MAGYAR NEMZETI BANK

REPORT ON THE BALANCE OF PAYMENTS

SEPTEMBER
2015

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

This analysis was prepared by the MNB's Directorate Monetary Policy and Financial Market Analysis under the general guidance of Barnabás Virág, Executive Director in charge of Monetary Policy, Financial Stability and Lending Incentives. Contributors: Anna Boldizsár, Csaba Csávás, Zsuzsa Kékesi, Balázs Kóczián, Péter Koroknai, Rita Lénárt-Odorán and Balázs Sisak. The Analysis was approved for publication by Deputy Governor Márton Nagy.

This Report is based on information pertaining to the period ending 23 September 2015.

SUMMARY

External balance indicators continued to improve in 2015 Q2. In addition to rising net lending, the individual sectors continued to reduce their external debt, as **seen in the continued correction of the external debt ratios, which thus reduced the external vulnerability of the Hungarian economy**. As an effect of data revision, **the FDI investments of non-residents became much higher** than forecasted earlier, which may further improve the assessment of Hungarian economic processes. The **annual current account surplus rose to 3.8 percent of GDP**, whilst the capital account primarily consisting of EU transfers also showed a surplus of nearly 5 per cent of GDP. Consequently, the Hungarian economy's **net lending increased to 8.7 percent of GDP, substantially exceeding the level observed in neighbouring countries**.

The data disclosed in September **significantly changed the 2014 balance of payments data**: according to the corporate questionnaires, partly due to transitional effects, last year's **profits of foreign-owned corporations increased to a very high extent, by about 50 per cent** on an annual basis. The revision fundamentally influences the assessment of the external balance developments in two ways. On the one hand, **the new deficit figure for the income balance was higher by 1.7 per cent of GDP and thus net lending has also decreased**; however, the GDP-proportionate value of around 6 per cent remains very high, and in 2015 Q2 its annual value substantially exceeded 8 per cent again. On the other hand, given that **the reinvested earnings of corporations was also higher due to the higher profit, the net FDI inflow were also higher than previously anticipated and thus approximated 3 per cent of GDP in 2014**.

As regards developments in Q2, the increase in net lending calculated from the real economy is due to the **rise in the foreign trade surplus and growing EU transfers.** Growth in net exports partly reflected **the improvement in the terms of trade** caused by the decline in commodity prices and partly **the faster growth in exports compared to imports**. In addition to favourable external demand, the continued positive gap between export and import was facilitated by the significant expansion in industrial production and moderate energy import, as well as the increase in construction investments which mainly have a lower import content. The **four-quarter value of use of EU transfers exceeded EUR 7 billion**, and consequently the transfer balance supports net lending to a record extent. The **deficit on income balance slightly declined, which can be attributed to the falling interest expenditure caused by the decrease in debt ratios,** as well as to the decline in corporate profits.

According to financing side processes, **Q2 was characterised by a decline in FDI funds and a decline in external debt. Non-residents' direct investment partly decreased as a result of seasonal reasons** (owing to dividend payments voted in Q2) **and partly owing to the acquisition of Budapest Bank by the state**; if the last factor is disregarded, the FDI decline is smaller than the values observed in the same period of last year. **External debt decreased by roughly EUR 1.4 billion**, partly caused by corporations and partly by the state. The latter is mainly **attributed to significant volume of sale of government securities**, the market effect of which may be counterbalanced by a rising volume of government securities purchases by banks due to the MNB's self-financing programme.

In Q2, **the country's net external debt declined significantly, falling to nearly 31 per cent of GDP**, which was caused both by the continued outflow of debt, the revaluation effects and by the increase in GDP. In line with our earlier expectations, **the residual maturity-based short-term external debt rose to EUR 23.8 billion**, as the growth was mainly caused by the shortening of a government loan expiring in 2016. Furthermore, **foreign currency reserves decreased below EUR 35 billion**, primarily as a result of withdrawals related to the conversion into forint. Overall, **the amount of foreign currency reserves still significantly exceeds the level expected by investors**.

Examining the savings of the sectors, the rise in **net lending** is attributed to **the continued decline in net borrowing by the state (to 1 per cent of GDP)**, which is caused by the increase in tax income, due to the expansion of wages and employment as well as to the reduction of the shadow economy and falling interest expenditures. **The change in the financial savings of the private sector continues to be determined by the realignment due to settlement of FX loans** (it increases the savings of households and decreases those of the banks). In Q2, **purchases of government**

securities by households was strong again, which continues to play an important role in the reduction of the state's external debt.

In our special topic, we discuss **the development of profits of foreign-owned corporations**. The considerable increase in income observed in 2014 was **partly caused by an outstandingly high increase in the profits of certain companies**, which was also supported by changes in ownership, but growth in profitability **could also be observed in a wider circle of sectors**. On the side of expenses, the decline in oil prices may have also contributed to the profitability of domestic corporations, while revenues were supported by the strengthening of the US dollar and by the increase in revenues due to the expansion of some companies. **With the substantial growth in last year, the profits of non-resident corporations reached pre-crisis levels**, while the dividend payment actually decreased slightly, and consequently, **the amount of income reinvested from profits in Hungary rose to an unprecedented level, thereby increasing FDI in Hungary**. Our international comparison shows that, while the rate of return by foreign corporations having their operation in Hungary earlier fell behind that of the countries of the region, compared to the increase of income in 2014, it has already reached the regional level, whereas the ratio of reinvested earnings is considered very high in Hungary.

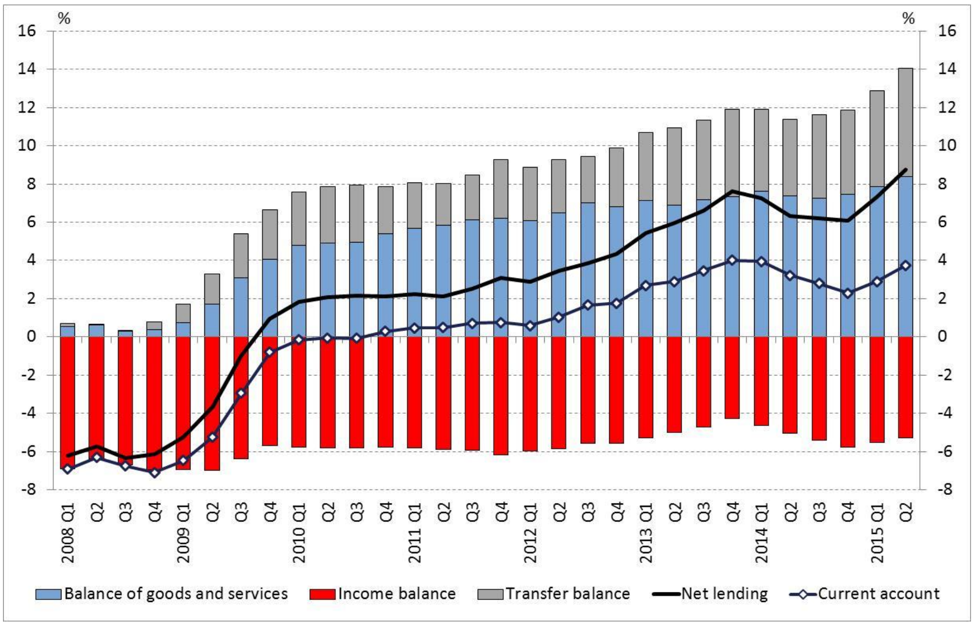
Content

1. REAL ECONOMY APPROACH

The revision of 2014 corporate profit figures substantially influenced the past development of external balance processes: according to the latest information, foreign-owned corporations' income was much higher than previously anticipated, which was combined with a higher deficit on the income balance and consequently with lower net lending. As regards processes in Q2, the net lending of the Hungarian economy rose to 8.7 per cent of GDP. The improved net lending is primarily attributable to the renewed rise in the foreign trade surplus, but to a smaller extent the development of the transfer balance and income balance also contributed to this. External demand remained favourable and was likely also supported by the lower oil prices, and in relation to this export growth continued to exceed growth in imports. Subdued imports in Q2 may have also resulted from the fact that it was primarily the volume of construction investments which increased and these investments have a lower import requirement. In addition, the foreign trade surplus may have been supported by the slight improvement of the terms of trade. In Q2, the utilisation of EU transfers continued to rise, which primarily financed the investments of the general government and thus may have played a significant role in the development of favourable investment in Q2. As the high profit increase last year may partly also have been supported by transitory items, the partially estimated deficit of the income balance may have decreased slightly in the past quarters.

According to the real economy approach, the *net lending* of the four quarters reached 8.7 per cent of GDP after strong growth in the past two quarters. In 2015 Q2, the net lending of the economy continued to rise: according to seasonally unadjusted figures, the aggregate sum of the current account and capital account amounted to EUR 2.3 billion. As a result, the external balance indicators have also increased substantially, and thus the annual value of the current account was 3.8 per cent of GDP, while net lending amounted to 8.7 per cent of GDP. Overall, all of the three factors of the real economy approach contributed to the rise in net lending (Chart 1). In the past quarter, the foreign trade surplus increased to a higher extent again, while the transfer balance has also continued to improve. The four-quarter value of the deficit in the income balance shows a slight decline, as the interest expenditures may continue to decrease this year. With receipt of the corporate questionnaires, there was a very serious revision showing the trend of a higher deficit on the income balance for 2014 related to direct investment of foreign-owned corporations, but only a portion of this deficit may reduce the income balance over the long run (for further details, see the box). Hungary's net lending is still considered to be outstanding even within the region: In the beginning of 2015, the similar indicator of the Slovakian, Polish and Czech economies was around 1 or 2 per cent of GDP.

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



All charts by the MNB unless otherwise indicated.

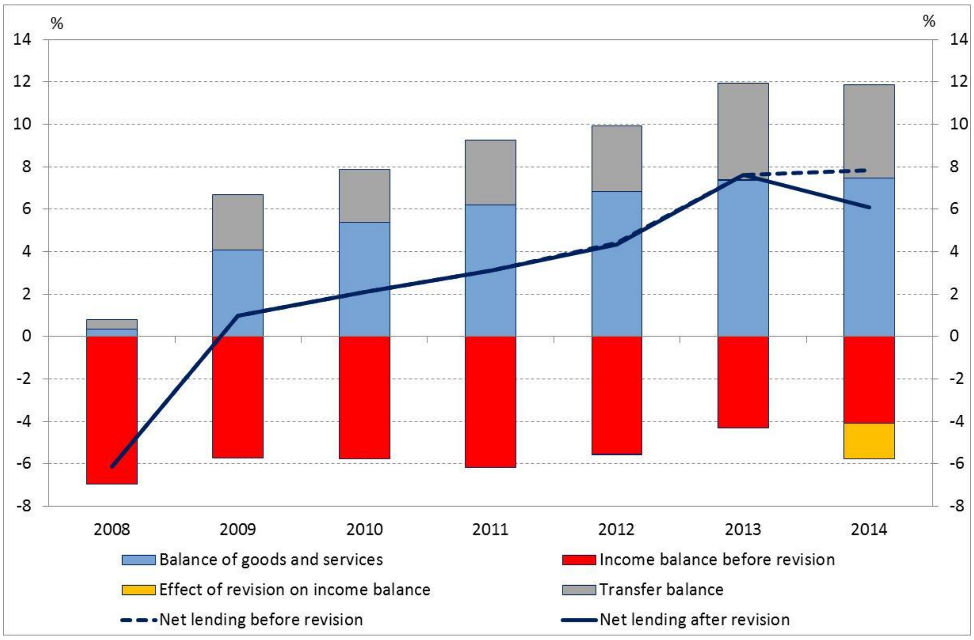
* Income balance: labour income, income on equity and income on debt. Transfer balance: sum of the capital account, other primary income and secondary income.

Box 1: Revision of the balance of payments

In its publication on the balance of payments, the MNB modified the balance of payments figures: as a result, the net lending was lowered by 1.8 per cent of GDP in 2014 in comparison to the figures estimated earlier, while the FDI investment of non-residents shifted upwards by EUR 2 billion. The actual figures on corporate profit are available in the balance of payments and within that in the income balance with a delay of nine months; pending the receipt of actual figures, the relevant figures of the balance of payments are based on estimates. The actual figures of the previous year are included on the basis of the corporate questionnaires received together with the data communication for September of each year. Thus, the profit figures for 2014 first appeared with the publication of balance of payments on 23 September2015. The corporate questionnaires indicate that the profits of foreign-owned corporations increase very dynamically, rising by about 50 per cent in comparison to the previous year (the background of this growth is discussed in detail in the special topic section at the end of the report). The revision fundamentally influences the picture of the external balance position in two ways.

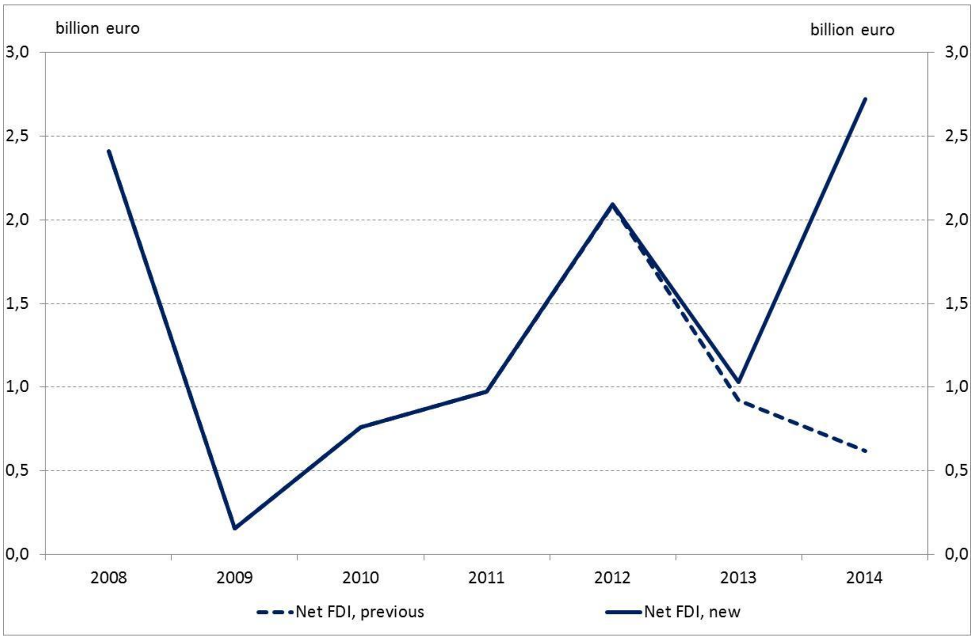
- On the one hand, the deficit on the income balance increased due to the higher profit. As a result of this and other smaller revisions, in 2014 GDP-proportionate net lending calculated in terms of the real economy approach was around 6 per cent instead of the 8 per cent estimated earlier (Chart 2). However, it is also worth noting that net lending significantly increased by 2015 Q2 and has already exceeded 8 per cent due to the rise in the trade surplus and the transfer balance.

