



REPORT ON THE BALANCE OF PAYMENTS



JUNE
2016

*‘We may not always be able to do what must be done,
but we must always do what can be done.’*

*Letters 27
Gábor Bethlen*



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In accordance with Act CXXXIX of 2013 on the Magyar Nemzeti Bank, the primary objective of the MNB is to achieve and maintain price stability and, without prejudice to its primary objective, the central bank is also responsible for maintaining the stability of the financial intermediary system. Developments in the external balance are key to financial stability, as developments relating to the balance of payments allow for conclusions to be drawn concerning the sustainability of economic growth and relevant risks. Moreover, the analysis of the balance of payments enables the identification of economic problems earlier, when they are developing, therefore steps can be taken to avoid them.

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

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

This analysis was prepared by the MNB's Directorate Monetary Policy and Financial Market Analysis under the general guidance of Barnabás Virág, Executive Director in charge of Monetary Policy, Financial Stability and Lending Incentives. Contributors: Anna Boldizsár, Gabriella Csom-Bíró, Orsolya Csontos, Zsuzsa Kékesi, Balázs Kóczyán, Péter Koroknai and Balázs Sisak. The Report was approved for publication by Deputy Governor Márton Nagy.

The present Report covers relevant information pertaining to the period ending 24 June 2016.

SUMMARY

Hungary's external balance indicators continued to improve slightly in 2016 Q1. The annual surplus on the current account balance rose to **4.7 per cent of GDP**, while net lending, which also contains the capital account, stabilised at the historically high level recorded in the previous quarter, i.e. close to 9 per cent. Both figures are **well above the average of the CEE countries**. Along with the high external position, **external debt continued to decrease slightly, and there was moderate net foreign direct investment**. In conjunction with the reduction in short-term external debt, this means that **the external vulnerability of the Hungarian economy continued to decrease in early 2016**.

In the **real economy approach**, the fact that net lending stabilised at a high level is attributable to the **improvement in the trade surplus and the income balance, which was counterbalanced by the decline in the transfer balance**. The growth rate of imports exceeded the expansion of **exports, which decelerated partly due to the temporary factory shutdowns early in the year**, but this impact was outstripped by the trade balance-enhancing effect of the **improving terms of trade** in the context of subdued energy prices. At the start of the new programming period, **the utilisation of EU transfers in the quarter was quite low, similar to the first years of the new period**, and therefore the transfer balance was only able to support net lending to a modest degree. The **income balance deficit shrank somewhat**, which can still be attributed to **declining interest expenses**, on account of falling external debt and lower interest rates.

In the **financing approach**, **net FDI inflows continued, while the reduction of net external debt decelerated**. On account of capital-in-transit transactions, the gross components of foreign direct investment declined considerably in the past two quarters, but adjusted for items in transit, FDI by non-residents continued to increase. **The sectoral distribution of the reduction in net external debt was strongly influenced by the fact that during the quarter the central bank provided liquidity to the banking system amounting to almost EUR 3 billion in connection with the forint conversion of foreign currency loans**. As a result, banks' net external debt fell considerably, while that of the consolidated general government rose. **The continued reduction of government securities holdings by non-residents** further reduced the gross external debt of the consolidated general government.

Both the net and gross external debt ratios continued to decline in early 2016. As a result of a slight decrease in net foreign loans and the increase in nominal GDP, **the net external debt ratio dropped to close to 24 per cent of GDP at the end of March**. As external liabilities fell more than external assets due to the sale of government securities by non-residents, **gross external debt relative to GDP decreased more than the net figure**. In parallel with gross external debt, **short-term external debt** – which is key from the perspective of the country's risk perception – also continued to fall, **moving to around EUR 20 billion**. As a result of a government bond maturing and the foreign currency drawdown linked to the forint conversion, foreign exchange reserves shrank to EUR 27.6 billion, but the **level of foreign reserves still far exceeds the reserve indicators that are closely monitored by investors**.

In the **sectors' savings approach**, the minor reduction in net lending can be linked to the **shrinking financial savings of households** in the context of easing precautionary considerations and expanding consumption. Retail government securities continued to gain ground in the first quarter, which further supports the decline in the government's external debt. Due to the expansion of revenues from consumption and wages and falling interest expenses, **the net borrowing of the government** dropped below 2 per cent, and thus **remains historically low**.

Our special topic deals with **developments in net external liabilities**. The **exceptionally large growth in external liabilities before the crisis can be primarily attributed to external borrowing linked to the growth model based on external funds**. Meanwhile, the stock of net FDI increased only moderately. In Hungary, **all three sectors contributed to the increase in net external liabilities before the crisis – and to their subsequent decrease – but the strongest expansion and adjustment was observed in the banking system**. In addition to net lending, developments in stock indicators were influenced by changes in prices and exchange rates as well: **a major part of the substantial increase in the debt ratio was attributable to the increase in external liabilities due to price effects**. According to our international comparison, the characteristics of EU countries substantiate the correlation described in the literature, namely that **as the level of development increases, external liabilities relative to GDP decrease**, and the ratio of debt-type funds becomes higher among net external liabilities.

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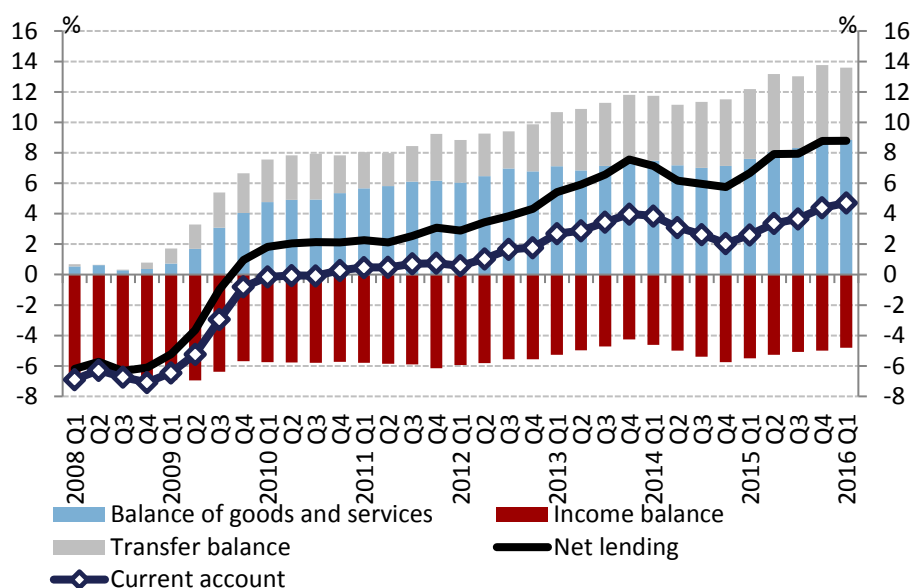
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1. REAL ECONOMY APPROACH

In the real economy approach, the four-quarter net lending of the Hungarian economy stabilised at 8.8 per cent of GDP in the first quarter of 2016, while the current account surplus reached another peak. The high external balance position was achieved in the context of a decrease in the transfer balance surplus, which was counterbalanced by the rise in the trade surplus and the improvement of the income balance. The significant trade surplus can be attributed to the rise in the net export of goods and the steadily high balance of services. The increase in the balance of goods was caused by the improving terms of trade due to subdued oil prices, while export growth fell somewhat short of import growth. In the first quarter, the income balance deficit continued decline modestly, still supported by the improving interest balance of foreign loans. The shrinking transfer balance surplus can be linked to the weak utilisation of EU funds typical in the first years of the EU's programming periods.

In the real economy approach, the four-quarter net lending of the Hungarian economy remained high in 2016 Q1, and the current account surplus continued to rise. Seasonally unadjusted net lending amounted to over EUR 2.1 billion in the first quarter, which was achieved against the backdrop of a current account surplus of EUR 1.7 billion and a capital account surplus of EUR 0.4 billion. Based on four-quarter data, net lending as calculated in the real economy approach stabilised at 8.8 per cent of GDP (Chart 1). This steadily robust net lending was achieved because of the effect of the transfer balance – that was lower due to the EU's new programming period – on external balance indicators, which was offset by the continued expansion of the trade surplus and the slight improvement of the income balance.

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



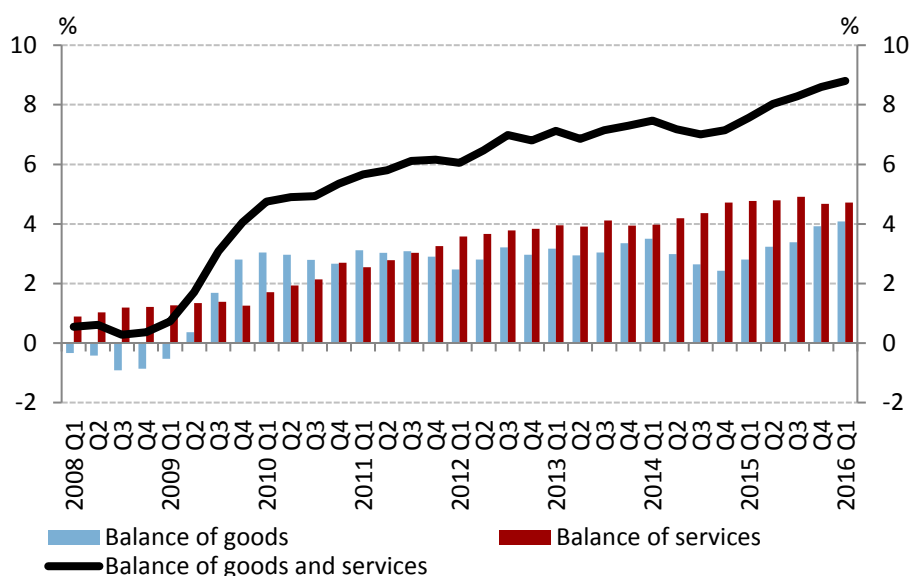
All charts by the MNB unless otherwise indicated.

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

1.1. Trade balance

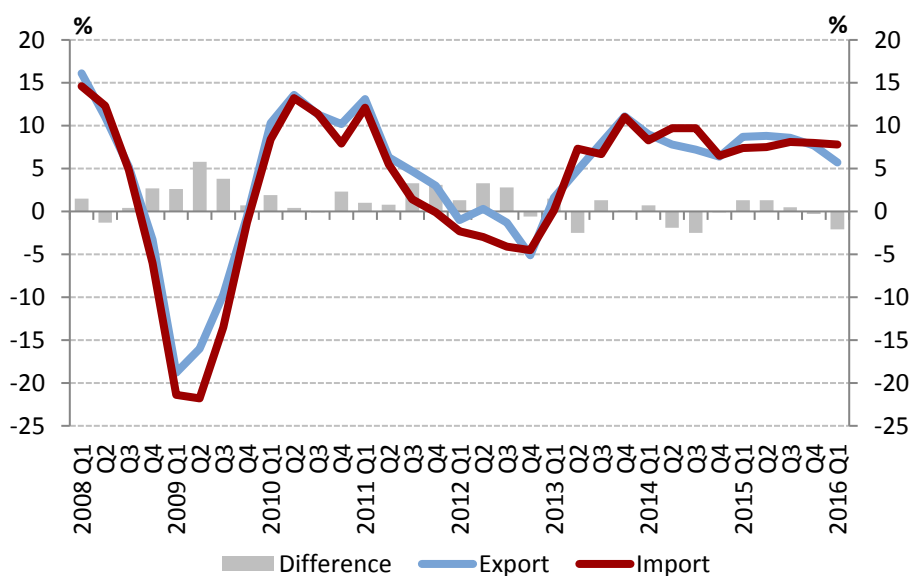
The rise in the trade surplus was due to the expansion in the balance of goods and the steadily high balance of services (Chart 2). Net exports continued to grow in 2016 Q1, and therefore the four-quarter trade balance reached a historic high of around 9 per cent of GDP. The rise in the trade surplus, which was also supported by improving terms of trade, was chiefly due to the expansion of the balance of goods surplus to 4.1 per cent, while the balance of goods services stabilised at an even higher level, at around 4.7 per cent of GDP.

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



A deceleration in the expansion of exports was observed in the first quarter, while the expansion of imports stabilised at a relatively high level (Chart 3). The muted export growth can be attributed to industrial performance which was weaker than in the past and steadily subdued external demand. The brief drop in the dynamics of industrial production can be mainly linked to the temporary shutdown of vehicle production (factory shutdowns early in the year, moderate capacity utilisation). It should be noted, however, that industrial production increased sharply in April. The expansion of imports exceeded the real growth of exports in the quarter, and therefore the net volume of exports diminished overall. The growth in imports can be mainly attributed to the substantial increase in demand for more import-intensive consumer durables (which was above 7 per cent in the first quarter). The gap between exports and imports seen in real growth was also influenced by the fact that, despite the slowdown in industrial production early in the year, the acquisition of goods with a high import content which are necessary for production was uninterrupted, and this development contributed to the dynamics of imports in itself.

Chart 3: Annual real growth of exports and imports

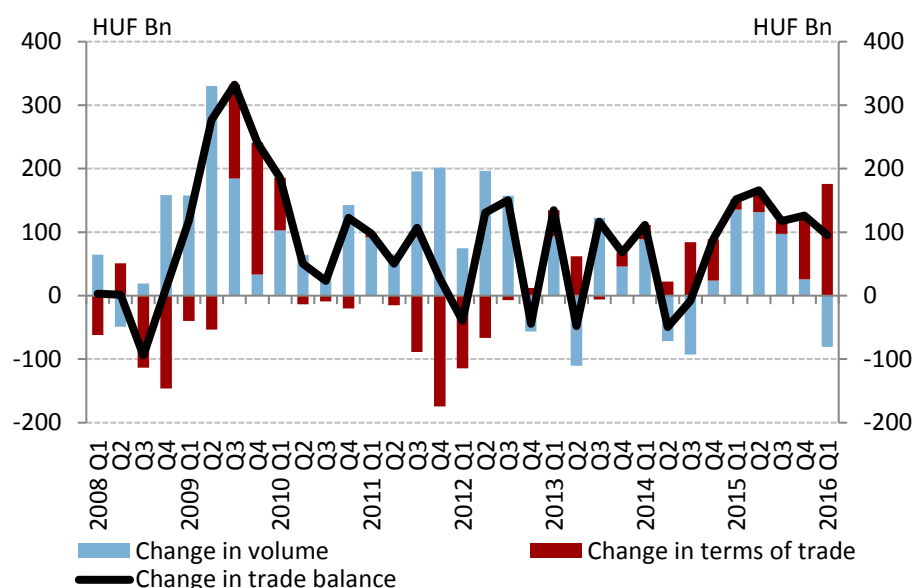


Source: HCSO, MNB

The trade surplus increased, despite the fact that export growth fell short of the expansion of imports, which was due to the marked improvement in the terms of trade (Chart 4). Import prices continued to fall in the first quarter,

mainly as a result of the moderate energy prices which account for a large portion of imports. At the same time, export prices remained flat, generating a tangible improvement in the terms of trade overall. Consequently, the change in external trade prices made the greatest contribution to the improvement of the trade balance since 2009.

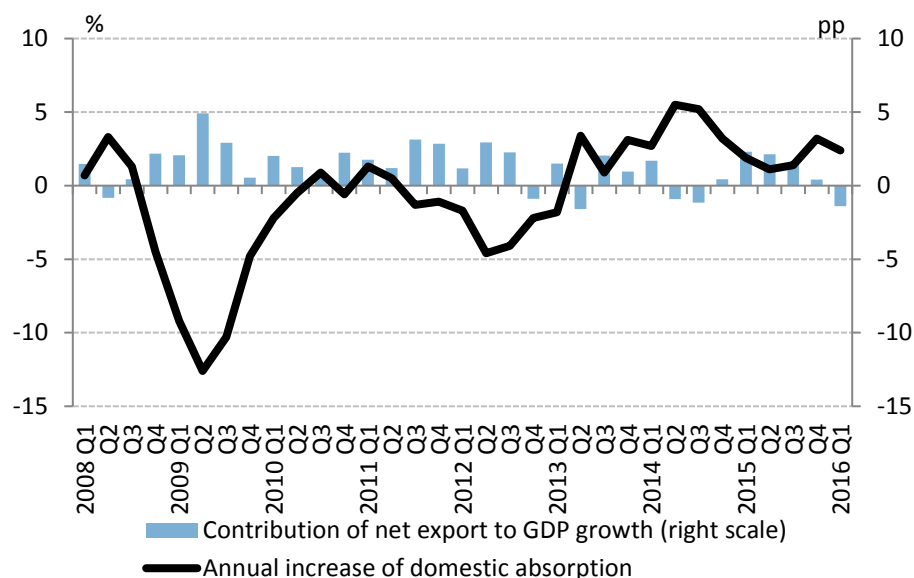
Chart 4: Developments in the components of the trade balance in GDP terms (year-on-year)



Source: HCSO

In the context of slower expansion in domestic absorption, the contribution of net exports to growth was negative (Chart 5). In parallel with the temporary dip in industrial production and the slump in investment dynamics, economic growth was subdued. A slowdown was registered in domestic absorption in the first quarter: public investment financed from EU funds declined, and corporate investment activity remained modest, while household consumption increased substantially during the quarter. Consequently, overall GDP growth was achieved in the context of expanding domestic absorption. In line with the upswing in household consumption, demand for more import-intensive goods rose during the quarter, and the import of goods necessary for production continued; as a result, the contribution of net exports to growth in the quarter was negative overall.

