



REPORT ON THE BALANCE OF PAYMENTS



APRIL
2014

*'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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Published by the Magyar Nemzeti Bank

Publisher in charge: Eszter Hergár

9 Szabadság tér, H-1850 Budapest

www.mnb.hu

In accordance with Act CXXXIX of 2013 on the National Bank of Hungary, the primary objective of the MNB is to achieve and maintain price stability and, without prejudice to its primary objective, the central bank is also responsible for maintaining the stability of the financial intermediary system. Developments in the external balance are key to financial stability, as processes relating to the balance of payments allow for conclusions to be drawn concerning the sustainability of economic growth and relevant risks. Moreover, analysis of the balance of payments makes it possible to identify and take actions to avoid economic problems earlier, when they are develop.

To that end, the Magyar Nemzeti Bank carries out comprehensive analyses of trends relating to Hungary's external balance on a regular basis, examining a number of indicators to assess macroeconomic imbalances and identifying elements and processes of critical importance for Hungary's vulnerability.

Given the lessons learned from the financial crisis and the recent period, the balance of payments of a given country and trends therein indicating potential dependence on external financing are particularly important in the economic press. Developments in the external balance position are also closely monitored by market participants and analysts. Therefore, the primary goal of the publication entitled Report on the Balance of Payments is to inform market participants – by way of this regular analysis – about developments in the balance of payments and thus provide deeper insight into the workings of the economy.

This analysis was prepared by the MNB's Directorate for Monetary Policy and Financial Market Analysis, Directorate for Fiscal Analysis and Directorate for Economic Forecast and Analysis, under the general guidance of Dániel Palotai, Executive Director in charge of Monetary Policy. Contributors: Gergely Baksay, Csaba Csávás, Zsuzsa Kékesi, Balázs Kóczián, Péter Koroknai and Ádám Martonosi. The report was approved for publication by Deputy Governor Dr. Ádám Balog.

The report reflects the views of staff at the organisational units concerned, and does not necessarily reflect those of the Monetary Council or the MNB.

This report is based on information in the period to 1 April 2014.

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Summary

Hungary's external balance has improved considerably in recent years. Profound adjustments in the private and the public sector have enabled the current balance to turn into a surplus, Hungary's net external debt to diminish as a result of repayments of foreign loans and, consequently, the dependence of Hungary's economy on foreign financing sources to diminish. **Hungary's net lending – which is high even by regional standards – has been shaped by the adjustment processes taking place in the economy and can be interpreted from a variety of statistical perspectives.**

On the one hand, trends in the real economy show that in the wake of the crisis each of the three components (trade balance, income outflow and transfer inflow) contributed to net lending. Domestic absorption, which declined due to deteriorating income trends and limited borrowing options, improved the trade balance, while declining profitability rates in the corporate sector had an upward effect on the income balance, and the rising use of EU transfers improved the balance of transfers to a considerable degree. The surplus on the trade balance approached 8 per cent of GDP in 2013, a significant ratio even by EU standards. The increase in Hungary's net exports was driven primarily by an upswing in automotive manufacturing and by the export-boosting effect of growing external demand, while internal demand rose slightly. Moreover, the moderate decline in interest expenditure brought about by a decrease in external debt and the high volume of EU transfers allowed Hungary to achieve an unprecedented net lending position of nearly 6.5 per cent of GDP in 2013. This historically high net lending was the combined result of a current account balance that rose to approximately 3 per cent of GDP and a capital account amounting to 3.5 per cent of GDP.

On the other hand, financing trends show that in the years following the crisis Hungary made substantial payments on its external debt, while foreign direct investment continued to flow into the economy. This trend continued in 2013: substantial net lending along with the inflow of working capital saw Hungary's net external debt decrease by EUR 9 billion. In the wake of the crisis, it was the external debt of the banking sector that shrank the most: the large scale placement of deposits and very subdued lending were reflected in the withdrawal of funds from the banking sector. However, the rate of this withdrawal has been moderated during the past quarters, likely in part due to a portfolio rearrangement caused by retail customers' preference for government bonds and investment fund units over bank deposits. At the same time, this trend may also have contributed to the general government sector reducing its reliance on foreigners' government bond purchases, resulting in a sharper decrease in net external public debt.

The net external debt rate determined by financing developments has been gradually decreasing in recent years, i.e. Hungary's external indebtedness has also moderated. The continued decrease in the net external debt of the state, banking and corporate sectors in Q4 pushed net external debt down to 35 per cent of GDP, significantly lower than both pre-crisis levels and the historic high of more than 60 per cent registered in early 2009. At the end of the year, short-term external debt, which is particularly important as regards vulnerability, stood at the level prevailing in 2013 H1, i.e. around EUR 28 billion. In other words, despite a considerable net lending position, Hungary's gross external borrowing remains elevated.

Finally, looking at the external balance from a sectoral savings standpoint, it is clear that Hungary's robust net lending has been made possible by the massive net saving of the household and corporate sectors, as well as by the tight spending control of the general government. In 2013, the net borrowing of the general government rose slightly, but remained below 3 per cent of GDP. The net savings of the corporate sector increased substantially in the course of the year, presumably thanks in part to large EU transfers, while household savings stabilised at a high level.

Comparing Hungary's trends to those of EU countries, it can be concluded that, although the Hungarian economy has accomplished a very significant adjustment, its external debt rate is still relatively high. In comparison to developments in the external balance of other countries in the Central and Eastern European region, the Hungarian economy is performing well

on a number of metrics. Firstly, Hungary's surplus on the trade balance far outstrips those of other Visegrád countries, in which changes in the relevant terms of trade played an important role. Moreover, EU transfers made an above-average contribution to the increase in Hungary's net lending. On the savings side, the low budget deficit and the level of household savings – which is remarkably high in international comparison – should be highlighted. Despite the favourable trends, however, Hungary's external indebtedness continues to exceed the regional average, which warrants the continued close monitoring of developments in the external balance.

1 Introduction

On numerous occasions, the events following the outbreak of the crisis have underlined the importance of balance of payment trends in the economy. On the one hand, the higher the current account deficit was in a country affected by the recession, the more dramatically its economy plummeted in the wake of the crisis. As previously abundant external funding sources dried up, strong adjustments were necessary in consumption and investment demand – in other words, Hungary’s earlier dependence on the external environment had a severe impact on the country during the crisis. On the other hand, even the mere news of a possible slow-down in the asset purchase programmes caused major turbulences in the market, and countries with adequate external balance ratios, which are thus less strongly dependent on foreign financing, proved to be more resilient in this situation. The Magyar Nemzeti Bank has always paid particular attention to changes in external balance trends, and in the future we wish to communicate the relevant internal analyses to a wider audience.

This report presents an analysis of trends in the balance of payments from the following three key aspects: the real economy, the structure of financing (financial balance) and the savings of various sectors, in other words their respective contributions to net lending (Chart 1), along with a discussion of changes in the portfolios of receivables from and liabilities to foreign partners.

1. According to the *real economy approach*, net lending is the part of income that is not spent on consumption or investment (for more detail, see Box 1). Accordingly, the three main components of net lending are as follows. The first item is the balance of goods and services, i.e. the net export balance of a country. The second component is the income balance, which represents the cumulative inflows and outflows of employee and shareholder income (profits, bond yields, dividend payments, income transferred home by those working abroad). The third main category is the balance of (unrequited) transfers to and from the country, comprising unrequited transfers stemming from the current account as well as the capital account.

Since EU transfers can be reflected both in the capital account and on the ‘unrequited transfers’ row of the current account, by analysing a country’s net position we examine the developments in the current and capital accounts, i.e. the country’s external financing capacity. If the overall balance of the current account and the capital account is positive, we talk about net lending, whereas a negative balance indicates net borrowing.

2. The *financing approach* is based on the financial balance component of the balance of payments, which indicates the foreign sources used by an economy to finance its spending beyond its income (where there is a need for external financing), or the financial transactions made with its residual income (where there is a financing capacity). Under this approach, the current account balance is divided, according to influx type, into debt-type (typically a type of loan) and non debt-type items (working capital or shares). It should be noted that changes in external financing can be classified not only according to the type of funds, but also according to the borrowing sector (general government, corporate, banking).
3. According to the *savings approach*, the net lending of a country can also be distributed between the sectors of the economy: the government, corporations and households.¹ Ultimately, the portion of income generated by the sectors of the economy that is not spent on consumption or accumulation indicates the country’s net financing capacity. In other words, the sum of the net financial savings of individual sectors (households, corporations, general government) equals the country’s net lending.

Theoretically, the three approaches arrive at the same result. Real economy processes are in fact reflected in financing developments: if, for example, the sum of the current account and the capital account is positive – as has typically been the case in the Hungarian economy in recent years – this will be reflected by positive sectoral savings positions, while the financial account will indicate an outflow of funds

¹ In the category of financial enterprises the MNB is, by its very nature, regarded as part of the general government and in the following part of the analysis the term ‘general government’ refers to the consolidated general government including the MNB. It should be noted here that, to make this paper a more convenient read, the households sector is often referred to simply as ‘households’.

(negative balance). This means that the total balance of payments should theoretically be zero. Data derived from the different approaches should be identical, but temporary differences are likely to arise due to non-integrated data sources, incomplete observation and the different handling of the exchange rate, which are then indicated under 'Net errors and omissions'. Nonetheless, developments in the real economy and financing appear to be largely similar over the long run.

The following two simple examples show how an economic event involving a foreign counterparty can appear – *ceteris paribus* – depending on the approach taken:

- If a Hungarian enterprise is exporting goods or services,
 - a. firstly, it adds to net exports, thereby increasing the net lending of the real economy;
 - b. secondly, it is paid in foreign currency (foreign assets) in exchange for the exported goods or services, and thus its foreign financial assets increase in the balance sheet, or it repays its foreign loan using the foreign exchange received;
 - c. thirdly, the transaction increases the savings of the corporate sector.
- When a Hungarian household repays its bank loan,
 - a. by reducing its liability it increases households' net financial savings;

Chart 1
Net lending according different approaches

(schematic chart using 2013 data)

Real economy approach		Sectors' savings position		Financing approach		
Net external position (current and capital account)	Trade balance 8.0%	Current account 3%	Net external position (net savings position, external outflows)	Government -2.9%	Debt -8.9%	Government -4.2%
	Income balance -6.0%			Households 5.3%	Foreign direct investments (FDI) 1.4%	Banking system -2.1%
	Transfers 4.5%			Corporates 5.1%		Corporate -1.2%
	Capital account 3.5%		Net errors and omissions 1%			

- b. if the bank does not wish to extend another loan, it repays its external debt using the repaid loan amount (if the previous loan was disbursed using funds borrowed abroad);
- c. the consumption of the sector will be less than its income, thus improving its current account balance.

Box 1
Net lending according to the real economy approach

The following is a drastically simplified illustration of the underlying logic of the real economy approach.² It should be emphasised right at the start that the formulae do not refer to any causal relationship at all – they only contain consistencies stemming from the accounting principles. Generally speaking, it should also be noted that, owing to the matching of the processes identified in the current balance, a variety of interpretations may be valid in relation to processes taking place in the Hungarian economy. It can be argued that, on the one hand, the trade surplus makes it possible for Hungary to repay its foreign loans. On the other hand, it is also true that since we are unable or unwilling to borrow, imports will remain low, which contributes to maintaining the considerably high trade surplus.

As noted, the unspent part of the income is referred to as the net lending (NL) calculated from the aspect of the real economy. In simpler terms, this means that the external balance position can also be regarded as the difference between the country's gross national disposable income (GNDI) and domestic absorption [household consumption (C), governmental (G) consumption and investments (I)]. In addition to disposable income, however, the sources of domestic absorption (and thus the financial savings) may also include capital transfers appearing in the capital account, so this should also be included in the national economy's income in a broader sense of the term.

(1) *Net lending = income in its broader sense – domestic absorption*

(2) $NL = GNDI + \text{capital transfers} - (C+I+G)$

² For an accurate, detailed explanation see the MNB publication entitled 'External accounts statistics, Hungary 2012'.

Accordingly, there is net lending if there is a positive difference between income in its broader sense and domestic absorption, i.e. if the sum of the national economy's spending on accumulation (investment and inventories) and consumption falls short of the country's disposable income (if spending exceeds income, the country is in need of external financing).

The net lending is explained through a breakdown of GDP and GNDI:

$$GNDI = GDP + \text{net external income} + \text{current transfers}$$

$$GDP = C + I + G + X - M$$

Net lending is derived from the above:

$$(3) NL = C + I + G + X - M + \text{net external income} + \text{current transfers} + \text{capital transfers} - (C + I + G)$$

$$(4) NL = X - M + \text{income balance} + \text{current transfers} + \text{capital transfers}$$

$$(5) NL = \underbrace{X - M + \text{income balance} + \text{current transfers}}_{\text{current account balance}} + \underbrace{\text{capital transfers}}_{\text{capital account}}$$

It follows from the above that net lending equals the sum of net exports (X-M), the income balance and the balance of unrequited transfers and capital transfers (transfer balance). Alternatively, on the basis of another grouping of the components, it equals the sum of the current account balance (CA) and the capital account.

This report applies the following train of thought. The real economy approach to the balance of payments is discussed first, starting with the main components including net exports, income balance and transfer balance. This is followed by a discussion of the financing processes, reviewing trends in non-debt type investments (primarily: FDI) and debt-type investments. After transactional data, a detailed discussion

of volume indicators is provided in Chapter 4, focusing primarily on debt ratios – primarily, short-term debt – which is of great relevance to Hungary's external vulnerability. Chapter 5 deals with the third approach to net lending, that is, the savings positions of the different sectors. Finally, Chapter 6 offers an analysis of Hungarian balance of payments data in an international – primarily regional – context.

2 Real economy approach

Following the onset of the crisis, net lending calculated on the basis of the real economy approach grew considerably, reflecting the rise in net exports – which was partially driven by external demand – and the increasing use of transfers from the EU. In the wake of the crisis, the income balance deficit declined due to foreign companies' lower profits and has since been eroding the Hungarian economy's balance position at a near-constant level. In 2013 Q4, the Hungarian economy's net lending grew stronger, primarily due to the growing surplus on the transfer balance, while the balance of goods and services showed a slight decrease. The dynamic rise in the transfer balance from mid-2012 onwards may be linked to the increase in the amount of EU transfers utilised by domestic economic agents, a trend which continued into the fourth quarter of the year, despite a temporary suspension of payments.

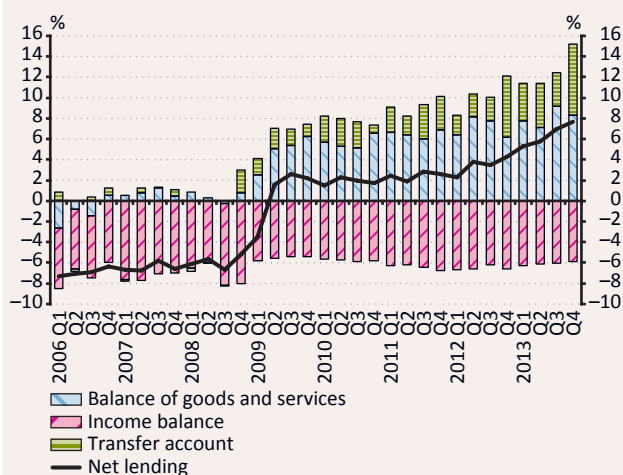
In the real economy approach, the net lending of the Hungarian economy improved somewhat in 2013 Q4 and approached 8 per cent of GDP. Based on real economic data, in 2013 Q4 there was a continued increase in the seasonally unadjusted net lending calculated to over EUR 2 billion, of which more than EUR 0.6 billion was accounted for by the current account surplus, while the capital balance (with capital transfers included) amounted to EUR 1.4 billion. Based on seasonally adjusted data, net lending from real economic data increased slightly in 2013 Q4, approximating 8 per cent of GDP. The massive net lending reflected both the trade balance, which remains at a significant level, and the high

transfer balance. Nevertheless, it should be noted that the strong and improving net lending was achieved despite the fact that the income balance deficit has been deteriorating the balance position of the economy at a nearly unchanged extent during the period under review (Chart 2).

Net lending in 2013 accounted for 6.5 per cent of GDP, showing considerable growth (Chart 3). In addition to an increase in both EU transfers and the trade balance surplus, a slight decline in the income balance deficit also contributed to the improving savings position of the economy. The rise in the trade surplus to unprecedented levels was likely mostly driven

Chart 2
Developments in net lending and its components

(seasonally adjusted figures,* as a percentage of GDP)

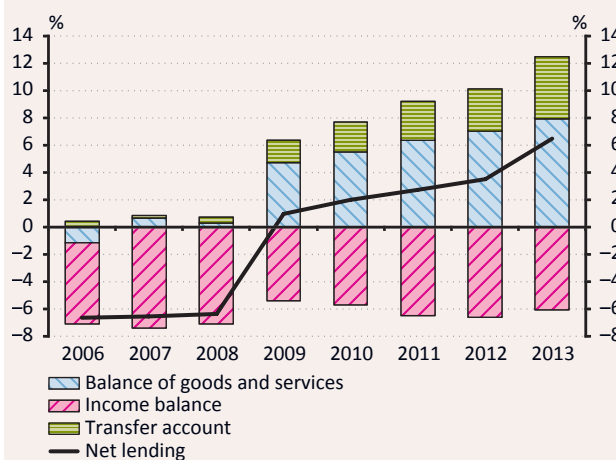


* The time series is adjusted directly for seasonal effects; therefore, the sum of the adjusted components of net lending does not necessarily match the adjusted figures of net lending.

Source: MNB.

Chart 3
Developments in net lending and its components

(annual figures, as a percentage of GDP)



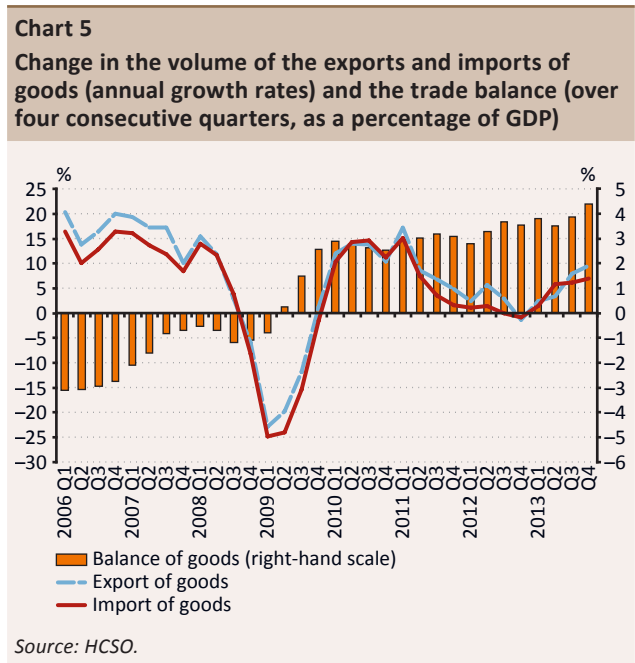
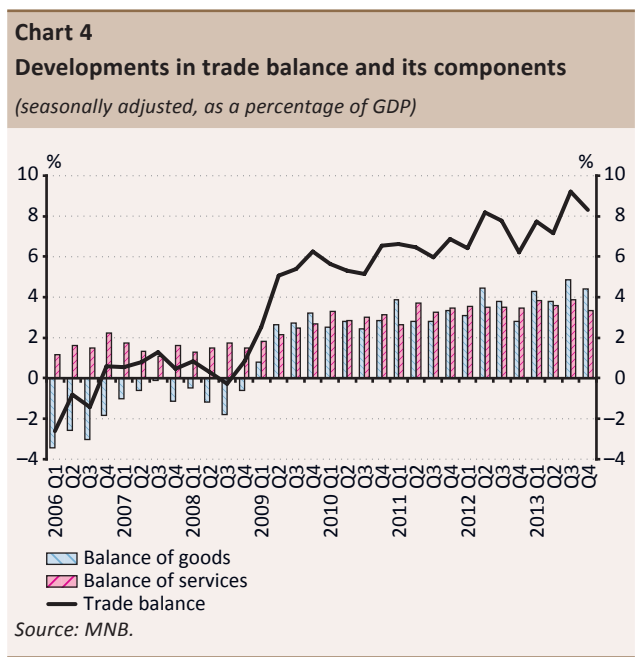
Source: MNB.

by the commissioning of new automotive manufacturing capacities. The utilisation rate of EU transfers was also well above those observed in previous years: higher payouts are concentrated to the end of the EU’s 2007-2013 budget period (and likely in the two years thereafter). The moderate decline in the income balance that was observed in 2013 was mostly due to a decrease in interest on intercompany loans. As a result of these processes, the current account balance rose to a record high of 3 per cent of GDP, while the capital account increased to 3.5 per cent of GDP, both of which contributed to Hungary’s record high net lending.

