REPORT ON THE BALANCE OF PAYMENTS

JANUARY
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'We may not always be able to do what must be done, but we must always do what can be done.'

Letters 27
Gábor Bethlen

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In accordance with Act CXXXIX of 2013 on the Magyar Nemzeti Bank, the primary objective of the MNB is to achieve and maintain price stability and, without prejudice to its primary objective, the central bank is also responsible for maintaining the stability of the system of financial intermediation. 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 developing.

To that end, on a regular basis the Magyar Nemzeti Bank carries out comprehensive analyses of trends relating to Hungary's external balance, 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 Monetary Policy and Financial Market Analysis under the general guidance of Dániel Palotai, Executive Director in charge of Monetary Policy. Contributors: Zsuzsa Kékesi, Balázs Kóczián, Péter Koroknai, Rita Lénárt-Odorán and Balázs Sisak. It was approved for publication by dr Ádám Balog, Deputy Governor.

This Report is based on information for the period ending 23 December 2014.

SUMMARY

***In 2014 Q3, the four-quarter surplus of the Hungarian economy's current account stood at EUR 4.2 billion**, while the capital account surplus, comprising mainly EU transfers, was in excess of EUR 3.8 billion. As a result, the four-quarter **net lending of Hungary rose to 8 per cent of GDP, still surpassing the values recorded in neighbouring countries by a large extent.** Net lending, already elevated earlier, may contribute to a further reduction in the external debt and vulnerability of the Hungarian economy.*

***The slight rise in net lending** calculated based on the real economy side **stems primarily from the rise in EU transfers** and, to a lesser degree, an improvement in the income balance, occurring in conjunction with a reduction in external debt. The external trade surplus decreased slightly in Q3, driven by dynamically rising investment and imports linked to the filling-up of natural gas storage facilities as well as by a slowdown in external demand.*

*Financing data also reflect that the economy's net lending rose in Q3. **Debt liabilities decreased substantially,** driven largely by the net debt reduction of the state consolidated with the MNB, amounting to more than EUR 1 billion. The latter stems primarily from the conversion of MNB bills to deposits, which changed the structure of external debt and mitigates gross external debt, while leaving net external debt unaffected. Following a substantial outflow during the previous quarter, Q3 saw a **net FDI inflow of EUR 0.5 billion.** It is noteworthy, however, that preliminary monthly data for October point to a further decline in external debt and FDI inflows at the end of the year.*

*The significant outflow of funds in 2014 Q3 and GDP growth resulted in **another decline in external debt ratios**; in other words, the increase in Q2, which stemmed primarily from falling yields, turned out to be only temporary. Net external debt fell to below 36 per cent of GDP, while gross external debt – following a more pronounced decrease than the net indicator – sank to 88 per cent of GDP. The reversal in gross external debt was mainly linked to the consolidated general government, driven largely by the conversion of the MNB's main policy instrument into deposits. **Short-term external debt continued to fall in Q3 to nearly EUR 24 billion, reducing the country's external vulnerability and dependence on external financing.***

*Analysing the external balance from the perspective of sectors' savings, the rise in net lending in Q3 **can be linked to higher financial asset accumulation by households and the general government's lower borrowing requirement, presumably related to the whitening of the economy.** At the same time, the improvement in the external position was mitigated by a decrease in corporations' financing capacity in the wake of higher investments. **Reallocation of the household portfolio also slowed:** the volume of bank deposits barely changed during the quarter and the volume of government bonds fell slightly, while mutual funds exhibited significant growth. Households therefore continued to indirectly increase their role in funding the state through purchases of investment fund shares, which may contribute to a further decline in foreign dependence.*

In our special topic section, we discuss the effects on external vulnerability of the measures related to households' foreign currency loans.** Settlement and forint conversion of foreign currency loans **will substantially reduce households' exchange rate risk**, and a strong adjustment may occur in the banking system, which may result in a decline in banks' external liabilities. Over the long run, foreign exchange reserves, the central bank's two-week deposits **and gross external debt may decrease by 9 per cent of GDP, but at the same time deleveraging will not affect net external debt directly.** Thus, as an effect of conversion to HUF, Hungary's external vulnerability indicators may improve significantly: in addition to renewal and interest risks related to external debt, the banking system's swap exposure may decrease as well. At the same time, **the adjustment process may have an effect on the government securities market as well**, with this also depending on the extent of the exchange rate risk non-residents intend to take and the development of yields. The measures related to foreign currency loans may indirectly **increase net lending to a small degree, via lower interest paid on foreign debt.

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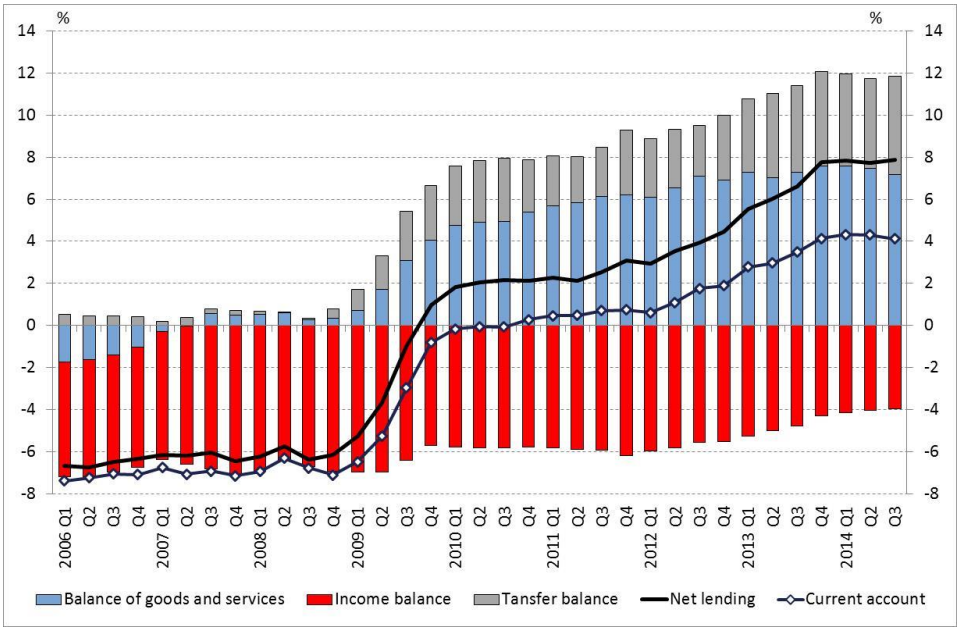
1. REAL ECONOMY APPROACH

Hungary's net lending stood at around 8 per cent of GDP in 2014 Q3, following a slight increase. The four-quarter surplus on the current account amounted to EUR 4.2 billion, while the capital account surplus reached EUR 3.8 billion. In the main, the improvement in the external position is linked to higher absorption of EU transfers, and to a smaller extent – in relation to shrinking external debt – a further decline in the income balance deficit. The external trade surplus fell slightly in Q3, driven by the import implications of dynamically investment growth and imports linked to the filling-up of gas storage facilities. Net lending may contribute to a further reduction in external debt and the vulnerability of the Hungarian economy.

Based on a real economy approach, the four-quarter net lending of the Hungarian economy improved slightly, standing at 8 per cent of GDP in Q3.[1] Seasonally unadjusted net lending amounted to EUR 2.4 billion in this period, exceeding the previous year's value in year-on-year terms. The rise in annual financing capacity stemmed primarily from stronger absorption of EU transfers, while the annual surplus on the current account remains at around 4 per cent of GDP, despite a slight decrease. The slight rise in the external balance surplus is therefore fundamentally linked to the rise in the transfer balance; the income balance [2] deficit narrowed slightly while the trade surplus shrank slightly (Chart 1). The surplus on Hungary's current account still exceeds those of its regional peers: based on data available before Q2, the annual balance of the current account remained in deficit in Poland and was close to zero in the Czech Republic, while the surplus of Slovakia was far lower compared to that of Hungary.

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



All charts by the MNB unless otherwise indicated.

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

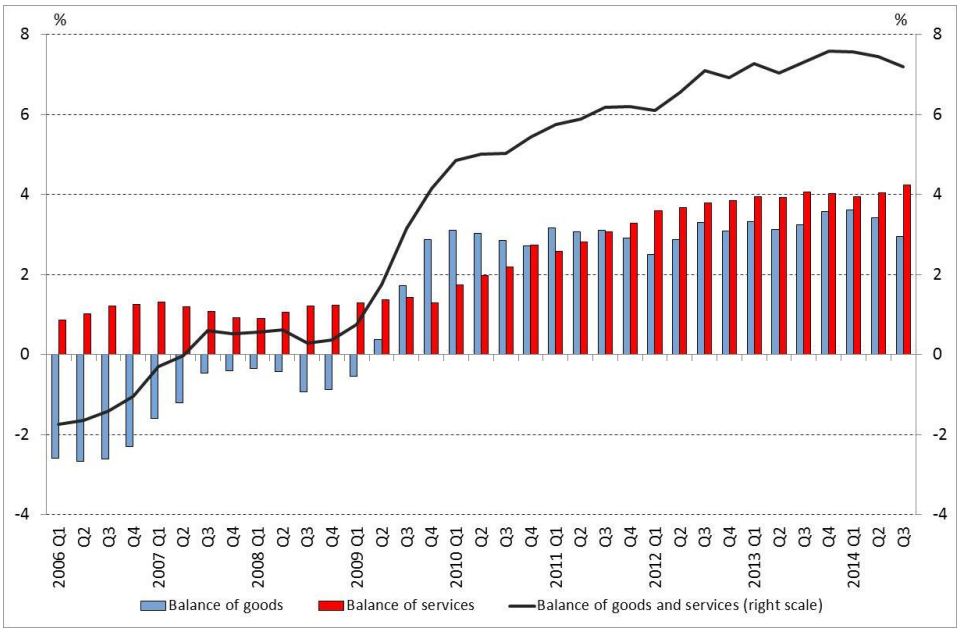
1.1. Balance of trade

[1] The revision of quarterly GDP slightly lowered external balance indicators as a percentage of GDP. The degree of this decline falls significantly short of the shift that occurred during the previous quarter (linked to normal and extraordinary revisions) and causes a one-off 0.1-0.2 percentage point decrease in levels.

[2] In our view, the "other primary income" classified now as primary incomes and secondary income categories both represent unrequited transactions that correspond to the category of current transfers previously recognised under transfers. Accordingly, in the rest of this document – with due consideration to the purposes of the analysis – the balance of transfers includes, in addition to the capital account, other primary incomes and secondary incomes that correspond to the formerly used unrequited transfers, while the income balance comprises primary income excluding other primary incomes.

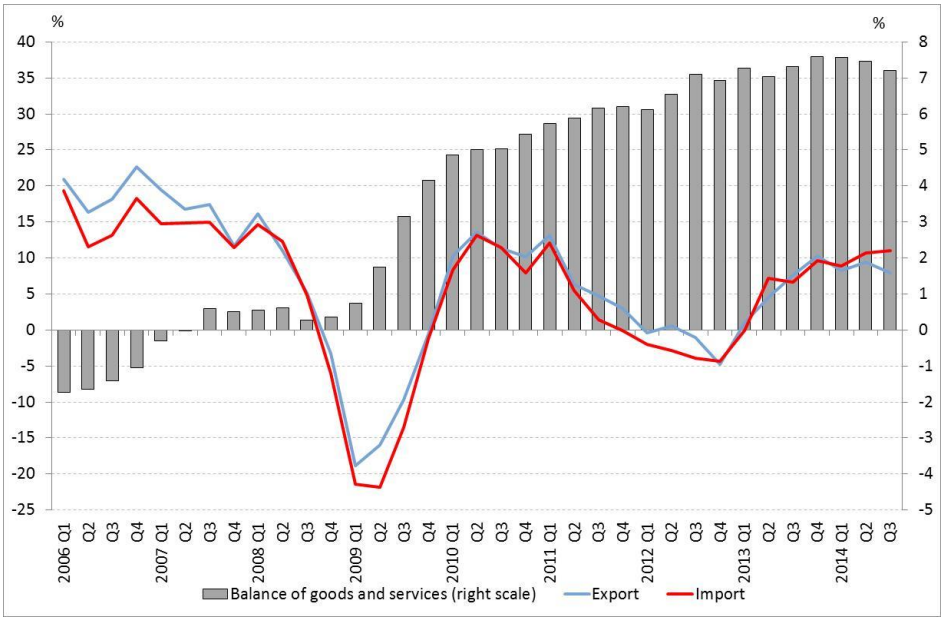
The four-quarter trade surplus continued to fall slightly, mainly due to a decline in the balance of goods, while the balance of services kept rising. Until the beginning of 2014, the balances of goods and services had each accounted for roughly half of the trade surplus. However, in recent quarters, the balance of goods started to decline, while the balance of services began to rise, following a protracted stagnation.