Chart 2: Impact of the revision on the income balance and net lending, GDP-proportionate values



- On the other hand, since the dividend figures for 2014 have not changed, the higher corporate profit represents higher reinvested earnings as well. As a result, within FDI, reinvested earnings became higher to a similar degree compared to the previous figures. In the case of total FDI, this means that instead of the earlier EUR 0.6 billion, the inflow amounted EUR 2.7 billion in 2014. (Chart 3). Thus, the outflow of funds last year was lower, i.e. net lending from the financing side shifted downwards in a similar way and to nearly the same extent as in the real economy approach.

Chart 3: Impact of revisions on FDI investments



The revisions in 2015 Q1 significantly affected the balance of goods and the income balance, while the balance of Net errors and omissions decreased. The higher deficit on income balance is the impact of actual data 2014: the profit estimates for 2015 also resulted in upward changes in the previous data communication. Additionally, as a result of other revisions, the amount of the balance of goods also declined. The changes in corporate profits did not affect the NEO of the balance of payments, because a higher reinvested earnings sets off the higher income balance deficit. On the other hand, owing to the balance of goods and the smaller revisions at the financing side, the net lending based on the real economy and financing approach approximated each other.

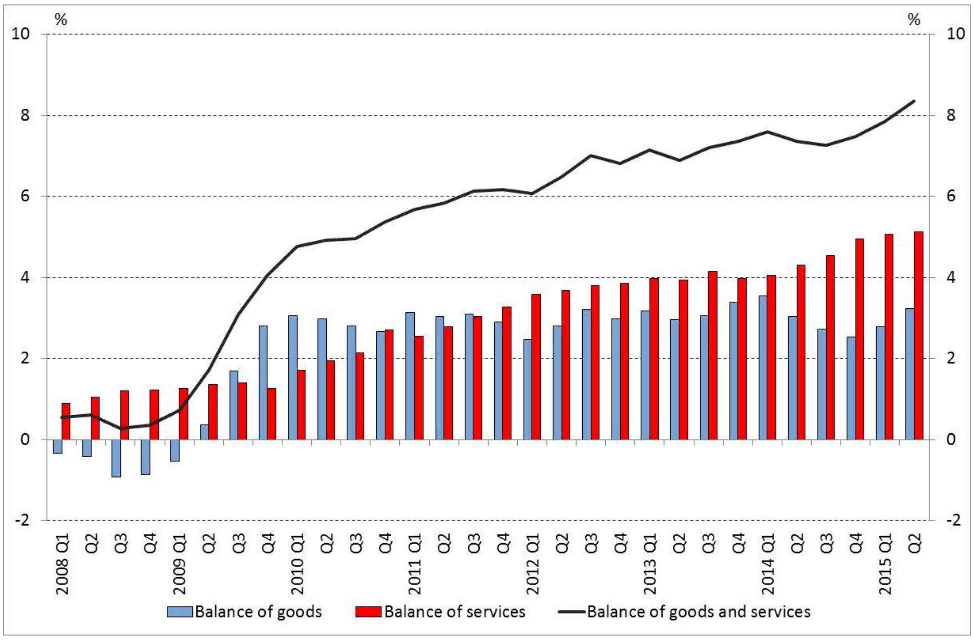
Table 1: Impact of the revisions on the components of net lending (EUR billions)

	2012	2013	2014	2015. Q1.
I.Net lending from real economy's side (1+2+3)	**-0.1**	**0.0**	**-1.8**	**-0.5**
1. Balance of goods and services	-0.1	-0.1	0.0	-0.3
2. Income balance	-0.1	0.0	-1.7	-0.3
3. Tranfer account	0.1	0.1	-0.1	0.0
Capital account	0.0	0.0	0.0	0.0
Current account	***-0.1***	***0.0***	***-1.7***	***-0.5***
II.Net lending from finanacing side -(5+…+8)	**0.0**	**0.0**	**-2.1**	**0.0**
5. Foreign direct investment	0.0	0.1	2.1	0.2
6.Portfolio investment, equity	0.0	0.0	0.0	0.0
7.Financial derivates	0.0	0.0	-0.2	-0.1
8.Net debt	0.0	-0.1	0.2	-0.1
Reserves	0.0	0.0	0.0	0.0
Net errors and Omissions (I.-II.)	***-0.1***	***0.0***	***0.3***	***-0.5***

1.1. Balance of trade

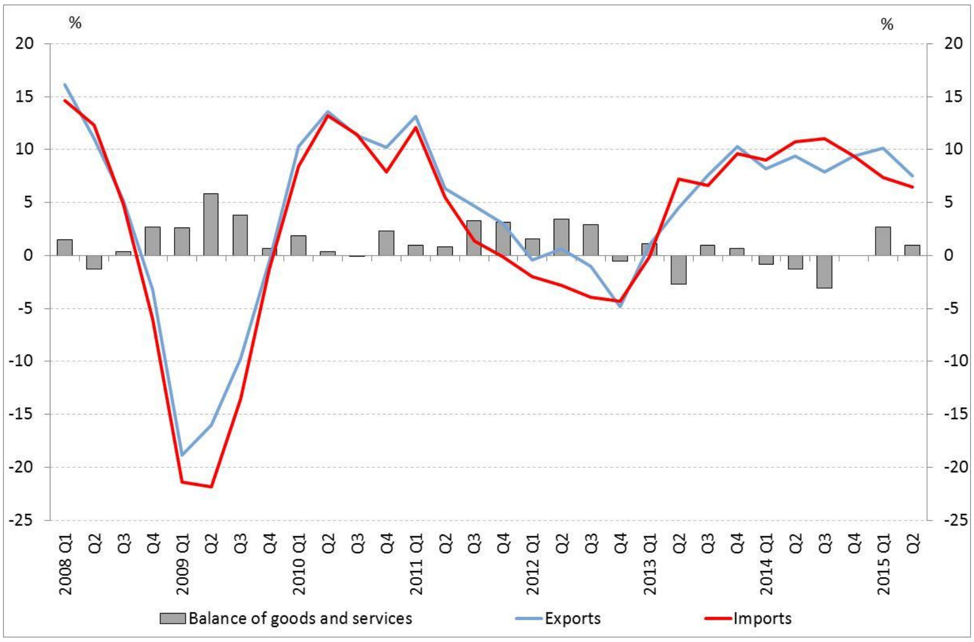
The significant rise in trade surplus occurred due to the continued increase in net exports of goods, while the balance of services was stable at a high level. Reaching a historical high, the four-quarter trade surplus exceeded 8 per cent of GDP. After an increase in the previous quarter, the surplus on the balance of goods continued to expand in Q2 as well, and consequently the four-quarter value exceeded 3 per cent of GDP again. In the past two quarters, the balance of services stabilised at a historical high of around 5 per cent of GDP. Tourism and transport services made outstanding contributions to the surplus on the balance of services, which was very high in international comparison even (the balance of services was discussed in details in special topic of "Report on the Balance of Payments of June 2015").

Chart 4: Developments in the balance of trade and its components (four-quarter values as a percentage of GDP)



In Q2, the growth rate of exports and imports also slowed, but growth in exports continued to exceed growth in imports, resulting in growth in net exports for the four quarters. External demand continued to develop favourably, and in line with this industrial production expanded strongly. Looking at the industrial sectors, the production of vehicles showed outstanding performance, which was also reflected in the increase of export volume. The growth in the volume of imports fell short of real growth in exports in Q2 again, pointing to an increase in net exports. Energy imports continued to fall in Q2, which can be explained by the slower replenishment of gas storage capacities. Import growth slowed, despite the fact that household consumption continued to increase and the volume of investments (which have a stronger relation to imports) has also risen. The declining import growth can be explained by the fact that the volumes of investments by governmental and quasi fiscal sectors which have a lower import content have increased, while the investment activity of corporations manufacturing products for domestic and external markets, which have a higher import content, was subdued.

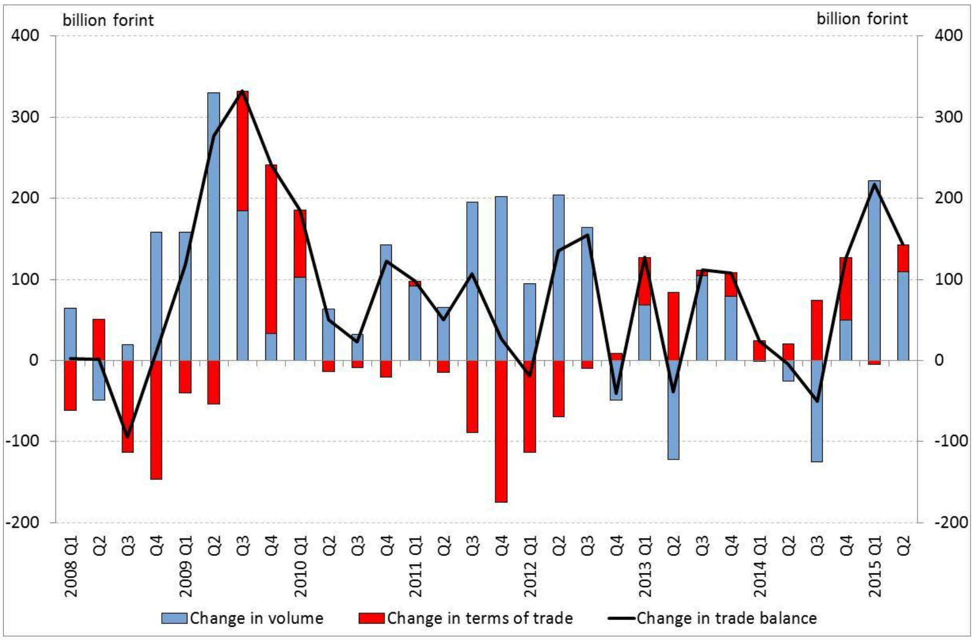
Chart 5: Annual real growth of exports and imports



Source: HCSO, MNB.

The rise in net exports was also supported by the improvement in the terms of trade to a smaller extent. In Q2, in addition to the stagnation in export prices, import prices continued to decrease, which led to an improvement in the terms of trade. The fall in oil prices (and commodity prices in general) may be behind this. Oil and other commodities have a higher weighting within imported products than within exported products, and consequently falling commodity prices lead to an improvement in the foreign trade balance.

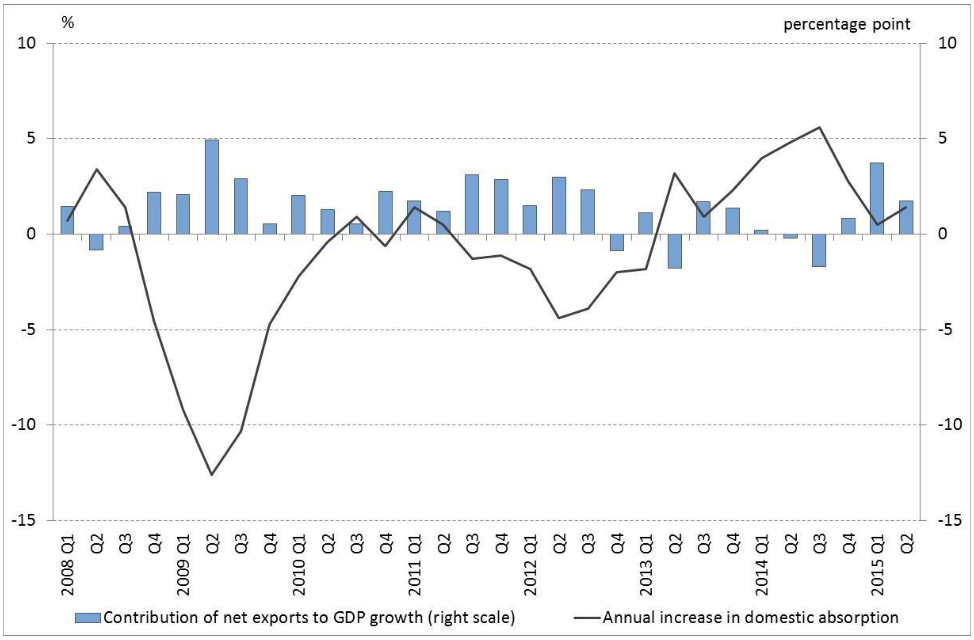
Chart 6: Developments in the balance of trade according to GDP (year-on-year)



Source: HCSO.

In parallel with the acceleration in domestic consumption, the growth contribution of net exports has fallen, but still remained substantial. Household consumption continued to rise in Q2, while investments expanded at a higher rate again. As a result, net exports' contribution to economic growth declined somewhat in comparison to the previous quarter. Nevertheless, net exports contributed nearly 2 percentage points to the GDP growth of 2.7 per cent and this contribution can still be considered very high.

Chart 7: Annual rate of increase in domestic absorption and the contribution of net exports to GDP growth



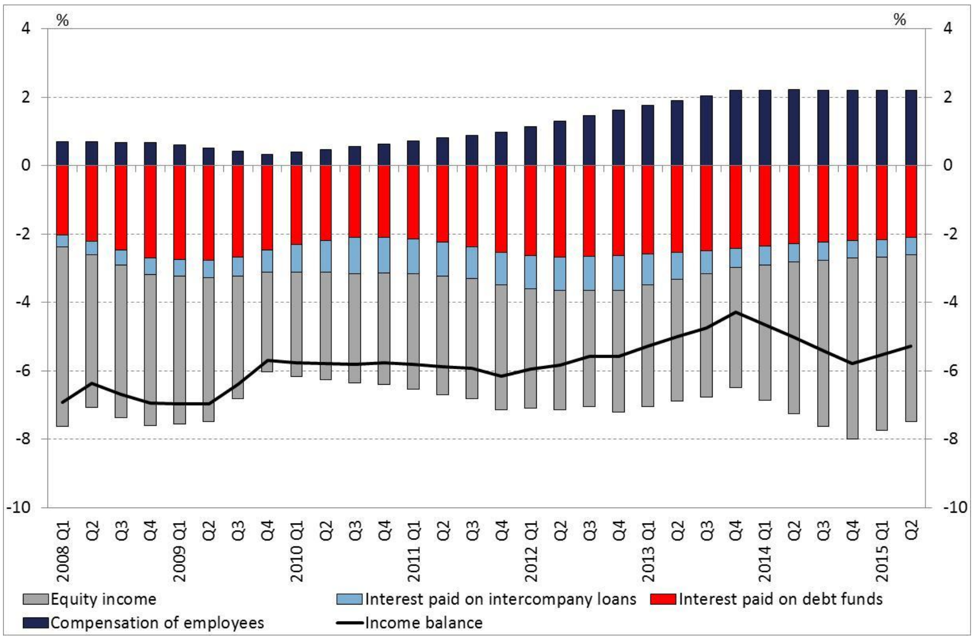
Source: HCSO.

1.2. Income balance

Following a significant increase in 2014, the deficit on the income balance may have declined slightly in the past quarters. In Q2, interest payments on foreign loans and the (estimated) development of income on equity also lowered the deficit on the income balance, and thus the four-quarter value of the deficit fell to 5.3 per cent of GDP. As a result of revision of the profits of foreign-owned corporations, income on equity showed strong growth in 2014 (for further details on the revision see the special topic). Currently, only estimates are available for the profit rate of 2015:[1] because a portion of last year's growth was likely based on non-recurrent factors or can be considered transitional, the GDP-proportionate net profit expenditures may decrease slightly in 2015. The gradual decline in the interest balance of foreign loan continued in Q2 as well, which can be attributed to the fall in external debt and repricing of the loans. Compensation of employees improved the income balance by the earlier rate of 2.2 per cent of GDP, and thus according to the data available, the GDP-proportionate value of income received by persons who have worked abroad for a shorter period than one year has not changed for about one and a half year.