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

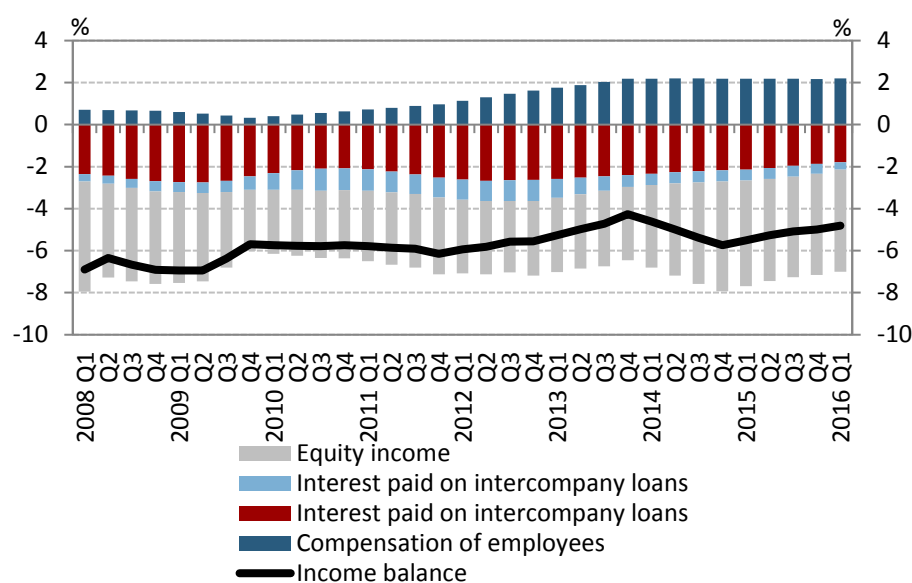


Source: HCSO

1.2. Income balance

The gradual improvement of the income balance observed since 2015 continued in 2016 Q1, which was mainly supported by falling interest expenses. The four-quarter value of the income balance deficit declined to 4.8 per cent of GDP, which was primarily influenced by the improving interest balance of foreign loans (bank loans and intercompany loans) (Chart 6). Thanks to the low yield environment, external debt continued to be repriced in the first quarter, and gross external debt kept decreasing slightly, which resulted in a falling interest balance deficit. In addition, the relatively low income balance was also significantly influenced by the income received by persons who have worked abroad for a period of less than one year, which stabilised at around 2.2 per cent of GDP. With respect to the profit of foreign-owned companies, we only have estimates for the quarter,¹ and based on these, equity income outflows remained almost stable.

Chart 6: Developments in the items of the income balance* (four-quarter values relative to GDP)



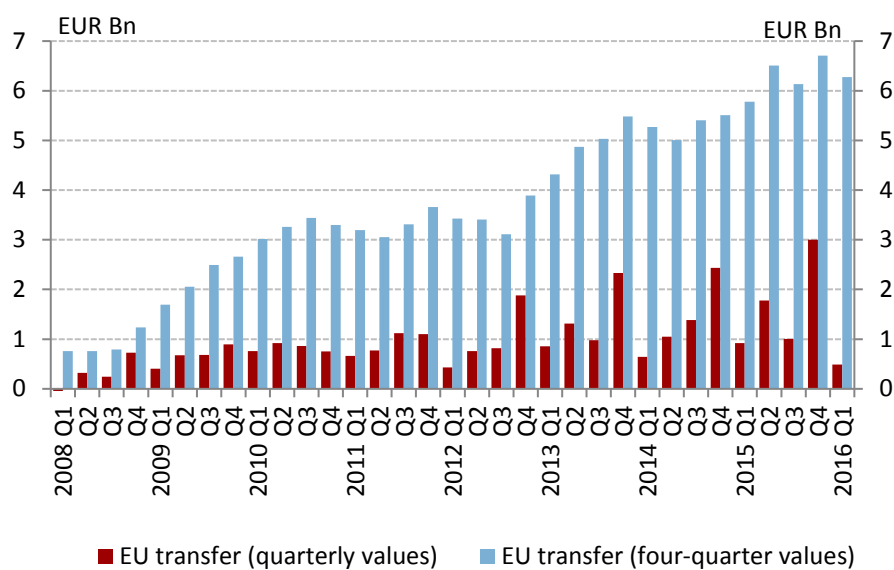
* Income balance: labour income, income on equity and income on debt.

1.3. Transfer balance

In parallel with the exhaustion of funds from the 2007–2013 EU programming period, the four-quarter surplus of the transfer balance diminished (Chart 7). Most of the transfers reaching Hungary are EU funds, which in 2016 Q1 fell substantially short of the historic high levels seen in previous quarters. The drawdown of grants from the 2007–2013 EU programming period generated an exceptional inflow of funds in the previous year. Nevertheless, in 2016 Q1 – after the exhaustion of the funds from the previous programming period – less EU funds reached Hungary, which is linked to the slower onset of the new programming period. Overall, four-quarter net EU fund inflows dipped to EUR 6 billion, which can be primarily attributed to more subdued fund utilisation. In addition, the payment of the contribution to the EU’s budget at the beginning of the year also contributed to the low first-quarter inflows.

¹ Quarterly data on the profitability of foreign-owned corporations operating in Hungary is limited, and therefore information on quarterly outflow of profits is mostly based on estimates. For more details, see the publication entitled “Methodological notes to the Balance of Payments and International Investment Position Statistics” on the website of the MNB. The 2015 corporate profit estimates will be replaced by actual data from corporate annual financial statements to be disclosed in September 2016.

Chart 7: Developments in EU transfer inflows

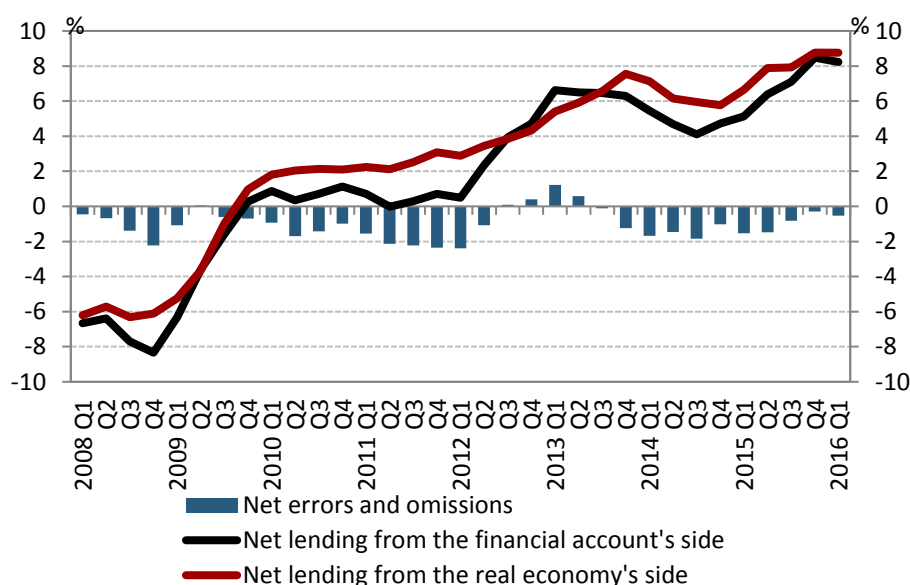


2. FINANCING APPROACH

The four-quarter figures of the financial account indicate a slight reduction in net lending. FDI inflows continued in the quarter, resulting in a EUR 0.2 billion expansion of net FDI funds. Similar to previous quarters, the development of the gross components of FDI was hampered by capital-in-transit transactions, but according to adjusted data, FDI funds expanded. The reduction in net external debt slowed considerably, and its structure was strongly influenced by the fact that during the quarter the central bank provided liquidity to the banking system amounting to almost EUR 3 billion in connection with the forint conversion of foreign currency loans. As a result, banks' net external debt declined significantly, while that of the consolidated general government rose. For the time being, the foreign currency received by the banks increased their foreign assets, and therefore their gross external debt did not change substantially. This was observed in the context of the reduction of short-term liabilities and the expansion of long-term liabilities. Although the net external debt of the consolidated general government swelled, this was mainly linked to the decline in foreign exchange reserves, while the reduction of government securities holdings of non-residents continued in the first quarter.

Based on the items of the financial account, the four-quarter external position of the economy, having risen to over 8 per cent previously, contracted somewhat in the first quarter, and continued to fall short of the value calculated from the side of real economy transactions.² Thus, the decline in the external debt indicators of the economy is still lower than the figure calculated on the basis of the current account and the capital account, which, however, is a correlation that has characterised the Hungarian economy and the country's regional peers for a long time. This trend was only reversed for a short while at the end of 2012, when the figures of the financial account showed greater outflows than indicated in the current account and the capital account. This difference hovered below 1 per cent of GDP in the past quarters, which is low by international standards (for more details see the March 2016 Report on the Balance of Payments).

Chart 8: Two types of net lending and "Net errors and omissions"
(four-quarter data relative to GDP)

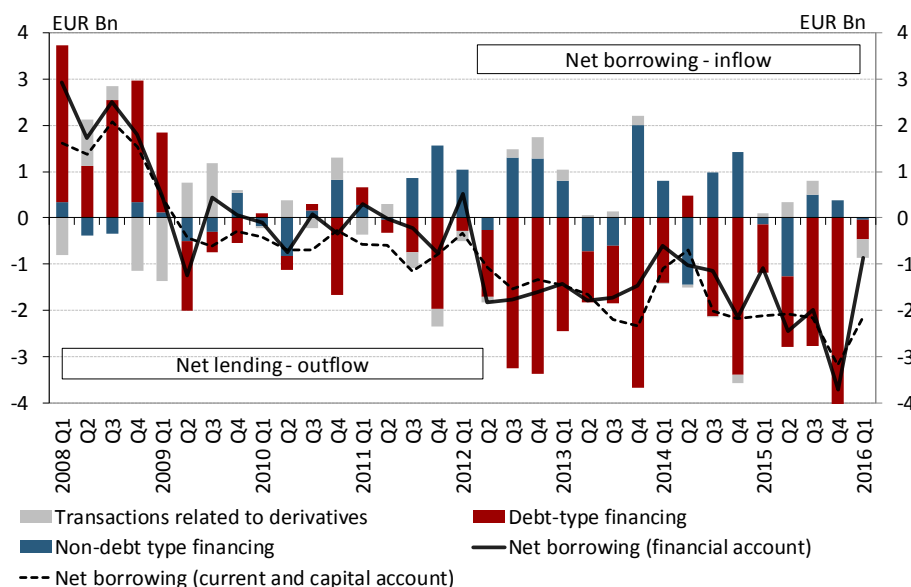


Net lending calculated from the financial account nosedived in the first quarter, and consequently the net external liability of the economy dropped only modestly, by EUR 900 million. The pronounced dip at the beginning of the year

² 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 actors 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 rates, as indicated by the category "Net errors and omissions".

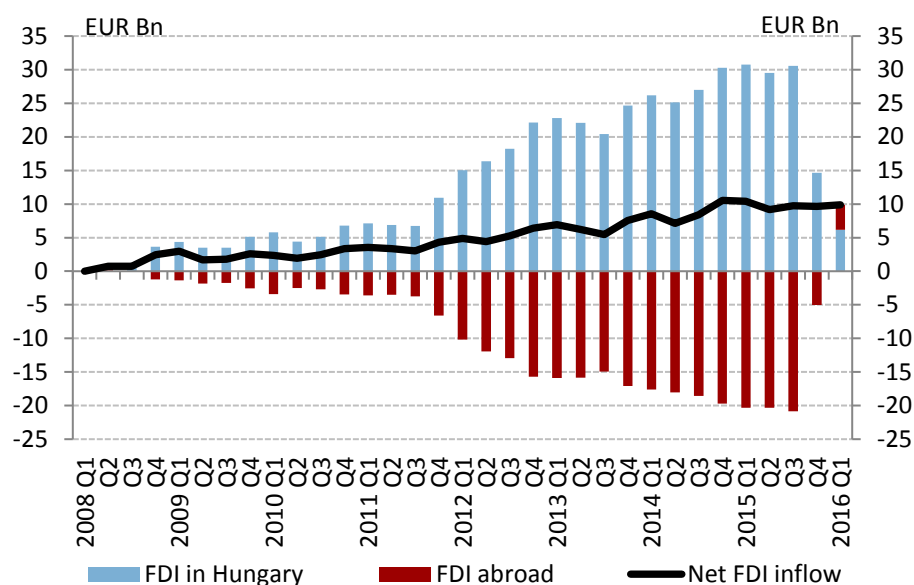
was probably a seasonal phenomenon, as in recent years net lending in the first quarter has been significantly lower than the figures recorded later in the year (Chart 9). The decline in net external debt continued, albeit only moderately, and its structure was influenced by the foreign currency liquidity provided for the forint conversion. The outflow of funds observed with respect to derivative transactions can be attributed to the corporate sector, and especially to a Hungarian-owned enterprise, while among non-debt liabilities, the rise in FDI was offset by the reduction in net equity investments by non-residents.

Chart 9: Developments in the structure of external financing (unadjusted transactions)



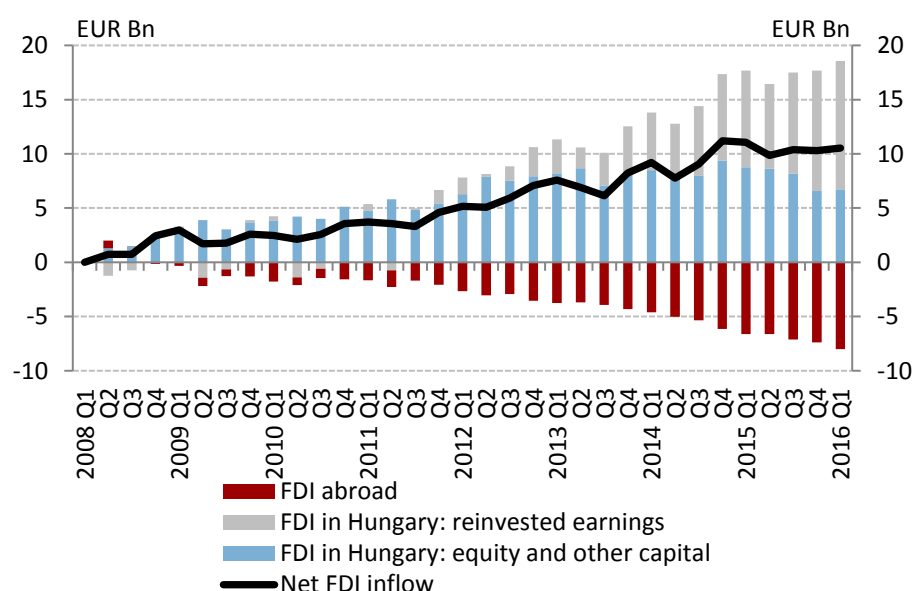
2.1. Non-debt liabilities

In 2016 Q1 net FDI by non-residents in Hungary increased marginally. In addition to the expansion of net liabilities, capital-in-transit transactions considerably reduced Hungarian and foreign investments both in 2015 Q4 and 2016 Q1. The data from 2015 Q4 and 2016 Q1 were strongly influenced by capital in transit, which led to a drop in the gross components in the amount of EUR 25 billion overall (Chart 10). The decline in FDI funds at the end of the year in Hungary was mainly attributable to the sale of a foreign-owned multinational corporation's foreign subsidiary, the purchase price of which was reflected in the rise in credit claims. Thus, on the one hand, the transaction reduced the foreign equity of domestic companies (because it sold a foreign subsidiary) and, on the other hand, the credit claim against the affiliated foreign company reduced Hungarian investments. Capital-in-transit transactions lowered Hungarian and foreign equity by close to EUR 9 billion in the first quarter (for more details see the press release "Developments in the balance of payments based on 2016 Q1 data").