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



In 2014 Q3, the annual balance of trade began to decline in conjunction with slightly slower export growth and mildly stronger import growth, with the latter driven by the filling-up of gas storage capacities. The widening gap between real growth rates in exports and imports may have been driven by a number of factors, in addition to the base effect. Exports may have been negatively impacted by weakening external demand which also affected Hungarian industrial production, and a drop in exports to Russia and Ukraine. At the same time, it is important to emphasise that dynamic exports by domestic vehicle manufacturing and the related sectors – dampened by temporary production shut-downs at several automotive plants in August – continued to have a positive effect on the export performance of the Hungarian economy. In the third quarter, in addition to the import implications of rising investment expenditures, imports were also driven by the additional "filling-up" of natural gas storage capacities in Hungary, far outstripping the previous year in year-on-year terms (by EUR 300 million). Overall, the above changes in volumes pointed towards a decrease in the trade surplus.

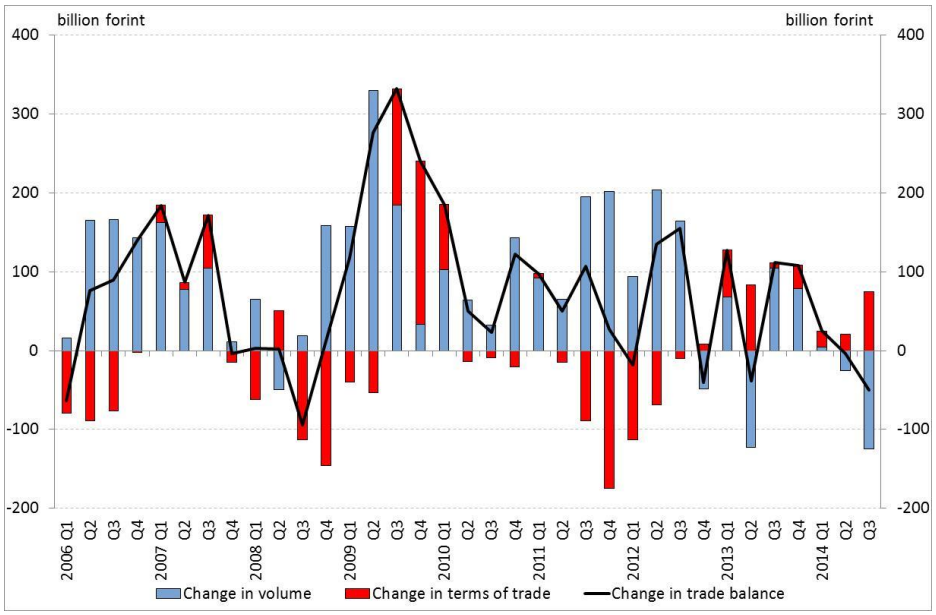
Chart 3*: Annual real growth in exports and imports and GDP-proportionate annual trade surplus*



Source: HCSO, MNB.

The trade surplus decline stemming from volume was partially offset by a further improvement in the terms of trade. Based on export and import price indices, following the small improvement in the previous quarters, the terms of trade contributed to the surplus on the balance of goods and services to greater extent (Chart 4.). Low commodity prices and weak external inflation contributed to this stronger improvement in the terms of trade, as well as a shift towards higher value exports.

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

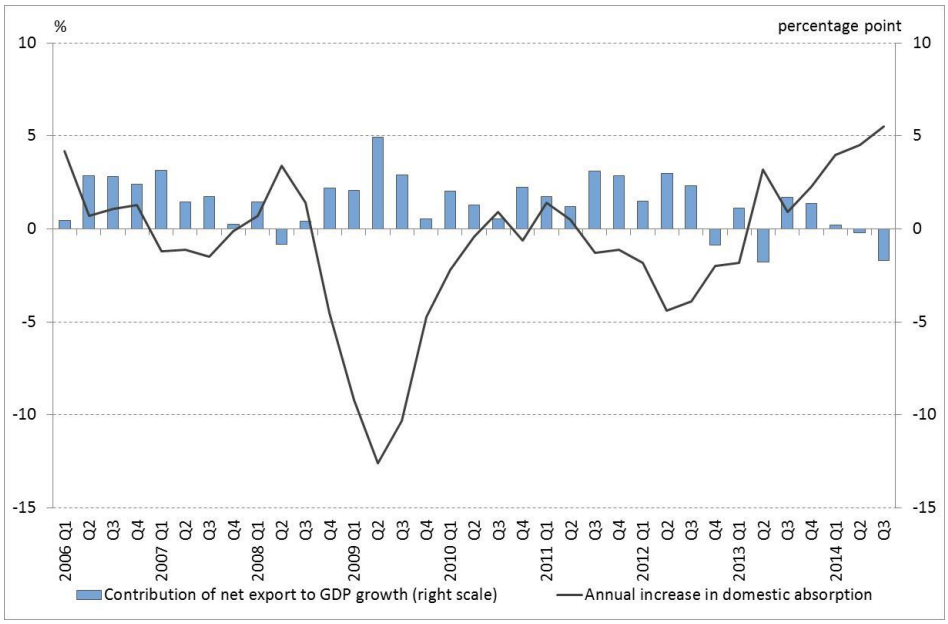


Source: HCSO.

In the context of rising domestic absorption, the contribution of net exports to growth turned negative, partly due to imports related to the filling-up of gas storage capacities. The development characteristic since the middle of 2013 continued in 2014 Q3: the expansionary effect of household consumption, the FGS and rising EU transfers on investment drove a continuous acceleration in domestic absorption, which exhibited an expansion not seen since 2005 (Chart 5). In addition to economic growth, which was characterised by a more balanced structure in the past, the contribution of net exports to growth typically only slowed economic growth in the previous quarters, whereas it

retarded economic growth more markedly in Q3. However, the filling-up of gas storage capacities in Q3 contributed far more to this than the deterioration in the underlying trends: the 100 per cent import content of this substantially lowered the contribution of net exports to growth, which was offset in terms of economic growth by similar additional growth in inventories.

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



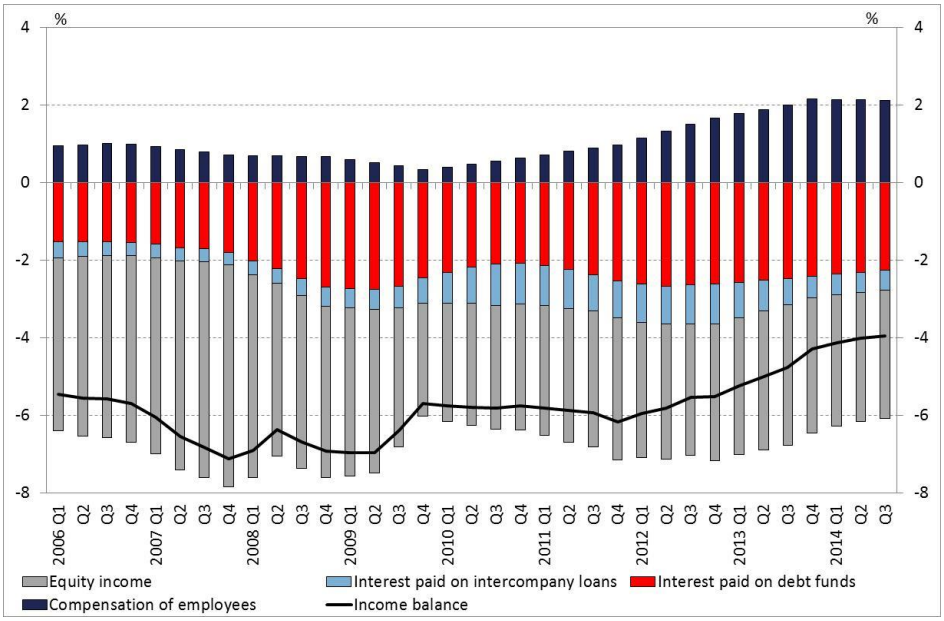
Source: CSO.

1.2. Income balance

In Q3, the four-quarter value of the income balance deficit fell to less than 4 per cent of GDP, which continues to drive a rise in net lending and thus a further reduction of external debt and the vulnerability of the Hungarian economy. The majority of factors constituting the balance contributed to the reduction of the income balance deficit (Chart 6). The sharpest decline occurred in interest paid abroad: the external debt of economic agents is continuously shrinking in parallel to continuously elevated net lending, which, along with falling yields, is reflected in the interest paid on foreign debt. In addition, the estimated outflow of funds from the profit of foreign-owned firms also decreased very slightly.[3] The earnings of resident employees stagnated in Q3, but remained substantial, significantly improving the Hungarian economy's income balance.

[3] Only a limited amount of quarterly data is available on the profitability of foreign-owned enterprises operating in Hungary; therefore, information on quarterly profit outflows are based on estimates for the most part. For more details, see the statistics publication entitled '*Hungary's Balance of Payments and international investment position statistics, 2012*'.

