REPORT ON THE BALANCE OF PAYMENTS

2018
JULY

'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, 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: 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 21 June 2018.

Summary

In 2018 Q1, **the net lending of the Hungarian economy increased** due to the rising absorption of **EU transfers.** As a result of the net savings position and FDI inflows, **the country's external debt indicators continued to decline,** further **reducing the external vulnerability of the economy.** The **current account surplus** amounted to 3.1 percent of GDP, which **significantly exceeds the level typical of the countries in the region.**

Net lending according to the real economy approach rose to 4.7 percent of GDP. The increase stemmed from the expansion in EU transfers, while the trade surplus declined further, in line with robust expansion in investment, strong consumption dynamics and a slight deterioration in the terms of trade owing to higher oil prices. At the same time, the rate of decline in the goods balance decelerated at the beginning of the year, as a result of the restrained growth in inventories early in the period. Similarly to end-2017, the services balance continued to rise, and thus the **trade surplus remained high,** reaching 7.5 percent of GDP. The **unchanged income balance deficit** of 5 percent of GDP evolved as a result of a decline in the interest balance and lower wage incomes from abroad.

At the start of the year, four-quarter net lending increased on the basis of the **financing side** as well, resulting from **a significant decline in net external debt and net FDI inflows of EUR 0.4 billion. All three sectors contributed to the outflows of debt-type liabilities.** The decline in the banking sector's net external debt occurred in parallel with a significant expansion in foreign assets, which may have still been linked to the increasing FX deposits of the private sector. In line with these developments and supported by revaluation effects and nominal GDP growth, **external debt-to-GDP ratios continued to fall** (net external debt amounted to around 11 percent of GDP, while the gross indicator was close to 59 percent). Looking at the sectors, **the general government's net external debt declined to the greatest extent,** but on the whole, every sector contributed to the decrease in net external debt. The net external debt of the banking sector and companies also declined, mainly as a result of the significant expansion in assets. Following a sharp decline at end-2017, the country's **short-term external debt rose** by EUR 1.5 billion to EUR 18.2 billion, which is primarily attributable to companies, and to a lesser extent to the banking sector and the general government. **FX reserves** continue to **significantly exceed the level expected and considered safe by investors.**

In terms of the **savings of sectors,** the increase in net lending was driven by the **rising net lending of the private sector,** while the net borrowing of the state exceeded 2 percent. The latter was mainly related to the expenditure side, and within that partly to the high investment expenditures, which may have contributed to the decline in the trade surplus as well. The **increase in the net financial savings of households** resulted from a modest rise in net borrowing for housing, while the accumulation of financial assets stabilised at a high level. In Q1, in addition to liquid financial assets, households increased their **holdings of long-term government securities;** the latter led to a decline in the renewal risk and thus in **lower vulnerability of the economy.**

In our special topic, we examine the changes in Hungary's external vulnerability compared to emerging countries. As a result of **changes in global risk tolerance,** investors are once again paying closer attention to developments in individual countries' external balance indicators. According to our analysis, **Hungary is one of the countries with more stable fundamentals.** This is suggested by the fact that Hungary's current indicators are now steadily favourable and stock variables also indicate major declines in external imbalances. The most relevant factor is that – following the outbreak of the crisis – the Hungarian **economy's net lending** became positive, which means that **Hungary does not have to rely on external funds.** Accordingly, as a result of the adjustment following the crisis, both **net and gross external debt declined considerably,** while **other indicators** related to the external balance (share of foreign debt and foreign currency within government debt, total and FX indebtedness of the private sector, short-term external debt, reserve adequacy) **also show that the external vulnerability of the Hungarian economy is low.** This is also corroborated by the fact that in 2017 the **European Commission** established that – in contrast to many other EU countries – **there are no imbalances in Hungary** which would justify the preparation of a detailed analysis.

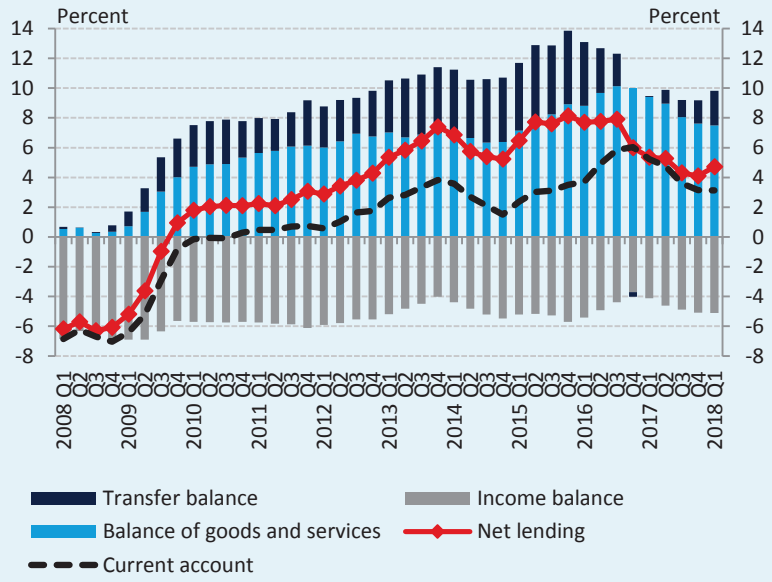
Content

1 Real economy approach

Based on the real economy approach, in 2018 Q1 the net lending of the Hungarian economy rose to 4.7 percent of GDP, primarily owing to the stronger absorption of EU funds. In parallel with this, while current transfers and imports increased, the current account remained unchanged, still amounting to 3.1 percent of GDP. The items of the current account also did not change significantly in the period under review: the decline in the trade balance observed in 2017 slowed down, while the income balance deficit remains at 5 percent of GDP. The trade surplus fell to 7.5 percent of GDP, as import growth was slightly higher than export growth and the terms of trade deteriorated due to rising oil prices. The income balance deficit remained unchanged, due to an improvement in the interest balance and a decline in wage incomes from abroad. Hungary's net lending continues to exceed the levels seen in the other countries from the region.

In 2018 Q1, Hungary's four-quarter net lending according to the real economy approach rose to 4.7 percent of GDP, while the current account surplus stabilised at 3.1 percent of GDP (Chart 1). According to seasonally unadjusted data, net lending increased to more than EUR 2.1 billion in the first quarter, with similar surpluses observed in the current account and the capital account. The more favourable external balance indicator compared to the previous quarter was primarily attributable to the significant improvement observed in the transfer balance surplus, with the trade surplus at 7.5 percent of GDP and the income balance deficit at 5.1 percent of GDP. The improvement in the transfer balance was primarily attributable to EU transfer inflows.

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

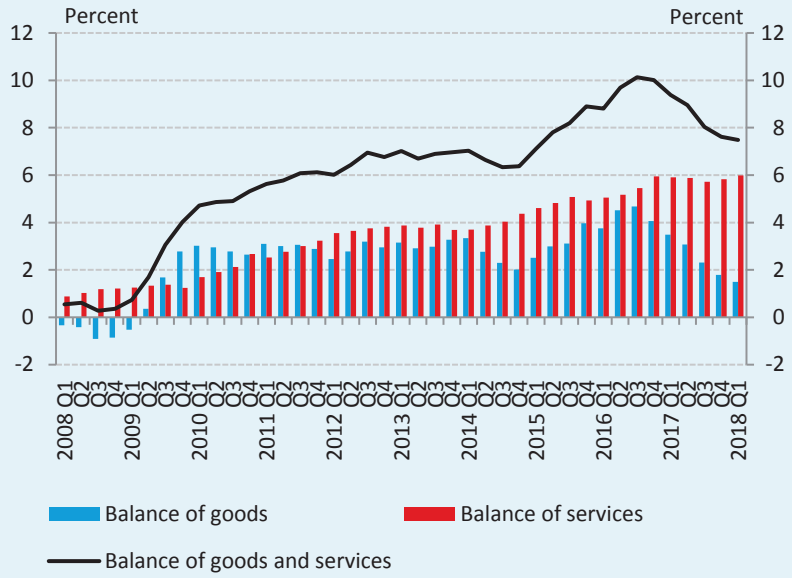


**Income balance: earned income, income on equity and income on debt. Transfer balance: sum of the capital account and other primary and secondary income.*
All charts by the MNB unless otherwise indicated.

1.1 Trade balance

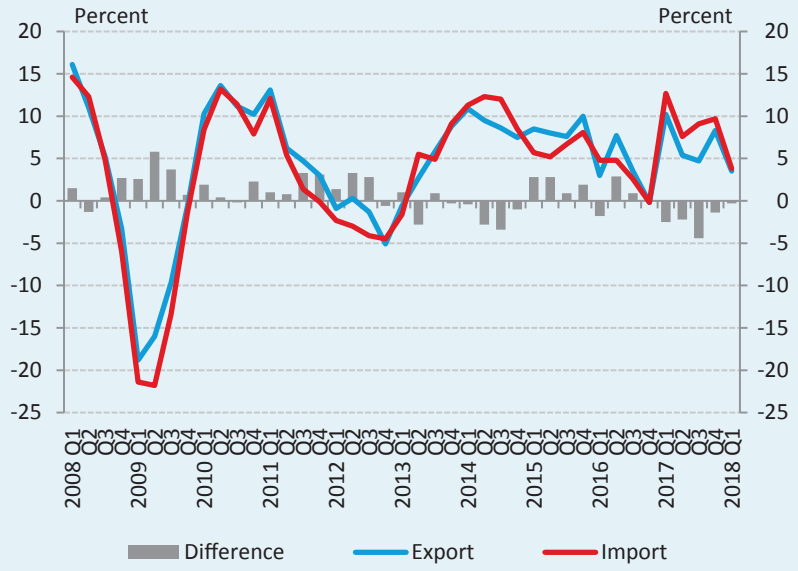
The decrease in the trade surplus decelerated during Q1, as a result of a continued decline in the goods surplus and a slight increase in the surplus of services (Chart 2). The gradual decline in the trade surplus, which has lasted since mid-2016, decelerated in 2018 Q1, and the balance amounted to 7.5 percent of GDP. The decline was still primarily attributable to the decrease in the goods surplus, which decelerated in Q1. This is partly a result of imports growing slightly faster than exports, and partly due to the relative change in foreign trade price levels. The higher import growth was mainly correlated with stronger household consumption as well as the expansion in corporate and public investment. Export growth slowed down owing to subdued industrial production (especially in March), while the start of production at recently implemented investment projects to expand capacities helped to boost exports. As in the previous quarter, the services surplus increased somewhat more to reach 6 percent of GDP, mainly as a result of developments in transport, infocommunication services and tourism.

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



Real growth in imports and exports in the first quarter amounted to 3.8 percent and 3.5 percent, respectively, and these values were lower than the figures observed in the previous quarters (Chart 3). In previous periods, annual real import growth exceeded the growth rate of exports and amounted to around 10 percent, which was mainly related to investment projects to expand capacities and rising consumption. At the same time, more subdued developments in industrial production restrained both indicators in 2018 Q1. However, the faster import growth was also supported by a more vigorous increase in the consumption of durable and semi-durable goods, which have a higher import content. In addition, compared to previous periods, the higher degree of production from inventories may have also played a role in the subdued level of annual real growth in imports. As a result of the above, the difference between the two indicators declined considerably, although import growth was still slightly higher than that of exports.

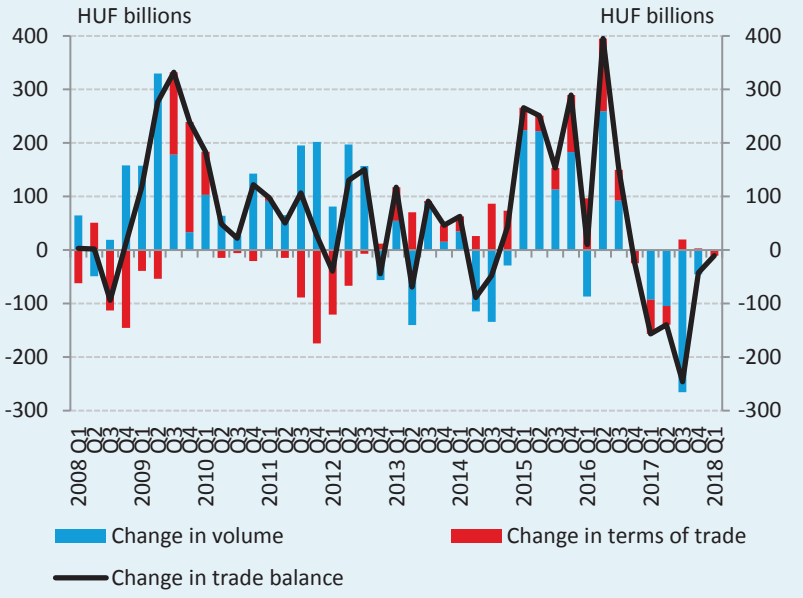
Chart 3: Annual real growth of exports and imports



Source: HCSO, MNB.