2.1 BALANCE OF TRADE

Although the trade surplus – in line with the balance of goods and services – dropped in Q4, the rate of this decline fell short of that seen at the end of 2012, and thus the trade surplus remained above 8 per cent of GDP. The net balance of trade in goods and services each accounted for approximately half of the trade surplus. The increase in Hungary’s exports of goods over past periods was supported by the commissioning of new automotive industry capacities. Another factor driving the increase in the surplus was the fact that import growth came to a halt, as one-off impacts observed in earlier quarters (e.g. public transport procurements) faded. The balance of services has been relatively stable in recent years (for quite some time, services have accounted for about 50 per cent of the trade surplus), with the slight decrease seen during the second half of 2013 mainly stemming from a rise in imports of services.

During the second half of 2013, exports of goods grew faster than imports, and thus trade in goods for the four quarters



increased further by the end of the year. In real terms, exports had been growing faster than imports even before the crisis, but it was not until 2009 that the balance of trade turned positive, primarily owing to differences in the levels of exports and imports. Both imports and exports plummeted during the crisis, as a result of contracting domestic absorption and a decline in external demand. In the wake of the crisis, as the global demand environment recovered, Hungary’s exports picked up faster, while the volume of imports grew less dynamically owing to persistently weak domestic demand. In recent quarters, export growth has been accelerating gradually, primarily due to the gradual deployment of new production capacities, in parallel with an increase in external demand.

Developments in the export of goods in recent quarters has been shaped by a gradual recovery in external demand. Among Hungary’s main trading partners the strongest pull on exports was generated by the accelerating performance of the German economy. Only part of the German import demand related directly to consumer goods – Hungarian exporters played a major role as suppliers as well. A portion of Hungary’s exports end up on the US market and in developing Asian markets after further processing in global manufacturing chains. Developing country demand for imported goods plays an even more important role for Hungary’s exports through these connections. In the wake of the preceding year’s recession, 2013 saw accelerating economic growth in Hungary’s main export market, the European region. Another factor worth mentioning is the significant rise in export orders for Hungarian industrial goods seen during Q4, which, similar to the year-end processes of 2012, was due to the fact that

Chart 6
Developments in new export orders in industry and in orders for industrial goods from Germany (change in percentage rates, relative to 2005), and the IFO index



Source: HCSO, IFO Institut, Destatis.

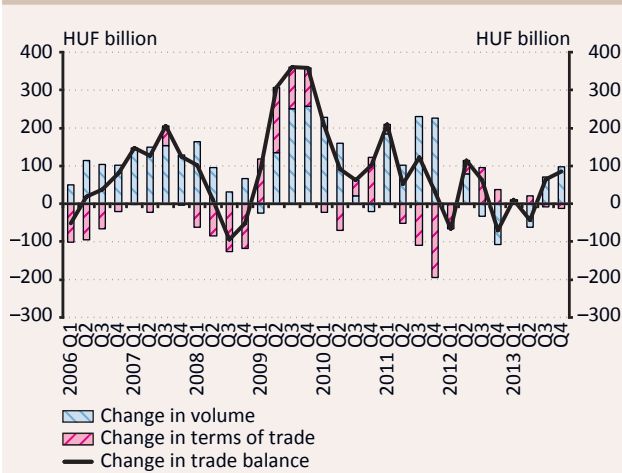
major automobile manufacturers placed most of their orders for the entire year in a single quarter.

From the aspect of improvement in the balance of goods, the importance of changes in the terms of trade has been diminishing in recent quarters. In the initial phase of the crisis, the change in the terms of trade contributed substantially to the rise in the balance of goods. During 2013 H2, the improvement in the terms of trade also added to the growth in the surplus on the balance of trade in goods, for the most part as a result of a decrease in raw material prices. Declining raw material prices pushed both export and import prices down, but the fall in oil prices restrained import price changes to a stronger degree. In view of Hungary’s foreign trade prices, the terms of trade stagnated both at the end of the year and throughout 2013 overall.

The newly launched automotive manufacturing capacities gradually boosted Hungary’s exports, while exports of electronic goods declined somewhat. The crisis was followed by restructuring within Hungary’s manufacturing sector, leading to a significant decrease in electronics sector output. This trend continued into 2013, even though at this point it was only partially attributable to capacity downsizing.

In addition to faster export growth, demand for imports also increased slightly towards year-end. In the wake of the crisis, Hungary saw its imports shrink – partly as a result of weaker demand for imports due to falling production, and partly as a consequence of falling investment activity and consumption of domestic economic actors, with the latter triggered by a crisis-induced deterioration in their income

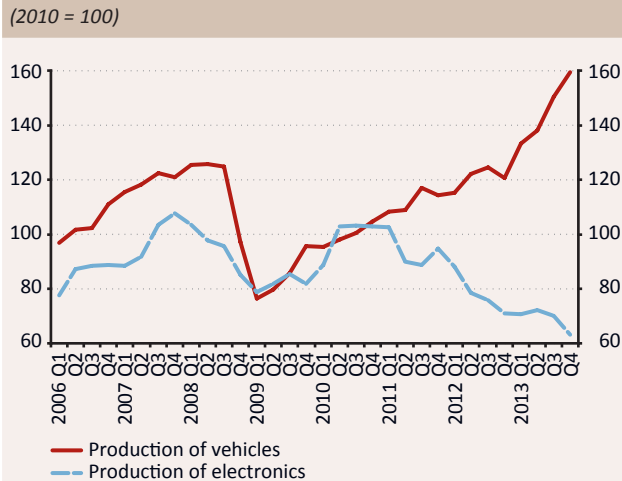
Chart 7
Developments in the factors of trade in goods (year-on-year)



Source: HCSO.

position and a shortage of bank financing. After the crisis, production recovered in parallel with the external demand environment, while domestic actors’ demand for imports was very weak as a consequence of the balance adjustment necessitated by the elevated debt. The structure of economic growth became increasingly balanced over the course of 2013: in contrast to the past, the rates of growth of both consumption and investment have been growing gradually. While external demand increased, import growth slowed in Q3, resulting in a rising trade surplus. At the end of last year, domestic investments grew at the fastest rate, primarily due to accelerated utilisation of EU funds, but the investment-

Chart 8
Developments in the output of the automotive and electronics sectors (2010 = 100)



Source: HCSO.

Chart 9
Annual rate of increase in domestic absorption and the contribution of net export to GDP growth

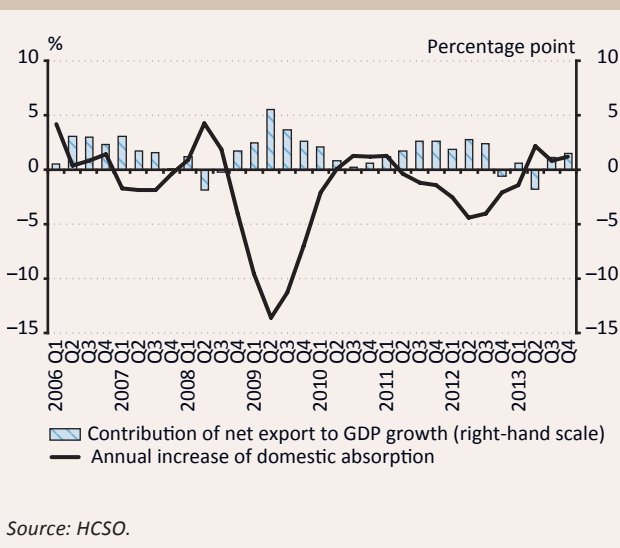
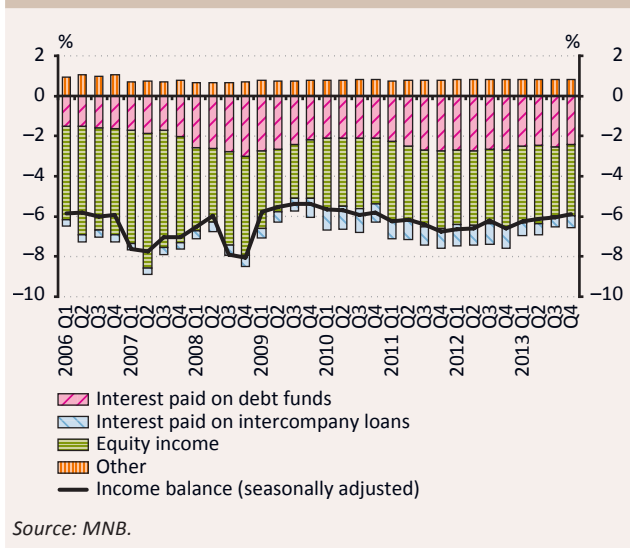


Chart 10
Developments in the items of the income balance (relative to GDP)



boosting effect of Phase 1 of the FGS is also likely to have played a minor role.

2.2 INCOME BALANCE

Relative to previous quarters, the income balance deficit only decreased at a modest rate in Q4, and the trend of rearrangement seen previously among the components of the balance continued. The seasonally adjusted income balance deficit amounted to 5.9 per cent of GDP, which was only marginally lower than the average quarterly ratio recorded in 2012. After a temporary stabilisation in Q3, interest paid on loans borrowed earlier decreased yet again (this applies to loans and bonds, with interest rates payable on intercompany loans³ provided to Hungarian subsidiaries stagnating). Consequently, the minor improvement in the income balance in 2013 was primarily due to the decline in interest paid on loans (Chart 10).

Little data is available on income outflows relating to shares. Only a limited amount of quarterly data is available on the profitability of foreign-owned enterprises operating in Hungary, and therefore information on quarterly profit outflows are based on estimates for the most part.⁴ As regards outflows of income in relation to shares, data is available concerning dividends, according to which Q4 dividends were slightly below seasonal expectations, with annual dividend payouts amounting to approximately EUR 3 billion, similar to the 2012 figures. It should nevertheless be noted that, since

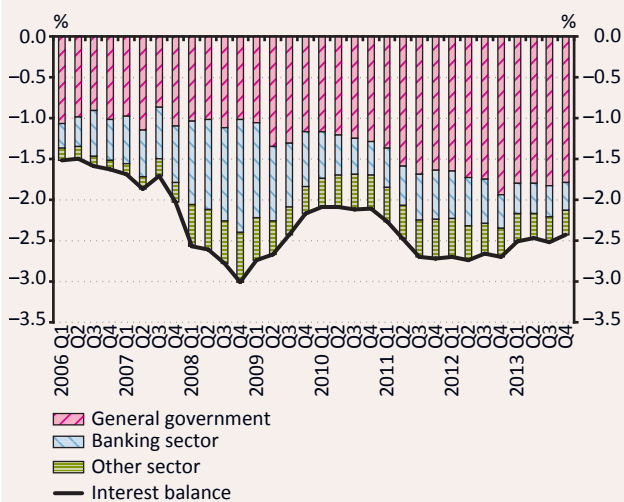
in recent years some 75% of dividends were paid out in Q2 each year, Q4 data conveys relatively little information.

Following the stabilisation seen in Q3, the interest paid on foreign debt liabilities decreased further in Q4, amounting to approximately 2.4 per cent of quarterly GDP. In comparison to 2012, the amount of interest paid to foreign recipients on the basis of various market loans and bonds fell by 0.2 per cent of GDP in 2013. Of the total decrease, the amounts paid by banks in the form of interest fell most significantly, but the amount of interests paid by the other sectors, predominantly the corporate sector, also decreased. The downward change was mostly driven by the decrease in foreign debt: in 2012-2013, banks' net external debt shrank by some EUR 7 billion overall, while corporate sector debt fell by close to EUR 3 billion, thereby reducing the income balance deficit. During the same period, the net external debt of the general government sector also decreased substantially (by about EUR 7 billion), nonetheless the amount of interest transferred abroad by the state did not change significantly in 2013, as a consequence of changes in the structure of the net debt. On the one hand, in 2013 the state – with a view to decreasing the foreign exchange part of debt – financed its deficit and its maturing debt (part of which was denominated in foreign currencies) by issuing HUF government bonds which were purchased by foreign investors as well, which had a nominal interest rate higher than the interest rates on repaid foreign exchange loans and bonds, which in part reflects the costs of eliminating exchange rate risk. It is also true, however,

³ For purposes of this analysis, intercompany loans are typically treated as items not qualifying as debt financing – see Box 3 for more details.

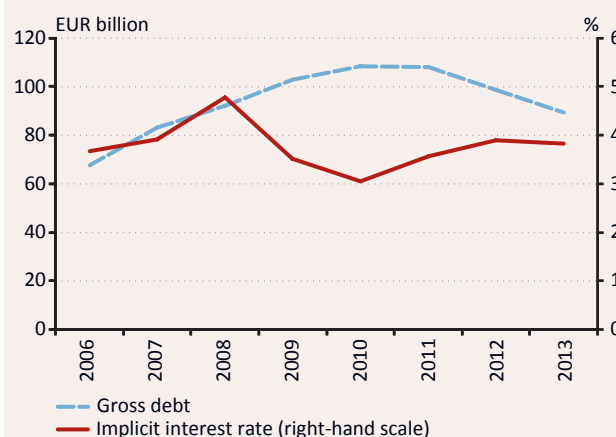
⁴ For more detail, see the statistics publication entitled 'Hungary's Balance of Payments and international investment position statistics, 2012'.

Chart 11
Developments in the interest balance and its breakdown
(as percentages of GDP)



Source: MNB.

Chart 12
Developments in average gross external debt and its implicit interest rate



Note: Debt does not include intercompany loans.

Source: MNB.

that part of the government bonds denominated in HUF were purchased by Hungarian investors, reducing thereby the amount of interest paid to non-residents.⁵ On the other hand, the early repayment scheme and the foreign exchange required for the repayment of public foreign exchange loans resulted in a significant decrease in the MNB's foreign exchange reserve, as a result of which the interest revenue on the foreign receivables of the state consolidated with those of the MNB decreased substantially in comparison to the earlier amounts.

The improvement in the interest balance was mainly driven by the decrease in external debt, and the implicit interest rate on the portfolios remained around 4 per cent. The interest balance is determined by interest paid on the foreign loans of the domestic sectors; therefore, the following section provides a more in-depth analysis of interest payments (owing to the distorting effect on data of the foreign exchange reserves, which are by their nature composed of safe assets, an analysis of the gross amounts seems more appropriate). The amount of interest payable during a given quarter is determined by two main factors: the outstanding portfolio and the applicable interest rates. The net lending seen since the onset of the crisis and, after a temporary halt,

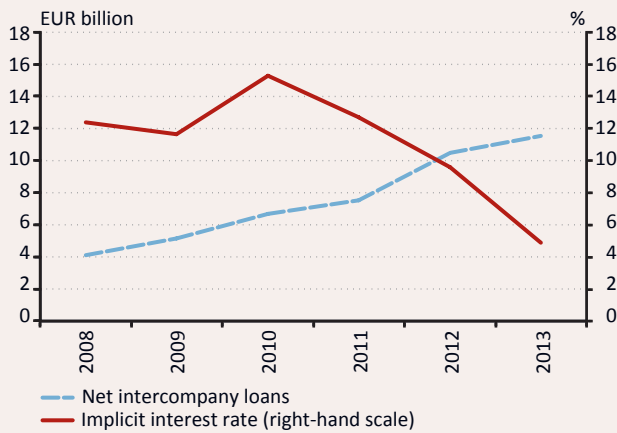
the steady FDI influx have resulted in a substantial decrease in average external debt, which at the end of 2013 stood at 88 per cent of GDP. By contrast, the implicit interest rate, the other dominant factor affecting interest payments which is calculated as the ratio of the average current debt volume to that of the preceding year, was actually higher in 2012-2013 than in the years following the crisis, which slowed down the improvement of the interest balance caused by the decrease in debt volume.⁶ The implicit interest rate remained around 4 per cent in 2013.

In the case of intercompany loans – as the combined result of effects opposite to those of debt-generating funds – the amounts of interest paid in the previous year decreased. The net volume of intercompany loans – categorised as direct investments – has increased substantially in recent years (due to the significant amount of capital in transit, it is more appropriate to present net data instead of the gross data applied to debt-generating funds). By contrast, the rate of implicit interest paid on intercompany loans declined steadily from 2010 (Chart 13). Consequently, despite the substantially larger net portfolio, the interest income outflow associated with intercompany loans has fallen to a level not recorded since the onset of crisis (Chart 10). It should also be noted

⁵ At the same time, via a lower reserve level, the shift to HUF financing also contributed to the reduction in interest paid by the MNB (primarily to domestic agents) on two-week bonds.

⁶ Developments in the implicit interest rates do not necessarily reflect the changes in the current levels of interest, because at present interest also needs to be paid on debt originating from earlier periods at their applicable rates (e.g. fixed interest-bearing debt); in other words, the repricing of the total debt volume with the new interest rates may, in view of the multiple-year average maturity period, prove to be a lengthy process.

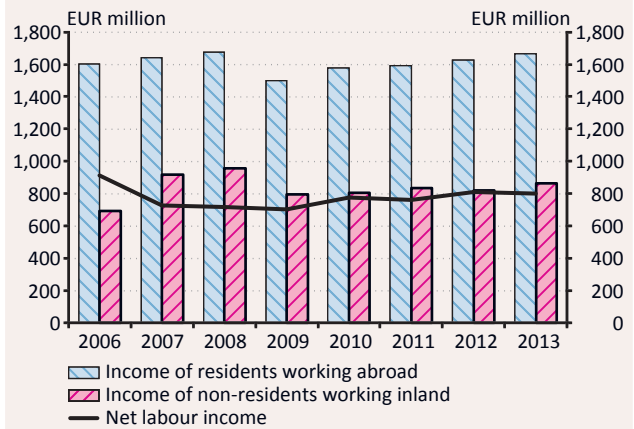
Chart 13
Developments in the net portfolio of and implicit interest rates on intercompany loans



Note: Owing to changes in the methodology applied in relation to the current account, comparable data is available only for the period since 2008.

Source: MNB.

Chart 14
Incomes of resident employees working abroad



Source: MNB.

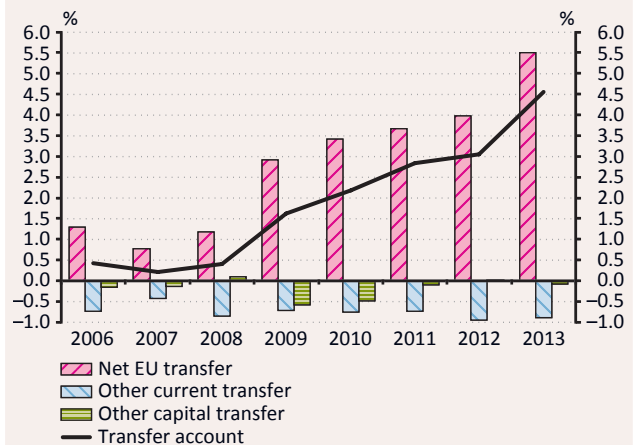
in relation to intercompany loans that, owing to parent companies' financing policies, the interest rates payable on such portfolios do not necessarily reflect market rates.

The net amount of income of resident employees working abroad was around EUR 0.8 billion, which is more or less consistent with the level observed in recent years. The income of those employed abroad also remained more or less unchanged. The approximately EUR 0.4 billion income in Q4 means that the annual amount continues to be around EUR 1.6-1.7 billion. It is also worth noting that non-residents working in Hungary also earn a substantial amount of income, equalling about half of the income earned by residents employed abroad. Accordingly, in 2013 the income of resident employees working abroad improved the income component of the current account by a net amount of approx. EUR 0.8 billion. The income component of the balance of payment statistics only comprises incomes of those employed abroad for less than one year. Remittances of those employed for longer periods of time are recognised in the 'current transfers' row. This amount, however, is negligible in comparison to the income of those employed for less than one year.

