector may still be deemed favourable, as prior to the end of 2016 the sector's short-term external debt has not been this low since 2004, and short-term external debt based on original maturity is also at a historic low. The decline in the ratio of short-term debt within total external debt continued in 2017, and thus it is lower than the pre-crisis level (Chart 40).

Chart 40: Developments in short-term external debt based on residual maturity



At the end of 2017 Q4, the level of short-term external debt fell by EUR 2.3 billion quarter on quarter, supported by all three sectors. The largest decline in quarter-on-quarter terms was recorded by the banking sector, followed by the general government and the corporate sector.

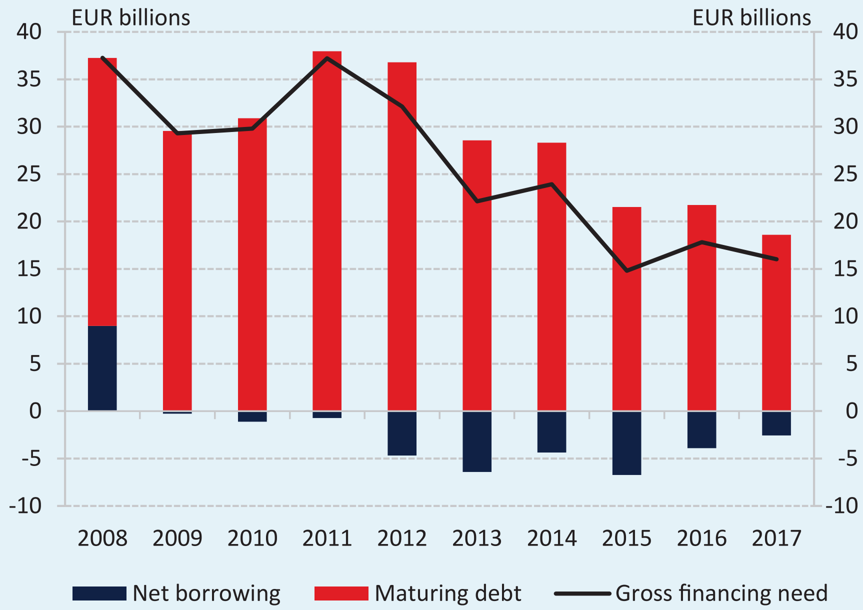
- In the fourth quarter, the short-term external debt of the *consolidated general government* declined by some EUR 800 million, which is linked in equal parts to short-term external debt based on original maturity and amortising short-term debt. Short-term external debt based on original maturity declined in connection with the Government Debt Management Agency's margin liabilities. The foreign currency bond swap performed by the Agency in October was a key factor behind the decline in amortising debt, which also reduced short-term external debt based on original maturity, due to the fall in the margin stock. The general government's short-term external debt has not been lower than this since before the outbreak of the financial crisis.

- The *banking sector's* short-term external debt based on original maturity fell by EUR 1 billion in the fourth quarter and at the end of 2017 it amounted to roughly EUR 5.8 billion. The decline was equally attributable to the fall in the external debt based on original maturity and in the amortising debt. The low figure may have been also attributable to the balance sheet optimisation usually performed by the banking sector at year-end.

- The *corporate sector's* short-term external debt fell by almost EUR 0.5 billion during the quarter, mostly linked to the sector's external debt based on original maturity.

In 2017, Hungary's gross financing need fell to EUR 16 billion, which may be related to the fall in expiring debt. Short-term external debt as of December 2016, i.e. external debt expiring in 2017, fell short of the previous year's figure by some EUR 3 billion and amounted to EUR 18.6 billion (Chart 41). Hungary's net lending according to the financing approach, which reflects the country's financing need (and its surplus funds after the post-crisis adjustment), fell to 2.6 percent of GDP in 2017, and thus the gross financing need obtained as the difference of the two indicators fell to EUR 16 billion.

Chart 41: Developments in the gross borrowing requirement



3.5 Reserve adequacy

In 2017 Q4, foreign exchange reserve holdings rose, primarily as a result of the forint liquidity providing swap instrument related to the restriction of the three-month central bank deposit and EU transfers received from the European Commission. At the end of 2017, international reserves amounted to EUR 23.4 billion, representing an increase of EUR 1.1 billion compared to level recorded in September. Changes in the foreign exchange reserves were influenced by a number of factors, of which the items exerting the largest influence were as follows:

- The net *foreign currency financing of the Government Debt Management Agency* reduced the reserve level by more than EUR 640 million. In October, a *JPY-denominated foreign currency bond* expired in the amount of EUR 150 million; in addition, the repayment of the development loans drawn down in euro represented a decline of EUR 375 million during the quarter. In December, as a result of the favourable forint market and household demand, *foreign currency bonds were repurchased* in the amount of roughly EUR 130 million. The *issuance of household foreign currency bonds* during the quarter raised the reserves by roughly EUR 20 million.

- The maturity of *unconditional swaps related to the forint conversion of household foreign currency loans* in December 2017 reduced the level of reserves by almost EUR 250 million. As part of the MNB's forint conversion programme, banks purchased foreign currency from the central bank in a total amount of EUR 9.7 billion between 2014 and 2017. Upon the expiry of the last transactions, the respective commercial banks drew down from the MNB the total foreign currency amount necessary for the forint conversion.

- The reserve reducing effect of the *other foreign currency expenditures of the Government Debt Management Agency and the Hungarian State Treasury* amounted to almost EUR 700 million, while that of revaluation resulting from the depreciation of other currencies against the euro was close to EUR 150 million. The *margin deposit related to the FX-swap transactions of the Government Debt Management Agency* and the *foreign currency deposits placed by domestic banks at the MNB* appeared as additional reserve reducing items, in the amount of almost EUR 700 million in total.

- *EU funds* raised the reserves by more than EUR 1.9 billion, which can be explained by the submission of the performance-based invoices related to the 2014–2020 EU programming period and the settlement of such by the Commission.

- The reserve increasing effect of the *forint liquidity providing foreign exchange swap instruments* was EUR 1.7 billion in the fourth quarter.

For 2017 as a whole, the foreign exchange reserves declined by EUR 1 billion, as the impact of the swap maturities related to the forint conversion, the net foreign currency financing of the Government Debt Management Agency and the other foreign exchange transactions of the Government Debt Management Agency and the Hungarian State Treasury was only partially offset by reserve increasing factors. The MNB's international reserves dropped from EUR 24.4 billion registered at the end of 2016 to EUR 23.4 billion by the end of December 2017, which was mostly attributable to the following factors:

- Similarly to the previous years, the Government Debt Management Agency repaid its foreign currency debt in the amount of EUR 1.7 billion without any major issuance of international foreign currency bonds. The fall in the reserves, related to the *net foreign currency financing of the Agency,* was primarily the combined result of the foreign currency bond maturities, the foreign currency loan repayments, the repurchase of the foreign currency bonds at the end of the year, the issuance of renminbi-denominated foreign currency bonds and the net issuance of household foreign currency bonds. (In October 2017, the Agency performed an international foreign currency bond swap transaction, where it repurchased USD bonds in the amount of USD 1.16 billion. For the financing of the consideration for the redeemed bonds, the Agency issued new euro bonds in the amount of EUR 1 billion, with maturity in 2027. The foreign currency bond swap had no effect on the volume of foreign exchange reserves.)

- The *other foreign currency transactions of the Government Debt Management Agency and the Hungarian State Treasury* (e.g. foreign currency interest payments and the margin deposit flows linked with the FX-swap transactions of the Agency) reduced the reserve level during the year by roughly EUR 3.6 billion.

- The quarterly maturities of the unconditional swap instruments related to the phase-out of household foreign currency loans reduced the foreign exchange reserves by EUR 1.1 billion, the payment flows linked to the foreign currency pillar of the third phase of the Funding for Growth Scheme by almost EUR 200 million, while the revaluation of the reserve holdings outstanding in certain other currencies by EUR 800 million, of which the latter is partly a temporary effect.[6]

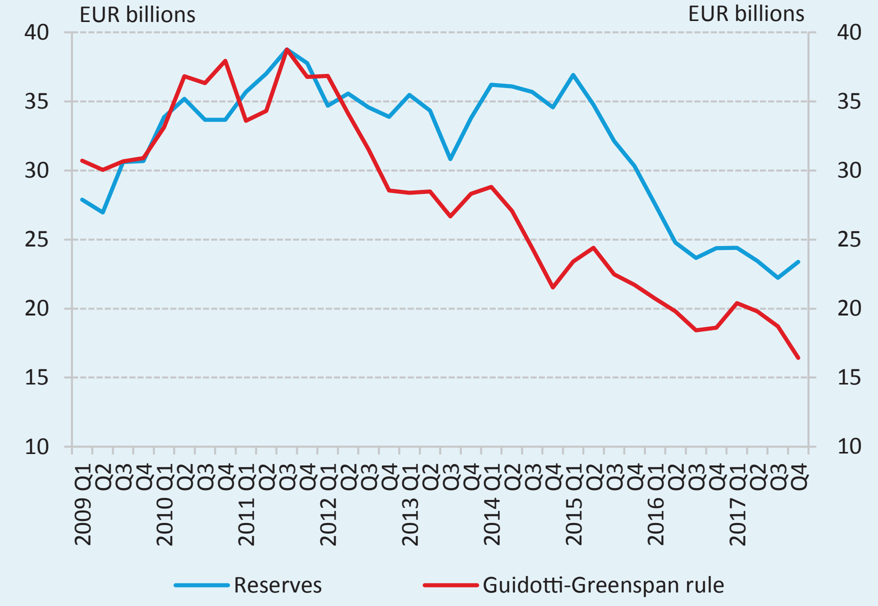
- Contrary to the aforementioned items, the EU funds raised the reserves by EUR 2.8 billion, while the forint liquidity providing foreign exchange swap instrument, announced from mid-October 2016, increased reserves by EUR 3.6 billion.

- Other factors (such as the banks' foreign currency deposits placed at the MNB, the rollover of the MNB's cross-currency swap transactions in the major currencies) offset each other, and thus on the whole they had no effect on the reserve level.

As a result of the large decline in short-term external debt and the increase in foreign exchange reserves, the level of foreign exchange reserves, similarly to previous years, significantly exceeds the level expected by investors in 2017 again. Considering the Guidotti-Greenspan rule – which is also closely followed by the central bank and investors – the foreign exchange reserves of EUR 23.4 billion recorded at the end of 2017 substantially exceed the volume of short-term external debt, which amounted to EUR 16.4 billion. The changes in foreign exchange reserves were strongly influenced by the payment of the EU funds, mostly concentrated at the end of the year, and the MNB's foreign exchange swap transaction with a monetary policy objective, the impacts of which were only partially reduced by the government's net foreign currency financing, the foreign currency items linked to the Government Debt Management Agency and the Hungarian State Treasury, and the swap maturities related to the conversion of household foreign currency loans into forint. The decrease in short-term external debt can be linked to a great degree to the banking sector, but the general government's and the corporate sector's short-term external debt also declined compared to the end of September 2017. In accordance with this, the reserve adequacy in proportion to short-term external debt improved by roughly EUR 3.5 billion in 2017 Q4, and thus the room for manoeuvre above the Guidotti-Greenspan indicator reached EUR 7 billion, which continues to represent a safe level (Chart 42).

6 The exchange rate movements of the euro influence the foreign exchange reserves, because the portfolio elements of the reserve in currencies other than euro must be revalued at market rates. The revaluation effect is partly temporary, because upon the rollover of the hedging transactions the MNB usually gets back higher amounts of euro on the expiring transactions than it needs to transfer for the new transactions.