In the first quarter, the relative change in price levels slightly lowered the goods and services surplus, while the change in volume – as a result of the different levels of imports and exports – did not alter it significantly (Chart 4). Whereas prior to 2017 Hungary's terms of trade had improved considerably in line with the moderate commodity prices, last year the terms of trade had a slightly negative impact on the trade balance due to rising oil prices. In 2018 Q1, the detrimental impact of rising oil prices on the relative price level was once again reflected in the negative contribution of the terms of trade. While a moderately faster increase in imports was observed in terms of the real growth rate, this is not reflected in the change in volume, due to the level of exports, which significantly exceeds imports.

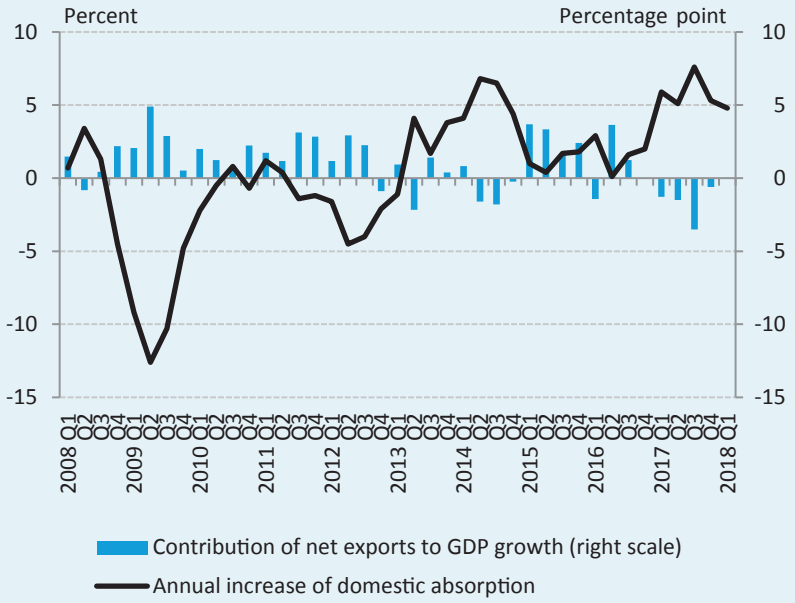
Chart 4: Developments in the balance of trade factors according to GDP (year-on-year)



Source: HCSO.

Similarly to previous periods, GDP growth in Q1 was supported by the steadily high level of the annual growth rate of domestic absorption, while the contribution of net exports to growth was neutral (Chart 5). At the beginning of the year, economic growth was attributable to households' buoyant consumption and to gross fixed capital formation, while the contribution of net exports to GDP was around zero. EU funds used during the quarter also contributed to the dynamic expansion in investment. Changes in the contribution of net exports to GDP growth were more favourable than last year, possibly due to the significant decline in the four-quarter value of inventories (which may have been reflected both in the higher exports or more subdued imports).

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

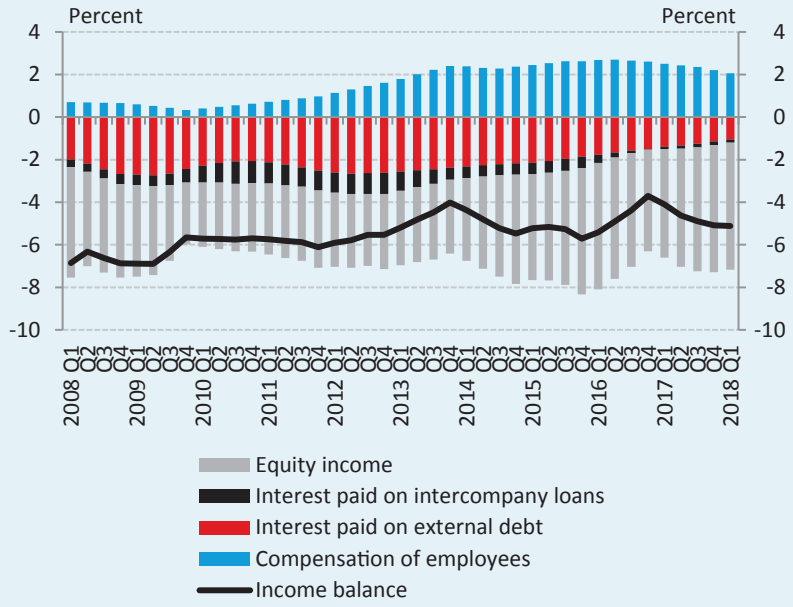


Source: HCSO.

1.2 Income balance

Similarly to the trade balance, the income balance also did not change in the period under review and remained around 5.1 percent of GDP (Chart 6). The gradual increase in the income balance deficit seen since end-2016 came to an end in 2018 Q1, primarily due to the improvement in the interest balance of foreign loans and the unchanged level of foreign-owned companies' estimated profits as a proportion of GDP. The decline in net interest expenditures continues to be supported by the low yield environment as well as the further decrease in net external debt. At the same time, improvement in the income balance was hindered by a decline in the wage income of those working abroad for less than a year, which is mainly attributable to the decline in the number of persons temporarily working abroad. On the whole, at the end of the quarter, the four-quarter deficit of the income balance amounted to 5.1 percent of GDP, and the size of the deficit is increasingly determined by the profits of foreign-owned companies.

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

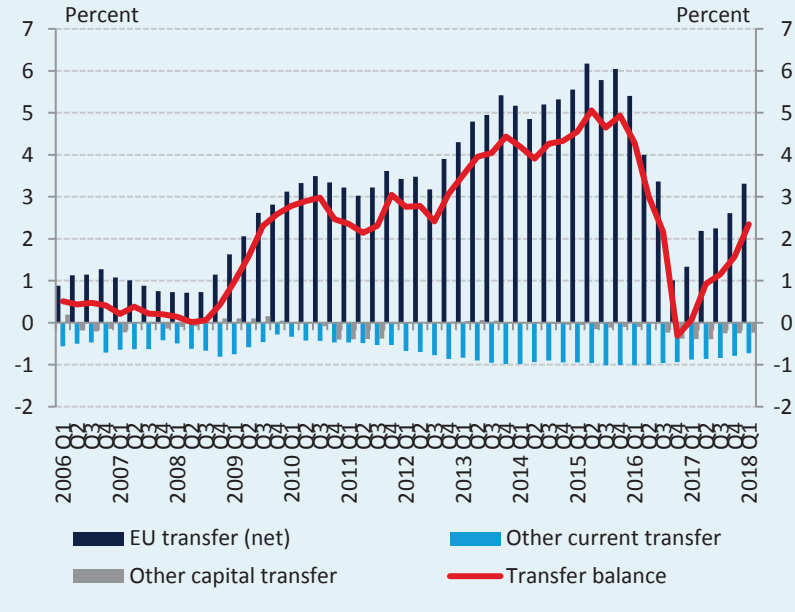


*Income balance: earned income, income on equity and income on debt.

1.3 Transfer balance

As a result of the increase in the absorption of EU funds in 2018 Q1, the surplus of the transfer balance rose to 2.3 percent of GDP, contributing to Hungary's more favourable net lending (Chart 7). In relation to the closing of the funds from the previous 2007–2013 EU budget cycle, the transfer balance declined at the end of 2016. In line with the steadily rising absorption of funds from the new EU budget cycle, the surplus of the transfer balance increased considerably in 2017. In 2018 Q1, more dynamic absorption of EU funds than in the previous quarters further improved the transfer balance surplus, which rose to 2.3 percent of GDP by the end of the quarter. In addition to EU funds, the lower deficit of other current transfers also resulted in a rise in the transfer balance, which may also have been attributable to the decline in the wage incomes of persons working abroad, as the related tax payments are stated among current transfers.

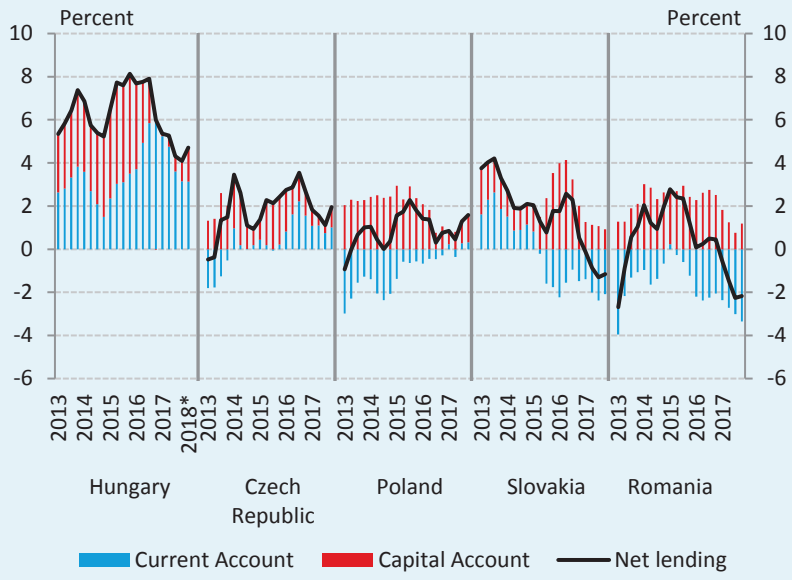
**Chart 7: Four-quarter developments in the items of the transfer balance*
(four-quarter values as a percentage of GDP)**



1.4 Regional overview

At end-2017, net lending improved in all of the countries in the region, mainly owing to the increasing absorption of EU funds, but Hungary's surplus still exceeds that of other countries in the region (Chart 8). In 2016, the largest fall in net lending took place in Hungary, Slovakia and Romania, which had had the highest quarterly absorption in the previous cycle, and – in addition to the drop in EU funding – the decline was also attributable to the deterioration in the current account (driven by trade developments) (for more details see the special topic of the January 2018 Report on the Balance of Payments). With the closing of the funds from the previous EU budget cycle, net lending fell considerably in the region. Nevertheless, in line with the inflows of funds from the new budget cycle, the decline tended to turn into a rise in 2017 H2. According to the latest data, Hungary's current and capital accounts exceed the levels observed in the countries of the region, as a result of which Hungary's net lending is also more favourable than in the countries of the region.

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



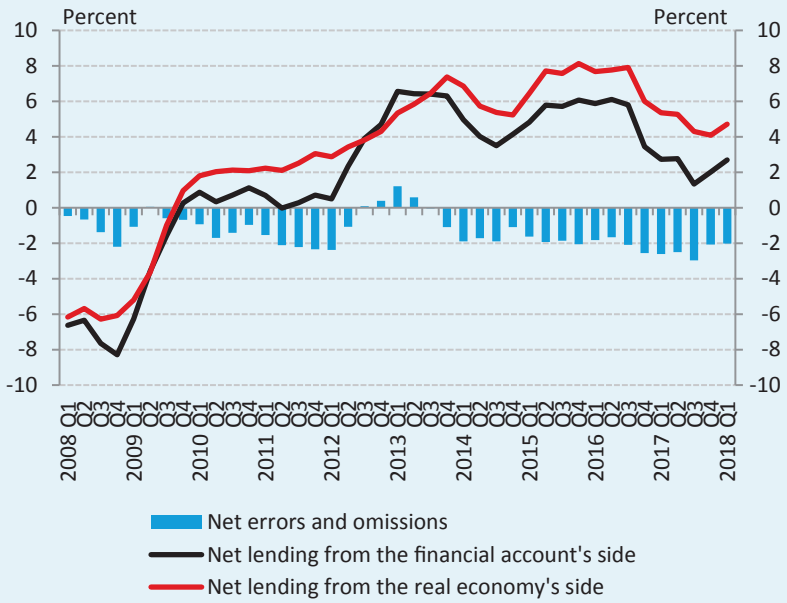
**2018 Q1 data are available only for Hungary.*
Sources: MNB, Eurostat.

2 Financing approach

Based on the financial account, the increase in net lending in Q1 resulted from FDI inflows and a significant decline in net external debt. All three sectors contributed to the outflows of debt-type liabilities. The decline in the banking sector's net external debt took place in parallel with a significant expansion in foreign assets, which may still have been attributable to the increasing FX deposits of the private sector.