Chart 10: Developments in FDI (cumulative transactions³)

Based on data adjusted for capital-in-transit transactions, FDI by non-residents in Hungary increased by EUR 0.9 billion in the first quarter, while net investments grew by EUR 0.2 billion. As capital-in-transit transactions significantly distort developments in FDI, analyses should use data adjusted for these transactions. According to such data, FDI by non-residents in Hungary increased by EUR 0.9 billion, while outbound investments by residents expanded by EUR 0.6 billion. Therefore, net FDI in Hungary increased by EUR 0.2 billion in the first quarter. The surge in net liabilities was influenced by the capital increase of CIB Bank amounting to over EUR 0.1 billion,⁴ and the FDI-increasing effect of the estimated reinvested earnings.⁵

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



³ Although cumulative outbound FDI transactions are in negative territory, this only means that, due to the capital-in-transit items, the cumulative transactions since 2008 indicate a decline in residents' investments abroad. Nevertheless, as seen in Chapter 5 which deals with stock indicators in more detail, residents still make considerable outbound investments.

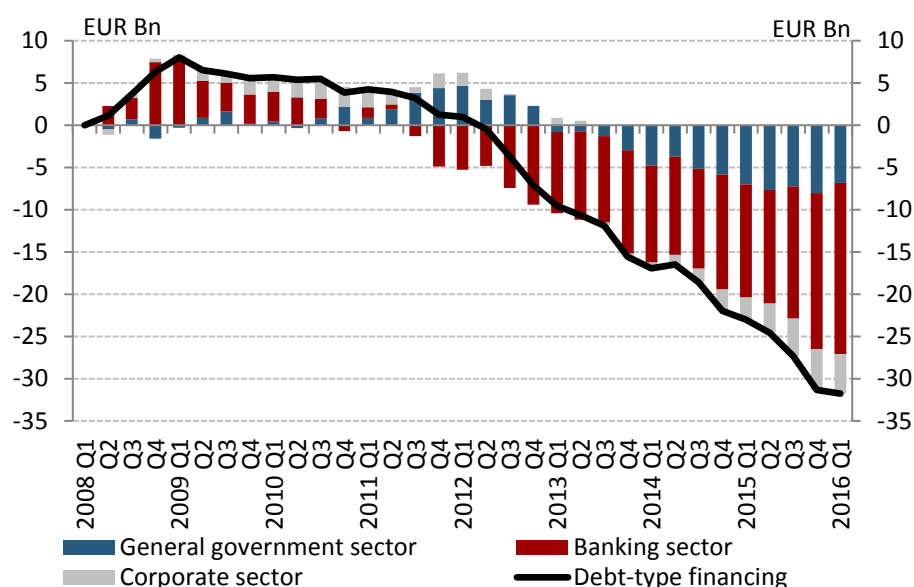
⁴ http://www.cib.hu/system/files/server?file=/Sajtoszoba/CIB_Bank_reszv_hat_2016_02_23.pdf&type=related

⁵ The 2015 profitability figures of enterprises are based on estimates until the receipt of the corporate questionnaires in September 2016.

2.2. Debt liabilities

Repayment of external debt by economic actors slowed in the first quarter, but its sectoral distribution was markedly influenced by the foreign currency liquidity provided to the banking system for the conversion of foreign currency loans (decreasing the share of banks and increasing that of the state). Debt repayment by economic actors slackened considerably in the first quarter, amounting to merely EUR 0.4 billion compared to almost EUR 4 billion in the previous quarter. The sectoral distribution of fund outflows was heavily influenced by the fact that during the quarter the central bank provided substantial (EUR 2.9 billion) foreign currency liquidity to the banking system in connection with the forint conversion of foreign currency loans. This transaction reduced the net external debt of the banking system, but increased that of the consolidated general government.⁶ Overall, the net external debt of the state increased by EUR 1.2 billion, while that of the banking system decreased by EUR 1.8 billion (changes in the size of the columns illustrating cumulative data in Chart 12 show the change in net external debt for each sector). Corporate net external debt grew marginally, rising by EUR 0.2 billion in the quarter.

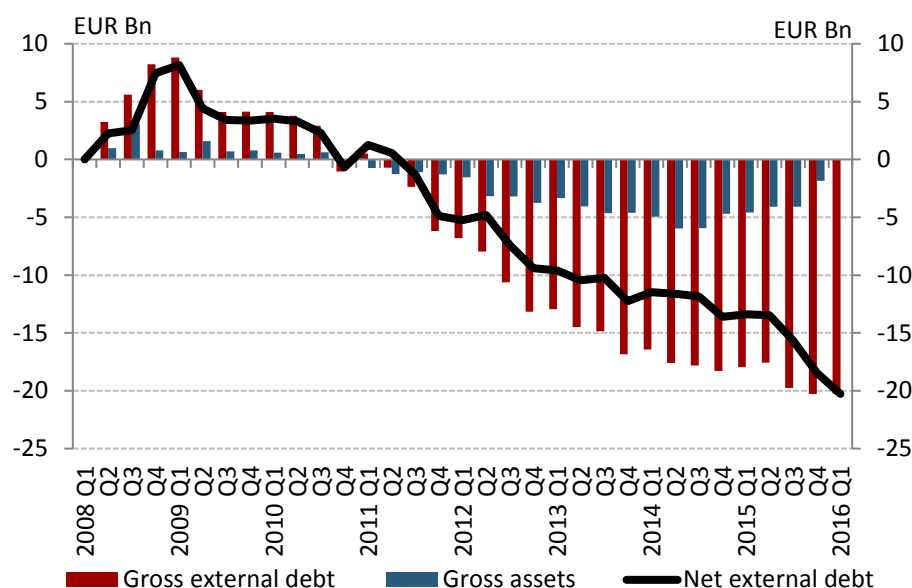
Chart 12: Developments in net debt-type financing by sector (cumulative transactions)



The net external debt of the banking system fell by EUR 1.8 billion, which was almost entirely reflected in the rise in foreign assets. This was strongly influenced by the fact that during the quarter banks received foreign currency liquidity from the MNB amounting to EUR 2.9 billion, in connection with the closing of the foreign currency swap transactions previously linked to forint conversion and settlement. A reduction in short-term external liabilities has been observed in the case of banks since mid-2015, the impact of which is mitigated by the rise in longer-term liabilities, which is favourable from a stability perspective. This continued in the first quarter: banks' short-term debt decreased by EUR 900 million, while their long-term debt increased to a similar extent. The realignment of the funding structure may have been influenced by the foreign currency equilibrium ratio regulation introduced by the MNB (for more details on short-term external debt, see the part on the development of debt indicators).

⁶ For the purposes of the analysis, the general government sector is consolidated with the MNB when examining the structure of external financing.

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



The net external debt of general government consolidated with the MNB increased by EUR 1.2 billion as external debt decreased less and reserves declined more (Chart 14). The net external debt of the consolidated general government has fallen considerably in recent years. The decline was mainly due to the dwindling government securities holdings of non-residents, which have amounted to almost EUR 8 billion since the end of 2014. The increasing prominence of domestic actors was also supported by the self-financing programme. In the first quarter, in addition to the continued contraction of the gross external debt of the consolidated general government, foreign exchange reserves also shrank as a result of the closing of the foreign currency swap transactions linked to the forint conversion. Overall, this resulted in a EUR 1.2 billion rise in the net external debt of the general government.

The following factors decreased the net external debt of the general government:

- economic actors continued to utilise EU transfers (mainly linked to the previous programming period) (EUR 0.4 billion), although to a lesser extent than earlier, which boosted foreign exchange reserves and thus reduced net external debt;
- non-residents continued to sell their forint-denominated government securities during the quarter (EUR 0.9 billion);
- non-residents reduced their foreign currency-denominated government securities holdings (EUR 0.6 billion);
- the increase in foreign reserves also contributed to the reduction of the state's net external debt as the short-term foreign currency swap transaction provided to the banking system at the end of December matured at the beginning of the quarter (EUR 0.4 billion), as did several longer-term foreign currency swap transactions linked the Funding for Growth Scheme.

The following factors increased the net external debt of the general government:

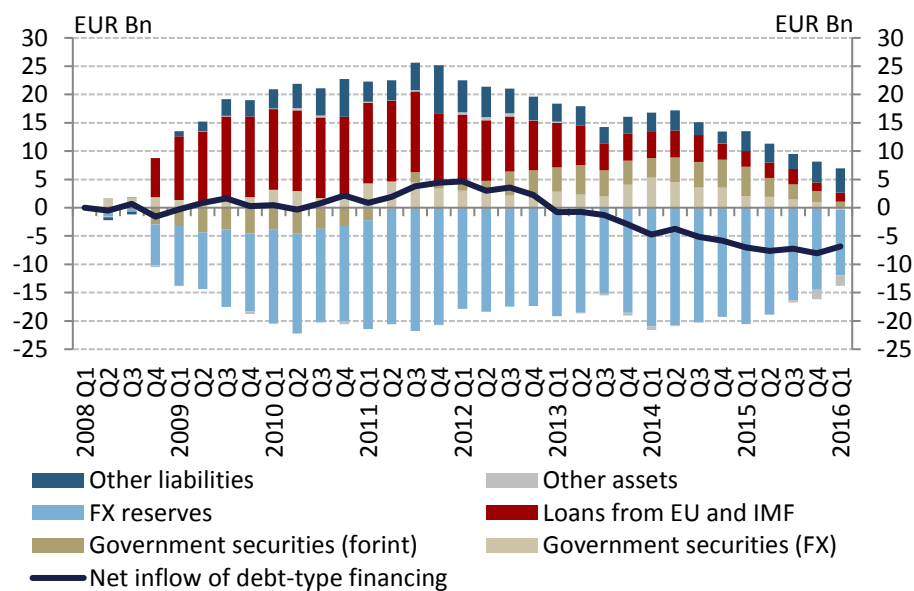
- the maturity of the foreign currency swap transactions provided to banks in connection with the forint conversion of foreign currency loans depleted foreign exchange reserves by EUR 2.9 billion;
- in addition, the interest paid by the state on foreign currency bonds and the state's other foreign currency payment obligations (e.g. foreign pension payments) also lowered foreign reserves.

The following factors did not change the net external debt of the general government, but influenced the size of its gross components:

- during the quarter, the EU transferred an advance of the funds to be utilised in the new programming period, which increased both the reserves and external debt (EUR 0.6 billion);

- in March a GBP-denominated bond mainly held by non-residents matured, which reduced both the general government's gross external debt and the reserves (EUR 0.7 billion);
- during the quarter, the dollar appreciated against the euro, and thus foreign deposits on the margin account held at the state diminished, which in turn cut the gross external debt of the state as well as the reserves (EUR 0.4 billion).

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



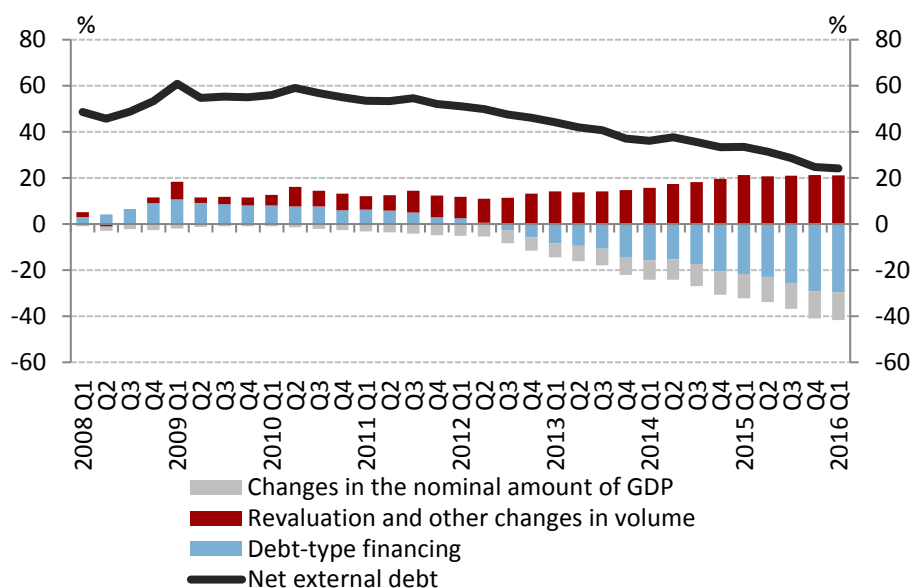
3. DEVELOPMENTS IN DEBT RATIOS

In the first quarter, the external debt indicators of the Hungarian economy continued to adjust: net external debt fell to nearly 24 per cent of GDP and gross external debt approximated 74 per cent of GDP. The outflow of debt-type liabilities, revaluation effects and the expansion of nominal GDP all played a part in the reduction of net external debt. Hungary's gross external debt relative to GDP shrank by more than net external debt, as the reduction of external debt was greater than the contraction in the country's foreign assets. The downward trend in short-term external debt also continued in the period: at the end of the first quarter, this indicator which is key to the country's risk perception stood at around EUR 20 billion. The reduction was mainly due to the shrinking short-term debt of the banking system and the government sector's bond maturity as well as a substantial reduction of its originally short-term external debt. The volume of foreign exchange reserves still considerably exceeds the level expected by investors

3.1. Developments in net and gross external debt

In parallel with decelerating fund outflows, the country's net external debt continued to fall in the first quarter, albeit to a lesser extent (Chart 15). The fall in debt to 24 per cent of GDP was supported by all components: in addition to the outflow of debt-type liabilities, both the increase in GDP and revaluation effects facilitated the decline in this indicator, although the latter two factors exerted a more limited impact. Revaluation effects decreased the indicator overall, but this was the result of opposite trends: while the forint's appreciation against the US dollar reduced net external debt, the revaluation of government securities⁷ and the depreciation of the forint against the euro increased it. In addition to the revaluation effects, the outflow of debt-type liabilities also mitigated net external debt (see the chapter on the financing approach). Furthermore, the expansion of nominal GDP also contributed to the decline in the indicator.

Chart 15: Components of changes in net external debt
(cumulative data without intercompany loans relative to GDP, end-2007 = 0)



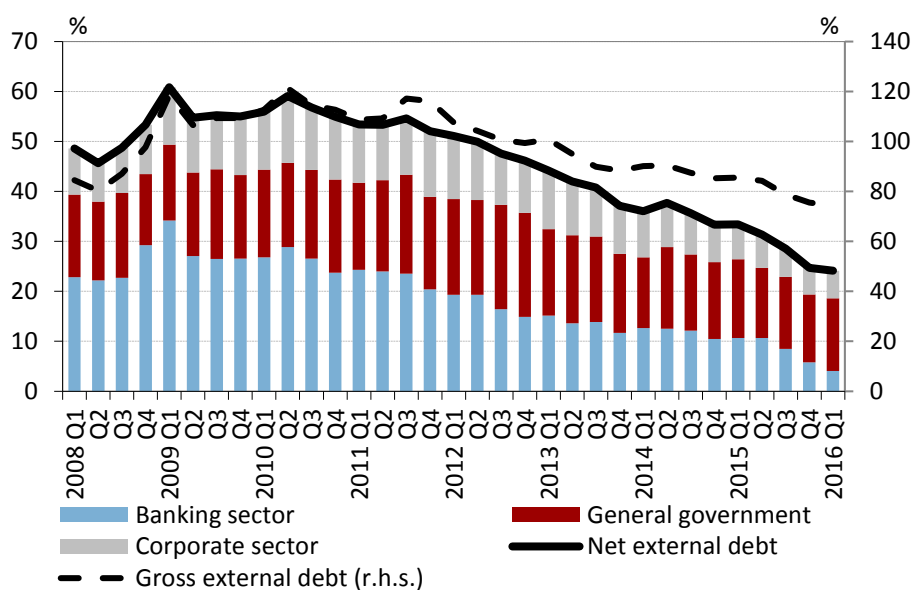
The reduction in net external debt during the first quarter was mainly due to the substantial decrease in the banking system's external debt (Chart 16). The net external debt of the banking system contracted by 1.7 per cent of GDP in the first quarter, which was primarily supported by the rise in the sector's foreign assets. The latter was heavily influenced by the fact that during the quarter the MNB provided foreign currency to the banks amounting to EUR 2.9 billion, in connection with the closing of the foreign currency swap transactions linked to forint conversion and settlement. This, however, pointed towards an increase in the net external debt of the consolidated general

⁷ Since balance of payments statistics present government security holdings at market rate, their value may be affected significantly by shifts in yields. By contrast, the Government Debt Management Agency recognises the government bond holdings of non-residents at face value.

government, since the central bank's foreign reserves fell due to conversion of foreign currency loans. This is because the maturity of the swaps linked to forint conversion only restructured net external debt: while the foreign currency liquidity received reduced the external debt of the banking system, the net external debt of the general government increased on account of the depletion of foreign reserves. In addition, the revaluation of the stock of government securities due to the drop in yields also raised the net external debt of the general government. The increase in general government net external debt was slowed by the shrinking government securities holdings of non-residents as well as the appreciation of the forint exchange rate against the US dollar. Overall, the rise in the consolidated general government's net external debt fell short of the decrease observed in the banking system, and therefore the reduction of the Hungarian economy's net external debt continued. Corporate net external debt did not exhibit a marked change: the upsurge in external liabilities was more or less offset by the expansion of foreign assets. The reduction in net external debt in the past year was chiefly attributable to the banking system: while banks' net external debt amounted to 11 per cent of GDP in early 2015, it stood at around 4 per cent of GDP at the end of 2016 Q1.