Chart 42: Developments in foreign exchange reserves and the Guidotti-Greenspan indicator

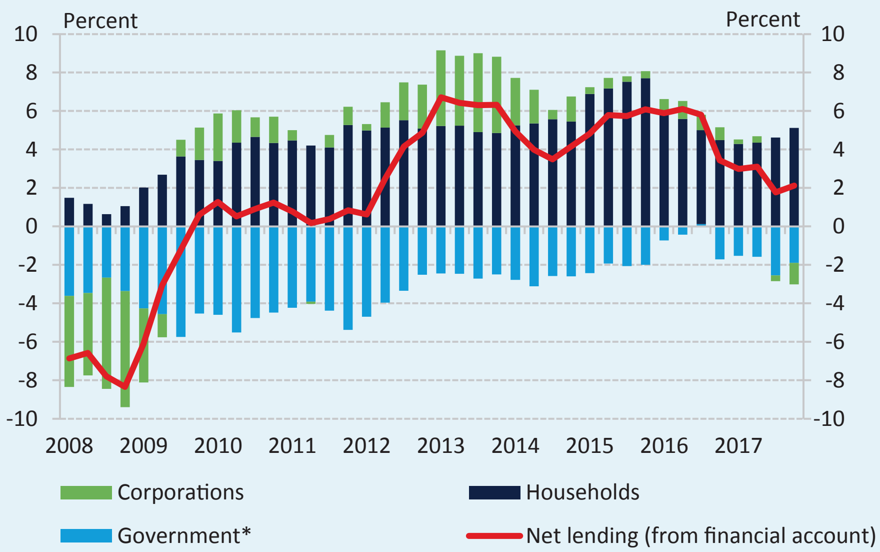


4 Sectors’ savings approach

The decline in the Hungarian economy's net lending in 2017 was the combined result of opposite processes: after a large decline, the net position of the corporate sector turned into net borrowing, while households' net savings rose, and the net borrowing of the consolidated general government increased slightly. In 2017 Q4, the companies' net lending declined significantly, the impact of which was partially offset by the improvement in the net position of households and the consolidated general government. The continuous rise in corporations' investment activity and households' slowly increasing housing investments made an important contribution to the decline in the private sector's net lending. Nevertheless, households substantially increased their net savings in the second half of the year, which may have been linked primarily to rapid wage growth, and the weakening credit demand, after a temporary improvement, also pointed in this direction. After a moderate improvement, the general government’s net borrowing remained below 2 percent of GDP in the fourth quarter, borne by the rise in budget revenues in parallel with wage growth and rising consumption and the decrease in interest expenditures.

The Hungarian economy's net lending according to the sectors' savings approach was 2 percent of GDP in 2017 Q4, which developed in conjunction with higher net household savings and net borrowing of the general government and the corporate sector (Chart 43). The change in the financial savings of the individual sectors is ultimately reflected in external funding, and thus changes in the external balance can also be captured as the sum of the sectors’ savings – which also corresponds to the financing side processes. Based on preliminary data, the annual net borrowing of the consolidated general government slightly exceeded the level recorded last year, but nonetheless remained moderate. Once again this year, the extremely low budget deficit is attributable to rising tax revenues from higher employment and consumption, and to the continued decline in interest expenses. The growth in households' net lending in the fourth quarter is due to the fact that the rise in incomes exceeded the increase in consumption. The net corporate position, which turned into net borrowing in the third quarter, rose further in the last quarter of the year, linked to rising investment and declining revenues.

Chart 43: Net lending of the individual sectors (four-quarter values as a percentage of GDP)

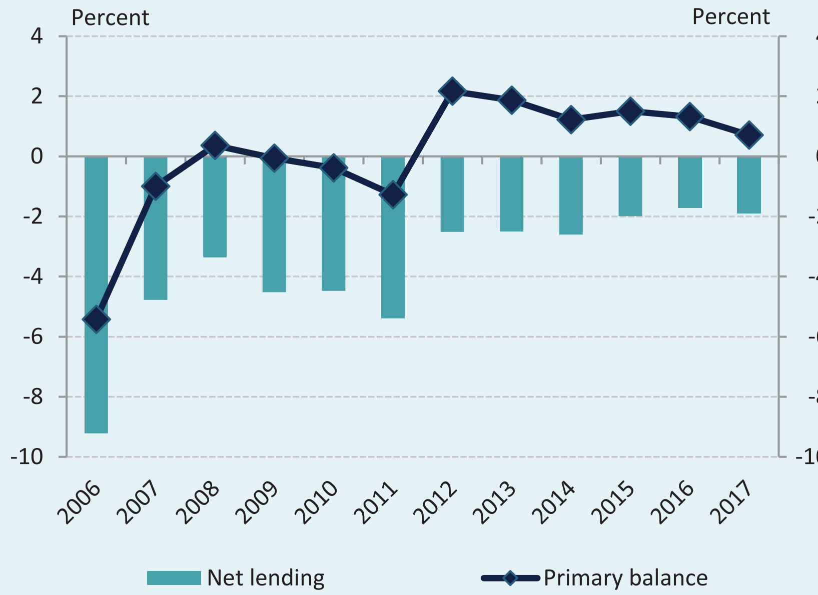


**General government represents the net borrowing according to the financial accounts. Corporate saving calculated as a residual.*

4.1 General government

The general government's net borrowing remained moderate in 2017 as well (Chart 44). In 2017, based on the preliminary data of financial accounts, the net borrowing of the general government amounted to 1.9 percent of the gross domestic product, i.e. the budget deficit is still low.[7] In line with the wage agreement concluded in 2016, the social contribution tax rate fell by 5 percentage points (to 22 percent) in 2017, the corporate income tax rate declined to a uniform rate of 9 percent from the earlier rates of 10 percent and 19 percent, and the amount of the minimum wage and the guaranteed wage minimum also rose further. As a result of the increasing wage outflow, revenues from labour taxes rose in nominal terms despite the tax cut, and the favourable labour market conditions also contributed to the rise in sales taxes by supporting consumption. On the expenditure side, due to the persistently low interest rate environment and the gradual repricing of debt, interest expenses declined further and the GDP-proportionate value of financial transfers also decreased. On the other hand, the increasingly effective absorption of EU transfers led to growth in the deficit as a result of higher co-financing.

Chart 44: Developments in the net lending of the general government (as a percentage of GDP)

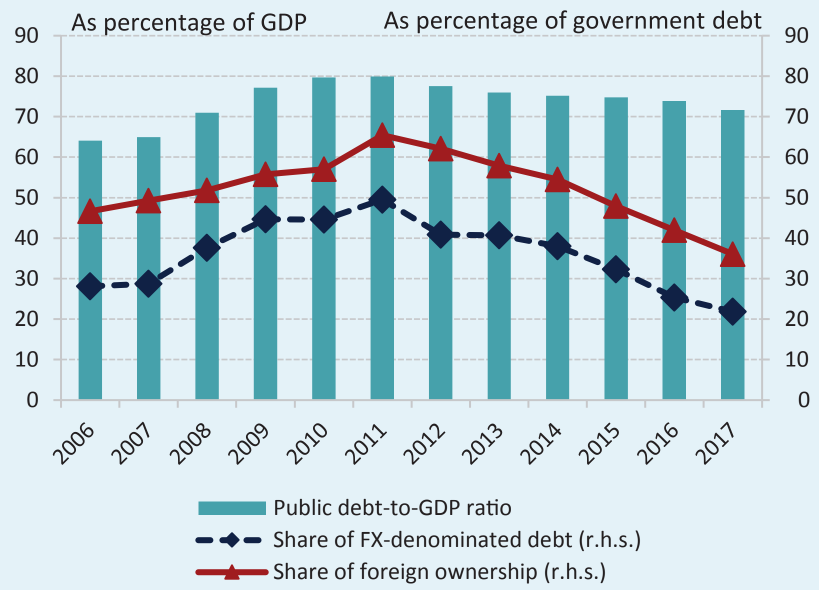


Source: MNB.

The trend decline in gross government debt as a percentage of GDP, which has been observed since 2011, continued in 2017 as well (Chart 45). By the end of 2017, the level of GDP-proportionate government debt fell to 71.7 percent, which represents a significant, 2.2-percentage point decrease compared to the figure recorded at the end of 2016. Dynamic economic expansion, falling interest expenditures and the positive primary balance all supported the decline in government debt. In addition to favourable macroeconomic fundamentals, one-off factors also influenced the value of debt in 2017. While the decrease in the margin deposit resulting from the weakening of the US dollar against the euro contributed to the decline in debt, the pre-financing of EU transfers increased the value of the cash-based deficit and through that the government debt.

7 For 2017, the data regarding the ESA balance of the budget is not yet available, but preliminary net lending data calculated according to the financial accounts usually only differs slightly from the ESA-balance.

Chart 45: Developments in gross government debt and the proportion of non-resident holding and foreign currencies within that

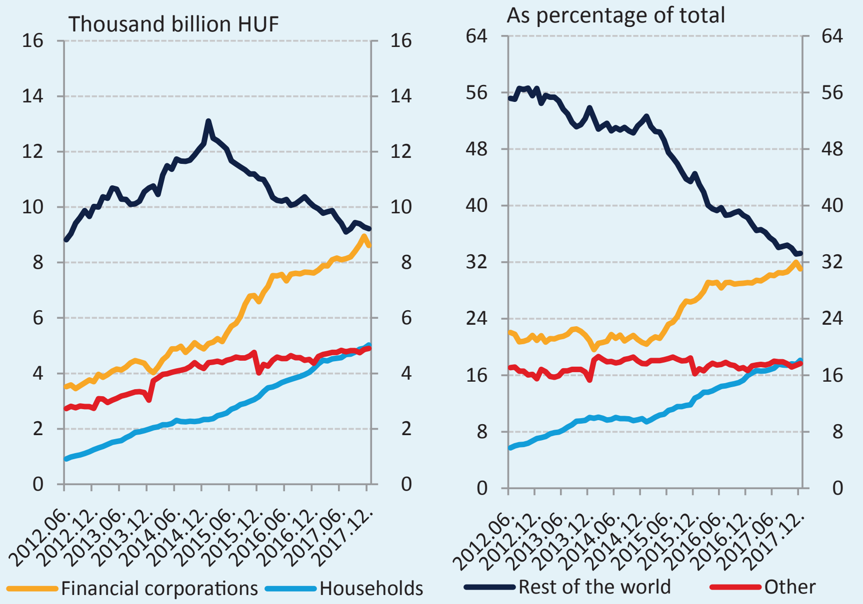


Note: Ratio of non-resident holdings calculated based on nominal value; the 2017 value is an MNB estimate.
Source: Government Debt Management Agency, MNB.

The decrease in foreign currency ratio and the decrease in non-resident holdings within the government debt supported the decline in external vulnerability. One of the key objectives of the government debt management strategy was to strengthen domestic financing, also supported by the central bank's self-financing programme. As a result, the proportion of non-residents' holdings within government debt decreased substantially, dropping from 65 percent at the end of 2011 to 35 percent by the end of 2017. In the meantime, the foreign currency ratio within central debt dropped below 22 percentage points from its historic high of 50 percent recorded at the end of 2011. The trend decrease in non-resident holdings and the foreign currency ratio make a considerable contribution to the continuous decrease in external vulnerability and to the upgrading of Hungary's credit rating.

The decline in non-resident holdings was facilitated by the rise in the government securities holdings of households and banks. In 2017, households' holdings of government securities rose by more than HUF 800 billion to exceed HUF 5,000 billion by the end of the year (Chart 46). With this, the households directly hold more than 18 percent of the securities issued by the government (with this figure reaching 29 percent, taking into consideration government securities holdings through mutual funds, insurers and pension funds), which may be deemed high in an EU comparison. In parallel with the transformation of the central bank's set of monetary instruments, the volume of government securities held by credit institutions, in addition to the households' holdings, also rose dynamically, increasing by nearly HUF 1,000 billion.

Chart 46: Government securities holdings of households, banks and non-residents

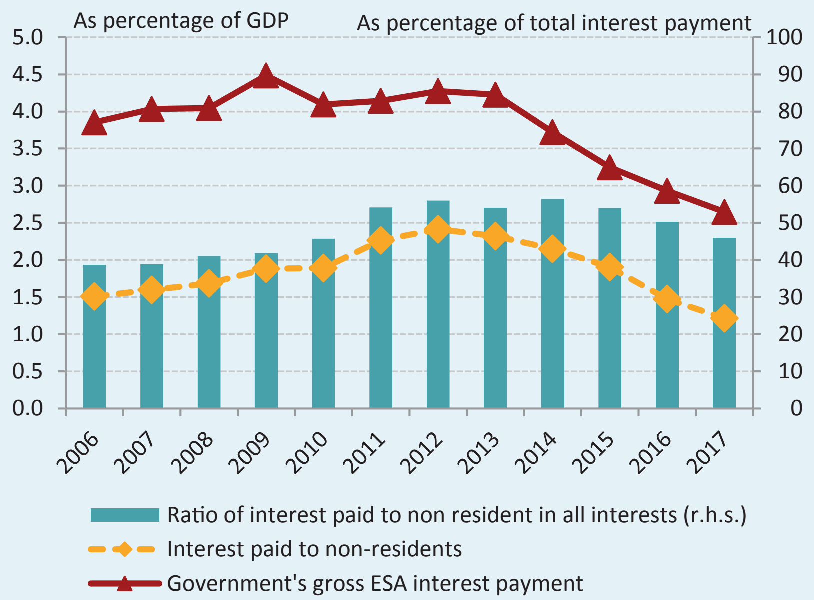


Source: MNB.