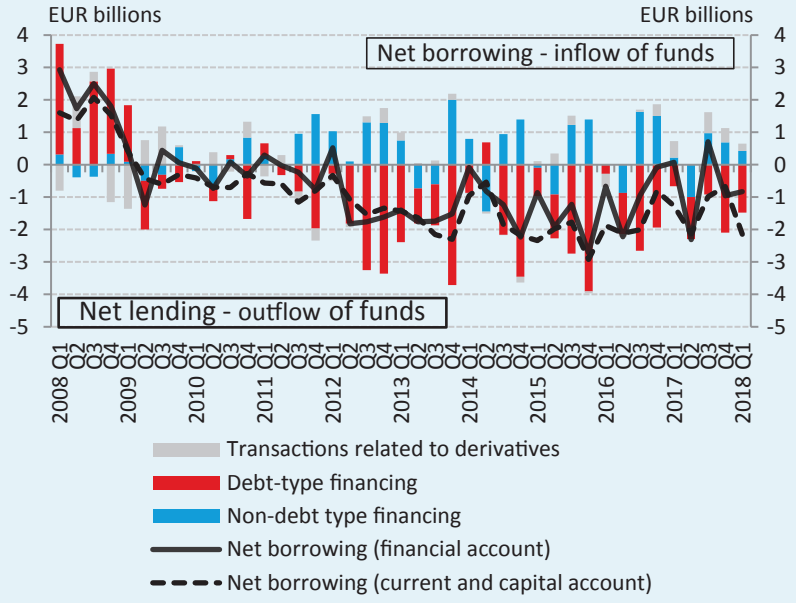
In 2018 Q1, four-quarter net lending according to the financing side increased to 2.7 percent of GDP (Chart 9). The increase in this indicator according to the financial account roughly corresponded to the change that took place in net lending calculated on the basis of the real economy approach, and thus the difference between the two indicators became stable. Net errors and omissions were close to their long-term average of around 2 percent of GDP, i.e. the decline in the country's external debt indicators still falls considerably short of the degree expected on the basis of the real economy approach.

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



In the first quarter, net lending calculated on the basis of the financing side declined slightly, amounting to EUR 0.8 billion (Chart 10). As in the previous quarters, the outflow of funds only concerned debt-type liabilities, and thus the country's net external debt according to transactions fell by EUR 1.5 billion. Non-debt liabilities (which are mainly related to FDI) expanded by some EUR 0.4 billion in Q1, considerably exceeding previous years' Q1 values.

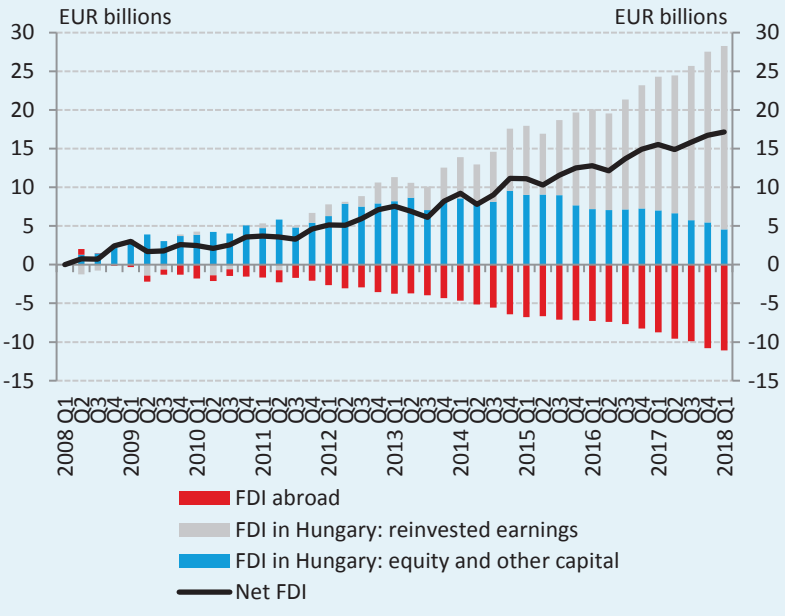
Chart 10: Structure of external financing (unadjusted transactions)



2.1 Non-debt liabilities

In 2018 Q1, as a result of an increase in reinvested earnings, net foreign direct investment expanded further in Hungary (Chart 11). In order to eliminate the distorting effects, it is advisable to examine the data net of capital-in-transit transactions and the rearrangement of the asset portfolio. Accordingly, in the first quarter the net FDI stock expanded by EUR 400 million as a result of transactions, which was the outcome of contrasting effects. Foreign-owned companies' equities declined slightly during the quarter, which was partly attributable to the fact that the National Public Utility Service Provider bought up ÉGÁZ-DÉGÁZ Gas Distribution Plc. Nevertheless, foreign companies' reinvested earnings increased significantly, while intercompany loans declined slightly. There was also strong growth in Hungarian companies' investments abroad during the quarter.

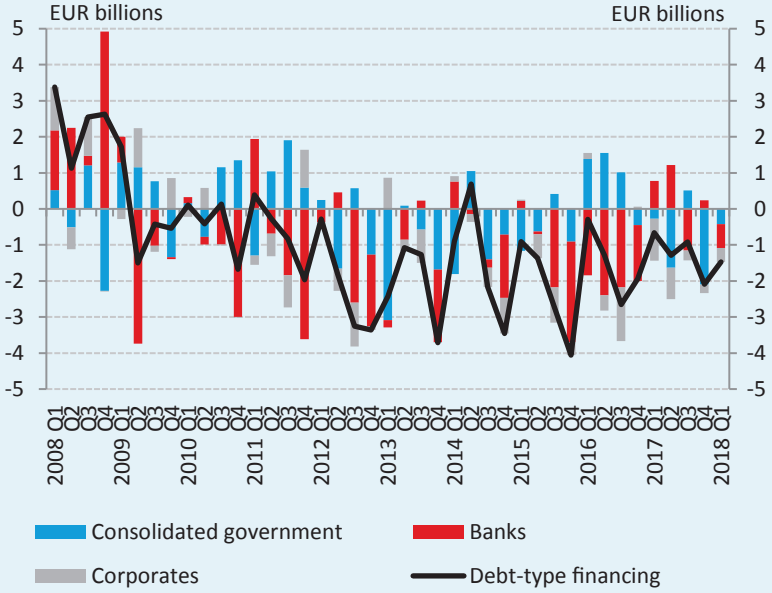
Chart 11: Developments in FDI without capital-in-transit transactions (cumulative transactions)



2.2 Debt liabilities

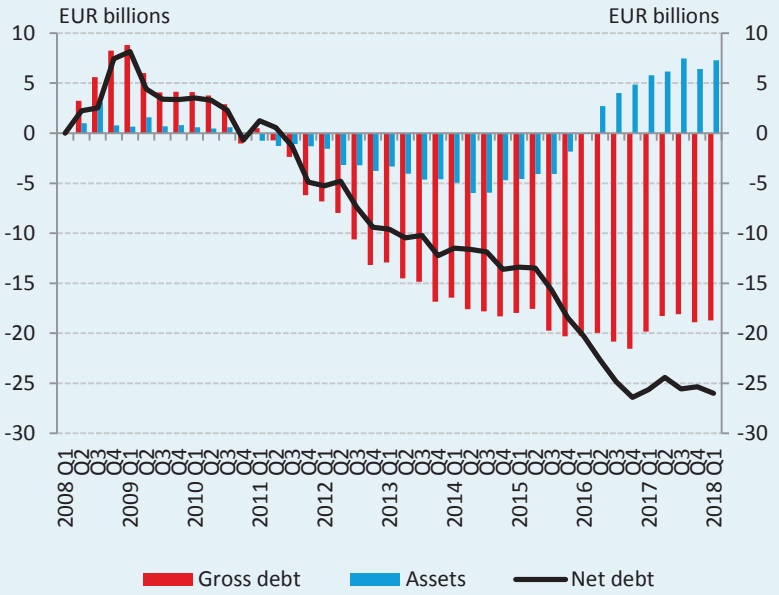
In line with the seasonality, in Q1 the outflow of debt funds declined slightly, with contributions from all three sectors (Chart 12). Following the growth typical in the previous year, the banking sector's net external debt as a result of transactions decreased by nearly EUR 700 million, explained completely by an expansion in foreign assets. The decline in the net external debt of the consolidated general government continued in early 2018 as well, while the net external debt of companies also declined again following the steady decrease that was typical last year.

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



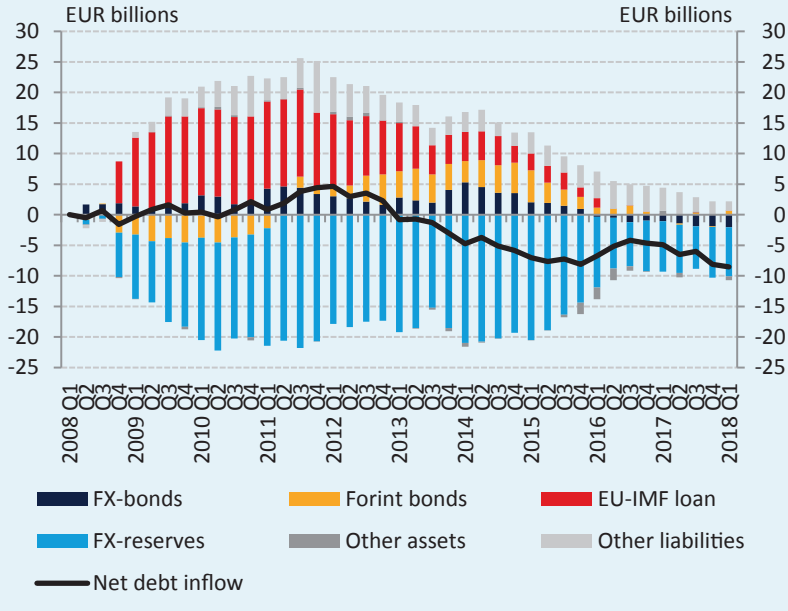
Banks' net external debt declined further, due to an expansion in foreign assets in line with the developments seen in past years (Chart 13). Following a decline in the previous quarter, the foreign assets of the banking sector increased considerably again in 2018 Q1 and rose by nearly EUR 900 million, while the sector's gross external debt – resulting from transactions – increased by EUR 200 million. As a result, banks' net external debt fell by some EUR 700 million. In addition to the FX deposits of the domestic corporate and household sectors, an increase in external liabilities may also have played a role in the expansion of foreign assets. The slight increase in banks' foreign liabilities was attributable to short-term liabilities, which may have been related to the adjustment of banks' end-of-year balance sheet optimisation, while short-term debt liabilities declined.

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



The net external debt of the consolidated general government including the MNB declined significantly in Q1, primarily in relation to the increase in foreign assets (Chart 14). In 2018 Q1, the net external debt of the consolidated general government declined further by approximately EUR 400 million. The net outflow of funds resulted from a significant increase in the foreign assets of the state in the period under review, while foreign liabilities expanded to a lesser extent. The increase of more than EUR 800 million in the general government's receivables from the rest of the world was related to the absorption of EU funds, while FX reserves declined by a total EUR 300 million in the first quarter. The expansion of some EUR 700 million in non-residents' forint government securities holdings led to a rise in the foreign liabilities of the state, the effect of which was mitigated by the decline in margin deposits and the repayment of a maturing US dollar bond. The margin account decline and the maturing dollar bond reduced the FX reserves as well and therefore, it did not affect net external debt.

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



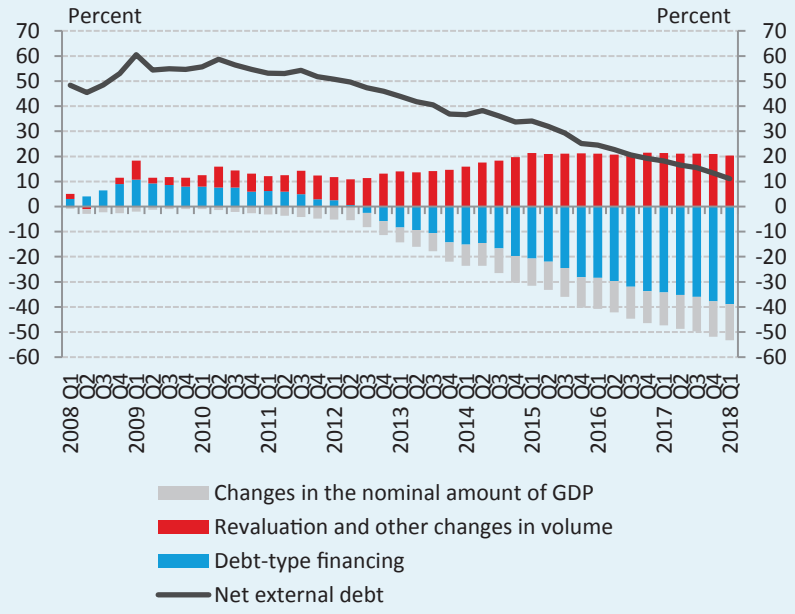
3 Developments in debt ratios

In parallel with ongoing debt outflows, Hungary's external debt ratios continued to decline in 2018 Q1. Net and gross external debt were down by 2.2 percent and 1.2 percent, respectively, bringing the net indicator to around 11 percent of GDP, while gross external debt was close to 59 percent of GDP. The decline in net external debt took place in parallel with a stronger outflows of debt liabilities, but the revaluation of stocks, which was related to the appreciation of the forint against the US dollar and a slight rise in yields, and nominal GDP growth also contributed to the decrease in the indicator. The general government played the main role, but on the whole each sector contributed to the decline in net external debt. In the case of the consolidated general government, the decline resulted from transactions as well as revaluation. The net external debt of the banking sector and companies also declined mainly as a result of the significant expansion in assets. In terms of the gross external debt-to-GDP ratio, the decline was completely related to the consolidated general government, while the gross external debt of the private sector did not change in the period under review. Following a steep decline at end-2017, Hungary's short-term external debt rose by EUR 1.5 billion to EUR 18.2 billion, which is primarily attributable to companies, and to a lesser extent to the banking sector and the general government. FX reserves continue to significantly exceed the level expected and considered safe by investors.