[1] Quarterly data on the profitability of foreign-owned corporations operating in Hungary is limited, and therefore information on quarterly outflow of profits is based mostly on estimates. For more details, see the statistics publication entitled 'Hungary's Balance of Payments and international investment position statistics, 2012 on the website of MNB'. 2015 corporate profit estimates will be replaced by actual data from corporate annual financial statements to be disclosed in September 2016.

Chart 8: Developments in the items of the income balance* (four-quarter values as a percentage of GDP)

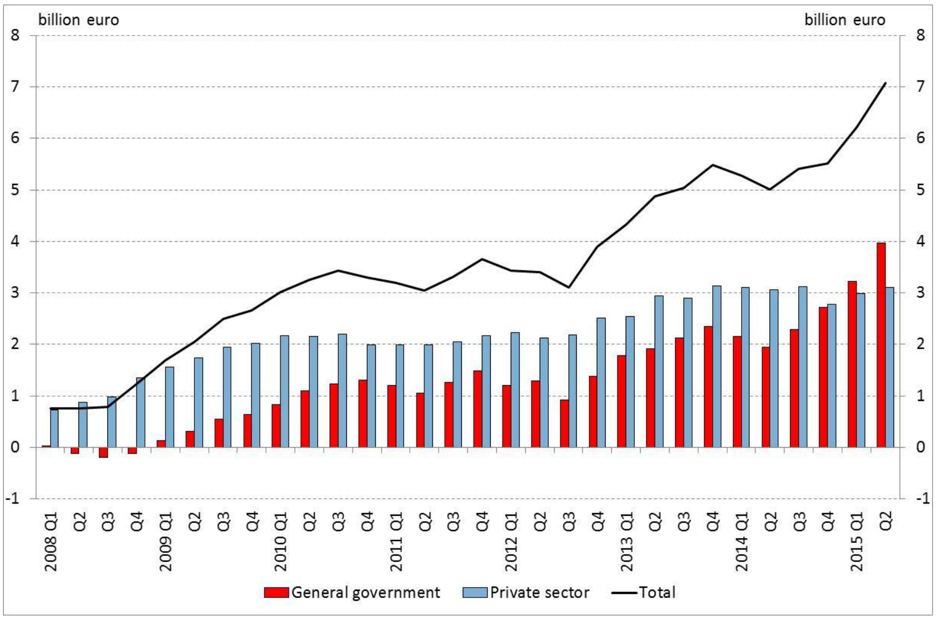


*Income balance: labour income, income on equity and income on debt.

1.3. EU transfers

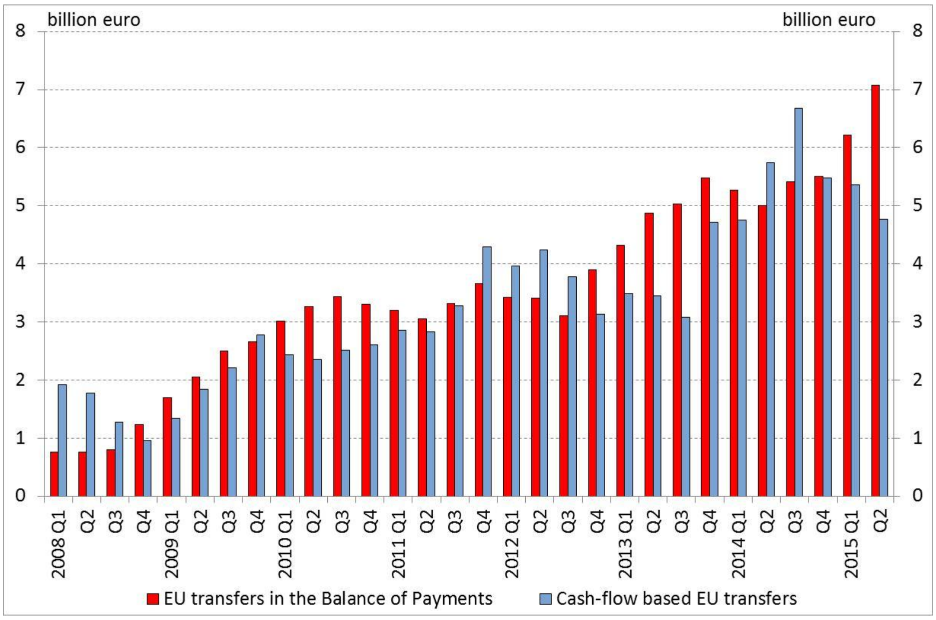
The balance-improving effect of EU transfers continued to rise dynamically, in addition to increasing utilisation by the state. In 2015 Q2, EU transfers amounting to EUR 1.9 billion were utilised, marking a significant rise compared to the same period of the previous year. As a result, the four-quarter value of EU transfers accounted for in the balance of payments has already exceeded EUR 7 billion, i.e. the transfer balance continues to significantly support the net lending of the Hungarian economy. In terms of the distribution of transfers by sectors, there was a change: until 2014 it was typical that primarily the private sector received the EU funds, but in the past quarters the volume of governmental EU transfers increased at a very high rate, as a result of which the state utilised significantly more EU funds than the private sector. Capital transfers typically financing investments and infrastructure developments accounted for the highest share within transfers: three fourth of the funds coming to Hungary in the second quarter, i.e. about EUR 1.4 billion comprised this kind of transfer. The above-mentioned two processes, investment-purpose transfers primarily utilised by the state, may have been reflected in the Q2 investment statistics as well, according to which the performance of government investments and that of quasi-fiscal sectors increased substantially.

Chart 9: Sectoral distribution of net EU transfers (four-quarter values)



The value of EU transfers paid by the state (utilisation of balance of payments transfer, accrual-based data) increasingly exceeds the amounts transferred by the EU to Hungary (cash-based data). The trend characterising the past period continued in Q2 as well: the four-quarter value of subsidies utilised, in other words actually received by the operators, continued to increase, while the annual value of funds transferred by the EU to Hungary continued to decrease. EU transfers (nearly EUR 1.2 billion in Q2) continued to remain behind utilisation by the sectors (EUR 1.9 billion), the difference is represented by the governmental re-financing. This may be explained by the fact that, despite delays in the assessment and payment of EU funds, the state pays the claimed amounts still before they are transferred by the European Commission to Hungary. This pre-financing also increases the cash deficit of the budget, however it is without prejudice to the accrual-based ESA deficit. On the other hand, in the case of some programmes, in smaller part the achievement of 95 per cent of the limit may also cause the difference between both indicators, which amount is paid by the European Commission to the Member States only after the closing of the programmes and the period.

Chart 10: EU transfers according to the accrual-based and the cash-based approach (four-quarter values)

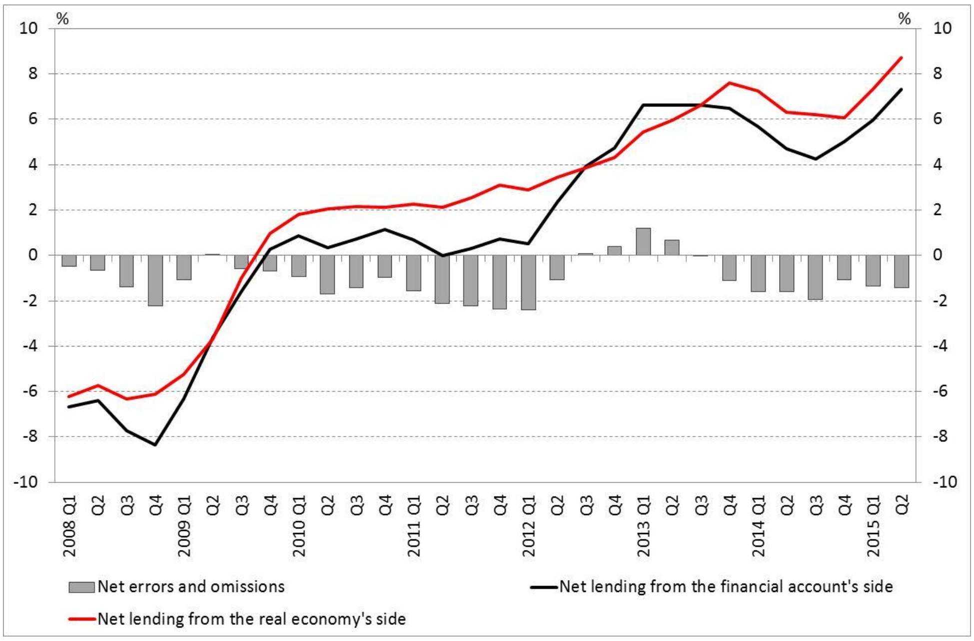


2. FINANCING APPROACH

The financing data also indicate rising net lending, but its level is lower than that obtained using the real economy approach. Q2 was characterised by a decrease in the non-debt liabilities (due to the acquisition of Budapest Bank and payment of dividends) and by the continued repayment of external debt. At the same time, it is also worth noting that the data revision considerably increased the FDI inflow in 2014 by about EUR 2 billion; a portion of the higher reinvested income from profits may also increase the amount of FDI funds coming to Hungary. As a result of continued sales of government securities by non-residents, the gross external debt of the state continued to decline, the market effect of which was counterbalanced by the purchase of government securities by banks. The reduction in the net external debt of the state was, however, slowed by the fact that FX reserves also fell, due to sale of foreign currencies in relation to the conversion into forint and the acquisition by the state.

According to the financing approach, the four-quarter net lending rose to around 7.3 per cent of GDP in Q2, falling behind the value calculated from the side of the real economy.[2] Net lending calculated on the basis of real economy data exceeds the figure calculated from the financing side, which means that the decline in the economy's external debt indicators was smaller than it would have been based on the data of real economy. On the other hand, this correlation was typical in the past as well and it can be said in general about Hungarian net lending. The difference between the two approaches has essentially not changed and continues to amount to 1.4 per cent of GDP.

Chart 11: Two types of external financing and "Net errors and omissions" (four-quarterly data as a percentage of GDP)



The seasonally unadjusted outflow of funds rose in Q2, which occurred in conjunction with a decrease in external debt (loans and bonds) and non-debt liabilities. In Q2, net lending calculated according to the financing approach rose to EUR 2.5 billion, and consequently external debt fell to a larger degree than in the previous quarter (Chart 12). To a similar degree, the higher outflow of funds related to the non-debt liabilities and debt liabilities, while derivative items slightly reduced net lending. The declining value of government securities held by non-residents also contributed to the reduction in external debt (which was counterbalanced by the expanding demand of banks and households due to the MNB's self-financing programme on the government security market). Within non-debt liabilities, the decline in direct capital investments fell behind the value for the same period of the previous year.

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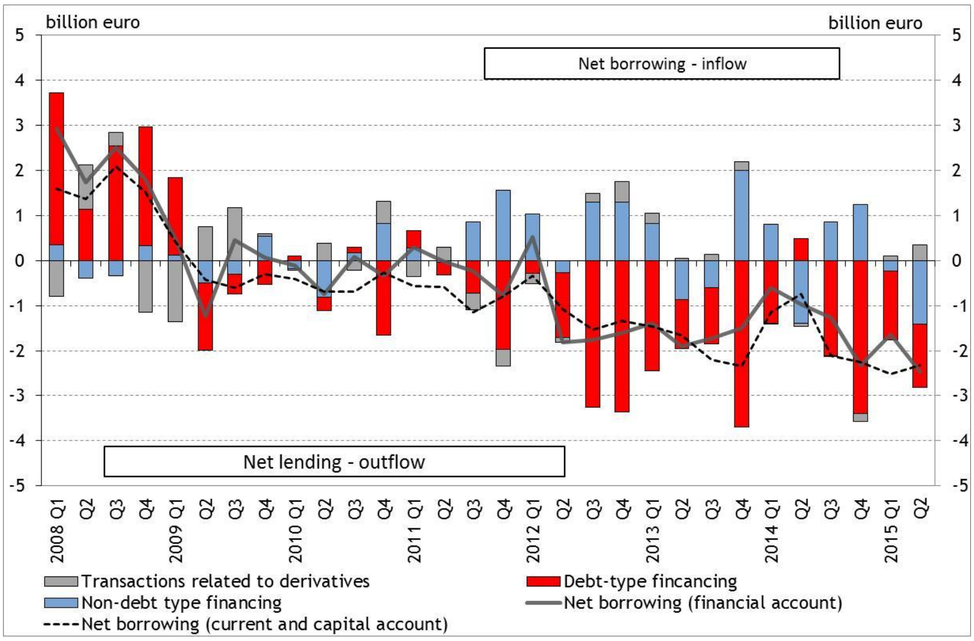
[2] Trends in the balance of payments can also be analysed by examining the financing of real economy transactions. Indeed, the financial account shows what types of transactions were used by resident economic agents to finance transactions in the real economy that had an effect on net financial worth.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

Chart 12: Developments in the structure of external financing (unadjusted transactions)



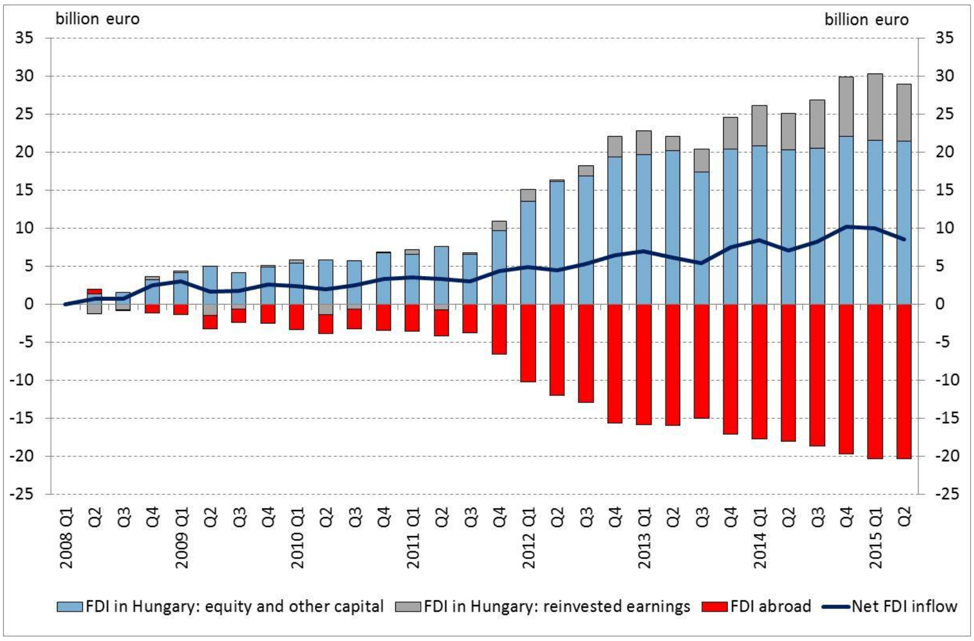
2.1. Non-debt type liabilities

In 2015 Q2, net foreign direct investments contracted by about EUR 1.4 billion as a result of a decrease in the volume of reinvestments due to seasonal effects and a decline in equity investments due to one-off effects. In Q2, net foreign direct investments in Hungary decreased considerably, which was essentially caused by both one-off and seasonal effects (Chart 13).

