



# REPORT ON THE BALANCE OF PAYMENTS



JULY  
2014

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

*Letters 27  
Gábor Bethlen*



# REPORT ON THE BALANCE OF PAYMENTS

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

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

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

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

*This Report is based on information pertaining to the period ending on 24 June 2014.*



## SUMMARY

*In 2014 Q1, the four-quarter surplus of Hungary's current account rose to a historical peak and exceeded EUR 3.5 billion. The surplus, which amounts to 3.6 per cent of GDP, is considered extremely high by regional standards; indeed, based on data available until the end of 2013, the 2 per cent surplus of Slovakia was recorded in the context of a declining trend, while the Czech Republic and Poland continued to report current account deficits.*

*From the side of the real economy, the substantial net lending reflected the **growth in the trade surplus** and the **transfer balance** which, surpassing the level recorded a year earlier, is still **considered high**. In addition to the upswing in external demand and automotive manufacturing, the growth rate of exports remains high, while the expansion in imports remained dynamic in the context of increasing consumption and investment. On the whole, despite steadily growing domestic use, **net exports continue to boost economic growth**.*

*Following an improvement in the past quarter, the terms of trade also contributed to the upturn in the balance of goods. The decline in the four-quarter value of the income balance was supported by **the moderation of interest payable on foreign loans outstanding**. The absorption of EU transfers remained significant in 2014 Q1.*

*According to the financing approach, in line with the trend observed in previous quarters, the contraction of external debt continued; amid **outstanding net lending and the inflow of foreign direct investment**, Hungary reduced its net external debt further, which may contribute to the stability of the Hungarian economy and financial system. The decline in net external debt primarily reflected the general government's substantial reduction of its net external debt, mainly as a result of the increase in foreign exchange reserves owing to the inflow of EU transfers. As opposed to previous trends, however, the external debt of the banking sector increased somewhat, possibly related to the fact that, in the context of low deposit interest rates, households have increasingly shifted their focus from deposits to government securities and mutual fund shares/units. Accordingly, households increasingly participate in the funding of the general government, thereby contributing to the reduction of the state's reliance on foreign financing.*

*The high net lending recorded for Q1 contributes to the reduction of Hungary's external debt, which continued to decline at the beginning of 2014, dropping below 35 per cent of GDP. These developments indicate that Hungary relies less and less on external funding, and the self-financing capacity of the economy is strengthening. The decline in the debt ratio is the net result of opposing effects: the net outflow of debt liabilities and the growth in nominal GDP were partly offset by the depreciation of the forint exchange rate. To a large degree, the fact that **the gross external debt of Hungary still slightly exceeded 90 per cent of GDP** can be attributed to this and to foreign currency bonds issued for the financing of later maturities. In Q1, **short-term external debt** based on residual maturity stood close to the level prevailing in the previous quarter, i.e. around EUR 28 billion. In other words, despite a considerable net lending position, Hungary's gross external borrowing remains relatively high. All of this provides justification for the MNB's self-financing concept, which is intended to reduce gross external debt further and to increase the internal financing of the state.*

*Analysing the external balance from the aspect of the savings of individual sectors, it is evident that the **net lending of the private sector was increased by rising wages in the household sector and presumably reduced by recovering investment on the side of corporations**, while net borrowing by the state remained subdued.*

*As a special topic, we are presenting the developments of FDI (foreign direct investment) in Hungary based on various aspects. Broadly speaking, **net FDI slowed — similarly to the countries in the region — in the years following the onset of the crisis**. Recently, significant one-off items — capital injections owing to banks' losses or decreasing FDI due to government acquisitions, for instance — have shaped the level of net FDI inflows. Overall, **data adjusted for one-off impacts still reflect continuous net FDI inflows**. Ultimately, **besides the high net lending value, which is outstanding even by regional standards, FDI inflows enable Hungary to reduce its external debt continuously and to reach the values prevailing in the region shortly**.*





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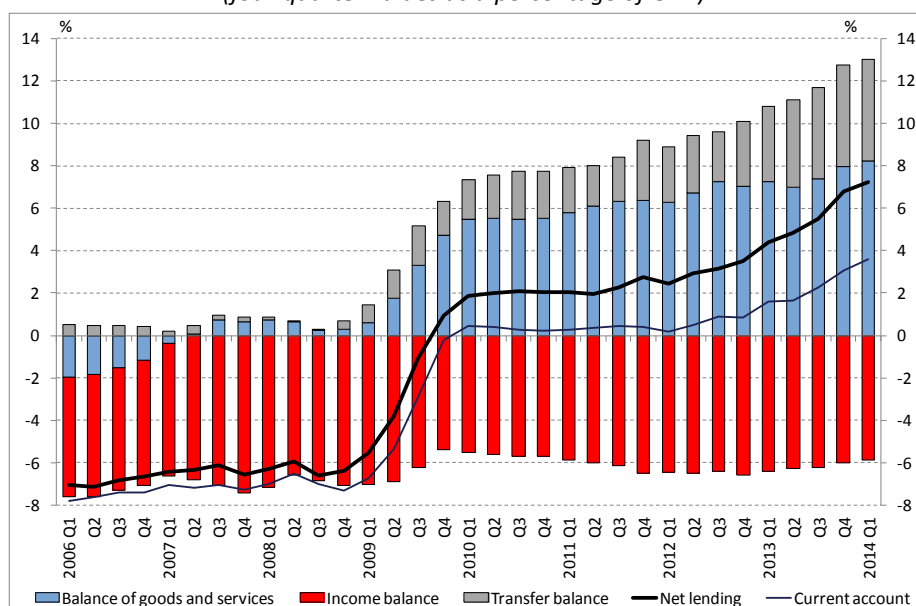


## 1. REAL ECONOMY APPROACH

*In 2014 Q1, the four-quarter surplus of Hungary's current account rose to a historical peak and exceeded EUR 3.5 billion, while the net lending of the Hungarian economy increased to 7.2 per cent of GDP, also a record high. The growing surplus on the trade balance can be attributed to a significant improvement in the terms of trade in Q1, while in the context of recovering external demand and dynamically growing automotive manufacturing, the growth rate of exports corresponded to the significant expansion of imports brought about by the acceleration of domestic absorption. Within the slightly declining income balance, the interest payable on foreign loans outstanding decreased, along with the outflow of funds relating to the income on equity. Surpassing the level recorded a year earlier, the absorption of EU transfers remained significant in 2014 Q1.*

According to the real economy approach, the four-quarter value of the Hungarian economy's net lending rose to a historical high in 2014 Q1, amounting to 7.2 per cent of GDP. Significantly surpassing the value recorded a year before, seasonally unadjusted net lending approached EUR 1.6 billion in 2014 Q1. The current account surplus stood at EUR 1.0 billion, while the capital account surplus (comprising mainly EU transfers) was close to EUR 0.6 billion. Based on seasonally adjusted data, in 2014 Q1 net lending derived from real economy figures accounted for 7.6 per cent of GDP. The high net lending figure reflected the growth in the trade surplus and the transfer balance which, although declining somewhat, is still considered high. In line with the trend observed in recent quarters, the deficit of the income balance<sup>1</sup> declined slightly further (Chart 1). It is noteworthy that the surplus of the Hungarian economy's current account is considered extremely high by regional standards; indeed, based on data available until the end of 2013, the 2 per cent surplus of Slovakia was recorded in the context of a declining trend, while the Czech Republic and Poland continued to report current account deficits.

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

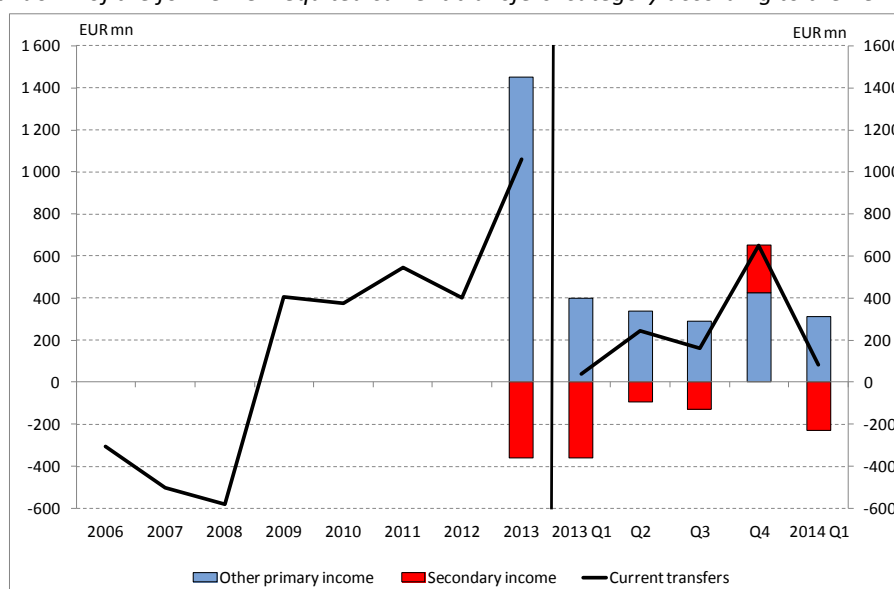


<sup>1</sup> Resulting from the changes in methodology, a part of current transfers is recognised under primary incomes, while the other part is included in secondary incomes. However, since the time series calculated according to the new methodology are not yet available, for the purposes of this publication, data are analysed according to the old structure of the balance of payments. For details on the methodological changeover, see the website of the MNB: <http://english.mnb.hu/Statistika/methodological-changeover-2014-bpm6-esa2010>.

*Box: Practical information on the methodological changeover<sup>2</sup>*

For the most part, the methodological changeover affected the presentation of data and the structure of the current account; net lending remained unchanged and comparable to previously presented data. Some items of the goods and services balance have been reclassified; however, this did not modify the consolidated surplus of the two balances: such items include, for example, goods purchased and sold by resident traders abroad without importing them into their own country, which are now recognised under the balance of goods instead of services, while high-value goods acquired abroad for personal use have been reclassified and moved to the balance of goods from services. Another important modification of the real economy approach affects current transfers. Some of these (namely taxes and subsidies on products and production and rent, as they are incomes payable to the owners of natural resources such as land) have been reclassified as other primary income, while some of them are to be recognised under secondary income (they are usually small value regular transfers directly affecting the size of disposable income). In other words, while EU transfers were included in the balance of transfers which comprised unrequited current transfers and the capital account in the former system, according to the new methodology, EU transfers will be recognised partly as primary income and partly as secondary income, with the third part remaining in the capital account.

*Chart 2: Breakdown of the former 'Unrequited current transfers' category according to the new methodology*



On the financing side of the balance of payments, the financial account has been also affected by changes, mainly in respect of the presentation of data. On the one hand, the time series presented in the balance of the financial account now includes changes in the foreign exchange reserve as well. On the other hand, the items of the financial account will show changes in net receivables rather than net liabilities; therefore, in theory, its balance will be identical with the sum of the current account and the capital balance (in practice, the difference between the two will be the 'Net errors and omissions'). As a result, the sign of net lending will be identical regardless of the approach of calculation, i.e. whether it is calculated from the real economy side (as the combined current account and capital account) or from the financing side (financial account balance), and this change in the sign convention will be also reflected in sub-categories. As another novelty, the former breakdown of foreign direct investments into foreign investments abroad or in Hungary is being replaced by a breakdown into assets and liabilities. The main difference between these two concepts arises when a Hungarian company – the former recipient of the investment – lends funds to (or acquires equity in) its original investor. As opposed to the previous practice, this will not reduce FDI in Hungary, but generate an increase in the assets row of FDI investments. In another important change, the direct

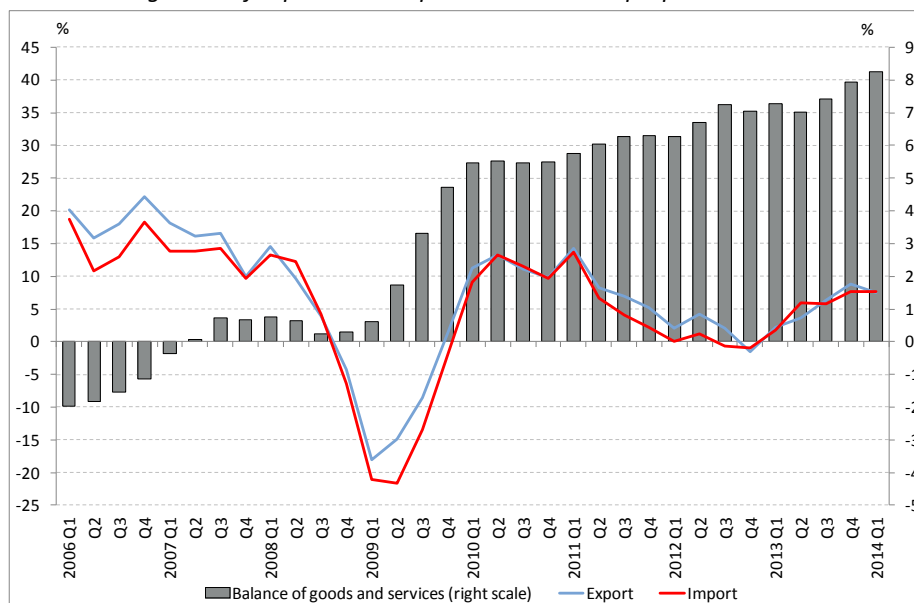
<sup>2</sup> For details about the methodological changeover, see the website of the MNB: <http://english.mnb.hu/Statiztika/methodological-changeover-2014-bpm6-esa2010>.

investment relationship is now based on the criterion of voting power instead of equity. Within portfolio investment, bonds and money market instruments are replaced by short-term and long-term debt securities.