3.1 Developments in net and gross external debt

In 2018 Q1, the country's net external debt declined by 2.2 percentage points to 11.1 percent of GDP, which was mainly attributable to outflows of debt liabilities, but the revaluation of stocks and the change in nominal GDP also contributed to the decline (Chart 15). This indicator is of key importance in terms of the external vulnerability of the country and declined to 11.1 percent of GDP by end-March. The decline in the debt ratio primarily resulted from outflows of debt liabilities amounting to 1.2 percentage points, but the revaluation of stocks and the increase in nominal GDP also contributed significantly to the decline. While the weakening of the forint's exchange rate against the euro had only a minor effect on the net external debt (EUR-denominated debt is roughly offset by a nearly identical level of EUR reserves), the strengthening of the forint against the US dollar reduced the ratio considerably. In addition, the repricing of government securities holdings due to the slight increase in yields also contributed to the decline in the debt indicator.

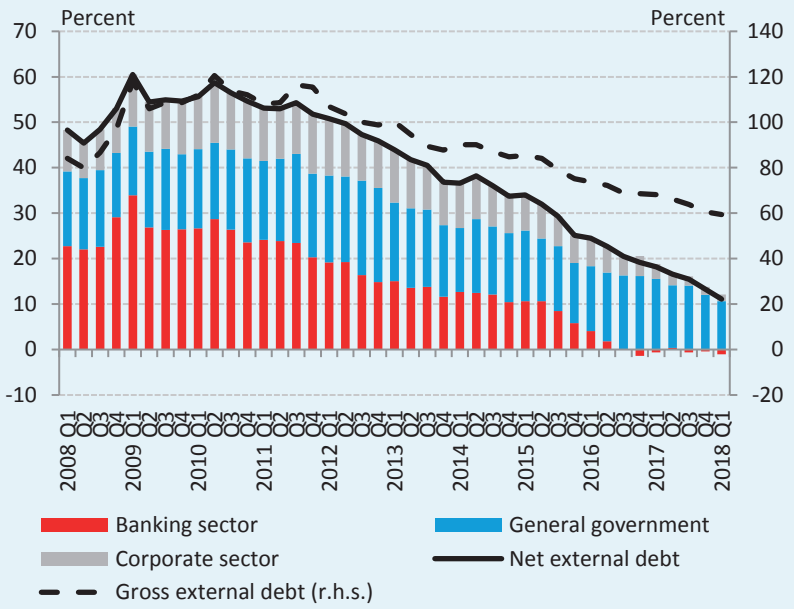
Chart 15: Components of changes in net external debt
(cumulative values excluding intercompany loans as a percentage of GDP, end-2007 = 0)



The decline in net external debt in Q1 is primarily related to the general government, but on the whole, every sector made a contribution (Chart 16). The decrease in the net external debt of the general government resulting from transactions can be ascribed to the increasing absorption of EU funds. In addition, although non-residents' government securities holdings increased as a result of transactions, the appreciation of the forint against the US dollar and the repricing due to the slight rise in yields resulted in a lower debt ratio. In the case of the banking sector, the significant expansion in assets caused the decline in the debt ratio. In the case of the consolidated general government, changes in both liabilities and assets contributed to the decline, while in the case of companies the increase in foreign assets exceeding that of liabilities led to the decrease in net external debt.

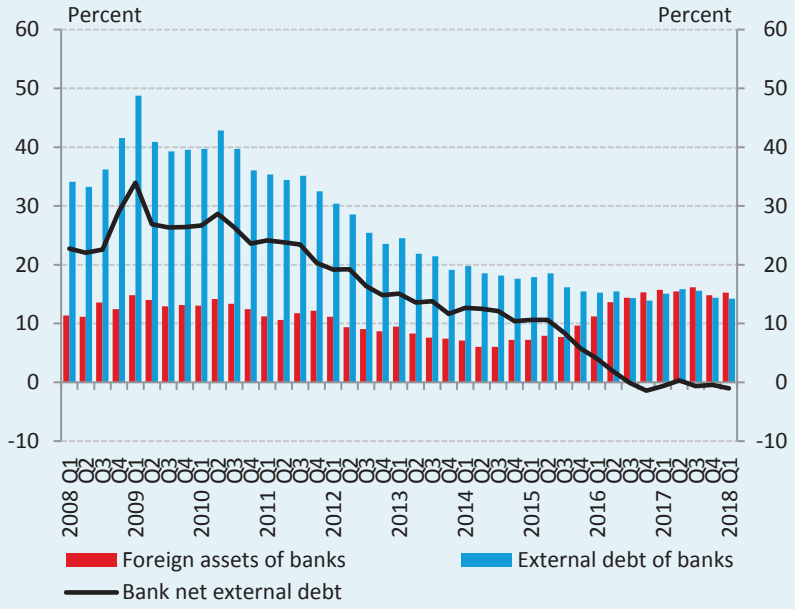
In 2018 Q1, gross external debt declined further, falling by 1.2 percentage points to below 60 percent, i.e. to 59.4 percent of GDP. The reduction in this debt ratio was primarily the result of a decline in holdings due to revaluation, but GDP growth was also a contributing factor. Based on the breakdown by sector, the gross external debt of the consolidated general government fell by 1.2 percent of GDP, while the 0.2 percentage point decrease registered for the banking sector was offset by the same degree of increase in the indicator for the corporate sector. Accordingly, on the whole, the gross external debt of the private sector remained unchanged in the quarter under review.

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



In 2018 Q1, the net external debt of the banking sector declined primarily as a result of a significant expansion in assets, and thus the sector's foreign assets continue to exceed its foreign liabilities (Chart 17). The decline in the banking sector's net external debt is primarily attributable to the expansion in assets, but in contrast to the transaction data, due to the revaluation, gross liabilities vis-à-vis the rest of the world also fell slightly: the rise in the former corresponded to 0.4 percent of GDP, while the latter declined by 0.2 percentage point. The increasing FX deposits of the private sector significantly contributed to the expansion in the banking sector's foreign assets.

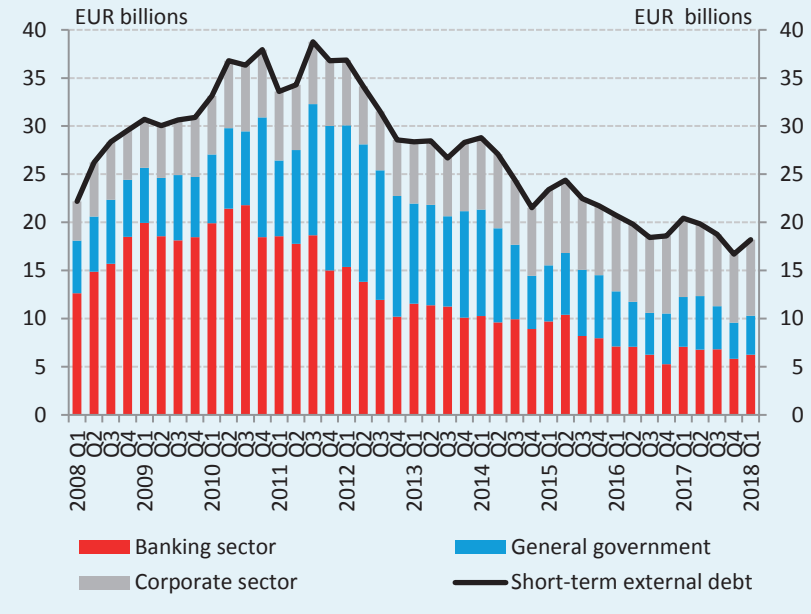
Chart 17: Developments in the banking sector's external assets and debt (as a percentage of GDP)



3.2 Developments in short-term external debt

At the end of the first quarter of 2018, following a rise of some EUR 1.5 billion, short-term external debt – which had reached a historical low at end-2017 – amounted to EUR 18.2 billion (Chart 18). The increase in short-term external debt was mainly related to the corporate sector, while the banking sector and the consolidated general government contributed only to a smaller extent. In Q1, the short-term external debt of the consolidated general government, banks and companies rose by EUR 0.3 billion, EUR 0.4 billion and EUR 0.8 billion, respectively. As a result of a euro bond maturing in January 2019, the rise in the short-term external debt of the general government is attributable to debt with shortening maturity, whose degree at the same time was partly offset by the decrease in margin accounts, hedging the US dollar exposure to euro. The rise of EUR 0.8 billion of the indicator of companies is attributable partly to the sector's commercial credit and partly to the expansion in companies' other short-term external debt. Short-term external debt based on original maturity caused the increase in the case of banks as well, while the sector's debt that became short-term declined slightly.

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



3.3 Developments in foreign exchange reserves and reserve adequacy

In 2018 Q1, the level of FX reserves declined slightly, with items related to government debt management as the main contributors. At end-March 2018, international reserves amounted to EUR 23.1 billion, representing a decline of EUR 300 million compared to the end-2017 level. The following main items influenced the changes in FX reserves:

- The *EU funds* amounting to nearly EUR 750 million received during the quarter constituted the main reserve increasing item. In addition, the increase in the holdings of *forint liquidity providing FX swap instruments,* the *revaluation effect* stemming from the appreciation of other currencies against the euro as well as *domestic banks' FX deposits placed with the MNB* were smaller contributors to the increase in reserves.

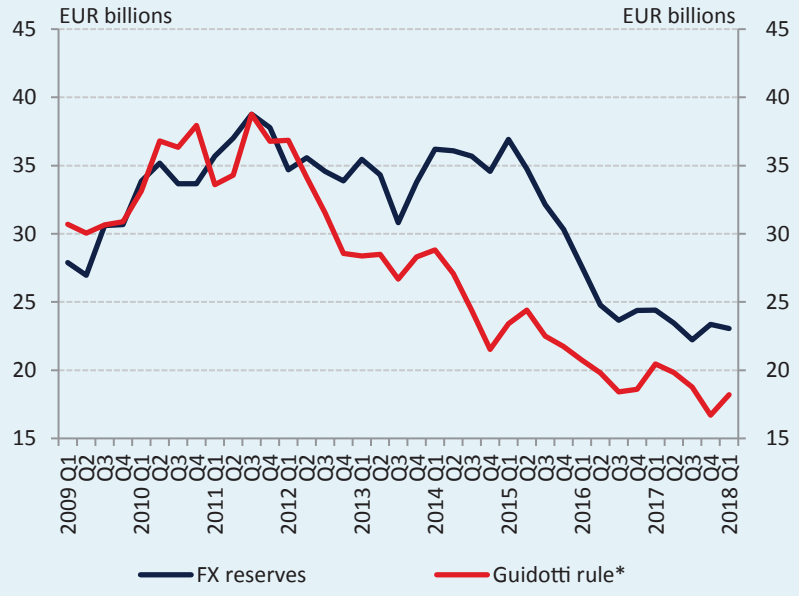
- The reserve reducing effect of *public foreign currency expenditures* was around EUR 700 million, particularly in relation to the FX interest expenditures of the Government Debt Management Agency (ÁKK) and the Hungarian State Treasury (MÁK), while the *net FX financing of the ÁKK* was nearly neutral. In February, one USD-denominated FX bond matured with a value of nearly EUR 280 million. The impact of this was mitigated by the issue of a JPY-denominated bond in March with a value of some EUR 230 million. As a result of the two items, the effect of net FX financing on the level of reserves was practically neutral.

- FX reserves were further reduced by changes *in margin deposit holdings related to the ÁKK's hedging swap transactions,* which are mainly attributable to the appreciation of the euro versus the US dollar observed for most of the period.

- The loans granted within the framework of the FX pillar of the third phase of the Funding for Growth Scheme reduced the level of reserves by a mere EUR 20 million in Q1.

In parallel with the slight decrease in foreign exchange reserves, short-term external debt increased by the end of Q1, but foreign exchange reserves still considerably exceed the level expected by investors. Based on the Guidotti–Greenspan rule, which is closely followed by both the central bank and investors, the foreign exchange reserves of EUR 23.1 billion at the end of March 2018 exceed the level of short-term external debt, which amounts to EUR 18.2 billion. As opposed to the EUR 0.3 billion decline in FX reserves, short-term external debt increased by some EUR 1.5 billion from the historical low measured at end-2017. Nevertheless, Hungary's short-term external debt is still considered low. Based on the Guidotti rule, FX reserves in 2018 Q1 exceeded short-term external debt by almost EUR 5 billion (i.e. to a greater degree than the 2017 average difference), which still represents a safe level.