- The acquisition of Budapest Bank by the state also played a role in the decline in capital investments, which reduced net foreign investments in Hungary by about EUR 600 million.
- Corporations typically vote in Q2 the amount of dividends to be paid to their shareholders, which results in a reduction of reinvested income in the case of foreign-owned corporations. As an effect thereof, reinvested incomes of non-residents declined by EUR 1.2 billion in 2015 Q2.
- On the other hand, loans received by foreign-owned corporations from their parent companies boosted capital investments by non-residents by nearly EUR 1.2 billion, resulting in an increase in FDI.

It is worth noting that, as a whole, disregarding the one-off effects, the decline in net direct investments in Q2 was smaller than the value observed one year earlier.

Chart 13: Developments in direct investment (cumulative transactions)

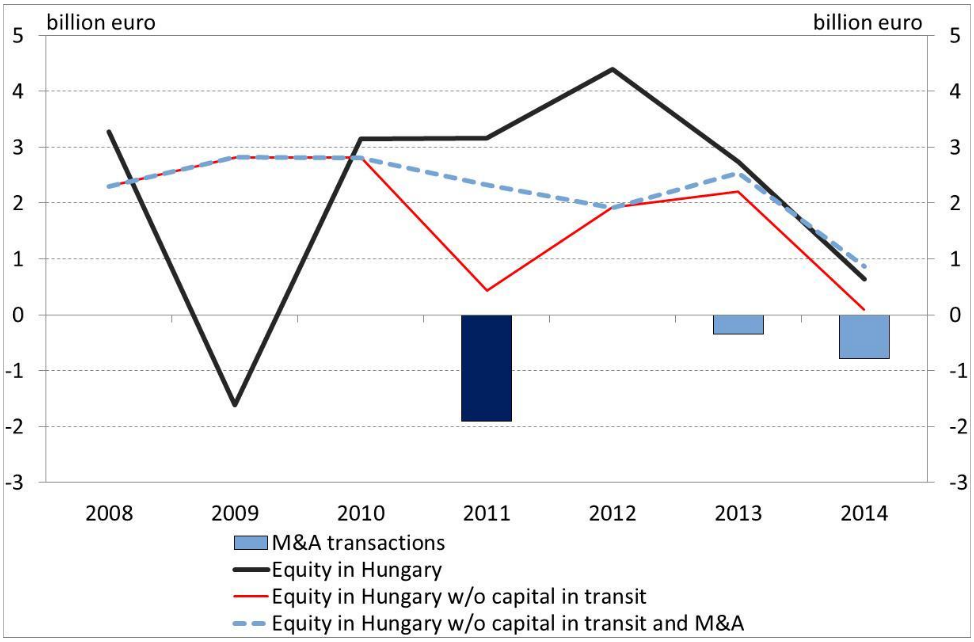


Box 2: Separation of M&A transactions within foreign direct investments

Simultaneously with the publication of the balance of payment figures, cross-border mergers and acquisitions (hereinafter referred to as M&A) have been separated within foreign direct investments. In addition to the distinction between the so-called "capital in transit" already indicated separately from 2008, the separation of M&A is reasonable because the FDI category mostly connected to investments and capacity expansion can be distinguished by filtering out M&A. Transactions belonging to the category of M&A are related to changes in ownership. However, only the financing structure is altered by the change in ownership, but no additional funds are provided to the corporation. If these transaction types are filtered out of the data in addition to capital in transit, we can obtain a better picture of FDI inflows related to greenfield investments and capital increases. Statistics has been publishing the M&A breakdown within the transactions filtered from capital since 2013.

The effect of M&A transactions is more significant in Hungary in the case of domestic investments and their filtering out results in a higher FDI share. The capital in transit (for example borrowing of loans in a foreign country which is re-lent by the relevant company to a foreign country) distorts the FDI share transactions upwards, and consequently filtering these out results in lower transactions (we move from the black line to the red line on Chart 14 in this way). On the other hand, filtering out M&A transactions, i.e. ownership changes, may result in a higher FDI inflow than that (relation of the dashed blue line to the red line). Within domestic FDI shares, EUR 350 million was attributed to ownership changes in 2013 and nearly EUR 800 million in 2014. Acquisitions by the state also contributed to this: the acquisition of the gas business of E.ON took place in 2013 and that of Antenna Hungária and Fővárosi Gázművek in 2014. Even though no comprehensive data are available regarding 2011 the increase in the participation of the state in MOL reduced the FDI shares substantially, by nearly EUR 2 billion.

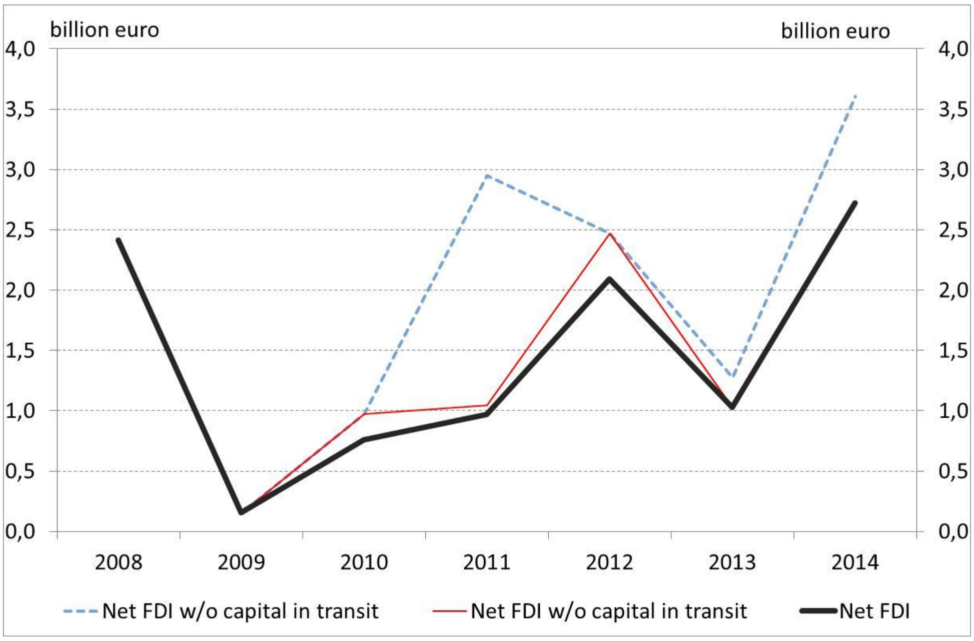
Chart 14: Adjustment of the domestic FDI share transactions by the capital in transit and the impact of M&A



Note: The filtering out of acquisition of MOL by the state in 2011 is an own adjustment.

Following the filtering out of capital in transit and M&A transactions, a more favourable picture of the FDI processes emerges. The capital in transit affects the total net FDI data (i.e. transactions including equities, reinvestment of earnings and the intercompany loans), to a smaller extent, because it's either a flow between the domestic and foreign investments, or a flow from equity to intercompany loans. Thus, adjusted net FDI may actually differ from the original, unadjusted data by the effect of ownership changes. As described earlier, the impact of the adjustment was substantial in 2011 and 2014, and thus in these years net FDI is essentially EUR 1 billion higher if one considers the FDI reducing effect of ownership changes.

Chart 15: Adjustment of total FDI for the impact of capital in transit and M&A

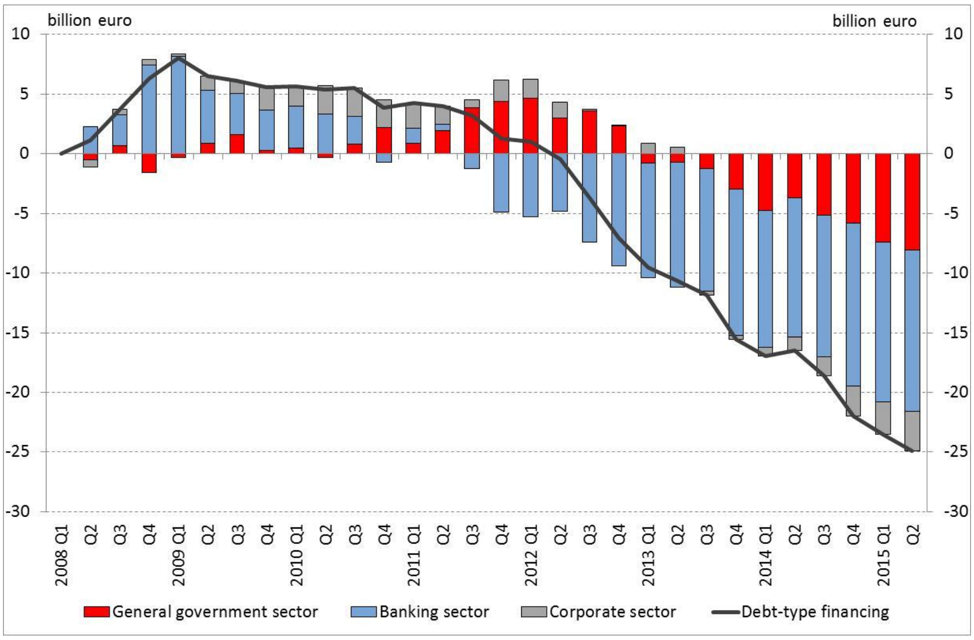


Note: The filtering out of acquisition of MOL by the state in 2011 is an own adjustment.

2.2. Debt funds

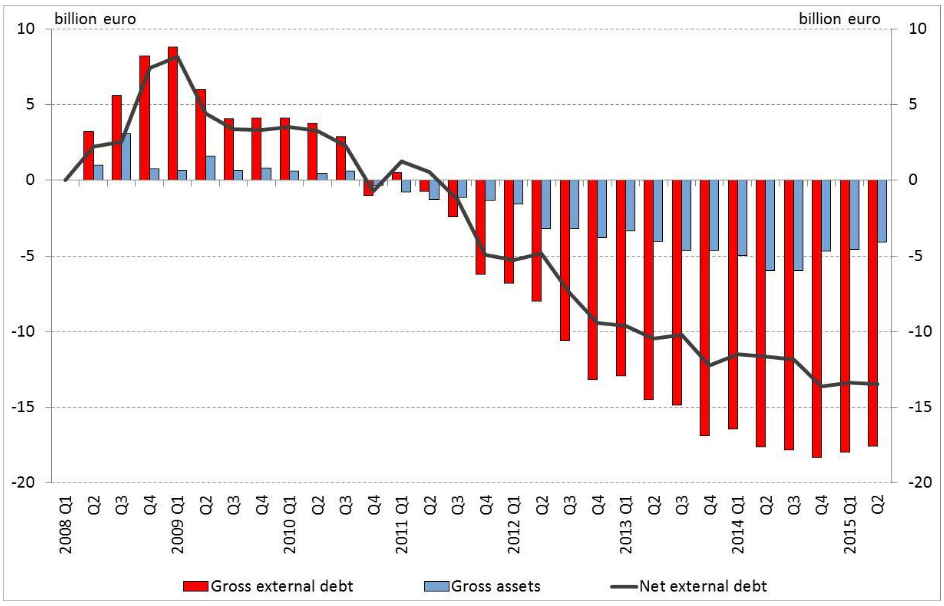
The repayment of debt liabilities also continued in Q2, with the corporate sector playing the largest role, in addition to the general government. Deleveraging by economic agents continued, as a result of which the external, debt-type liabilities of the economy decreased by about EUR 1.4 billion in Q2. Every sector participated in the reduction of net external debt, but the largest repayment was carried out by the state. The reduction of consolidated state debt amounted to about EUR 0.7 billion, while corporations reduced their debt by EUR 0.6 billion. As regards the outflow of state funds, the declining amount of government securities held by non-residents is worth mentioning, with the MNB's self-financing programme also possibly playing a role in this (Chart 16 shows the cumulated data, with the size of columns illustrating the changes in net external debt of the relevant sector).

Chart 16: Developments in net debt-type financing per sector (cumulative transactions)



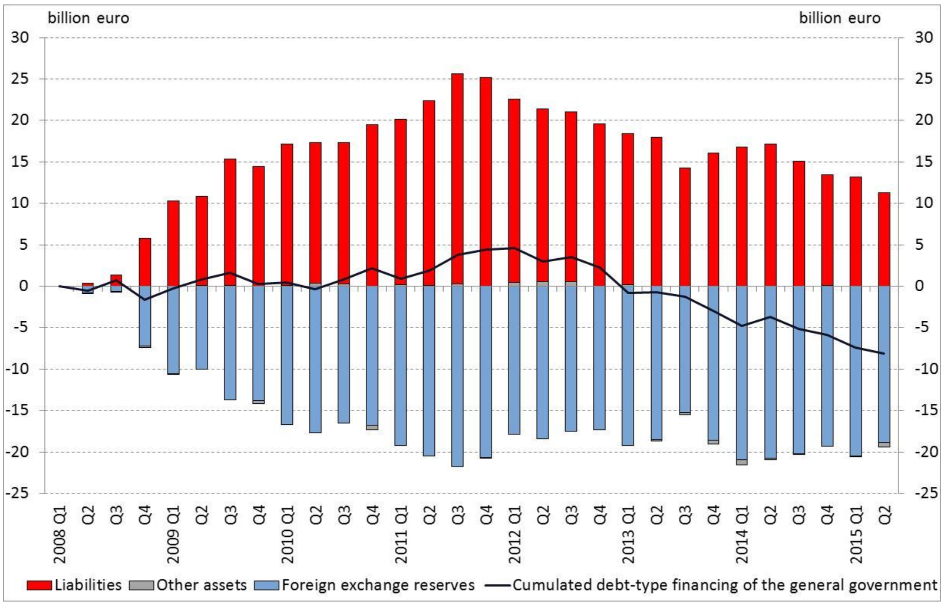
The net external debt of the banking sector dropped slightly, by about EUR 100 million, with a smaller increase in external debt and a larger increase in receivables from non-residents. The decline in the net external debt of the banking system developed in the manner that the gross external debt of the banking system rose at a lower rate, by about EUR 400 million, which did not appear for all agents: the external debt of some agents increased, while other agents repaid their foreign liabilities. Lending and parent bank financing processes may have also contributed to borrowing by banks which increased their external debt. It is worth noting that Q2 was the first time since 2010 when the gross external debt of the banking system rose not only during the adjustment following balance sheet optimisation at year-end. The increase of debt developed with a rise of about EUR 500 million of foreign receivables; within this, it was primarily the amount of short-term foreign deposits which rose.

Chart 17: Developments in the banking sector's gross external debt and asset transactions (cumulative transactions)



The net external debt of the state consolidated with the MNB decreased by EUR 0.7 billion; in this regard, the largest role was played by the volume of government securities held by non-residents, which declined by more than EUR 2 billion (Chart 18). The value of government securities held by non-residents fell substantially, declining by more than EUR 2 billion during the quarter. However, its impact was counterbalanced by the purchases of domestic agents on the government securities market: as a partial result of the self-financing programme, banks increased their government security portfolio by about EUR 1.6 billion. In addition to the declining gross external debt of the state, foreign currency reserves fell by EUR 1.6 billion (as a result of transactions), which partly due to the need for foreign currency due to acquisition of Budapest Bank by the state and partly because of foreign currency provided to the banks for the conversion of FX loans to forint. The acquisition of Budapest Bank by the state did not impact net lending, but did influence the structure of the outflow of funds. As a result of this, the decline in the state's net external debt became more moderate, while the direct capital outflow became higher. The rise in other receivables lowered the net external debt of general government by a further EUR 0.3 billion, which was related to the accrual-based settlements of receivables from the EU created for EU subsidies pre-financed by the state.