### 1.1. Balance of trade

At the beginning of the year, exports rose to a similar degree as imports, which may have contributed to the increase in the trade surplus. The acceleration of economic growth at the beginning of the year was once again accompanied by a dynamic expansion of imports.<sup>3</sup> Although the real growth of exports decelerated, slowly recovering external demand continued to boost exports and resulted in relatively high export growth compared to the previous two years. As a result, the annual trade surplus rose further and exceeded 8 per cent of GDP.

Chart 3: Annual real growth of exports and imports and the GDP-proportionate annual trade surplus

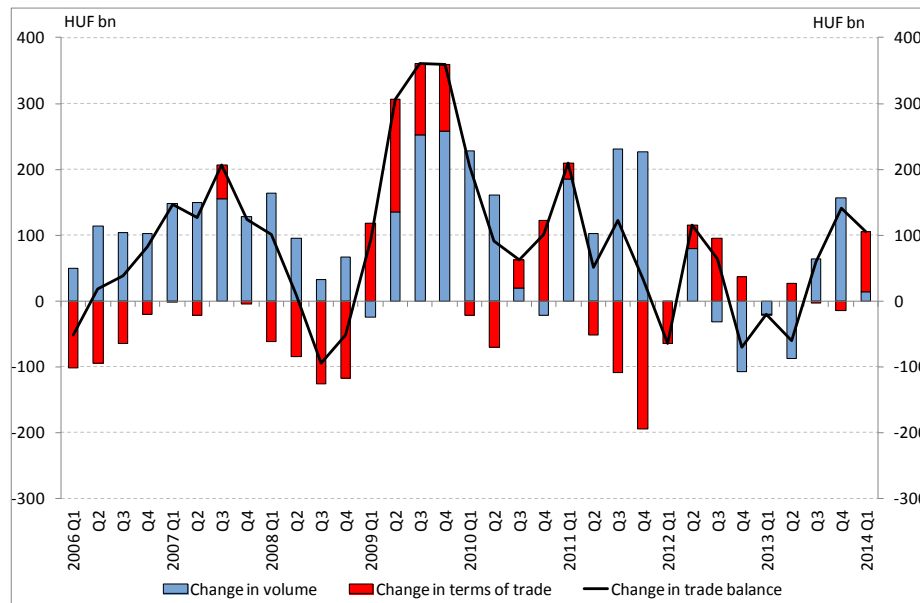


Source: HCSO, MNB. All charts by the MNB unless otherwise indicated.

In the past quarter, improving terms of trade were once again the driving force behind the increase in the balance of goods. Based on Hungary's foreign trade prices, the terms of trade more or less stagnated throughout the second half of 2013. This trend, however, changed profoundly in the first quarter of 2014 when low external inflation, falling oil prices and rising high-value vehicle exports gave rise to a marked improvement in the terms of trade which, in turn, played a decisive role in the increase in the goods surplus.

<sup>3</sup> Since longer time series of export and import data calculated on the basis of the new methodology are not yet available in the balance of payments statistics, this publication relies on data presented in the national accounts of foreign trade turnover.

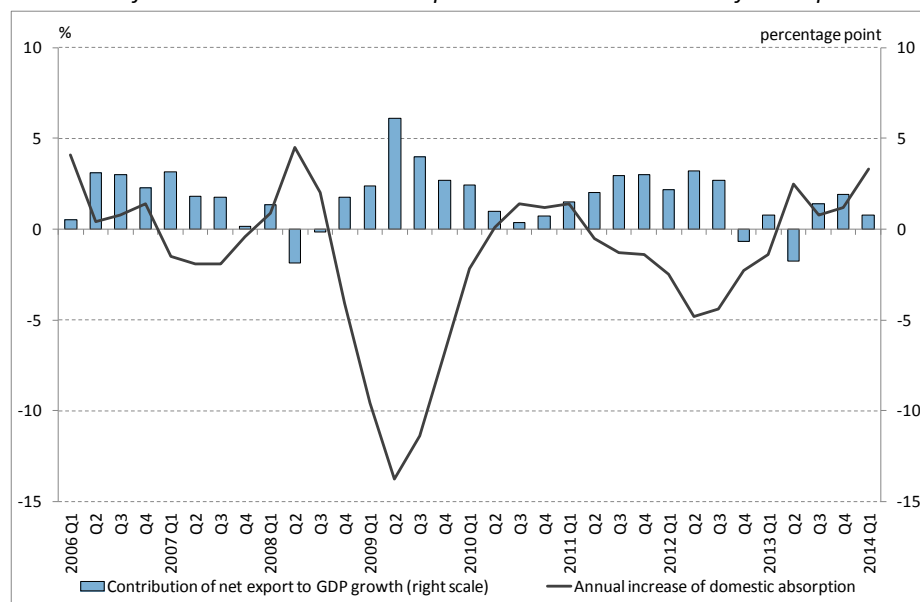
Chart 4: Developments in trade in goods\* and its components (annual change)



Source: HCSO. \*Due to the methodological changeover, the change in the balance of goods is not necessarily identical with the data presented in the balance of payments.

**Despite steadily growing domestic absorption, net exports continue to boost economic growth.** In recent quarters, economic growth has assumed an increasingly balanced structure: while growth was previously driven only by the trade surplus, recently it has been also boosted by household consumption and the upswing in investment spurred, presumably, by the FGS and the accelerated absorption of EU funds. At the same time, due to rising import demand, higher domestic consumption also increases imports. As seen before, despite these factors, the annual trade surplus increased further in Q1, and while the contribution of net exports to growth was less pronounced than in the previous two quarters, exports continued to support economic growth.

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

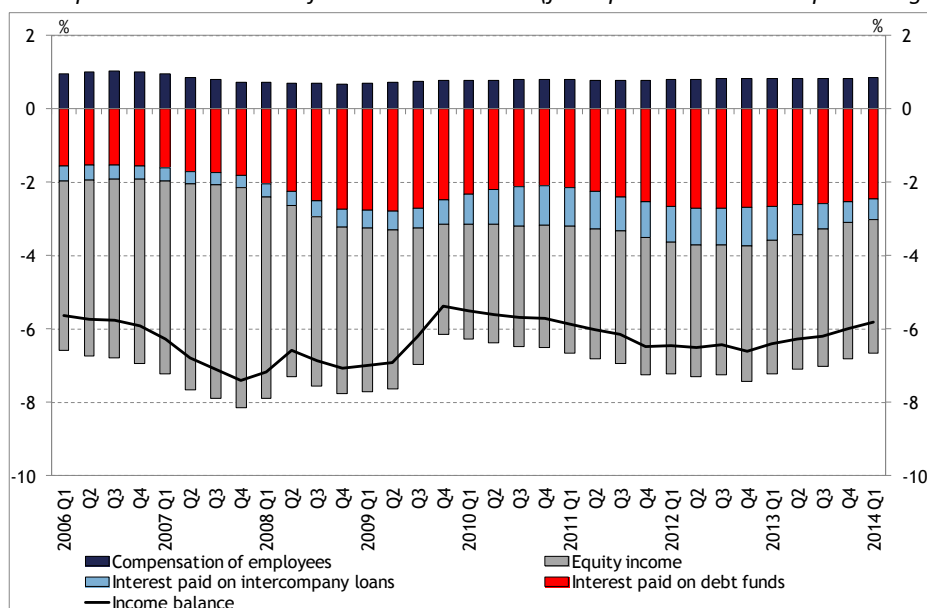


Source: HCSO.

## 1.2. Income balance

The four-quarter value of the income balance deficit continued to decline in Q1, dropping below 6 per cent of GDP. Interest paid on – intercompany, bank, or other – loans disbursed earlier continued to decrease slightly in 2014 Q1, and income outflows related to shares also declined somewhat compared to the previous quarter.<sup>4</sup> In respect of the outflows of income in relation to shares, data are only available for dividends, and since three fourths of the dividends were paid out in Q2 during the past few years, data pertaining to Q1 have relatively limited information content. Taken together, the above factors lowered the income balance deficit further at the beginning of 2014 (Chart 6).

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

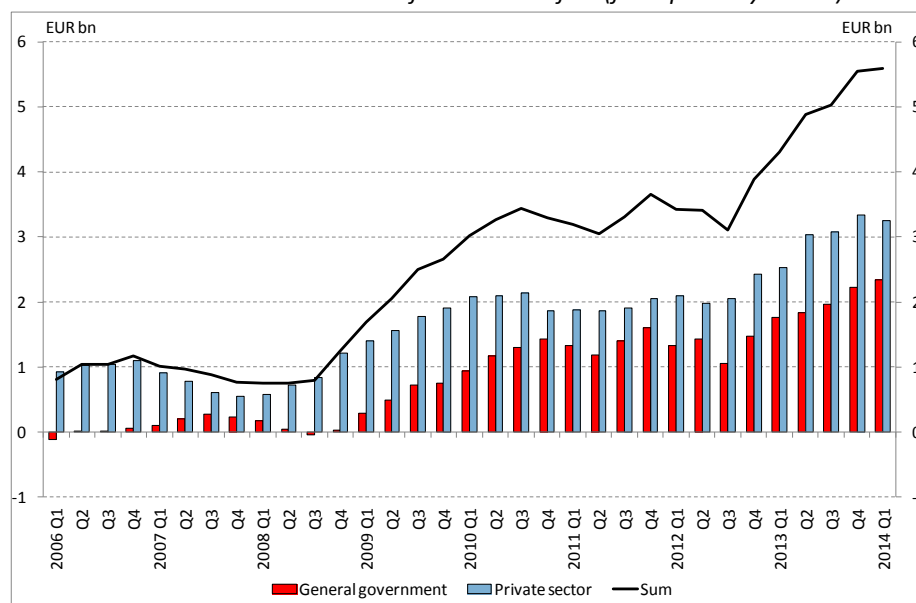


## 1.3. EU transfers

The absorption of EU transfers remained significant in 2014 Q1, and may have primarily supported private sector investment and in part, consumption. On an accrual basis, balance of payments data indicate that the absorption of EU funds amounted to EUR 0.9 billion in 2014 Q1, which slightly exceeds the value recorded a year earlier; thus the four-quarterly absorption of transfers increased somewhat overall, and amounted to around EUR 5.6 billion. Based on a sectoral breakdown, it can be established that, while the ratio of transfers to the general government has increased in recent years, the private sector's absorption of EU funds remained higher. Funds received by the general government went primarily toward the development of infrastructure (motorway construction, railway networks, M4 metro line) which, ultimately, may have boosted the income of the private sector. Within the private sector, households predominantly receive agricultural grants, while the subsidies transferred to non-financial corporations primarily serve development purposes. In addition, the corporate sector may still have access to EU funds through intervention purchases. In Q1, capital transfers continued to dominate domestic absorption (nearly EUR 0.6 billion). In addition, the trend observed in the previous period also continued: the private sector benefited more from EU grants.