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

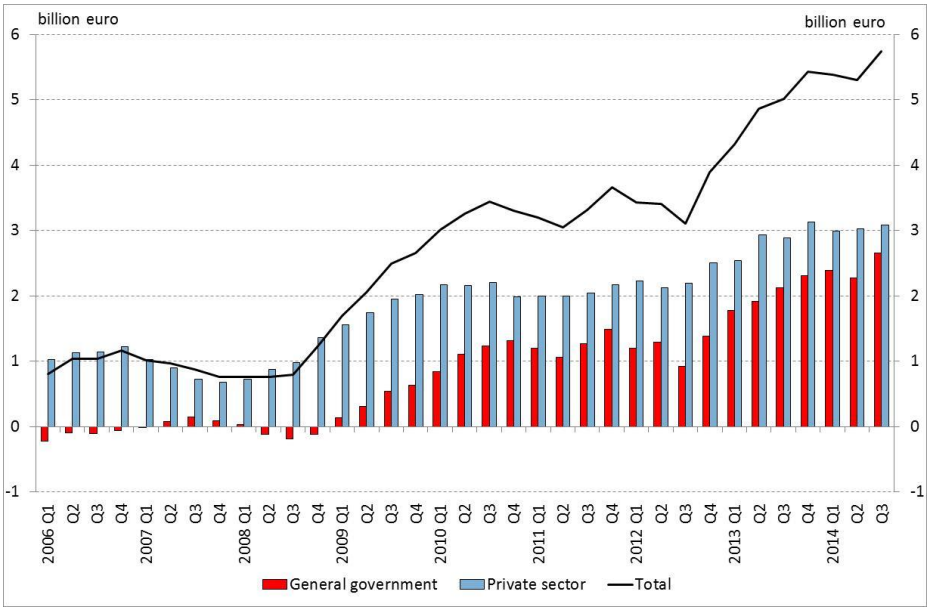


** Income balance: labour income, income on equity and income on debt.*

1.3. EU transfers

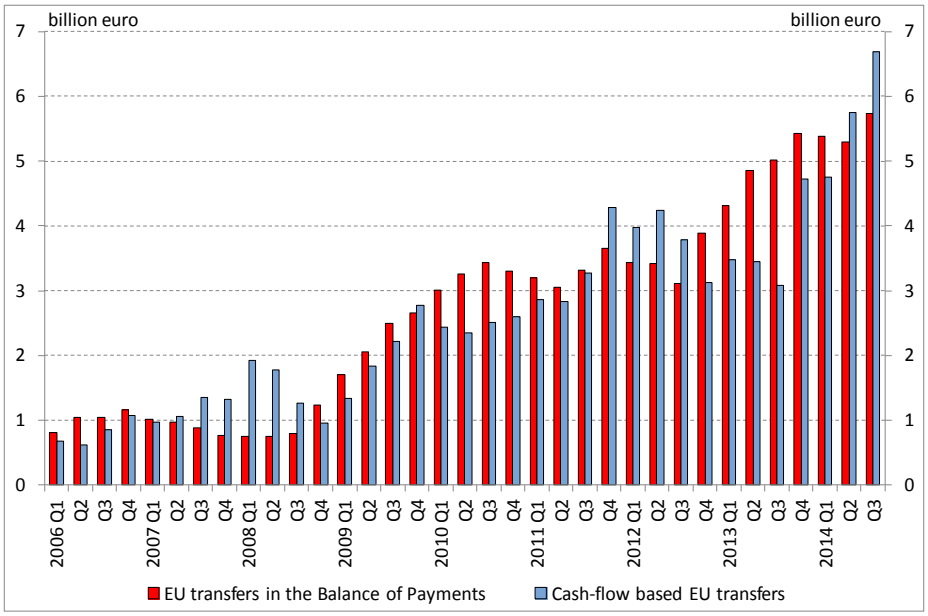
Absorption of EU transfers continued to rise in 2014 Q3, driven mainly by subsidies received from the general government. On an accrual basis, balance of payments data indicate that the absorption of EU funds exceeded EUR 1.4 billion in Q3, which substantially exceeds the value recorded one year earlier. Consequently, the four-quarter value of transfer absorption rose by EUR 0.4 billion to around EUR 5.7 billion (Chart 7), which significantly contributed to the increase in the country's net lending that materialised in Q3. Based on a sectoral breakdown, the ratio of transfers to the general government fundamentally increased; thus the public sector's absorption of EU transfers approached that of the private sector (it is still important to note that infrastructure development financed from the funds received by the general government may have partly increased the private sector's income). In Q3, the absorption of capital transfers driving investment activity was dominant (EUR 1 billion), while the value of EU transfers recognised under other primary income – those deriving from product and production taxes and subsidies – was smaller.

Chart 7*: Sectoral breakdown of net EU transfers (four-quarter values)*



In Q3, EU transfers on a cash-flow basis were far higher in year-on-year terms, amounting to an annual figure of EUR 6.7 billion (Chart 8**).** In addition to the (accrual-based) absorption of EU transfers as presented in the balance of payments, the cash-flow based value of EU transfers (which increases foreign exchange reserves) continued to increase markedly in 2014 Q3. This may be explained by the fact that the settlement of invoices suspended in April was resumed. Overall, EU transfers in Q3 were roughly on par with absorption, but due to the exclusion from calculations of the fall in transfers that occurred one year earlier, the increase in the four-quarter transfer figure significantly exceeded absorption.

Chart 8: EU transfers according to the accrual-based and the cash-based approach (four-quarter values)

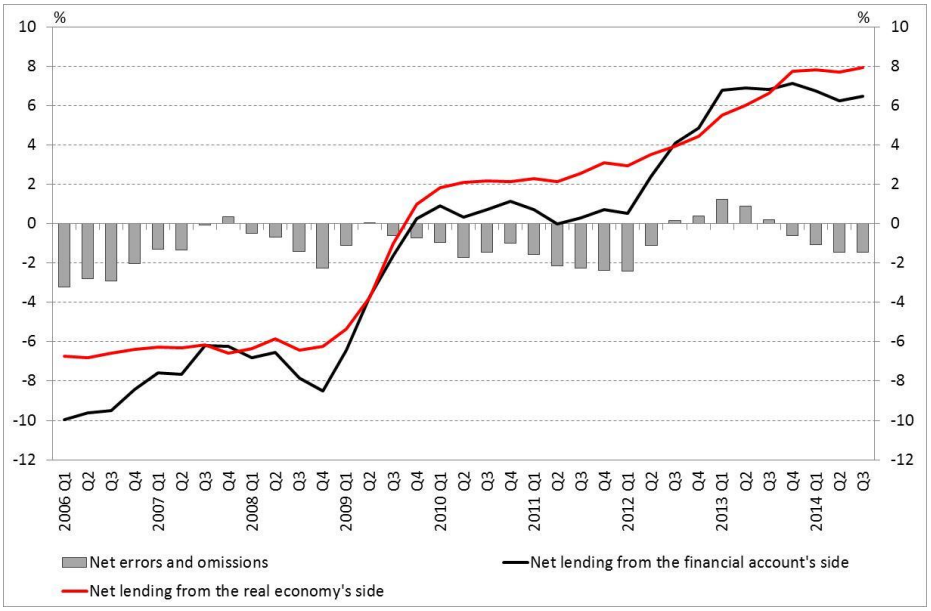


2. FINANCING APPROACH

Financing data also indicate that the economy's net lending might have remained substantial in Q3, due to a significant decrease in debt liabilities and an inflow of non-debt funds following their outflow in the previous quarter. Based on sectoral developments, resident agents substantially decreased their net external debt; the state, consolidated with the MNB, made a substantial contribution in this regard, amounting to a net reduction in debt of EUR 1 billion.

In Q3, the four-quarter net lending figure derived from financing data amounted to 6.5 per cent of GDP (Chart 9), remaining lower than the value calculated from the real economy transactions.[4] The negative statistical error therefore currently indicates that the external debt ratios of the economy declined at a slower rate than would have been suggested by real economy data (such as foreign trade and transfer data). The annual errors and omissions balance figure rose slightly, as net lending calculated from the real economy's side expanded at a faster rate in Q3 compared to the balance calculated from financing data.

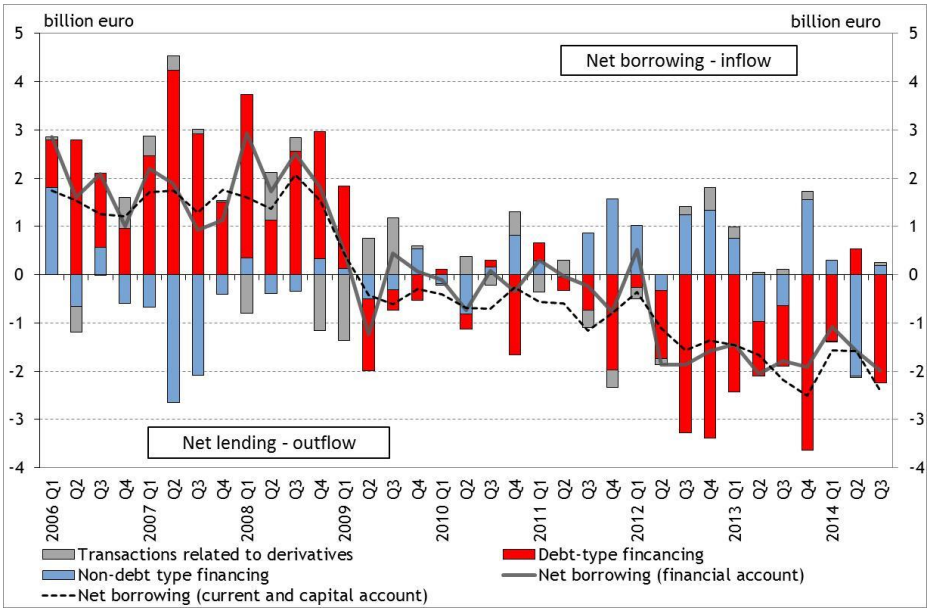
Chart 9: *Two types of net lending and "Net errors and omissions" (four-quarter data as a percentage of GDP)*



In Q3, the seasonally unadjusted outflow of funds rose to EUR 2 billion, which almost entirely stemmed from a decline in debt liabilities, further decreasing external debt ratios. The rise in net lending calculated from financing data means that external liabilities contracted to greater extent in Q3 compared to the previous quarter (Chart 10.). The stronger outflow of funds was fundamentally coupled with a strong outflow of debt liabilities. Based on transactions, Hungary's net external debt shrank by over EUR 2 billion over the course of a single quarter. A slight rise in non-debt liabilities materialised along with an inflow of FDI and a smaller decline in net portfolio equity liabilities.

[4] Trends in the balance of payments can also be analysed by examining the financing of real economy transactions. Indeed, the financial account shows what types of transactions were used by resident economic agents to finance transactions in the real economy that had an effect on net financial worth. While data derived from the real economy approach and the financing approach should be identical in theory, differences are likely to arise in practice due to non-integrated data sources, incomplete observation and the different treatment of the exchange rate, as indicated by the category of "Net errors and omissions".

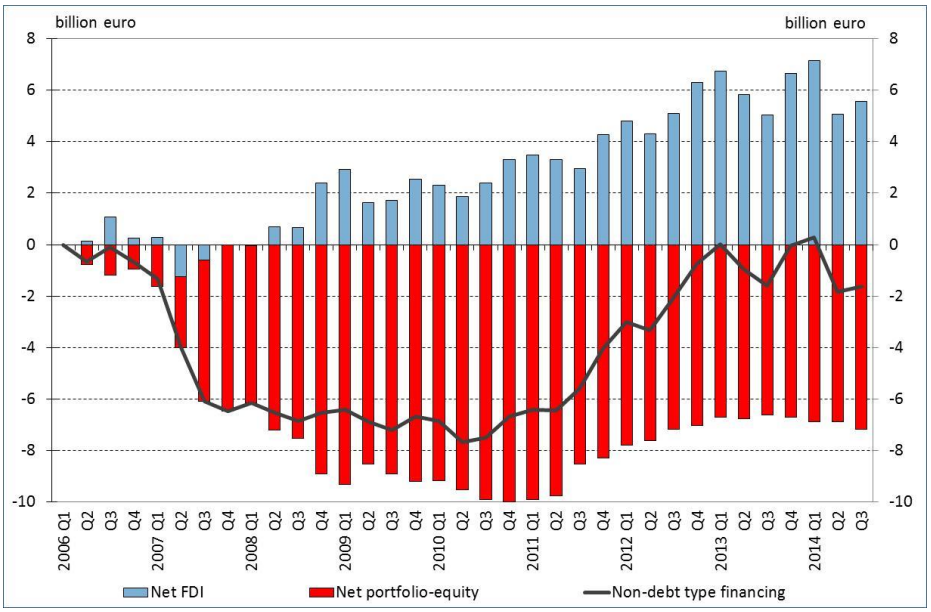
Chart 10: *Developments in the structure of net lending (unadjusted transactions)*



2.1. Non-debt liabilities

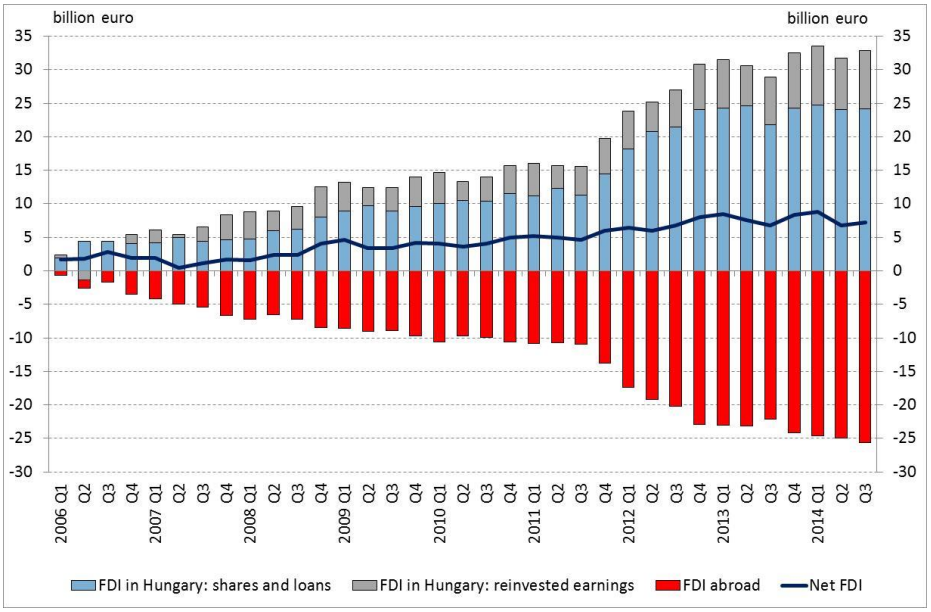
Following the outflow of funds in the previous quarter, the rise in FDI offset the decline in portfolio equity investments, resulting in an overall increase in the economy's non-debt funds. The economy's funds originating from FDI rose substantially during the quarter, primarily due to capital injections by banks. This was offset by a decrease in net portfolio equity liabilities (Chart 11.), driven primarily by foreign investments of residents.