2.3 TRANSFERS

The increase in the balance of transfers since end-2012 is linked primarily to the growing use of EU grants. In addition to current transfers, the balance of transfers comprises capital transfers as well. To obtain a full view of Hungary's position relative to non-residents, in addition to the current

Chart 15
Developments in the transfer balance
(as a percentage of GDP)



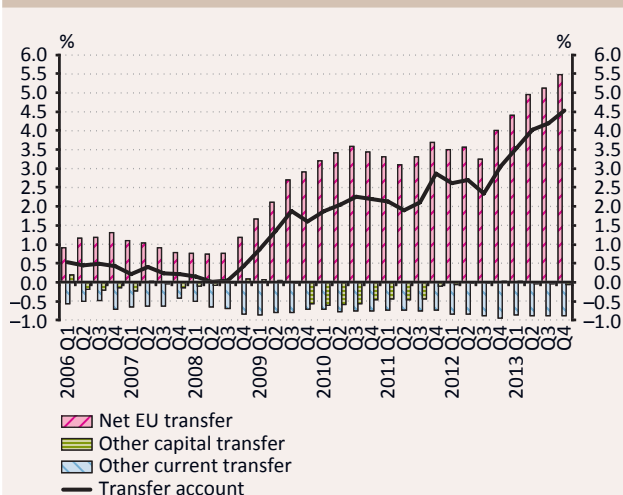
Source: MNB.

account, the capital account should also be taken into consideration: on the one hand, this is where the bulk of the amounts received from the EU are stated; on the other hand, capital transfers also provide Hungary's economy with external funding. While current transfers are usually regular transfers of small amounts comprised in the recipients' incomes (e.g. agricultural subsidies), capital transfers are occasional transfers of large amounts, adding to the assets of the transferees (e.g. investment subsidies). The increase in the balance of transfers in recent quarters has predominantly

Chart 16

Developments in the transfer balance

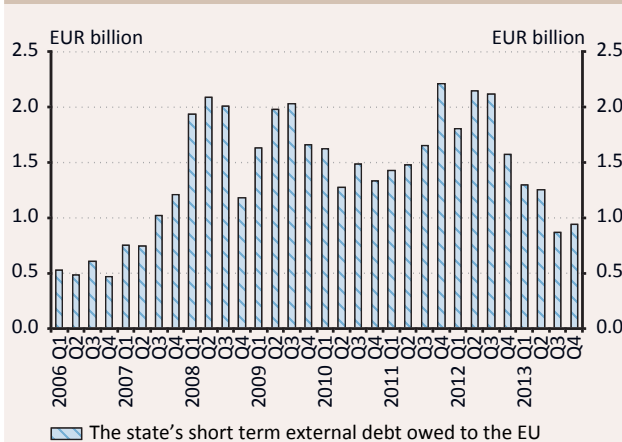
(four-quarter data as percentages of GDP)



Source: MNB.

Chart 17

Developments in the state's short-term external debt owed to the EU



Source: MNB.

been the result of the rising use of EU transfers. The other main element of the balance of transfer is other current transfers including primarily transfers in the private sector, social security contributions and taxes paid abroad. The amount of such transfers – which affect the economy's savings position negatively – reduced the transfer balance relatively steadily by 0.5-1 per cent of GDP annually.

The dynamic growth in the use of EU transfers which began in 2012 H2 continued in 2013 Q4. The amount received by Hungary in the form of EU grants significantly exceeds the amount contributed by Hungary to the EU budget. Since its accession to the EU, Hungary has received large amounts of grants: by the end of 2013 Q4 domestic agents had spent a net amount of transfers of nearly EUR 23 billion. While the amount of EU grants was slightly lower at the beginning of the 2007-2013 budget period, by 2012 it had increased to nearly EUR 4 billion (4 per cent of GDP). The process which had a positive impact on Hungary's net lending continued in 2013 as well: the amount of grants used was nearly EUR 5.4 billion (5.5 per cent of GDP), reflecting a significant year-on-year increase (Chart 16). The remaining components of the transfer balance did not show a significant change.

The temporary suspension of payments had no significant impact on the use of EU transfers. While the EU suspended the disbursement of grants for a time in 2013, this did not affect the current account in a perceptible manner. This is explained by the fact that the transfers from the EU are recognised in the current account when they are spent, based on the accrual-based accounting approach. Accordingly, Hungary's net lending is improved by EU transfers not when the transfers are made (when they appear in the foreign

exchange reserve), but when the grants are actually utilised. Thus, the amounts of transfers could be used even during the temporary suspension of transfers through the state's prefinancing of EU projects (using amounts transferred from the EU earlier), enabling the continued disbursement of grant funds even while EU transfers were suspended.

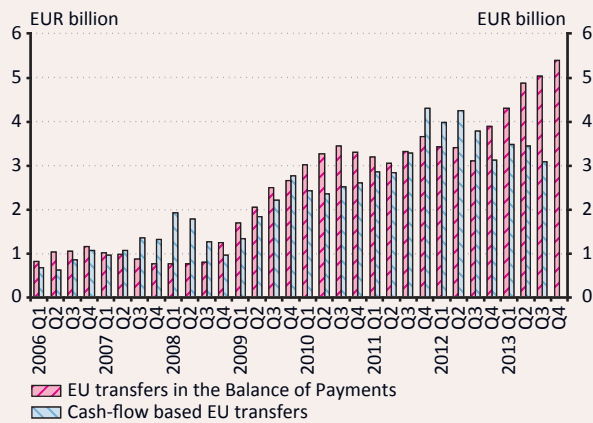
The resumption of disbursements in Q4 did not affect Hungary's short-term external debt, as the state paid the amount transferred to the private sector. It should be also noted that the amounts disbursed and thus prefinanced by the EU also affect Hungary's external debt, because until the payment of the grants by the state they increase the general government sector's short-term liabilities to the EU. Since the amounts concerned had been transferred by the EU earlier – i.e. they were already reflected by the level of foreign exchange reserves – they do not result in a deterioration in the foreign exchange reserve conformity of the national economy and have no effect on net external debt. The effects of the temporary suspension of transfers are also reflected by a decrease in short-term liabilities to the EU: by the end of 2013 Q3 the ratio had fallen to a level not seen since the beginning of 2007, but at that time the amounts of EU transfers were also substantially smaller. Even the resumption of payments in October did not generate a material increase in the volume of short-term liabilities to the EU, as the state disbursed the large amounts transferred in Q4 to private sector participants.

Box 2

Cash-based and accrual-based accounting of EU transfers

EU transfers booked in an accrual-based accounting system may differ in the short run from the amounts booked in cash accounting, but they are similar in the longer run. At the beginning of the EU budget period, the amount of EU transfers flowing into Hungary exceeded the amount paid to recipients. However, upon the conclusion of projects, payments to the sectors gained momentum: for instance, in 2012 Hungarian agents used more funds than were transferred by the European Commission. 2011 was again characterised by project pre-financing, but the second half of 2012 saw a rise in transfer utilisation. On the whole, while during the past year domestic agents utilised over EUR 5 billion from EU transfers, the total amount actually transferred by the EU during the same period was far less than that (Chart 18), and the rest of the amount spent came from funds that had been transferred by the EU earlier, but were still available for use.

Chart 18
Developments in EU transfers booked in an accrual-based and in a cash-based accounting system
(four-quarter amounts)



Note: For cash flow data only till Q3.
 Source: MNB.

3 Financing approach

The positive turnaround in the balance of payments following the crisis is reflected in financing trends as well: in the context of dwindling external funds, domestic participants were forced to carry out significant adjustments. In line with the massive net lending position, debt-type financing decreased with inflows observed for non-debt type financing. After a steady inflow from 2011 onwards, net foreign direct investment declined in 2013 Q2 and Q3, partly as a result of one-off factors. Q4, however, saw substantial inflows of foreign direct investment again. Debt-type financing also continued to decline: as opposed to previous years, throughout 2013 the bulk of this outflow was linked to the general government instead of the banking system. Banks' external financing declined to a lesser degree in 2013, in which the withdrawal of household deposits may have played a role. At the same time, in addition to the increase in foreign exchange reserves in the wake of EU transfers, the shrinking of Hungary's net external debt was also aided by the stronger involvement of domestic sectors in the financing of the government sector.

In addition to real economic developments, the trends in the balance of payments can also be analysed by examining how individual transactions are financed. The financing approach shows changes in (the level or composition of) the net financial assets of resident economic agents through which they financed transactions in the real economy. Before the crisis, this meant that consumption and investment beyond disposable income levels required external financing, which affected the Hungarian economy in the form of net borrowing and foreign direct investment. As regards the post-crisis period, the financing side shows the foreign asset purchases/debt repayments on which agents of the economy have been spending their financial savings originating from the unconsumed part of their income, in light of the massive trade surpluses of recent years. As noted in the introduction, the data derived from the two different approaches ought to be identical, but differences are likely to arise due to non-integrated data sources, incomplete observation and the different handling of the exchange rate, as indicated by the 'Net errors and omissions', i.e. statistical error. It should nonetheless be pointed out that developments in the real economy and in financing appear to be largely similar over the long run (Chart 21). The financing approach distinguishes three basic forms of financing:

- *non-debt type financing*: including foreign direct investment (equity capital, reinvested earnings and intercompany

loans; see Box 3 for more details) and – from the category of portfolio investments – shares;

- *debt-type financing*: that is, external (bank) loans (including Hungarian banks' financing from their parent banks),⁷ along with bonds and money market instruments (from the category of portfolio investments) as well as the change in the foreign exchange reserve (as one of the largest external asset item);
- *derivative instruments*: that is, futures contracts (interest rate swaps, forward rate agreements, various foreign exchange forward transactions) and option-type derivative transactions.⁸

The net lending of more than EUR 2.1 billion calculated from financing data in Q4 continues to indicate a massive net savings position and slightly exceeds the nearly EUR 2 billion posted by the real economy side. In recent quarters, financing side data has regularly indicated higher net lending than real economic data (Chart 21). Consequently, since mid-2012 the four-quarter net lending figure calculated from the aspect of the financing side has been higher than the level calculated for the real economy, and the 'Net errors and omissions' (NEO), i.e. the difference between the two, has turned positive after the negative figures seen in previous years. The higher financing side savings position means that

⁷ In the case of financial enterprises it is not possible to identify a loan from the parent company as an intercompany loan or a simple bank loan; therefore, they are fully recognised among bank loans as prescribed by the applied statistics method.

⁸ Financial derivatives are not considered to be debt given that no payment obligation is linked to these instruments and they do not generate interest income either. For more details, please see the publication Hungary's Balance of Payments and International Investment Position Statistics, 2012.

Box 3

Why are intercompany loans categorised as non-debt type liabilities?

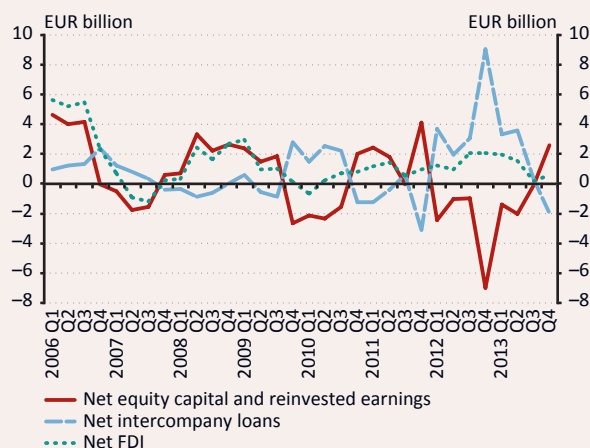
Based on economic considerations, it is worth adjusting debt ratios to exclude intercompany loans. In multinational companies the parent company supplies its subsidiaries with financing subject to more favourable terms than market conditions; with the financing provided from the income generated by the group or from borrowings. According to international statistical methodology, intercompany loans mean loans within foreign direct investment and, as such, they represent debt-type financing; based on economic considerations, however, in our analyses they are not considered to be debt-type liabilities. This is because, by nature, renewal, interest rate and exchange rate risks are much smaller in the case of intercompany loans than in case of borrowing from a bank. At the same time, despite the decline observed in recent years, the implicit interest paid on intercompany loans is higher than that paid for other debt elements. This demonstrates that investors do not regard intercompany loans as loans, as they expect higher returns on them than in the case of loans obtained from the market. Recently, foreign analysts have also started to separate intercompany loans from external debt.⁹

Intercompany loans have a close relationship to equity financing.

In line with the practice of balance of payments statistics, corporations' intercompany loans are recognised among the direct investment items in view of the fact that, based on experience, the interoperability between intercompany loans and direct equity investment is relatively simple and can take place without any fundamental reason and with no impact on market developments. The similarity between these two types of financing – equity financing and intercompany loans – is underscored by the fact that they have often shown opposing movements in recent years and their combined time series has proved to be more stable.

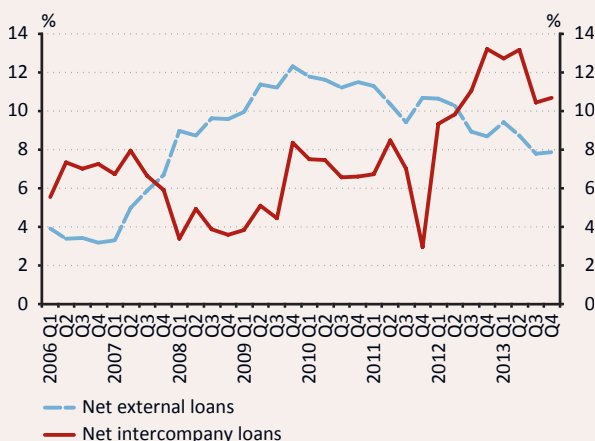
Compared to the rest of the debt elements, intercompany loans imply more stable financing. Experience shows that an unfavourable market environment prompts the outflow of debt-type funds first. This was observed in Hungary as well: while the foreign loans of companies have been declining since 2010, intercompany loans have been on the rise. Accordingly, intercompany loans are considered to be a more stable form of financing than other debt elements.

Chart 19
Changes in intercompany loans and FDI
(four quarterly transactions)



Source: MNB.

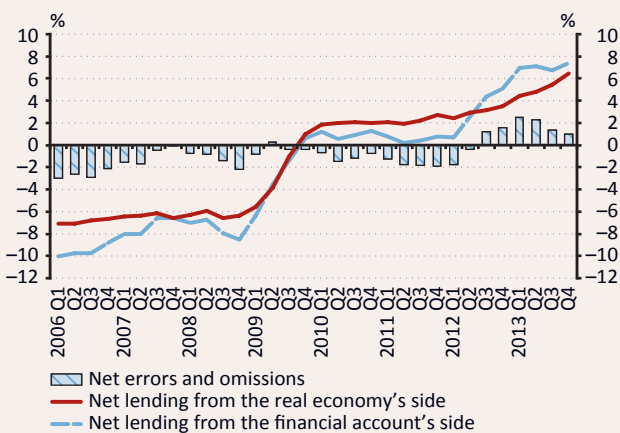
Chart 20
Foreign and intercompany loans of non-financial corporations
(as a percentage of GDP)



Source: MNB.

⁹ For example, see the analysis entitled 'Should We Worry about External Debt?' published by Morgan Stanley on 4 November 2013.

Chart 21
Two types of net lending and 'Net errors and omissions'
(four quarterly data as a percentage of GDP)



Source: MNB.

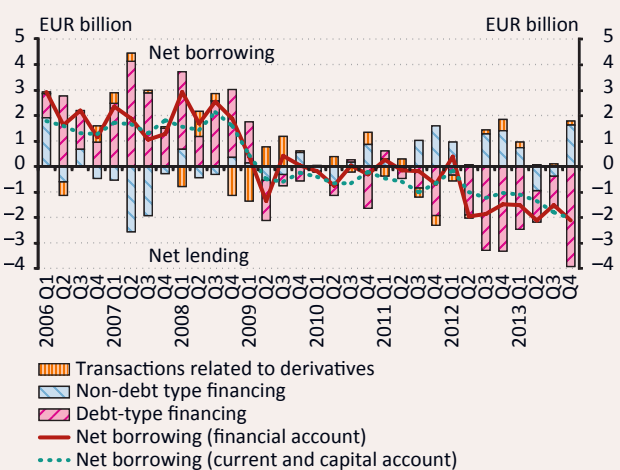
the improvement in the external debt ratios is higher than what would follow from real economic data (based on the current balance). At the same time, according to the real economy approach, net lending continued to increase in Q3, reducing the gap between the two different types of net savings positions. In Q4, NEO remained practically unchanged, due to higher savings accumulated on the financing side again.

The outflow of debt-type financing was extremely high in Q4, while a considerable inflow of FDI was also observed,

following the outflows in Q2 and Q3. In addition to the net lending in 2011 and 2012, a continuous inflow of non-debt type financing was also observed (essentially in the form of foreign direct investment, an increase in foreign investors' portfolio of domestic shares, and a decrease in domestic investors' portfolio of foreign shares), along with an outflow of debt-type financing (in essence, through repayment of external loans borrowed earlier on). In 2013 Q2 and Q3, non-debt type financing also flowed out and it was only the massive savings position that made it possible to see a decline in net external loans in Q2 and Q3 as well, albeit at a lower rate than in the previous year. However, Q4 saw considerable direct investment inflows once again, at a rate not seen since the end of 2011 (Chart 22). Consequently, in the context of the FDI inflow and persistently robust net lending, net external debt fell drastically by nearly EUR 4 billion in the span of one quarter.

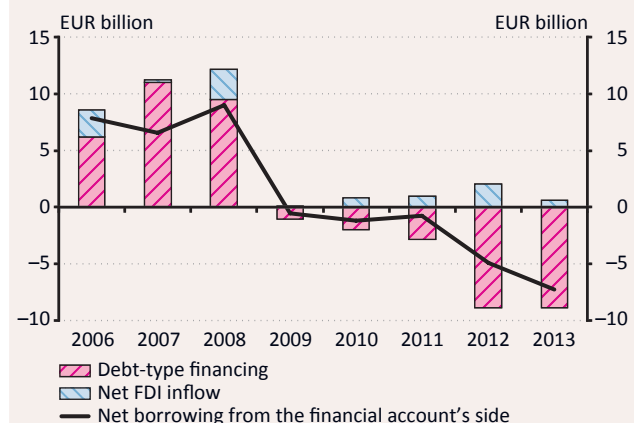
Net debt-type financing continued to decline and net foreign direct investment continued to increase throughout 2013. The outflows of net FDI observed during the year, mostly owing to one-off factors, were more than offset by substantial inflows in Q4. As a result, on balance, net FDI flow was nearly EUR 0.6 billion in 2013, which roughly corresponds to the levels recorded after the crisis.¹² Thus, excluding one-off effects, it can be established that within non-debt type financing, the level of net foreign direct investment was relatively stable in the years following the crisis, in the range of EUR 0.5-1.0 billion. In 2013, the debt-type external financing of the economy declined by nearly EUR 9 billion, i.e.

Chart 22
Developments in the structure of external financing
(unadjusted transactions)



Source: MNB.

Chart 23
Developments in foreign direct investment and debt-type financing



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

¹⁰ At the same time, the increase in net foreign direct investment in 2012 – the rate of which surpassed that observed in recent years – can be attributed to a one-off factor, i.e. capital increases in the bank sector in the context of the early repayment programme.

at a rate similar to that observed in the previous year. While the outflows affected all three sectors, significant differences can be observed in the sectoral breakdown of the debt reduction (see Chapter 3.2 for more detail).