The adjustment of gross external debt also continued in the first quarter, and the indicator amounted to 74.3 per cent of GDP at the end of the period (Chart 16). The decline in gross external debt observed in the first quarter can mainly be linked to the outflow of the debt-type liabilities of the general government, especially the reduction of the government securities holdings of non-residents and the margin accounts, as well as a foreign currency bond maturity. By contrast, the gross external debt of the private sector did not change substantially: the slight drop in the gross external debt of the banking system was counterbalanced by the rise in the gross debt of the corporate sector. Hungary's gross external debt relative to GDP shrank by more than net external debt, as the reduction of external liabilities was greater than the contraction of the country's foreign assets.

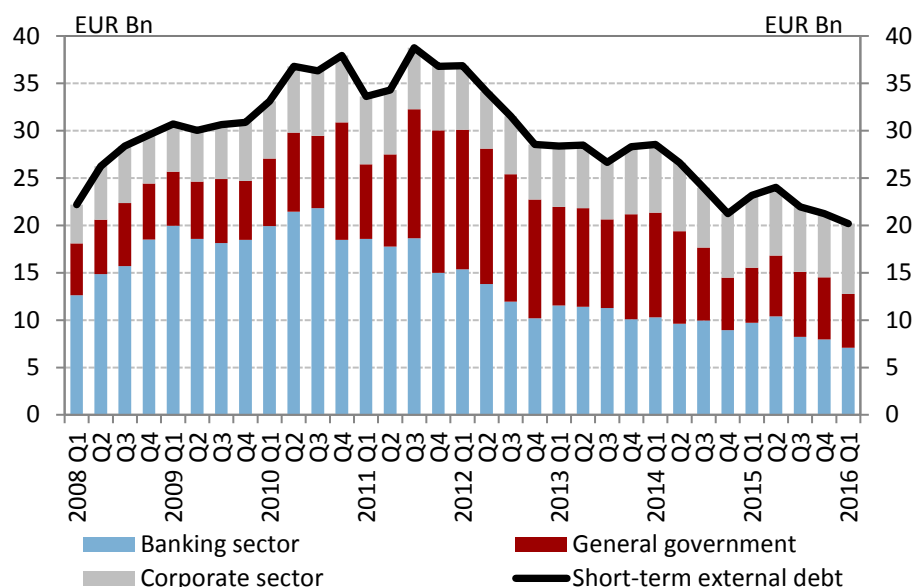
Chart 16: Net external debt by sectors and gross external debt (relative to GDP, excluding intercompany loans)*



3.2. Developments in short-term external debt

Hungary's short-term debt fell by almost EUR 1 billion to around EUR 20 billion at the end of the first quarter (Chart 17). According to the maturity ladder published together with the quarterly balance of payments, the country's amortising long-term external debt shrank by EUR 0.4 billion. The contraction can be mainly attributed to the general government: the amortising debt was reduced on the one hand by the repayment of a GBP-denominated government bond maturing in March, and on the other hand by the sale of government securities by non-residents. In addition to amortising debt, originally short-term external debt also diminished considerably, falling by EUR 0.6 billion to EUR 13.4 billion at the end of the first quarter, which marks a historic low level since 2005.

Chart 17: Developments in gross short-term external debt based on residual maturity



Developments in short-term external debt by sectors show that the reduction was due to the banking system and general government, while the rise in the short-term external debt of companies offset this to some extent. The short-term external debt of the general government fell by almost EUR 0.9 billion compared to the end of the fourth quarter, which was influenced by the aforementioned contraction in amortising debt and the originally short-term debt. The originally short-term external debt of general government decreased by about EUR 0.4 billion, mainly on account of the reduction in the margin volume. In the case of the banking system, the decline in short-term external debt continued, which was mainly linked to compliance with the changing regulations. Nonetheless, the fall in the sector's short-term external debt was somewhat offset by the slight increase in amortising debt. The reduction in short-term external debt was slowed by the fact that the corporate sector's short-term external debt rose by almost EUR 0.9 billion in the first quarter, which can be attributed to a large rise in the originally short-term debt. A substantial portion of the increase, however, can be explained by the temporary, short-term borrowing of one company.

3.3. Developments in foreign exchange reserves and reserve adequacy

In 2016 Q1, foreign reserves dropped to EUR 27.6 billion, mainly due to the maturity of the foreign currency swap transactions linked to the forint conversion of household foreign currency loans. The decline of almost EUR 3 billion was basically the result of the following factors:

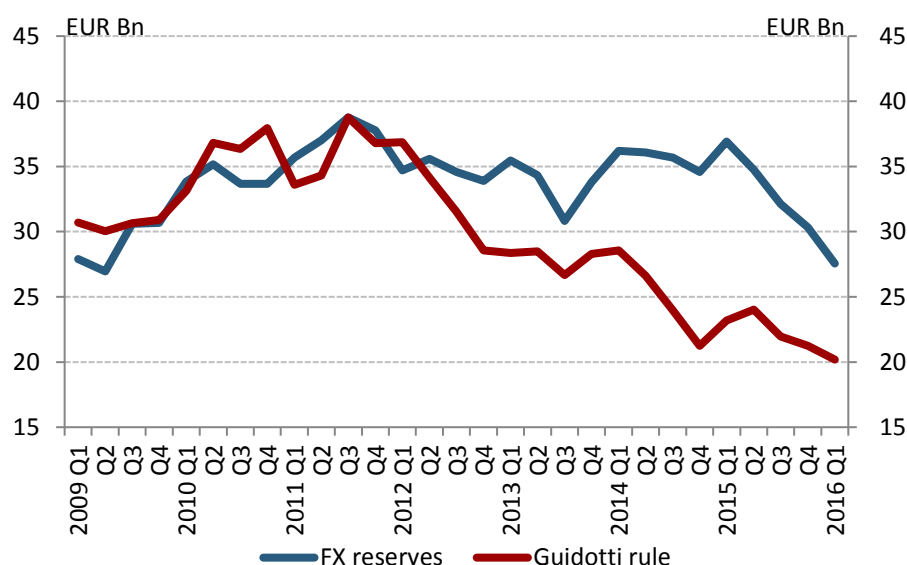
- The maturity of the foreign currency swaps linked to the forint conversion of household foreign currency loans reduced reserves by a total of EUR 3 billion, out of which the maturity of unconditional swap transactions in mid-March amounted to almost EUR 2.1 billion, while the use of the foreign currency rolled over in the conditional instrument depleted reserve holdings by EUR 0.9 billion. With the swap instrument of the MNB conditional on the reduction of short-term external debt, credit institutions were able to roll over the foreign currency purchased at FX tenders linked to forint conversion until 30 March 2016, therefore at the end of 2016 Q1 the foreign currency not taken until that time was also obtained by the banks.
- Another item that reduced the reserves was the Government Debt Management Agency's foreign currency financing, which in the period under review was mainly linked to the maturity of a GBP-denominated foreign currency bond amounting to EUR 0.6 billion. The Government Debt Management Agency repaid its foreign currency debt from the foreign currency bought from the central bank from its rising forint deposits. The increased forint-market bond issues by the Debt Management Agency indicated the support for the debt management policy based on rolling over maturing foreign currency liabilities mainly from forint (negative net foreign currency issue), thereby ensuring the growing forint liquidity of the state. This was enabled by the

surplus demand generated by banks mainly due to the measures of the self-financing programme as well as by the substantial government securities purchases by households.

- The foreign currency expenses of the Hungarian State Treasury, the Hungarian Debt Management Agency's other foreign currency transactions and the changes in its mark-to-market stock of deposits linked to its hedging swap transactions, which can be mostly explained by the appreciation of the euro against the dollar during most of the period, reduced foreign reserves by approximately another EUR 1 billion.
- In contrast to the above-mentioned factors, the inflow of EU funds of EUR 1.2 billion and several other items facilitated an increase in reserves, for example the maturity of the central bank's one-week EUR/HUF FX swap providing euro liquidity at the end of December 2015, the closing of certain FX swap transactions related to the third pillar of the Funding for Growth Scheme before their maturity, and the rise in Hungarian banks' stock of foreign currency deposits with the central bank. However, these items were only able to partially offset the reduction in foreign exchange reserves on account of the MNB's programmes.

In addition to the decrease in foreign exchange reserves, short-term external debt also declined, and therefore the volume of foreign exchange reserves still considerably exceeds the level expected by investors. In contrast to the EUR 2.8 billion drop in foreign reserves observed in 2016 Q1, short-term external debt fell less, by close to EUR 1 billion, which resulted in the depletion of the foreign currency surplus relative to short-term external debt. According to the Guidotti–Greenspan rule, which is closely monitored by both investors and the central bank, FX reserves exceeded the stock of short-term external liabilities substantially, by more than EUR 7 billion in 2016 Q1. The level of FX reserves is also adequate with respect to the other indicators closely watched by the IMF.

Chart 18: Short-term external debt and the stock of foreign exchange reserves of the Hungarian economy



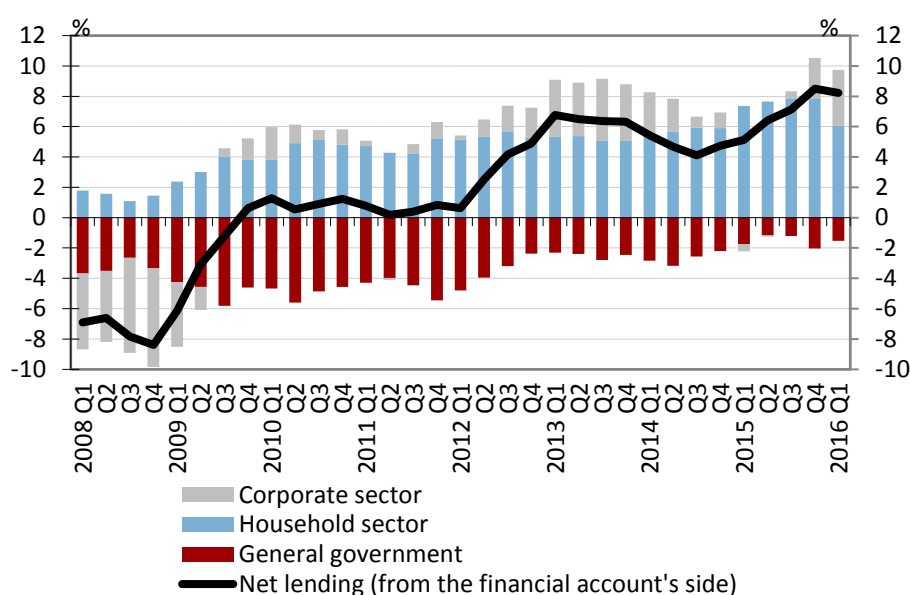
*Guidotti indicator: short-term external debt based on residual maturity.

4. SECTORS' SAVINGS APPROACH

The external position of the economy – calculated from the financing side – sank to close to 8 per cent of GDP in 2016 Q1. Although the net lending of the general government and the corporate sector developed favourably compared to the previous quarter, as a result of the decline in households' financial savings, the net lending of the economy diminished somewhat overall. As the one-off impact of the settlement that emerged in 2015 Q1 disappeared from the four-quarter indicator, it reduced the net lending of households and increased that of companies. Households' net savings were also cut by the loosening precautionary considerations and the related expansion of consumption, while the downturn in investment improved the position of companies. Households continued to increase their government securities savings in the first quarter, while the stock of bank deposits and investment funds diminished.

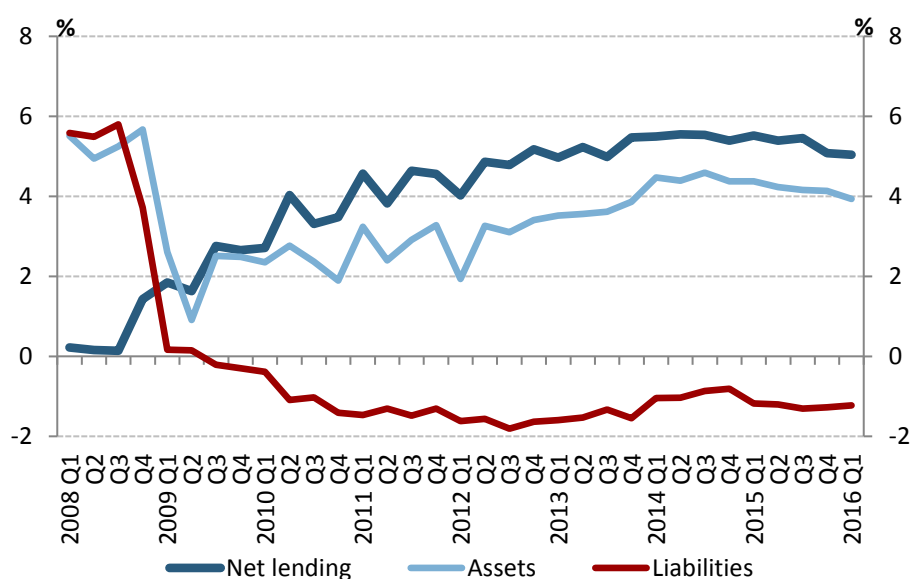
In the first quarter of the year, the four-quarter net lending of the economy fell to near to 8 per cent of GDP, which can be primarily attributed to the decreasing net lending of households. Meanwhile, the net borrowing of the state declined (Chart 19). The modest net borrowing of the budget is due to the expansion of consumption, the rise in tax revenues resulting from growing employment and the shrinking interest expenditures. The tax credit for growth supported reduced net borrowing on the revenue side, while the same was true of the lower own contribution of the state due to the drop in EU transfers on the expenditure side. In 2015 Q1, the profit-decreasing impact of the settlements related to foreign currency loans reduced the net lending of companies and increased that of households. The one-off effect of the settlements disappeared from the indicator in 2016 Q1, which resulted in a decrease in the net savings of households and an increase in that of companies. In addition, households' diminishing net lending was further reduced by the rising consumption linked to loosening precautionary motives.

Chart 19: Net lending by sectors (four-quarter values relative to GDP)



According to the underlying trends, households' seasonally adjusted net savings fell to 5 per cent of GDP, which was influenced by both the sluggish expansion of credit demand and the dwindling accumulation of assets. As a result of increasingly fading precautionary considerations, household borrowing continued to expand, but overall the sector is still a net repayer. Despite the substantial growth in real wages due to rising employment and the tightening labour market, the accumulation of financial assets slightly decreased, which also suggests the easing of precautionary considerations. Lower risks as a result of the forint conversion and the improving income prospects also contributed to the moderate decline in net financial savings.

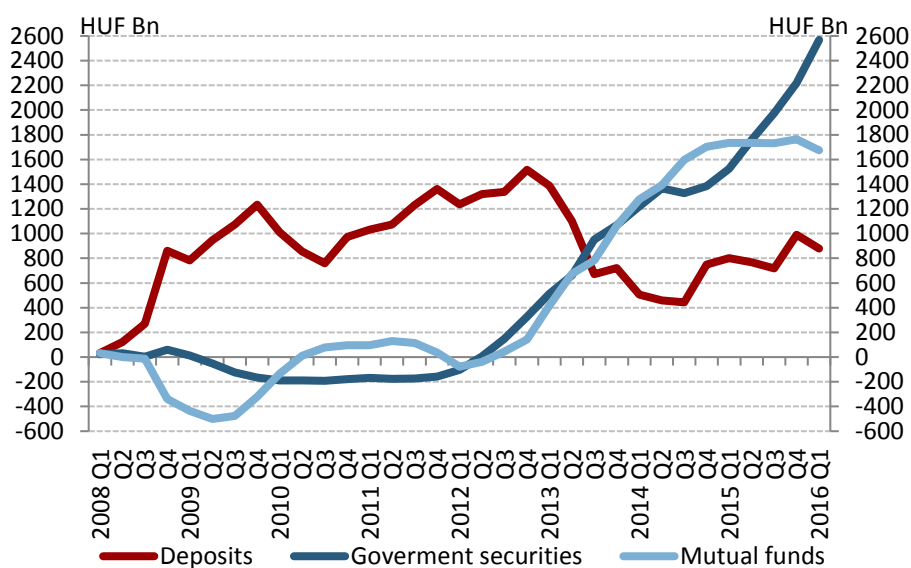
Chart 20: Underlying trends in household net lending (seasonally adjusted data relative to GDP)



* The revised net savings of households excludes transactions which boost the savings of the sector related to the early repayment scheme, the disbursement of real yields, the indemnification of the deposit holders of defaulting savings cooperatives, and the estimated impact of the foreign currency loan settlement and forint conversion.