Chart 11: *Developments in the influx of non-debt liabilities (cumulative transactions)*



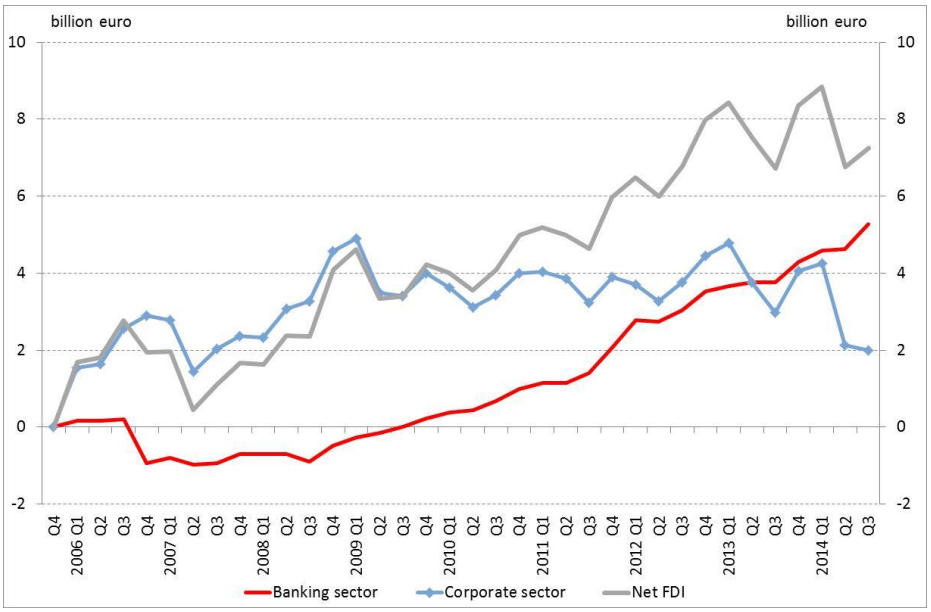
In 2014 Q3, following a decline during the previous quarter, net FDI rose by EUR 0.5 billion, driven by a significant rise in reinvestments and equity. Net FDI to Hungary increased during the quarter: the EUR 1 billion rise in reinvestments and EUR 1.3 billion rise in equity was offset by a decrease in intercompany loans and a rise in investments abroad (Chart 12). State acquisitions played a role in the rise in shareholdings, the impact of which was offset by capital injections by banks. During the quarter, the foreign owner of two large banks (Erste and MKB) carried out capital injections, increasing foreign investments in Hungary by EUR 600 million according to press reports. In addition, the state acquired MKB Bank during the quarter, decreasing FDI in Hungary by EUR 50 million.

Chart 12: Developments in foreign direct investment (cumulative transactions)



The rise in net FDI stemmed largely from another wave of capital injections by banks, while the corporate sector's FDI funds shrank. The corporate sector's FDI funds stagnated following the onset of the crisis, but the past two years have been characterised by a decline on the whole (Chart 13.). Rising net lending in parallel with corporate deleveraging, along with investment activity falling short of disposable income, is reflected on the funding side not only in the repayment of bank loans, but also in developments in the sector's direct investments. In 2014 Q3, the outflow of net FDI funds in the corporate sector continued, albeit at a slower pace. Meanwhile, new foreign investment was channelled into the banking system, primarily in the form of capital injections. Bank capital injections, a regular practice since the onset of the crisis, thus materially contributed to the influx of FDI to Hungary: more than EUR 5 billion in FDI was channelled into the banking system compared to the end of 2008.

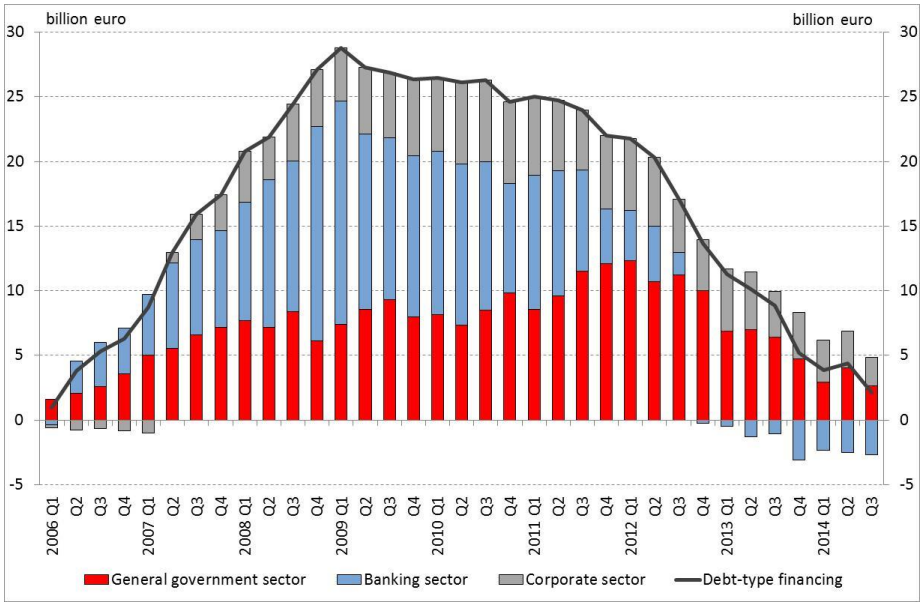
Chart 13: *Developments in net FDI by sector (cumulated transactions)*



2.2. Debt liabilities

In Q3, the outflow of debt funds exceeded EUR 2 billion, the bulk of which was linked to the general government. At the same time, the rest of the sectors also scaled back their net external debt. The rise in debt observed in the previous quarter proved to be only temporary, and 2014 Q3 saw a considerable decline in the net debt liabilities of the economy. While all sectors contributed to the contraction, the most significant decline – nearly EUR 1.4 billion – was linked to the general government consolidated with the MNB, owing, in part, to the conversion of MNB bills into deposits. In addition to the general government, banks and corporations also scaled back their external debt (changes in the size of the columns illustrating cumulated data in Chart 14 show the change in net external debt for each sector). As a result, the four-quarter cumulated debt reduction of domestic sectors approached EUR 6.7 billion which, although still significant, indicates a decline compared to the nearly EUR 8.5 billion outflow of funds observed in 2013.

Chart *14: Developments in net debt-type financing by sector (cumulative transactions)*



After a temporary rise in the previous quarter, the net external debt of the general government consolidated with the MNB decreased by EUR 1.4 billion (Chart 15.). In 2014 Q3, the gross external debt of the consolidated general government shrank by EUR 2 billion. In addition to a EUR 1.4 billion contraction in the MNB bill holdings of non-residents, the repayment of a foreign currency bond also caused a downward shift in the gross external debt of the general government during the quarter. At the same time, a moderate increase in the HUF-denominated government paper exposure of non-residents worked in the opposite direction. The foreign exchange reserves of Hungary – as the foreign asset of the general government consolidated with the MNB – declined by EUR 0.5 billion in Q3. Foreign exchange reserves were reduced both by the maturity of the foreign currency bond and recourse to the three-month foreign exchange swap instrument, which was only partly offset by the inflow of EU transfers. (The three-month foreign exchange swap instrument of the MNB reduced the net outflow of funds in the case of the general government, while it increased such outflows in the case of banks). Taken together, in contrast to the typical trend observed in previous quarters, changes in foreign exchange reserves in Q3 slowed down the decline in the net external debt of the state.

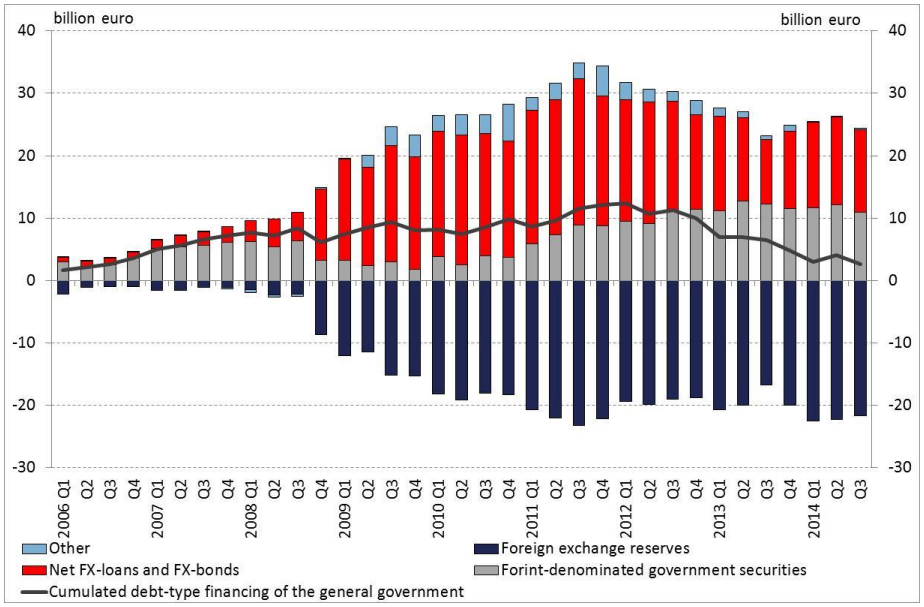
The forint liquidity outflows from the MNB bill may have been partly absorbed by the banking sector. The conversion of the MNB bill into deposits affected financing developments in the banking sector and the public sector through several channels: the short-term forint liquidity of some banks expanded significantly in the past six months, indicating that former non-resident holders of the MNB bill may have already reacted to the announcement of the scheduled conversion of the two-week central bank instrument. Therefore, although the conversion of the MNB bill

into deposits reduced the external debt of the consolidated general government, a portion of the forint liquidity thus released in the banking sector.

While conversion of the MNB bill had no effect on the level of net external debt, it may have lowered the gross external debt of Hungary. Funds released from the MNB bill portfolio may have increased both the deposit holdings and the government paper portfolio of non-residents (in other words, only the sectoral distribution of net debt changed, while its level remained the same). At the same time, it may have pushed down the level of gross external debt if non-residents sold the funds thus released to residents in exchange for foreign currency, instead of investing them in HUF-denominated instruments (net external debt remains unchanged in this scenario as well, given that the decline in gross external debt is accompanied by a corresponding decline in the foreign assets of a resident).

The conversion of the MNB bill affected the structure of net external debt through swap market developments as well, and it may also have lowered Hungary's gross external debt. Partly as a result of the self-financing programme, swap spreads widened considerably in September, presumably connected to the excess forint liquidity resulting from the conversion (the increased forint liquidity raises swap spreads through non-residents' elevated demand for foreign currency). Swap market developments may also explain the temporary recourse to the MNB's three-month foreign exchange swap instrument, which lowered the level of foreign exchange reserves, thereby increasing the net external debt of the consolidated general government. Parallel to the recourse to the central bank's swap instrument, however, the forint liquidity of non-residents decreased with an assumed decline in the forint-denominated instruments held by non-residents as well (which reduced gross and net external debt alike). It should be noted that the conversion of the MNB bill into deposits changed the structure of net external debt, while at the same time, gross flows (foreign exchange reserves, gross external debt) may also have decreased through various mechanisms.