3.1 NON-DEBT TYPE FINANCING

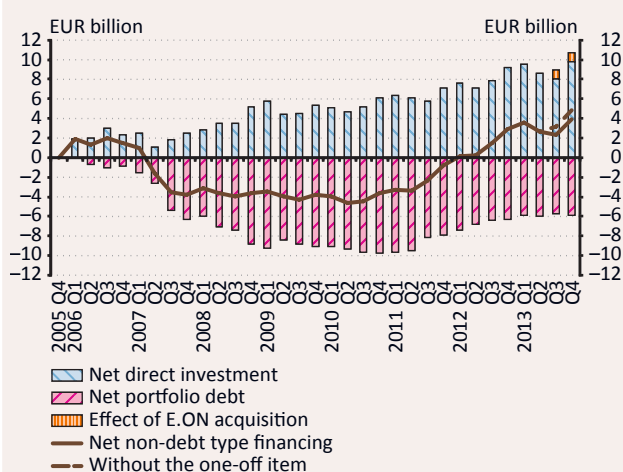
Following the decline in the previous quarters, in Q4 the inflow of foreign direct investment increased. The significant and continuous net inflow of non-debt type financing in 2011 and 2012 was explained partly by an increase in foreign direct investments and partly by the rise in net portfolio liabilities. However, net foreign direct investment declined in Q2 and Q3, which could no longer be offset by the increase in net portfolio debt – consequently, this had a major impact on non-debt type financing as well (Chart 24). This was, however, also affected by certain one-off and seasonal factors. On the one hand, dividends at foreign-owned domestic companies are typically accounted for in Q2 – which entails an outflow of foreign direct investment – and while this outflow was offset by the inflow of other non-debt type financing in 2011 and 2012, this was not the case in 2013. On the other hand, towards the end of Q3 the state acquired E.ON for close to EUR 0.9 billion, resulting in a decrease in foreign direct investment in Hungary, or in other words, a foreign direct investment outflow. In Q4, however, foreign direct investment increased substantially once again; thus, on

balance, net foreign direct investment inflows characterised 2013 as well. Rising dividends and the increase in reinvested income and intercompany loans all contributed to the growth observed in Q4.

As regards foreign direct investments, it is worth focusing only on the trends in net FDI data, primarily owing to the large amounts of capital in transit. The trend of gross capital inflow is strongly affected by the increasing weight of capital flowing through Hungary. That is because, likely on account of certain special features of the Hungarian tax system, some companies offer intercompany loans to, or inject capital in, their subsidiaries in Hungary – which they immediately pass on to external recipients – purely for tax optimisation purposes: in statistics, this is referred to as capital in transit, which has been separately listed in the balance of payments statistics since 2008.¹¹ On the other hand, capital in transit only affects the gross side and, by its very nature, does not distort net FDI data, which is why our analyses are focused more on these. Nevertheless, capital in transit plays a significant role in dampening the net figures in comparison to what could be expected on the basis of the gross inflow (Chart 25). Moreover, the data may be substantially influenced by changes in the financing structures of individual companies.

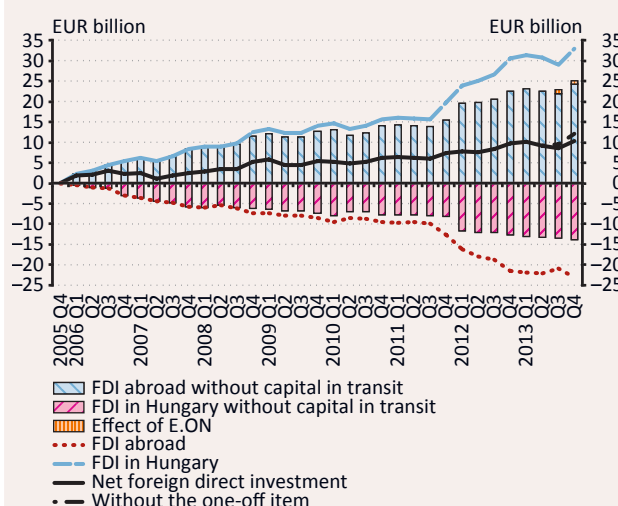
Changes in portfolio investments, i.e. the other component of non-debt type financing, showed a modest net outflow

Chart 24
Developments in non-debt financing
(cumulative transactions)



Source: MNB.

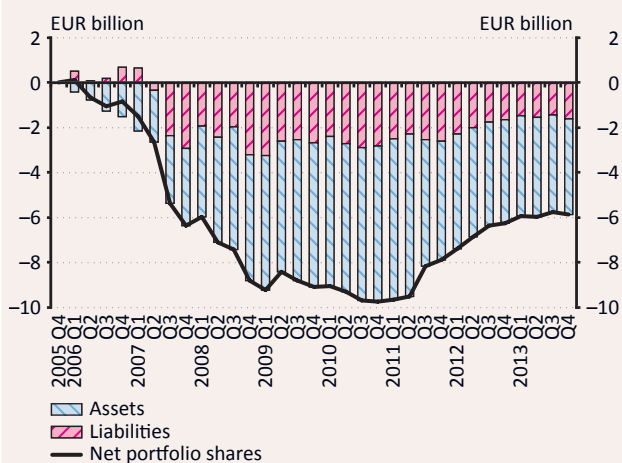
Chart 25
Developments in foreign direct investment
(cumulative transactions)



Source: MNB.

¹¹ In this context it should be noted that data for enterprises that have established in Hungary solely for tax optimisation purposes (special purpose entities, SPEs) are automatically listed separately in the balance of payments statistics. The operations of SPEs are, in essence, limited to raising funds (capital, loans) from abroad and immediately passing them on to other foreign undertakings, i.e. their activities have no impact on real economic processes. The total gross loan portfolio of SPEs hovered in the range of 20-40 per cent of GDP.

Chart 26
Drivers of changes in net portfolio investment
(cumulative transactions)



Source: MNB.

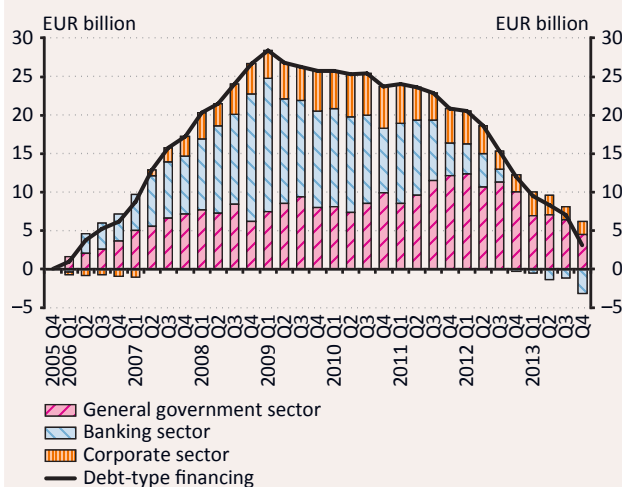
of financing, slightly reducing the effects of the FDI inflow. In recent years, the trend of the time series relating to portfolio investments has been shifted by a decrease in domestic participants' foreign share portfolios and by an increase in foreign participants' domestic shares towards an increase in the inflow of financing, and thus nearly EUR 4 billion worth of such funds have arrived in Hungary since end-2010 (Chart 26). In the past two years, the decrease in the portfolio of foreign equity instruments has been associated primarily with the sale of shares taken over by the state in the course of the transformation of the pension system, but the resulting inflow of financing has decelerated markedly in recent quarters. The modest outflow observed in Q4 was the net result of the slight decline in external assets and foreign participants' sales of domestic shares.

3.2 DEBT TYPE LIABILITIES

2013 Q4 saw a continued decrease in the economy's net external debt type financing. The outflow of the economy's debt-type net external financing continued in 2013 Q4, totalling nearly EUR 4 billion. In a breakdown by sector, this was a combined result of the fact that the consolidated general government and the banking sector reduced their liabilities by EUR 2 billion each, while the transactions of corporations did not materially affect their net external debt level (in the chart showing the cumulative data, changes in the heights of the columns illustrate changes in the net external debt of each sector).

In 2013, the outflow of debt-type financing can be linked primarily to the consolidated general government. Along with the increase in foreign currency reserves in the wake

Chart 27
Developments in net debt-type financing per sector
(cumulative transactions)



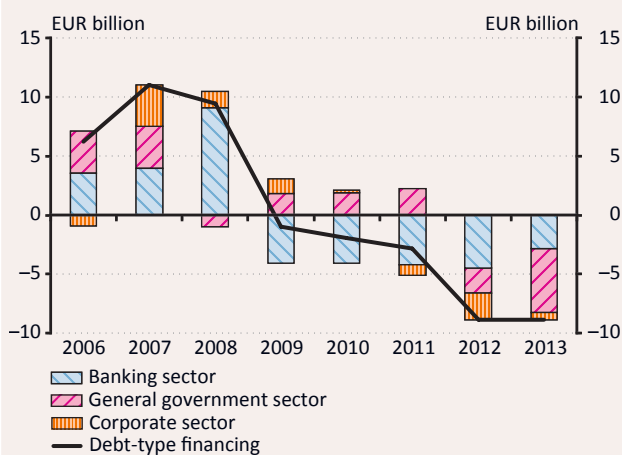
Source: MNB.

of EU transfers, this outflow was also supported by the stronger involvement of domestic sectors in the financing of the government sector. After the outbreak of the crisis, initially only the banking sector's external debt declined, but, starting from 2012, the outflows affected all three sectors. As opposed to previous years, in 2013 the decline in debt was linked primarily to the consolidated general government instead of the banking sector. It is important to stress that the decline in the general government's net external debt was also supported by domestic sectors' purchases of government securities and by the increase in foreign currency reserves in the wake of EU transfers. In 2013, domestic participants purchased HUF-denominated government papers with a value of nearly HUF 3.5 billion in total. The foreign exposure of the general government was further alleviated by the issue of the Premium Euro Hungarian Government Bonds. While the sales of the Premium Euro Hungarian Government Bonds increased the foreign currency reserves, they only reduced external debt slightly, as those purchasing the bonds were mostly domestic participants. In other words, the stronger involvement of domestic sectors in the financing of the government contributed to the decline in the general government's net external debt.

The decline in the banking sector's net external debt in 2013 was less pronounced than the dramatic decrease observed in recent years. The banking sector's gross external borrowing approached EUR 25 billion between 2006 and 2008 (Chart 29). The sector's net external debt, however, increased by a mere EUR 17 billion during the same period, owing to transactions, i.e. a simultaneous rise in external assets. The gradual decrease in financing in recent years was also toned down by the sale of external assets, and therefore the net

Chart 28
Developments in debt-type net liabilities of individual sectors

(annual transactions)



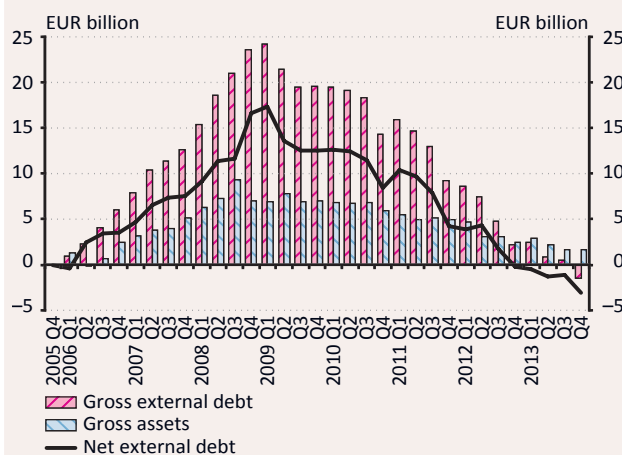
Source: MNB.

financing outflow fell short of the drop in external financing. According to transaction data since 2006, at the end of 2013 the banking sector's external debt (gross and net) was below that of the basis period. A review of the trend in net external debt over the last three years reveals that, while in 2011 and 2012 banks repaid a larger portion of their external loans as a consequence of increased household loan repayments (boosted by the early repayment programme), the sector's net outflow of financing decelerated in 2013. At the same time, the net external debt of the banking system decreased significantly, by nearly EUR 2 billion in Q4. The substantial decline in the corporate sector's loan portfolio observed in Q4 may have contributed to this: banks may have used the funds thus released to repay their external debts.

The earlier dynamic outflow of financing from the banking system decelerated in 2013, which may have also been supported by the shift in households' portfolios toward liquid assets and government securities. In 2013, banks' net external debt decreased, as a result of transactions, by less than EUR 3 billion, compared to outflows of EUR 4-4.5 billion in previous years. The lower level of outflows may be primarily attributed to the more subdued reduction of gross liabilities. The fact that households reduced their deposit holdings with banks by more than HUF 800 billion in 2013 may have also contributed to lower gross outflows (for more detail, see the discussion of the savings approach below). Households' withdrawal of deposits reduced the amount of financing available to banks to reduce their external debt. At the same time, the fact that external assets (i.e. the difference between gross and net outflows) declined to a lesser degree compared to 2012 pointed to higher net outflows.

Chart 29
Developments in the banking sector's gross external debt and asset transactions

(cumulative transactions)

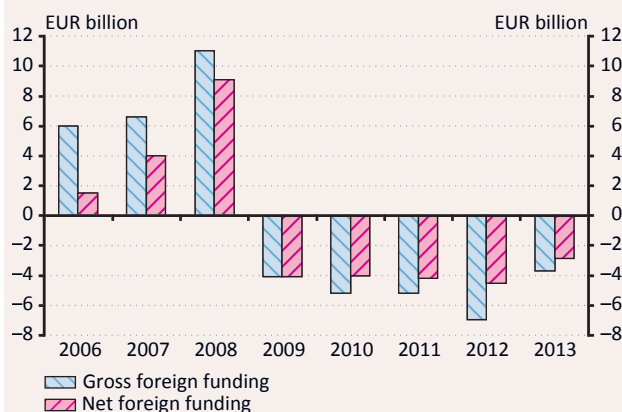


Source: MNB.

The general government – consolidated with the MNB – has managed to gradually reduce its net external debt over the past two years. A closer look at the transactions shows that the net external debt of the general government, as consolidated with the MNB and also including changes in the foreign exchange reserves as a form of external assets, had been on an upward trend until late 2011, but has since been diminishing steadily (according to cumulative transaction data with the exchange rate effect eliminated, by 2013 Q4 it had dropped below the pre-crisis level). This gradual decrease may also have been enabled by the fact that the general government deficit was around 2 per cent of GDP in 2012 and below 3 per cent of GDP in 2013. Moreover, the increased involvement of households in financing the state also helped

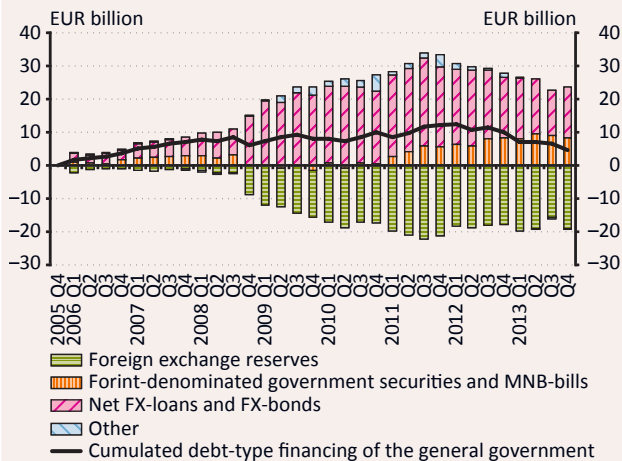
Chart 30
Developments in the net and gross liabilities of the banking sector

(annual transactions)



Source: MNB.

Chart 31

Breakdown of net external debt of the general government consolidated with the MNB*(cumulative transactions)*

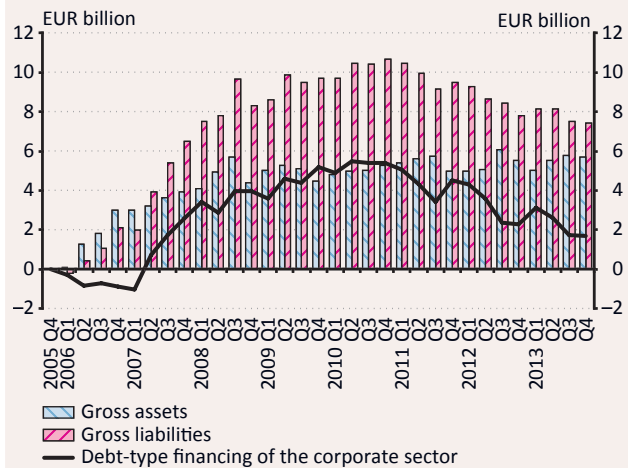
Source: MNB.

the government to reduce the sector's net external debt at an increased rate during recent years.

The net external general government debt continued to fall in 2013 Q4, primarily through a decrease in foreign investors' government bond portfolio and the increase generated by EU transfers in foreign currency reserves. In 2013 Q4, the net consolidated external general government debt sank by nearly EUR 2 billion as the result of a combination of factors (Chart 31):

- The portfolio of government securities and MNB bills held by foreign investors decreased by a total of nearly EUR 0.8 billion. Non-residents acted as sellers primarily in the HUF-denominated bond market (EUR 0.4 billion), while their maturing discount Treasury bill portfolio did not change considerably. On the other hand, foreign investors reduced their MNB bill portfolio significantly, by almost EUR 0.4 billion as well, mostly in relation to their end-of-year balance sheet adjustments. Although the FX bond issuance in November increased non-residents' exposure by nearly EUR 2 billion, it did not influence the level of net external debt as, through the increase in the government's FX deposits, the foreign currency inflow ultimately increased the foreign currency reserves.
- The net external general government debt also declined, due to the increase in foreign currency reserves generated by EU transfers. After lifting the suspension of disbursements, the European Commission transferred a significant amount of funds, which elevated the level of the foreign exchange reserves. Since the government transferred most of these grants to the private sector in Q4 already, the government's debt to the EU increased only slightly on a quarterly level.

Chart 32

Developments in the corporate sector's net external debt type financing*(cumulative data)*

Source: MNB.

On balance, therefore, EU transfers increased the level of foreign exchange reserves, thereby reducing the net external debt of the consolidated general government.

The accumulated net external debt of the corporate sector grew dramatically before the crisis, followed by a more modest increase thereafter, but has been slowly decreasing since 2011. The external debt of the corporate sector rose steeply from as early as 2006 but it was, for a while, offset by the increased expansion of the sector's external assets, as a consequence of which the net external debt of the corporate sector remained largely unchanged. Increased foreign borrowing resulted in a marked rise in the net external corporate debt later on, a trend that continued even after the outset of the crisis, and it was not before 2011 that it started to decline. As a result of the latter, the corporate sector's time series reflecting cumulative transactions – in essence, the data from which the exchange rate effect is eliminated – sank back to the pre-crisis level from 2012 H2, which points to the reduction of corporations' external funding. In other words, the persistent net financial savings position of the corporate sector (see the description of the savings approach) is also reflected in the declining net external debt of the sector. Accordingly, on the one hand, the net savings position may indicate that corporations spend less money on investment than the income they generate and, on the other hand, it points to the decline in the sector's foreign loans.

The net external debt of the corporate sector stagnated in 2013 Q4. In Q3, there was no perceivable change in the net external debt of the corporate sector, owing to the slight, parallel decline in foreign loans and external assets.

4 Developments in debt rates

As a result of the depreciation of the forint and the decline in nominal GDP, debt rates increased steeply following the outbreak of the crisis. However, as a result of a massive outflow of funds and an increase in nominal GDP, the adjustment of Hungary's external debt ratio commenced from mid-2010. The net external debt ratio fell to 35 per cent of GDP from 60 per cent at the beginning of the crisis and thus dropped below the level recorded in 2006. In a sectoral breakdown, thanks to balance sheet adjustments, the net external debt of banks and the general government is now significantly lower than its pre-crisis level. Meanwhile, in Q4 net external corporate debt was around the levels recorded in mid-2008. In addition to net external debt, Hungary's gross external debt also declined further in Q4, dropping to 88 per cent of GDP. At the same time, due to a loan maturing in November 2014, in Q4 the level of short-term external debt based on residual maturity rose to close to EUR 28 billion, a level observed in 2013 H1.