<sup>4</sup> Only a limited amount of quarterly data is available on the profitability of foreign-owned enterprises operating in Hungary; therefore, information on quarterly profit outflows are based on estimates for the most part. For more details, see the statistics publication entitled 'Hungary's Balance of Payments and international investment position statistics, 2012'.

Chart 7: Sectoral breakdown of net EU transfers (four quarterly values)



**The weaker forint exchange rate at the beginning of the year did not affect the total HUF-denominated value of EU funds received in the given period.** As a rule, beneficiaries submit their invoices expressed in forints; therefore, upon the budgeting of EU expenditures, grants are also denominated in forints. In other words, in the case of a depreciation of the forint, the European Commission has to transfer a smaller amount of foreign exchange in order to meet the annual payment obligation. *Over the long run*, however, a weaker exchange rate may have a tangible impact on the size of HUF-denominated EU transfers. Indeed, the 7-year appropriations allocated to individual Member States are defined in foreign exchange; therefore, a persistently weaker exchange rate increases the HUF-denominated value of EU transfers and accordingly, over the short term – as long as the change in exchange rate has no effect on the cost side – the funds may provide an opportunity to implement more projects. The total impact of the exchange rate, however, is rendered more complex by the fact that, due to the import content of planned projects, investment expenses may also increase, thereby limiting the room for manoeuvre.

**Although the European Commission has temporarily suspended the payment of new invoices from Q2 owing to due diligence performed in relation to the new institutional structure, this does not necessarily imply a deceleration of transfer absorption.** The transformation of the Hungarian institutional system of grants is currently being reviewed by the European Commission; therefore, the Hungarian authorities will not submit new payment requests until the completion of the review (invoices submitted earlier, however, will be paid). Since the balance of payments is calculated according to an accrual-based accounting approach, transfers from the EU are recognised when they are spent and not when the funds are transferred; therefore, by way of pre-financed projects (and already submitted invoices) the absorption of EU transfers may continue.



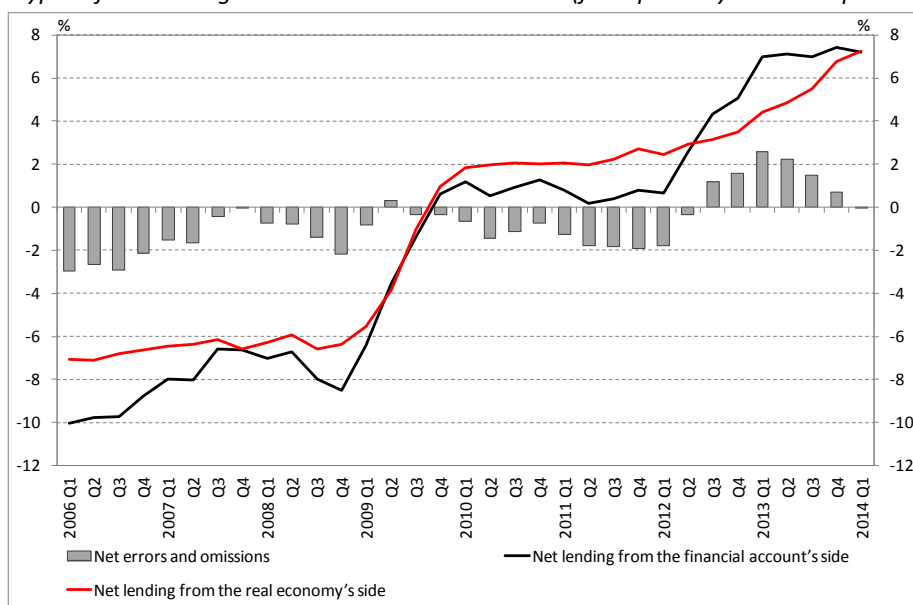
## 2. FINANCING APPROACH

*In line with the massive net lending position, net external debt continued to decrease and sectors continued the balance sheet adjustments commenced earlier, while inflows were observed for non-debt type funds. After a substantial inflow in 2013 Q4, net foreign direct investment increased further in 2014 Q1 by more than EUR 0.6 billion. Debt-type funds also continued to decline: most prominently, the general government reduced its net external debt, in which the rise generated in reserves by the inflows of EU transfers may have played a leading role. As opposed to the decline seen in recent quarters, banks' external debt increased, which may have reflected, in part, the portfolio rearrangement of households.*

In addition to real economic developments, trends in the balance of payments can also be analysed by examining how individual transactions are financed. The financing approach shows – in light of the massive trade surpluses of recent years – the foreign asset purchases/debt repayments on which agents of the economy have been spending their savings originating from the unconsumed part of their income. While data derived from the two different approaches should be identical in theory, differences are likely to arise in practice due to non-integrated data sources, incomplete observation and the different treatment of the exchange rate, as indicated by the category of 'Net errors and omissions', i.e. the statistical error (Chart 8).

In Q1, the four-quarter GDP-proportionate net lending figure derived from financing data and calculations from the real economy approach points to nearly identical net savings in the economy. This emerged in the context of an upward drift in net lending from the real economy side and a decline in savings calculated from the financing side. Although the four-quarter net lending of the economy calculated from financing items decreased marginally in the first quarter, it still reached a historically high value, approaching nearly 7.2 per cent of GDP. Since the beginning of 2013, the difference between the two financing approaches has gradually been diminishing (in the context of an increase in net lending derived from real economy data), and by 2014 Q1 the degree of difference fell to a minimum. The roughly identical net lending figures derived from the two approaches indicate that (excluding revaluation effects) the external debt ratios of the economy decline in line with the figure calculated from indicators based on the real economy approach.

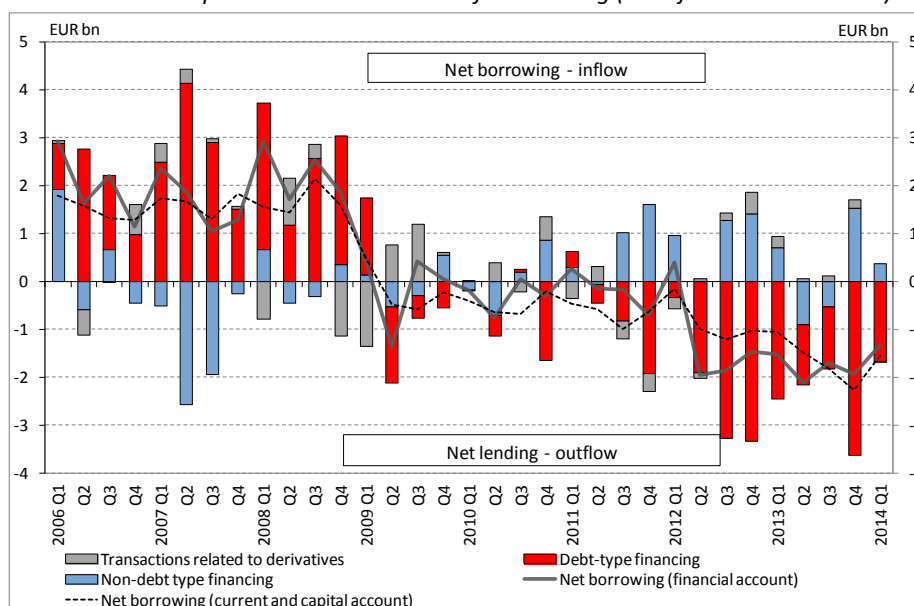
Chart 8: Two types of net lending and 'Net errors and omissions' (four quarterly data as a percentage of GDP)



Following the extremely high level of debt repayment recorded for Q4, the outflow of seasonally unadjusted funds declined at the beginning of 2014. The outflow of funds emerged amid the decline in net debt-type financing once again (repayment of external loans, increase in FX reserves), while non-debt type financing, predominantly in the form of FDI, increased. In line with considerable net lending, Q1 saw a continued decline in net external liabilities amid continuing net debt-type outflows and the inflow of non-debt type financing. After the peak observed at the

end of the year, debt-type financing outflows declined somewhat, but still amounted to a high figure, nearly EUR 1.7 billion (Chart 9). The more moderate outflows of debt may reflect the continuing deposit outflows of households, which may also have contributed to banks' external borrowing. At the same time, non-debt liabilities continued to grow as the foreign direct investments of non-residents expanded.

*Chart 9: Developments in the structure of net lending (unadjusted transactions)*



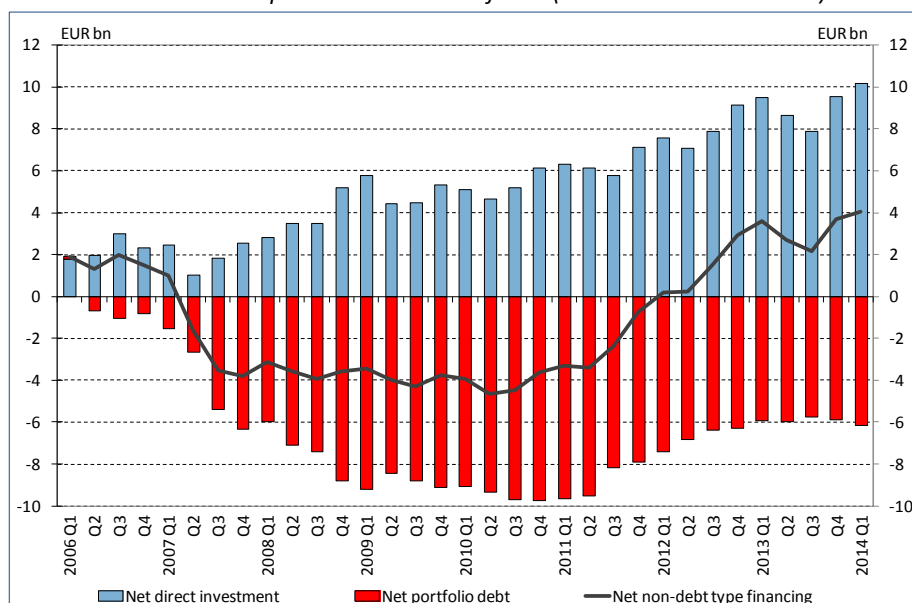
## 2.1. Non-debt liabilities

**In Q1, net foreign direct investments rose by an additional EUR 0.6 billion, while net portfolio equity investment<sup>5</sup> declined. As a result, the value of non-debt liabilities rose by EUR 0.4 billion.** Inflows and outflows in the economy are significantly influenced by capital in transit, which takes advantage of the specificities of the tax regime. However, due to its very nature, this affects only gross flows, with no impact on net changes. It is therefore worth focusing on trends in the net foreign direct investments of non-residents, which were up more than EUR 0.6 billion in Q1, slightly exceeding the value recorded for the same period in the previous year (Chart 10). The other important item of non-debt liabilities<sup>6</sup> reduced this amount by less than EUR 0.3 billion, which reflected the contraction in non-residents' net equity investments in Hungary and the increase in residents' equity investments abroad. Taken together, non-debt liabilities rose by around EUR 0.4 billion in Q1.

<sup>5</sup> For the purposes of this publication, in addition to equity investments, portfolio equity investments also include mutual fund shares/units.

<sup>6</sup> Due to economic considerations, for the purposes of this publication external debt is analysed with the exclusion of intercompany loans; consequently, intercompany loans are classified as non-debt liabilities. For more details on the reasons behind this, see Box 3 in the April 2014 publication of the 'Report on the Balance of Payments'.