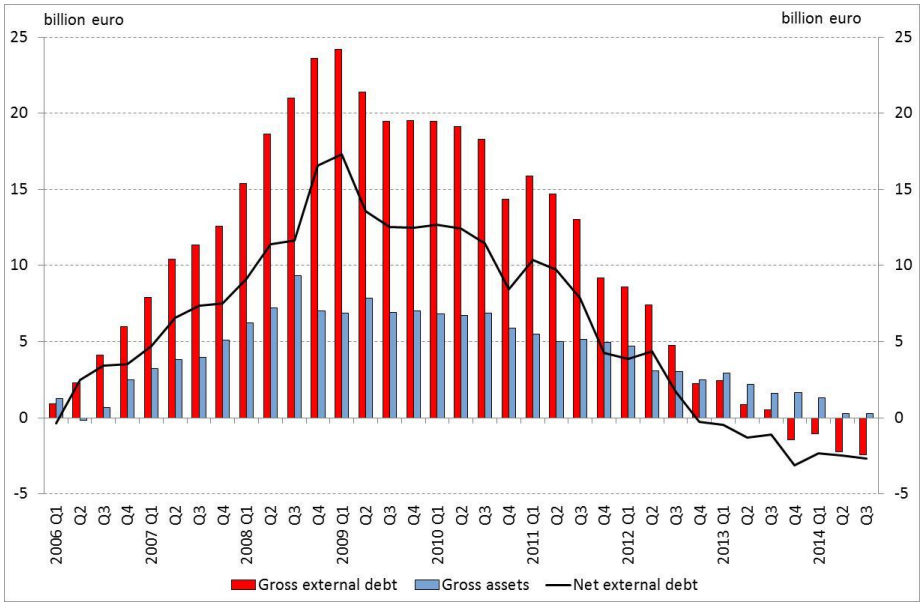
Chart 15: *Breakdown of net external debt funds of the general government consolidated with the MNB (cumulative transactions)*



The decline observed in the net external debt of the banking sector in 2014 Q3 emerged against the backdrop of a decrease in gross external liabilities, whereas the net external debt of the banking sector had shown a moderate increase in the previous part of the year. The decline in the net external debt of the banking sector emerged amid a more marked decline in gross external debt and a smaller increase in external assets. Although the external liabilities of the sector contracted in Q3, in the first nine months of the year banks' net external debt had, for the first time since the outbreak of the crisis, increased. Developments in Q3 may have been partly driven by the conversion of the MNB bill into deposits; indeed, the moderation of banks' external liabilities may have been dampened by the fact that some of the external liabilities stemming from the MNB bills converted during the quarter may have flowed into the banking sector. Banks' four-quarter net outflow of funds continues to fall short of the values recorded in the

previous three years. In the recent period, the moderation of net liabilities may have been restrained by the contraction in households' bank deposits which, however, subsided perceivably in Q3. Although developments in the household deposit portfolio could have resulted in a higher outflow of funds in the banking sector, their effect was cushioned by the moderate upswing in households' net new borrowing and the new deposits of non-residents.

Chart 16: *Developments in the banking sector's gross external debt and asset transactions (cumulative transactions)*

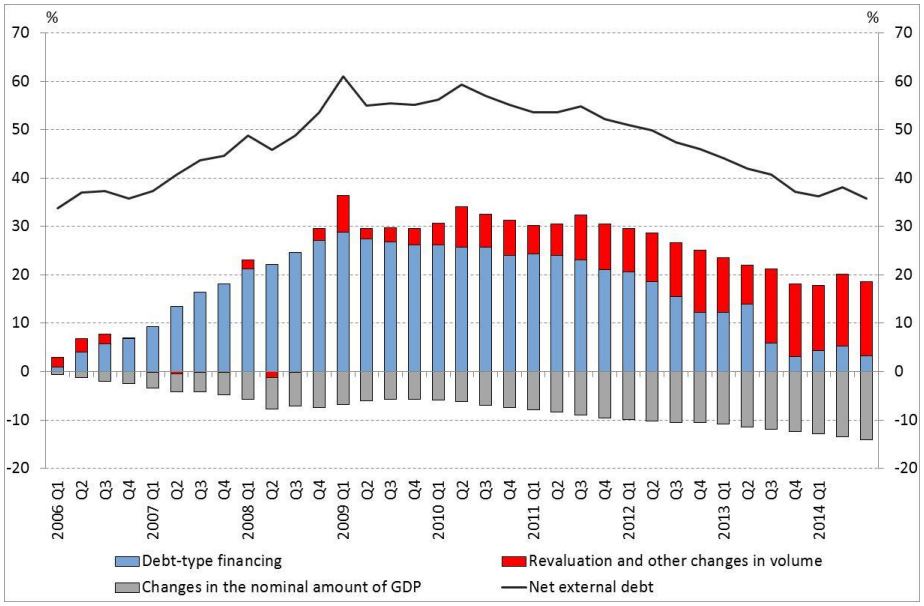


3. DEVELOPMENTS IN DEBT RATIOS

Driven by substantial outflows of funds and GDP growth, following a temporary rise, debt ratios decreased again in 2014 Q3. For the first time since the end of 2006, net external debt dropped below 36 per cent of GDP. Gross external debt fell even more markedly than net external debt and, after a substantial, 3.2 per cent decline, it stood at 88 per cent of GDP at the end of the quarter. The sectoral breakdown shows that the adjustment of the indicators could be mainly attributed to the consolidated general government, to which the conversion of the MNB's key policy instrument was a main contributor. Short-term external debt based on residual maturity shrank further and approached EUR 24 billion in Q3. The contraction was supported by the maturity of amortised long-term debt components and a decrease in the general government's short-term debt based on original maturity.

Following a spike in the previous quarter, the net external debt of Hungary declined again in Q3, mainly as a result of the outflow of debt liabilities. The indicator, which also includes receivables from the rest of the world, decreased primarily as a result of the repayment of foreign debt components. The GDP-proportionate indicator was also pushed down by growth in nominal GDP, but the adjustment was restrained by the shift in the forint exchange rate against the US dollar. In addition, the decline in external assets (foreign exchange reserves) observed in Q3 also moderated the decline in net external debt.

Chart 17: *Components of changes in net external debt (cumulated, GDP-proportionate values, end-2005 = 0)*

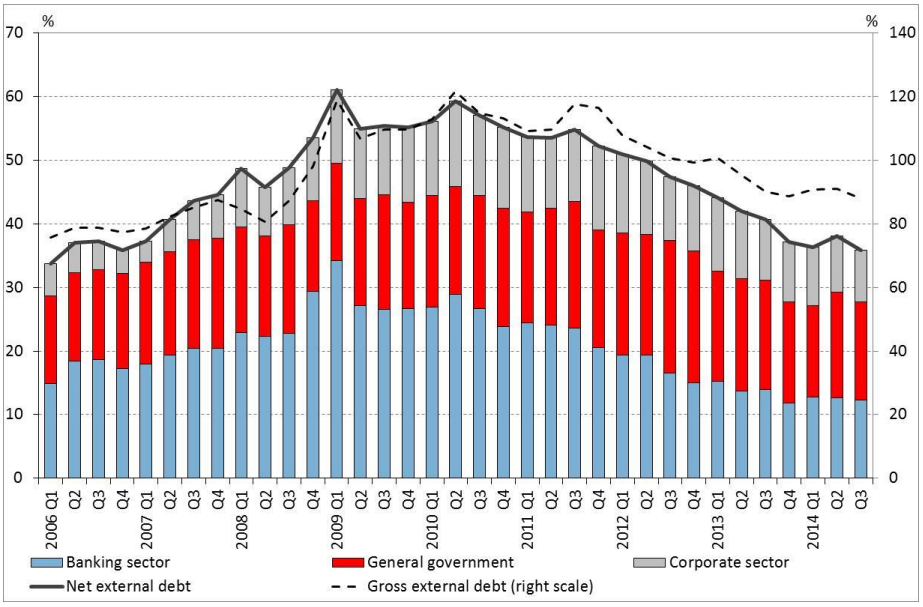


All three sectors contributed to the reduction of net external debt. In Q3, the net external debt of the consolidated general government fell by nearly 1.2 per cent of GDP, primarily reflecting the contraction in the MNB bill portfolio of non-residents driven, for the most part, by the conversion of the MNB bill into deposits as part of the self-financing programme. Following a slight decline in the previous quarter, the net external debt of the banking sector continued to decrease, but the decline may have been restrained by the fact that the funds released from non-residents' MNB bill holdings flowed into bank deposits. The net external debt of the corporate sector also decreased.

Gross external debt stood at 88 per cent of GDP at the end of Q3. The more pronounced decline in gross external debt also reflected the outflow of debt funds. The contraction in gross external debt – which surpassed the decline in net external debt – was mainly shaped by developments in the debt of the consolidated general government: the gross external debt of the sector fell by more than 2 per cent of GDP (while net external debt decreased to a lesser degree, by 1.2 of GDP). Since the level of foreign exchange reserves shrank in parallel with the maturity of the foreign currency government bond, the repayment of the bond did not influence Hungary's net external debt; however, it reduced its gross external debt. Besides the consolidated general government, the other two sectors also

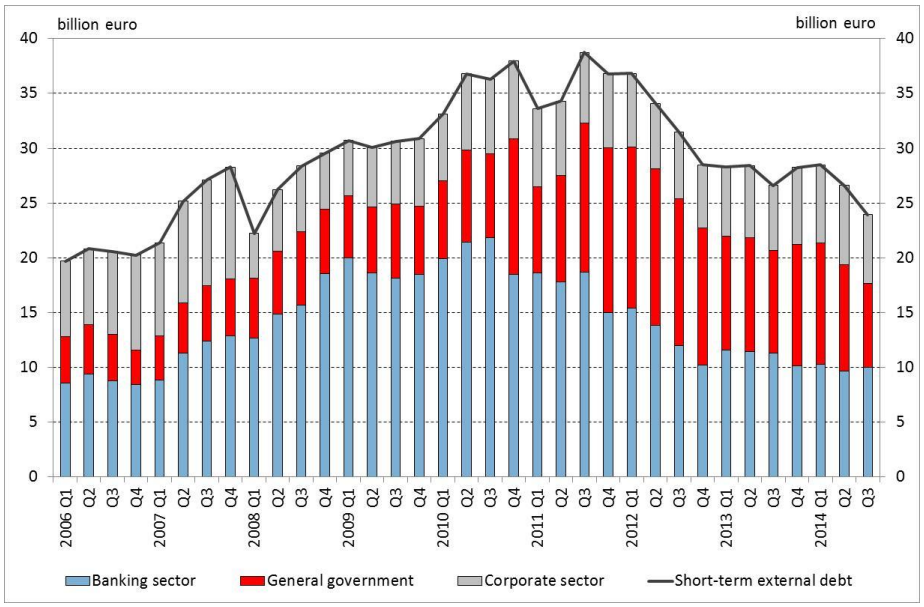
retrenched their exposure to the rest of the world, contributing to a more sizeable reduction of GDP-proportionate gross external debt.

Chart 18: *Net external debt in a sectoral breakdown and gross external debt (as a percentage of GDP, excluding intercompany loans)*



Short-term external debt – an essential factor from the perspective of Hungary's measure of vulnerability – dropped to around EUR 24 billion in Q3, primarily reflecting a decline in long-term amortised debt. According to the maturity breakdown of the quarterly balance of payments, amortising long-term debt fell by more than EUR 2 billion to EUR 7.1 billion by the end of Q3. In addition to amortising debt, short-term debt based on original maturity shrank to around EUR 16.8 billion, down by EUR 0.3 billion. Consequently, short-term debt based on original maturity has dropped below the level recorded at the end of 2006.