Chart 19: Short-term external debt and the FX reserves of the Hungarian economy



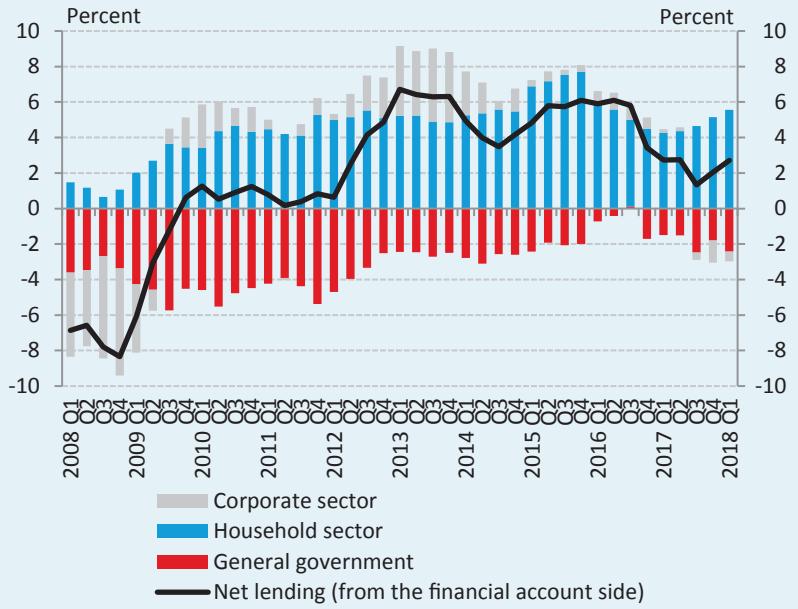
** Guidotti rule: short-term external debt based on residual maturity.*

4 Sectors' savings approach

In 2018 Q1, the four-quarter net lending of the economy according to sectors increased to 2.7 percent of GDP. The increase in the private sector's net lending significantly exceeded the expansion in the net lending of the general government, which was reflected in rising net lending. Compared to the previous quarter, the net borrowing of the general government increased slightly, but can still be considered subdued. According to seasonally adjusted data, households' net borrowing rose slightly due to housing loans, while the accumulation of financial assets stabilised at a high level. In Q1, in addition to liquid financial assets, households increased their holdings of long-term government securities. The rise in the average maturity of retail government securities contributed to the decline in renewal risk and thus to the mitigation of the vulnerability of the economy.

According to the savings of sectors, the four-quarter net lending of the Hungarian economy rose to 2.7 percent of GDP in 2018 Q1 (Chart 20). The four-quarter net borrowing of the budget rose to above 2 percent of GDP in Q1, which was primarily related to the expenditure side, and within that to the rise in investment, operating and personnel costs. In contrast to previous years, companies have exhibited net borrowing for three quarters, which is primarily explained by the continuous expansion in investment. In the past quarter, households' four-quarter net financial savings increased to 5.6 percent of GDP, which is a result of rising gross financial asset accumulation due to expanding incomes, while net borrowing remained restrained.

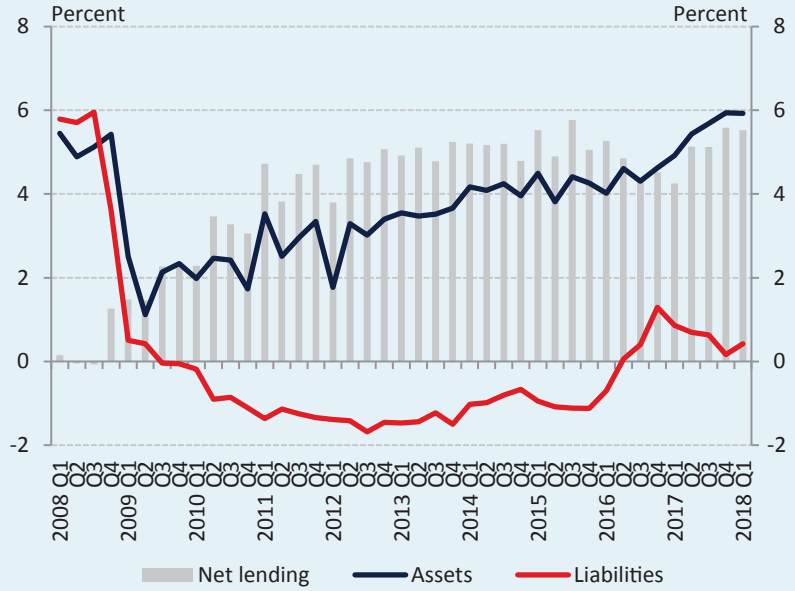
Chart 20: Net lending of the individual sectors* (four-quarter values as a percentage of GDP)



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

Households' net financial savings according to seasonally adjusted underlying developments amounted to 5.6 percent of GDP in Q1 (Chart 21). Households' seasonally adjusted net borrowing increased slightly in Q1, resulting from continued growth in housing loans, while consumer loans declined slightly. Similarly to the previous quarter, households' gross financial savings amounted to around 6 percent of GDP in Q1, which was primarily attributable to an expansion in bank assets and cash holdings, while government securities holdings increased to a lesser extent.

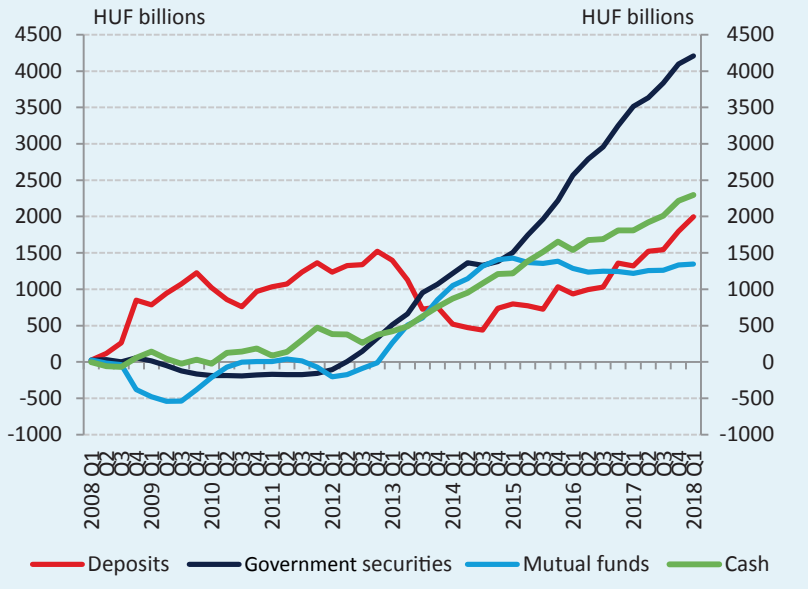
Chart 21: Net lending of households
(seasonally adjusted revised* values, as a percentage of GDP)



**Figures showing underlying trends, adjusted for the impact of pension savings, the early repayment scheme and the real yield payment, the indemnification of the depositors of liquidated mutual savings banks as well as the forint conversion and settlement. Time series are adjusted separately.*

In Q1, liquid investment assets expanded to a larger degree, while government securities expanded to a lesser extent, but this continues to significantly support the financing of the general government from domestic sources (Chart 22). The increase in households' government securities savings continued in early 2018 as well: the sector's government securities holdings rose to above HUF 5,100 billion. In spite of the high maturing stock, households further increased their government securities holdings, although the degree of the expansion was smaller than in previous quarters. Concerning the maturity structure of government securities, the decline in short-term securities holdings was offset by an increase in long-term securities. Households still prefer liquid investment assets: in parallel with a major expansion in overnight deposits, cash holdings also increased to a lesser extent.

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



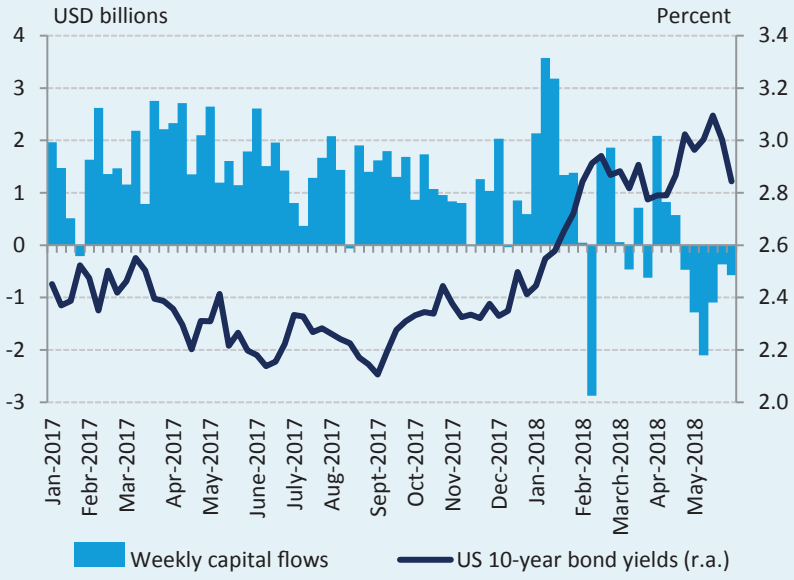
5 Special Topic: Hungary's external balance indicators in the context of the emerging market turbulence

In parallel with the Fed's gradual increase in interest rates, global risk tolerance has changed. As a result, compared to past periods emerging markets were characterised by higher financial market volatility and outflows of funds. Consequently, investors are once again paying closer attention to developments in countries' external balance indicators. In this study, we examine Hungary's relevant indicators in an international comparison, which suggests that Hungary is one of the less exposed countries. This is suggested by the fact that Hungary's current indicators have become persistently favourable and stock variables also indicate major declines in external imbalances. One of the most important related factors is that the net lending of the Hungarian economy became positive after the outbreak of the crisis, which means that Hungary does not have to rely on external funds. Moreover, the Hungarian economy finances the rest of the world, while the current account deficit continued to grow in several emerging countries. Accordingly, as a result of the adjustment following the crisis, both net and gross external debt declined considerably, and thus the indicators of the economy's fundamental developments belong to the middle of the pack of emerging countries. In addition, other indicators related to the external balance (share of foreign debt and foreign currency within government debt, total and FX indebtedness of the private sector, short-term external debt, reserve adequacy) also show that the external vulnerability of the Hungarian economy is low. This is also corroborated by the fact that in 2017 the European Commission's report which was introduced after the crisis and examines macroeconomic imbalances established that – in contrast to many other EU countries – there are no imbalances in Hungary which would justify the preparation of a detailed analysis.

5.1 Underlying reasons for and consequences of market turbulences

Global risk tolerance changed in 2018 Q2 and, in parallel with this development, capital outflows were typically seen in the emerging markets (Chart 23). In the past months, the appreciation of the US dollar versus the euro and a rise in US dollar yields were observed, which is attributable to various factors. One of these is that – in line with expectations – the Fed increased the key interest rates in March and June, by 25 basis points each time, as a result of which the interest rate band rose to the range of 1.75–2.0 percent; further tightening measures are expected for this year. As a result of the Fed's tightening monetary policy, the direction of global capital flows reversed: while following the outbreak of the crisis significant external funds flowed to the emerging markets as a consequence of the loose monetary policy of the world's leading central banks, recently – as in the 'tapering talk' period – contrasting developments have started, i.e. withdrawal of capital from emerging markets is observed. Meanwhile, the ECB's decision-makers decided in June that the ECB will reduce the monthly amount of purchases to EUR 15 billion in September, and will terminate asset purchases after December 2018, while maintaining the current level of the policy rates at least until the summer of 2019. In addition to monetary policy developments, domestic tensions in Italy also contributed to the deterioration in global risk tolerance and thus to the capital outflows from emerging markets, repricing of financial assets and especially to the strengthening of risks related to the periphery of the euro area.

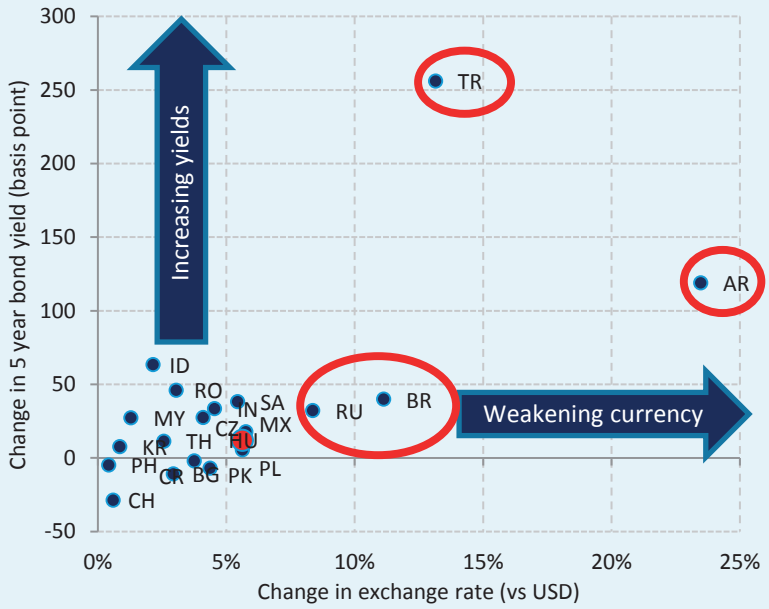
Chart 23: US 10-year yield level and weekly emerging bond market capital flows



In line with the above, significant turbulence was experienced in the emerging markets in recent months, with different impacts across countries (Chart 24). The faltering of the emerging markets affected Turkey and Argentina the most, while the Russian and Brazilian markets also reacted in a more sensitive manner compared to the average. In these countries, the unfavourable developments were reflected not only in the weakening of foreign exchange rates, but also in a rise in long-term government securities yields. The following section offers a detailed presentation of country-specific factors that were identified in these markets and that significantly amplified these markets' sensitivity to external shocks and to a possible reversal of capital flows.