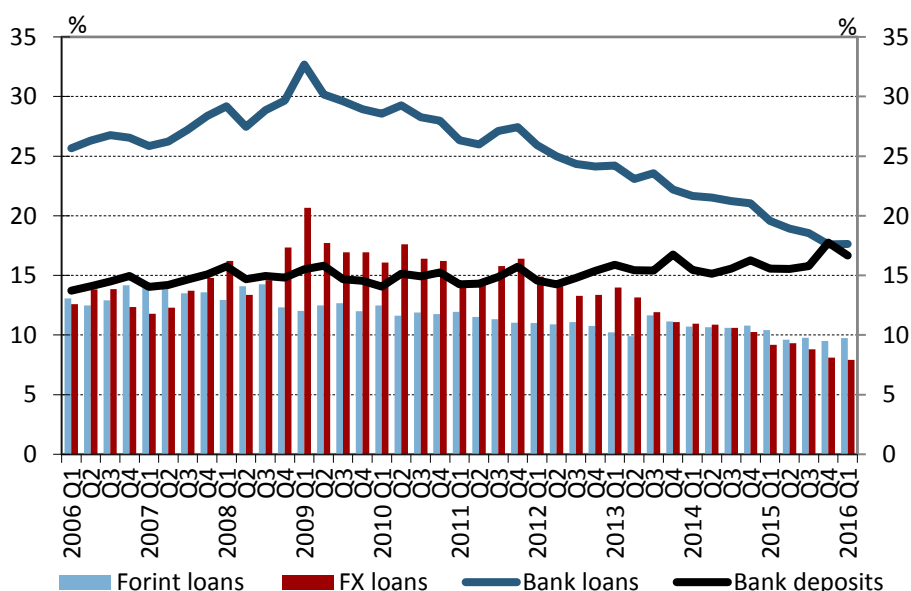
In the first quarter, government securities continued to gain ground rapidly, while mutual fund shares and bank deposits diminished. Earlier, we observed that due to falling bank yields, households had invested a portion of their savings previously held in bank deposits in securities offering higher yields. The process of portfolio restructuring came to a halt in mid-2014, and the volume of demand deposits, which are considered a liquid form of investment, started to rise again. The increasing yield spread of government securities generated growing demand for government securities at the end of 2015, while until 2015 Q3 the volume of bank deposits and investment funds remained more or less stable. In 2016 Q1, the growth of government securities continued, despite the yields offered to the public having decreased slightly. The high demand can still be explained by the substantial yield spread as compared to the alternative forms of investment. Meanwhile, the stock of bank deposits and mutual fund shares diminished, which in the case of the former can be considered a seasonal effect, while in the case of the latter it may be linked to the relatively low historical yields which are monitored by the public in the case of investment units. Among investment funds, property funds expanded the most, but the volume of bond and money market funds decreased, and therefore this process reduced the state's indirect household financing.

Chart 21: Cumulative transactions of household instruments



In recent years, developments in corporate liabilities contributed significantly to the reduction of banks' external debt, but in early 2016 the opposite happened. Over recent years, companies have steadily increased the volume of their deposits, which could be primarily attributed to the income-boosting effect of EU transfers. In addition, corporate investments declined steadily, which also contributed to the rise in companies' bank savings. As a result, companies' bank deposits grew by HUF 750 billion in 2015. According to our observations on the liabilities side, corporate debt reduction gained pace by the end of 2015. Due to the rise in deposits and the drop in loans, by the end of 2015 the stock of companies' bank deposits and loans were equal in size. These developments enabled banks to reduce their external liabilities more rapidly. Nonetheless, in 2016 Q1 corporate borrowing experienced a slight upsurge once again, and at the same time companies' deposits shrank, which suggest that their financing requirement has risen.

Chart 22: Developments in companies' bank loans and deposits (relative to GDP)



5. SPECIAL TOPIC: CHANGES IN NET EXTERNAL LIABILITIES

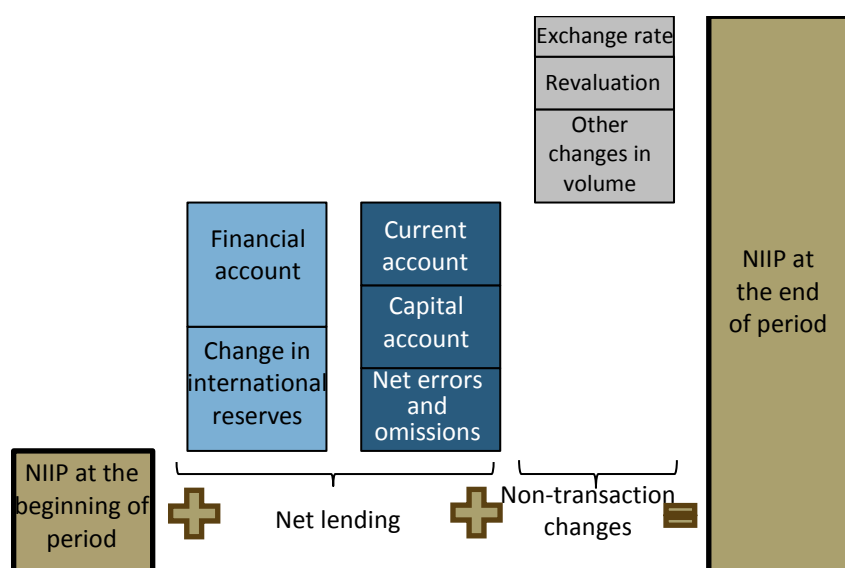
This special topic section deals with changes in net external liabilities. The importance of the stock indicators was highlighted by the crisis, as Hungary was hit particularly hard by the crisis, because prior to the outbreak thereof Hungary had the highest stock of net foreign liabilities within the European Union. The outstandingly high growth in external liabilities is primarily attributable to the earlier growth model relying on external funds and to foreign borrowing; the net FDI stock increased only to a lesser degree. The sectoral breakdown reflects that all three sectors contributed to the pre-crisis increase and to the subsequent decrease in the stock of net foreign liabilities, but the largest growth and adjustment – in line with the soaring of foreign currency lending and then with deleveraging by the private sector – took place in the banking sector. Hence, the change in the attitude of domestic actors and growth relying on internal savings have a tangible impact on the indicators of external liabilities. The change in the balance indicators was strongly influenced, in addition to the financing capacity, by the price and exchange rate fluctuations: only about one-third of the strong pre-crisis growth in the debt ratio was attributable to the external financing in excess of the GDP growth impact, whereas the position deteriorated to a substantially larger degree as a result of the growth in external liabilities due to price impacts – this reflected the impact of the rise in share prices, as well as the growth in the value of the non-residents' FDI stock. Based on an international comparison, the characteristics of the EU countries support the connection described in the specialist literature, according to which – in parallel with an increase in level of development – the value of the external liabilities to GDP ratio decreases and the ratio of debt-type financing is higher within net external liabilities.

5.1. Introduction

The international investment position (IIP) is a stock-oriented statement closely related to the flow-type balance of payments. The balance of payments is a statistical statement that quantifies the real economy, income and financial transactions between the resident and non-resident actors for a given period. That is, the balance of payments contains flow-type data, which provide a picture on the economy's balance of payments position and its dependency on external liabilities *in the given period*. The notion of the *stock-oriented* international investment position is closely related to this balance of payments statistics, which takes stock of the country's outstanding financial receivables and payables against non-residents *at a given moment in time*. Among the indicators, the net international investment position (NIIP), also referred to as net foreign asset (NFA), bears the utmost importance: this deducts from the country's total receivables from non-residents its payables to non-residents, thereby generating a net receivable indicator. This shows whether on the whole the foreign financial assets or foreign debts of the given country's actors are higher. If the value of the external liabilities is higher than that of external assets, the economy has a net foreign (external) liability (the NIIP indicator will be negative), while in the opposite case it has a net external receivable.

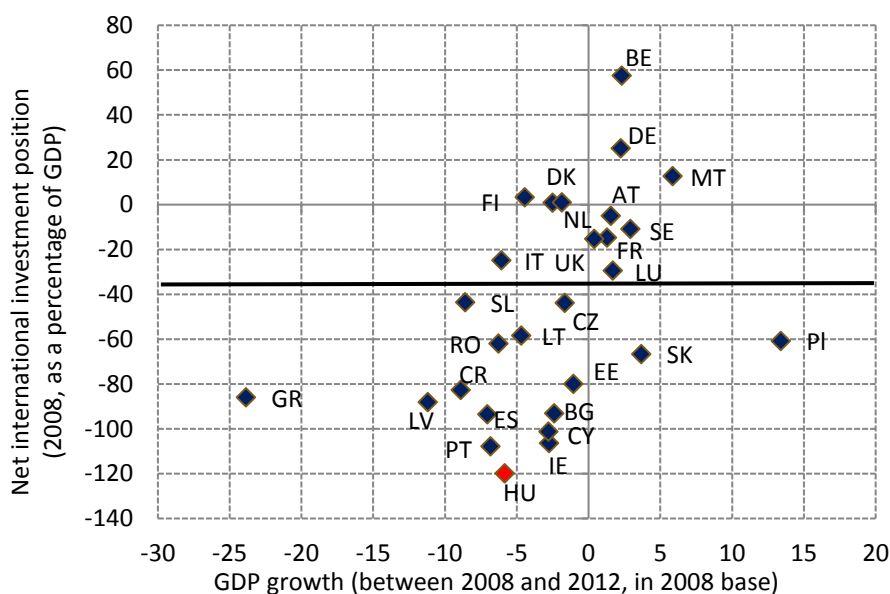
The size of the international investment position is also influenced, in addition to the transaction data of the given period, by the revaluation of the outstanding stocks and other changes in volume. The year-end value of NIIP is composed of the outstanding stock at the beginning of the year, the net foreign financing (external surplus in financing terms), the revaluation and other change in volume impacting the stock (Chart 23). The value of the outstanding stocks is influenced by market prices and changes in the exchange rate of the various currencies, and other factors – independent of the underlying processes (e.g. methodological changes, write-off of receivables).

Chart 23: Schematic diagram of the components of the international investment position



The crisis also highlighted the fact that the net international investment position provides important information on the vulnerability of a given country and the sustainability of its growth, and hence the European Commission has paid special attention to this ratio ever since. The experiences gained from the economic crisis indicated that the international investment position also provides important information with regard to the external vulnerability of an economy. In countries where economic agents had previously accumulated high external liabilities – such as the Mediterranean countries, or Hungary due to the foreign currency lending – the adjustment after the economic crisis entailed much larger sacrifices than in the countries with lower external liabilities (Chart 24). This is partially due to the fact that during the pre-crisis years these countries financed investment and consumption from external funds, and thus the adjustment in this area entailed a substantial downturn. For example, before the economic crisis, Hungary's net international investment position showed the highest net liability within the EU, which signalled severe vulnerability. The European Commission also recognised the importance of examining the investment position, using NIIP as one of the key indicators in its macroeconomic imbalance procedure (MIP), where the threshold value signalling an imbalance is -35 per cent. That is, if a country's net external liabilities exceed 35 per cent of the GDP, this ratio signals an imbalance.

Chart 24: Relation between the pre-crisis value of the net liabilities and post-crisis GDP growth



5.2. Changes in external liabilities in Hungary

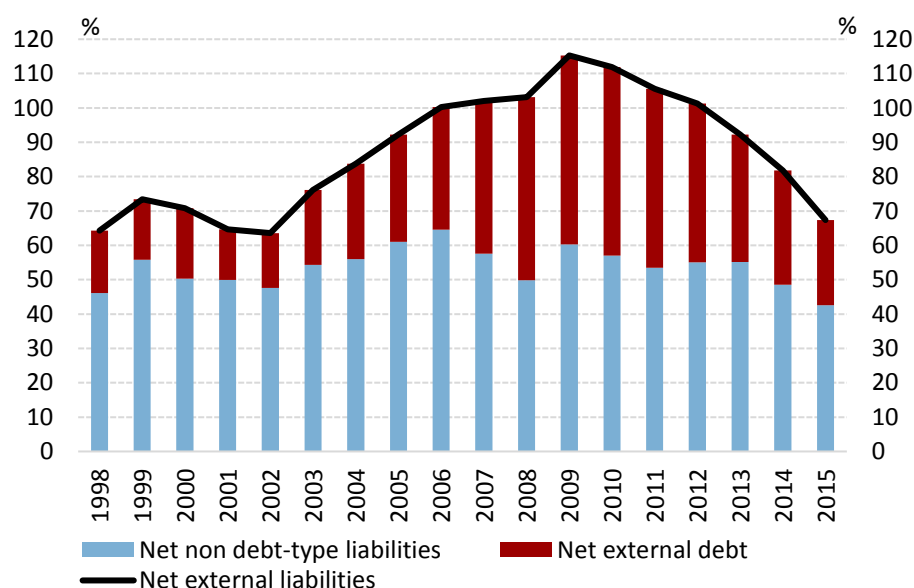
The section below describes how the international investment position can be broken down by the liability type (debt-type and non-debt type liabilities) and by the sector (public, corporate or bank sector) which raises the funds, and demonstrates the development of the indicator in the context of these factors in recent years. The breakdown by the type of liability reflects an increase in debt-type liabilities before the crisis, followed by a gradual decline. The net FDI stock accounts for the major part of non-debt creating liabilities, which increased after the political transition until the 2000s, followed by a slowdown. In addition, after 2010 the volume of capital in transit increased, as a result of which the gross value of the direct investment inflow and outflow increased. As regards the sectoral breakdown, the type of financing raised is characteristic of the given sector: the state typically raises debt-type liabilities, while non-financial corporations usually receive foreign direct investment. In contrast to these, banks accumulated high foreign debts, used primarily for the financing of borrowing by enterprises and households. Finally, the section also describes the factors that influenced external liabilities, apart from transactions (price effect, exchange rate effect, effect of the change in nominal GDP).

5.2.1. Breakdown by liability type

The international investment position is essentially comprised of two factors: debts and non-debt liabilities. External liabilities can be allocated to two large categories, depending on the nature of the liability they represent. The external *debt* of the country includes financial liabilities (e.g. bonds, loans, commercial loans) that entail some sort of instalment and/or interest payment obligation. That is, this category includes the monetary assets lent by non-residents to the actors of the country (e.g. government debt held by non-residents). In addition, the non-debt liabilities of *a capital nature (equity type)* also form part of external liabilities, where the aforementioned obligation with maturity does not exist: either an ownership relation is established (e.g. direct equity and portfolio share) or no transfer of funds takes place at all upon concluding the transaction (e.g. financial derivatives, which does not mean that the management of the position will not require financing later on). The debt-type and non-debt external liabilities together constitute the given country's external liabilities.

The share of debt-type liabilities within net foreign liabilities rose to a high level before the crisis, due to the growth model relying on external finance, but since 2010 it has been gradually decreasing in parallel with the increase in internal savings. After the political transition until the end of the 1990s, the Hungarian economy's net foreign liabilities increased due to the inflow of non-debt liabilities supporting enterprises' finance-intensive investments. Hungary's significant current account deficit remained in place in the 2000s as well, but this was already financed primarily by foreign borrowing and bond issue – in parallel with the surge in foreign currency lending – and not by FDI liabilities, and thus the role of debt-type liabilities within external liabilities increased. Such realignment of the financing structure is partially the result of a natural process, as in parallel with the development of the internal financial markets and the institutional system it becomes less and less important for foreign investors to make equity investments (see more details in subsection 5.3.2). On the other hand, the external debt was in part the result of the former growth model that relied on external liabilities, where due to the high budget deficit and foreign currency lending to households, the savings of domestic actors was insufficient for financing the investments and consumption, and hence external funds had to be raised. After the outbreak of the financial crisis, in parallel with the adjustment by the sectors, the reduction of banks' external debts commenced, and together with this the ratio of external debt within external liabilities started to fall. Later, this process was also supported by the MNB's self-financing programme, as a result of which the state's external debt fell significantly. In addition, there was also a material change in the attitude of the non-financial private sector, and instead of the former indebtedness the domestic agents were characterised by financial accumulation and the repayment of loans drawn down earlier. By the end of 2015 net foreign liabilities – which had decreased by 7-8 per cent of GDP annually since 2009 – fell to 72 per cent of GDP, which was primarily attributable to the decline in foreign debt, deposits and borrowings, and to a lesser degree to the increase in financial assets.