Chart 19: *Developments in gross short-term external debt based on residual maturity*



The decline in short-term external debt based on residual maturity can mainly be linked to the general government and corporations, whereas Q3 saw a rise in the short-term external debt of the banking sector. The short-term external debt of the consolidated general government declined by nearly EUR 2 billion, partly owing to a fall in short-term debt based on original maturity and amortised long-term external debt. On the one hand, the

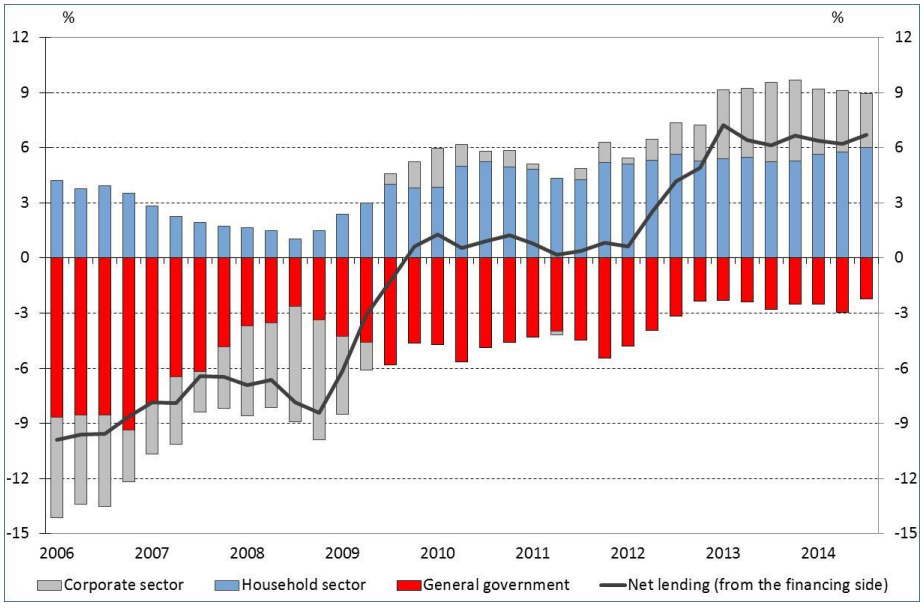
conversion of the key policy instrument of the MNB significantly reduced the short-term external debt of the general government and, on the other hand, the repayment of the foreign currency bond maturing in July also helped to lower outstanding short-term debt. Similarly, primarily owing to the phasing out of a maturing loan, the short-term debt of the corporate sector shrank by nearly EUR 1 billion in Q1. At the same time, after the drop recorded in the previous quarter, the short-term debt of the banking sector rose to EUR 9.9 billion, up by nearly EUR 0.3 billion. The rise affected the components of short-term debt based on original maturity (in the wake of the conversion of the MNB bill into deposits, non-residents' excess forint liquidity may have increased deposits at banks).

4. SECTORS' SAVINGS APPROACH

According to the financing approach, the net lending of the economy increased substantially during Q3, which is related to households' elevated accumulation of financial instruments and considerable economic growth. Indeed, in parallel with the economic expansion, high wage dynamics and recovering employment bolstered the tax revenues of the state, which may have been boosted further by the whitening effect of the installation of cash registers. At the same time, the net savings of corporations deteriorated owing, in part, to higher tax payments and the expansion in corporate investment. Portfolio shifts in the household sector subsided: in Q3, the decline in the bank deposit portfolio was marginal, with only a slight contraction in the government portfolio; mutual funds, however, saw significant expansion. At the same time, the latter trend implies that the household sector further increased its indirect share in the financing of the public sector.

As regards the net financial savings of sectors, the improvement in the net lending position of the economy occurred in the context of an increase in households' net savings, a decline in the general government's net borrowing and a reduction in corporations' net saving. The decline in the general government's net borrowing can be attributed to the increased VAT revenues against the backdrop of recovering consumption and the whitening effect of the installation of online cash registers, along with higher tax revenues stemming from employment growth (Chart 20). At the same time, the net saving of corporations fell in Q3, presumably reflecting the absorption of EU transfers and investment projects boosted by the Funding for Growth Scheme. The net saving of corporations may have been also pushed lower by increased VAT liabilities associated with the installation of online cash registers. Despite all these factors, the corporate sector continued to contribute significantly to the net lending of the economy. However, households also increased their net savings in Q3, thanks primarily to increasing asset accumulation amid a slight decline in net repayments of loans.

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



According to data from the preliminary financial accounts, both the four-quarter value and the seasonally adjusted value of households' net financial savings rose to around 6 per cent of GDP in 2014 Q3. The steadily high net saving position is presumably the result of improving employment, rising real incomes and the precautionary motives prevailing since the onset of the crisis (Chart 21.). The expansion observed in seasonally adjusted financial assets in Q3 exceeded 5 per cent of GDP; i.e. they rose close to pre-crisis levels, despite the fact that households continued to be net loan repayers. While a part of household sector borrowings generated savings, for example, through the sale of used homes, thereby increasing financial instruments, the current rise in household's financial assets is remarkable even without an improvement in lending. At the same time, households' adjustment on the liability side decreased slightly to 1 per cent of GDP which, however, can still be considered significant.

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

**The revised net saving figure of households excludes transactions which boost the savings of the sector linked to the early repayment scheme, the disbursement of real yields and the indemnification of the deposit holders of defaulting cooperative banks.*

In Q3, households invested their new savings mainly in mutual fund shares; at the same time, the shift of instruments from bank deposits to securities decelerated. In the past year and a half, households significantly restructured the instruments in their portfolio: they reduced their bank deposits considerably, in parallel with a dynamic increase in holdings of government bonds and mutual fund shares. The low yields on bank deposits encouraged households to invest their accumulated savings in instruments offering higher returns. Q3 saw a remarkable change in this trend: the decline in the deposit portfolio nearly came to a halt, while the government paper portfolio contracted somewhat. These developments may be consistent with the further reduction of the interest rate on the Treasury Bills targeted at households. At the same time, the inflow of funds into mutual fund shares continued, presumably due to the steadily higher yield premiums over retrospective yields. Given that households preferred bond funds among the mutual funds in Q3, the continuing rise in mutual fund shares may have bolstered the domestic indirect financing of the general government, which points to a reduction of gross external debt ratios over the longer term.

Chart 22*: Cumulative transactions of household instruments*

5. EFFECTS ON EXTERNAL VULNERABILITY OF THE MEASURES RELATED TO FOREIGN CURRENCY LOANS

In the framework of our special topic, we deal with the effects of measures related to foreign currency loans on external vulnerability. The settlement related to household foreign currency and foreign currency denominated mortgage loans and the conversion of loans into forint change the balance sheet of the affected participants. The foreign exchange risk, which was previously borne by households, will decline significantly and be transferred to the balance sheet of the consolidated general government. After the conversion of the foreign currency loans, the foreign currency assets of households, at the sector level, will exceed the stock of remaining foreign currency loans, while the foreign currency assets of the consolidated general government will decrease. This is because the foreign exchange necessary for the conversion of foreign currency loans into forint will be made available to the banks by the central bank, to the debit of the foreign exchange reserves. Moreover, a strong adjustment will start in the banking system as a result of the fall in banks' foreign currency demand because of the conversion, which may ultimately appear in a gradual decline in forint liquidity and the external funds of the banking system. At the end of the adjustment process, foreign reserves, the central bank two-week deposit and (in view of our assumptions) gross external debt may fall by 9 per cent of GDP (ceteris paribus); at the same time, the balance sheet adjustment will not affect net external debt directly. In addition to this, reserve adequacy will not be violated, since the decrease in reserves will occur gradually, over several years, and part of the debt outflow may occur over the short term. Thus, as an effect of the conversion of foreign currency loans, Hungary's external vulnerability indicators may improve significantly: in addition to the rollover and interest rate risks related to external debt, the swap exposure of the banking system may decrease as well. At the same time, the adjustment process may have an effect on the government securities market too; however, the latter also depends on the extent of exchange rate risk to be undertaken by non-residents and developments in yields. As an indirect effect of the measures related to foreign currency loans, a slight improvement in the external balance may also occur – through lower interest payments on external debt.

5.1. Introduction

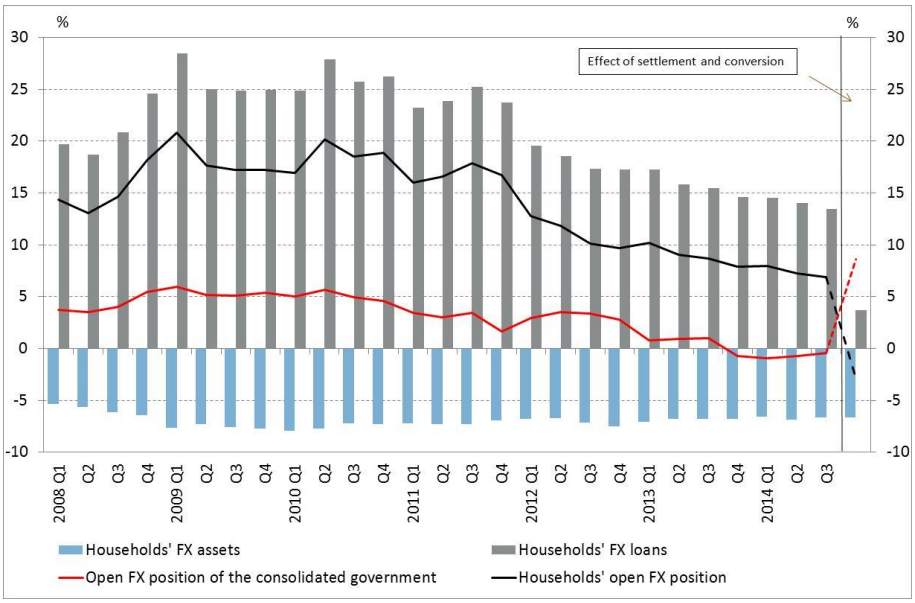
As a special topic, we present the effects of the most important regulations governing households' foreign currency and foreign currency denominated mortgage loans on the financing position of the individual sectors, the external balance and developments in external debt indicators. In chronological order, the first measure was the Settlement Act passed in September 2014, according to which overpayments arising as a result of unfair conditions (e.g. the exchange rate margin and the unilateral interest rate increases) must be paid back to borrowers.[5] In the case of still existing contracts, this means the reduction in principal, whereas in the case of already terminated contracts it means reimbursement in cash. The second measure was the Act on the conversion of foreign currency loans into forint, and then another Act was passed in November about the details of that. On the basis of these, conversion of households' foreign currency and foreign currency denominated mortgage loans to forint will take place on the 1st of February 2015. The exchange rates to be applied upon the conversion to forint were determined in the laws passed, similarly to the conditions whereby the central bank will provide foreign currency to the commercial banks for the conversion of the foreign currency loans. The third measure was the so-called Act on the "fair banking system", in which, among others, provisions governing the interest rates charged on forint loans were stipulated. The new instalments will actually have to be paid from May 2015, but the borrowers will get back the additional instalments paid since 1 February. The measures listed above significantly change the financial balance sheets of the economic agents affected, and thus we think it is worth summarising and presenting the main effects of the regulations governing foreign currency loans on the balance sheet of households, the banks and the central bank, as well as on the external balance position and the external debt indicators.

[5] Settlement refers to all loan contracts concluded since 1 May 2004, except for overdrafts and loans with state interest subsidy.