Chart 18: Breakdown of net external debt of the general government consolidated with the MNB (cumulative transactions)



3. DEVELOPMENT OF STOCK INDICATORS

In Q2, the external debt indicators of the Hungarian economy declined considerably: net external debt fell to nearly 31 per cent of GDP and gross external debt approximated 85 per cent of GDP. The decline of more than 2 percentage points in net external debt can mainly be ascribed to the continued outflow of funds as well as to revaluation due to increasing yields. On the other hand, Hungary's gross external debt only declined at a slower rate: despite the fact that the gross outflow of funds was higher due to the declining stock of government securities held by non-residents, revaluation effects curbed the adjustment of indicators. Short-term external debt based on residual maturity amounted to EUR 23.8 billion at the end of 2015 Q2, and its rise was primarily caused by the more significant increase in the shortening debt of the government sector and the borrowing of short-term funds by the banking sector. Primarily as a result of foreign currency withdrawal related to the conversion into forint, foreign currency reserves decreased below EUR 35 billion. Thus, reserve adequacy deteriorated as a whole, but these changes did not cause any surprises, and the level of foreign currency reserves continues to substantially exceed the level expected by investors.

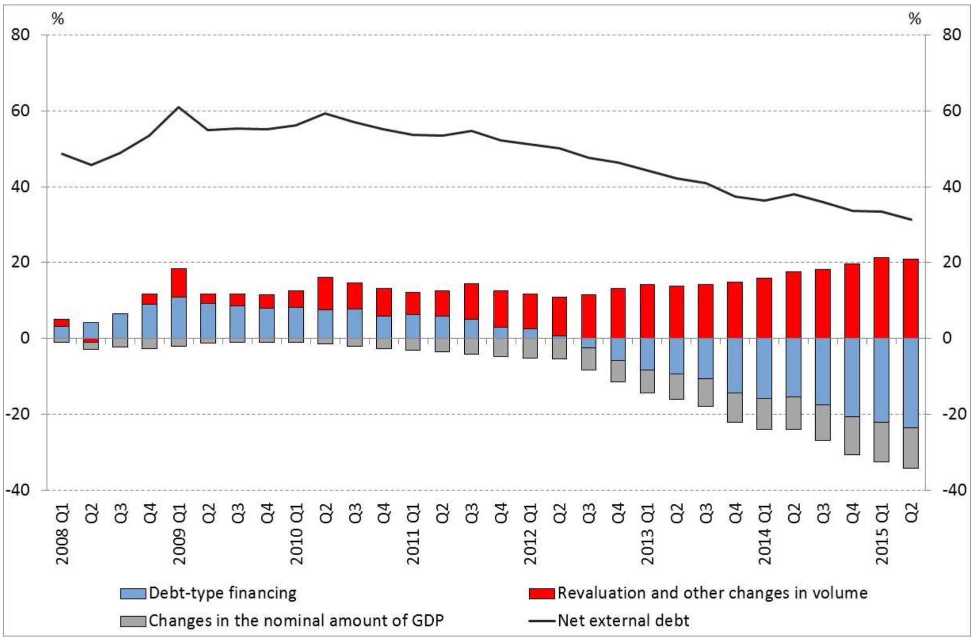
3.1. Developments in debt ratios

Owing to the continued outflow of funds, Hungary's net external debt fell again in 2015 Q2. All major components contributed to the reduction in the debt indicator calculated without intercompany loans:[3] in addition to the declining in debt-type liabilities, both the increase in GDP and revaluation effects drove the decline in the indicator. On the other hand, the revaluation effect developed from mutually opposing processes: while the devaluation of the forint against the US dollar resulted in a slight increase in net external debt (due to FX reserves, the EUR/HUF exchange rate only slightly influenced net external debt), the repricing of government securities more than counterbalanced this effect. On the whole, revaluation effects reduced the indicator. The main factor in this regard was that, in parallel with mildly rising yields on the government security market, the market value of government securities held by non-residents decreased.[4] In addition to the revaluation effects, the outflow of external debt-type liabilities also mitigated net external debt (see Chapter on the Financing Approach). GDP growth also lowered the external debt ratio.

[3] Based on economic considerations, it makes sense to adjust the debt indicators for ownership loans; for further details, see Box 3 in the Report on the Balance of Payments of April 2015.

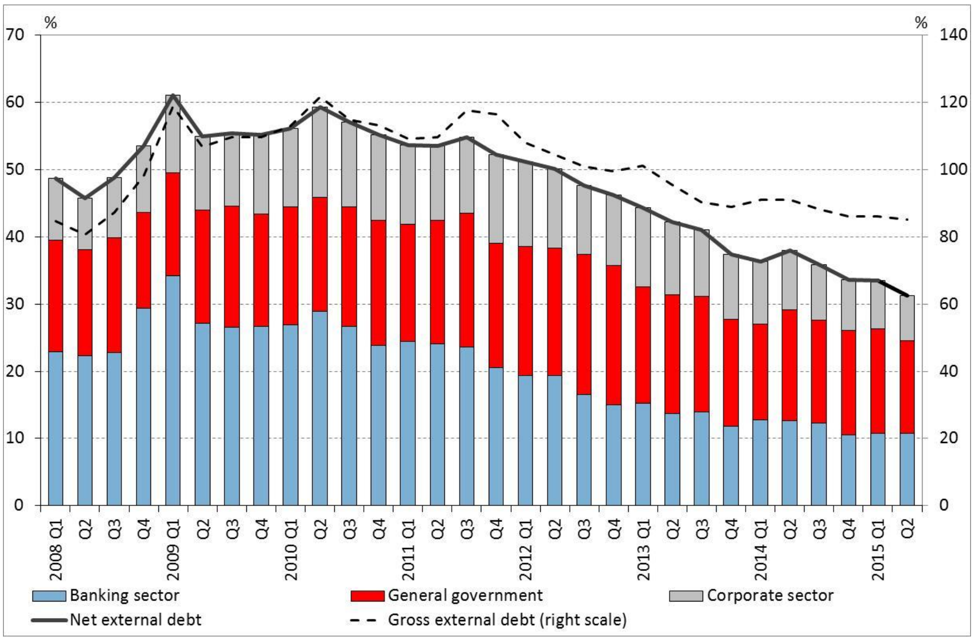
[4] Since balance of payments statistics present government security holdings at market rate, their value may be affected significantly by shifts in yields. By contrast, the Government Debt Management Agency recognises the government bond holdings of non-residents at face value.

Chart 19: Components of changes in net external debt* (cumulated, GDP-proportionate values, end-2005 = 0)



In Q2, net external debt continued to fall, declining to 31.2 per cent of GDP, which is mainly attributable to the higher decrease in the net external debt of the consolidated general government. The net external debt of the consolidated general government dropped by nearly 2 per cent of GDP in Q2, which can also be explained with the yield change and the depreciation of the US dollar against the euro, in addition to the decline in the stock of government securities held by non-residents. At the same time, the decline in the net external debt of the consolidated general government was slowed by the fact that in this period the central bank's FX reserves fell due to the need for foreign currency for the conversion of FX loans into forint and the acquisition of Budapest Bank by the state. In addition, the decline in the debt of the corporate sector also contributed to the decrease in net external debt. On the other hand, the GDP-proportionate net external debt of the banking system did not change significantly: although transactions lowered the correction of the indicators, the revaluation slowed this down.

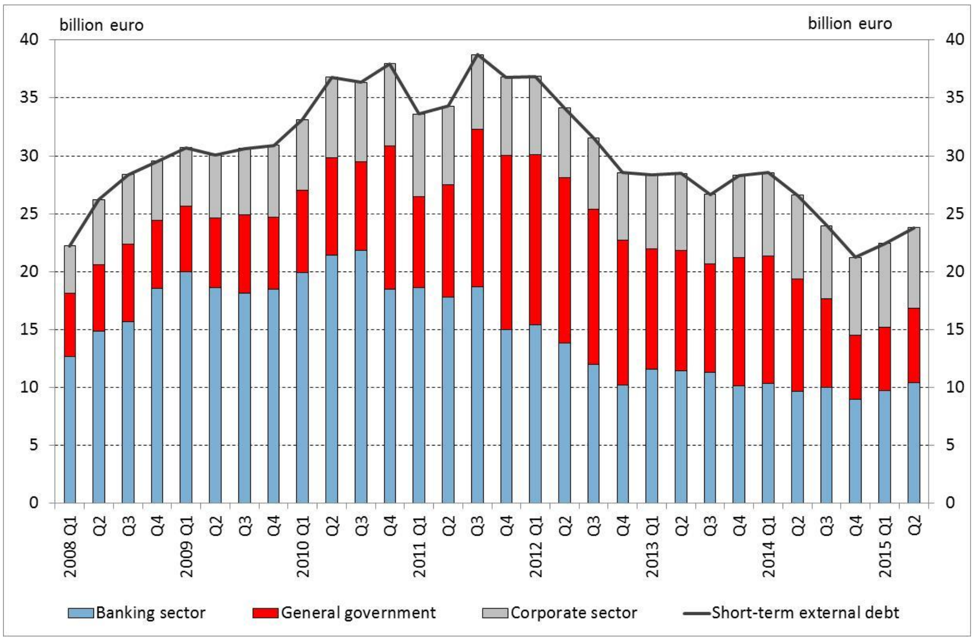
Chart 20: Net external debt in a sectoral breakdown and gross external debt (as a percentage of GDP, excluding intercompany loans)



Gross external debt continued to fall in Q2 and amounted to around 85 per cent of GDP at the end of the period. During the quarter, gross external debt declined, which is attributable to the outflow of the debt-type liabilities of the general government, i.e. the decrease in government securities held by non-residents. On the other hand, the decline in the external debt of the general government was slightly hampered by the rise in the gross debt of the banking sector and the corporate sector, due to the weakening of the forint. As a result of these processes, the ratio of gross external debt to GDP decreased at a smaller rate than in the case of net external debt.

The short-term external debt of the economy on the basis of residual maturity rose by EUR 1.4 billion to EUR 23.8 billion in Q2, which is primarily attributable to the rise, expected earlier as well, in the shortened debt of general government, but borrowing by banks also contributed to this. The short-term external debt of the general government increased by nearly EUR 0.9 billion as compared to the end of Q1, with a rise in the shorter-term debt and a fall in debt based on original maturity. The increase in the short-term external debt of the general government is attributable to the rise in the amortised debt, which is mainly related to the EU loan becoming due in April 2016. It is important to add that the sale of bonds by foreign agents may have lowered the amortising debt stock of the state, and consequently the amortising debt of the general government may reach its peak at a lower level than previously expected. The short-term external debt of the general government according to original maturity fell by about EUR 0.5 billion, with a decrease in margin stock and sales of discount treasury bills by non-residents. The short-term extremal debt of the banking sector rose by EUR 0.7 billion, which primarily related to the borrowing of short-term funds by the bank sector. At the same time, the short external debt of the corporate sector slightly mitigated in Q2.

Chart 21: Developments in gross short-term external debt based on residual maturity



3.2. Development of reserve adequacy

Primarily due to the use of swap instruments related to the conversion of mortgage loans into forint, the stock of FX reserves decreased in 2015 Q2. At the end of Q2 2015, international reserves amounted to EUR 34.8 billion, representing a EUR 2.1 billion decline as compared to EUR 36.9 billion at the end of March 2015. The expiry and termination of central bank FX swaps connected to the conversion of mortgage loans into forint played a the main role in the decline in FX reserves.[5] The MNB allowed the partial and later the full termination of FX swaps related to FX tenders prior to expiry. The banks had the opportunity to close the unconditional FX swaps expiring at the latest

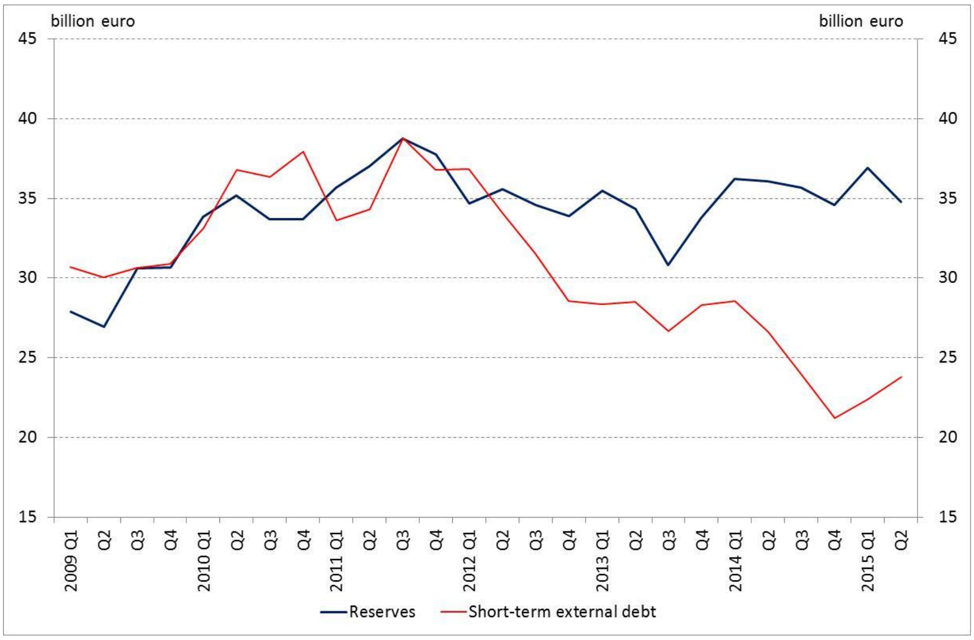
[5] Related to the conversion of mortgage loans into forint, credit institutions roll over the FX liquidity required for the termination of exchange rate position, made availably by the MNB to them by FX swap and CIRS instruments. The swap instruments expire continuously and gradually until the end of 2017, or become terminable in the framework of a separate termination tender, extending the settlement to the charge of the FX reserve to this period.

in March 2016 earlier, in April 2015 in a maximum amount of 20 per cent of the value of foreign currencies bought on settlement and forint conversion tenders. From June, the MNB held further termination tenders, at which the unconditional swaps could already be terminated prior to expiry without any restrictions. Overall, in Q2 the terminated unconditional swaps had a reserve-reducing effect in the amount of about EUR 0.6 billion and the swap expiries in the amount of nearly EUR 1.4 billion. The FX liquidity granted to the state for the acquisition of Budapest Bank and the revaluation of FX reserves represented a further item reducing the reserves, which was partly offset by the effect of inflows of EU funds, which increased reserves.