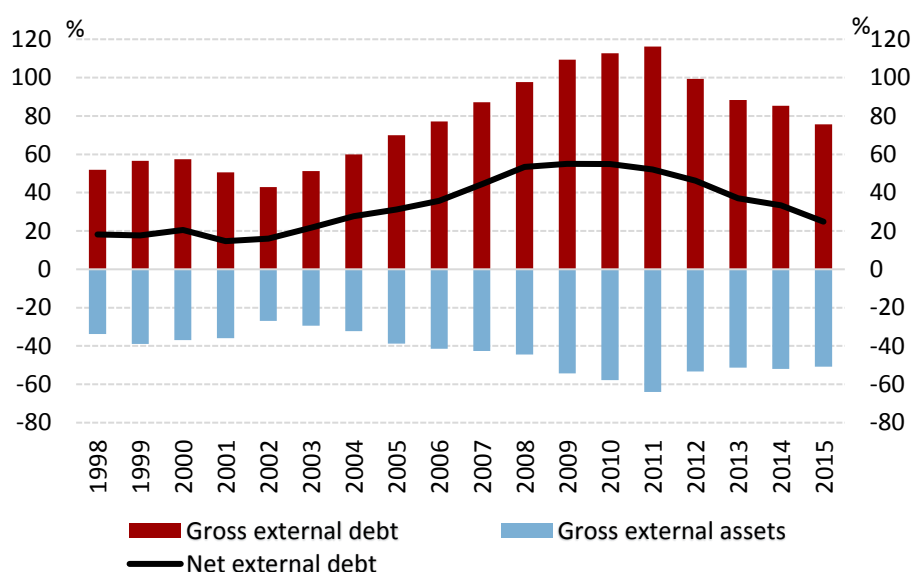
Chart 25: Developments in net external liabilities (end-of-period values relative to GDP)



In the mid-2000s, in parallel with the surge in foreign currency lending and budget spending overruns, the net external debt of the Hungarian economy increased. Until the mid-2000s the net external debt of the Hungarian economy was relatively stable at around 20-25 per cent of GDP. In this period, households' financial savings covered the state's net borrowing, while in the corporate sector the share of non-residents gradually increased, i.e. the enterprises' external liabilities originated from non-debt creating flows. However, from 2002 the general government's net borrowing increased considerably due to the increasingly lax fiscal policy, while as a result of the strong borrowing by the household sector the net lending of households decreased. Moreover, households typically borrowed in foreign currency, which prompted banks to resort to external finance, while under decreasing household savings the state was also forced to rely on foreign funding to a greater degree. On the whole, in the financing of the sectors non-debt liabilities were replaced by foreign loans and bond purchases by non-residents. The inflow of debt-type liabilities – and thereby the dynamic increase in the external debt-to-GDP ratio – was attributable to the decreasing household financial savings resulting from the surge in foreign currency loans, the increasing external financing of the banking system and the financing of the income balance deficit by debt-creating liabilities.

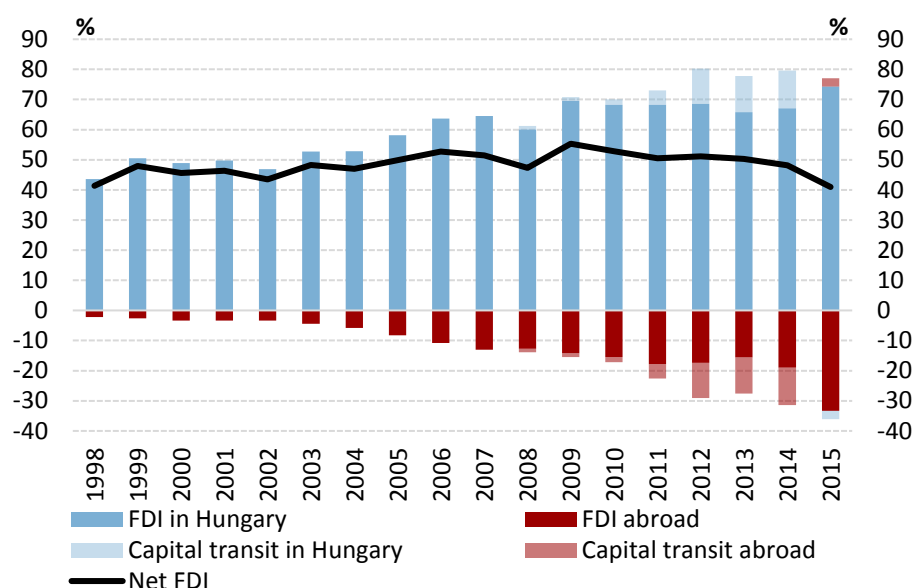
The forint exchange rate, which depreciated during the crisis, gave rise to an increase in the balance of foreign currency loans, and then, in parallel with the adjustment of the sectors, the net external debt set on a declining path. Following the outbreak of the crisis – due to the depreciation of the forint exchange rate and the decline in nominal GDP – the external debt ratios continued to increase. The drawdown of the IMF and EU loans also contributed to the rise in gross debt, but as they increased reserve holdings as well, these had no influence on net external debt. By 2009, net external debt – which had risen to 55 per cent of GDP – reached its peak. Following this, due to the adjustment by the private sector and the decline in banks' lending activity, deleveraging commenced, and hence net external debt gradually decreased. In 2015 net external debt amounted to 25 per cent of GDP – i.e. it had fallen by almost 30 percentage points since 2010 – which was also attributable, in addition to the strong deleveraging, to the rise in nominal GDP.

Chart 26: Change in external debt (end-of-period values relative to GDP)



In recent years, the net FDI stock, which accounts for the major part of non-debt creating liabilities, declined slightly, which primarily occurred in an environment of increasing outward flows. The economic transformation that followed the political transition, the privatisation and the favourable returns realisable in an economy struggling with capital shortfall, resulted in a rise in corporate investments and a substantial balance of payments deficit, which was financed by raising foreign working capital. As a result of this, net FDI funds increased until the early 2000s. From then on, under decelerating gross FDI inflow – attributable to declining corporate investment – outward investments by residents also increased, and thus the increase in net FDI funds remained moderate. The net GDP-proportionate value of the FDI stock was affected by the crisis primarily through the change in GDP: in 2009, due to the decline in nominal GDP, the net GDP-proportionate FDI stock increased, while this effect faded in parallel with the recovery in economic growth. Meanwhile, the gross value of FDI inflows and outflows increased continuously, which was partly due to the substantial volume of capital in transit: part of the funds, presumably for tax optimisation purposes, was transferred to Hungarian subsidiaries in the form of intercompany loan or capital, which was forwarded by the companies abroad. In recent years, the gross FDI inflow was slightly exceeded by domestic agents' outward investments, and thus the net FDI stock decreased slightly. This was also due to the FDI reducing effect of the acquisitions by the state, while the FDI inflow resulting from the banks' capital injection only offset the FDI decrease generated by the banks' losses.

Chart 27: Changes in foreign direct investment stock* (end-of-period values, relative to GDP)

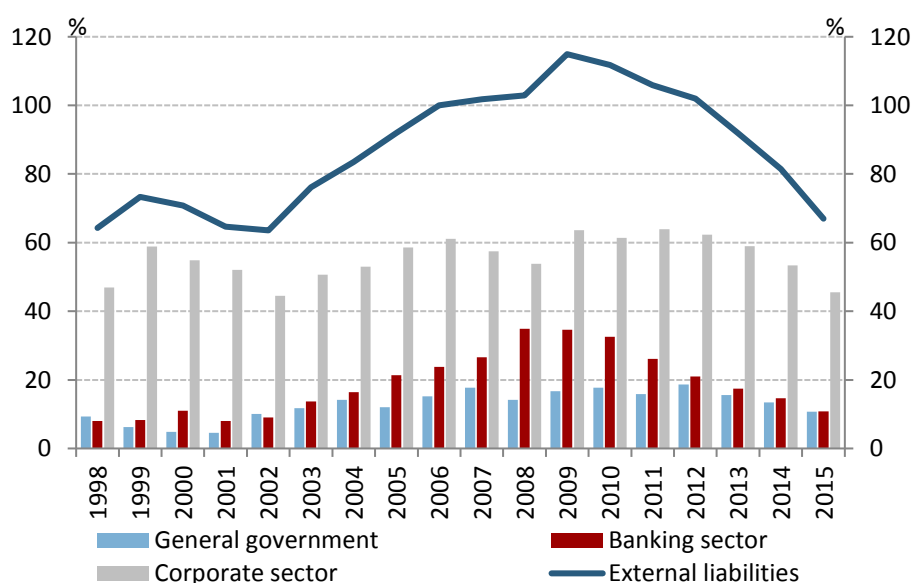


* Capital-in transit is represented as cumulative transactions, thus the negative value of FDI in Hungary means, that it is lower than basis year.

5.2.2. Sectoral breakdown

The international investment position can be decomposed not only by liability type, but also by the sector that raised it. In this context, there are several sectors in which the net international investment position, just like the investment type, is characteristic of the sector. One of these is the general government, which only raises debt-type foreign liabilities, while the central bank has external assets (which, in part, is linked with the state's external indebtedness). On the other hand, non-financial corporations mostly raise non-debt type external funds, which they only partially supplement with debt-type liabilities (e.g. in the form of intra-group loans, bank loans or supplier payables). Finally, the banking system's external liabilities may take the form of foreign direct investments or debt-type liabilities, and similarly, both types of investments also exist as external assets. According to the sectoral breakdown, all three sectors contributed to the pre-crisis growth and the subsequent decline in net foreign liabilities.

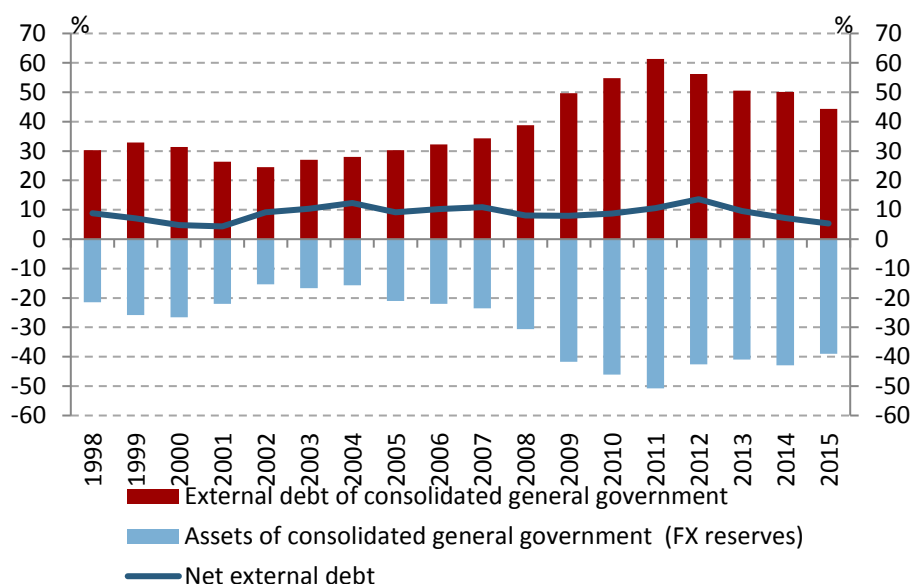
Chart 28: Changes in the net foreign liabilities of the individual sectors (as a per cent of GDP)



The state – if national savings prove to be insufficient – finances its operation by external liabilities, and in parallel with that the central bank's foreign currency reserves (external assets) may also increase. In our analyses, by general government we usually mean the consolidated position of the general government and the central bank against the non-resident sector. This consolidation is justified, because the change in the central bank's foreign exchange reserves is substantially influenced by the state: when the state issues foreign currency bonds, it converts the foreign currency thus obtained into forint at the central bank – as its expenses are typically generated in forint – and simultaneously with that the central bank's foreign exchange reserves also increase. Hence, the central bank's external assets and the state's external debt stand in close relation with each other (the latter is also increased by the purchase of government bonds by non-residents, whereas the change in foreign exchange reserves is also affected by inflows of EU transfers).

In accordance with the above, the Hungarian state's external debt and external assets typically changed in a similar manner, and the state's net position was relatively stable. From the early 2000s, the high general government deficit was financed by the non-resident sector to a substantial degree, which was reflected by the continuous increase in the state's external debt, amounting to more than 30 per cent of GDP by 2007. On the other hand, foreign exchange reserves increased at a similar rate, and thus the net external debt of the consolidated state was typically around 10 per cent of GDP. During 2008–2009, due to the drawdown of the IMF-EU loans, the state's external debt and the foreign exchange reserves increased substantially, by almost 20 per cent of GDP, and thus net external debt did not change materially. The increase in net external debt continued until 2011. In 2012 no new foreign currency bond was issued, and so the foreign currency liquidity necessary for the repayment of the expiring foreign currency debt was provided from the reserves. The impact of this was further exacerbated by the fact that at the end of 2011 and early 2012 the foreign currency necessary for the early repayment of the foreign currency loans at preferential exchange rate was provided to the banks by the central bank to preserve financial stability; as a result of this the foreign exchange reserves fell significantly, while the state's gross external debt changed only to a lesser degree, leading to an increase in net external debt. However, after this the state's consolidated net and gross external debt started to decrease gradually, with the MNB's self-financing programme playing a material role in this development.

Chart 29: External debt and external assets of the state and the central bank (as a per cent of GDP)

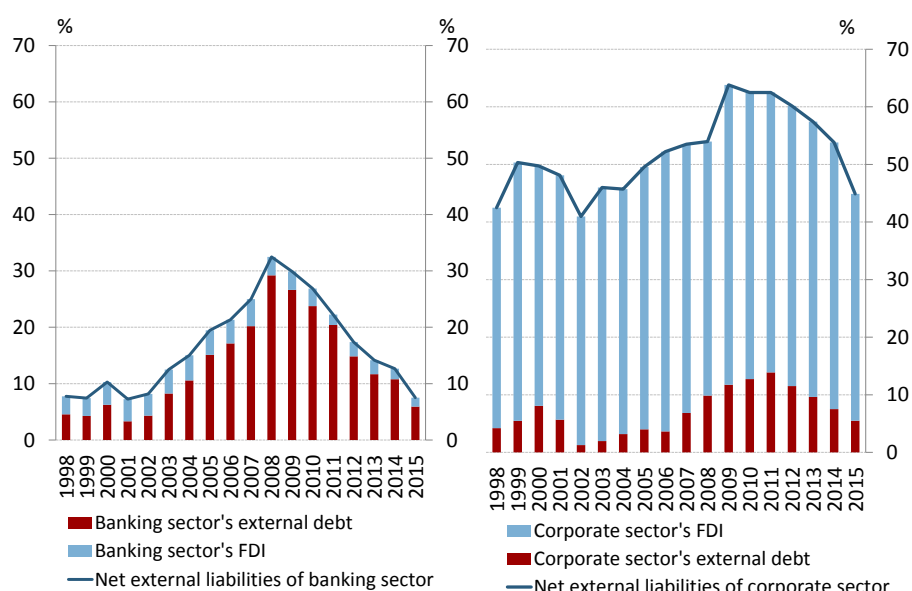


Non-financial corporations primarily receive FDI funds from abroad, and in recent years this fell due to international and country-specific reasons, but it is still substantial, amounting to roughly 45 per cent of GDP. In contrast to the general government, the non-financial corporate sector raises non-debt type funds to a larger degree, primarily consisting of foreign direct investments and thus the bulk of the external liabilities are related to these. The net FDI debt of corporations already amounted to almost 40 per cent of GDP in the late 2000s as a result of the earlier privatisations, and this growth continued until 2009, when the ratio exceeded 50 per cent of GDP. However, after the

financial crisis it can be generally stated that the capital inflow in the converging countries fell,⁸ and thus the FDI funds received by Hungary also decreased. The impact of this was further exacerbated by the state's acquisitions in recent year (including the acquisition of MOL, E-on and Antenna Hungaria), as a result of which the non-resident sector's direct investment in Hungary decreased further. In addition, the larger resident companies increased their outward investments by acquiring foreign companies, which resulted in a decrease in net foreign liabilities through the increase in receivables. Corporations also borrow, partially from foreign banks, which is reflected in the corporations' negative net debt-type receivables. The degree of this, in line with the general deleveraging observed in the economy – i.e. the gradual reduction of the outstanding borrowing – has declined in recent years.