This chapter presents the level and composition of external debt. Developments in debt rates have a significant impact on the perception of Hungary's external vulnerability. Changes in the volume indicators of external debt typically reflect those indicated by the debt-type transactions presented above under financing developments. In comparison to transaction data, volume indicators provide additional information as they also reflect the impact of changes in exchange rates and in the prices of securities. In addition, they allow for the examination of various levels, which ensures easier comparison of data pertaining to other periods than the examination of cumulative transactions. Net external debt is the net result of gross external liabilities and external debt type assets (the latter also includes the central bank's external assets and its foreign exchange reserves).¹²

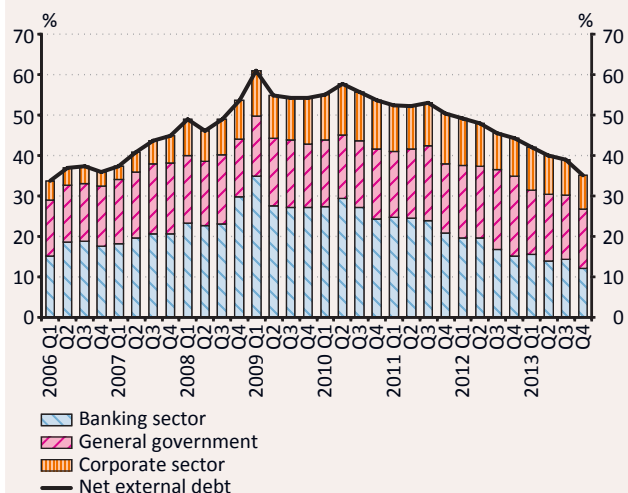
4.1 NET EXTERNAL DEBT

Net external debt continued to decline in the fourth quarter of the year. Net external debt fell to 35 per cent of GDP and now stands at the level recorded in 2006 (Chart 33). After a slight increase in the previous quarter, in Q4 the net external debt of the banking sector declined again, which may have reflected a more substantial decline in the loan portfolio of the corporate sector. As a result, the net external debt level of the banking sector is now far below the level observed at the beginning of the crisis. In Q4, the net external debt of the consolidated general government was down nearly 1.5 per cent of GDP, which can mainly be attributed to the decline in non-residents' holdings of government securities and the increase in foreign currency reserves generated by

EU transfers; consequently, the net external debt of the government fell to a level not seen since 2006. Net external debt within the corporate sector did not change materially and remained at one of the lowest levels observed in recent years.

The recent decline in net external debt has been primarily driven by the outflow of debt-type funds and, to a lesser degree, by the growth in GDP, while the process was slowed overall by revaluation. Changes in GDP-proportionate net external debt can be attributed to three factors: transactions, revaluation and changes in the nominal amount of GDP.

Chart 33
Net external debt in a sectoral breakdown
(as a percentage of GDP)



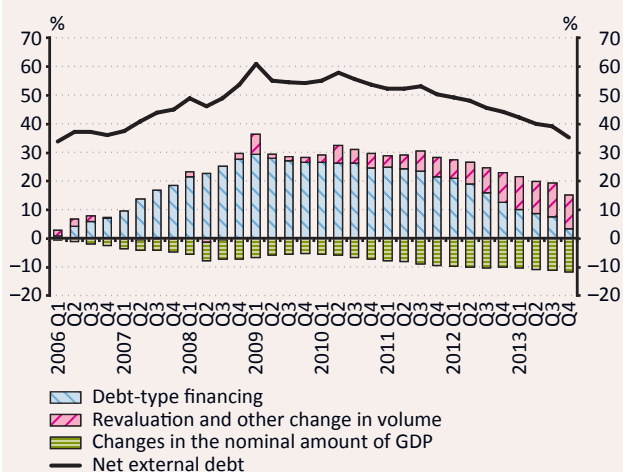
Source: MNB.

¹² Intercompany loans are still not regarded as items increasing total external debt – this is discussed in more detail in Box 3 above.

Chart 34

Components of changes in net external debt

(cumulated, GDP-proportionate values, end-2005 = 0)

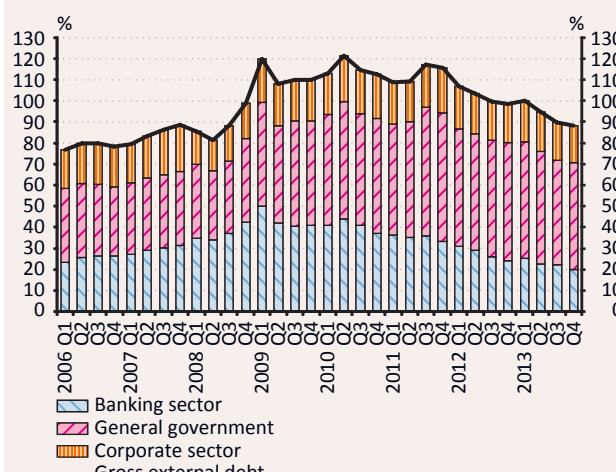


Source: MNB.

Chart 35

Gross external debt in a sectoral breakdown

(as a percentage of GDP)



Source: MNB.

In line with the increase in net lending, the decline in net external debt since mid-2010 has been primarily driven by the repayment of external debt; changes in transactions accounted for most of the nearly 20 percentage point GDP-proportionate decline. By contrast, revaluation had the opposite effect: depreciation of HUF increases the foreign currency denominated part of net external debt, while no such immediate effect is observed in the case of GDP which is expressed in HUF. In the course of 2012-2013, even the revaluation of HUF-denominated government bonds had a perceptible effect, as the decline in long-term yields raises the external debt rate through the increase in security prices.¹³ The nearly 0.5 per cent appreciation of the forint in Q4 resulted in a slight decline in the level of net external debt. In addition, the gradual increase in nominal GDP also slightly reduced the net external debt-to-GDP ratio. It is also worth noting that, while the fall in nominal GDP during the crisis put upward pressure on the rate, the growth observed in recent years has already offset the impact of the crisis.

4.2 GROSS EXTERNAL DEBT

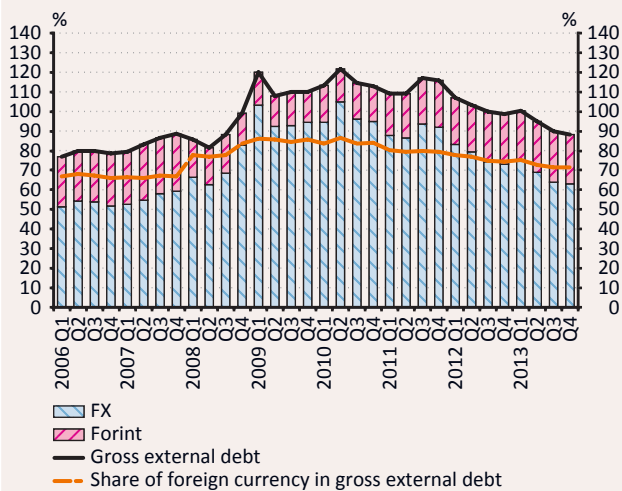
The decline in gross external debt continued in the fourth quarter of the year. After a substantial decline recorded in the previous quarters, Hungary's gross external debt continued to shrink only slightly further in Q4, dropping to 88 per cent of GDP. The decline in gross external debt was smaller than that observed in the case of net external debt, which can be mainly attributed to the issuance of foreign currency bonds which, while increasing gross external debt,

does not influence its net value due to the parallel increase in foreign exchange reserves. The gross external debt of the banking sector dropped slightly further and now stands at a level significantly lower than its pre-crisis value. While the contraction of banks' loan portfolio observed in recent years points to a decline in external debt, this has been offset by the accelerated deposit outflows recorded in 2013 – the funds thus lost need to be replaced by other resources, occasionally by external funds, which may put downward pressure on the rate of the outflows. Of these three sectors, the general government continues to have the highest gross external debt. The gross debt of the broader public sector – which also includes the MNB – still accounts for more than half of total external debt. Before the crisis, the sector's gross debt made up about 40 per cent of Hungary's total debt, and it rose sharply at the onset of the financial crisis as a result of borrowing from international organisations and the dramatic depreciation of the HUF. As opposed to the other two sectors, it was not before early 2012 that the declining trend of general government debt – as a percentage of GDP – began; indeed, during the first years of the crisis gross external public debt continued to grow, partly as a consequence of the revaluation of portfolios owing to the weakening of the HUF.

Although the share of foreign currency in gross external debt has declined continuously in recent quarters from its peak of 85 per cent in mid-2010, as a result of the FX bond issuance in Q4 it stagnated at a level above 70 per cent at the end of the year. The composition of gross debt in terms of currencies is another important indicator of vulnerability,

¹³ In the balance of payment statistics securities are registered at market prices; by contrast, securities are taken into account at nominal value in EU public debt statistics.

Chart 36
Currency structure of gross external debt
(as a percentage of GDP)



Source: MNB.

as the higher the share of foreign currency, the higher the risks; partly because of the foreign currency liquidity required for loan payments, and partly as a consequence of the debt increasing effect of any HUF weakening. Owing to the FX bond issuance, the ratio of gross debt denominated in foreign currency to total gross debt stagnated at above 70 per cent in Q4, but it was still slightly below the level recorded before the outbreak of the crisis. This ratio, masks sectoral heterogeneity, however. Nearly all of the private sector's external debt (around 90 per cent) is denominated in foreign currency, and only the banking sector has debt denominated in HUF (partly associated with the management of foreign banks' HUF liquidity). Owing to the large portfolio of HUF-denominated government securities held by non-residents, only a substantially smaller part of the debt accumulated by the general government is denominated in foreign currency (about 60 per cent). This value, however, is higher than the pre-crisis level: while borrowing from the IMF/EU and the weakness of the HUF during the crisis raised this ratio considerably, the repayment of IMF/EU loans and the increasing ratio of forint financing pointed to a decline in the share of the foreign currency component of public debt. It should also be noted that, although debt denominated in HUF may be generally considered favourable (since repayment requires no liquidity in foreign currencies and its value relative to GDP is not affected by HUF depreciation), the high share of non-residents in the total portfolio of government securities may be perceived by investors as a vulnerability.

4.3 SHORT-TERM EXTERNAL DEBT

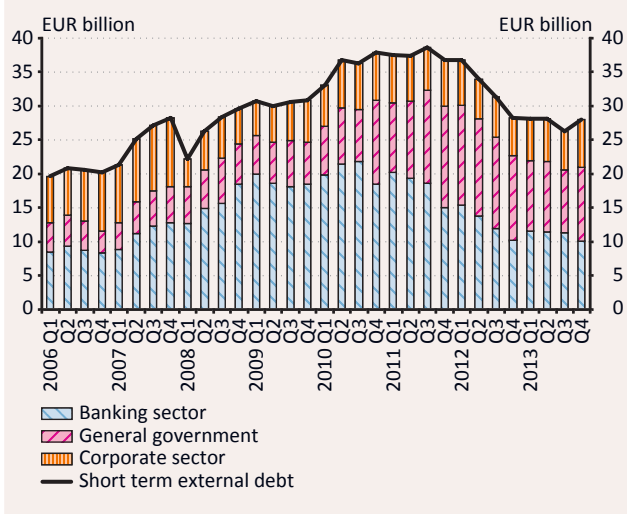
The level of short-term external debt based on residual maturity increased by nearly EUR 1.5 billion to around EUR

28 billion in Q4. Consequently, at the end of 2013 it hovered around the level observed in the first half of the year. Analysing the trend of gross short-term external debt is particularly important from the aspect of the level of the central bank's foreign exchange reserves expected by foreign investors (see Box 4). Therefore, the recent changes in short-term external debt are discussed below in a sectoral breakdown.

- In the review period, the short-term external debt of the *general government* increased by EUR 1.5 billion. This increase was the combined result of several factors: the remaining maturity of the EUR 2 billion EU loan was shortened to less than one year as of November 2014, but this was partly offset by a decline in other debt elements. Downward pressure on the government's amortised long-term debt (long-term debt that becomes short-term debt) was exerted by the Hungarian National Debt Asset Management issuing a new series of bonds maturing in 2019 to replace the bond series maturing in 2014 (i.e. those convertible to Richter shares). In addition, external debt was also reduced by the payment of a HUF-denominated government bond held mainly by non-residents, which matured in October. At the same time, there were no material changes in the general government's short-term debt based on original maturity.
- The *banking sector's* short-term debt portfolio fell by approximately EUR 1.2 billion, partly owing to a decline in short-term external debt on original maturity (EUR 500 million) and a decline in amortised long-term external debt (EUR 700 million). The decline in amortised long-term debt can be attributed to the repayment of the amortised long-term debt on the one hand, and prepayment (i.e. payment prior to maturity) of amortised long-term debt on the other hand. Following a temporary increase in the previous quarter, banks' short-term external debt based on original maturity decreased once again in Q4, reaching a record low level of nearly EUR 8 billion.
- The short-term external debt of the *corporate* sector increased by about EUR 1.3 billion, and thus the level of short-term debt slightly exceeds the average of recent years. The bulk of this increase can be attributed to the fact that a corporate loan's remaining maturity dropped below one year.

The level of short-term external debt is still considered high, but it is now significantly below its EUR 38 billion peak recorded in mid-2011. Thanks to a slight increase in Q4, the level of short-term debt based on residual maturity has now returned to the level observed in 2013 H1. Nevertheless, the level of short-term debt based on residual maturity is lower than what was observed at the end of 2008. As regards sectors, while the level of the banking sector's short-term

Chart 37
Developments in gross short-term external debt based on residual maturity



external debt is lower, that of the government is higher than it was at the time of the collapse of Lehman Brothers. The latter was also driven by some other factors not related to the debt management operations of the Government Debt Management Agency (ÁKK). For example, the increase in the amount placed by non-residents in deposit accounts in relation to the ÁKK's derivative transactions is not linked to the government's active fund-raising activities, but is associated with fluctuations in cross-exchange rates (at the same time, the level of foreign exchange reserves is also on the rise, i.e. it has no impact on vulnerability). The increase in foreign investors' portfolio of MNB bills is partly associated with the overall increase in the total portfolio, and the swap portfolio of domestic banks vis-à-vis non-residents has also increased. Non-residents, in turn, invest some of the acquired HUF liquidity in MNB bills.

Owing to the substantial share of parent bank financing, the short-term external debt portfolio accounts for some 50 per cent of the banking sector's total debt. While the amount of the banking system's short-term external debt portfolio is nearly equal to that of the government, a comparison of the short-term debt to the given sector's gross debt shows a marked difference. In the banking sector, this ratio is about 50 per cent, i.e. about half of the banks' debt – including longer-term items with short remaining maturity – matures within one year. This high percentage stems partly from parent bank financing. As regards the general government sector, short-term external debt accounts for around 20 per cent of total external public debt, given that the debt manager prefers to keep a relatively low proportion of short-term items, in view of the renewal risks. The share of the corporate sector's total short-term external debt in its total debt is about 40 per cent; direct investment, however, is the main form of external funding for companies, with short-term debt only being a supplementary form of financing, for instance in relation to working capital loans or commercial loans.

Due to the significant maturities stemming from the relatively high gross external debt, dependency on external funds remains high. The positive picture suggested by the current account balance calls for further nuancing. Although the balance of payments surplus and the continuously declining external debt indicators mitigate the riskiness of Hungarian assets, gross borrowing cannot be ignored. This figure refers to the total amount required for financing the current account deficit during a period and for repaying maturing debt (in the event of a current account surplus, maturing debt can be reduced by the net financing capacity amount). Net external lending therefore reduces Hungary's gross borrowing, but it also needs to renew maturing debt for specific periods, which calls for substantial foreign funding.

Box 4

Why is the level of short-term external debt important?

The level of the external debt of an emerging economy is a key indicator of its external vulnerability. Short-term external debt comprises those components of a country's debt to foreign creditors and lenders that mature within a year. A high level of short-term external debt implies a renewal risk. This may come to the fore during a debt crisis, when foreign investors are not willing to renew their maturing receivables from a country, resulting in a rapid outflow of capital, while the country concerned cannot finance itself from abroad. In this case, the funds lost need to be replaced from some other source, e.g. from the country's own reserves. In the absence of foreign exchange liquidity, the government or the private sector may fail to repay its external debt and face bankruptcy. It takes a great deal of adjustment and increased financial savings to avoid the threat of a default, which may trigger an economic downturn. Moreover, if the foreign exchange debt is repaid from savings denominated in the country's own currency, in the case of a floating rate the inevitable sale of domestic currency will lead to a significant weakening of its exchange rate, further aggravating the balance of payments crisis. On the other hand, in the case of a fixed exchange rate regime, this may deplete the foreign exchange reserve which, in turn, may ultimately lead to the abandonment of the exchange rate regime and trigger an exchange rate crisis.

Short-term external debt has not always been regarded as an important factor in setting the sufficient level of foreign exchange reserves. Investors had focused on two high profile indicators before the outbreak of the exchange rate crises in the 1990s. On the one hand, the *import coverage ratio*, in relation to which the requirement was that the reserves should cover the costs of at least 3 months' imports. This ratio is of relevance in the case of a payment crisis, when exports plummet and the foreign currency required for imports can only be supplied from the reserves. The other popular rule of thumb is the *quantity of money rule* according to which the reserves need to cover a given proportion of a certain monetary aggregate. This is intended to capture the reserve requirement of conversion into a given foreign currency in a crisis situation when domestic participants start disposing of their savings – held in the form of deposits or cash – by exchanging them into foreign currencies which they consider to be a safer option.

In the wake of the crises in Latin America and South-East Asia, short-term external debt gained prominence as an indicator that can be used to set the optimal level of foreign exchange reserves. The level of short-term external debt exploded in the 1990s in certain Latin American and South-East Asian countries. Following the previous capital restrictions, the spread of foreign currency liberalisation increasingly allowed countries to accumulate short-term foreign debt. The crises in Mexico (1994–1995), South-East Asia (1997–1998) and Brazil (1998–1999) were partly caused by the fact that the foreign exchange reserves of the countries concerned were substantially exceeded by their short-term external debt. These countries suffered massive capital outflows which could not be offset by their foreign exchange reserves; consequently, they were forced to abandon their fixed exchange rate regimes. It was in view of the lessons drawn from these crises that the *Greenspan-Guidotti* rule was developed in 1999 based on proposals offered by the former governor of the central bank of Argentina, Pablo Guidotti, and former Fed governor Alan Greenspan. According to the rule, the foreign exchange reserve must be sufficient to cover the short-term external debt so that the country concerned continues to be able to finance the maturing part of its external debt even if external financing comes to an abrupt halt. This ratio enables investors to take into account the short-term external debt denominated in the domestic currency as well – its repayment does not require foreign exchange, but its sell off by foreign participants may trigger the devaluation of the domestic currency's exchange rate, which, in turn, may require the use of the foreign exchange reserve. Statistics distinguish between *short-term debt based on original maturity* and *amortised long-term debt* (originally long term, but turning to short term over time) – the latter must also be included in the calculation of short-term external debt, as the two are not different in an economic sense.

5 Sectors savings approach

All sectors played a role in the substantial rise in net lending following the crisis. On the one hand, shrinking external and internal borrowing options, balance sheet adjustment, and heightened precautionary considerations all led to a surge in the net financial savings of the private sector. On the other hand, the government's low net borrowing – along with restrained spending – contributed to the improvement in the economy's net lending. The net savings of companies increased significantly throughout the year, presumably driven in part by substantial EU transfers, while the net financial savings of households stabilized at an elevated level.

Developments in the net lending are presented below from the perspective of savings, through the net savings of individual sectors. The level of net lending (or net financial savings) of the domestic sectors is the same in the case of the financing approach, since the net lending of the domestic economy is ultimately reflected in foreign financing. Yet there is also a difference: whereas in the case of the financing approach we examined how the individual sectors finance themselves directly from abroad (thus banks will play a special role, since households arrange their foreign transactions through banks almost exclusively, while companies do so partially), in the savings approach we analyse the net financial savings of individual sectors. The savings approach reveals more about the behaviour of individual sectors, and thus we can give different types of explanations for the

development of net lending, compared to the real economy approach. Among other things, financial accounts reflecting developments in the net financial savings of various sectors can be used to examine shifts in the financial savings of the domestic sectors and to observe underlying financing trends by breaking down the economy's net lending by sector, thereby detecting potentially developing imbalances more easily.