5.2. Balance sheet adjustment of the individual sectors

The extent of exchange rate risk undertaken by the economic agents will be rearranged because of the settlement related to household mortgage loans and the conversion to forint. Foreign currency assets of households will exceed the foreign currency loans at the sector level. The foreign currency position of the sector has opened significantly with the spread of foreign currency lending to households: the foreign currency loans taken out significantly exceeded the savings of households held in foreign currency. At the end of 2014 Q3, households had a foreign currency loan stock of more than HUF 4,000 billion and foreign currency assets of HUF 2,000 billion, mainly foreign currency bank deposits, thus its open foreign currency position (foreign currency loans minus foreign currency assets) was almost 7 per cent of GDP. The settlement related to foreign currency loans decreases the outstanding loan stock by approximately HUF 600 billion,[6] whereas the conversion to forint affects a further stock of HUF 2,400 billion. Thus, the open foreign currency position accumulated earlier will not only decrease, but it will be of the opposite direction, i.e. at the sector level households will have foreign currency assets exceeding the amount of foreign currency loans. The arising foreign currency position – of opposite direction than earlier – may amount to approximately 3 per cent of GDP (in the calculation we started out from the stocks at end-2014 Q3). Based on the aggregated data, it seems that while earlier the potential weakening of the forint affected the financial situation of households unfavourably, with the turnaround in the direction of the foreign currency position, a potential weakening of the forint will result in a more favourable financial situation at the sector level. However, it is important to emphasise that the same is not necessarily true for households taken individually. Because after the conversion of mortgage loans into forint, households will still have foreign currency loans, at the same time foreign currency assets are not necessarily held by the same participants.

Chart 23: The effect of the settlement and the conversion to forint on the open foreign currency position of households and the consolidated general government (GDP-proportionate values)



Source: 2014 Q3 preliminary financial accounts.

Note: The open foreign currency position stems from the difference of foreign currency liabilities and foreign currency assets of the sectors (we illustrated foreign currency assets of households in the negative range). The open position of the consolidated general government includes foreign currency debts and foreign currency assets of the central government, the local governments and the central bank.

[6] The profit impact of the settlement on the banking system is a total of HUF 900-1,000 billion. Of this, HUF 100 billion is payment in cash related to already terminated contracts, HUF 200 billion is provisions formed already earlier for non-performing loans, and HUF 600 billion is the decrease of the currently existing stock because of the recalculation of former unfair conditions.

The exchange rate risk, which was previously borne by households, will be transferred to the balance sheet of the consolidated general government. The banks provided the foreign currency loans accumulated earlier either from direct foreign currency funds or, if they collected sufficient forint deposits, they swapped their forint funds into foreign currency. With this they aimed at closing their open foreign currency position (because of the relevant capital regulations, banks do not typically have a significant open foreign currency position). The foreign currency position of the participants affected in the settlement and the conversion to forint – thus, that of the banks as well – is actually rearranged already at the announcement of the relevant laws. The major part of the foreign currency necessary for closing the opening bank foreign currency position, almost EUR 9 billion, was provided to the commercial banks by the MNB.[7] The participation of the MNB is of special importance, because otherwise the foreign currency demand of the banks would have been directed to the foreign exchange market, which would have caused considerable pressure on the exchange rate of the forint. At the same time, the foreign currency received from the MNB returned to the central bank through swap transactions. Foreign exchange reserves actually decrease only when the banks actually use this foreign currency (for the repayment of some external funds). This may occur until the end of 2017 gradually, in smaller amounts.[8] Thus, after the foreign currency auctions the MNB incurred forward foreign currency liabilities vis-à-vis the banks (which will later appear in the decrease of foreign exchange reserves with the utilisation of the foreign currency). Accordingly, the foreign currency position of households was transferred to the balance sheet of the central bank already after the foreign currency auctions, whereby the open foreign currency position of the consolidated general government opened significantly, by EUR 9 billion.

The conversion to forint opens the foreign currency position of the consolidated general government considerably, but at the same time the continuous inflow of EU transfers may gradually reduce the open foreign currency position. Recently, the open foreign currency position of the general government consolidated with the MNB has been around zero, since the amount of the foreign currency funds of the general government (typically foreign currency bonds issued abroad, foreign currency loans taken) has been more or less identical with the foreign exchange reserves of the central bank. The conversion to forint constitutes a major change in this relationship, which opens the foreign currency position of the consolidated government significantly, by 9 per cent of GDP, in the manner described above. However, we expect the gradual closing of this over the longer term. The funds received from the EU increase the foreign exchange reserves of the central bank, and thus they have a decreasing effect on the net external debt of the consolidated government and its open foreign currency position. (The external balance improving effect of the EU transfers and the decrease in the net external debt can be deduced from the side of the savings of the sectors too, as there is an increase in the income that can be spent, the net lending of the domestic sectors improves).

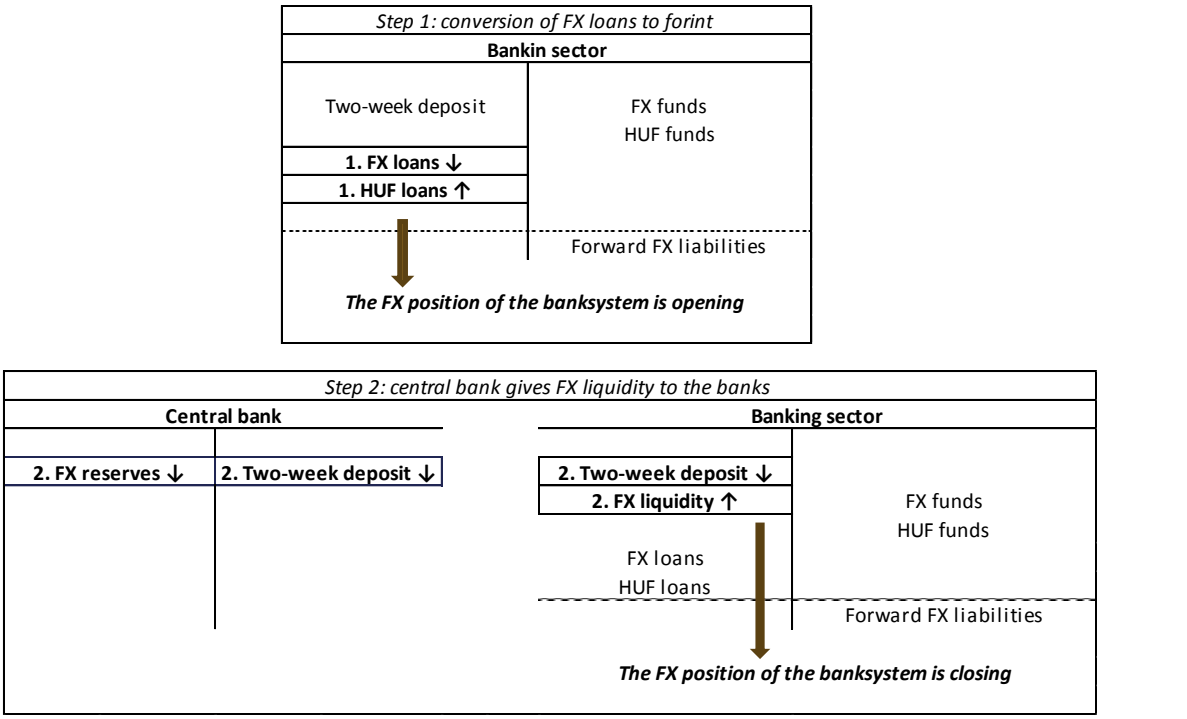
5.3. Development of external debt

In addition to the gradual decrease of central bank foreign exchange reserves, the banks repay their external debt, while the central bank two-week deposit decreases. With the conversion of foreign currency loans to forint, the foreign exchange demand of the banking system will decrease significantly: the foreign currency funds accumulated directly earlier or obtained through swap transactions will not be necessary. This is because on the asset side of the banking system there will already be forint loans against the foreign currency and forint funds (Step 1). After this, the foreign currency necessary for closing the resulting opening in the foreign currency position is actually transferred from the central bank to the banking system to the debit of forint liquidity; thus in parallel with the decrease of reserves, the money deposited in the two-week central bank instrument will decrease as well (Step 2). The forint liquidity of the banking system and foreign exchange reserves will decrease gradually, in several steps, until the end of 2017.

[7] The banks presumably obtained the EUR 1 billion, necessary for closing the foreign currency position in addition to this, on the foreign exchange market. This foreign currency demand may have arisen gradually, still before the foreign currency auctions.

[8] For more details, see: Hoffmann-Kolozsi-Nagy (2014): "The conversion to forint decreases the balance sheet of the central bank and thus forint liquidity extended in time".

Chart 24: Effect of balance sheet adjustment of banks on external debt, schematic balance sheets



Note: In the figure, on the one hand, we made the assumption that in parallel with the decrease in the the swap stock vis-à-vis non-residents and, together with this, the decrease in forint liquidity held by non-residents, the foreign participants decrease their bank HUF funds one on one and they do not sell HUF government securities. On the other hand, we have simplified the deduction of the balance sheet adjustment by not stipulating separately the off-balance sheet swap transactions originating because of the central bank foreign currency auctions in the balance sheet of the central bank and the banking system. (At the same time, the swap stock originating with the foreign currency auctions decreases in parallel with foreign exchange reserves when the foreign currency provided in the foreign currency auction is actually transferred to the banks.)

From the foreign currency received from the MNB – in return for forint liquidity – the banks, having mainly foreign currency funds, may repay their foreign currency debts. The banks with significant amount of forint funds – that have built a considerable HUF/FX swap stock vis-à-vis foreign participants because of this – may adjust to the conversion of foreign currency loans to forint by closing their swap transactions. The foreign participants invested a part of the forints obtained from swap transactions concluded with the banking system in forint assets (in addition to the government securities stock of non-residents, the short-term forint deposit stock vis-à-vis the domestic banking system has increased significantly in recent years). Since forint liquidity held by non-residents may decrease as well as a result of conversion to forint, foreign participants may sell forint assets (Step 3). This may be realised in the decrease in forint deposits held in the Hungarian banking system by non-residents, but it may also result in selling of

government securities.[9] If we assume that, at the banking system level, foreign currency debt is repaid from the foreign currency received from the central bank, and the sale of foreign assets accompanies the closing of the swap transactions, gross external debt may decrease by almost 9 per cent of GDP as an effect of the settlement and the conversion to forint; however, this may also be realised only gradually, similarly to the development of foreign exchange reserves and the central bank two-week deposit.[10]

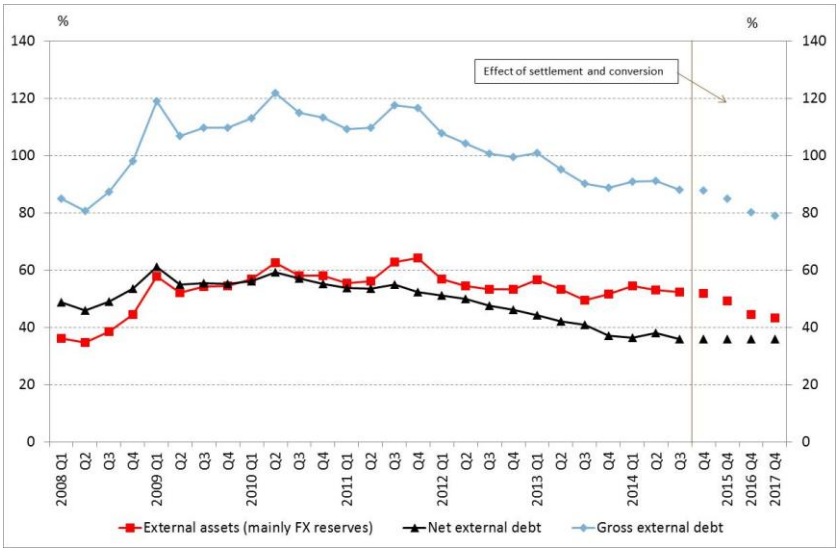
The gross external debt reduction materialising as a result of the conversion to forint and the settlement may partly appear in a decrease in short-term external debt. In the framework of the foreign currency auctions, a part of the banks undertook to decrease the short-term external debt in their balance sheet. Under these conditions, the banks received EUR 2 billion at the foreign currency auctions – related to the conversion to forint and the settlement – which means that, in parallel with the phasing out foreign currency loans, they have to decrease their short-term external debt by half of this, i.e. by EUR 1 billion. However, the reduction in the short-term external debt may be implemented in addition to this as well. If, in relation to the adjustment mechanisms presented earlier, the reduction in the swap stock of the banking system against non-residents is significant, it may cause a considerable outflow of short-term forint funds placed in the Hungarian banking system earlier. However, in the case of adjustment within the balance sheet, the banks do not necessarily repay short-term foreign currency funds. It is worth mentioning that, in the course of bank adjustment occurring upon early repayment, the short-term foreign currency funds decreased considerably (for more on this, see the text in the box).