In conjunction with a decline in the yield of long-term government securities, the government's interest expenditures decreased further. As a result of the low yield environment and the gradual repricing of debt, the general government's GDP-proportionate gross interest expenditures continued to decline in 2017 (Chart 47). Compared to the level of 4.3 percent registered in 2012, the general government's interest expenditures amounted to 2.6 percent of GDP in 2017. The stable macroeconomic situation in Hungary, the central bank's programmes (easing cycles, self-financing programme, transformation of the set of monetary policy instruments), the upgrades of the credit rating and the supportive international environment all contributed to the decrease in government securities market yields and the related decrease in gross interest expenditures. The yield on 10-year government bonds dropped to 2 percent, while that on 5-year bonds fell to close to 1 percent by the end of the year. In addition, in September 2017, the yield on the 3-month and 12-month T-bills also fell to the negative range and it is close to zero at present as well.

In 2017, government interest paid to non-residents fell to 1.2 percent of GDP. In terms of the income balance of the balance of payments it should be noted that in line with the decrease in the general government debt holdings of non-residents and the forint yields, the degree of the interest paid to non-residents declined further. Based on the debt management strategy, in the coming years the decline in the debt holdings of non-residents may continue, and thus the degree of interest paid to non-residents may also keep declining.

Chart 47: Developments in the interest expenditures of the general government



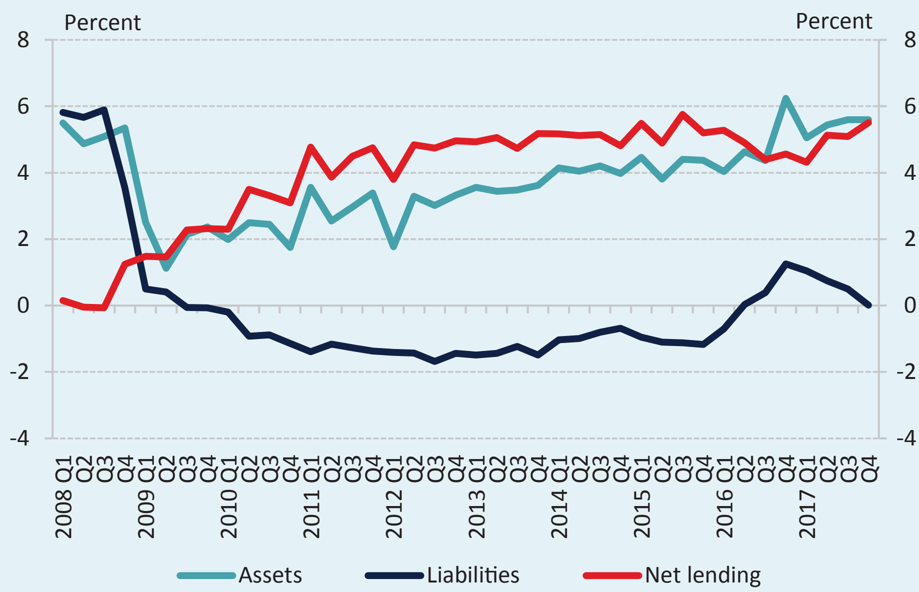
Note: The data do not contain the imputed interest expenditures incurred since 2012 on account of the pension system reform.

With a goal of improving the debt structure, in October 2017 the Government Debt Management Agency organised a foreign currency bond swap auction. As part of the transaction, the Agency repurchased US dollar bonds with short residual maturity and high interest in the amount of USD 1.16 billion and then issued 10-year euro bonds in almost the same amount. The yield of the latter was below the yield of the Portuguese, Italian and Romanian 10-year euro bonds. As a result of the foreign currency bond swap, the average residual maturity of the government debt rose, short-term external debt declined and it also resulted in interest savings based on the accrual approach.

4.2 Households sector

Based on the seasonally adjusted figures, households' net lending rose to 5.5 percent of GDP in 2017 Q4, according to the underlying trends (Chart 48). The downward trend observed in 2016 in households' seasonally adjusted net financial savings halted in mid-2017, with savings then rising to 5.5 percent of GDP in the fourth quarter – i.e. after the temporary decline in 2016, savings returned to the level observed in 2015. The increase in the net position is partly due to the substantial rise in gross financial savings, which may have been linked to higher wages resulting from the increasingly tight labour market. On the other hand, the gradual decline in net new borrowing observed in 2017 led to growth in net financial savings, which may be mainly related to the slack demand for consumer loans, while the housing loan portfolio increased as a result of transactions in the past one year. The rise in housing loans also implies growth in financial assets, as the homes purchased from loans typically appear among sellers as financial instruments. The temporary rise in net new borrowing between mid-2016 and autumn 2017 was mostly due to the growth in loans granted to the self-employed and after the fading of this impact, households' net new borrowing fell to zero in the fourth quarter.

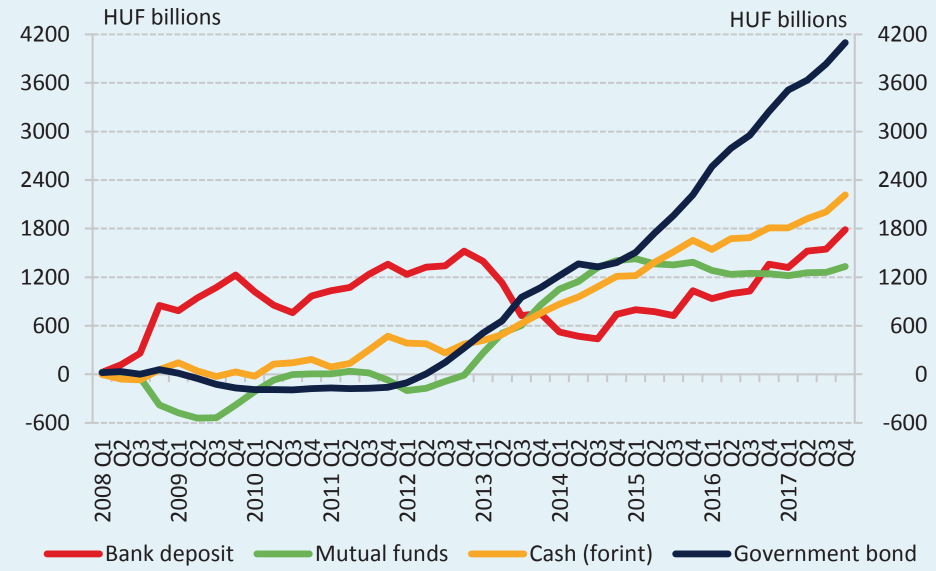
Chart 48: Net lending of households (seasonally adjusted revised* values, as a percentage of GDP)



*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 of liquidated savings cooperatives as well as the forint conversion and settlement.*

As a result of the rapid growth in financial assets, increases were registered for practically all forms of investment, but the demand for household government securities was still dominant, which may be deemed favourable in terms of the government's external vulnerability (Chart 49). The uninterrupted growth in households' government securities holdings seen since 2012 continued in 2017 as well, thanks primarily to the significant yield advantage realisable in the low yield environment, in contrast to other forms of investments. By end of 2017, households' government securities holdings exceeded HUF 5,000 billion. A large part of the new savings of households was spent on government bond purchases in 2017 as well, but cash and bank deposit holdings, and even mutual fund share holdings also grew slightly. The asset value of the money market and bond funds, containing lower-risk securities and hence characterised by lower retrospective yield, decreased further, while holdings of higher-risk mixed and real estate funds rose. This suggests that in the low yield environment a smaller portion of investors turned to riskier forms of investments promising higher yields, but the holding of liquid forms of investment and government securities is still dominant. Households' strong demand for government securities increased the domestic financing ratio of the general government, which is favourable in terms of Hungary's external vulnerability.

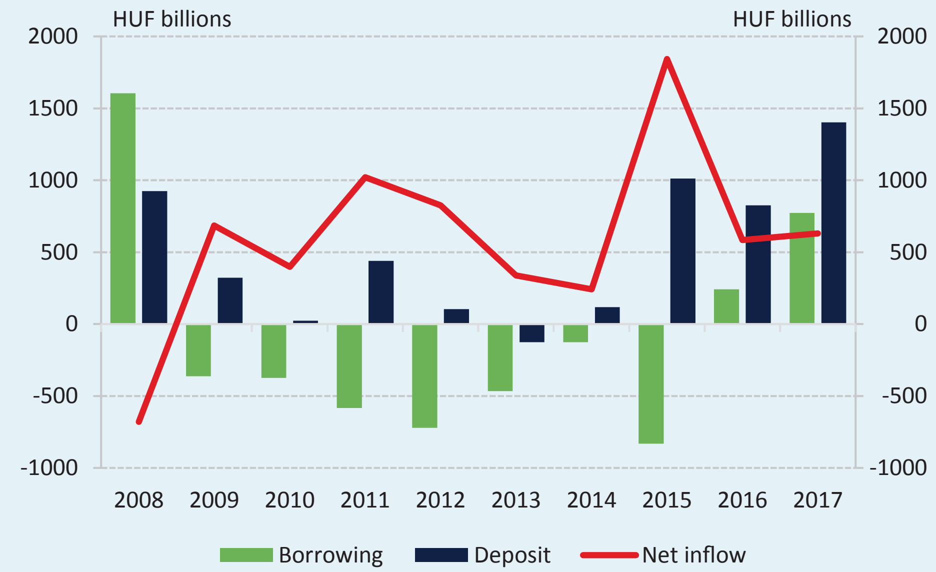
Chart 49: Developments in households' key financial assets (cumulative transactions)



3. Box: Developments in the private sector's bank loans and deposits

In 2017, the private sector significantly increased its outstanding borrowing, but new deposits also rose to a similar degree, and thus the volume of funds placed with banks was similar to the level registered in 2016. The bank loans of the households and companies continuously declined in the post-crisis years, but in 2016 a turnaround was observed on the credit side, and the private sector's net borrowing continued to increase in 2017 as well. However, this did not reduce the funding available for the banks, as the new deposits of the private sector also rose. On the whole, the rise in net liabilities of banks was close to the 2016 level (Chart 50). The private sector's position against banks may have resulted in a decline in banks' net external debt.

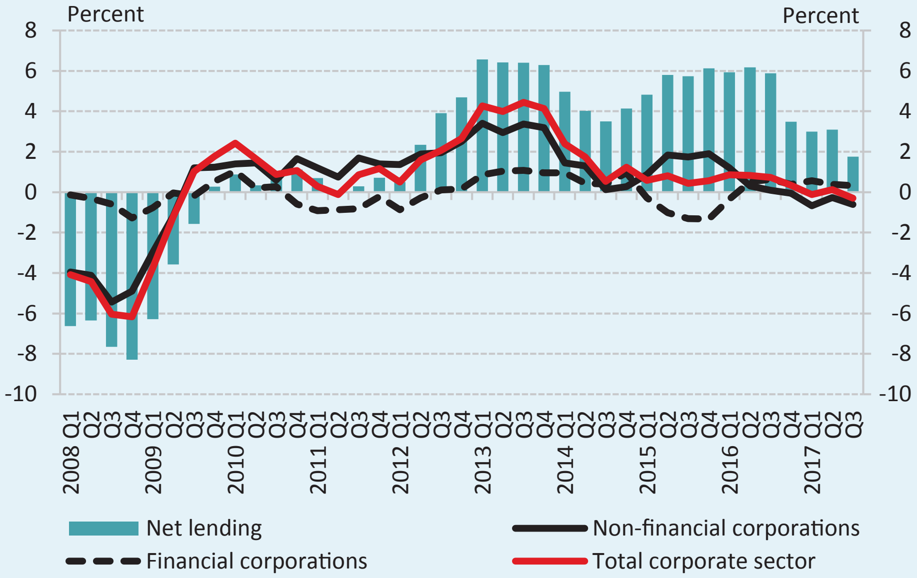
Chart 50: Developments in the private sector's bank loans and deposits



4.3 Corporate sector

The net position of the corporate sector, which turned into net borrowing, contributed strongly to the decline in net lending. According to the four-quarter data, the net lending of the entire corporate sector turned negative in the third quarter.[8] The decline may be linked to the fall in non-financial corporations' net lending, which was partially offset by financial corporations' stable net lending: similarly to the previous year, the net lending of financial corporations was moderately positive in 2017 as well (Chart 51).[9] However, on the whole the corporate sector contributed to the decline in the economy's net lending.