In contrast to non-financial corporations, banks accumulated high foreign debts, used primarily for financing the borrowing of enterprises and households. The banking system's net direct debt is much smaller than that of corporations, as only the capital necessary for the acquisition or establishment of financial institutions or for replenishing losses, arrived in Hungary in the form of foreign direct investment. On the other hand, banks also used external funds for their operation, supplementing domestic funds. As a result, with the deepening of the financial intermediary system and the spread of household and corporate lending, in the early 2000s banks also continuously increased their external debt. Due to the aversion to risk and deleveraging resulting from the crisis, after 2008 households and corporations started to repay the outstanding borrowing built up earlier, which was reflected in a fall in banks' external debt. Banks' FDI stocks were also influenced by the increase in the outward investments of large domestic banks and by the state acquisitions (MKB Bank and Budapest Bank). Banks' net FDI stock relative to GDP has fallen by roughly 2 percentage points since the outbreak of the crisis, despite the fact that foreign banks provided capital injections to their Hungarian subsidiaries in excess of EUR 4 billion. This is mainly attributable to the fact that the write-offs due to the higher volume of non-performing loans attributable to the crisis, and the losses linked to the early repayment and the settlement resulted in a decrease in the FDI stock, the impact of which was further strengthened by the foreign capital injections of domestic banks.

Chart 30: Breakdown of the banks and corporations' net external liabilities by FDI and debt-type liability (as a per cent of GDP)



⁸ IMF, 2016.

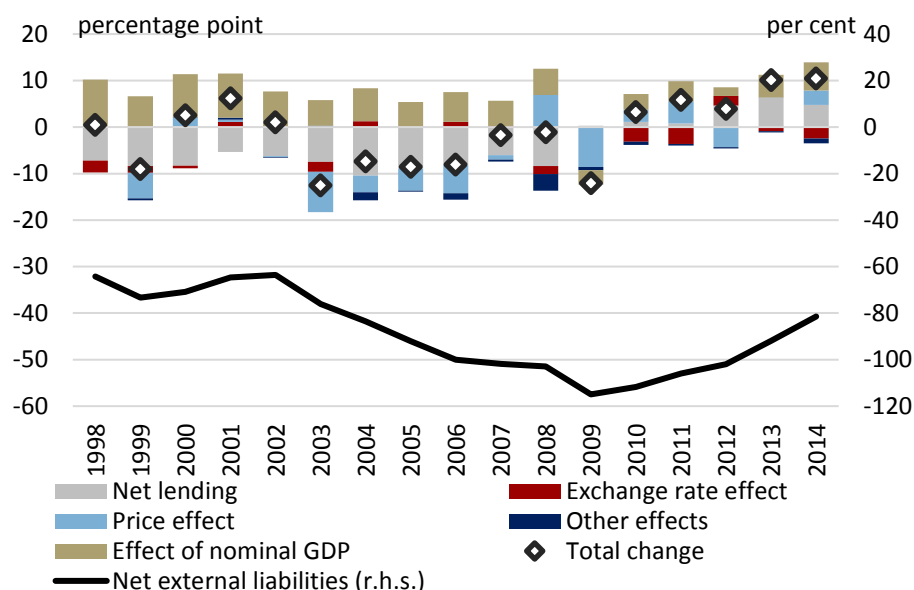
5.2.3. Factors affecting the change in external liabilities

In addition to transactions, the change in external liabilities is also significantly influenced by revaluations attributable to price and exchange rate fluctuations. As mentioned before, in addition to the transaction data of the given period, the size of the international investment position also depends on the revaluation effects influencing the outstanding liabilities. The non-transaction flows can essentially be attributed to three factors:

- *Exchange rate effect:* in addition to the foreign currency debt, the depreciation of the forint results in an increase in the forint equivalent of the foreign currency liabilities, and hence an increase in external liabilities;
- *Price effect:* when there is a shift in the price of the various securities, the holding of the given securities changes – the impact of this can be observed in the revaluation of equity-type liabilities (upon an increase in the value of domestic shares or FDI liabilities, external liabilities rises) and also in the repricing of the government securities holding of non-residents (in this case, the price of the government securities practically increases with the a in yields, and hence external debt also rises);
- *Other volume change:* in addition to the foregoing, the liability stocks may be influenced by other factors as well (e.g. methodological changes, write-off of receivables, company liquidations).

In addition to net lending, price effects also made a major contribution to the pre-crisis increase and subsequent adjustment in external liabilities. Between 1998 and 2002, the ratio of Hungary's net external liabilities to GDP was relatively stable, as the liability-increasing effect of the external liabilities that were necessary for the functioning of the economy and for investments (net lending impact) was more or less offset by the rate-decreasing effect of growth in nominal GDP. The ratio of external liabilities rose spectacularly (by almost 40 percentage points) between 2003 and 2007. However, only the lesser part (about one-third) of this growth was attributable to the fund raising in excess of the GDP growth impact, while the position was deteriorated to a much larger degree (almost 25 percentage point in five years) by the growth in external liabilities attributable to price effects – this reflects the impact of the rise in share prices and in the value of non-residents' foreign direct investments. The crisis caused considerable changes in the processes observed in external liabilities up until then via several factors. On the one hand, due to the economic downturn the change in GDP in 2009 – in contrast to the former growth-absorption effect – substantially worsened the indicator for external liabilities. In addition, the depreciation of the exchange rate caused by the crisis also resulted in growth in external liabilities: since 2008 the impact of the exchange rate shifts has worsened the ratio of external liabilities by almost 10 percentage points. Due to these factors, the turnaround in the current account (as the economy's previous substantial net borrowing changed to net lending) could be felt only gradually and to a lesser degree. On the other hand, it should be noted that – in contrast to the processes that characterised the pre-crisis period – the price-type effects also improved the ratio of external liabilities: in 2008 the fall in the price of quoted shares (which later on adjusted) and in 2010–2011 the decrease in the value of foreign direct investments (partially due to the extraordinary profit/loss items) and the decrease in the price of government securities due to the yield increase, made a substantial contribution to the increase in the external position.

Chart 31: Change in the net international investment position and the key influencing factors (as a per cent of GDP)



Box: Impact of extraordinary profit/loss items on external liabilities ratios

In the balance of payment statistics, transactions reflect only the profit/loss items under the current operating performance concept (COPC); however stocks are also influenced by these extraordinary profit/loss items. These items are shown as revaluation – price and exchange rate changes – and other changes in volume in the statistics. As discussed in an earlier report, the balance of payments statistics include the profits/losses according to the current operating performance concept of the enterprises operating in the economy (for more details see: Report on the Balance of Payments, September 2014). This means that, in contrast to the concept that takes into account all corporate income elements (all inclusive concept), in order to avoid distortions, it ignores the profit/loss items realised outside the normal course of business – such as the profit/loss items related to revaluation and extraordinary events. These do not appear as the transactions but other changes in stock (revaluations and other changes in volume), since these profit/loss items do have an effect on the value of the investments (positions).

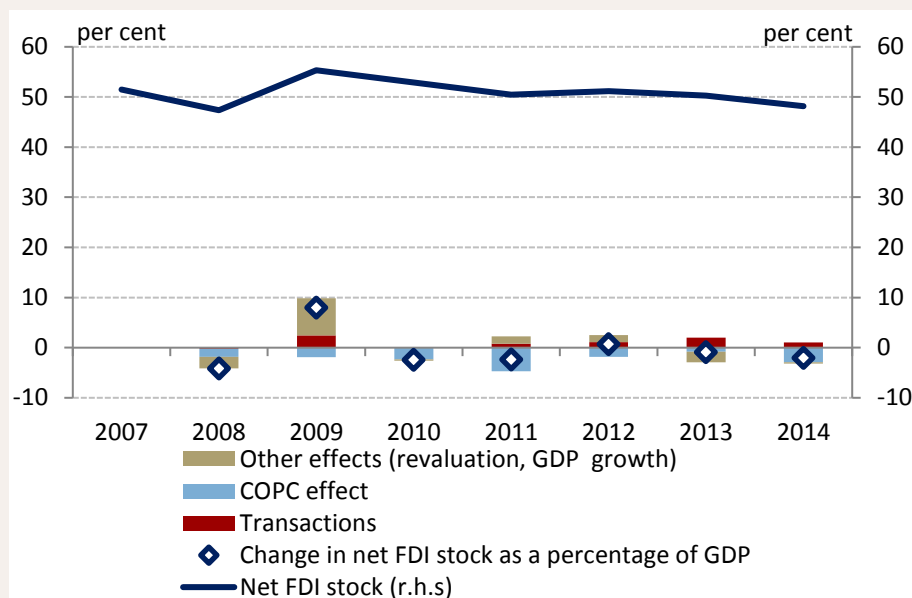
The post-crisis extraordinary losses reduced non-residents' investments in Hungary, and hence also lowered net external liabilities. In the post-crisis years, companies with foreign currency exposures usually recognised losses on the revaluation of their liabilities due to the depreciation of the forint, while it may have been favourable for the exporter companies that they were able to keep their prices low. The losses resulting from these and the one-off measures (e.g. early repayment at preferential exchange rate) reduced the invested capital, and thereby the value of foreign direct investments in Hungary. Similarly, the value of the outward investments of resident companies also depreciated due to the extraordinary losses. However, as the outward investments by resident companies are of smaller value than the inward investments, on the whole the net effect of the two items entailed a decrease in net liabilities.

While the transactions of non-residents – including the reinvested earnings – increased, the extraordinary losses reduced the value of the stock of the foreign direct investments in Hungary. Since 2008, based on the profits recorded according to the COPC, non-residents increased their direct investments in Hungary by 7 per cent of GDP, which was also attributable to the reinvestment of the ordinary profits according to COPC.⁹ The impact of this was offset by the

⁹ It should be noted that the recognition of the extraordinary losses (i.e. the profit according to the current operating performance concept) in the balance of payments entails an increase in reinvestments. The reinvestment by non-residents – the part of the realised profit not distributed as dividend – is ultimately obtained on the basis of the residual principle. Hence as a result of separating the extraordinary losses, the ordinary

fact that the extraordinary losses (recorded as other changes in stock) reduced the value of foreign direct investments by 16 per cent of GDP, while the other revaluation effects slightly increased the FDI stock. This means that the modest decrease in foreign direct investment positions in recent years was essentially linked to the extraordinary losses connected to the COPC.

Chart 32: Net direct investment and extraordinary profit/loss items (relative to GDP)



5.3. International comparison

The section below reviews the connection between net external liabilities, the composition thereof and the development level of a country, and the degree to which Hungary fits into the international and regional trends in this context. According to the specialist literature, less developed countries tend to rely on external liabilities to a larger degree, while the relatively richer countries invest in the converging economies from their accumulated capital stock. In the EU Member States, the GDP per capita and net foreign asset balance of the country relative to GDP are in line with this theory, which roughly corresponds to the development level of the country in Hungary as well. There is also a connection between the composition and development level of external liabilities, which is supported by experience as well: in the case of the converging countries, FDI-type financing is more typical, while the more advanced economies finance themselves by external borrowing. When analysing Hungary in an international comparison, it is clear that, among the EU countries, one of the most significant adjustments in the international investment position took place in Hungary.

5.3.1. Connection between external liabilities and the development level of a country

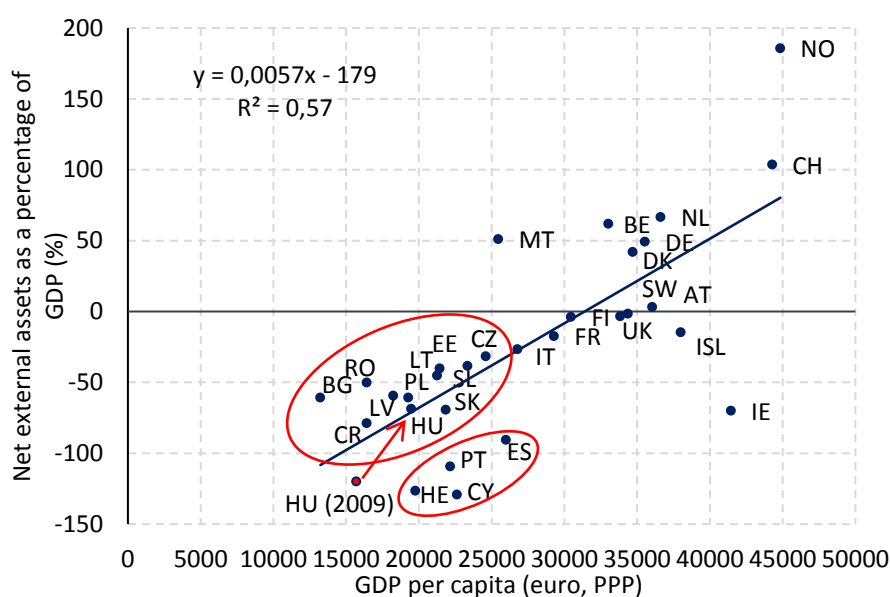
According to the specialist literature, the net external liabilities of a country are determined, *inter alia*, primarily by the development level of the country. The development level measured by GDP per capita affects the external debt of an economy through several channels. On the one hand, the capital stock of the relatively less developed countries is smaller, which, due to the high marginal benefit of the capital, promises a higher return on investments. Since in countries with lower GDP per capita the low income is accompanied by smaller savings, the need to raise external funds is relatively higher, which results in an increase in external liabilities. In other words, the poorer countries implement investments with the use of external funds and such investments increase their income to a degree that allows them to repay the loans later on. On the other hand, in the relatively richer countries the accumulated capital

profit/loss will be higher than the corporations' actual profit after tax (furthermore in a period of extraordinary profit the income related to current operating performance will be lower). Thus under a constant dividend, in the ordinary course of business a higher amount is recognised as reinvested earnings.

stock is larger (while the marginal benefit of the capital is already lower in these countries), hence they can also invest larger amounts in the converging economies, where they can achieve higher growth and profit than in their domestic economy. In addition, the size of an economy's external liabilities is also influenced by the respective country's potential growth, the depth of its integration in the international financial system and demographic conditions.¹⁰

The characteristics of the EU countries support the theory described above: the stock of net external assets relative to the GDP of the individual countries increases in parallel with the growth in development level, i.e. the external liability decreases (Chart 33). Thus, based on the theory related to the external liabilities of converging countries and the chart containing the data of the EU countries, in fact it may be deemed natural that Hungary still has substantial external liabilities, which, relative to the countries under review, may be deemed ordinary. On the other hand, the level of this cannot be deemed high when compared to the region either – while in 2009 the outstandingly high level of Hungarian external liabilities made a major contribution to the vulnerability of the Hungarian economy and the more severe effects of the crisis, the net external liabilities seen in 2015, amounting to 70 per cent of GDP, roughly corresponds to the country's level of development. Meanwhile, it is also clear that – despite the recent adjustment – the majority of the Mediterranean countries (Greece, Portugal, Cyprus and Spain) have much higher external liabilities than would be justified by their level of development. The chart also shows that countries above a certain level of development (e.g. Denmark, Germany, Belgium, the Netherlands) already have positive net external assets, i.e. they "finance" the indebted countries.¹¹

Chart 33: Relation of GDP per capita and net foreign assets as a per cent of GDP in 2015



Source: Eurostat.

5.3.2. Relation between the composition of external liabilities and the development level of the country

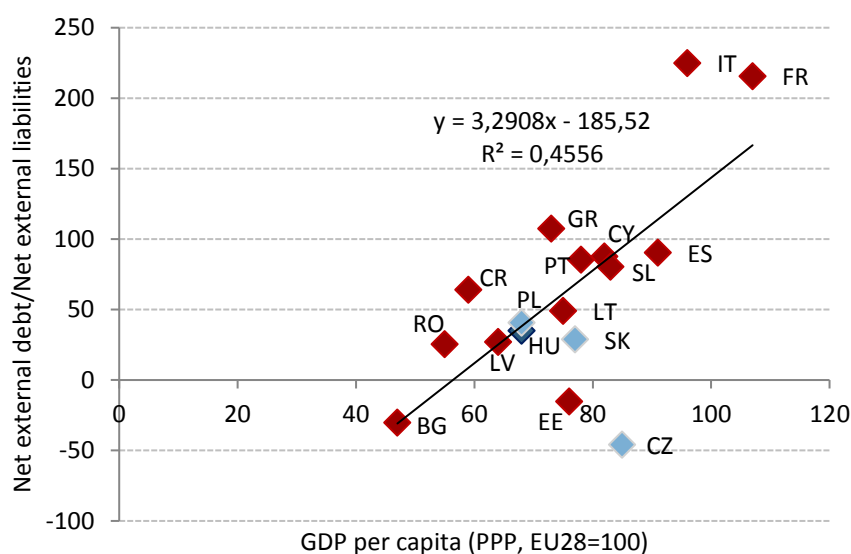
When examining the countries of the European Union it is clear that the more developed a country is, the higher the ratio of the debt-type liabilities among the net foreign liabilities is. According to the theories dealing with foreign liabilities, while in the case of the converging countries the FDI-type financing is more typical, the more advanced economies tend to finance themselves by foreign borrowing. On the one hand, in the countries with relatively underdeveloped financial markets and weak institutions the foreign-owned companies rely on direct capital. In

¹⁰ For more details, see MNB Bulletin 2008/3 – Péter Koroknai: Hungary's external liabilities in international comparison

¹¹ According to the chart there are substantially more countries with net external liabilities than lender countries; however, several lender countries are not shown on the chart (e.g. Japan), and the loans provided by larger economies (e.g. Germany) may cover the foreign liabilities of several countries.

addition, several economic models also demonstrate¹² that the substantial role of direct investments may reflect the high risk of the country, the unpredictability of its legal system or a weak institutional framework. In parallel with this several studies¹³ showed that a more predictable economic environment and higher level of development is usually accompanied by a higher ratio of debt-type foreign investments. In addition, according to empirical studies, countries which are unable to raise funds in their own currency (the "original sin" problem) rely on working capital in their external financing to a much higher degree. The figures of the European states in need of external financing are in line with the conclusions of this theory: based on Chart 34 the more developed a country is (higher GDP per capita), the higher the ratio of debt-type liabilities within net external liabilities. As regards the countries under review, the debt to total external liabilities in Hungary (dark blue) is in line with the level of development and with the countries of the region (light blue).