In addition to the decline in FX reserves, short-term external debt rose, resulting in a contraction of surplus FX reserves compared to short-term external debt. In the context of declining FX reserves, the stock of short-term external debt rose by EUR 1.4 billion: on the whole, this resulted in a narrowing of the gap between short-term external debt and FX reserves. On the other hand, both the change in FX reserves and short-term external debt could be expected according to earlier information, and consequently there was no surprise in relation to reserve adequacy. The rise in short-term external debt was caused by items attributable to the shortening debt of the general government and the borrowing of funds by certain financial institutions.

The amount of foreign exchange reserves still significantly exceeds the level expected by investors. On the basis of Guidotti-Greenspan rule which is closely monitored by both investors and the central bank, FX reserves substantially exceed the stock of short-term external liabilities in 2015 Q2 as well. It must be emphasised that the FX swap instruments related to the conversion into forint will cause reserves to decline by EUR 7 billion by the end of 2017, which will appear in the reduction of short-term debt stock through the adjustment by credit institutions. Furthermore, one of the major factors influencing reserves is EU transfers, and the balance of these EU transfers will most likely continue to be positive, which will have the consequence of boosting FX reserves, but – assuming utilisation thereof in Hungary – this does not affect the stock of debt, and the result of the two process improves the reserve adequacy ratios, which are based on short-term external debt.

Chart 22: Short-term external debt and the stock of foreign exchange reserves of the Hungarian economy

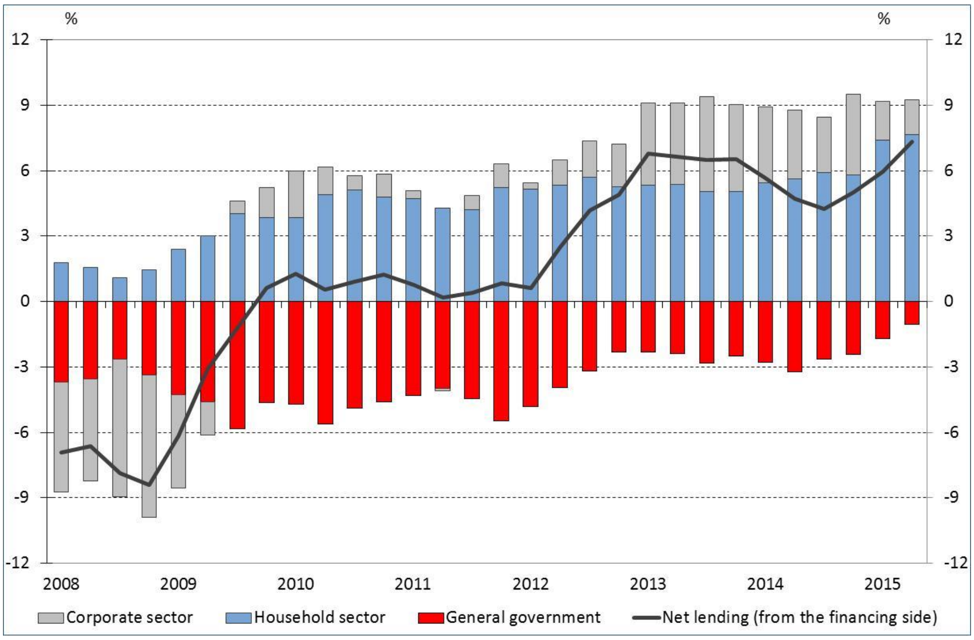


4. SECTORS' SAVINGS APPROACH

The economy's net lending continued to increase in 2015 Q2, due to decreasing net borrowing of the general government, while the settlement of FX loans restructured the savings positions of households and companies. In addition to higher tax revenues, the decreasing net borrowing of the state is attributable to the decline in interest expenditures, while the pre-financing due to EU transfers mentioned earlier do not influence the accrual-based deficit. The net lending of private sector did not change substantially, but the distribution between sectors changed: the decrease in net lending by financial enterprises and the increase in net savings by households stems from the settlement of foreign currency loans. The net lending of households is high even after filtering out one-off effects. In Q2, in respect of households' financial assets, the expansion of holdings of government securities was the most significant, while holdings of mutual fund shares, which were popular earlier, stagnated. Based on monthly figures, purchases of government securities by households were also considerable in July to August, which allowed for a further reduction of the external debt of the state.

In 2015 Q2, the four-quarter net savings of the economy rose to 7.3 per cent of GDP, due to the historically low net borrowing of the general government (Chart 23). The four-quarter net borrowing of the general government amounted to only 1 per cent of GDP in Q2, which is a historically low value. On the revenue side, this may be due, *inter alia*, to the increasing tax revenues caused by the rise in wages and employment as well as to the VAT revenues that increased due to the reduction of the shadow economy. On expenditure side, the gradually declining interest expenditures of the state deserve mention, and the impact of this may continue to increase due to the gradual repricing of the stock. On the other hand, the net lending of private sector has not changed substantially, while, due to the settlements, the net savings of households continued to increase, the net savings of financial enterprises temporarily[6] fell, due to the losses.

Chart 23: Net lending of specific sectors (four-quarter values as a percentage of GDP)



According to the underlying developments, the financial savings of households may have changed by around 5 per cent of GDP, but the assessment of the underlying developments is rendered difficult by the lack of exact knowledge about the processes relating to the settlements. The high net savings of households according to the underlying developments is caused by increasing precautionary savings after the crisis, the gradually expanding employment and rising real incomes in recent years as well as by the continued pent-up loan demand. In line with

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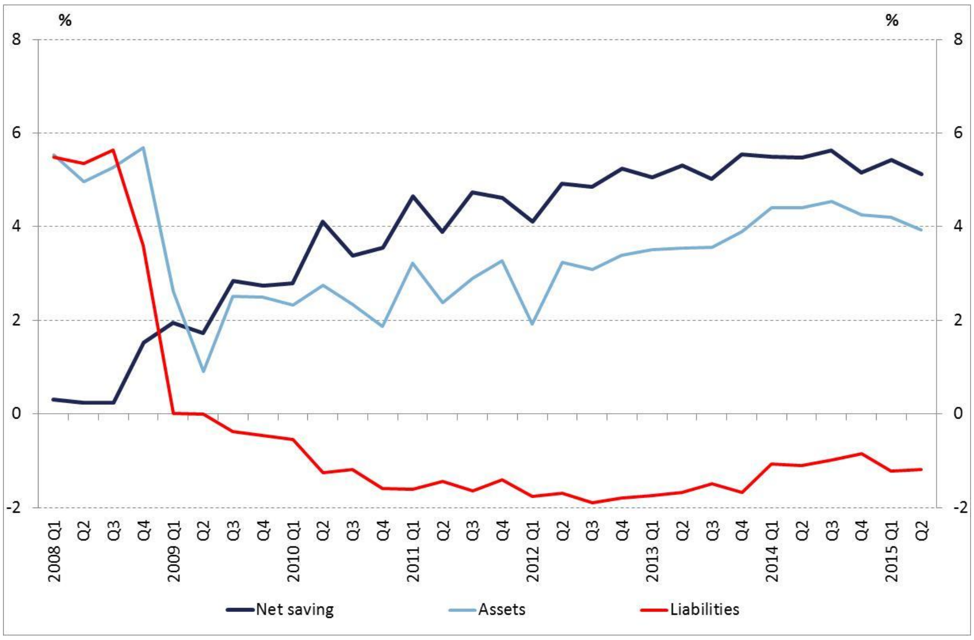
[6] In the statistics the decline in household deposits held at banks undergoing liquidation is not part of financial transactions of households, while indemnification paid by the Deposit Insurance Fund forms part thereof. Thus, as a result of indemnification household savings increased by the amount of indemnification.

the declining exchange rate exposure, the conversion of FX loans into forint in Q1 may moderate the savings of household for precautionary reasons, as a result of which the net savings of households may fall slightly, but may remain much higher than the pre-crisis level.

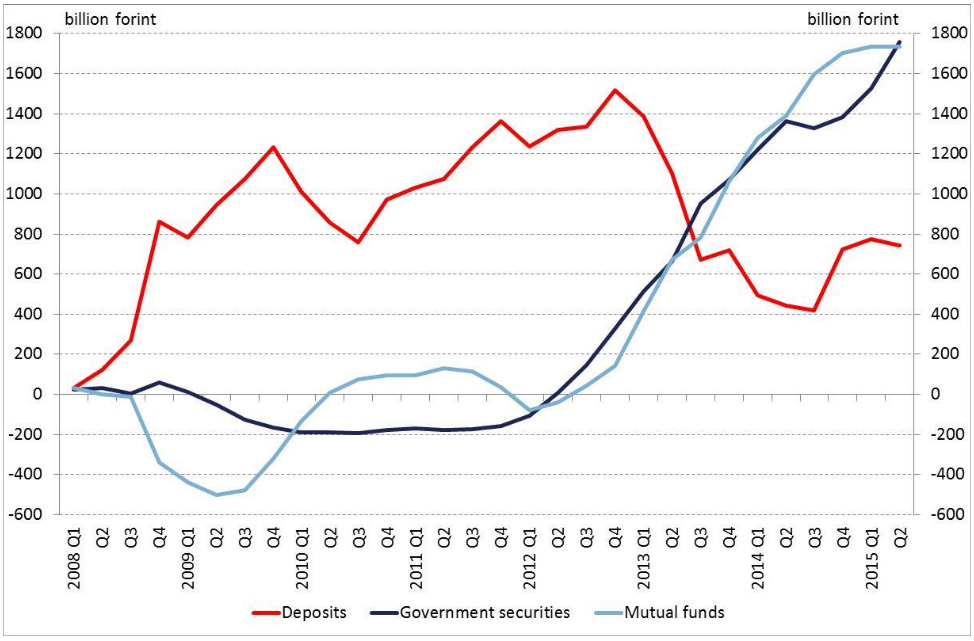
Chart 24: Net saving of households (seasonally adjusted revised* values, as a percentage of GDP)



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

In Q2, in terms of financial assets, government securities were popular with households, which may be primarily caused by the significant interest advantage offered by retail government securities. The restructuring of household portfolios was mainly caused by the reduction of bank deposits and the increased purchases of government securities and mutual fund shares in recent years. Among the purchases of financial instruments by households, securities continue to have special priority: by the end of Q2, the value of government securities held by households exceeded HUF 2,700 billion, which, in addition to the purchases of government securities by banks, as mentioned earlier, help the state to lower its external debt. Government securities held by households still feature an interest advantage over bank deposits, as a result of which the stock of these government securities increased during Q2. In addition, in Q2 the popularity of government securities may have also been supported by the uncertainty regarding other financial investment providers, and the money received back by the households as a consequence of settlements relating to FX loans may also have increased the volume of government securities of households. At the same time, the rise in price of mutual investment shares, likely on the basis of expected closing the interest cycle, slowed down essentially and therefore, they may have become a less attractive option for households.

Chart 25: Cumulative transactions of household instruments



5. INCOME OF FOREIGN-OWNED COMPANIES

As a special topic, we address the changes in the income of Hungarian companies under foreign ownership generated through foreign direct investments. The latest balance of payments data indicate a significant increase in the 2014 profits of foreign-owned companies, recovering to the levels seen before the crisis. Given the moderate decline in dividend payments, the volume of reinvested earnings in Hungary has reached unprecedented levels, adding to Hungarian FDI. The significant increase in income was due partly to an outstanding increase in the profits of specific companies, reinforced by changes in ownership; however, an increase in profitability was also apparent across a wider range of industries. On the cost side, the profitability of domestic companies may have benefited from dropping oil prices, while revenues may have been helped by an appreciating US dollar as well as by increased revenues generated through the expansion of certain companies. With regard to the profit of foreign firms, it is important to know that the balance of payments statistics do not present firms' profit after tax, but profits from normal business operations excluding non-recurring effects and revaluation. Based on firms' unadjusted profit after tax, the net lending of the Hungarian economy would have been even higher in recent years. Our international comparison shows that while previously the returns of foreign companies operating in Hungary fell short of other countries in the region, with the increase in income recorded in 2014 Hungary caught up with the rest of the region, while the ratio of earnings reinvested in the country is very high in regional comparison.

5.1. Introduction

Our special topic addresses the profits of foreign-owned companies. The relevance of this topic is underlined by the fact that profit figures for 2014, so far based on estimates only, are being replaced by actual data as corporate questionnaires are being received. Until the annual reports and questionnaires are processed, data on the income of foreign companies are limited; therefore, until September of the year following the current year, the profit figures are, for the most part, based on estimates. In the current reporting, the difference between actual data and the initial estimates were particularly great, which is due partly to non-recurring effects, while it also reflects the improving profitability of foreign-owned companies. It should also be pointed out that the balance of payments statistics only include companies' profits from normal business operations, excluding non-recurring effects from profit after tax; in the case of Hungary, this means that companies' disposable income may be lower than that disclosed in balance of payment statistics, which is consistent with a lower deficit of the income balance, and higher net lending.[7] This section starts with an overview of the income of foreign-owned companies and banks, followed by a discussion of the background to the outstanding increase in income in 2014. Next, we explain the influence on the balance of payments data of the fact that such data only include profits from normal business operations (current operating performance concept). Finally, we analyse the returns and dividend pay-out ratio of foreign-owned companies operating in Hungary, as well as the changes in those indicators, by comparing them against the region and then the whole of the European Union.

5.2. Income reported in the balance of payments

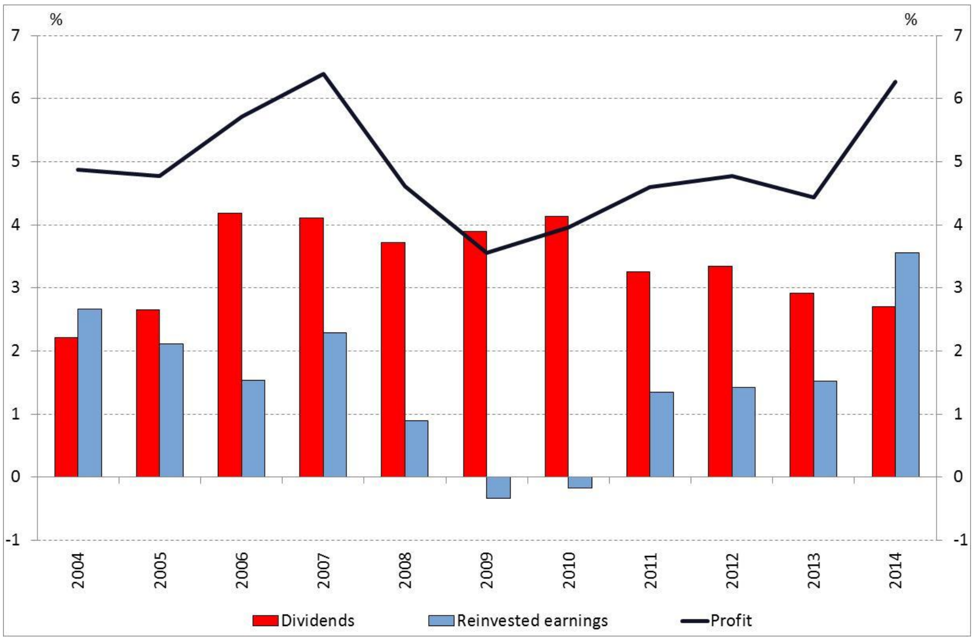
In the past year, the ratio of profit to GDP passed the 6% mark again, as reflected in a strong increase in reinvested earnings. In the aftermath of the crisis, the fall in the profits of foreign companies primarily affected reinvested earnings, while dividend payments[8] remained stable at approximately 4% of GDP. This may be related to the fact that after 2008 a diminishing return on investment and deteriorating growth prospects led to a decline in domestic investment projects and consequently, foreign-owned companies transferred a greater share of their profits to their home countries. The growth in profits driven by economic recovery from 2011 onwards was accompanied by a fall in dividend payments, as a result of which reinvested earnings returned to above 1% of GDP. In 2014, the significant growth in foreign companies' profits, approximating 2% of GDP, was primarily driven by an increase in reinvested

[7] In the balance of payment statistics, non-recurring effects and revaluation are reported as flows other than transactions.