Chart 51: Net lending of companies and external surplus (four-quarter values as a percentage of GDP)

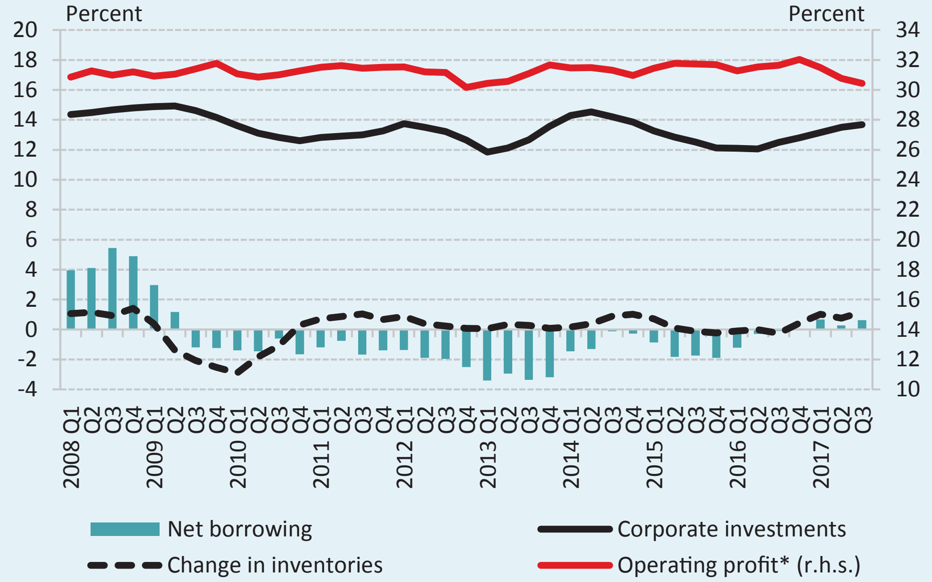


Non-financial corporations' net borrowing rose to 0.6 percent of GDP, partly as a result of lower revenues and the growth in investment, while the reduction of inventories continued. The operating surplus of non-financial corporations continuously decreased, in part due to rising wages. The continuous rise in enterprises' investment activity, which reached the level registered in 2014 by the end of the year, also resulted in growth in net borrowing. By contrast, the fact that enterprises reduced their inventories led to a decline in net borrowing (Chart 52).

8 Financial accounts for 2017 Q4 will only be published after the editorial deadline for this report.

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

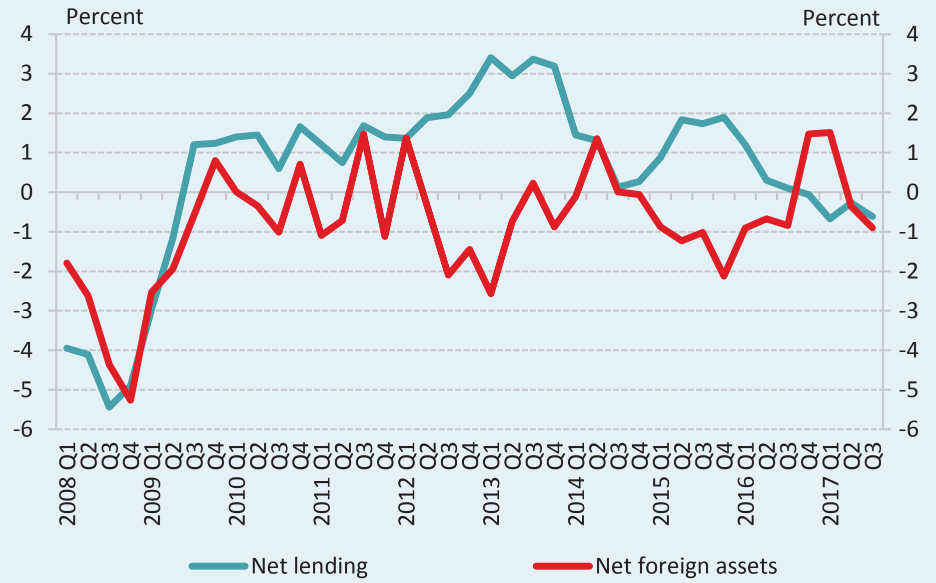
Chart 52: Non-financial corporations' net borrowing relative to GDP and the main underlying real economy factors (four-quarter values calculated from national accounts)



Indicator adjusted for companies' interest and shareholder income. Data related to the borrowing requirement are only available until the third quarter.
Source: HCSO, MNB.

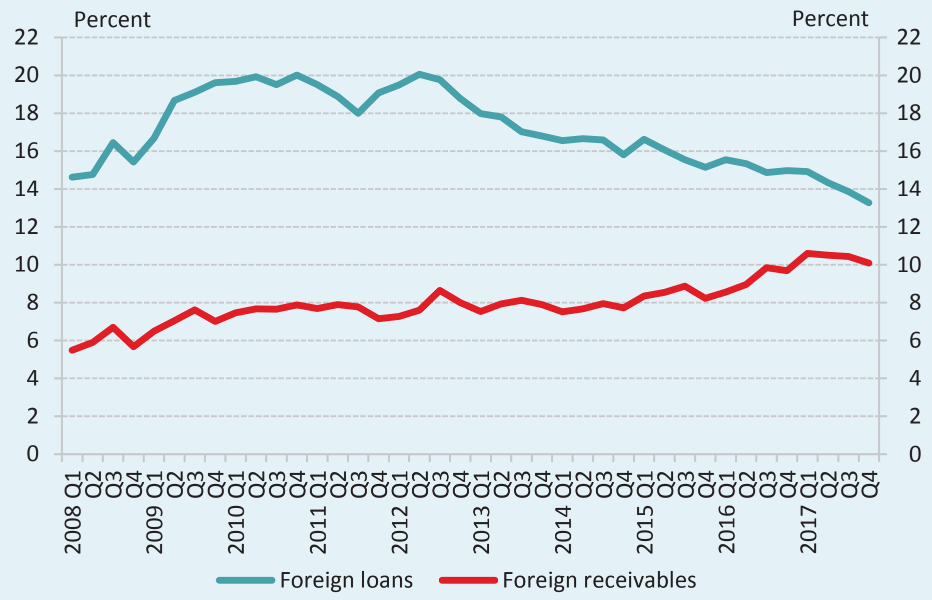
The trend decrease in the net lending of non-financial corporations developed in conjunction with rising borrowing from the non-resident sector (Chart 53). After the third quarter of 2016, the net external liabilities of companies stemming from transactions once again rose slightly in the second and third quarters of 2017. The rise could be linked to equity-type liabilities, and particularly to the high reinvested earnings, partially based on estimates, while borrowing from abroad continued to decline as in the previous years. On the other hand, there was robust growth in domestic loans, which led to a decrease in the net saving of companies. The financial assets of companies also rose significantly in the first three quarters of 2017, partially offsetting the growth in liabilities. Corporations mostly increased their domestic bank deposits and non-resident participations in 2017 as well.

Chart 53: Net lending and net external transactions of non-financial corporations (four-quarter data, as a percentage of GDP)



The decline in companies' external loans accelerated in 2017, while their external assets stabilised. Companies' outstanding foreign loans fell below 14 percent of GDP by 2017 Q3, which was also supported by the adjustment affecting companies' external liabilities and strong growth in GDP. The rise in external assets observed in 2016 halted in 2017 and stabilised at around 10 percent of GDP (Chart 54).

Chart 54: Volume of foreign loan liabilities and receivables of non-financial corporations (as a percentage of GDP)



5 International comparison

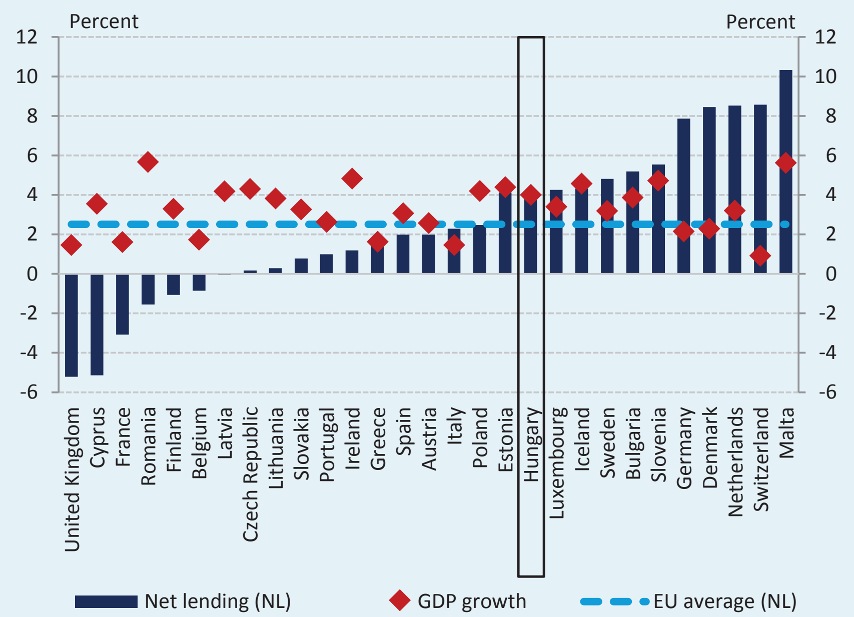
Net lending of Hungary in 2017 amounted to more than 4 percent of GDP, which still exceeded the average of the EU member states. Similarly to Hungary, the current account balance fell in most of the countries in the region, due to the rise in import-intensive investments and expanding consumption. In addition, following the improvement in the terms of trade observed in previous years, the increase in oil price reduced the external trade balance of the countries of the region. While in Hungary the fall in the current account surplus was partially offset by the inflow of funds belonging to the new programming period of the EU, in other countries of the region – with the exception of Poland – no improvement in the transfer balance was observed. The outstanding net lending of Hungary was supported by the high savings – even in a regional comparison – of the private sector, while the budget deficit was in line with the level observed in the region. In parallel with this, in 2017 Hungary's external vulnerability continued to decrease, as a result of which Hungary's net external debt fell below the level observed in Poland and Slovakia, while the gross external debt dropped close to the average of the region.

In the section entitled "International comparison", we present Hungary's external balance processes in comparison to the countries in the region. The Hungarian balance of payments figures should be compared primarily with those of the countries with a similar development level, facing similar challenges. In line with this, we base our international outlook primarily on these factors. For this purpose, the most ideal group of countries comprises the countries in the region which acceded to the European Union at the same time, along with Romania, which joined the EU later and does not always show the same trends as those observed in the Visegrád countries.

5.1 Net lending

Based on the forecasts for 2017, Hungary's net lending still exceeds the anticipated average EU values (Chart 55). Hungary's net lending amounted to 4.1 percent of GDP in 2017, which – according to the European Commission's forecast – exceeds the level anticipated for the countries in the region. Similarly to the development in Hungary, the average net lending of the EU-28 countries declined compared to 2016 and amounted to 2.5 percent of GDP. The highest net lending in the European Union is still observed primarily in the export-oriented countries, but in these developed countries the favourable external balance position is usually accompanied by lower GDP growth. Hungary's economic growth was 4 percent in 2017, which also exceeds the EU-28 average.

Chart 55: Development of net lending in 2017

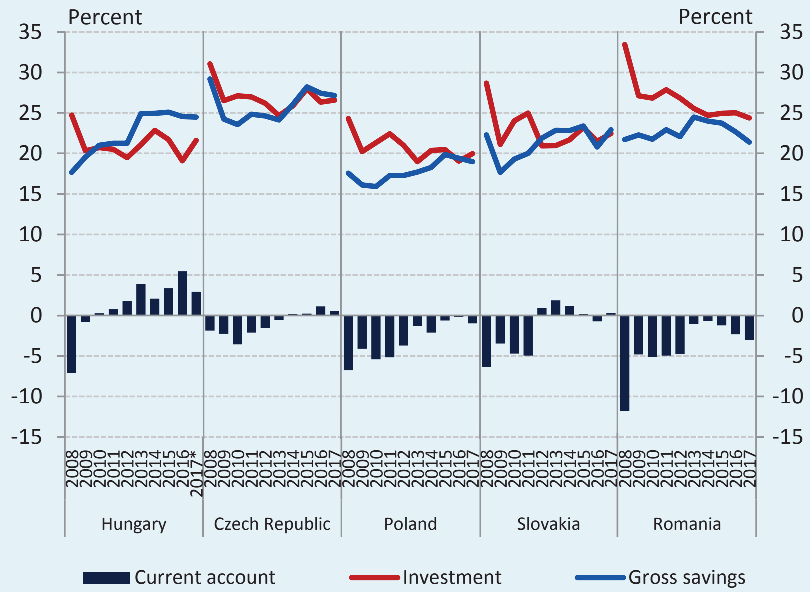


*Source: *Based on the European Commission's forecast.*

5.2 Development of savings and investment ratios

Hungary's high net lending stems primarily from gross savings exceeding the regional average, but – despite the rise recorded in 2017 – the total investment ratio also slightly falls short of the average of the region. An economy's current account balance is the difference of gross savings (saving calculated as the difference of income and consumption) and the national economy's total investment (investment and inventories). Before the crisis, the total investment ratio in the region significantly exceeded the rate of internal savings, which led to a current account deficit and the raising of external funds (Chart 56). By contrast, in the post-crisis years, due to the declining investment ratio and the gradually rising gross savings resulting from deleveraging, the current account balance improved in all countries. In Hungary, the gross savings-to-GDP ratio was around 25 percent in recent years, which strongly contributed to having the highest net lending in the region. According to the IMF forecast, in 2017 the current account balance in the neighbouring countries typically deteriorated, which was mostly attributable to the rise in investment, while in Romania it was caused by the decline in gross savings.