- Turkey is being focused on by the markets mostly because of its balance problems: in addition to the current account deficit, which is the most critical problem, the size of corporate debt and within that the high ratio of foreign currency, as well as the lack of trust that surrounds the independence of monetary policy add to the vulnerability of the country.
- Investors' attention turned to Argentina because of its significant twin deficit, the critical size of FX debt and double-digit inflation.
- Through trade relations, Brazil may primarily be affected by the crisis in Argentina, and in addition to that, the October elections also carry uncertainty.
- In Russia, investor sentiment deteriorated mainly due to the US sanctions.
- Meanwhile, as a result of the political uncertainty related to the elections, long-term government securities market yields increased in Italy, where – due to Italian banks' high government securities holdings – the turbulence may also rapidly spread over to the banking sector, which may represent a contagion risk for several EU countries as well.

Chart 24: Emerging market foreign-exchange rates and changes in 5-year yields between March and May 2018



Source: Bloomberg.

In parallel with the above, markets are paying more attention to the external balance indicators of Central East European emerging countries, including Hungary. A country's assessment by investors is influenced by many – macroeconomic or financial – variables (e.g. potential growth, government debt, activity rate, etc.), but in this study we give a detailed overview of the external balance related indicators (e.g. net lending and current account, net and gross external debts etc.) of Hungary and similar emerging countries, which may provide help in the assessment of the external vulnerability of Hungary. It is worth considering that yield increases and exchange rate weakening were typical of the countries of the region as well in the period under review, but their degree fell significantly short of that of the countries mentioned above.

5.2 External balance indicators

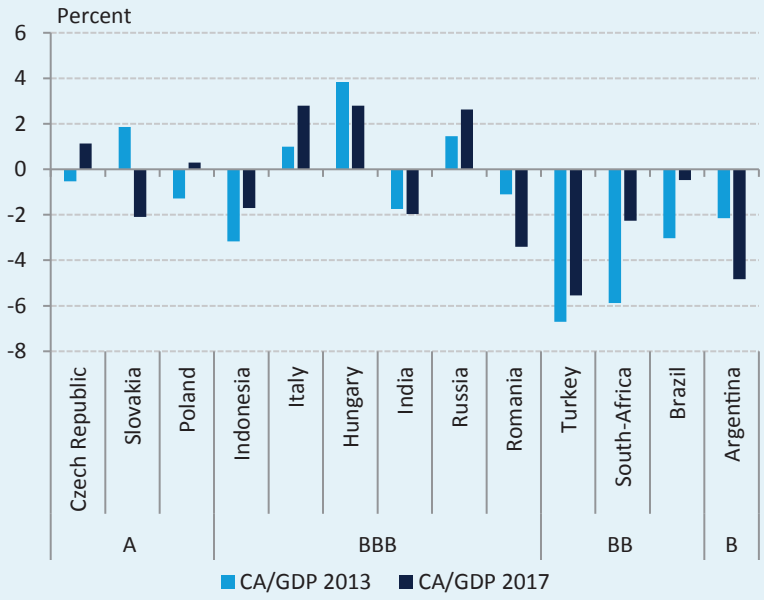
Several balance of payments indicators may be good gauges of the vulnerability of individual countries. While external debt and balance indicators were considered less important in the pre-crisis years, when liquidity was ample, the 2008–2009 financial crisis and the subsequent debt crisis in the Mediterranean countries shed more light upon the importance of these indicators. This is reflected, for example, in the Macroeconomic Imbalance Procedure (MIP) as well, which was introduced by the European Commission, and which monitors various indicators originating from the balance of payments statistics. In addition, many analyses prepared by market, investment bank and international institutions also devote particular attention to these indicators when assessing the external vulnerability of a country.

5.2.1 Current account balance and net lending

Net lending provides information on the economy's dependency on external funds. The current account balance and net lending are the most closely monitored indicators which indicate external imbalance and vulnerability. The current account balance is the difference between the savings and investment of an economy. Consequently, a deficit means that either the level of savings is low compared to that of investment, or investment is relatively too high (or both), which can be financed with the involvement of external funds. Net lending, which is the balance of the current account and the capital account, is considered to be a more important indicator in the case of a country where funds appear in the capital account in a permanent and predictable manner. If this indicator is negative, the country has external net borrowing, i.e. economic agents are compelled to obtain funds corresponding to that value. Persistently high external net borrowing generates high external debt, which increases vulnerability due to the interest payment and the renewal risk.

In Hungary, the current account surplus and the significant net lending are important factors in the shock absorbing capacity of the economy. Both the period of the 'tapering talk' and the experiences of recent months indicate the importance of the current account balance in investors' assessment. Investors started to differentiate more strongly among emerging countries between mid-2013 and early 2014, when the reduction of the Fed's liquidity increasing programme received increased attention, focusing mostly on countries that had high current account deficits (e.g. 'the fragile five', i.e. Turkey, South Africa, Brazil, India and Indonesia). At that time, investors may have thought that the current account deficit of the Turkish economy was too high, which could only be financed at increasing costs in the future. As a result, the currencies of vulnerable countries depreciated considerably, and an increase in long-term yields was seen. By contrast, tapering only had a smaller impact in Hungary, which had a significant current account surplus. Likewise, in the spring of 2018, the turbulences most strongly affected Turkey and Argentina, which have the highest current account deficits, while the Central East European region, which has a more favourable external balance position and credit rating, was less affected. (Russia's current account surplus is mainly attributable to its commodities exports.)

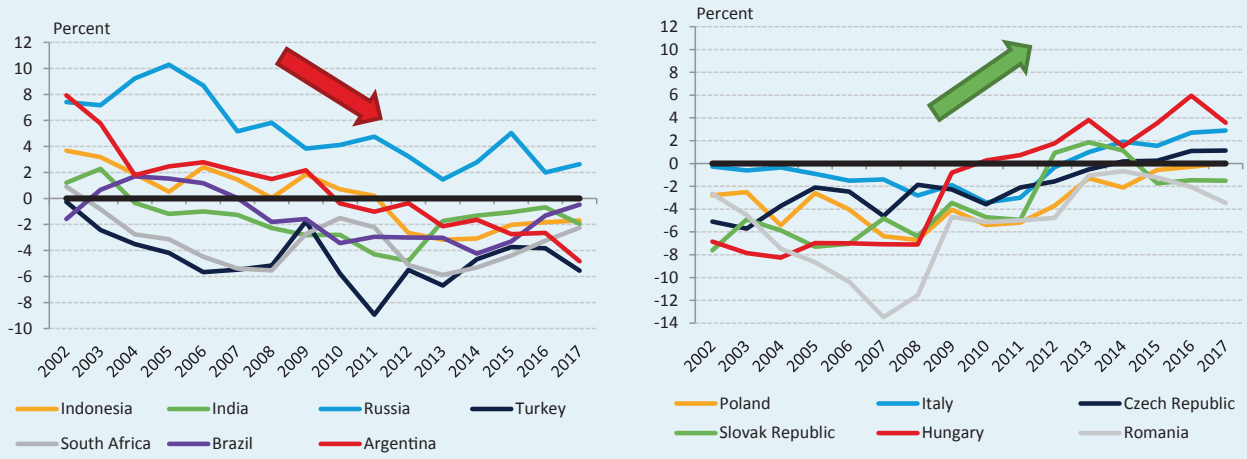
Chart 25: Current account balance in some emerging countries, and of the region



Note: The order of individual countries was determined according to the Fitch rating.
Source: WEO, Eurostat, Fitch

In terms of investor assessment, one relevant factor is that a significant adjustment took place in Hungary's current account following the crisis. Persistent surplus recorded for this indicator has also supported the adjustment of stock indicators since then. As Chart 26 also illustrates, following the outbreak of the financial crisis, the most significant adjustment took place in Hungary, and both the stabilisation of the budget deficit below 3 percent as well as private actors' balance sheet adjustment increased the balance of the current account (and net lending) considerably. Similar developments took place in the Central East European countries, while the sovereign debt crisis delayed the adjustment in Italy, but starting from 2013 the indicator moved onto an improving path there as well. By contrast, a persistent deterioration in the current account balance is observed in the case of the fragile five and Argentina, which has an unfavourable impact on the debt indicators of these economies (see the chapters below) and on their assessment by investors. All of this plays a role in the differentiation among emerging countries by investors.

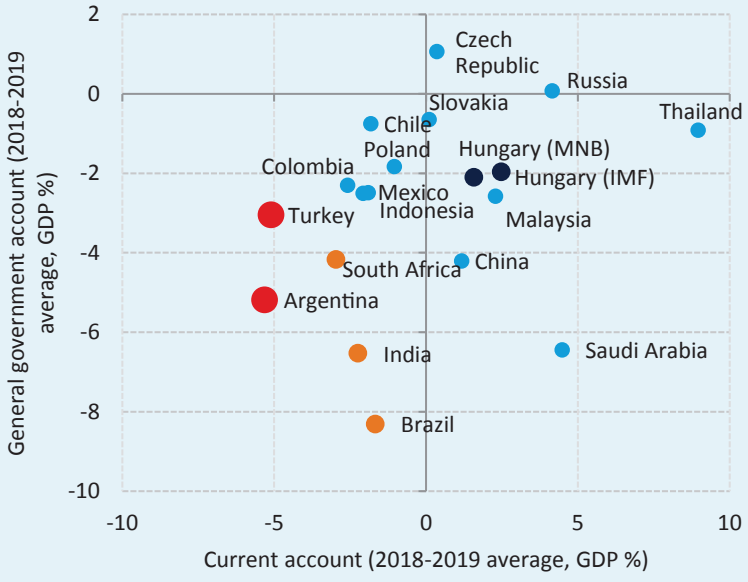
Chart 26: Current account balance in some emerging countries, and of the region (as a percentage of GDP)



Source: WEO

While significant twin deficit was typical of the countries most affected by the market turbulence, the moderate deficit of the Hungarian budget further reduces the risks related to external financing. In contrast to the low Hungarian budget deficit, the countries reacting to external shocks in a more sensitive manner in recent weeks (Turkey and Argentina in particular) have struggled with significant twin deficits, i.e. they do not have any budgetary leeway to offset an economic slowdown that may take place if external sources of funding dry up (Chart 27). Since 2012, the budget deficit in Hungary has decreased to below the 3 percent level required by the Maastricht criterion. In parallel with that, the government debt-to-GDP ratio has also been on a declining path. Another favourable trend is that the ratio of foreign currency and foreign debt within government debt also started to decline (see below for more details). On the whole, this reduces the country's external vulnerability and significantly improves its assessment by investors.

Chart 27: Expected fiscal and current account balances of selected emerging countries (IMF, average of 2018–2019)



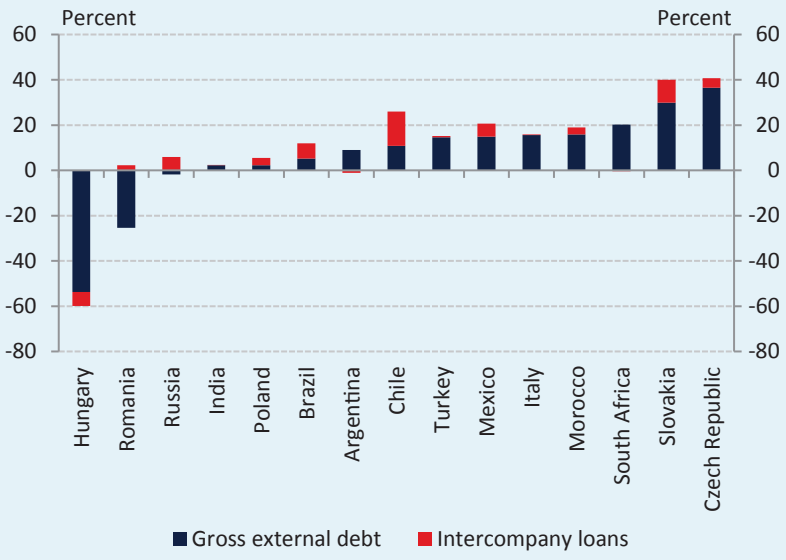
Although Hungary is a small, open economy, the possible contagion channels for turbulence occurring in emerging markets through trade relations are weak. In assessing the vulnerability of an economy it may be expedient to pay attention to the concentration of exports as well. In recent years, the performance of net exports has contributed significantly to Hungary's current account surplus and net lending. Within that, however, the structure of exports is rather concentrated as some 70 percent of Hungarian exports are directed to EU Member States, and more than one quarter of exports goes to Germany, which is Hungary's most important trading partner. As a result of the high concentration of foreign trade, net exports primarily depends on economic activity in the euro area (and on the performance of the German economy in particular). Accordingly, a deceleration in emerging markets would have a moderate impact on this indicator of Hungary. The risks related to concentration are reduced by the fact that after Germany the scope of partner countries is rather diversified. Due to the uncertainties in the Italian market, it could also be justified to examine Hungary's exposure to Italy, but the latter accounts for less than 5 percent of Hungary's external demand.