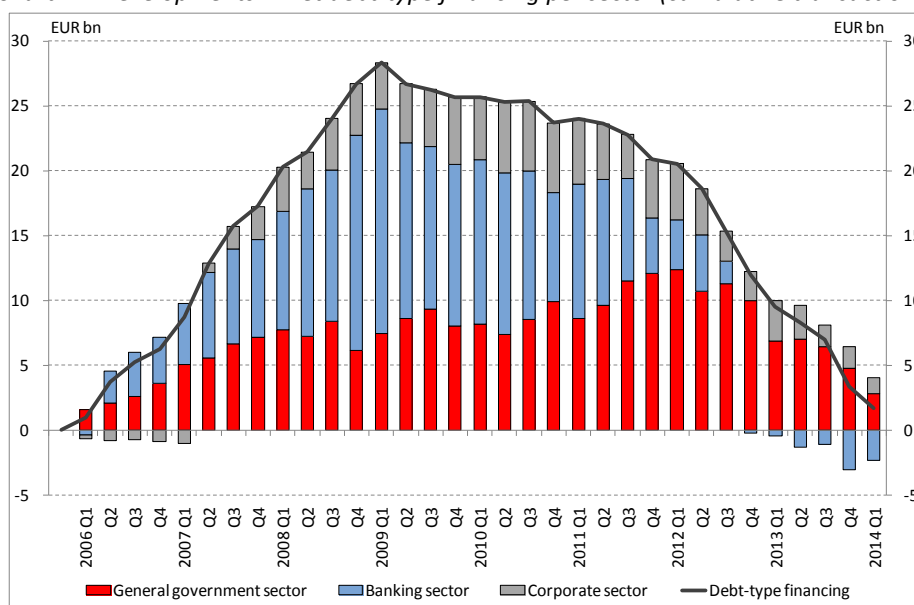
Chart 10: Developments in non-debt funds (cumulative transactions)



## 2.2. Debt liabilities

The economy's debt liabilities continued shrinking in Q1, but contrary to earlier trends, the banking system's net external debt rose, while the general government's declined. 2014 Q1 saw a continued decline in the economy's net external debt, amounting to nearly EUR 1.7 billion. In contrast to earlier quarters, the banking system's external debt rose by nearly EUR 0.8 billion, which was more than offset by shrinking general government debt consolidated with the MNB, which decreased by nearly EUR 2 billion. Moreover, the corporate sector also contributed to the repayment of external debt, repaying EUR 0.4 billion in foreign loans. This means that residents have scaled back their net external debt by EUR 19 billion in the barely two years since early 2012 by repaying foreign loans and increasing their external assets (changes in the size of the columns of Chart 11 illustrating cumulated data shows the change in net external debt for each sector).

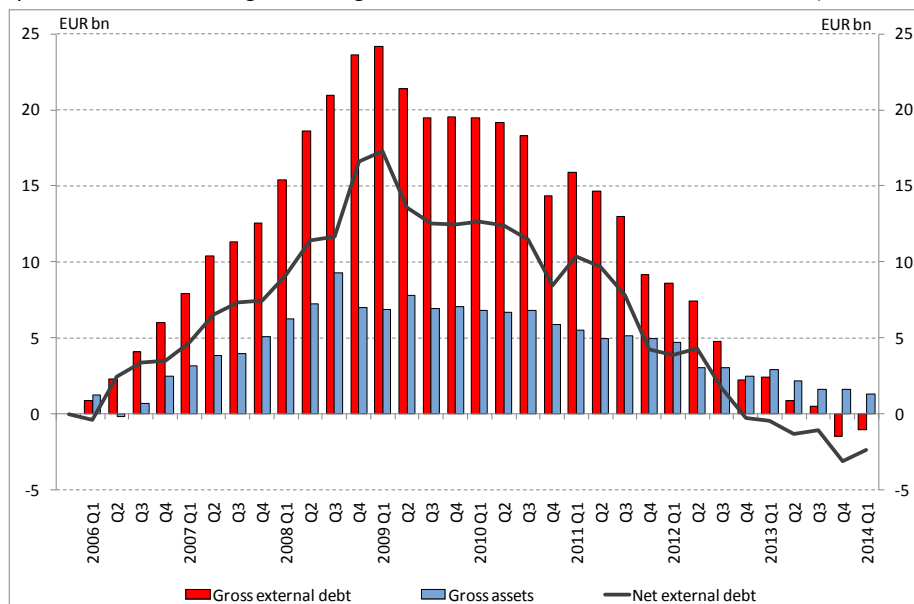
Chart 11: Developments in net debt-type financing per sector (cumulative transactions)



Diverging from its trend of recent years, the banking system's net external debt expanded in Q1, but this does not necessarily represent a lasting turn in trend. Banks have gradually continuously been scaling back their external debt, partially offset by the reduction in their foreign financial instruments. Breaking from the previous tendency, 2014 Q1 saw a rise in banks' external debt, coupled with a reduction of their foreign assets. This resulted in an

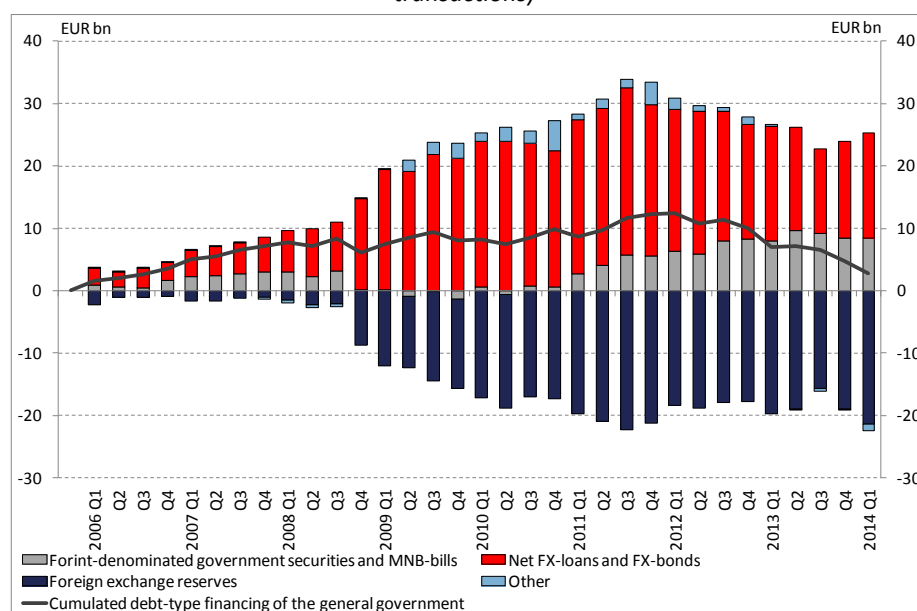
expansion of over EUR 0.8 bn in banks' net external debt in Q1 (Chart 12). This increase in external debt may be linked to the continued withdrawal of deposits by households (see Chapter 4 for a more in-depth analysis). At the same time, there have been cases of stagnating or slightly rising external debt within the banking system during certain quarters over the past two years within a general context of gradually decreasing external debt. The inflow of funds observed in Q1 may be an adjustment of the sharp dip registered in Q4. Therefore it cannot be inferred from the quarterly figure that the Hungarian banking system is once again steadily relying on external liabilities.

*Chart 12: Developments in the banking sector's gross external debt and asset transactions (cumulative transactions)*



**Net external general government debt continued to decline in early 2014, primarily through the increase in foreign exchange reserves generated by EU transfers.** Net general government external debt consolidated with the MNB decreased by nearly EUR 1.8 billion in Q1. The decrease was mainly linked to higher foreign exchange reserves (Chart 13 – rising foreign exchange reserves decreases net external debt), and was also driven by the scaling back of the MNB's other liabilities and the Government Debt Management Agency's margin account balance. In parallel with the rise in foreign exchange reserves, the stock of foreign currency bonds held by non-residents also increased (resulting from the issue of USD bonds in March), while forint bonds and MNB bills held by non-residents remained largely unchanged. Net foreign currency bond issues by the state did not affect net external general government debt as consolidated with the MNB, due to the similar rate of increase in foreign exchange reserves, but did lead to a rise in gross external debt.

Chart 13: Breakdown of net external debt of the general government consolidated with the MNB (cumulative transactions)



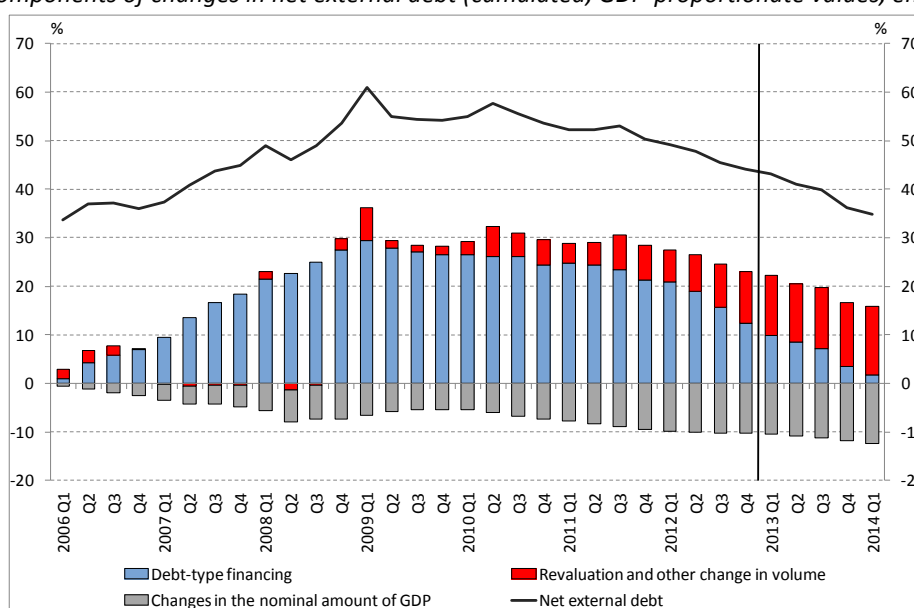
### 3. DEVELOPMENTS IN DEBT RATIOS

*The adjustment of net external debt continued in Q1, with the indicator falling to nearly 35 per cent of GDP. Hungary's gross external debt was still slightly above 90 per cent of GDP in Q1, linked primarily to the foreign currency bonds issued to finance later maturities and to the depreciation of the exchange rate. Short-term external debt based on residual maturity remained broadly stable in Q1.*

In terms of Hungary's vulnerability, stock indicators are also extremely significant in addition to flow-type indicators. Developments in debt ratios have a significant impact on the perception of Hungary's external vulnerability. The indicators focused on by investors generally exhibit similar changes as those stemming from financing developments. At the same time, stock data also capture revaluation (of foreign currency and instruments) effects alongside the total debt accumulated in the past, providing a more accurate picture of total external dependency. In addition to gross debt ratios, net external debt, which includes external debt type assets (such as foreign exchange reserves) is also worth examining. Another advantage of net indicators is that income from foreign investments improve the income balance deficit and therefore qualify as net stock indicators from the perspective of a country's net lending.

**Hungary's net external debt shrank further in Q1, resulting from opposing impacts.** Declining external debt ratio excluding intercompany loans in Q1 were driven by a substantial outflow of debt liabilities, i.e. repayment of foreign loans and the increase in foreign assets, and nominal GDP growth. Meanwhile, the 3-4 per cent depreciation in the forint exchange rate vis-à-vis the main currencies relevant in terms of external debt composition (euro and Swiss franc) by the end of Q1 countered the reduction in debt. Stemming from these developments, net external debt shrank to 35 per cent of GDP, even lower than the level prevailing at the end of 2006.<sup>7</sup>

Chart 14: Components of changes in net external debt (cumulated, GDP-proportionate values, end-2005 = 0)\*



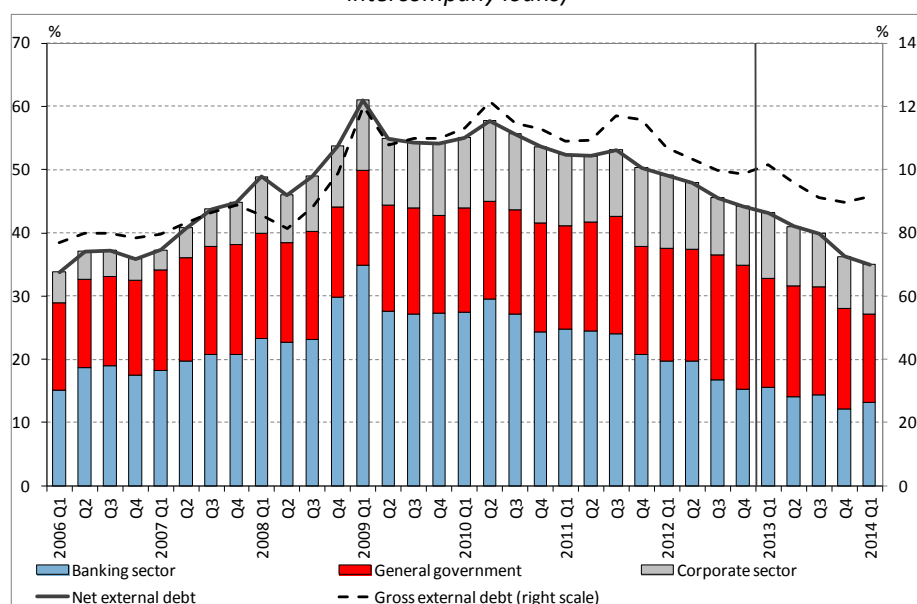
\* Debt ratios were also revised in the context of the publication of the balance of payments in June. Data available from 2013 Q1 already captured the upside impact of SDR allocation on debt, while the preceding period still features data defined using the old methodology (see footnote 7 for more detail).