All in all, the foreign currency transactions related to the settlement and the conversion to forint do not affect net external debt. The net external debt of an economy can change with the change in its net lending position and/or the shift of the economy's external financing structure. For example, if economic agents spend less, with the given income available to them, the net lending increases, and thus lower external financing is necessary. If this is implemented with the repayment of foreign loans or the accumulation of foreign (debt-type) assets (and the extent of FDI-type fund raising does not change), net external debt also decreases. Net external debt may change even if the net lending position does not change, if the ratio of debt and non-debt type liabilities changes in the structure of financing. Although the foreign currency transactions related to the settlement and the conversion of foreign currency loans to forint rearrange the balance sheets of the participants as we presented it earlier, neither the net lending, nor the ratio of debt-type financing changes directly. Because as an effect of the foreign currency transactions, the gross sides of the net external debt – the external debt of the banks and foreign exchange reserves, as the foreign asset of the central bank – decrease jointly and to a similar extent.

[9] In the case of closing the swap transactions concluded with non-residents, we assumed that it entails selling some HUF assets, and this is the mechanism through which external debt decreases. At the same time, depending on the development of the prices, it is conceivable that the foreign investors will be willing to hold HUF assets uncovered as well. They may receive the HUF necessary for this from a Hungarian participant, in return for foreign currency. Thus, the adjustment may be implemented not via the decrease in gross external debt, but through the increase in foreign assets of a Hungarian participant.

[10] The bank balance sheet adjustment, starting as a result of the conversion to forint, may have an effect on the government securities market as well, but this depends on the development of the government securities market yields as well. If foreign investors sell government securities, the self-financing programme of the central bank may gain ground, and the government securities may be transferred from non-residents to Hungarian participants.

Chart 25: Expected effect of the settlement and the conversion to forint on external debt (GDP-proportionate values)



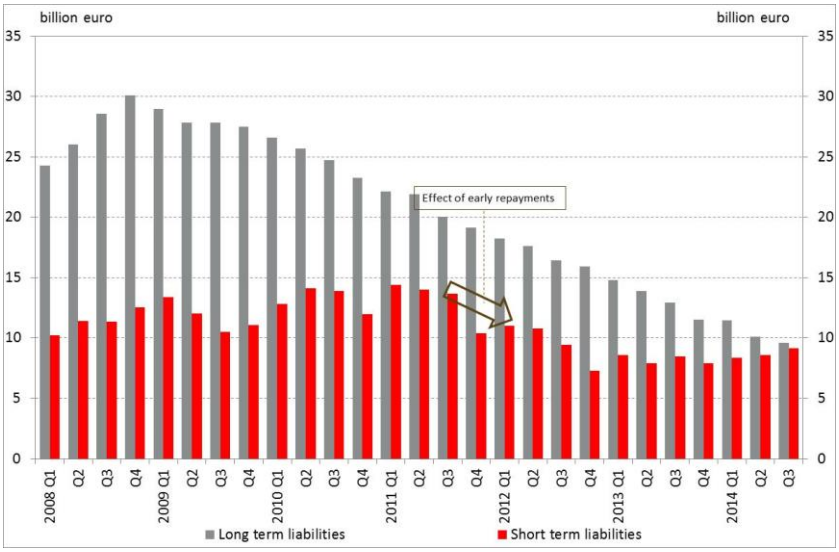
Box: Effect of early repayment on external debt

The early repayment programme, in autumn 2011, rearranged the balance sheets of the affected participants similarly to the conversion to forint: foreign exchange reserves and gross external debt decreased by EUR 2.6 billion, while the measure did not affect net external debt.

The foreign currency loan stock on the asset side of the balance sheet of the banking system decreased (households financed the greater part of this from savings and a smaller part from forint loans), as a result of this the foreign currency position of the banking system opened. A considerable part of the foreign currency necessary for closing the open position took place to the debit of the foreign exchange reserves of the MNB, and was covered by foreign currency sales of almost EUR 2.6 billion. In parallel with this, the forint liquidity of the banking system also decreased to a similar extent. After the early repayment, the outflows of funds of the banks accelerated, in which a major role may have been played by the balance sheet adjustment of the banks to the early repayment. Since, as an effect of the measure, both the external debt of the banks and foreign exchange reserves decreased, net external debt did not change.

Considering the maturity structure of the outflows of funds of the banks, the decrease in short-term funds was of such an extent that reserve adequacy was essentially not impaired. Of the outflows of funds that occurred at the end of 2011 and the beginning of 2012, the decrease in funds of short-term maturity was EUR 2.6 billion. It is important to emphasise that during the early repayment programme, the banking system possessed higher short-term external debt than it has now, so there were more opportunities for reducing short-term funds. In addition, auctions related to the early repayment programme conditioned to reduce short-term debt.

Chart 26: Development of gross external funds of the banking system



5.4. Net lending position of the sectors and development of the external balance

The disposable income of households increases with the regulations governing foreign currency loans, and a significant part of this may be spent on consumption; thus, according to our expectations, the savings path of households will not change considerably. In the course of settlement, approximately HUF 100 billion is connected to actual payments to households for contracts already terminated. In addition to this, the lower instalments on loans will also increase the remaining disposable income after the instalments in 2015 by approximately HUF 100-120 billion, because the settlement decreases outstanding principal, whereas the Act on the fair banking system imposes a cap on interest rates on loans, which jointly results in lower instalments compared to the previous levels. Households may spend a significant part of the resulting disposable income on consumption, in line with the estimates published in the Inflation Report. Thus, according to our expectations, the effect of payments connected to terminated contracts and the new instalments on net savings will not be considerable in 2015 (for details about this, see the Inflation Reports of September and December 2014).[11] At the same time in the long term the net savings path will fundamentally be lower by 0.1-0.2 per cent of GDP as the combined effect of the lower instalment burdens and increasing consumption.

At the same time, the external balance may be improved by the further decreasing profit of the foreign-owned banks. The banking system records a large one-off loss because of the settlement, which consists of the HUF 100 billion actually paid to households and the HUF 600 billion decrease in outstanding borrowing.[12] Since these are not items that can be connected to the so-called normal business operations in the balance of payments, they will not affect the profit of the foreign-owned banks and the external balance because of a statistical correction.[13] In contrast to the increase in the disposable income of households, the banks are faced with lower interest income in the long term as an effect of the measures, which foreshadows a lower profit path looking ahead at the level of the banking system.[14] Thus, the income position of households improves to the debit of the profit of the banks. This appears in the external balance in such a way that the smaller profit of the foreign-owned banks may improve the income

[11] Moreover, the settlement will reduce the outstanding borrowing of households by HUF 600 billion, which will be settled in a transaction as well, thus it will increase net savings in 2015 as a one-off effect.

[12] Moreover, the loss related to non-performing loans will be another HUF 200 billion, at the same time the banks already formed provisions for this earlier, thus this loss will appear already before the settlement.

[13] The items not related to normal operation are removed by the Balance of payments statistics from the profit after tax data of the foreign-owned banks and corporations, appearing in the income balance. For more details, see the Report on the Balance of Payments, September 2014.

[14] For more details, see the Stability Report, November 2014.

balance through the lower incomes transferred abroad (only the profit after tax of the foreign-owned banks appears in the income balance). Naturally, the extent of the external balance improving effect also depends on how much is saved and consumed by households from the income increase vis-à-vis the banks. If the consumption effect is higher, the external balance may improve only slightly.

As an effect of the measures, the interest balance vis-à-vis non-residents may improve slightly as well, further increasing the net lending of the economy. In addition to developments in the profit of the banks, further external balance improvement is expected through the interest balance belonging to net external debt. This is the case since the significantly decreasing gross external debt involves lower interest expenditures transferred abroad than earlier. Meanwhile, interest income realised on the gradually decreasing foreign exchange reserves fall as well; however, the two effects combined may result in a lower income balance deficit by 0.1-0.2 per cent of GDP and a slightly more favourable net lending position in the long term.

5.5. Effect of the measures on external vulnerability

In summary, we can say that the measures related to the foreign currency loans decrease the external vulnerability of the Hungarian economy.[15]

- **The extent of exchange rate risk borne by households will decrease significantly.** Not only will the open FX position of households decrease, it will be of the opposite direction as before, i.e. at the sector level FX assets will exceed FX loans. Thus, households will be much less exposed to the unfavourable effects of the potential depreciation of the forint on the loan stock and the instalment burdens, in the case of external shocks.

- **Gross external debt will decrease considerably.** With the settlement and the conversion to forint, gross external debt may decrease significantly, by even 9 per cent of GDP, if, in addition to the repayment of foreign currency debts, the closing of swap positions entails a decrease in the forint assets of non-residents as well. At the same time, the decrease will occur gradually until the end of 2017. The reduction in gross external debt is important partly in terms of the decline in risks of rollover entailed with outstanding debt.

- **Due to the gradual decrease in foreign exchange reserves, reserve adequacy will not be impaired.** The decrease in foreign exchange reserves will occur gradually. Moreover, a part of the decrease in gross external debt may be realised in the reduction of short-term external debt, which means that required reserve level may decrease as well. Thus, foreign exchange reserves will remain consistently above the level expected by investors.

- **The external balance may improve slightly through the decrease in incomes transferred abroad.** The measures related to foreign currency loans decrease the profit of the banking system over and above the one-off large loss as well. Moreover, the interest burden paid on foreign debt will decrease as well.

- **The swap exposure of the banking system will decrease, which contributes to financial stability through lower exchange rate risk of the banks.** According to our expectations, banks' balance sheet adjustment will occur partly via the decrease in the swap stock of the banks vis-à-vis non-residents. Lower swap exposure decreases the vulnerability of the banking system at the time of external shocks and swap market disturbances. Namely, swap market disturbances may entail rollover risks and financing tensions (because of the margin requirements).

At the same time, the conversion to forint may indirectly influence the financing processes of the consolidated general government.

[15] In addition to the effect on external vulnerability, it is important to emphasise that the conversion of foreign currency loans to forint may have a favourable effect on the interest channel of the transmission mechanism as well. After the conversion to forint, the change in central bank base rate may have a more direct effect on the decisions of households about consumption and savings through the interest rates of forint deposits and the forint loan stock.

- **The open foreign currency position of the consolidated general government opens considerably, by 9 per cent of GDP, while this does not entail additional financing risk.** A significant weakening of the exchange rate entailed with an external shock unfavourably affected both the financial wealth of households (i.e. the foreign currency loan stock) and the repayment of loans as well. After the conversion to forint, a potential weakening of the exchange rate will negatively affect the open foreign currency position of the general government consolidated with the central bank (net wealth effect). Foreign currency assets will already be less than foreign currency debts at the consolidated level. However, the foreign currency debt and maturities of the state will not change with the conversion to forint.
- **Conversion to forint may have effects on the government securities market.** If the banking system closes its existing swap stock to a large degree, the extent of forint liquidity held by non-residents, which ensured the financing of forint assets purchased by non-residents, may decrease considerably. Because of this it is conceivable that non-residents will sell forint government securities, which also depends, at the same time, on developments in yields on the government securities market. At the same time, the government securities may be transferred to domestic participants, in line with the objectives of the self-financing programme.

Gábor Bethlen

(15 November 1580 – 15 November 1629)

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

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

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

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

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