Chart 34: Ratio of debt-type liabilities to net external liabilities



The chart includes only countries with net foreign liabilities.

Investment banks and credit rating agencies often regard a high ratio of net borrowing covered by direct capital and generally not by debt as a positive phenomenon in terms of external vulnerability. However, the advantages of non-debt creating foreign investments (FDI, shares) is disputed both in theoretical and empirical terms.¹⁴ On the one

¹² According to the theory of Neumann (2003), non-resident investors give preference to those forms of financing (e.g. receivables representing ownership right, such as direct capital, shares) which may help them reduce their information disadvantage relative to residents. It follows from this that the more transparent a country's capital market is – i.e. the smaller the information asymmetry between the residents and non-residents is – the larger role the debt-type liabilities may play in external finance. Furthermore, according to Albuquerque (2003), a substantial part of direct investments is of non-tangible nature (technology, brand names), hence it is more difficult to expropriate them, which has relevance, because the non-resident investors give preference to those forms of financing that are more difficult to expropriate directly or indirectly. It follows from this that countries with less developed legal and institutional structure – where the probability of the potential expropriation of yields is higher – can finance themselves only with working capital, while in countries with developed capital market the ratio of debt-type financing, which in theory is easier to expropriate, is higher. (Neumann, R.M. (2003): International Capital Flows under Asymmetric Information and Costly Monitoring: Implications of Debt and Equity Financing, *The Canadian Journal of Economics*, 36(3), pp. 674–700; Albuquerque, R. (2003): The composition of international capital flows: risk sharing through foreign direct investment, *Journal of International Economics*, 61 (2), pp. 353–383)

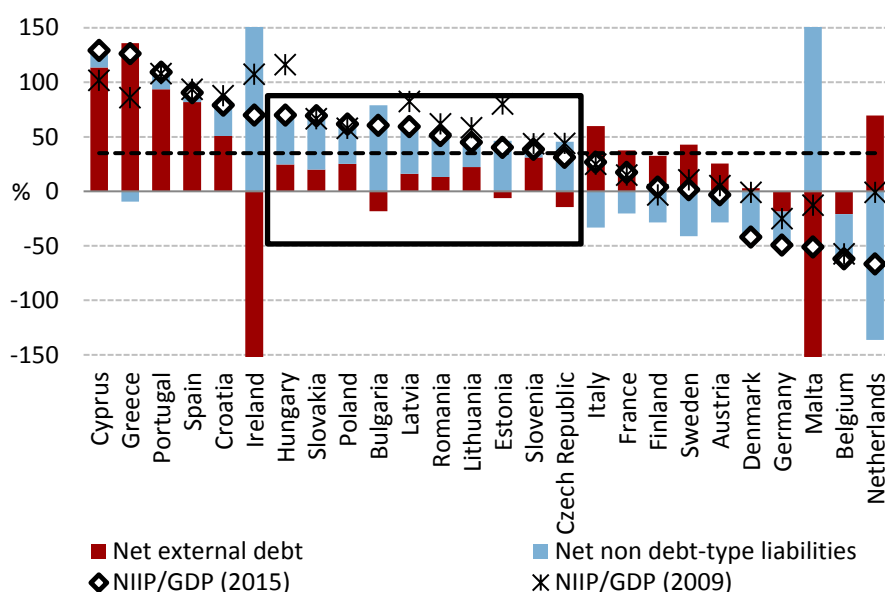
¹³ Albuquerque, R. (2003): The composition of international capital flows: risk sharing through foreign direct investment, *Journal of International Economics*, 61 (2), pp. 353–383; Faria, A.–Mauro, P. (2004): Institutions and the External Capital Structure of Countries. *IMF Working papers*, No. 04/236.; Faria, A.–Lane, P.R. – Mauro, P.–Milesi-Ferretti, G.M. (2007): The Shifting Composition of External liabilities, *Journal of European Economic Associations*, 5(2-3), pp. 480–490; Daude, C. – Fratzscher, M. (2008): The pecking order of cross-border investment. *Journal of International Economics*, 74(1), pp. 94–119.

¹⁴ For more details, see MNB Bulletin 2008/1 – Komáromi, A. (2008): The structure of external financing: Is there a reason to worry about financing through debt?

hand, the form of financing has no direct relation to the purpose of utilisation, i.e. the growth in investment activity can be financed not only by FDI, but also by external debt. On the other hand, direct capital is not necessarily a stable form of financing either, as corporations may arbitrarily restructure their funds, as a result of which in the event of a crisis the withdrawal of capital may appear not only as direct capital outflow. Finally, it is a traditionally accepted explanation that non-debt creating liabilities – particularly the direct capital – may contribute to economic growth through their external impact; however, the benefits attributed to direct capital (e.g. new technology, access to new markets, management capabilities) are linked to the company itself rather than to the method of financing.

In terms of vulnerability, the determinant is thus the international investment position rather than structure of financing. Accordingly, the European Commission has also specified a "limit" for the level of this position. The indicators examined in the European Commission's macroeconomic imbalance procedure include the given country's international investment position, which is assessed by the Commission as an indicator signalling imbalance if it exceeds 35 per cent of GDP. Based on Chart Chart 35, it can be stated that upon examining the Member States of the European Union, the net international investment position is below the 35 per cent limit in those countries that were characterised by net outward FDI – which cannot necessarily be expected of the converging countries of the region. In an international comparison, Hungary's net investment position relative to GDP – after the adjustment that followed the outstandingly high pre-crisis value – is similar to that of the countries that joined the European Union in 2004 and 2007 (Chart 35). In this group of countries, Hungary's NIIP/GDP ratio cannot be regarded as outstanding. In addition, the external liabilities also resemble those of the group of countries under review in terms of its structure, where the ratio of net external debt is more or less ordinary. The latter suggests that in the converging countries the missing internal funds are replaced by external liabilities. Hence in these countries the net international investment position shows a substantial – over 35 per cent of GDP – deficit. Thus, it may also be worth considering the level of economic development, when examining the indicator's ability to signal imbalance.

Chart 35: Decomposition of net external liabilities (relative to GDP, 2015)



Source: Eurostat

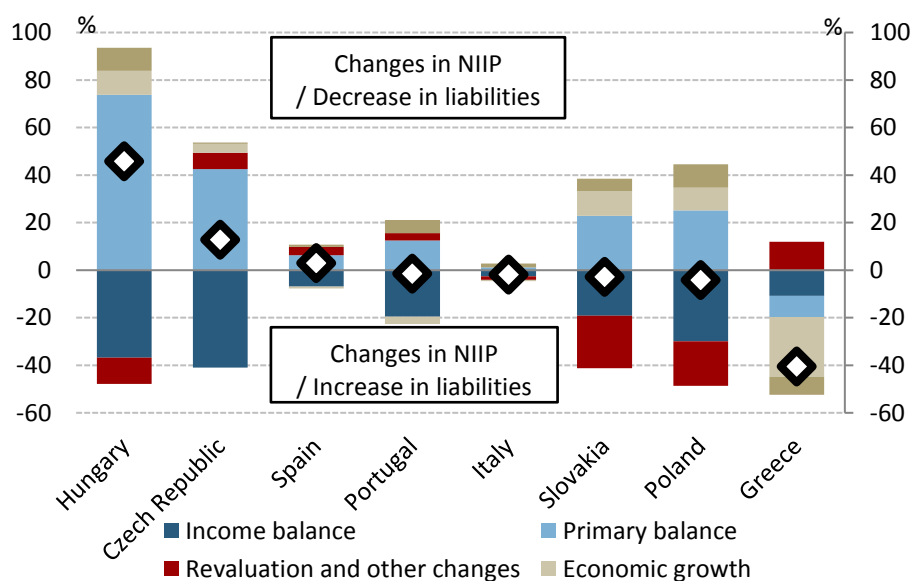
5.3.3. Change in external liabilities after the crisis in the CEE region and the Mediterranean countries

The change in the external liabilities-to-GDP ratio can be linked essentially to three factors: the economy's net lending, the exchange rate movements of the existing debts and the change in GDP. The change in a country's outstanding external liabilities is primarily determined by the development of the country's *net lending*, which comprises two variables: the *income balance* related to the external liabilities accumulated in the past, and the *primary*

balance capturing the new foreign liabilities necessary for the functioning of the economy in the given period (sum of the external trade balance and the transfer balance). The income balance essentially depends on the size of the country's external liabilities accumulated in the past. By contrast, the part of net borrowing that exceeds the income balance, i.e. the primary balance is rather linked to the economic processes of the given period. If within the external liabilities the ratio of foreign currency-denominated liabilities is high, *revaluation* may also be an important factor, which may arise due to the exchange rate (foreign currency or other assets) fluctuations. For example, upon the depreciation of the foreign exchange rate, the value of the foreign currency-denominated debt in domestic currency terms will rise even if the given country takes on no additional loans. Furthermore, since we examine the value of external liabilities relative to GDP, growth in nominal GDP reduces external indebtedness. Within the impact of GDP growth, a distinction should be between *actual growth in the economy* and the *rise in the price level*.

Of the CEE and Mediterranean countries under review, external liabilities relative to GDP fell to the largest degree in Hungary between 2009 and 2015. This is primarily attributable to the fact that upon the outbreak of the crisis, Hungary's net foreign liabilities were the highest, and thus the mitigation of the external imbalances required substantial adjustment. In the CEE region, the external liabilities of the Czech Republic fell – to a much lesser degree than that of Hungary – while there was no material change in the indicators for Slovakia and Poland. Most of the Mediterranean countries were also characterised by high external debt, which rose even further after the outbreak of the financial crisis, and some adjustment commenced only after the sovereign debt crisis; consequently, on the whole only minor shifts were seen. By contrast, Greece's external debt relative to GDP increased considerably and is still at its historic peak. In the following we describe, based on Chart 36, the factors that may explain these shifts.

Chart 36: Factors influencing the change in external liabilities relative to GDP between 2009 and 2015 in the CEE and Mediterranean countries



Source: Eurostat

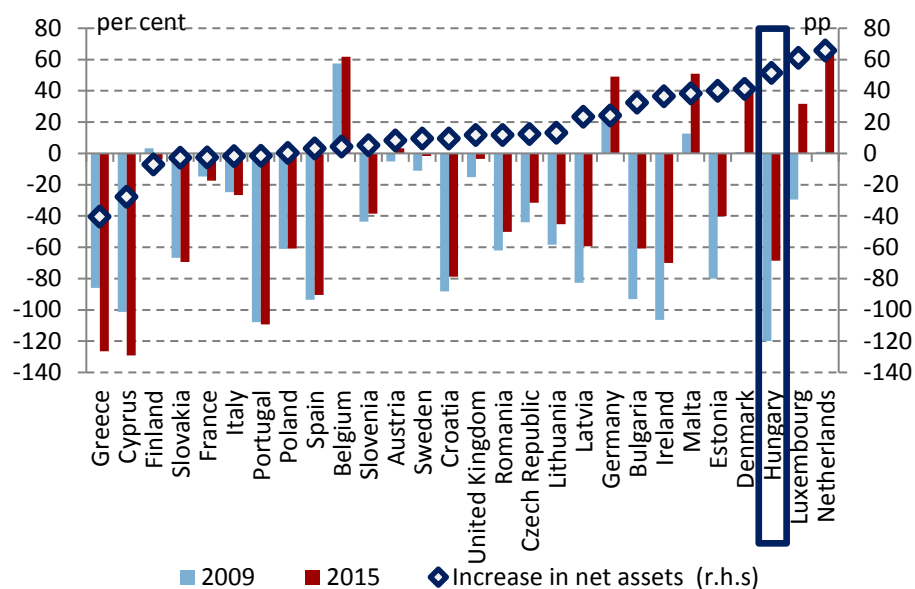
- Income balance.** Based on intuition, the income balance deficit increases the debt of countries with higher initial outstanding debts to a greater degree, because the given country presumably incurs higher interest or yield payment obligations on the higher outstanding debt or working capital. In line with this, in Hungary, which had the highest initial outstanding external liabilities among the countries under review, the income balance deficit raised the indicator to the largest degree. On the other hand, among the countries under review, in the Czech Republic – which had much lower external liabilities than Hungary – the income balance deficit would have contributed to the greatest degree to the rise in external liabilities, which essentially can be attributed to the extremely high profit of the companies that are owned at least partially by non-residents. The income balance deficit in the Mediterranean countries – despite the relatively high net foreign liabilities

- had a lesser impact on the change in external liabilities, which can be explained by the lower interest environment of the euro area and by the outward FDI's more substantial income balance improving effect.
- **Primary balance.** Among the countries under review, growth in the primary balance contributed to the largest extent to the reduction in external liabilities in Hungary, followed by the countries of the region. This is attributable to the fact that in the countries of the region, and particularly in Hungary and in the Czech Republic, the external trade balance substantially increased substantially after the outbreak of the crisis and their transfer balance surplus was also increasing, which is linked with the drawdown of the EU transfers (in the region this item was outstanding in Poland, apart from Hungary). In contrast to the processes observed in the CEE region, in the Mediterranean countries the external trade balance only showed a surplus for the first time around 2012 (in Greece it still showed a deficit) and the degree of this fell significantly short of that observed in Hungary and in the CEE region. This may be attributable to the fact that these countries were forced to make only smaller adjustments as a result of the financial crisis, which later on was accelerated by the sovereign debt crisis. In addition, in these countries the transfer balance is also much more moderate than in the CEE region.
- **Revaluation.** In the case of Hungary and Poland, revaluation pointed to an increase in external debt, which may be attributable to the fact that in the period under review both countries' currency depreciated against the euro. By contrast, in the Mediterranean countries – as their debts were predominantly denominated in their own currency – the revaluation effect was negligible.
- **Economic growth and inflation.** Of the countries of the region, in Hungary, Poland and Slovakia nominal growth in GDP also made a substantial contribution to the reduction of the external liabilities-to-GDP ratio; moreover, in the case of Poland and Slovakia this ratio would have deteriorated in the absence of this. However, on the whole in the case of Hungary and Poland only roughly half of the debt reduction can be attributed to actual growth in the economy, while the other half of nominal GDP growth is due to inflation (although at present inflation in both countries substantially falls short of the target, it was the highest in these two countries between 2009 and 2012). In the Mediterranean countries – with the exception of Greece – the change in nominal GDP had only a minor effect on the ratio of external liabilities to GDP. However, real GDP between 2009 and 2015 fell by more than 20 per cent in Greece, and hence this component played the largest role in the growth in the external liabilities-to-GDP ratio. Moreover, in parallel with the economic downturn, inflation in Greece has been negative since 2013, which also resulted in a further increase in external liabilities via the continued erosion of nominal GDP.

5.3.4. What was the degree of adjustment during the crisis?

In terms of the net international investment position, one of the largest adjustments among the EU countries took place in Hungary. In Hungary in 2009 the net foreign liabilities amounted to 120 per cent of GDP. On the other hand, as a result of the – previously presented – loan repayments, the higher absorption of EU transfers, the globally lower capital inflows and the acquisitions by the state during the crisis, this net liability had dropped to less than 70 per cent of GDP by 2015. The degree of the fall amounted to roughly 50 per cent of GDP, which was the third largest adjustment among the EU countries, while in the Mediterranean countries – partially as a result of the loans received from the international organisations – the value of the external liabilities-to-GDP ratio typically increased. It should be noted that by 2015 Hungary's net external liabilities relative to GDP had fallen to the level of Slovakia and Poland.

Chart 37: Change in the EU countries' international investment position between 2009 and 2015 (as a per cent of GDP)



Source: Eurostat

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Gábor Bethlen

(15 November 1580 – 15 November 1629)

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

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

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

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

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