[8] In our discussion, we disregard outstanding dividends as they typically represent payments against previously accumulated retained earnings, with a lesser influence on the profits generated in the year concerned.

earnings, the volume of which more than doubled over the past year. Meanwhile, following a moderate decline, dividend payments stabilised at around 3%, their usual level over the past few years. That increase already pushed the profit generated by foreign companies to pre-crisis levels, accompanied by the rise of reinvested earnings to unprecedented levels.

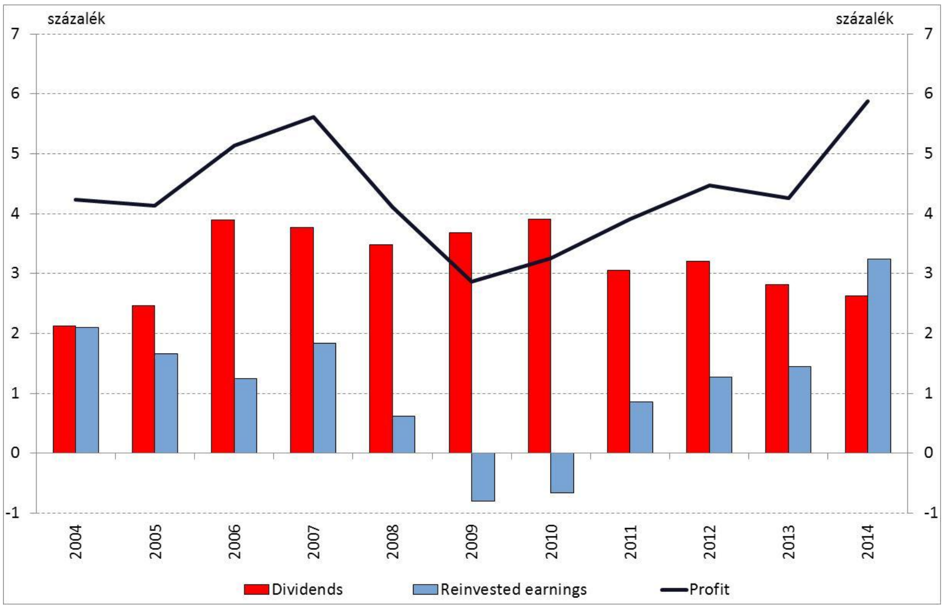
Chart 26: Utilisation of income generated in Hungary by foreign-owned companies and banks (as a percentage of GDP)



5.2.1. Non-financial corporations

2014 saw a major increase in the profits of foreign-owned non-financial corporations, which, due to a moderate drop in dividend payments, led to a tangible increase in reinvested earnings. As in previous years, in 2014 non-financial corporations generated the vast majority (over 90 percent) of foreign-owned companies' profits. Accordingly, dividend payments and earnings reinvested by non-financial corporations showed a trend very similar to that followed by all foreign companies. In 2014, profit grew significantly, which is due partly to an increase in non-recurring effects (see below). The increase in reinvested earnings was accompanied by a moderate drop in interest payments. In the light of direct capital inflows, this indicates that although new investments are less frequently implemented using foreign funds, the companies producing in Hungary reinvest a major part of their profits in the country. This drove reinvested earnings to unprecedented levels as a percentage of GDP.

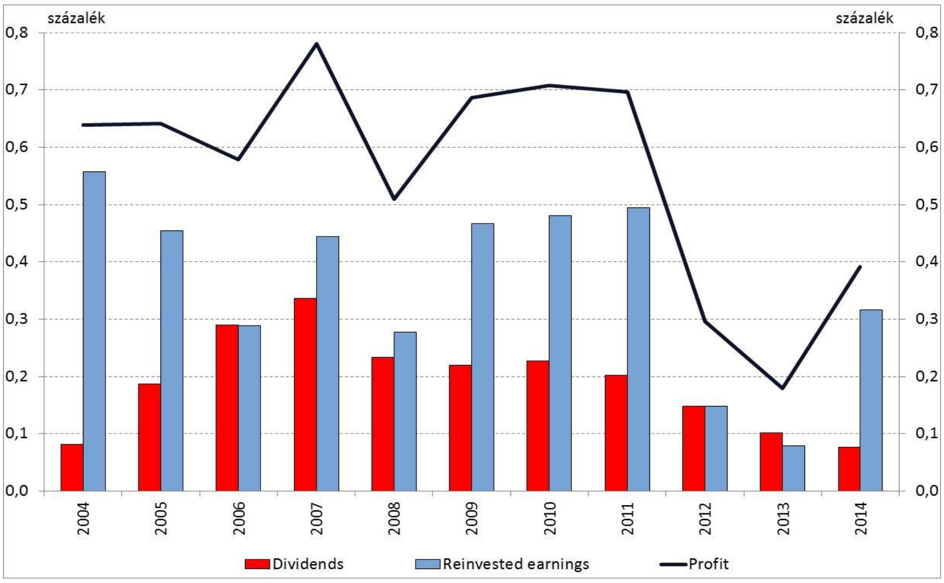
Chart 27: Utilisation of income generated by foreign-owned non-financial corporations (as a percentage of GDP)



5.2.2. Banking sector

Similarly to non-financial corporations, the profits of foreign-owned credit institutions (net of the profit impact resulting from the settlement of household loans) also showed a tangible increase over the past year, but as opposed to corporations, their profits remain below pre-crisis levels. Credit institutions are also similar to corporations in that growth in their profits drove an increase in their reinvested earnings, while dividend payments dropped moderately. Nevertheless, banks' 2014 profits remain a significant 50% below their historic high in 2007. Banks' profitability from normal business operations continues to be narrowed by diminishing interest margins, a slowdown in lending, and the bank levy.[9] At banks, in relation to the significant reinvestment of the profits generated, a role may be attributed to the banking sector's losses, resulting partly from the settlement of loans, as well as to the progressive tightening of capital adequacy ratios in accordance with international standards.

Chart 28: Profits, gross dividend payments and reinvested earnings of foreign-owned banks as a percentage of GDP

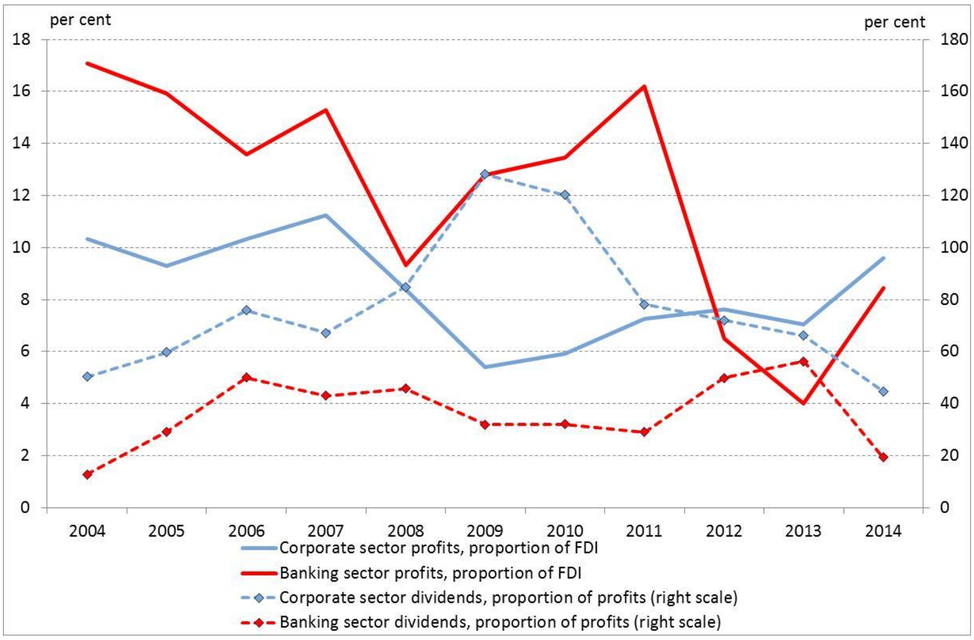


[9] Banks' profitability may also have been affected by the conversion of foreign exchange loans and a high rate of delinquent debtors, which, however, had no influence on profits from normal business operations – for more details, see the section on profit after tax.

5.2.3. Profitability of banks in comparison to the profitability of non-financial corporations

In 2014, the return on investment increased in both the banking system and with corporations, but non-financials continue to report higher returns. The dividend pay-out ratio dropped to a very low level for both corporations and banks. In terms of profits as a percentage of GDP, we found that the profits generated by corporations are significantly higher than those of financial undertakings. In terms of profits on FDI stock, until 2012 banks had higher rates than corporations, and since then, corporations have reported higher profits in that regard as well (Chart 29). In 2014, the increase in profits on foreign direct investments was accompanied by a rate of growth that was higher in the case of banks than with corporations. As regards banks' increased profit rates, it should be noted that the balance of payments reports profits from normal business operations (that is, the impacts of e.g. settlement with FX and HUF debtors are not reflected). There was a significant drop in the dividend pay-out ratio in the case of both corporations and banks (equivalent to a higher rate of reinvested earnings), but the reasons for this are presumably different in the two sectors. A decrease in the ratio of dividends paid against the profits of corporations may indicate that as growth recovers and prospects improve, corporations may be implementing investments which are not necessarily financed from borrowed funds. Conversely, a reduction in banks' dividend pay-out ratio may indicate foreign-owned banks' efforts to ensure that the losses resulting from settlements are made up against the subsidiary banks' own funds, while keeping capital increases at moderate levels.

Chart 29: Profits generated by foreign-owned corporations and banks in Hungary(return on equity to dividend pay-out ratio)



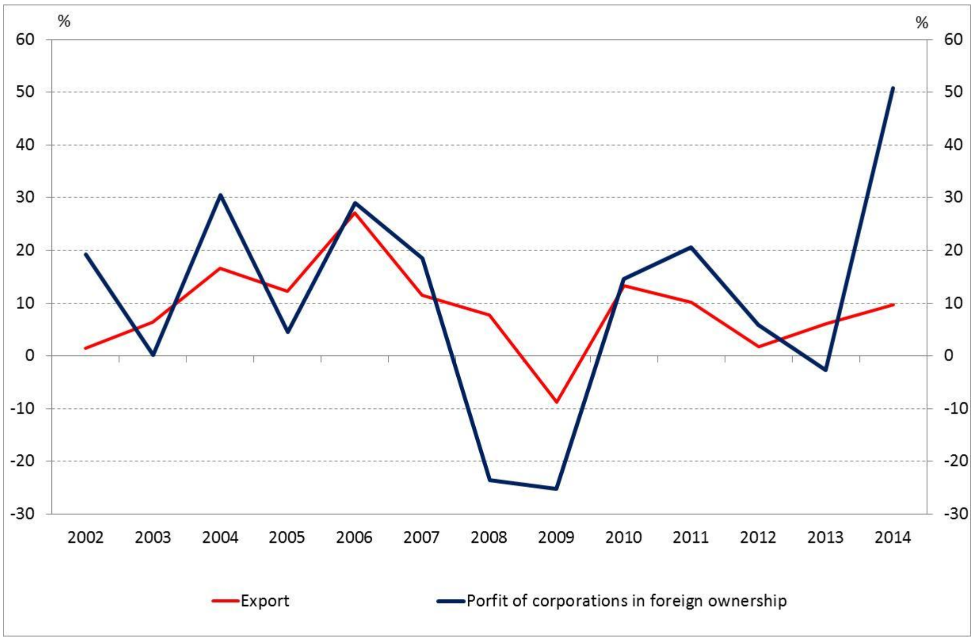
5.2.4. What might be behind the outstanding rate of profit growth?

The profits of foreign-owned corporations have previously been relatively volatile compared to growth in exports, but the 2014 rate of profit growth significantly diverged from export growth. A major part of foreign-owned corporations are engaged in foreign trade and produce for exports. That is why it is appropriate to make inferences on their profitability based on export performance. In recent years, changes in foreign corporations' income have been aligned relatively closely with export growth; however, the latest data published on corporate profits indicate that profit growth has become completely unanchored from export growth (Chart 30). Against an approximately 10% growth in exports, the profits of foreign-owned corporations after taxes were 50% higher than in 2013. It should also be noted that corporations' dividend payments remained level in 2014 and, according to the preliminary monthly data available, also into the first half of 2015, although assuming recent years' usual pay-out ratio corresponding to pre-crisis levels, higher profits would have been accompanied by a far higher ratio of dividend payments.

A major part of the outstanding growth in profits is attributable to a few corporations, but profit growth was widespread. These non-recurring effects accounted for approximately one-half of the overall profit growth of about HUF 650 billion. The most important are the following:

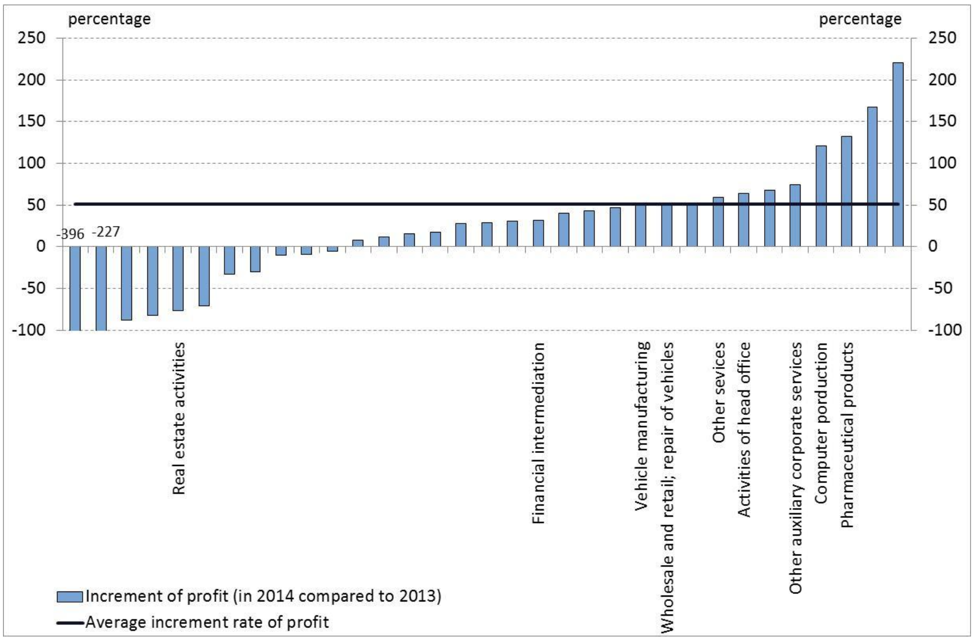
- **Profit growth of individual corporations**: Some corporations reported outstanding rates of profit growth, which clearly determined the profit growth observed in the industry concerned. The profits of the eight corporations with the largest rates of profit growth, at least HUF 15 billion each, grew by a total of HUF 260 billion, corresponding to 0.8% of GDP. Importantly, such growth did not necessarily indicate an improvement in profitability: one corporation achieved a significant increase in profits through the sale of a business and other tangible assets. Therefore, a part of profit growth at individual corporation level is not expected to be sustained.
- **Composition effect**: There were changes in ownership as a result of which corporations with significant profits were acquired directly by foreign shareholders, or formerly loss-making corporations were sold by their foreign parents. Both types of change in ownership drove an increase in the profits of foreign-owned corporations, amounting to approximately HUF 90 billion (0.3% of GDP).