5.2.2 Gross external debt

The level of gross external debt is an indicator of the external vulnerability of a country, i.e. it shows the amount of foreign debt accumulated by economic agents. Accordingly, among other things it contains the government securities held by non-residents, the external liabilities of the banking sector as well as corporate loans from abroad. In terms of vulnerability, it can be considered an important indicator as the events in 2008 highlighted that upon the occurrence of an external shock external liabilities may exit the economy in a relatively short time, and thus an overly high level of gross external debt poses a refinancing risk, which can lead to money market tensions.

As a result of the adjustment of domestic sectors, gross external debt declined by more than 50 percent of GDP in Hungary between 2010 and 2017, while it increased in the majority of the countries under review (Chart 28). Following the crisis, the behaviour of sectors changed considerably in Hungary: in the case of households, borrowing was replaced by the repayment of loans, while the previously significant general government deficit declined, and the external debt of the state decreased gradually, partly as a result of an upturn in government securities purchases by households and partly as a result of the MNB's self-financing programme. In addition, external financing, which had been typical before the crisis, was replaced by significant net lending of the economy, which was also reflected in the decline in external debt. As a result, Hungary's gross external debt declined by more than 50 percent of GDP between 2010 and 2017, and if intercompany loans[1] are also taken into account the decline exceeds 60 percent of GDP. This is the strongest decline among the focus countries and countries of the region under review, where gross external debt usually even increased during the period.

Chart 28: Changes in gross external debt and intercompany loans (difference between 2017 and 2010 as a percentage of GDP)

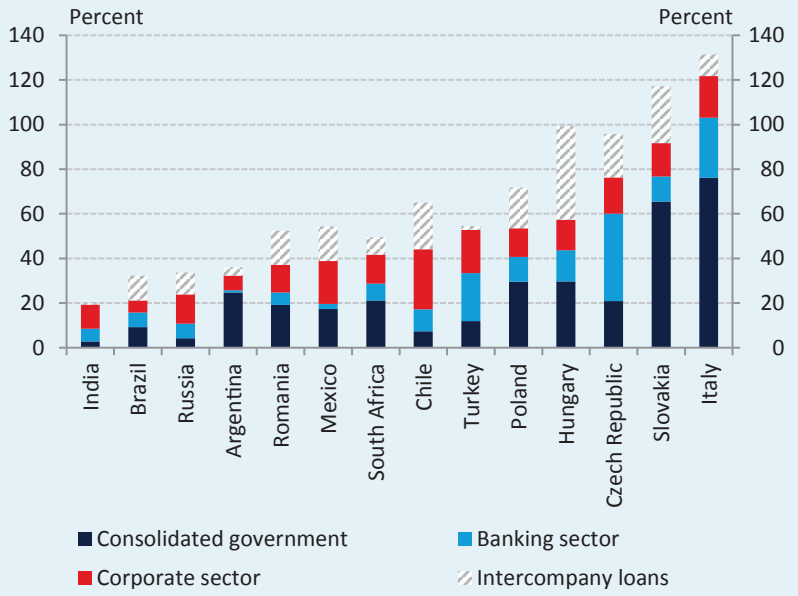


Sources: IMF, own calculation.

[1] Intercompany loans mean the debt stated within foreign direct investment.

According to fundamental data – which do not include intercompany loans – Hungary's gross external debt is in line with the figures observed in the countries of the region (Chart 29). Hungary's gross external debt, which reflects the fundamental developments and excludes intercompany loans, amounted to 60 percent of GDP at end-2017, corresponding to the average value of the other countries in the region. Looking at the sectoral breakdown, the level of the external debt of the consolidated general government in Hungary is similar to that of Poland, but lower than in Slovakia, which is a member of the euro area. It is also worth calling attention to the fact that the external debt of banks and companies in Hungary can be considered as below average, and accordingly, an ensuing potential loss of funds would presumably hinder economic growth to a lesser extent. The external debt of the banking sector in the Czech Republic considerably exceeds that of the other countries under review, reflecting the effect of the exchange rate floor applied between 2013 and 2017. It is also important to note that in Slovakia and Italy, where gross external debt is the highest among the countries under review, the external debt indicators of the economy are also increased by the TARGET debts related to the euro area. In parallel with that, however, in the Eurostat or IMF databases the gross external debt is larger than the fundamental indicator and contains special purpose entities and intercompany loans as well. At the same time, based on economic considerations, the much lower risks related to these do not justify their inclusion in the gross external debt figure.[2]

Chart 29: Breakdown of gross external debt (2017, as a percentage of GDP)



Note: The order of individual countries was determined according to debt excluding intercompany loans, as usual in the analyses of the MNB.
Sources: IMF, own calculation.

5.2.3 Net external debt

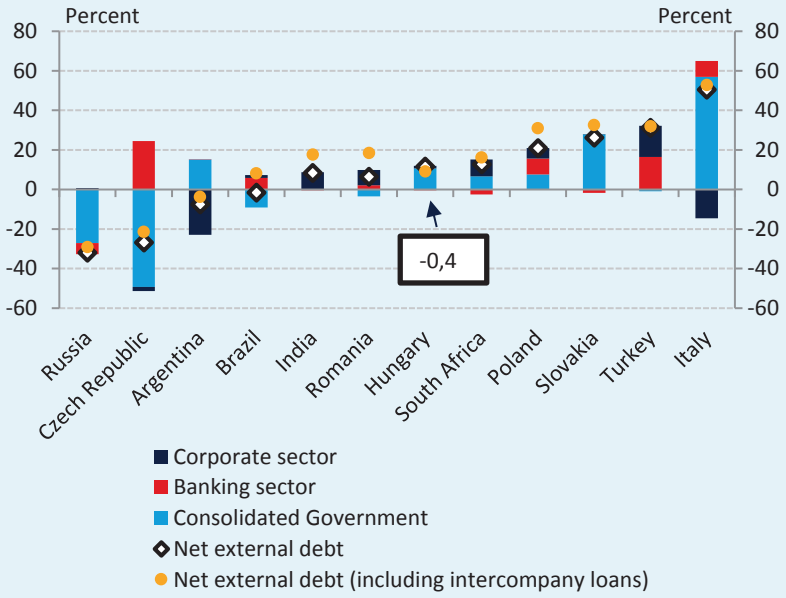
Net external debt provides a more complete picture of the solvency of economic agents compared to gross external debt, as the former takes into account not only the payables but the receivables as well (Chart 30). While gross external debt shows only the external indebtedness of the economic agents of a country, net external debt takes into account not only the liabilities but also how much of debt type assets invested abroad economic agents have. A significant portion of these assets is constituted by the FX reserves held by central banks, which fundamentally ensure the liquidity related to

[2] In the case of special purpose entities (SPEs), the funds that represent external debt are immediately lent on by these entities to another country, and thus the net indicator does not rise, only the gross debt and asset indicators. Accordingly, a possible outflow of this type of external debt is not a problem for the functioning of the domestic economy for two reasons: firstly, the external asset behind it provides 'cover' for this liability; secondly, as these entities do not participate in the real economy, a decline in these liabilities does not have an impact on economic performance (for more details on SPEs, see the October 2011 issue of the MNB Bulletin). An IMF study also called attention to the data distorting effect of SPEs: in relation to that, in its country analysis regarding Hungary, in the case of the external debt indicators the organisation presents the data excluding SPEs (Lane – Milesi-Feretti, IMF Working paper, WP/17/115). In addition, the risk of external debt related to intercompany loans is much lower because the renewal risk of funds received from the parent company by a foreign-owned company operating in Hungary is negligible and their interest rate risk is also much lower than that of a loan with a market interest rate. The lower renewal risk is also corroborated by the fact that the size of loans received from owners did not decline even against the background of a general narrowing of external liabilities following the crisis, i.e. they tended to have a stabilising role. In addition, it is also important to call attention to foreign companies' capital-in-transit transactions: within these, the funds (typically intercompany loans) received by (non-SPE) companies operating in Hungary are transferred on to another affiliated undertaking operating abroad. At the same time, the transaction, which entails an increase in gross external debt, also means the same degree of increase in external assets, and thus the related risk is much lower.

the external liabilities of the general government, but domestic households' and companies' investments abroad also appear here, partly through the banking sector.

Due to the significant decline observed in recent years, the level of Hungary's net external debt is low, and within the region, the indicator is lower only in the Czech Republic. As a result of the post-crisis adjustment, in parallel with the gross external debt the net indicator also decreased considerably. Previously, the decrease was mainly attributable to the decline in external debt, while recently an increase in the private sector's external assets has also contributed. As a result of the latter development, banks and companies may have accumulated a sufficiently large safety buffer that may significantly reduce the negative effects of a possible capital withdrawal. The net external debt of Hungary excluding intercompany loans (and the indicator including intercompany loans) falls in the middle of the field of the countries under review, and can be considered low compared to the other countries of the region. As mentioned above, the operation of SPEs is based on the forwarding of funds, and therefore it usually [3] does not affect the net indicator.

Chart 30: Sectoral breakdown of net external debt, and intercompany loans (as a percentage of GDP, 2017)



Sources: IMF, own calculation.

In Hungary, the net external debt of banks, which turned into negative, can be considered favourable in terms of the country's external vulnerability. At the time of the outbreak of the financial crisis, of the sectors in Hungary, banks had the highest net external debt, which started to decline in 2010. By end-2016, external assets exceeded external liabilities and thus the indicator became negative. Various factors played a role in banks' change-over to internal financing, e.g. the fact that with the decline in FX lending in Hungary they were less and less dependent on external funds.

5.2.4 Short-term external debt and reserve adequacy

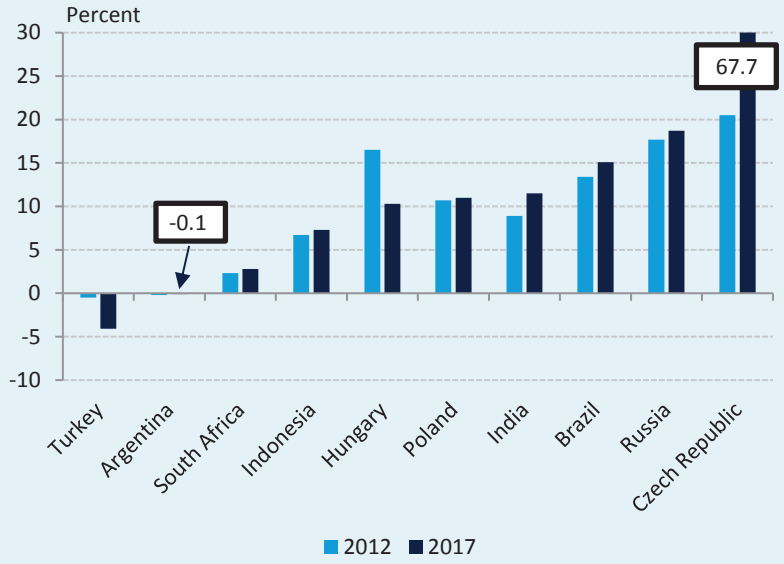
In terms of external vulnerability, the maturity structure of external debt is also of primary importance. The external debt of an economy can be broken down by maturity: debt repayment due over one year (long term) and within one year (short term). Short-term external debt based on original maturity only comprises securities and loans that mature within one year upon issue, while the indicator based on residual maturity also contains the debt whose maturity shortens, which is one of the most important indicators of the assessment of reserve adequacy. The importance of the indicator was strengthened by the financial crisis, as in its initial phase, due to the narrowing of banks' opportunities to borrow long-term loans, the shortening of the maturity structure of external debt posed a major financing risk. At the same time, already following the Asian financial crisis it was expressed that foreign

[3] In the case of asset transformation – if the two legs of the incoming and outgoing funds are equity and debt – capital-in-transit may also have an impact on net external debt.

exchange reserves should be sufficient for a country not to need borrowing from external markets for a year, i.e. FX reserves must exceed the country's debt that matures within a year (Guidotti–Greenspan rule).