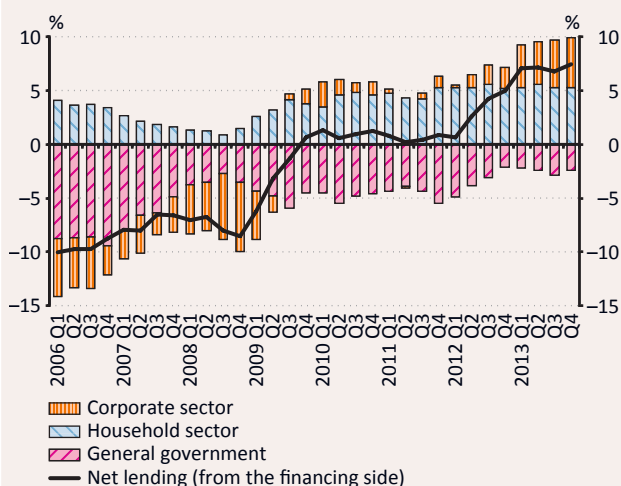
The significant net savings of the household and corporate sectors and the moderate spending of the general government also contributed to the high level of net lending.

The four quarterly net financial savings of households are high, presumably because of the rise in real incomes; they have stabilised at a level exceeding 5 per cent of GDP (Chart 38). The four quarterly accrual-based net borrowing of the consolidated general government decreased as a result of the changing seasonality of tax revenues compared to the previous year, while the sector's net borrowing can still be considered low, compared to previous years. In the meantime, the financial savings of the corporate sector increased over the course of the year, in which the significant EU transfer inflow was also a contributor.

Chart 38

Net lending of specific sectors

(four quarterly data as a percentage of GDP)



Note: As regards the general government, net borrowing based on the financial accounts is presented, adjusted for the transfer of private pension fund assets in 2011.
Source: MNB.

5.1 HOUSEHOLD SECTOR

The net savings of households have grown gradually since the crisis and stabilised at a high level in the past two years (Chart 39). After the crisis, the savings habits of households changed dramatically. Prior to the crisis, households had negligible net financial savings in addition to significant borrowings (i.e. households did not finance the funding needs of other economic agents, and thus those needs were mainly financed from foreign funds). However, as a result of the crisis, borrowing fell significantly and households started to repay their loans taken out earlier. In parallel to this, the gross financial savings of households decreased; among other

things, this may have resulted from the fact that some of the loans taken out earlier by households increased the savings of other households through the purchase of homes. Due to developments on the asset side and on the liability side, the net financial savings of households started to increase after the crisis, reaching a level of above 5 per cent of GDP in the past period. It also means that, for precautionary reasons, as opposed to their previous behaviour, households spent a smaller portion of their generated income on consumption and accumulation than before, while they set aside more savings. Thus, households supply the other sectors of the economy with funds. At the same time, over the past few years, other economic agents mainly used these funds to reduce their external debts.

In Q3 2014, the seasonally adjusted net saving of households rose slightly and stood above 5 per cent of GDP. The net financial savings of households in 2013 Q4 were marked by a continuing decline in the loan portfolio and growing financial assets (Chart 39). Net loan disbursements to households dipped during the quarter and remained negative (i.e. based on transactions, loan repayments of households exceeded borrowings). Consequently, the adjustment on the liability side prompted by the crisis is still in progress among households, with a seasonally adjusted value of around 1.7 per cent of GDP in Q4. On the asset side, households increased their financial assets by nearly 3.5 per cent of GDP, similar to the previous quarters. At the same time, underlying trends in the accumulation of financial assets suggest that, since the beginning of the year, the population has shifted from bank deposits to setting aside significant savings in securities,

which may have also shaped developments in the external debt of other sectors.

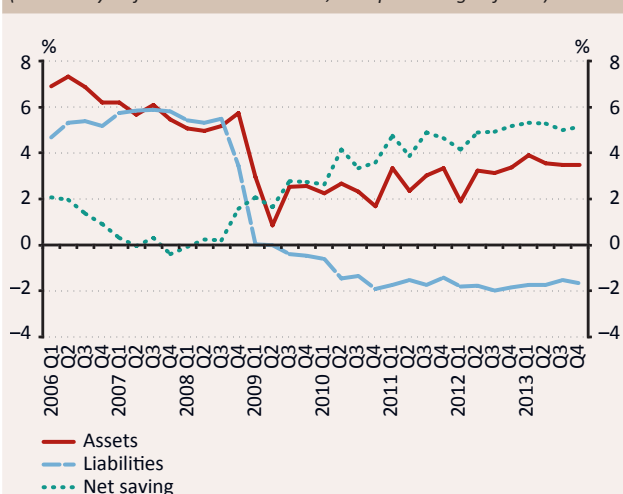
Since 2006, households have significantly changed the composition of their financial asset portfolio several times: in 2013 this resulted in an extensive downsizing of bank deposits. Cumulative data on the financial savings of households suggest that the population rearranged its financial assets after the onset of the financial crisis (Chart 40). Shortly after the outbreak of the crisis, cumulative transaction data indicate a sharp increase in bank deposits. This process may be the result of the rising interest rate of bank deposits (in line with the increasing central bank base rate) and the decline in risk appetite in the face of the crisis. In parallel with this, households decreased their savings in investment fund shares/units and government securities; in part, this may have been the consequence of portfolio shifts toward bank deposits or, alternatively, households simply sold some of their assets amidst the scarce lending in the wake of the crisis to improve their financing position. In 2012, new signs pointed to a change in the preferences of households in respect to financial assets: savings showed an increase in government securities and investment fund shares/units, while households also continued to set aside savings in bank deposits. By 2013, this behaviour had changed: households reduced their savings in bank deposits, while at the same time they increased their cash and security-type savings.

In 2013, households reduced their savings in bank deposits, while they significantly increased savings in government securities, mutual fund shares/units and cash (Chart 40). Amongst other things, the reasons for this are the subdued inflation and interest rate environment, the higher yield on government securities, the transaction duty increase and the health contribution imposed on interest income. On the asset side, in the case of households a shift toward security-type assets was apparent as early as 2012. In 2013, this trend intensified and the population saved more in government securities and investment fund shares/units, compared to the preceding year. Simultaneously, households reduced savings held in bank deposits. Despite these developments, however, at the end of 2013, the savings of households held in bank deposits still by far exceeded their combined savings in government securities and investment fund shares/units. The cash portfolio of households also showed a significant increase in 2013, which may have been caused by several factors. Subdued inflation and gradually decreasing interest rates mitigated the costs of holding cash, while the increase in the transaction duty and the health contribution imposed on interest income may have also steered households toward cash savings. In this context, it is worth taking note of the factors that may encourage households to purchase government securities and investment fund shares/units.

Chart 39

Net saving of households

(seasonally adjusted revised* values, as a percentage of GDP)

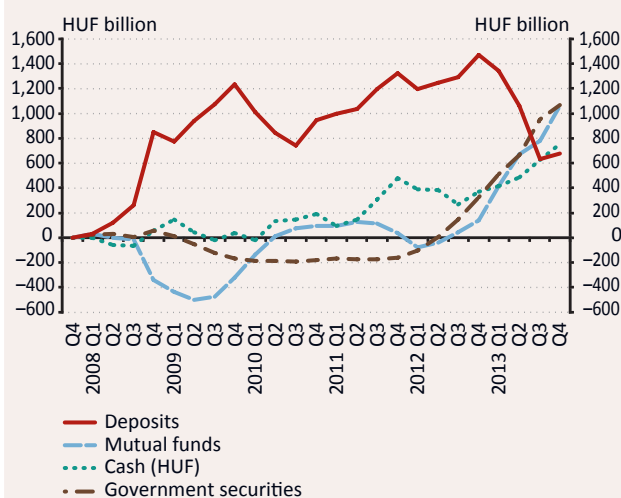


* With private pension fund savings, early repayment and real yield disbursements.

Source: MNB.

On the one hand, the retrospective yields of investment fund shares/units and government securities, which are popular among households, promise much higher yields than bank deposits with the same maturities. On the other hand, investment funds where more than 80 per cent of the portfolio is invested in HUF-denominated government securities are exempted from the health contribution levied on interest incomes last autumn. Similarly, HUF-denominated government securities are exempt from health contributions, and their yields are higher, compared to bank deposits offering identical terms.

Chart 40
Changes in key financial assets of households
(cumulative transactions)



Source: MNB.

Box 5

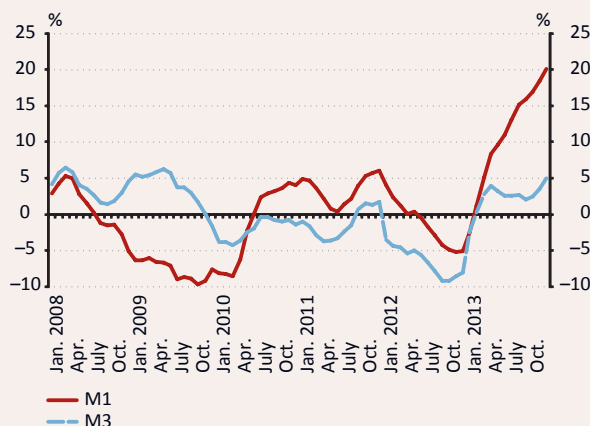
Background of the gap between monetary aggregates

In 2013, the difference between the growth rates of monetary aggregates rose significantly. The annual real growth rate of monetary aggregates had typically been similar in the past, and shifts in general took place in the same direction. Obviously, this was also influenced by the fact that M3, the broad monetary aggregate, includes the M1 aggregate, which contains liquid assets only (and additionally includes, inter alia, bank deposits with a maturity of less than two years and bank securities, along with money market funds). One period was an exception: in the months following the onset of the crisis, the growth of the M1 aggregate, which includes liquid assets, decelerated significantly, presumably also because of the fall in consumption, while as a result of the portfolio shift to safer assets, the growth of the M3 aggregate even increased (Chart 41). The process last year implied a sharp change compared to the quite similar trends observed over the three years that have passed since then: while the real growth of M1 rose above 20 per cent, that of the M3 remained below 5 per cent.

The portfolio rearrangement of households plays a dominant role

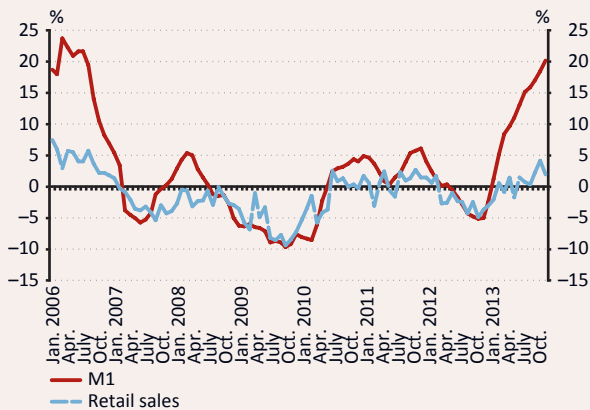
in the opening of the gap between the growth rates of monetary aggregates. In order to shed light on the background of the widening difference between these growth rates, we examined the extent to which various components contributed to the annual real growth rate of the M3 aggregate (Chart 43). Based on the contribution of individual factors to growth, it can be established that the gap between the narrower and the broader monetary indicators can be linked to changes in the savings structure of the household sector. On the one hand, cash in circulation, mainly owned by households, rose sharply (by almost HUF 350 billion) in 2013 H2, which can be explained by record low inflation and continuously decreasing deposit interest rates, together with the increase in the transaction duty. On the other hand, at the same time, after the decline in 2012, retail sales increased again in 2013 (Chart 42) (i.e. the increasing consumption of the population during the year may have contributed to the accelerating increase of liquid assets).

Chart 41
Annual real growth rate of key monetary indices



Source: MNB.

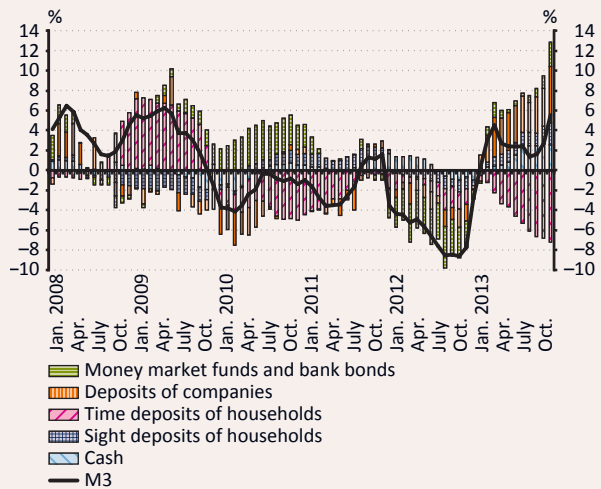
Chart 42
Annual real growth of M1 and retail sales



Note: Retail sales data do not contain the revisions made in March 2014.

Source: MNB.

Chart 43
Major factors of the annual real growth rate of M3



Source: MNB.

Households decreased their time deposit portfolio to an extent not seen before, dampening the growth rate of M3 (Chart 43). In addition to liquid assets, investment funds and the general government benefited from the downsizing of deposits (through the increasing government security portfolio held by households). It should be mentioned that non-money market investment funds keep a significant amount of bank deposits in their portfolios (almost 30 per cent of total financial assets). That means that the ever-increasing contribution to M3 of the corporate sector, which includes non-money market investment funds, can partially be traced back to the portfolio shifts of households.

On the whole, the behaviour of households may have also contributed to developments in external debt-type funds.

As already described in the section on the approach from the financing side, we saw a smaller fund outflow for banks in 2013 compared to previous years, while the consolidated general government reduced its external debts to a greater extent. The shifts observed during the rearrangement on the asset side among households (meaning that households provided less funding to banks while the government received substantial new funding) may have contributed to the process significantly. At the same time, it should be noted that the investment fund share/unit purchases of households continue to represent banking funds, since several investment service providers predominantly invest the savings held by them as bank deposits. Accordingly, although households reduced their savings in bank deposits directly, we can get a much more accurate view if we also take indirect funds into account.

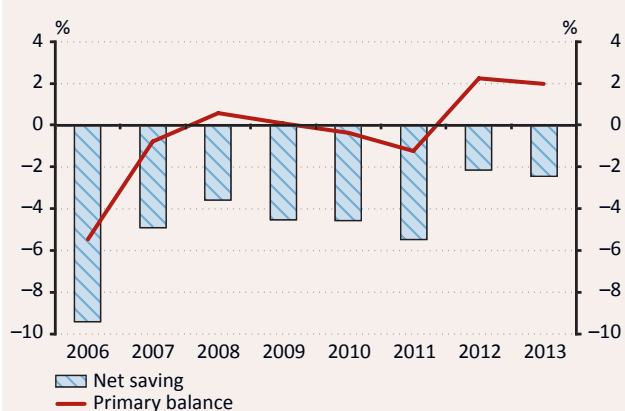
5.2 GENERAL GOVERNMENT

The government's low net borrowing also contributed to the improvement in the economy's net lending in 2013. The net borrowing of the general government was almost 2.5 per cent of GDP, which continues to reflect a low fiscal deficit. The low net borrowing of the general government shows

that the twin deficit, which was typical of Hungary before the crisis (i.e. simultaneous high deficits of both the current account and the general government) was almost completely eliminated. For the first time since 2010, the current account shows a surplus and the deficit of the general government decreased significantly, while the primary balance calculated without interest expenses has shown a surplus since 2012.

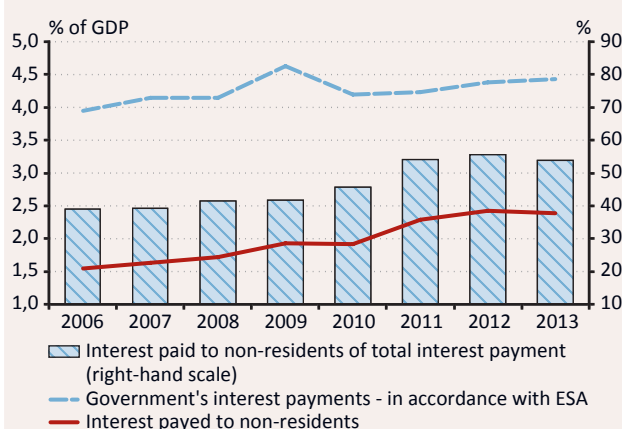
The low level of the general government's net borrowing primarily reflects the impact of numerous measures geared towards a sustainable budget. In 2013, deficit-decreasing steps were twice taken in the budget. In May 2013, the government ordered the blocking of certain expenses; in June, it improved the balance of the general government by increasing revenues (transaction duty, telecommunications tax, mine annuity, health contribution). Increased revenues as well as the electronic toll introduced in July are already partly reflected in the net borrowing for the year. However, other factors increased the budgetary deficit. On the expense side, the most significant of these are the salary increase in the public education sector and the increase in public sector employment, while revenue-side measures included the abolition of special sectoral taxes (partially offset by the newly introduced insurance, telecommunications and public utility taxes, and the increased income tax for energy suppliers).

Chart 44
Changes to the net borrowing of the general government
(as a percentage of GDP)



Source: MNB.

Chart 45
Interest expenditures of the general government



Source: MNB.

The interest rate on government debt paid to non-residents increased after the crisis. Within the general government balance, the interest expenses paid to non-residents are directly seen in the current account. The state's GDP-proportionate interest expenses have shown a slightly increasing trend over the past years. On the one hand, this is a result of government debt, which increased at the beginning of the crisis; on the other hand, it is due to the permanently high government security market yields. The incorporation of market yields into the government's interest expenditures is a slow process, because the state pays the interest rate for the portion of the government debt that was issued in the past (based on the yields that were valid at that time). Current yields only prevail for expiring and newly issued debt. The interest rate paid to non-residents increased in 2011, when investors significantly increased their Hungarian government security portfolio in the high-yield environment. Also, in addition to increasing interest expenses paid to non-residents, the portion of interest expenses paid to non-residents also rose in 2011, due to the composition effect of the restructuring of the private pension funds.

Issuance strategy in past years has gradually decreased the foreign exchange debt ratio within government debt. In the aftermath of the economic crisis, the loans taken from international organisations substantially increased the share of foreign currency within government debt. The ratio thus exceeded the level deemed acceptable by Hungary, and consequently the Government Debt Management Agency defined the objective of scaling down the foreign currency ratio. As a result, foreign currency-denominated government securities were only issued in 2010, 2011 and 2013 in the amounts necessary to cover maturing debt, and the

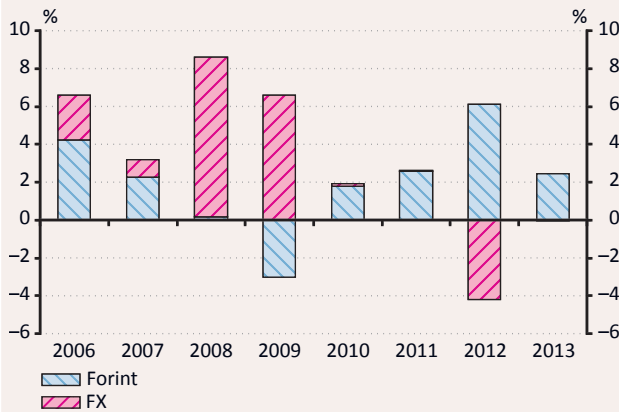
remaining net borrowing was covered in HUF (Chart 46). In 2012, the substantial non-resident and household demand for HUF-denominated government securities prompted the Government Debt Management Agency to refrain from issuing foreign currency denominated government bonds, contrary to earlier plans. In other words, the government opted to fund its maturing foreign currency-denominated debt mainly from HUF assets and existing financial instruments in 2012.

The ratio of non-residents within government debt is gradually declining but still remains above pre-crisis levels, partly due to the revocation of government bonds included in the pension fund portfolio. Non-residents assumed a progressively larger share in the funding of government debt following the onset of the crisis. The sharpest increase occurred in 2011, when the share held by non-residents spiked as a result of the revocation of government bonds – previously held by residents – following the transfer of wealth linked to the private pension fund portfolio (Chart 47). Subsequently, however, parallel to a decline in net public external debt, the share of non-residents progressively waned as a consequence of the aforementioned Government Debt Management Agency objective and repayment of the IMF loan. Nonetheless, this share still exceeded pre-crisis levels as 2013 drew to a close.