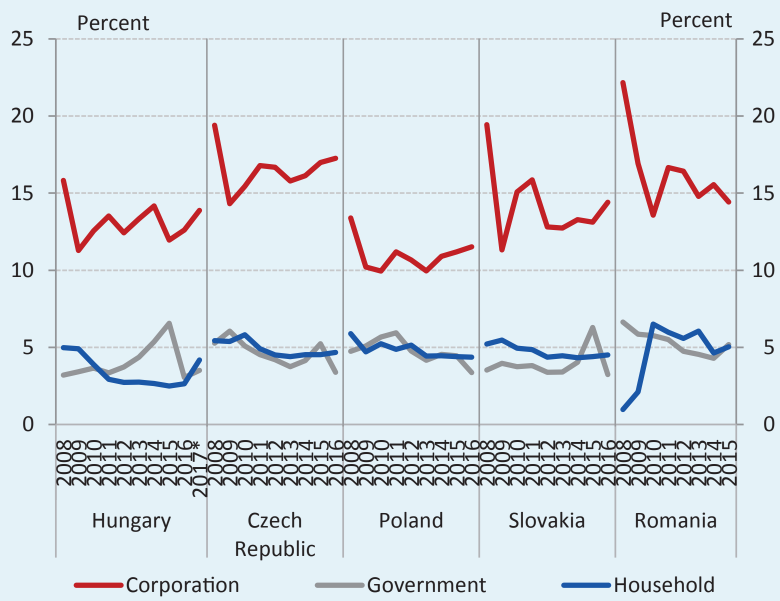
Chart 56: Development of gross savings and total investment ratios (as a percentage of GDP)



** For 2017 the gross savings rate is derived from the total investment and current account data. 2017 values in other countries of the region are based on WEO estimate.*
Source: WEO.

The investment ratio still fell short of the region in 2016, primarily due to the low household investment, while corporate investment, which is more relevant for potential economic growth, was close to the regional average (Chart 57). The breakdown of investments by sectors shows that after the growth in investment which occurred in parallel with the inflow of EU funds, general government investment decreased in 2016 following the decline in the inflow of funds. This process impacted the countries of the region to a different degree: the most spectacular declines were observed in Hungary – where roughly half of general government investment were financed from EU funds – and in Slovakia, while in the other regional countries the ratio of general government investment declined to a somewhat lower degree. Before the crisis, the investment ratio of Hungarian households corresponded to the regional level; however, since then (in line with developments in household lending) this ratio has fallen substantially short of both the pre-crisis level and the regional average. The corporate investment ratio shows that the investment ratio of the Czech companies – following the post-crisis decline – returned more or less to the pre-crisis level, thus it stands out in the region, while that of Hungarian companies exceeds the Polish level, as is the case in Slovakia and Romania as well.

Chart 57: Distribution of the investment ratio by sectors (as a percentage of GDP)



Source: Eurostat; no 2016 figures were available for Romania.

5.3 Net lending and its real economic factors

The GDP-proportionate external balance position of the countries in the region declined in 2017, mostly owing to the decrease in the balance of trade and the transfer balance (Chart 58). According to the four-quarter data calculated based on the real economy approach, Hungary's net lending was around 4 percent of GDP, which still substantially exceeds the close to zero values observed in the other countries. While developments in the transfer balance were still moderate in most of the countries of the region in 2017, Hungary's transfer balance – in line with the inflow of funds belonging to the EU's new programming period – once against supported the development of net lending.

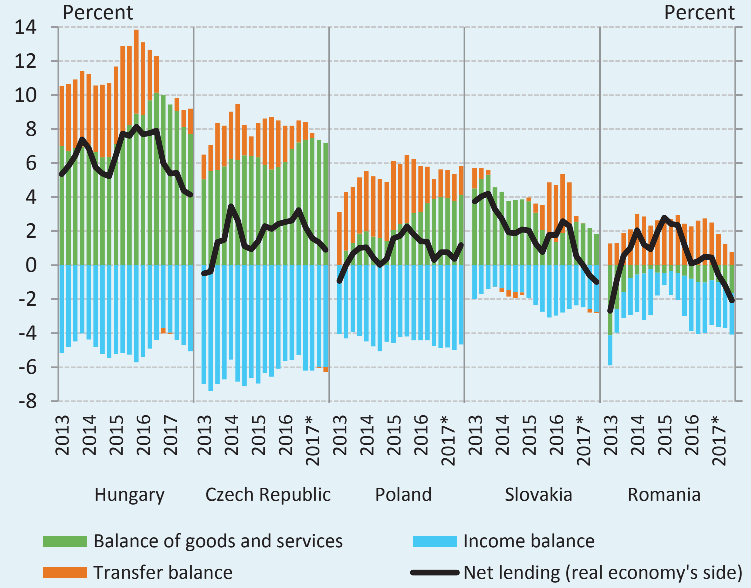
Developments in the factors of net lending in the region:

- The four-quarter surplus of the **goods and services balance** as a percentage of GDP declined in all countries in the region – except in Poland – in 2017, primarily as a result of the rise in import-intensive investment and expanding consumption. The largest decline occurred in Hungary; nevertheless, the trade surplus of Hungary – similarly to Czech Republic – is still outstanding in the region. Contrary to the trade surplus characterising the Visegrád countries, the trade balance of Romania shows a deficit, due to high goods imports.

- The deficit on the **income balance** was stable in most of the neighbouring countries in 2017, in contrast to the modest rise observed in Hungary. The income balance deficit in the region is still mainly caused by the outflow of incomes related to equities, which is presumably attributable to the rising profit of the foreign-owned enterprises in the favourable economic environment. The income balance deficit in the Czech Republic, Hungary and Poland is around 5–6 percent of GDP, while it is lower in Slovakia and Romania (where gross external debt is generally lower than in the region), amounting to 3–4 percent of GDP.

- At the end of 2016, in line with the end of the EU 2007–2013 programming period, the **transfer balance** declined considerably in the countries in the region. Thereafter, in the second half of 2017, the inflow of funds belonging to the new programming period had a positive impact on the external balance position in Hungary and Poland. However, in the Czech Republic, Slovakia and Romania, there is still no sign of acceleration in the absorption of funds, and hence the developments in the transfer balance had no significant effect on net lending.

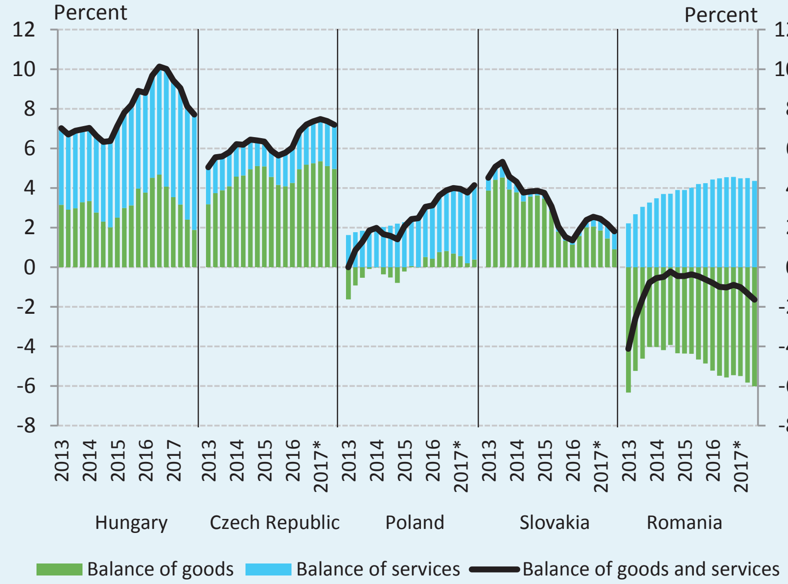
Chart 58: Current accounts and capital accounts of the Visegrád countries (four-quarter values as a percentage of GDP)



** The value stated for 2017 is the four-quarter value calculated up to 2017 Q3.*
Source: Eurostat, national central banks .

The decrease in the trade balance characterising in the countries of the region is mostly due to fall in the goods balance (Chart 59). Similarly to Hungary, in most countries of the region the surplus on the goods and services balance declined in the past one year, as a result of the increase in domestic demand items. The underlying reason for this that – although the export market share of the countries of the region also generally continued to increase in 2017 (see below) –growth in imports was higher than growth in exports, which caused the surplus of the goods balance to decline. The most spectacular decrease took place in Hungary; nevertheless the Hungarian external trade surplus still exceeds the levels observed in other countries of the region. Similarly to Hungary, the more moderate output of vehicle manufacturing, representing a high weight, may have also contributed to the decline in the goods balance in the Czech Republic and Slovakia. By contrast, in Poland (where the surplus of the service balance is dominant, similarly to Hungary and Romania), the trade balance slightly improved, which was primarily attributable to the surplus in transportation – however, it should be noted that there was a moderate decline in Poland's goods balance as well.

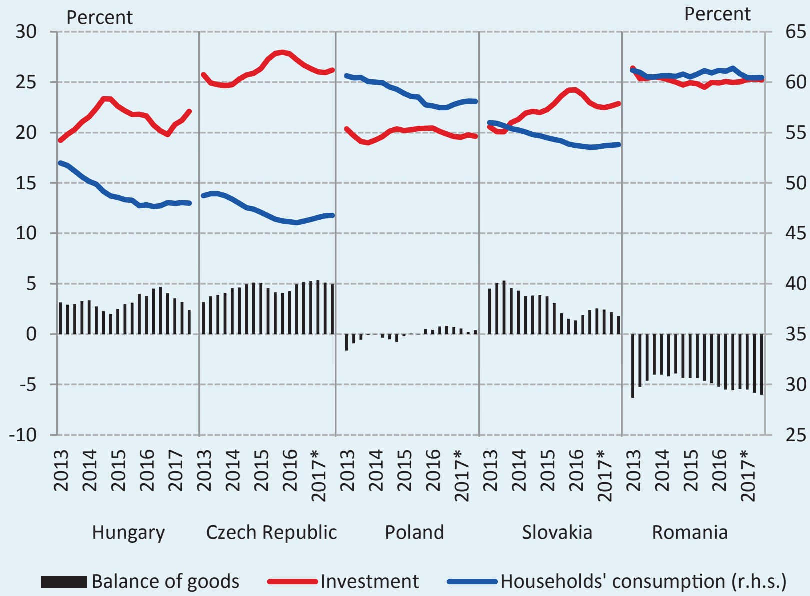
Chart 59: Distribution of the balance of goods and services (four-quarter values as a percentage of GDP)



** The value stated for 2017 is the four-quarter value calculated up to 2017 Q3.*
Source: Eurostat.

The decline in the balance of goods observed in the region was mostly attributable to the rise in domestic absorption (Chart 60). In 2017, the goods balance deteriorated in all countries of the region, with the exception of Poland, primarily due to the rise in the domestic absorption items. In Hungary, the larger degree fall in the goods balance stemmed from the considerable rise in the investment ratio compared to other countries of the region, accompanied by higher imports. Similarly to Hungary, the decline in the goods balance in Slovakia was also caused by the rise in the investment ratio, while in the Czech Republic and Poland, it was mostly due to the expanding household consumption.

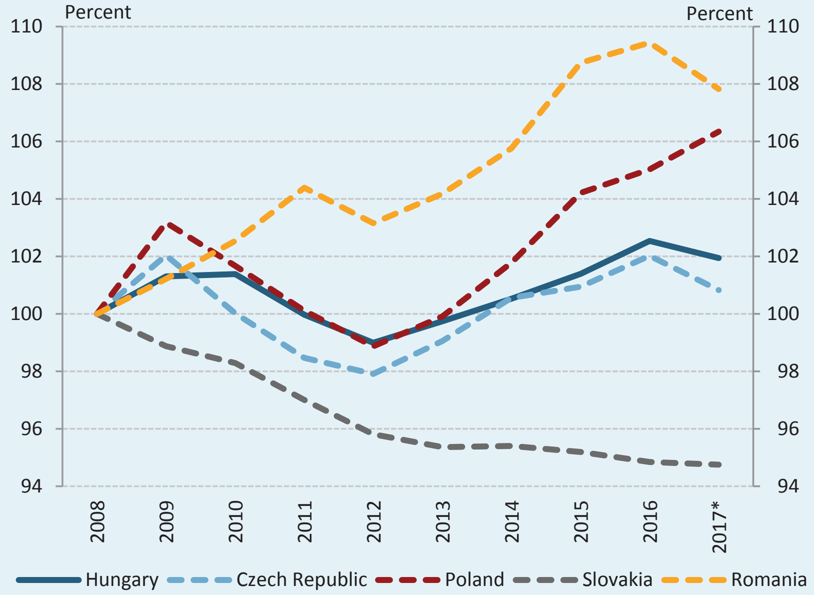
Chart 60: Household consumption and total investment (as a percentage of GDP)



**The data series last until the end of 2017 Q3.*
Source: Eurostat.

Changes in the terms of trade mostly had a negative impact on the region in 2017 (Chart 61). As a result of moderate commodity prices and the low inflation environment (and exchange rate trends) the terms of trade gradually improved in the region from 2012 (with the exception of Slovakia, which joined the euro area), but, in parallel with rising oil prices, a general deterioration was observed in 2017. Thus, in addition to growth in domestic use, this may have also contributed to the decline in the trade balance of the countries of the region in 2017. On the other hand, based on the forecast of the European Commission, in Poland the terms of trade continued to improve in 2017 as well, which may have contributed to the improvement in its trade balance in the past quarters, as a unique development among the countries in the region.