<sup>7</sup> Stocks of foreign liabilities were also revised in line with the new balance of payments methodology. Net external debt rose by nearly 1 per cent of GDP, as SDR allocation under the new methodology must be recorded as foreign debt liabilities. As until now the SDR allocation received only increased foreign exchange reserves, the change not only increases gross external debt, but also net external debt.

**The decline in net external debt is essentially linked to the consolidated general government.** The decreasing stock indicator was mainly shaped by developments in financing. Net external consolidated general government debt to GDP shrank by nearly 2 percentage points, driven by increasing foreign exchange reserves stemming from EU transfers. The repayment of foreign loans by the corporations sector also drove the decrease in external debt (0.4 percentage points). External financing by the banking system was also reflected in the stock indicator: banks' external debt rose by nearly 1 percentage point. At the same time, the sector's external debt still remains far below pre-crisis levels.

**At the end of Q1, gross external debt was still slightly above 90 per cent of GDP, which can be attributed to several factors.** On the one hand, in Q1 the issuance of foreign currency denominated bonds by the state exceeded the value of foreign currency denominated bond repayments, which drove the gross debt ratio upwards.<sup>8</sup> On the other hand, it should be noted that developments in gross external debt were more strongly shaped by the depreciating forint than net debt, as the portion of Hungary's external assets denominated in foreign currency was also revaluated in the wake of changes in the exchange rate.

*Chart 15: Net external debt in a sectoral breakdown and gross external debt (as a percentage of GDP, exclusive of intercompany loans)\**

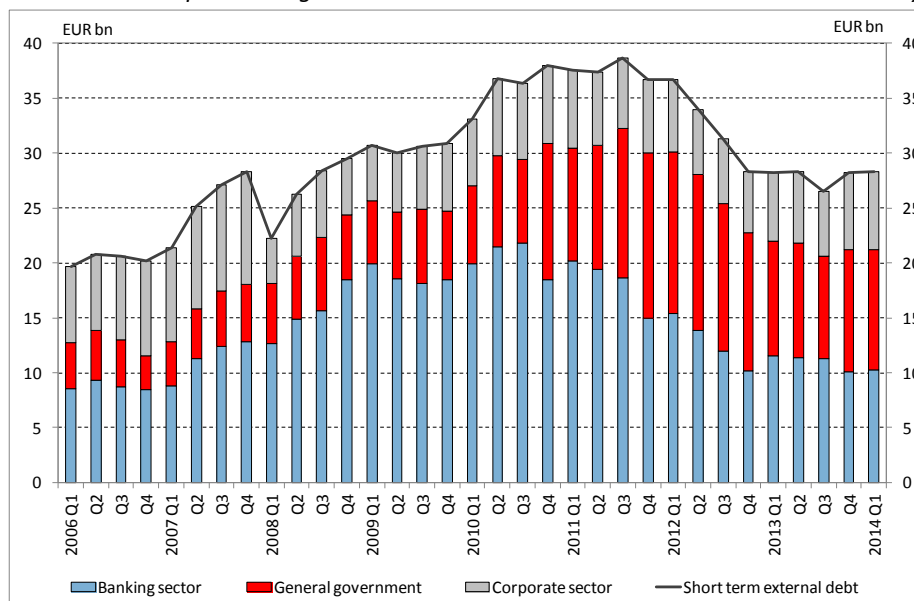


*\* The methodological changeover (see footnote 7 for more detail) renders the comparison of 2012 Q4 and 2013 Q1 data difficult.*

**Short-term external debt based on residual maturity amounted to around EUR 28 billion in Q1, similarly to the end of 2013.** Short-term external debt, which is essential for assessing the external vulnerability of the country, consists of two elements: short-term debt according to original maturity and amortised long-term debt. The table of external debt maturities was also published with the quarterly balance of payments, showing that amortised long-term debt amounted to roughly EUR 11.5 billion at the end of Q1. Total short-term external debt remained at its Q1 level on account of several opposing developments: the slight increase in originally short-term debt was offset by a decline in amortised long-term debt. Regarding the latter, it should be noted that the volume of amortised long-term debt based on the maturity ladder may continue to decrease in the upcoming quarters, thereby reducing Hungary's external vulnerability and dependency on external funding.

<sup>8</sup> The issuance of foreign currency denominated does not impact a country's net debt (as it also increases the level of foreign exchange reserves), only increasing gross external debt.

Chart 16: Developments in gross short-term external debt based on residual maturity



The sectoral breakdown of short-term external debt reveals that the slight increase in the banking system and among corporations was offset by the decline within the general government. Following a sharp decline in the previous quarter, the banking sector's short-term debt portfolio expanded by approximately EUR 0.2 billion, along with a decline in short-term external debt on original maturity (EUR 0.4 billion) and in amortised long-term external debt (EUR 0.2 billion). Shrinking amortised long-term debt within the sector is mainly linked to the fact that banks – presumably in order to comply with the foreign exchange funding adequacy ratio – may have performed early repayments on their debt maturing in subsequent quarters. Originally short-term bank debt remains at a historical low in spite of the increase. Contrary to the previous quarter, the short-term consolidated general government external debt also contracted slightly, driven mainly by the decline in the MNB's other loan liabilities, the stock in discount Treasury bills held by non-residents and other short-term external general government debt (such as the Government Debt Management Agency's margin account balance), which was only partially offset by the higher volume of MNB bills held by the non-resident sector. The stagnation of the general government's amortised long-term debt is the result of opposing impacts. A government US dollar bond with an original maturity of 10 years maturing next February became short term, along with another forint bond, which drove debt upwards. This was offset by a foreign currency bond reaching maturity in January and the repayment in February of a forint government bond held in large quantities by the non-resident sector. External debt within the corporations sector only rose marginally.



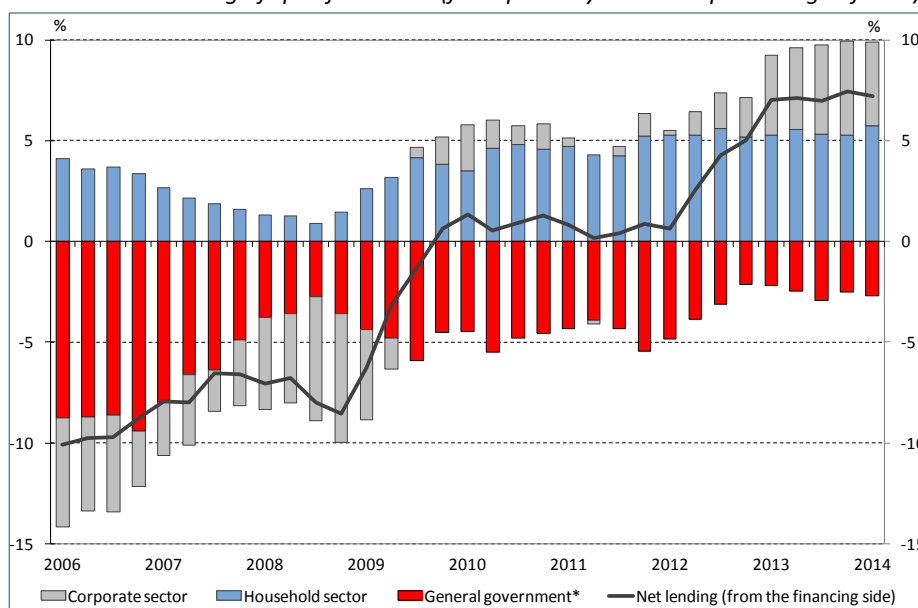
#### 4. SECTORS' SAVINGS APPROACH

*Net lending, which fell slightly at the beginning of the year, can presumably be attributed to lower corporate net lending in the wake of increasing investments, and to a smaller extent to the slightly rising borrowing requirement of the general government, which nonetheless remains at a historical low. Along with rising employment and wage disbursements, the financial savings of households increased slightly, while asset portfolio rearrangement in favour of securities continued, in line with the previous trend.*

Developments in net lending are presented below from the perspective of savings, through the net savings of individual sectors. The level of net lending of the domestic sectors is the same in the case of the financing approach, since the net lending of actors of the domestic economy is ultimately reflected in foreign financing. The savings approach reveals more about the behaviour of individual sectors, and thus we can give different types of explanations for the development of net lending, compared to the real economy approach. Amongst other things, financial accounts reflecting developments in the net financial savings of various sectors can be used to examine shifts in the financial savings of the domestic sectors.

**High net savings by households and corporations and the general government's low borrowing requirement in Q1 led to elevated net lending within the economy.** Developments in household savings were shaped primarily by precautionary motives. The higher wage disbursements observed in Q1 were also reflected in households' rising net savings, which reached 5.7 per cent of GDP on annual terms (Chart 17). Corporations' net lending declined slightly, which may have been driven by lower transfer utilisation in Q1 compared to 2013 Q1, alongside a pick-up in investments. The accrual-based borrowing requirement of the consolidated general government for quarters remains a low, accounting for 2.7 per cent of GDP for the period ending with Q1. The slight increase compared to the end of 2013 was driven mainly by the pre-financing of European Union projects, alongside higher expenditures by budgetary institutions early in the year. The positive developments in tax receipts did offset this somewhat.

Chart 17: Net lending of specific sectors (four quarterly data as a percentage of GDP)

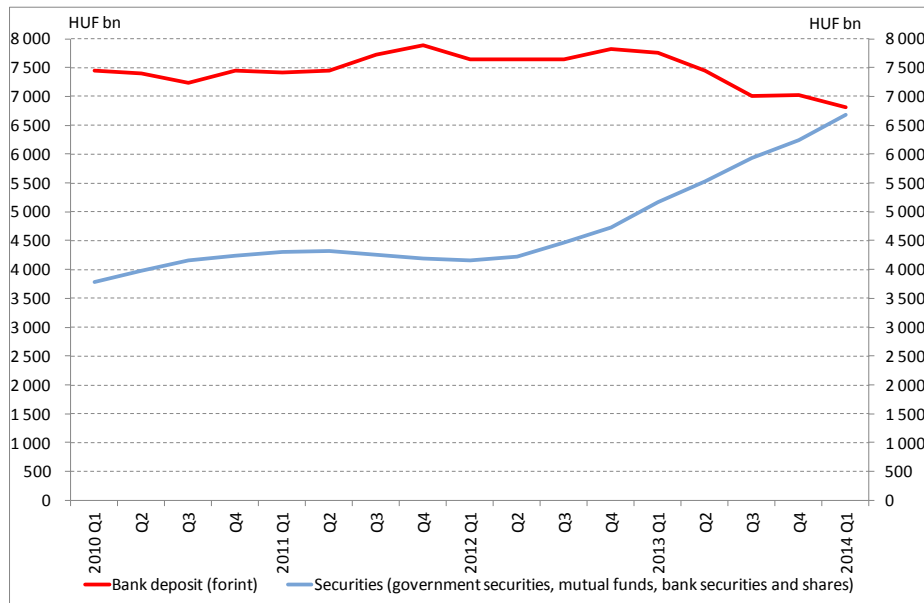


\* As regards the general government, net borrowing based on the financial accounts is presented, adjusted for the transfer of private pension fund assets in 2011. We computed the net lending of the general government and households for 2014 Q1 based on preliminary financial accounts, while the net saving of corporations is derived as a residual.