5.3 CORPORATE SECTOR

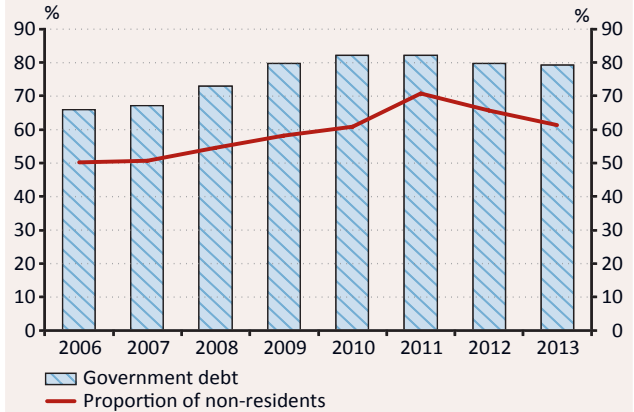
The large increase in companies' net savings played a dominant role in the significant growth of net lending calculated from the financing side, as seen after the outbreak of the crisis and since the beginning of 2012. Non-financial and financial corporations contributed equally to

Chart 46
Foreign currency structure of the Government Debt Management Agency's annual net debt issuance
(as a percentage of GDP)



Source: MNB.

Chart 47
Developments in government debt and the share of non-resident funding within government debt
(as a percentage of GDP and government debt)



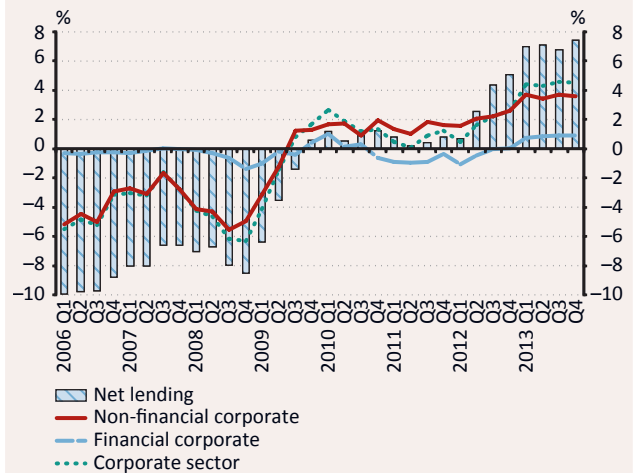
Note: Calculated from a non-uniform database, partly based on estimates.

Source: MNB.

the improvement seen in the past two years (Chart 48). However, it is worth noting that the net savings of financial corporations, by definition, is generally around zero. Financial corporations, as parts of the financial intermediary system, generally do not perform real economic activities, and the majority of the financial transactions performed by them affect both their financial assets and liabilities. Therefore, their net savings are close to zero; they are primarily influenced by the sector's profit or loss and changes in their financial assets (e.g. properties). Accordingly, the net savings of financial corporations was typically around zero before the crisis. Due to the crisis and subsequent to it has decreased significantly as a result of losses incurred during the early repayment scheme.¹⁴ In recent quarters, however, in parallel with the growth of the statistically recognised profitability of banks with domestic ownership, the net savings of financial corporations have improved slightly, contributing to the improvement of the net savings of the whole corporate sector. Apart from one-off transactions, the net savings of financial corporations remained permanently around zero in the past period; thus, in our analysis, we primarily focus on the financial savings of non-financial corporations.

From the financing side, the increase in the financial savings of non-financial corporations can primarily be attributed to the decline in borrowing. After the outbreak of the crisis, the borrowing of corporations fell significantly. Although non-financial corporations partially adjusted to the credit crunch by falling back on their financial assets, overall the sector's net savings improved significantly. Although in the recent period

Chart 48
Net savings of corporations and net lending
(four quarterly data as a percentage of GDP)



Source: MNB.

the accumulation of financial assets has started to increase again, in parallel with the easing of financing constraints, the raising of domestic and foreign funds by companies still remains significantly below the level that was typical before the crisis.

Capital in transit affects developments in the financial assets and liabilities of the financial sector – but reviewing the net changes in foreign assets, it can be established that the changes were dominant from the perspective of developments in the financial savings of companies. Since

¹⁴ The difference between market and fixed exchange rates as the capital transfer provided for the household sector, as described above, increased the net financial savings of households, on the one hand, and reduced the net savings of banks, on the other hand.

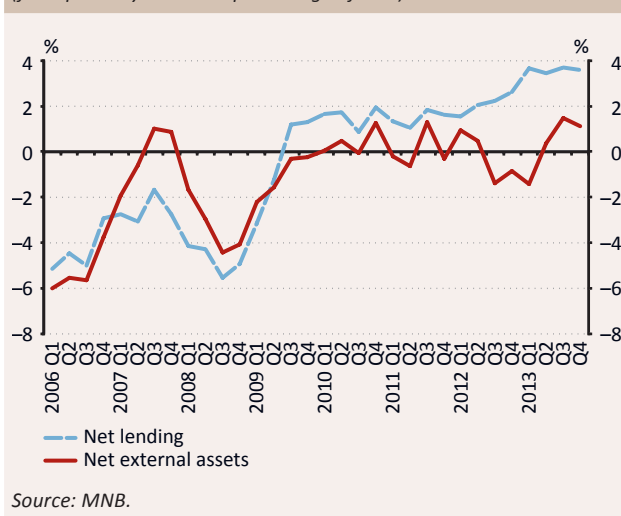
companies with foreign ownership frequently transfer funds through their Hungarian subsidiaries and companies often significantly rearrange their portfolios, only the net transactions of foreign assets and liabilities are worth examining. Accordingly, after the crisis, the increase in the net foreign assets of companies (and decline in the borrowing of foreign funds) played a key role in the rise of the sector's financial savings aside from the decline in domestic bank loans (Chart 49). From 2012, however, the financial savings of companies increased in parallel with some slight growth in foreign funds (net foreign assets decreased, as seen in Chart 49), and the movement in the opposite direction only tapered off in 2013. Thus, in the past years, companies increased their position vis-à-vis residents: mainly vis-à-vis banks (deposit placement and borrowing), but the increasing government security purchase of companies had a similar effect.

As regards corporate liabilities, the downturn in domestic and foreign borrowing was dominant, while equity capital continued to rise, albeit to a lesser extent. As for changes in the loan portfolio, the exposure to domestic banks decreased, while the decline in foreign loans was only moderate, even in the face of significant net lending. Companies' equity capital

Chart 49

Net savings and net foreign transactions of non-financial corporations

(four quarterly data as a percentage of GDP)



increased even after the outbreak of the crisis (i.e. in the recent period, the sector could receive new funds almost exclusively in this form, mainly from abroad).

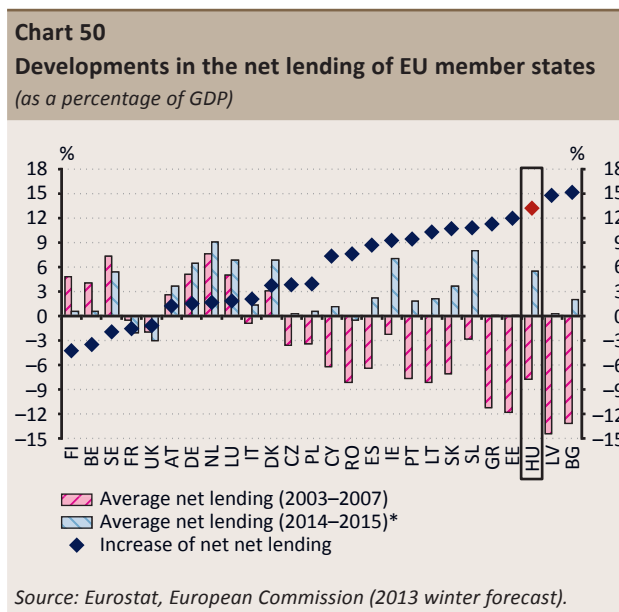
6 International comparison

Compared to other countries in the region, in addition to net exports, transfers also play an important role in the significant net lending of the Hungarian economy. On the one hand, the favourable trends in the real exchange rate and the terms of trade substantially supported the balance of goods and services, and thus Hungary's trade surplus greatly exceeds that of the Visegrád countries. On the other hand, the influx of EU transfers to Hungary is elevated and is higher than the subsidies received by the rest of the countries. As for the savings of different sectors, in addition to the low budget deficit, the significant savings of households and companies may have also contributed to a net lending that is outstanding even in regional terms. The external debt rate still exceeds that of the countries of the region despite the adjustment, whereas external debt in Mediterranean countries even grew during the crisis.

It is worth comparing the data of the Hungarian balance of payments to those of other countries. This chapter mainly focuses on a comparison with other countries in the region, while briefly touching upon some of the processes that, in some regards, set Hungary apart from the other countries. In order to assess the developments in Hungary's balance of payments in an international context, it makes sense to compare the Hungarian data to countries that are in similar situations. Therefore, comparison with the Visegrád countries seems relevant, since the economies of the region have faced similar challenges in past decades and all acceded to the European Union at the same time. The situation of Slovakia is special in the sense that, as a member of the euro area, it may have been less affected by the crisis, but on the other hand exchange rate adjustments could not take place given the country's use of the euro. It may also be useful to compare the situation of the Hungarian economy to the Slovakian processes from this perspective.

6.1 ADJUSTMENTS AFTER THE CRISIS

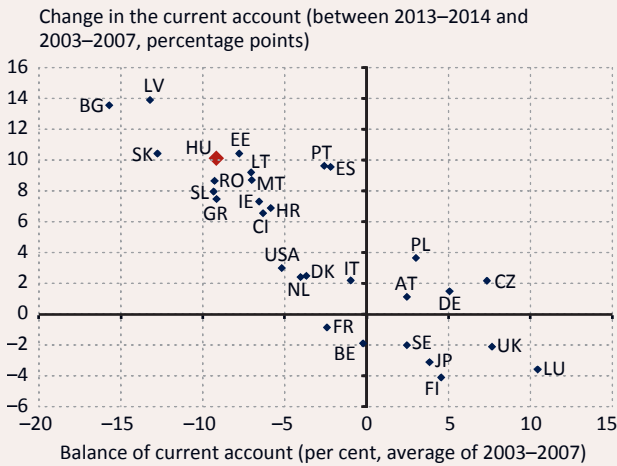
Compared to the member states of the European Union, the balance of payments improved considerably in Hungary as a result of the crisis. This improvement is likely to remain permanent over the medium term and may result in high net lending within the economy in the years ahead (Chart 50). In the years preceding the crisis, Hungary's net borrowing was one of the largest within the European Union. However, as a result of the crisis, net lending – the combined current and capital account balance – grew in line with a decline in domestic absorption and a greater utilisation of EU funds. This process was supported to a small extent by the lower deficit of the income balance due to the decreasing debt. Thus, based on the winter forecast of the European Commission issued in 2013, Hungary's net lending as a percentage of GDP



in 2014-2015 is likely to exceed the average of the period preceding the crisis by more than 13 per cent of GDP.

At the same time, it is also worth emphasising that, among EU member states, countries that had previously run significant deficits have shown the largest current account balance adjustments. Net lending is primarily shaped by the current account balance, and the bulk of the adjustment that materialised following the onset of the crisis was reflected in the current account balance. In this regard, besides Hungary, the most significant adjustments took place in the Baltic states and in Bulgaria and Slovakia. Overall, therefore, it seems that countries running the highest balance of payments deficits prior to the crisis showed the greatest improvement. While

Chart 51
Developments in the current accounts of EU member states
(as a percentage of GDP)



Source: Eurostat, European Commission (2013 winter forecast).

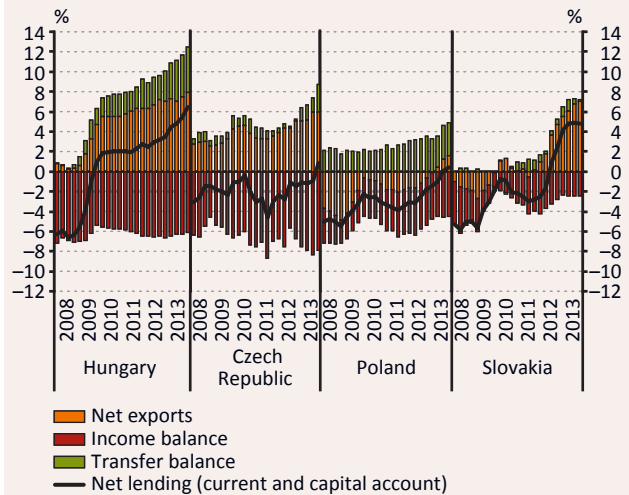
Hungary's current account balance started to improve directly after the crisis, many other countries, such as Slovakia, only began to see improvements in 2011-2012.

6.2 NET LENDING AND ITS FACTORS

In 2013 H2, the net lending of Hungary was especially high based on the four quarterly GDP-proportionate indices.¹⁵ Of the Visegrád countries, Hungary underwent some significant external adjustments after the crisis because of its high external debt, which was reflected in the high indebtedness of the government and the private sectors. As a result, both the government and the private sector lowered their consumption expenditures and used a larger portion of their incomes to reduce their debt. In turn, the economy's previous net borrowing turned into an outflow of funds, which is also reflected in the improving current account balance. In other Visegrád countries, external debt rates were also at a lower level, and therefore economic agents only had to perform minor adjustments (Chart 52).

- In the years directly after the crisis, the adjustment of the *goods and services balance* was smaller in the rest of the Visegrád countries than in Hungary. The trade surplus was already high in the Czech Republic when the crisis broke out, and it did not improve significantly, while Poland was more resilient during the crisis, partly due to its relatively large, closed economy. Slovakia's trade balance improved more significantly from 2011-2012 than anywhere else

Chart 52
Current accounts and capital accounts of the Visegrád countries
(four quarterly data as a percentage of GDP)



Source: Eurostat.

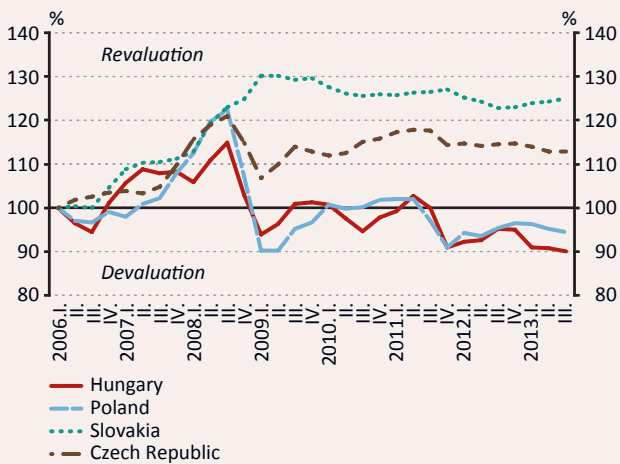
in the region, which can be attributed to a more robust growth in the export of goods, particularly automobiles. It should also be noted that net errors and omissions also rose significantly in Slovakia, i.e. improvements in the savings position in the real economy approach were not matched by developments on the financing side. Therefore, based on the net errors and omissions balance, actual net lending is smaller in the case of Slovakia, while in Hungary it is higher than what has been forecasted based on real economic data.

- The deficit of the *income balance* is particularly high in Hungary, due to its significant external debt. In the case of the Czech Republic, although the net external debt is negative (i.e. loans extended by domestic agents to foreigners exceed the country's foreign debt), owing to the high capital and portfolio investments by non-residents and presumably due to the elevated profit ratio, this country faces an income balance deficit that exceeds even that of Hungary.
- The *transfer balance* increases the net lending of the region's economies, mainly due to the utilisation of EU transfers.

As a result of these processes, in 2013 Q3, based on the four quarterly data, net lending was observed in each country of the region. In Hungary and Slovakia, its was around 5-6 per cent of GDP, but, based on the processes it is worth noting that net lending increased further in Hungary at the end of

¹⁵ Data are available until Q4 for Hungary and until Q3 for the other countries.

Chart 53
Changes in labour cost based real exchange rate
 (end of 2005 = 100)



Source: European Commission.

the year, while it stagnated in Slovakia between the beginning of the year and Q3. Based on the review of the other two countries in the region, after a gradual improvement in their current account balances, the sum of the current and the capital accounts showed a surplus in the year closing with Q3, hence their lack of need for foreign financing.

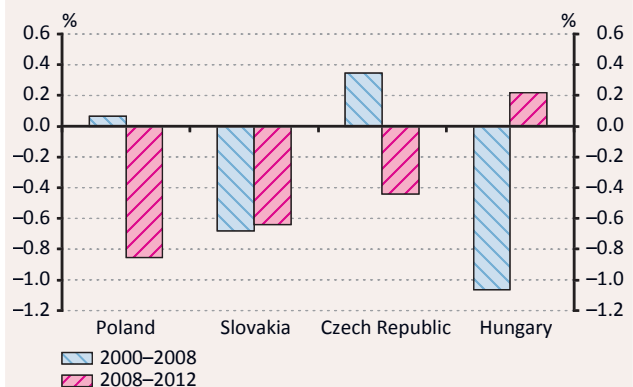
As for the competitiveness of the domestic export sector, the devaluation of the currency may have caused improvements in the export market share in the short run. Since the crisis, Hungary's real exchange rate has depreciated relatively steeply compared to other countries in the region, but the positive effects of this depreciation may have been curbed by a number of factors. In light of the high volume of foreign currency debt held by the private sector, improving price competitiveness may well have been partially offset by a deteriorating corporate balance sheet position at the consolidated level. Furthermore, given that imports of raw materials amount to a high proportion of overall exports (more than 50 per cent), the impact of the exchange rate on net exports may be limited. Finally, the bulk of Hungary's exports are concentrated in a small number of foreign-owned corporations, which keep their books in euros and therefore do not necessarily respond to short-term changes in the exchange rate. The service industry may have been more strongly affected by the exchange rate: in the first half of 2009, for example, when the forint depreciated sharply, there was a quick and considerable surge in shopping tourism. It should also be noted that, for example, the trade balance of Slovakia improved significantly in the past period along with a minor shift in the real exchange rate, which may indicate that, apart from the exchange rate, other (such as qualitative) factors can also have a considerable impact on the trade balance.

The improvement in the terms of trade may have also contributed to Hungary's improving balance of goods. In the period preceding the crisis, in regional terms the changes in the terms of trade were the least favourable in Hungary. However, in the first phase of the crisis, a significant improvement was seen in the domestic terms of trade: as opposed to the rest of the countries in the region, the favourable changes in the terms of trade strongly supported a rise in Hungary's trade surplus (Chart 54). The sustained improvement in the terms of trade may stem in part from the declining electronics sector, which has a falling price index, and also from the sustained decrease in international energy prices.

After the financial crisis, the largest adjustment took place in Hungary even according to the financing approach, which was reflected in the repayment of foreign loans (Chart 55). After the onset of the financial crisis, Hungary's net borrowing turned into net lending, which mostly took place in parallel with an increased outflow of debt-type financing (loans and bonds). In other words, economic agents began repaying their high external debt at a faster rate. By contrast, adjustment of a similar extent was not necessary in other Visegrád countries due to their smaller external indebtedness; therefore, foreign financing continued to rise in these countries even in the quarters following the crisis. In 2012, debt-type financing decreased for a short while in all the Visegrád countries.