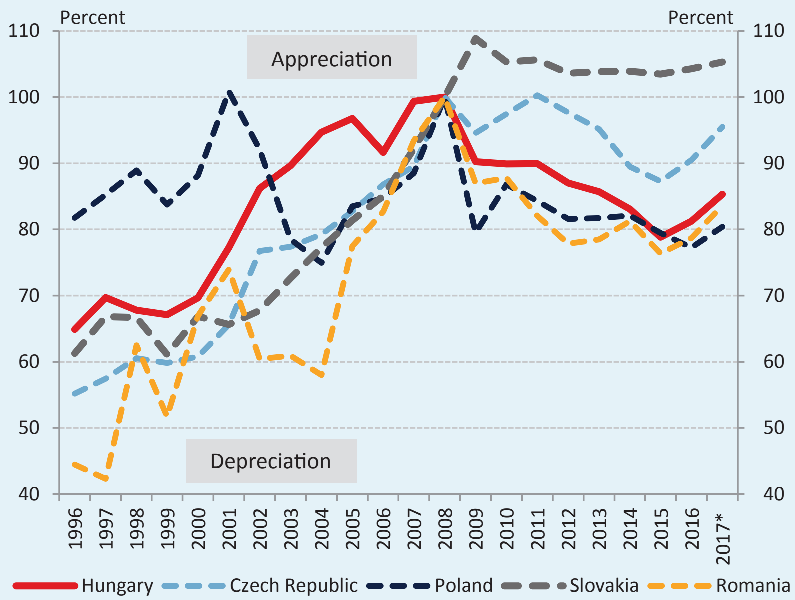
Chart 61: Changes in the terms of trade in the region (2008 = 100)



*Note: *2017 value is based on the European Commission's forecast.*
Source: European Commission.

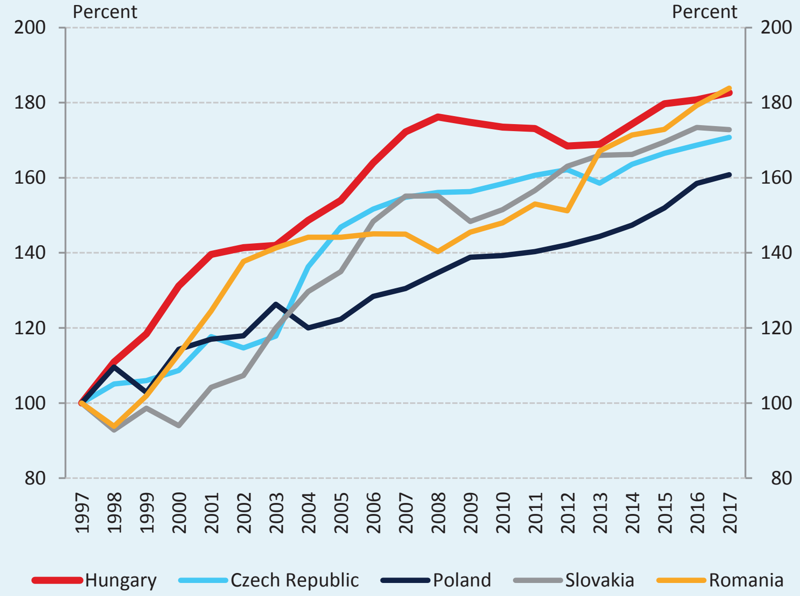
After the depreciation observed in the wake of the crisis, in the past two years, as a result of higher wages, the labour cost-based real exchange rate rose in all countries of the region. During the pre-crisis period in the countries of the region – partly due to improving productivity and rising labour costs resulting from the FDI inflow – the labour-cost based real exchange rate usually rose, followed by a decrease after the crisis, mostly due to the depreciation of the currencies of the region (in the case of Slovakia a different trend developed after 2010, which was mostly attributable to its euro area membership). The real exchange rate depreciation observed after the crisis may have contributed to the improvement in the region's competitiveness in the export market; however, in the past two years the previous declining trend turned into a rise (Chart 62), which may have been mostly attributable to the dynamic growth in labour costs – however, it should be noted that the export market share of the individual countries typically increased in this period as well (Chart 63). In addition, in the Czech Republic appreciation may have been also caused partially by the fact that in April 2017 the Czech central bank removed the currency cap, after which the exchange rate of the koruna appreciated against the euro.

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



*Note: *2017 value is based on the European Commission's forecast.*
Source: European Commission.

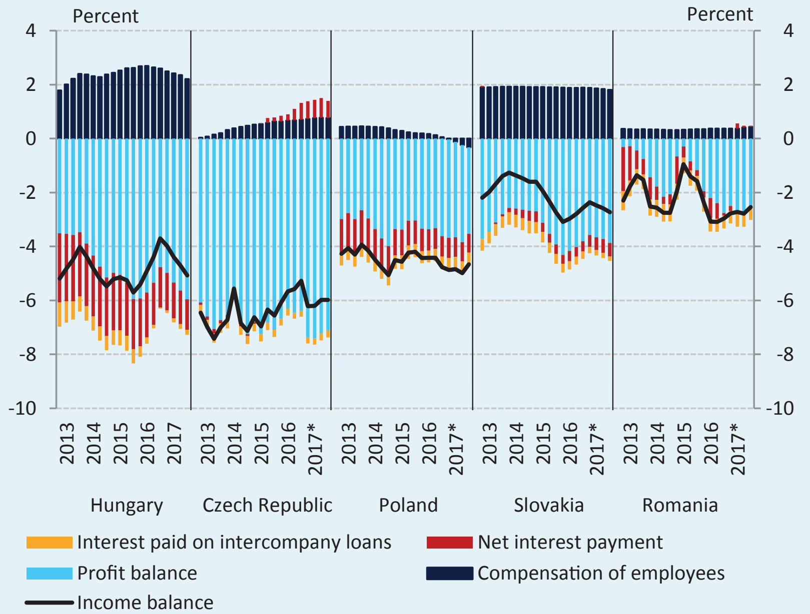
Chart 63: Changes in the export market share in the countries of the region (1997 = 100)



Source: Eurostat, CPB.nl.

In the countries of the region, the income balance typically deteriorated due to the rise in the profit of foreign-owned companies (Chart 64). After the crisis, there was a downward trend in Hungary's income balance deficit, which was initially fostered by the post-crisis deterioration in the profit of foreign-owned companies and then by the earned income of those working abroad and, due to the decline in external debt, by the fall in the interest paid on foreign loans. Nevertheless, in Hungary – similarly to Poland – the volume of interest expenditure paid abroad is still high, while in other countries of the region the volume of the income balance deficit is determined almost in full by the profit of non-resident companies. In 2017, in parallel with stronger economic growth, the profit of foreign-owned companies rose, which led to a moderate deterioration in the income balance. As a result of this – and in connection with the volume of the individual countries' FDI holding – the profit balance of non-resident companies was around 7 percent of GDP in the Czech Republic, followed by Hungary with the second highest ratio (almost 6 percent), while the ratios observed in the rest of the countries of the regions were 3–4 percent.

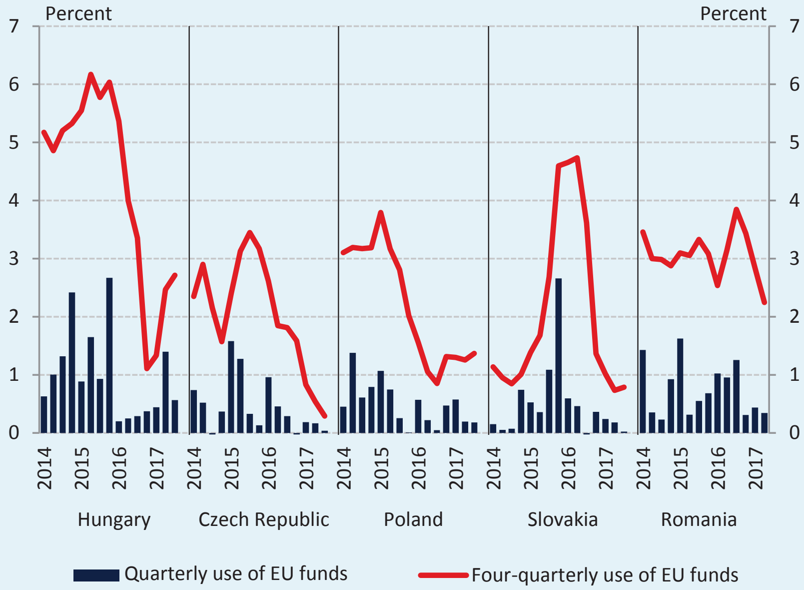
Chart 64: Developments in the components of the income balance*
(four-quarter values as a percentage of GDP)



** The value stated for 2017 is the four-quarter value calculated up to 2017 Q3.*
Source: Eurostat.

In 2017, among the countries of the region, the absorption of EU transfers only rose substantially in Hungary (Chart 65). With the end of the EU's 2007–2013 programming period, the inflow of EU transfers declined in all countries in the region, which – via the decline in the transfer balance – contributed to the deterioration in the external balance position. The decline was the most spectacular in Hungary, where the four-quarter value of the absorption of EU transfers as a percentage of GDP declined from the previous 6 percent close to 1 percent by the end of 2016. In other countries in the region, the absorption of EU transfers fell by roughly 2–3 percent of GDP. For the time being, in the region the inflow of funds belonging to the new programming period was significant only in Hungary, where the four-quarter value at the end of 2017 was close to 3 percent of GDP, representing the highest value in the region.

Chart 65: Absorption of EU transfers in the countries of the region (as a percentage of GDP)

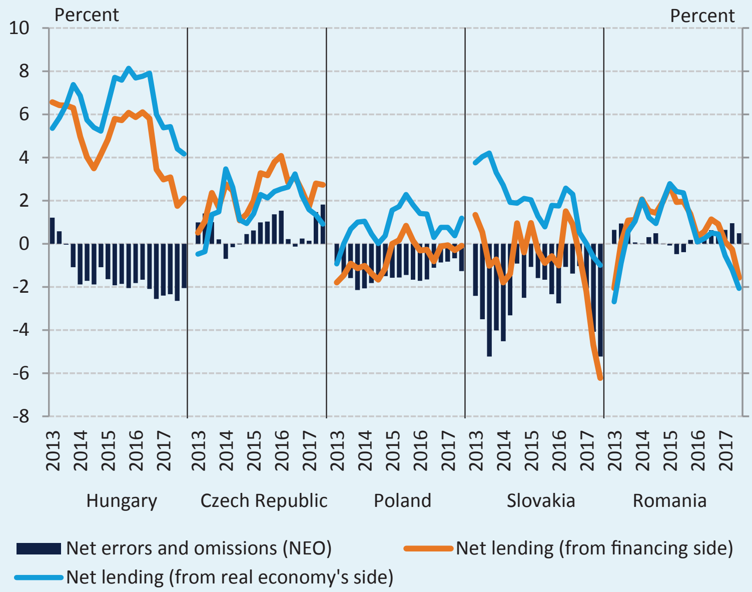


In the case of Romania the 2017 Q3 data were not available.
Source: Eurostat.

5.4 Financing side developments

Net lending calculated from the current account and the capital account balance generally exceeds the value calculated on the basis of the financing stated in the financial account (Chart 66). "Net errors and omissions" (NEO) contain the differences between net lending calculated based on the financing and real economy side. The difference between the two usually shows that net lending calculated on the basis of the real economy side exceeds the value obtained on the basis of the financial account, but there are examples of the opposite as well: in the past two years, for example, the value calculated from the financing side slightly exceeded the real economy side value in the case of the Czech Republic and Romania. In the rest of the countries under review, the difference is of opposite direction and relatively higher: the smallest difference, around 1 percent of GDP, can be observed in Poland, while in Slovakia the difference reaches 5 percent of GDP. In Hungary, the net balance of errors and omissions is consistently around 2 percent of GDP.