**The rearrangement of households' portfolio continued, which may have contributed to the rise in banks' external debt in Q1.** Households have increasingly shifted towards security-type assets since early 2012. Since early 2013, households have allocated some of their accumulated deposits to purchases of securities to the detriment of bank deposits. The reduction in deposits by households may have affected banks' withdrawal of external funds, as the

withdrawal of deposits is synonymous with less household funding for the banking system. In other words, households' withdrawal of deposits may have played a role in the rise in external financing within the banking sector in Q1. The picture is nuanced by the fact that households have also been decreasing their bank loans since the onset of the crisis, thus providing funds for the banking system. However, this fell short of the rate of withdrawal of household deposits in Q1. It is also worth noting that the rearrangement of household assets also resulted in a rise in households' security holdings, which approached their stock of bank deposit savings at the end of March (Chart18).

*Chart 18: Stock of households' bank deposits and instruments (stocks at the end of the quarter)*



## 5. DEVELOPMENTS IN FOREIGN DIRECT INVESTMENT IN HUNGARY AFTER THE CRISIS

*As a special topic, we present developments in FDI (foreign direct investment) in Hungary based on various aspects. Broadly speaking, net FDI slowed in the years following the onset of the crisis. Significant one-off items — capital injections owing to banks' losses or decreasing FDI due to government acquisitions, for instance — have shaped the level of net FDI inflows. Overall, data adjusted for one-off impacts still reflect continuous net FDI inflows, although at a lower rate compared to the pre-crisis era. Two things are worth noting regarding the lower FDI inflows. Firstly, the corporate sector has other sources besides FDI for implementing developments, such as foreign borrowing, and therefore assessing FDI alone may underestimate the extent of investments using foreign capital. Secondly, the inflow of FDI also slowed in the countries in the region — similarly to Hungary — following the onset of the crisis. Despite neighbouring countries having similar stocks of net FDI as Hungary, the outflow of income due to the foreign corporations' profits may be higher or lower compared to Hungary.*

### 5.1. Introduction

FDI is essential for economies as the inflow of capital boosts their competitiveness and these new investments may contribute to employment. Examining developments in FDI is especially relevant in the case of Hungary, as an analysis by the United Nations Conference on Trade and Development (UNCTAD) has revealed that Hungary's economy is one of the most strongly shaped by FDI.<sup>9</sup> Analyses typically focus on inflows of FDI into a country and attempt to draw conclusions from this on the economy's capacity to attract capital and on investments, and the resulting growth potential of the Hungarian economy. Foreign direct investment is particularly important for emerging economies to pre-finance the convergence process and for technology import. At the same time, it is worth noting that the outflow of income in the context of FDI reduces the net lending of the country.

For Hungary, we also need to examine FDI outflow as well as inflow, as only net FDI represents additional resources for the Hungarian economy; consequently, focusing on net FDI data is warranted. It should also be noted that, in addition to this, the breakdown of FDI by the nature of the capital involved (equity capital, reinvested earnings or intercompany loans) and by sector (banking and corporate sector), as well as the current situation of each sector can significantly nuance the picture of the volume and expected impact of FDI. This special topic therefore focuses on an overview of developments in FDI, followed by a breakdown of FDI by factors and sectors, a presentation of certain aspects of partner country and a sectoral breakdown before placing Hungarian data in an international context.

### 5.2. Developments in FDI inflows to Hungary

**The increasing prevalence of capital in transit substantially impacts developments in gross FDI in Hungary.** Factors with a large influence on gross flows must be distinguished in order to analyse FDI. Presumably due to the idiosyncrasies of the Hungarian tax system, certain corporations only provide intercompany loans to their Hungarian affiliates for tax optimisation purposes, which are then immediately transferred abroad by them. This is referred to as capital in transit and has been distinguished by the MNB in its balance of payments statistics since 2008.<sup>10</sup> Capital in transit, however, only affects gross flows and does not distort net FDI data due to its nature. This is to say that capital in transit transactions distort FDI inflow (investments of non-residents in Hungary) and FDI outflow (investments of residents outside of Hungary), but not their "net" balance. However, they do play a significant role in the far more restrained net values compared to gross FDI. The degree of statistical impact of such factors is illustrated for instance by the fact that since the end of 2011, half of inward FDI to Hungary was linked to capital

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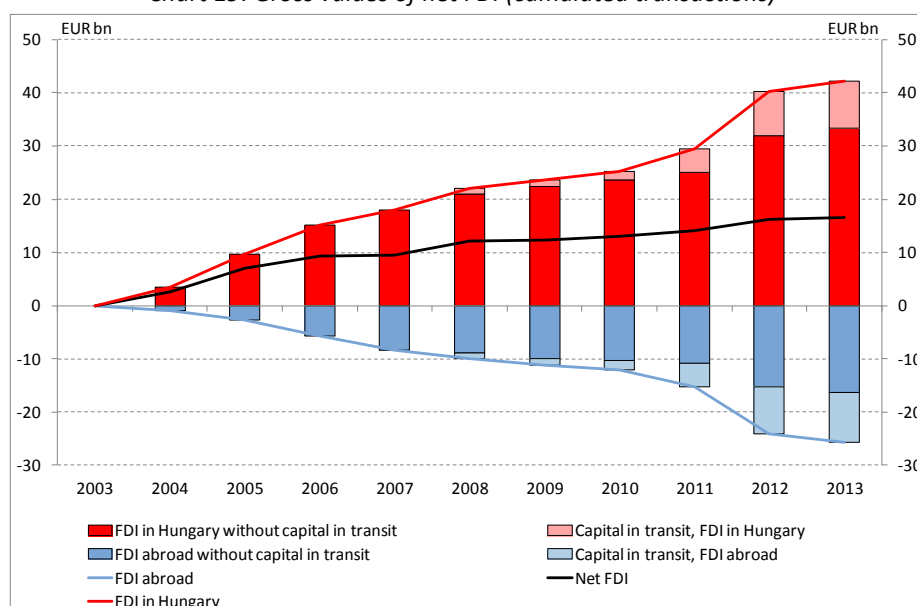
<sup>9</sup> Contribution to the economy is ranked in terms of value added, wages, employment, tax receipts, exports, investments and R&D expenditures. For more detail, see the UNCTAD's World Investment Report 2012.

<sup>10</sup> It should be mentioned here that the MNB distinguishes the data of special-purpose entities (SPEs) established for tax optimisation purposes in its balance of payments statistics. SPEs generally take out loans abroad and immediately forward them to other foreign corporations, with no impact on real economic processes. The stock of loans held by SPEs has been around 20-40 per cent of GDP over the past years. For more detail, see: PÉTER KOROKNAI-RITA LÉNÁRT-ODORÁN: The role of special purpose entities in the Hungarian economy and in statistics *MNB Bulletin, October 2011*. Tax optimisation purposes may also influence capital allocation decisions by corporations, thereby affecting the composition of FDI by factor: for instance, firms may substitute equity capital with intercompany loans (for more detail, see the section on *Breakdown by factors*).

in transit, i.e. meant no extra funding for the Hungarian economy (Chart 19, light red area). At the same time, there may be many other transactions still distorting gross statistics which cannot be filtered out.

**Net FDI rose significantly until 2006, followed by a marked slowdown, especially after the onset of the crisis** (Chart 19). There were significant amounts of FDI inflows to Hungary until 2006, even in net terms following deduction of FDI outflows.<sup>11</sup> Net FDI inflows then slowed, presumably linked to the dampening effect of budgetary adjustments on growth and the rising debt-type inflow tied to increasing foreign currency lending. The slowdown in net FDI inflow from 2006 can be attributed to a larger extent to waning gross inflows, as the FDI outflow of Hungarian corporations was maintained at an unchanged level. After the onset of the crisis, both gross FDI inflows and outflows slowed significantly, yielding low net FDI inflow. 2012 saw another significant rise in gross foreign direct investment (Chart 19, red line), but this was driven by the aforementioned capital in transit to an increasingly large extent (light red and light blue area), which is also reflected in the significant volume of FDI outflows (blue line), with capital in transit therefore having no impact on net figures. FDI inflows and outflows were also strongly affected by the portfolio realignment of certain corporations. Overall, net FDI inflows were thus far lower than gross inflows, but showed a perceptible rise over the past two years (Chart 19, black line).

Chart 19: Gross values of net FDI (cumulated transactions)



#### 5.2.1. Breakdown by factor

**As for developments in the factors shaping FDI, it is worth noting that since 2006 the majority of inflows have consisted of reinvested profit generated by the already established Hungarian affiliates of foreign corporations, rather than fresh FDI, which is more relevant in terms of capacity to attract capital.** Cumulated equity capital transactions ("fresh FDI") turned negative from 2003, largely due to the fact, for instance, that at the end of 2009 and 2012, and in the first half of 2013 equity capital was replaced by intercompany loans (Chart 20).<sup>12</sup> This change in the funding structure can be explained with several reasons. Among tax optimisation considerations, it should be noted that while interest paid on loans can be deducted from pre-tax profit, dividend payments can only be deducted from profit after tax.<sup>13</sup> It is also possible that owners have easier and more accurate control over the

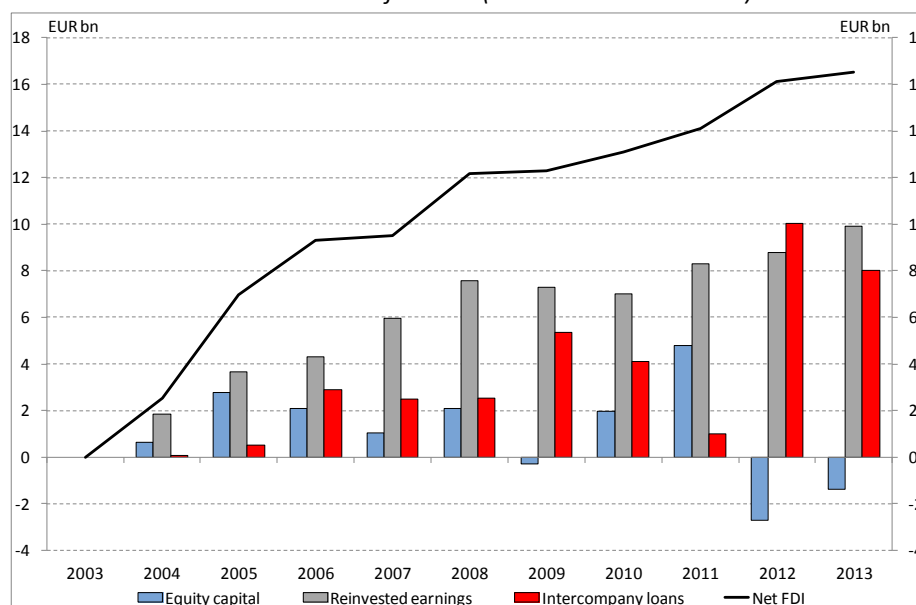
<sup>11</sup> In the financial account of the balance of payments FDI inflows refer to the balance of "foreign direct investments in Hungary", while FDI outflows refer to the balance of "foreign direct investments abroad".

<sup>12</sup> Equity capital refers to the balance of equity capital in the financial account, while reinvested earnings refer to reinvested earnings and intercompany loans refer to the balance of other capital.

<sup>13</sup> In addition, the time series for reinvested earnings featured in the publication uses the current operating performance concept, which may diverge substantially from the actual profit posted by foreign-owned corporations. The MNB publishes earnings based on the current operating performance concept in its balance of payments, which adjusts profit after tax by the amounts not linked to current operating performance — including items linked to depreciation of assets, exchange rate fluctuations, loan impairment and balloon repayment. For more detail on the

interest paid on a loan as opposed to the annual profit of a company. Interest income can be deducted more uniformly than dividend payments, as the latter is more prone to fluctuations.

Chart 20: Factors of net FDI (cumulated transactions)



Note: The 2013 transaction for reinvested earnings is an estimate, and may be revised once final data become available.