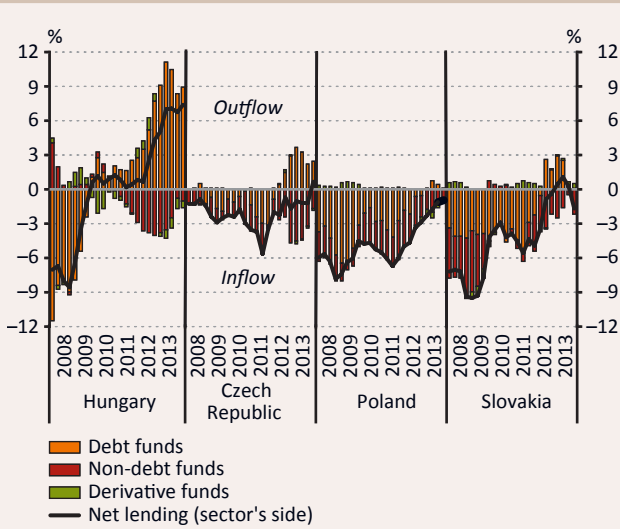
At the end of 2013, foreign financing decreased in Hungary and the Czech Republic, which was reflected in the outflow of debt-type financing. This outflow of funds took place in both countries besides the extensive repayment of foreign loans and the smaller inflow of non debt-type, equity-type investments. Meanwhile, in the two other countries of the region, foreign funds rose slightly due to the inflow of direct capital investments. On the whole, non debt-type financing

Chart 54
Changes in the terms of trade in the region



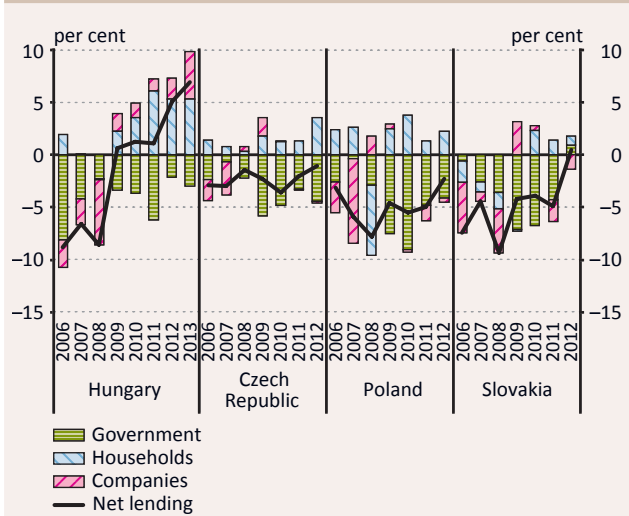
Source: Eurostat.

Chart 55
Net lending of the Visegrád countries
(four quarterly data as a percentage of GDP)



Source: Eurostat.

Chart 56
Net lending of the economy in a sectoral breakdown
(as a percentage of GDP)



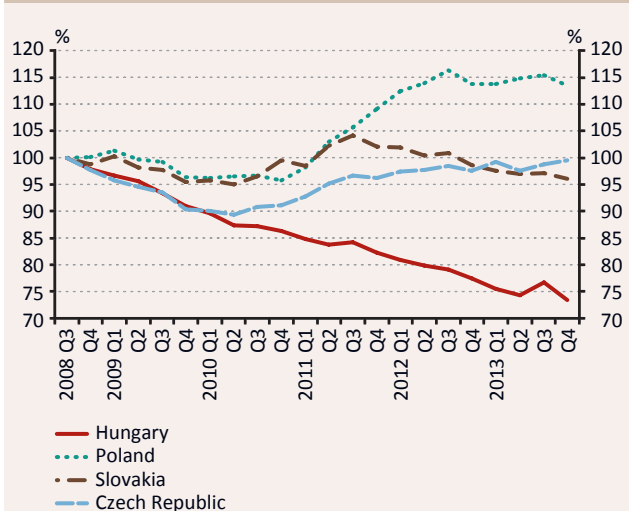
Source: Eurostat.

grew in all of the countries of the region, which can be interpreted as meaning that the countries in the region continue to represent attractive investment goals.

In Hungary, the much higher household savings and relatively high corporate savings are behind the net lending which is much higher than that of the regional countries, while the state's net borrowing is below average. After the crisis, the private sector significantly increased its net financial savings which, together with the government's subdued net borrowing, led to the situation where the earlier dependence on external funds turned into the repayment of previously drawn foreign loans. This applied to Slovakia's private sector as well (indeed, the former net borrowings were replaced by net savings, which developed while retail borrowing remained solid), but the general government only started the adjustment much later, which slowed down the adjustment of the net lending.¹⁶ As a result of the crisis, household savings rose across the region as well, but Hungarian households maintain the highest savings position within the region, and the growth of this position was the strongest in Hungary compared to the values before the crisis, which is in line with the fact that the decrease in consumption was the largest in our country after the crisis. Higher household savings mean that Hungarian households can finance the other agents of the

economy to a greater extent, compared to other countries in the region. In addition to household trends, it is typical of all countries of the region that the net borrowing of companies fell as a result of the crisis and the corporate sector turned to

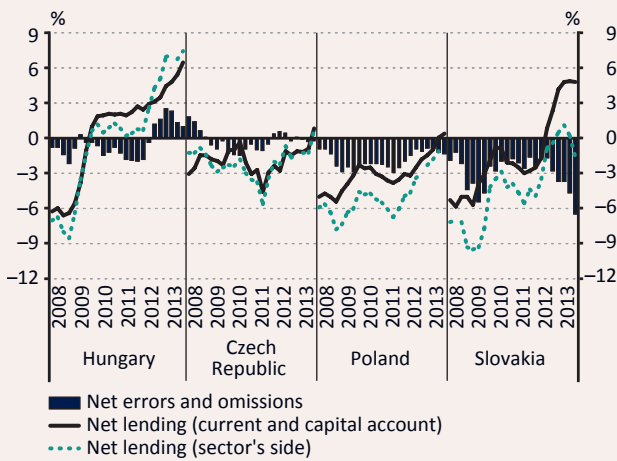
Chart 57
Changes in corporate borrowing
(data adjusted for exchange rate changes, October 2008 = 100)



Source: National central banks.

¹⁶ The high net borrowing after the onset of the crisis also contributed to the fact that Slovakia's government debt-to-GDP ratio rose by 24 percentage points between 2008 and 2012. However, in 2010, the escalating debt crisis drew attention to the sustainable debt paths and, as a result, the consolidated general government in Slovakia mitigated its net borrowing. In addition to the surplus of the consolidated general government (which is mainly owed to the Slovakian central bank) and the stabilisation of the savings of the private sector at a high level, the Slovakian economy became a net saver.

Chart 58

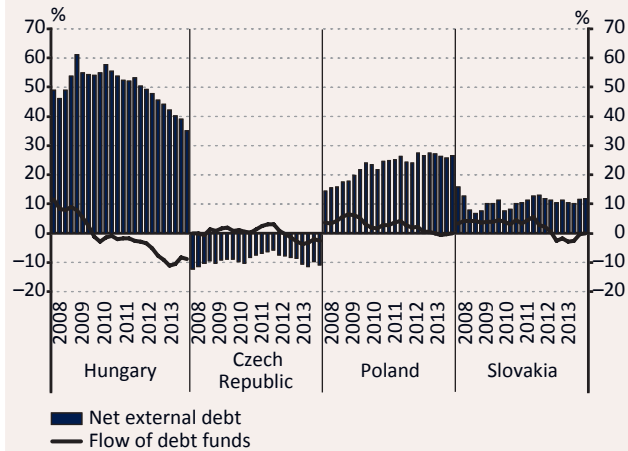
Balance of errors and omissions in the Visegrád countries*(four quarterly data as a percentage of GDP)*

Source: Eurostat.

a net savings position (although in the Czech Republic this was temporary). At the same time, it should be noted that, while in Hungary the net saving position developed in parallel with a permanent decline in corporate borrowing, the latter grew continually in the rest of the regional countries between 2010 and 2012. From the end of 2012, corporate loans started to decrease again in the rest of the countries of the region.

At the end of 2013, the net errors and omissions' balance was positive in Hungary, near zero in the Czech Republic and negative in the two other countries in the region. The net errors and omissions balance shows the difference between net lending based on the financing side, and the current and capital accounts; therefore, this item ensures consistency between the statistics collected from various sources. In Hungary, the two approaches approximated each other very closely after the crisis, and from mid-2012 onwards, the net errors and omissions balance turned positive (meaning that the developments indicated higher net lending on the financing side than on the real economy side), which was unique in the region. By the end of 2013, however, the index calculated based on the four quarterly figures decreased in Hungary and approached zero in the Czech Republic, demonstrating similar developments in the two net lending approaches. By contrast, the net errors and omissions balance is extremely high in Slovakia, representing more than 6 per cent of GDP. This means that while the economy is a net saver based on the trends of the real economy, the financing data show fund inflows.

Chart 59

Net external debt of the Visegrád countries*(as a percentage of GDP, without intercompany loans)*

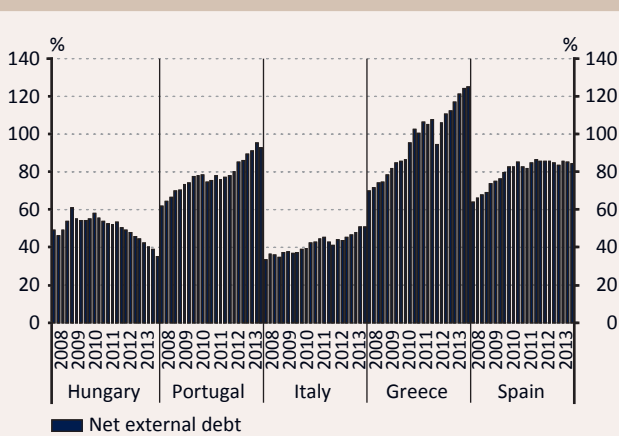
Source: Eurostat.

6.3 EXTERNAL DEBT RATIOS

Hungary's net external debt still exceeded that of the other Visegrád countries at the end of 2013, despite the strong downward trend seen in recent quarters (Chart 59). A country's external liabilities can be broken down into debt-type (e.g. loans, bonds) and non debt-type instruments (e.g. shareholdings). In respect of the portfolio of debt-type financing (excluding intercompany loans – see Box 3 for details), Hungary has the highest net external debt in the region. In light of the net external debt portfolios, Hungary is still the most indebted country in the region, despite the significant adjustment process seen in recent years, whereas the net external debt of the Czech Republic is outright negative. However, while in the past years GDP-proportionate external debt has stagnated in other countries of the region, in Hungary it has dropped significantly, by nearly 20 percentage points, since 2010. At the end of 2013, the economy's net external debt fell to 35 per cent of GDP, but it still exceeds the external debt of Poland and Slovakia.

Compared to the countries with significant external debt at the onset of the crisis, Hungary has greatly mitigated its external exposure, which only increased everywhere else. As regards external debt, it is worth examining the developments in countries which were already indebted before the financial crisis. Net external debt in the countries in the Mediterranean region only exceeded that of in Hungary ever so slightly when the financial crisis broke out. While the Hungarian economy adjusted significantly after the onset

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

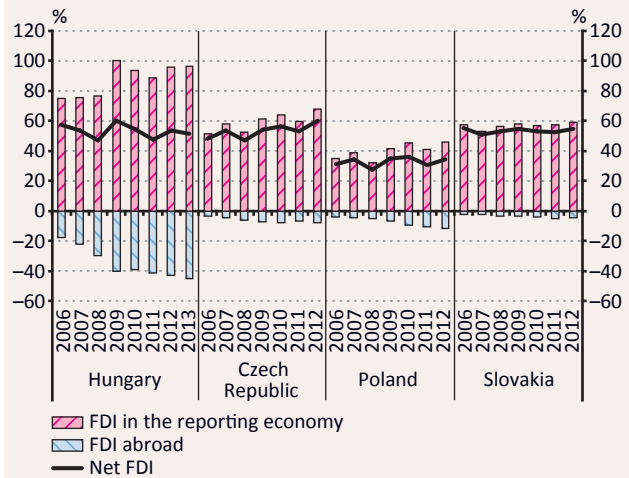


Source: Eurostat.

of the crisis, which by now is reflected in the decrease of debts to the level seen before the crisis, external debt in the Mediterranean countries continued to rise.

As for net FDI, regional differences are much less apparent. However, in respect of gross portfolios, Hungary has the highest value, partly due to capital in transit (Chart 61). Net FDI was around 50-60 per cent of GDP in the majority of the regional countries, and this ratio was only considerably smaller in Poland. Therefore, it should be noted again that the deficit of the income balance was higher in the Czech

Chart 61
Net FDI of the Visegrád countries
(as a percentage of GDP)



Source: Eurostat.

Republic than in Hungary, alongside a negative external debt and a net FDI portfolio similar to that of Hungary. This means that the Czech Republic pays higher yields on FDI investments than what is typical of Hungary. One of the biggest differences compared to the regional countries is that foreign investment by domestic agents is significant in Hungary. While the large corporations of the region invested less abroad, in the case of the Hungarian economy this index exceeds 40 per cent of GDP. At the same time, capital in transit plays an important role in it, as indicated above in the case of transactional data.

7 Glossary

Accrual basis	Transactions in the real economy are recorded at the date of the relevant economic event (e.g. utilisation of transfers) and not at the time the payment is actually made (see settlement basis).
Amortised long-term debt	Originally long-term debt with a remaining maturity of less than one year.
Balance of payments	The balance of payments includes the transactions between the resident and non-resident economic agents of a given country. It comprises the current account, the capital balance and the financial account.
Balance of trade	The balance of trade represents the difference between exports and imports of goods and services, that is, net exports.
Balance of transfers	In addition to unrequited current transfers, this comprises capital transfers as well.
Capital account	The capital account primarily comprises capital transfers. For Hungary, this mostly includes EU transfers (which even unrequited current transfers may contain).
Capital transfers	A capital transfer is an unrequited transfer, provided either in cash or in kind, that is relevant for accumulation of capital. When in cash, capital transfers represent occasional regular transfers of large amounts that add to the assets of the recipient (e.g. investment subsidies).
Current account	The current account contains the trade (goods and services) balance, the income balance and unrequited current transfers.
Current transfers	Current transfers represent unrequited, consumption-specific transfers provided either in cash or in kind. When in cash, they typically involve recurring transfers of small amounts, which constitute a part of the recipient's disposable income.
Debt liabilities	A subcategory of liabilities, comprising items where repayment and/or interest payment obligations are incurred (loans, deposits and debt securities). Loans represent financial transactions in which creditors provide funding to debtors, who in turn must repay the agreed amount by the deadline set forth in the loan agreement. When analysing the financial account, debt liabilities include foreign (bank) loans and deposits, portfolio investments (bonds and money market instruments), as well as foreign exchange reserves.
External debt	External debt comprises those debts of the economy as a whole (private and public sector combined) to another country that involve a repayment obligation with or without the payment of interest (loans, bonds).
External financing	The provision of funds for various (operational or investment-related) purposes from abroad.

External liabilities	External liabilities include all debt (loans, bonds) and non-debt (direct and equity investments) liabilities of the economy as a whole (private and public sector combined) towards another country. We can distinguish between net and gross external liabilities (refer to the definitions of gross debt indicators and net indicators for more detail).
Financial account	The financial account indicates the changes in financial instruments and liabilities that lead to net lending under the real economy approach.
Financing	Financing refers to the act of providing funds for various (operational or investment-related) purposes. In case of internal or self-financing, funding originates from domestic sources, whereas external financing refers to the provision of foreign funds.
Financing approach	This indicates the types of foreign (debt or non-debt) financing used by an economy for its spending beyond its income (in the case of net external borrowing), or the financial transactions made with its residual income (in the case of net lending).
Financial savings position	Also referred to as net lending.
Foreign direct investment (FDI)	FDI comprises those foreign investments where an investor resident in one country aims to obtain long-term holdings in a company resident in another country. Essentially, investments resulting in a minimum of 10 percent share of foreign ownership must be recorded in this category. If one or more ownership chains originate from one investor, every enterprise in every chain is in direct investment relationship.
Gross liability indicators	Gross indicators only take foreign investments in Hungary into account, disregarding foreign financial instruments held by Hungarian residents abroad (see net indicators).
Implicit interest	Implicit interest represents the average interest paid on debt.
Income balance	The income balance includes income flows relating to foreign investments (in the form of interest or dividends), as well as earnings received for work performed abroad.
Intercompany lending	Loans disbursed by the owner (and other affiliates belonging to the same group with the owner). On the balance of payments this is recognised as 'other capital' under FDI, and qualifies as a form of debt financing. However, for purposes of this report and due to economic considerations, this is regarded as non-debt financing, as our experiences show that there is a high degree of interoperability between participation and the various forms of intercompany lending and, furthermore, the risks entailed by intercompany loans (such as the renewal risk and the interest rate risk) are significantly lower than when borrowing from banks.
International investment position (IIP)	Supplementing the flow-oriented balance-of-payments statistics that describe the transactions between residents and non-residents, the IIP is a summary of stock-oriented statistical information on the stock of financial assets and liabilities towards non-residents.
Net errors and omissions (NEO)	These refer to statistical errors in the balance of payments. With the recognition of all transactions missing from source data as debit or credit

items, net errors and omissions (NEO) ensure the retroactive and formal compliance of the balance of payments with the principle of double-entry bookkeeping. This error is also manifested in the difference between the net lending capacities calculated from the real economy's side (current account, capital balance) and the financing side (financial account).

Net indicators	In addition to foreign investments in Hungary, net indicators also take into account – as a mitigating factor – the financial investments of Hungarian actors abroad.
Net lending/borrowing	Net lending (net financial savings) refers to the portion of income taken in the broader sense that is affected by neither consumption nor accumulation of capital in the economy. Net borrowing emerges when the balance of income and domestic absorption turns negative, that is, the sum of accumulation of capital in the national economy (in investments and changes in inventory) and consumption spending exceeds the country's disposable income.
Net lending calculated from above	Net lending/borrowing from the real economy's side, which is the balance of real economic transactions, is also called net lending/borrowing calculated from above, as it is derived from the current and capital accounts that are featured in the upper section of the balance of payments.
Net lending calculated from below	Net lending calculated on the financing side is the balance of transactions in financial instruments and liabilities. In balance-of-payments statistics, the value in the financing approach is referred to net lending/borrowing calculated from below because it is derived from the financial account featured in the lower section of the balance of payments.
Non-debt liabilities	Non-debt liabilities represents liabilities that do not involve any future repayment and/or interest payment obligations on the beneficiary's part. For purposes of this report and due to economic considerations, this category includes all foreign direct investments (both equity financing and intercompany lending, which, from a statistical standpoint, qualifies as debt), as well as portfolio investments (equity instruments only).
Portfolio investment	Portfolio investment refers to financial instruments traded (tradeable) on exchanges and other financial markets. Within portfolio investments, there are separate categories for equity instruments (portfolios and shares) and debt securities (bonds, money market instruments). Only participations up to 10 percent of ownership may be considered portfolio investments. Acquisition of ownership in excess of 10 percent is classified as direct investment.
Real economy approach	The real economy approach determines, based on external borrowing/lending that is the sum of the current and capital accounts – i.e. net exports – the income balance and the transfer balance, as to whether overall domestic absorption (in consumption and investments) exceeds disposable income.
Real exchange rate	The real exchange rate is the ratio of foreign and domestic price levels expressed in domestic currency – in other words, it indicates how much of a foreign good can be obtained for one unit of a domestic good.
Savings approach	The savings (or sometimes sectoral) approach shows the share of the individual sectors in the economy's net savings or net borrowing position.

Settlement basis	According to the settlement (or cash) basis, transactions in the real economy are recorded at the actual date the transfer or payment is made.
Short-term external debt (based on residual maturity)	Short-term external debt also includes, in addition to short-term debt based on original maturity, amortised long-term debt (originally long-term debt maturing within a year).
Special Purpose Entities (SPEs)	Special purpose entities (SPEs) essentially operate abroad, with minimal links to the host economy. They are primarily involved in group financing as a channel of funds within the group, with the direction and extent of transfers regulated by the respective parent company. Although the net cash flow of different financial instruments over a longer period is close to zero, given the large sums being moved around, the settlement of transactions particularly inflates the gross components of the financial account, thereby distorting the real economic and financial statistics of the national economy.
Terms of trade	The terms of trade is the ratio of a country's export price index to its import price index.
Unit labour cost (ULC)	The ratio of total labour costs (wages and public dues) to the real output of a given economy.

Gábor Bethlen

(15 November 1580 – 15 November 1629)

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

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

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

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

REPORT ON THE BALANCE OF PAYMENTS

April 2014

Print: Prospektus–SPL consortium

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