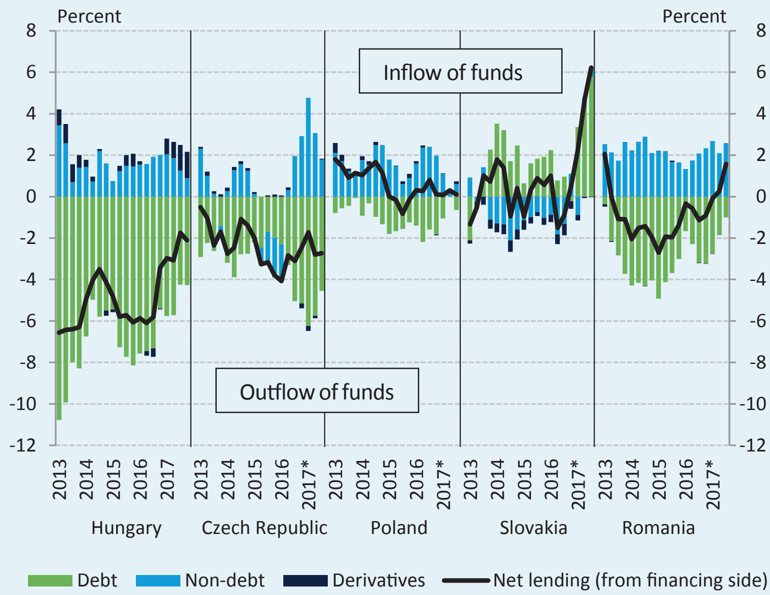
Chart 66: Development of net errors and omissions (four-quarter values as a percentage of GDP*)



In the case of the countries of the region up to 2017 Q3.
Source: Eurostat, national central banks.

In 2017, the countries in the region usually reduced their net external debt, in conjunction with inflows of non-debt liabilities (Chart 67). The position calculated from the financing side showed a mixed picture in 2017: Hungary and the Czech Republic were characterised by net lending and thereby by an outflow of funds, Slovakia and Romania by net borrowing and thereby an inflow of funds, while in Poland the external position was around zero. In 2017, the net inflow of non-debt liabilities was positive in the countries of the region – with the exception of Slovakia – and typically they registered an inflow of 1–2 percent of GDP. The external position and the non-debt inflows permitted the countries of the region to reduce their external debt – with the exception of Slovakia, where the sizeable financial account deficit was accompanied by negligible foreign direct investment, and thus last year it registered a substantial inflow of debt liabilities. In relation to the continued, but already more moderate deleveraging, Hungary registered a higher debt outflow, amounting to 4 percent of GDP, which was exceeded slightly by the Czech value alone.

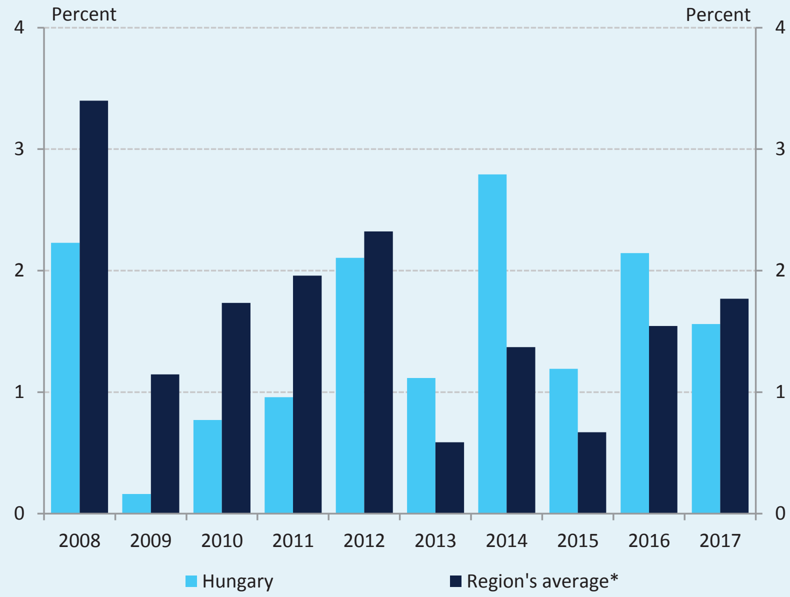
Chart 67: Net borrowing and the form of financing (four-quarter data, as a percentage of GDP)



**Data for the countries of the region were available up to 2017 Q3 (Czech Republic, Poland, Romania and Slovakia).*
Source: MNB, Eurostat.

The annual level of foreign direct investment was typically around 1–2 percent in Hungary, but on average a similar value can be observed in the other countries of the region as well (Chart 68). When examining the figures of the past ten years, it can be stated that the net FDI inflow of the countries of the region was quite similar. In Hungary, net FDI inflow was outstanding in 2014, but after that it declined sharply. Since then it has fluctuated at around 1–2 percent of GDP and in 2017 it amounted to 1.6 percent of GDP. However, a similar trend can be observed in the average for the countries in the region – the period after 2014 was characterised by a decline followed by a rise – which suggests that although country-specific factors also influence the inflow of funds to the individual countries, investors essentially judge the five countries similarly for the purpose of investments.

Chart 68: Net FDI inflow in the Visegrád countries (as a percentage of GDP)



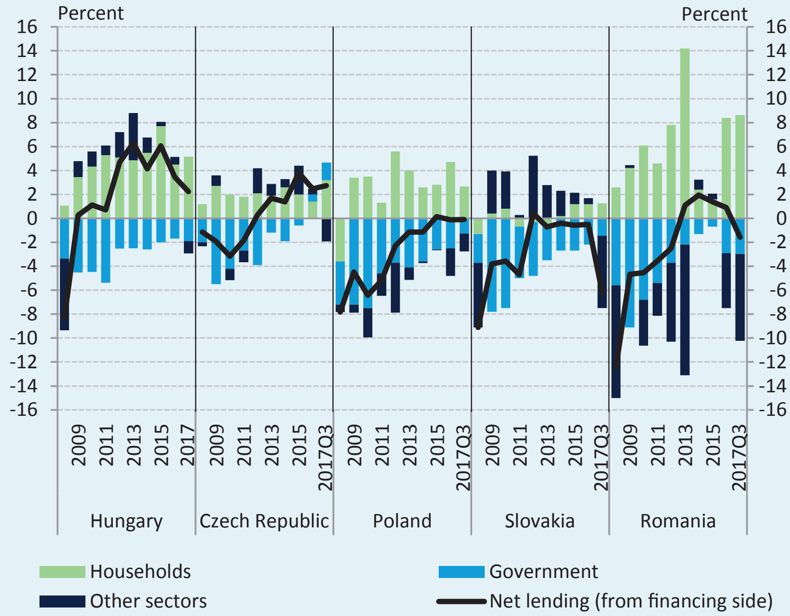
**Data for the countries of the region were available up to 2017 Q3.*
Source: Eurostat.

5.5 Savings side developments

Compared to the countries in the region, the high Hungarian external position is linked with the higher savings of the private sector, while the general government deficit was around the regional average in the past years. In Hungary, after the decline in 2016, last year the net savings of the household sector increased moderately, while the net position of the other sectors turned into net borrowing (Chart 69). As regards the countries in the region – considering the data available until 2017 Q3 – the financial savings of households in the Czech Republic and Slovakia fell short of the Hungarian level, while in Poland and Romania the tangible rise in the households' savings position offset the rise in the companies' borrowing requirement, which resulted in external borrowing of nearly zero.[10] In 2017, the general government's net borrowing in the countries in the region typically amounted to 2–3 percent of GDP; on the other hand, the Czech figure showed net lending, which – together with the household sector – contributed to net lending.

10 In Romania, the outliers related to households in 2013 and 2016 are attributable to the receivables from employers and insurance companies classified as other receivables.

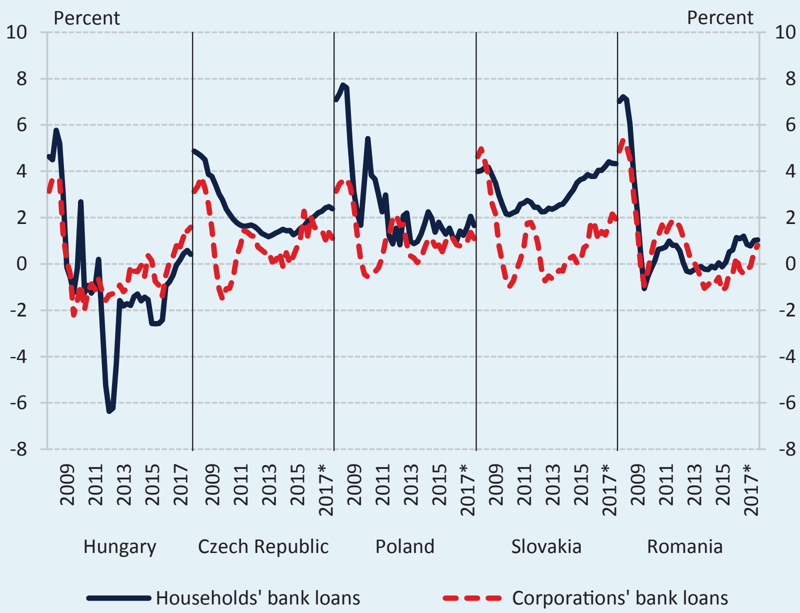
Chart 69: Net lending of the economy in a breakdown by sectors (as a percentage of GDP)



Source: MNB, HCSO, Eurostat.

Despite the rise in Hungary, the borrowing from banks by the private sector of the Visegrád countries still exceeds the degree observed in Hungary (Chart 70). The net new borrowing of Hungarian households from banks rose to 0.5 percent of GDP in 2017 Q3, which – together with the trends observed in 2016 – may imply that the sector's deleveraging has come to an end, and it is characterised by slowly, but steadily rising borrowing. In most countries in the region, households' net new borrowing from banks is also on the rise and exceeds the credit growth of Hungarian households. As regards the borrowing of non-financial corporations, the credit growth of Hungarian companies – partly also supported by FGS and MLS – more or less reached the value characterising the region, i.e. 1–2 percent of GDP. Romania shows a different picture than most other countries, as it is still unable to register a substantial rise in loans to enterprises. Overall, the constantly rising bank borrowing pointed to a decline in net lending in the countries of the region as well.

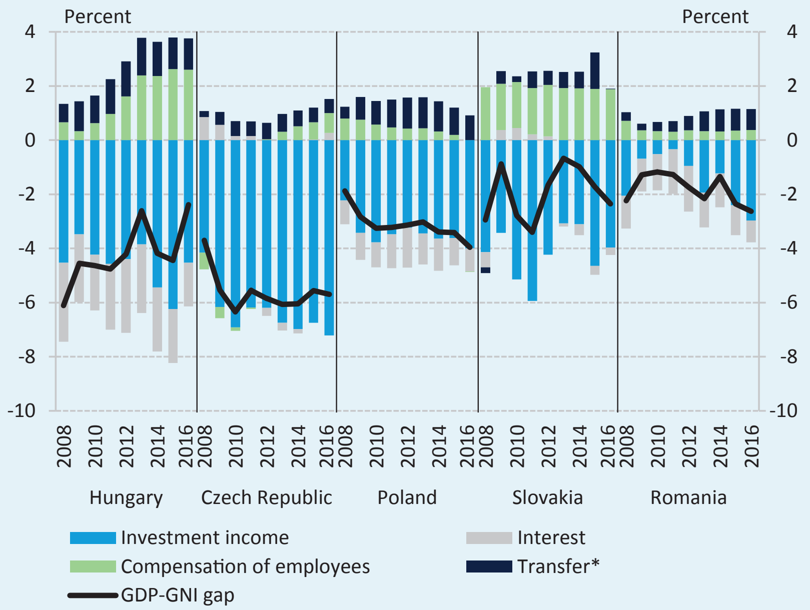
Chart 70: Four-quarter net borrowing of companies and households (as a percentage of GDP)



** Up to 2017 Q3.*
Source: ECB, Eurostat.

After the crisis, the GDP-GNI gap decreased substantially in Hungary, falling to the regional average, while in other countries of the region the gap did not change or even rose in some of them (Chart 71). The countries in the region are characterised by strong foreign direct investment, which is also reflected in the profit (sum of the capital and interest income) of foreign-owned companies: in the Visegrád countries it is around 4–8 percent of GDP, while in Romania, which joined the EU later, it amounts to 3–4 percent of GDP. The net shareholder income of non-resident companies is the highest in the Czech Republic and Hungary; however, the impact of this is offset to a much higher degree in Hungary by the balance of the compensation of employees and the current EU transfers. Accordingly, the difference between GDP and GNI is the highest in the Czech Republic. In addition, it should be noted that the compensation of employees and the transfer balance reduce the GDP-GNI gap in the other countries as well, which is attributable to the EU funds flowing into the region and the income of residents working abroad for less than one year. In Hungary, in line with the post-crisis deleveraging process, the GDP-GNI gap was characterised by a declining trend, which was followed by a temporary rise in 2014–2015, but in 2016 the difference decreased by more than 2 percent of GDP due to the fall in shareholders' income, also contributed to by individual corporate effects.[11] On the whole, it may be stated that while the GDP-GNI gap narrowed in Hungary in the past years, in other countries of the region it typically increased.