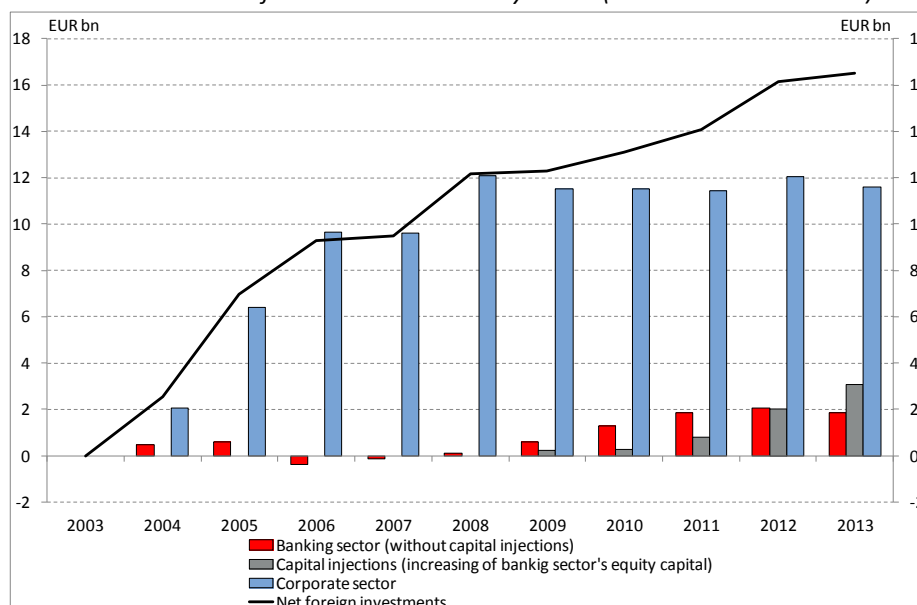
#### 5.2.2. Breakdown by sector

**The increase in net FDI inflows is largely linked to FDI flow into the banking system, while the corporate sector has not seen any net FDI inflows since the onset of the crisis.** Net FDI inflows can be broken down by sector, with the statistics providing information on which sectors (banking or corporate sector) attracted fresh FDI. The data show that leading up to the crisis, net FDI flowed into the corporate sector, then shifted to the banking sector following the onset of the crisis, with non-residents funding corporations through FDI to a far lower extent (Chart 21). It should be noted however that the corporate sector has other means of accessing external funding besides FDI, namely direct foreign borrowing. For instance, the Mercedes investment project in Hungary was completed not only using FDI, but also using substantial foreign (non-intercompany) loans.<sup>14</sup>

current operating performance concept, see Box 2 in press release of Hungary's balance of payments: 2012 Q2 ([http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Statiztika/mnben\\_statkozlemeny/mnben\\_fizetesi\\_merleg/CA12Q2\\_EN.pdf](http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Statiztika/mnben_statkozlemeny/mnben_fizetesi_merleg/CA12Q2_EN.pdf)).

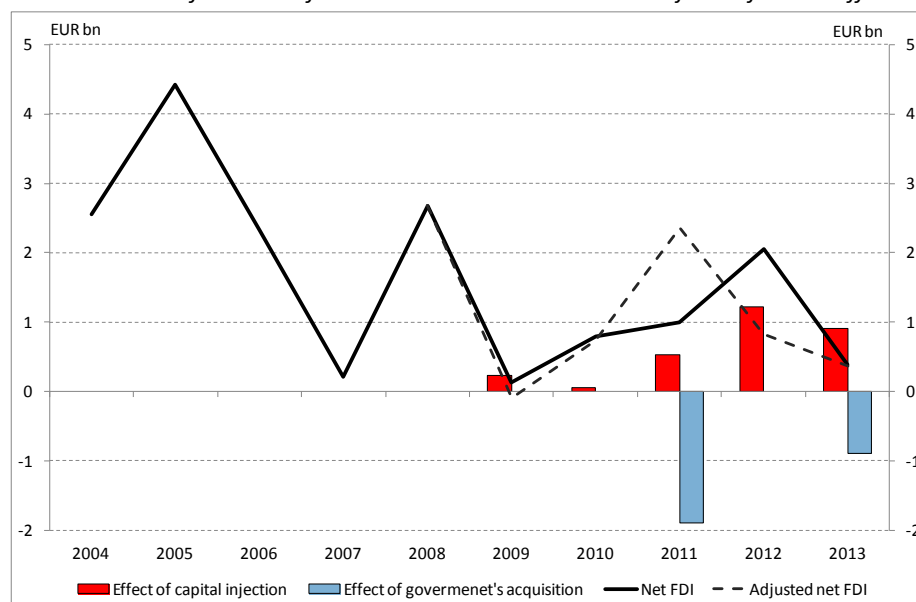
<sup>14</sup> Such transactions are recognised in the balance of payments statistics within the financial account under other investment, i.e. not under foreign direct investments.

Chart 21: Net FDI inflows in a breakdown by sector (cumulated transactions)



**Adjusting for significant one-off impacts does not substantially affect developments in net FDI inflows over the past years, with annual foreign direct investment typically amounting to around EUR 0.5-1 billion.** Since the onset of the crisis, numerous one-off factors have shaped net FDI inflows which may substantially distort the assessment of FDI in Hungary. An example of an impact distorting the fundamental developments upwards was the wave of capital injections by banks to offset the capital shortfall resulting from losses, while state acquisitions of corporations (2011: MOL, 2013: E.On) yielded a lower value for FDI inflows than the actual figure. Therefore, if we adjust the original net FDI time series by the net equity increases by banks and the value of state acquisitions, the adjusted time series may better reflect actual foreign direct investment by non-resident corporations in Hungary. The adjusted time series conveys a similar message to the original one: although net FDI inflows waned substantially following the onset of the crisis, they have been continuous since 2010, averaging EUR 0.5-1 billion annually.

Chart 22: Value of net FDI inflows as stated in statistics and adjusted for one-off items

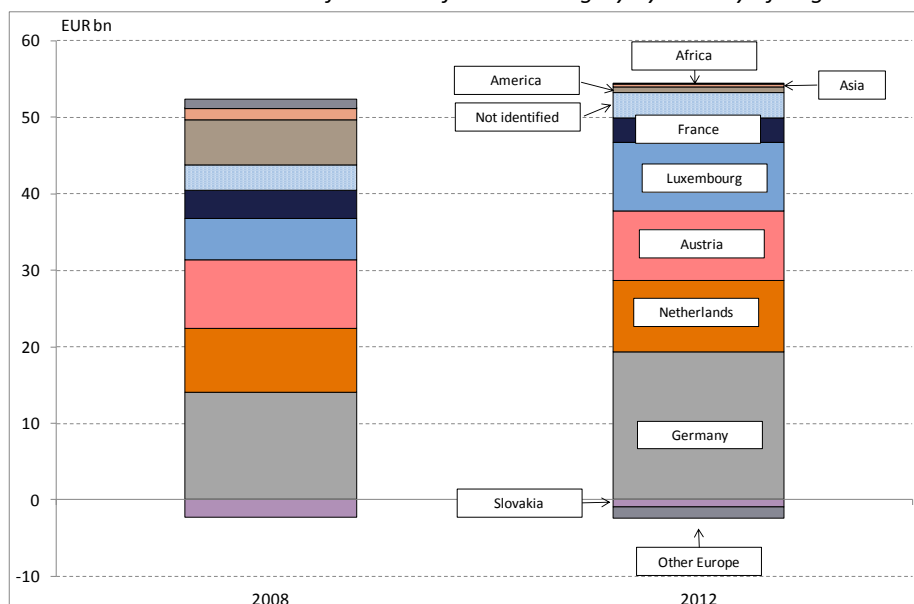


### 5.2.3. Breakdown by partner country

**Over 90 per cent of FDI in Hungary in 2012 was of European origin, and nearly 40 per cent of it was of German origin.** Net foreign direct investments by non-residents only rose slightly — by EUR 2 billion — between 2008 and 2012, while gross investments rose by over EUR 15 billion. The main — and increasingly dominant — source of FDI to

Hungary was Europe. While in 2008 nearly 80 per cent of investments originated from Europe, by 2012 this ratio had reached 90 per cent. Germany plays a central role, accounting in its own right for nearly 40 per cent of FDI to Hungary. Other major investors include Austria, the Netherlands, Luxembourg and France. Slovakia also deserves mention, where Hungarian residents have been stable investors over the past years. Besides Europe, the American continent, and more specifically the Central American region and the US were sources of more substantial FDI in Hungary, but net FDI fell back substantially by 2012 mainly due to outward FDI by residents to Central America.<sup>15</sup>

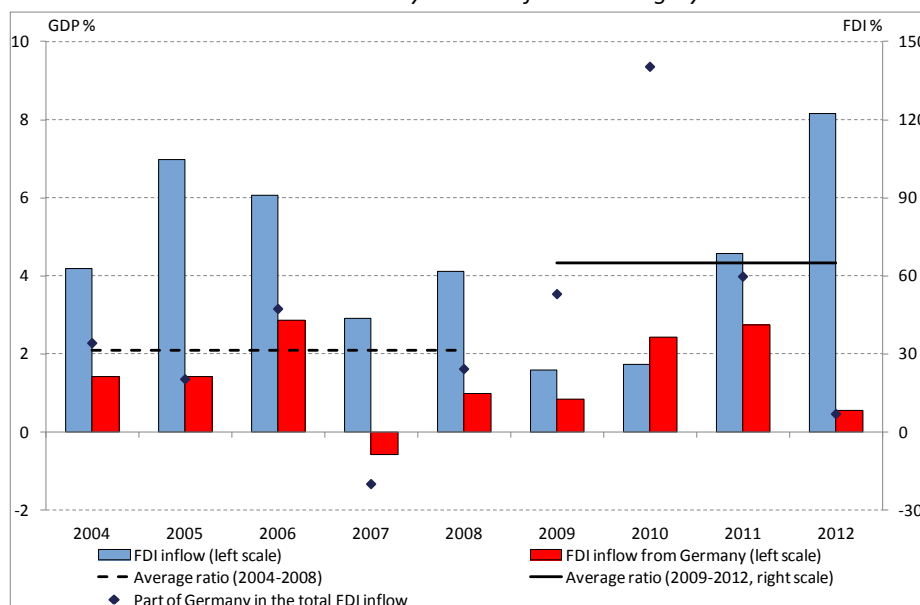
*Chart 23: Breakdown of net FDI inflows to Hungary by country of origin*



**The role of FDI originating from Germany has increased substantially since the onset of the crisis.** The breakdown of FDI by partner country shows that Germany has been one of the major investors in Hungary. German FDI inflows already accounted for approximately 35 per cent of total net inflows before the crisis (i.e. already significant), rising further to exceed 65 per cent following 2009, due in part to the salient figure for 2010. While Germany's share of FDI outstripped previous levels in both 2009 and 2011, it only accounted for a smaller chunk of the hefty FDI inflows registered in 2012. The fact that a large portion of total FDI inflows in 2012 were capital in transit (presumably not originating from Germany) may have contributed to this. In other words, despite decreasing net FDI inflows during the crisis, foreign direct investment from Germany did not decrease in nominal terms.

<sup>15</sup> It should be noted that current statistics are only able to accurately identify partner countries, while an affiliate operating in country "B" of a corporation from country "A" can invest the parent company's capital in Hungary. Translated to partner country terms, this means that the capital originates from the country where affiliate operates (in "B" country), while the actual originating country will have been country "A".