In parallel with the dynamic decline in the short-term external debt of the Hungarian economy since 2012, FX reserves considerably exceed the level expected by investors. Similarly to Poland, Hungary is ranked in the middle of the field, and reserve adequacy is not a particular risk factor. At the same time, a significant difference between Hungary and other countries is that in Hungary the dynamic decline in short-term external debt since 2012 has allowed the implementation of measures that entailed a decrease in FX reserves and significantly reduced the country's external vulnerability (e.g. conversion into forints and self-financing). On the whole, the reserve adequacy leeway can still be considered sufficient, since – on the basis of the Guidotti–Greenspan rule, which is carefully monitored by investors as well – reserves exceed short-term external debt by nearly EUR 5 billion. The situation in the Czech Republic was unique, because the indicator under review was already high in 2012, and then, as a result of the application of the exchange rate floor from November 2013, the FX reserves of the economy expanded to a greater degree than short-term external debt (at the same time, it needs to be kept in mind that following the abandonment of the exchange rate floor in the spring of 2017, non-residents did not close their short speculative positions, which – causing significant exchange rate volatility – may pose a risk).

Chart 31: Difference between FX reserves and short-term external debt based on original maturity as a percentage of GDP



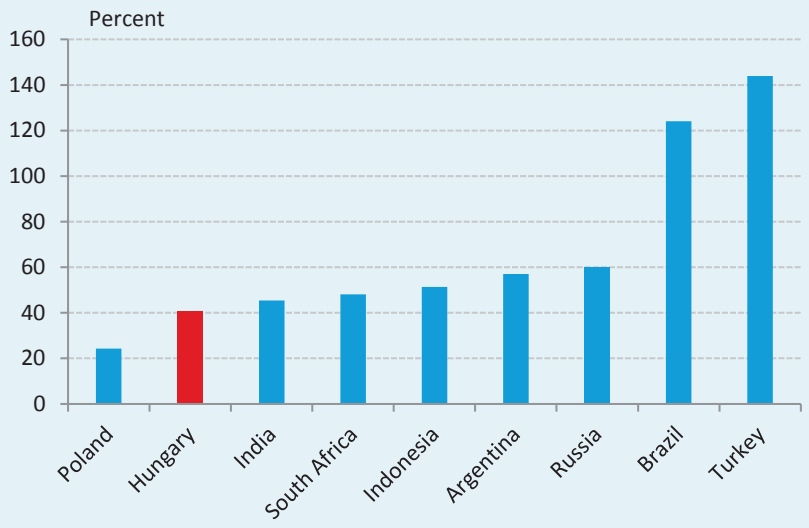
Source: Moody's

5.2.5 FX debt of the private sector

The case of Turkey called the attention of the market to the importance of the high indebtedness of the corporate sector and within that of the role of the significant proportion of foreign currencies. Increasing corporate indebtedness in Turkey cannot be considered a unique case, as it is typical of other emerging countries as well, but the developments in Turkey proved to be outliers. In addition, the high proportion of foreign exchange within the debt increases risks further, which may add to the probability of default if the exchange rate weakens and/or US dollar interest rates rise (see the case of Hungarian households with FX loans following the outbreak of the financial crisis).

The FX debt of Hungarian companies is low compared to the openness of the country (Chart 32). An examination of the indebtedness of non-financial corporations may reveal that companies' high FX indebtedness as a proportion of GDP might pose a risk for Hungary as well. At the same time, it is worth considering that Hungary is a small, open economy, and thus the companies that have FX debt have natural hedge as a result of FX incomes from export activities. Accordingly, the risk of corporate FX debt is better expressed by its ratio to export revenues. Even examining this indicator, it appears that the exposure of Turkey and Brazil is extremely high, due to the relatively low exports, while the exposure of Hungary can be considered low among the emerging countries.

Chart 32: Corporate FX debt as a percentage of exports (2017)



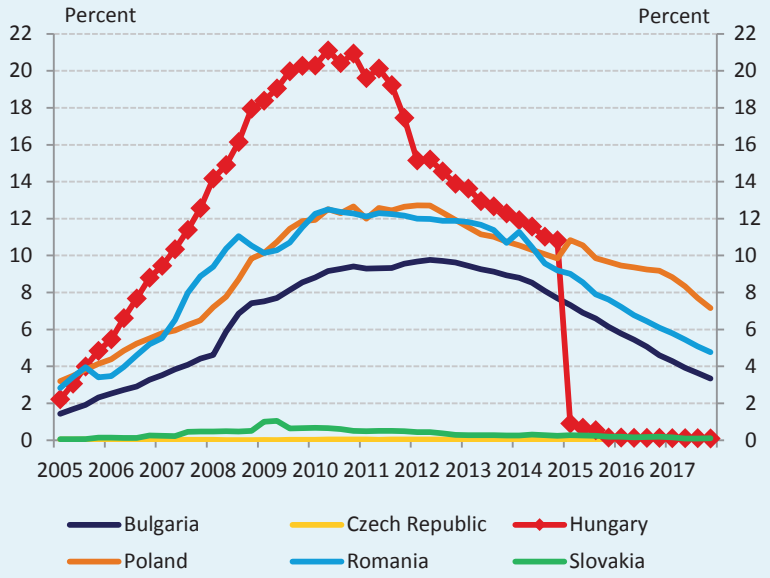
Sources: Nomura (IIF), OECD

Another important factor is that in Hungary a considerable portion of corporate FX loans is denominated in euro, and thus economic agents may be less sensitive to the appreciation of the US dollar. In Hungary, the majority of non-financial corporations' FX loans are denominated in euro; prior to the financial crisis, Swiss franc denominated loans prevailed, which ceased almost completely following the outbreak of the crisis. Vonnák (2015) [4] pointed out that in the case of Swiss franc loans the ratio of non-performance was twice as high as in the case of euro loans, where in certain periods the indicator was even more favourable than for forint loans. This may be explained by the fact that these companies have euro income, which considerably mitigates the risks stemming from non-performance.

While in many countries household FX loans are also sources of risk, Hungary's vulnerability is significantly reduced by the fact that household indebtedness declined considerably following the peak of the financial crisis, and as a result of the conversion into forints, the exchange rate exposure of the sector practically ceased to exist. Following the outbreak of the financial crisis, the default risk of Hungarian households, which were significantly indebted and mainly in foreign currency, considerably increased financial stability risks as well as the external vulnerability of the banking sector and the economy. As a result of the crisis – in relation to deteriorating income prospects – balance sheet adjustment of households started, but indebtedness continued to rise until 2011 due to the revaluation of FX loans because of the weakening of the exchange rate. This was followed by a dynamic decline, supported by households' balance sheet adjustment as well as the prohibition of FX lending and by the early repayment and the natural amortisation of loans. The most significant result was achieved with the conversion into forints in 2014, supported by a decline in FX loans outstanding, a fall in interest rates, the expansion in the central bank's leeway, a decrease in risk spreads and the legislative background (Banai – Kolozsi – Vonnák, Financial and Economic Review, 2015). As a result of the measure, households' exchange rate exposure ended, which had a favourable effect on the stability of the banking sector and the external vulnerability of the economy. By contrast, households' FX loans amount to 7 percent of GDP in Poland, 5 percent in Romania and 3 percent in Bulgaria, indicating higher vulnerability of their household sectors than in Hungary.

[3] http://econ.core.hu/file/download/mtdp/MTDP1528.pdf

Chart 33: Households' FX loans (as a percentage of GDP)



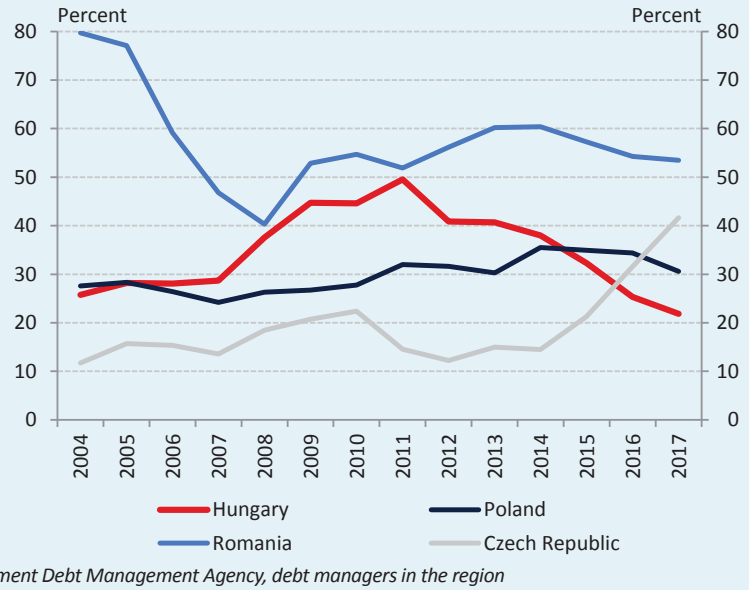
Sources: MNB, national central banks in the region.

5.2.6 Foreign exposure of the government securities market and public foreign currency debt

The high ratio of foreign investors within the state's own-currency debt may result in money market tensions in the event of unfavourable external shocks. One of the experiences of the crisis was that external funds may dry up or investments be withdrawn in a relatively short time. Accordingly, if the ratio of foreign investors is high within the state's own-currency debt, a withdrawal of funds following a shock may lead to a depreciation of the exchange rate and an increase in yields.

In Hungary, the ratio of foreign investors in the market of own-currency government securities is close to 20 percent, which is lower than in the majority of the countries of the region. Of the countries of the region, the ratio of foreign investors in the own-currency government securities market is above 40 percent and 30 percent in the Czech Republic and Poland, respectively. By contrast, according to the latest data, it was close to 20 percent in Hungary, which represents a significant decline compared to the level of 50 percent in 2011. Households' government securities purchases and the increasing government securities holdings of the banking sector contributed significantly to this decline. The increasing weight of the domestic sectors results in more stable financing for the state, thus reducing the refinancing risks of the general government and at the same time lowering the government securities market and FX market risks.

Chart 34: Ratio of foreign ownership in the market of domestic government securities (end-of-year values)



Sources: Government Debt Management Agency, debt managers in the region

5.3 Summary – What do others think about us?

5.3.1 European Commission: Macroeconomic imbalance procedure

The European Commission continuously monitors and assesses the macroeconomic balance position of Member States. The economic governance procedure of the European Union aims at the monitoring, prevention and correction of economic developments that have an unfavourable impact on Member States and the Union as a whole. One of the elements of the economic governance procedure is the Macroeconomic Imbalance Procedure (MIP), which was introduced in 2011, after the occurrence of serious external and/or domestic imbalances (e.g. current account deficit or asset price bubble) following the economic crisis. Every year, the European Union examines the individual Member States within the framework of the European Semester, [5] and prepares an in-depth review (IDR) about the countries where there are signs of excessive imbalance. Depending on the severity of the imbalance, the European Commission formulates economic policy recommendations for the member countries with excessive imbalances, and later regularly checks the implementation of these recommendations. Various indicators of imbalance are examined in the MIP; of them, the current account deficit, the external liabilities to GDP ratio, the real effective exchange rate, the nominal unit labour cost (NULC) and the export market share relate to the external imbalance.

According to the European Commission's latest (2017) report, in Hungary no imbalance can be identified that would justify the preparation of an in-depth review. Serious imbalances developed in Hungary prior to the crisis, and some of them remained after the crisis as well. Accordingly, following the introduction of the MIP, the European Commission formulated proposals in order to resolve the imbalances. In connection with external imbalances, the high external liabilities and debt were emphasised in the country reports on Hungary, but starting from the middle of the decade the gradual decline in risks was underlined. In recent years, with the decrease in external vulnerability Hungary was no longer subject for the MIP, i.e. in the Commission's opinion there were no signs of external imbalance. By contrast, in its latest report the Commission found 12 European countries where macroeconomic developments justify greater attention and the preparation of an in-depth review. Croatia, Italy, Spain and Slovenia are among these countries.

5.3.2 IMF and market analyses

In addition to the European Commission, it is mainly the IMF that monitors global imbalance developments and the external vulnerability of certain countries. Starting from 2015, every summer the IMF publishes its External Sector Report, in which it assesses global developments and also prepares more detailed analyses of the external balance – mainly current account – developments of some selected countries. However, Hungary is not among these countries. The latest report was published in the summer of 2017 and examines the developments until 2016. Consequently, its findings have become outdated in several respects. In addition, also every year, the IMF prepares its Article IV country reports: according to the latest report issued one year ago, improving growth, the persistently high current account surplus and the ensuing decline in debt can be considered favourable in Hungary, and the amount of FX reserves was also considered adequate. It was also added that for resilience to external shocks it is necessary to maintain the current account surplus over the medium term.

As assessed in market analyses, the fundamentals of Central East European countries, including Hungary, are stronger than those of other emerging markets. According to market analyses, the worsening atmosphere observed in recent months had a stronger impact on some countries that are considered more vulnerable, while the fundamentals are more stable in the Central East European countries both in terms of vulnerability and economic activity. In connection with Hungary, most analyses emphasise the current account surplus, the declining debt indicators and the associated decreasing FX ratio. The differentiation among the countries of the region is mostly affected by monetary policy expectations.

[5] The European Semester coordinates the economic policies of the individual countries and supports cooperation. Parts of the Semester are, inter alia, the analyses prepared by the Commission.

List of charts

Gábor Bethlen

(15 November 1580 – 15 November 1629)

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

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

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

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

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