Chart 71: Factors of the GDP-GNI gap



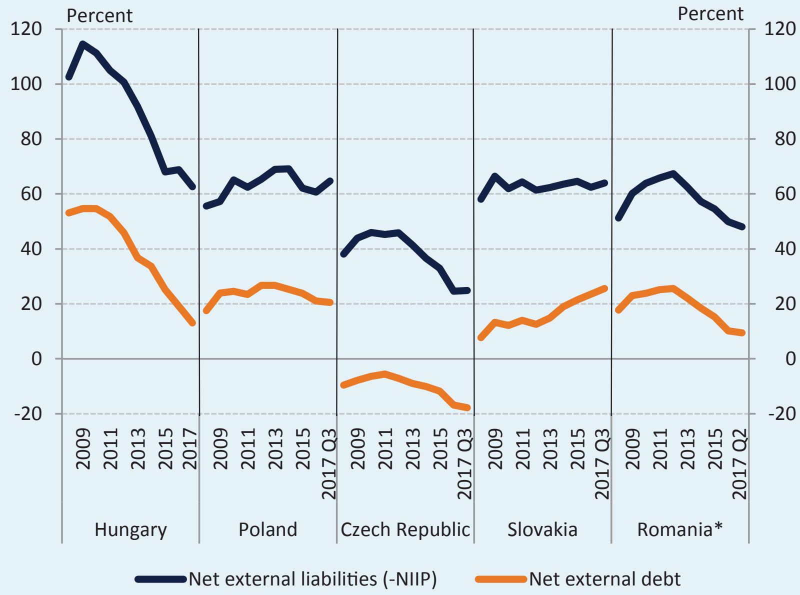
**Transfers included among other primary incomes.*
Source: Eurostat, HCSO.

5.6 External debt indicators

The dynamic decrease in Hungary's net foreign liabilities and debts continued in 2017 as well, with these indicators now corresponding to the regional average (Chart 72). In 2017, Hungary's net foreign liabilities amounted to 60 percent of GDP, which is at the same level as the Polish and Slovak figures, but still exceeds the Czech and Romanian values. In Hungary, net external debt fell from the extremely high post-crisis level, exceeding 50 percent of GDP, to 14 percent of GDP by 2017, representing a level similar to the Slovak, Polish and Romanian figures. In the Czech Republic, net foreign liabilities, in line with the net lending, and the external debt, which is negative anyway, have been decreasing for years, which was also supported by the maintenance of the currency cap – this is evidenced by the fact that in 2017 external liability indicators dropped to a much smaller degree, which may be linked to the removal of the currency cap at the beginning of 2017. On the whole, it can be stated that the countries in the region have sustainable debt indicators and their external vulnerability has not changed significantly compared to the previous year.

11 For more information, see Report on the Balance of Payments, October 2017, Section 5
http://www.mnb.hu/letoltes/fizetesi-merleg-en-2017-octoberboritoval.pdf

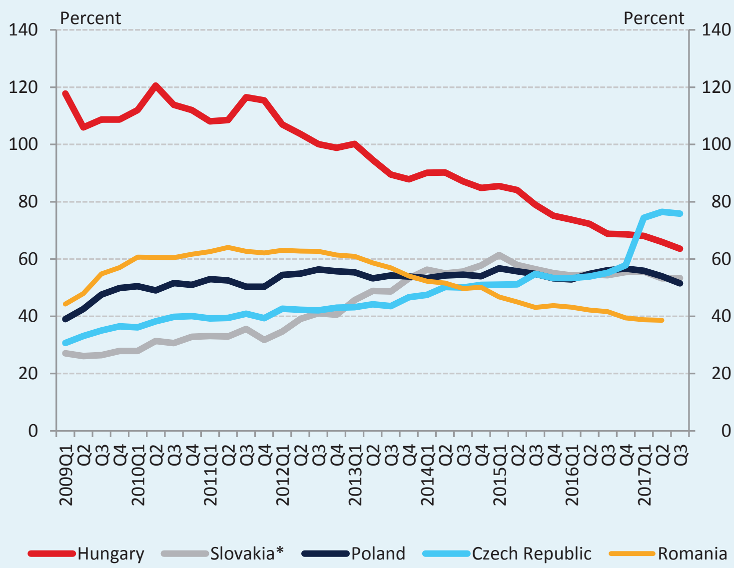
Chart 72: Developments in net external liabilities and external debt (as a percentage of GDP, net external debt without intercompany loans)



**The data series last until the end of 2017 Q2.*
Source: MNB, Eurostat (data including SPEs).

The downtrend in gross external debt as a percentage of GDP continued in Hungary in 2017 as well, while the ratio in the countries in the region – with the exception of the Czech Republic, which removed the currency cap – stabilised at a level that falls short of the Hungarian one (Chart 73). In the past decade, gross external debt fell significantly in Hungary, dropping from 120 percent of GDP close to 60 percent. In most countries in the region no deleveraging of similar degree was necessary, and thus their gross external debt was stable in the past years (a remarkable decrease occurred only in Romania in conjunction with temporarily positive net lending and steady FDI inflows). On the other hand, the Czech Republic showed a different picture in 2017: the Czech central bank carried out a major intervention in the foreign exchange market in the first quarter of 2017, which indirectly raised the external debt (see next paragraph). As a result of this, the gross external debt of the Czech Republic already exceeds the Hungarian value, and amounted to 76 percent of GDP in the third quarter of 2017 (however, in parallel with this the foreign exchange reserves of the Czech Republic also rose to a similar degree)**.**

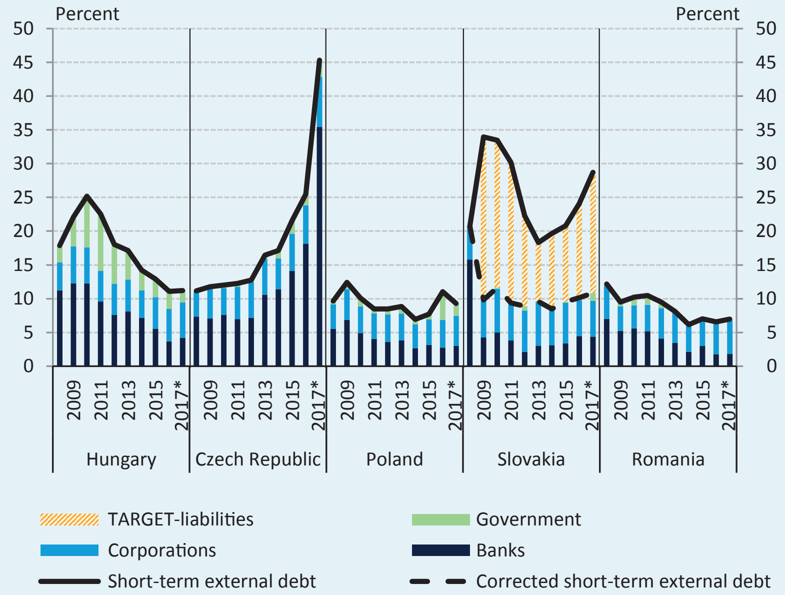
Chart 73: Developments in gross external debt in the countries of the region (as a percentage of GDP, without intercompany loans)



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

Hungary's short-term external debt based on original maturity was at the same level in 2017 as in the previous year, while it increased in most of the other countries in the region (Chart 74). Following a substantial rise, in the two years after the outbreak of the crisis Hungary's short-term external debt based on original maturity[12] was well above the level observed in other countries of the region. Hungary's short-term external debt started to decline after 2010, as a result of which it dropped in seven years to less than one half, i.e. from 25 to 11 percent of GDP. In 2017 Q3, the level of 11 percent of GDP roughly corresponds to the regional average. The large rise observed in the Czech Republic is primarily attributable to a larger increase in banks' foreign liabilities (even compared to their balance sheet total), which is partly due to the currency cap, which was in place in the Czech Republic for years. In order to maintain the fixed koruna exchange rate against the euro, the Czech central bank made purchases in the foreign exchange market, as a result of which a high volume of Czech koruna was obtained by non-residents. Non-residents placed a large part of this as short-term liabilities in the banking sector, which led to a rise in the short-term and gross external debt. Last year's outstanding value is attributable to the fact that the market was waiting for the removal of the currency cap – partly based on the central bank's communication – and a large position was built up in anticipation of this, due to which the central bank was forced to make further intervention. The impact of the removal of the currency cap last year is visible in the value soaring from 2016 to 2017. Meanwhile, the Polish and the Hungarian banking sectors were characterised by deleveraging: in Hungary, the sector's short-term external debt fell from the post-crisis 11 percent to 4 percent, while in Poland it dropped from 6 to 3 percent. After the decline observed in the past years (also as a result of the self-financing programme), the short-term external debt of the Hungarian general government, which was outstanding for many years, fell to the regional average, i.e. to 1 percent of GDP, and only Romania – which has substantially lower gross external debt than is typical for the region – registered a value lower than this. As regards the Slovak figure, it should be noted that the unadjusted high short-term external debt was caused by technical-type items related to the euro area membership. Eliminating these, we arrive at a figure similar to the Hungarian one.

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



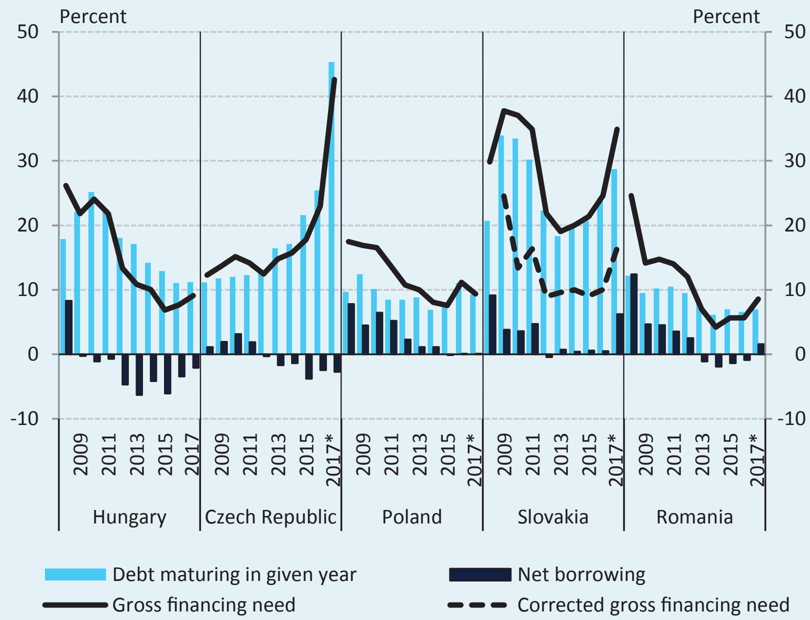
*Note: * Based on 2017 Q3 data.*
Source: World Bank Database, WEO.

Hungary's gross financing need amounted to 8 percent of GDP in 2017, which may be deemed favourable in a regional comparison (Chart 75). Gross financing need is the sum of external debt maturing in the given year (which corresponds to the short-term debt one year earlier) and the net lending of the country. Hungary's gross financing need calculated on the basis of the short-term external debt based on original maturity showed a minor increase last year compared to 2016, but it is still below the average of the region.[13] In the past years, Hungary's gross financing need was more or less steady, being the combined result of the declining net lending and the continued fall in short-term external debt. The gross financing need of Poland and Romania was at a similar level as that of Hungary in 2017 Q3, but even the rise in the Slovak (adjusted)

12 There are no data available for the countries of the region on amortising debt.
13 For the sake of comparability, the gross borrowing requirement was calculated by using short-term external debt based on original maturity.

figure from 10 to 15 percent of GDP may be deemed negligible compared to the Czech value. In the Czech Republic (as a result of the process described in the previous paragraph), there was a trend increase in the gross financing need in the past years, contributed to by the removal of the currency cap at the beginning of last year as a one-off increasing impact.

Chart 75: Changes in gross financing need
(based on short-term external debt, as a percentage of GDP)



Source: MNB, Eurostat, World Bank Database, WEO.

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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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