Chart 24: Germany's share of FDI to Hungary



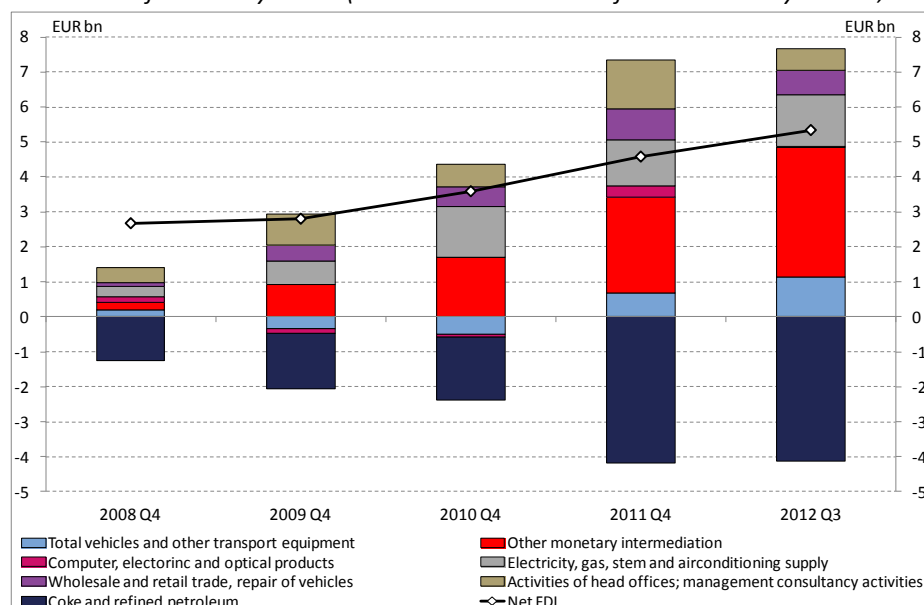
Note: FDI can also take on a negative value, for instance if a foreign corporation is wound up or increases its intercompany loans granted abroad.

#### 5.2.4. Breakdown by activity

While FDI has decreased in certain sectors over past years, it has soared in the automotive industry and the other monetary intermediation sectors. Analysis of FDI data by activity available since 2008 is difficult, due to the fact that capital in transit and portfolio reallocations often span multiple activities. We therefore focus on the net transactions of key sectors in our analysis and strive to eliminate the impact of transactions spanning multiple activities. The data show that the other monetary intermediation activity saw a marked rise in FDI (amounting to EUR 3.5 billion since 2008), linked partly to the capital injections used to buffer bank losses. The automotive industry also attracted substantial FDI, with investments in the sector rising significantly, despite the fact that one of the largest investment projects in recent years was implemented using foreign credit along with fresh FDI. Thirdly, FDI also rose by nearly EUR 2 billion in trade and the energy sector. Additionally, FDI in activities of head offices and management consultancy activity also expanded significantly in 2011-2012. It should be noted, however, that large multinational corporations may significantly impact activity-level statistics with reallocations between activities. By contrast, net FDI fell in the coke and refined petroleum and computer, electronic and optical products sectors. While the fall in FDI to the coke and refined petroleum sector stems mainly from increasing outward FDI by residents, the dip in FDI to the computer, electronic and optical products sector between 2011 and 2012 is mainly attributed to the reduction of capacities. The latter coincides with falling export performance in the electronics sector in the latter period.



Chart 25: Breakdown of net FDI by sector (cumulated transactions from 2008 in key sectors, EUR billion)\*



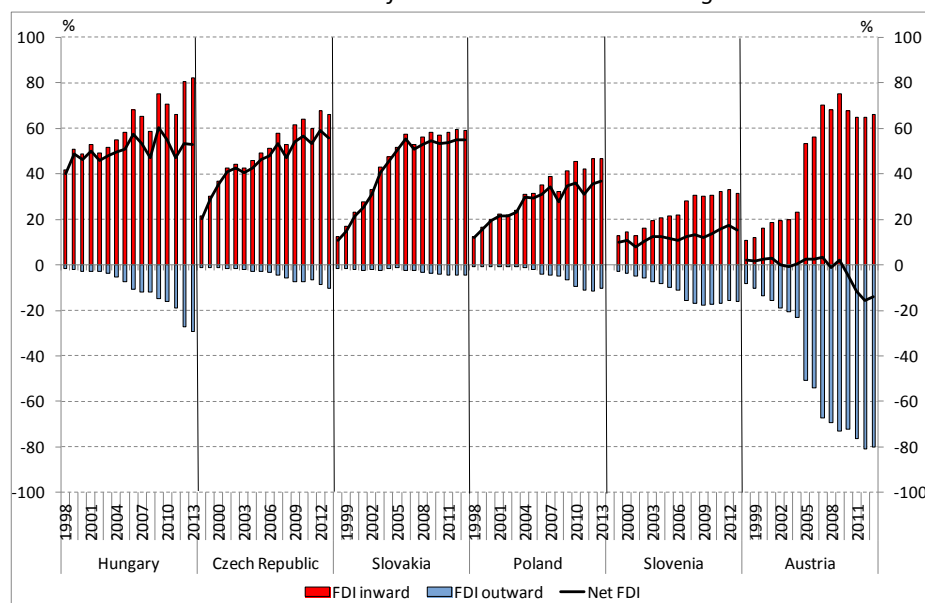
\*Note: Flow data for the automotive industry has been adjusted for the impact of reallocations between sectors. Certain large enterprises may pass on shareholder direct investments to their resident affiliates, which may distort the breakdown of FDI by activity. We have adjusted sectoral data for 2011 Q4 and 2012 Q1 for such transactions based on the MNB's press releases on the "Balance of payments" and the electronic reports of such large enterprises. The time series may have been affected by reallocations in 2012 Q4, and therefore we have only included data until 2012 Q3.

### 5.3. International comparison

The net stock of FDI in Hungary outstripped that of its regional peers in the early 2000s, but this difference had essentially eroded away by 2012. The wave of privatisation and the greenfield investments following the political changeover opened the door for the acquisition of substantial stakes in Hungarian corporations by non-residents, while Slovakia, the Czech Republic and Poland did not take this route, yielding lower stocks of FDI. Convergence in neighbouring countries began in the 2000s and continued until the onset of the crisis. The uninterrupted rise in the region, coupled with slowing FDI inflows to Hungary led to Slovakia and the Czech Republic catching up with Hungary by 2012 in terms of their stock of net FDI. Slovenia saw its stock of net FDI stagnate over the entire time horizon, alongside a nearly identical rise in gross flows. Austria featured different developments compared to the region, mainly due to differences in its level of development. The stock of net FDI decreased substantially from 2009 following an extended period of stagnation, mainly due to rising outward FDI by residents. The net stock of FDI is now positive in case of Austria (i.e. domestic investments by non-residents exceed residents' investments abroad), which is characteristic of advanced economies.

Investments by Hungarians abroad are only outstripped by Austrian investments, which may be largely driven by capital in transit, which is not eliminated from the international statistics. One of the major differences compared to other similarly developed countries (Czech Republic, Poland and Slovakia) is that Hungary features substantial investment abroad by residents. While large enterprises invested to a lower extent in the aforementioned countries, the indicator approaches 40 per cent of GDP in case of Hungary. However, capital in transit plays a significant role in this figure, as indicated above in the section on transactional data. FDI outflows from Hungary therefore exceed outflows from Slovakia, which also stand at an elevated nearly 20 per cent of GDP, but fall short compared to Austria, where outflows stand at 80 per cent of GDP (it should be noted that SPEs exert a substantial impact on the statistics in case of Austria as well).

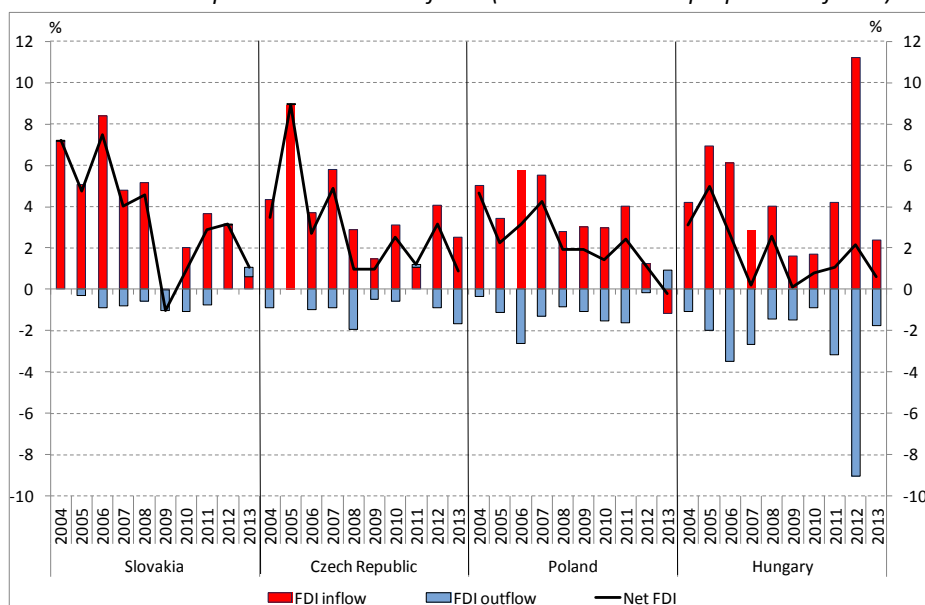
Chart 26: Breakdown of the net FDI stock in the Visegrád Six



Source: Eurostat

Transactional data for Visegrád countries yield a similar conclusion as stock data and also reveal that the inflow of FDI came to a halt in the wake of the crisis. The convergence in stock data is also reflected in transactional data, with countries in the region characterised by significant inflows of FDI in the early 2000s, outstripping even the rate observed in Hungary. This process played out in the course of two years in the case of the Czech Republic and Slovakia, while Poland saw a slower but more stable inflow of FDI. The inflow of FDI slowed in countries across the region following the onset of the crisis. It should be noted however that in the case of Hungary, as opposed to the rest of the region, net FDI inflows were realised along with substantial FDI outflows, which, in addition to capital in transit, stemmed from the substantial regional expansion of Hungarian multinational corporations and their potential capital injection obligations.

Chart 27: Developments in net FDI inflows (transactions as a proportion of GDP)

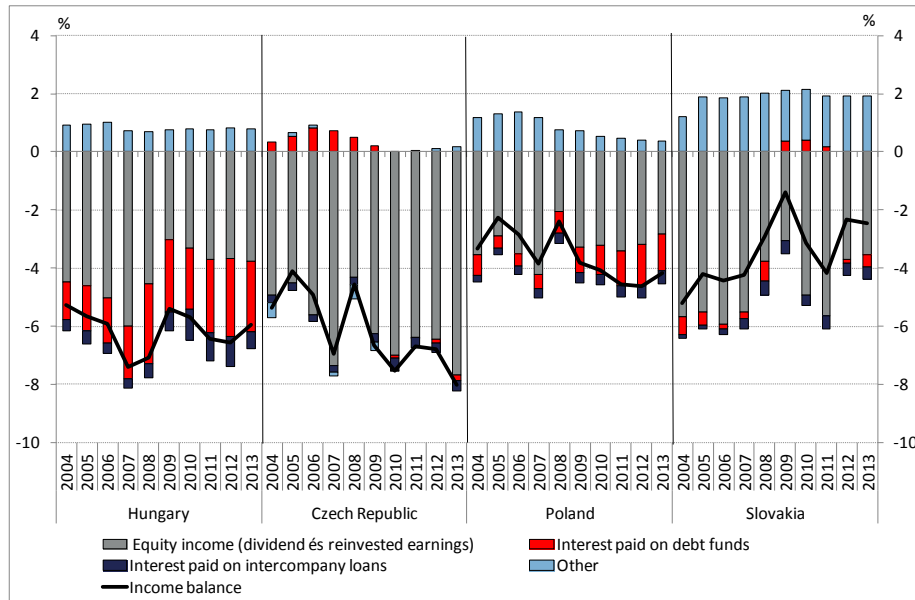


Source: Eurostat

Hungary's income balance in its balance of payments exhibits a substantial deficit due to the high stock of FDI, but the deficit on its income balance is not highest in the region. The profit realised on FDI (dividend and reinvested earnings) lowers a country's net lending through the income balance. Hungary's deficit of the income balance —

linked largely to profit on FDI and to interest on debt to a smaller extent — is high in a regional comparison. While the deficit on the income balance in Poland and Slovakia is lower than in Hungary, the Czech Republic has the highest deficit. The Czech deficit, which is larger than in Hungary, is interesting because the Czech economy has low net external debt, meaning that it is shaped almost exclusively by the high profits on FDI (Chart 28). Slovakia, which has almost identical stock of FDI, features similar outflows to Hungary; in other words non-resident investors achieve similar levels of profit on their investments.

*Chart 28: Components of the income balance (values as a proportion of GDP)*



Source: Eurostat

# Gábor Bethlen

(15 November 1580 – 15 November 1629)

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

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

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

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

**REPORT ON THE BALANCE OF PAYMENTS**

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