Chart 30: Profits of foreign-owned corporations and exports (annual growth rates)



Despite concentrated profit growth in a number of industries, the fact that profit growth was observed in a wide range of industries indicates a general increase in the profitability of foreign corporations. The overall profit of foreign corporations increased by approximately 50% in 2014: within manufacturing, pharmaceuticals, automotive and electronics production showed a marked growth in comparison with 2013. A significant increase in the profits of automotive production was characteristic of all agents in the industry, whereas within electronics, the increase was attributable to a few corporations only. In the case of pharmaceuticals, data also reflected the composition effect referred to above: the transfer of a domestic agent from indirect to direct foreign ownership generated substantial profits in foreign-owned manufacturing. Among the service industries, there was an outstanding increase in the profits of corporations providing retail trade and other auxiliary services. Although foreign corporations saw their profits decrease in a number of industries, these typically carry less weight within foreign direct investments; conversely, industries with FDI stock exceeding EUR 2 billion were more strongly represented among industries with high profit growth (Chart 31).

Chart 31: Profit growth of foreign corporations in specific industries (2014)

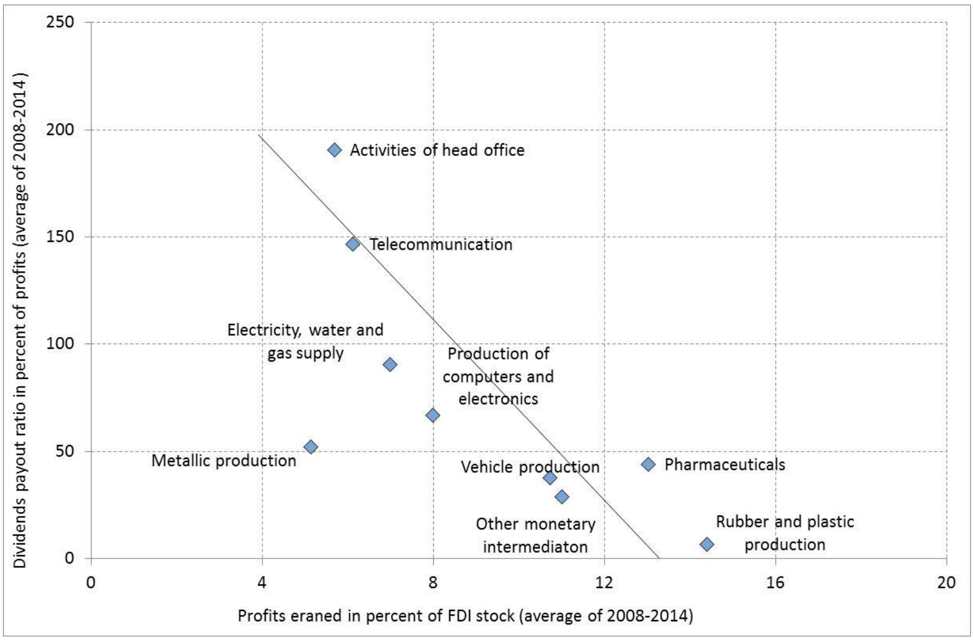


Industries with FDI stock exceeding EUR 2 billion are named.

The marked profit growth becoming completely unanchored from exports may also have been supported by the appreciating US dollar exchange rate and falling oil prices. Some foreign-owned companies invoice in EUR or USD rather than in HUF, and their sales revenues may be affected by exchange rate movements. In 2014, the forint depreciated against both currencies, which may have contributed to the profit growth of corporations invoicing in foreign currencies. Additionally, the revaluation of balance sheet items due to the appreciating US dollar may have led to a growth in income through increasing financial results (generally, the balance of payment statistics disregard the effect of such results; however, where such a result is realised by a corporation owned by a foreign-owned domestic corporation and the former transfers its profits, the result could still influence the profits of the foreign-owned corporation). The steep decline in oil prices seen since the second half of 2014 may have benefited corporations on the cost side. The increase in the profitability of foreign-owned corporations may also have been related to the tangible improvement in the balance of services which occurred in 2014. A major increase was observed in the export of transportation services, possibly driven by the successful expansion of foreign corporations engaged in transportation.

An examination of foreign direct investments by industry shows that in industries where higher profits were generated, shareholders reinvested a greater part of the earnings. In the years following the crisis, we found in several countries in the region that in certain years, dividends paid on foreign direct investments exceeded the profits generated by corporations. Among other factors, this is attributable to a shortage of liquidity experienced by foreign shareholders due to drying up money markets. As a result, dividends were also paid against retained earnings generated and reinvested in previous years. At the same time, an examination of industries with greater weight in terms of foreign direct investments in Hungary shows that a negative correlation exists between the profit generated and the ratio of dividends paid on profits. That is, a greater part of the profits generated in industries with higher profitability is reinvested by foreign investors, while in industries characterised by lower returns, earnings are repatriated.

Chart 32: Returns on foreign direct investments by industry and the ratio of dividends to profits in each industry (averages for 2008–2014*)



For automotive manufacturing, 2011 is disregarded due to a non-recurring effect.

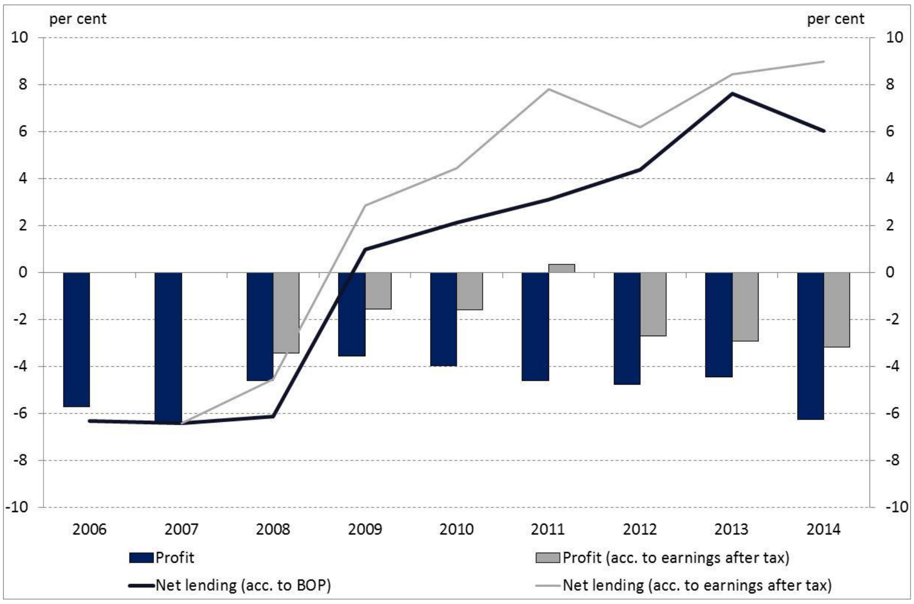
5.3. After-tax profit of foreign-owned companies

In compliance with international requirements, the statistics include only foreign-owned companies' profits from normal business operations. Based on the questionnaires completed, companies' profits are broken down into items that are classified as earnings for statistical purposes as well, and profit or loss from other than normal business operations (such as profit or loss resulting from revaluation, extraordinary depreciation or other volume changes[10]). Profits after tax excluding non-recurring effects and revaluation are called profits from current operating performance; this is the item included in the balance of payment statistics (for more details on the profit items taken into account during adjustment, see the statistical publication entitled "Methodology for the compilation of the balance of payments and international investment position statistics").

In 2014, companies' actual earnings were far lower than the profits from normal business operations as disclosed in the balance of payments, and failed to achieve any significant growth. This also means that companies' profits after taxes would have a less negative impact on the income balance and would represent a net lending higher than that in the balance of payments. Since in the aftermath of the crisis items outside the scope of normal business operations typically reduced companies' profits, the exclusion of such items from balance of payment statistics resulted in higher income and a higher deficit of the income balance (Chart 33). For example, in 2014 the adjustment, including the losses incurred from settlements on retail loans, amounted to approximately 3% of GDP, nearly three times the rate observed in 2013. That is, while net lending in the balance of payments was reduced in accordance with normal business operations, companies' after-tax profits would have implied an increase in net lending. Profits on foreign direct investments therefore increased significantly in 2014, approximating pre-crisis levels.

[10] For example, the losses incurred by banks as a result of the settlements of retail loans.

Chart 33: Profit from normal business operations and based on profit or loss after taxes,* and net borrowing (as a percentage of GDP)



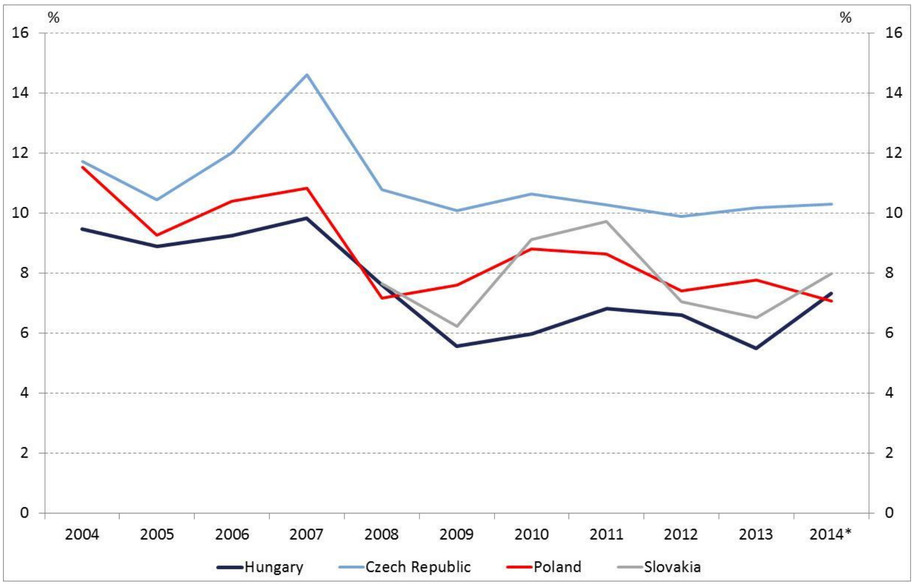
* The profit generated by companies is shown with a negative sign so that the representation is consistent with the income balance of the balance of payments.

5.4. International comparison

5.4.1. Regional comparison

In a regional comparison, Hungary has had the lowest returns on foreign direct investments in recent years, but more or less recovered to the Polish and Slovakian levels by virtue of the growth recorded in 2014 (Chart 34). It is appropriate to compare returns on foreign direct investments to those of countries in the region with similar circumstances. Following the onset of the crisis, profits on foreign direct investments fell in all countries of the region (typically by 4 to 6 percent) as recession hit their economies; despite this, foreign companies' return on equity remained highest in the Czech Republic and the lowest in Hungary. This is the difference which was reduced significantly last year, when Hungarian returns exceeded 7%, more or less recovering to the levels prevailing in the region. It should also be noted that in comparison with more advanced Western-European economies, Hungary has the potential for much higher returns (see below).

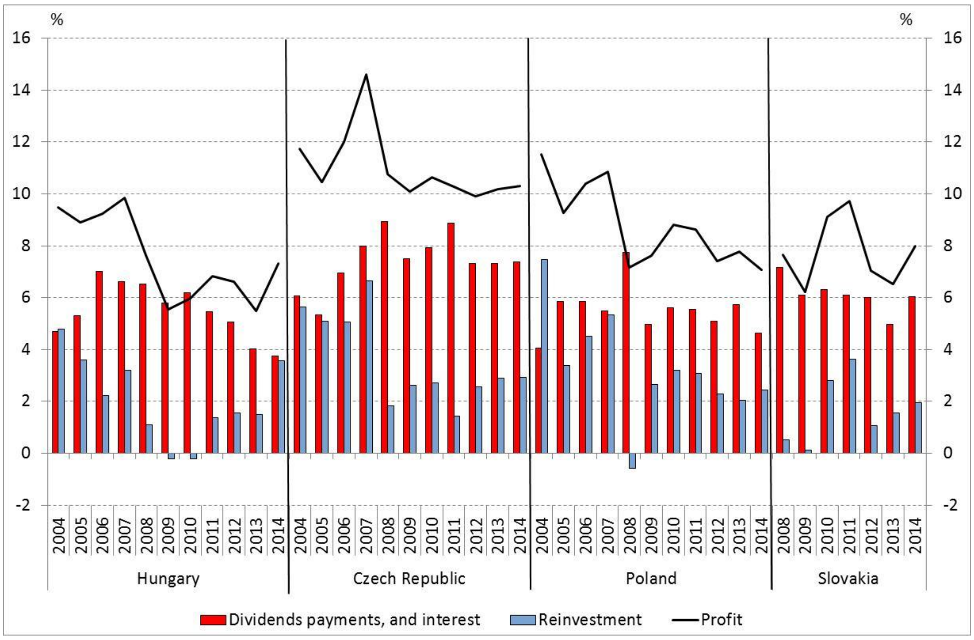
Chart 34: Return on foreign direct investments (profits on FDI stock as a percentage to the total FDI stock)



Source: Eurostat *In countries of the region, the 2014 figures are presumed to be estimates for the time being.

In 2014, foreign companies operating in Hungary reinvested approximately one half of their earnings, which is a very high ratio by regional comparison. As a percentage of returns on foreign direct investments, dividends remained relatively stable across the countries in the region, as a result of which the drop in foreign companies' profitability in the aftermath of the crisis predominantly led to a decline in reinvested earnings – in some of the Visegrád countries, FDI growth from reinvested earnings was negligible for a few years. The process may fit into the context of those explained previously: on the one hand, deteriorating growth prospects led to a drop in domestic investments and therefore to a decline in the reinvestment of foreign-owned companies' earnings, while on the other hand the crisis also made financing more difficult for parent companies, driving dividend payments higher. It should be noted that while in other countries the ratio of dividend payments to FDI stock has remained relatively stable over the past years, in Hungary it has followed a declining trend, although remaining much more stable than reinvestments. As a combined effect of the falling dividend pay-out ratio and the significant increase of the profit rate seen in Hungary in 2014, foreign shareholders reinvested about one half of their Hungarian earnings into their operations in the country, which is outstanding by regional comparison (Chart 35). The higher ratio of reinvested earnings is a welcome development also because it may entail an increase in working capital, which in turn may have a positive influence on Hungary's growth prospects.

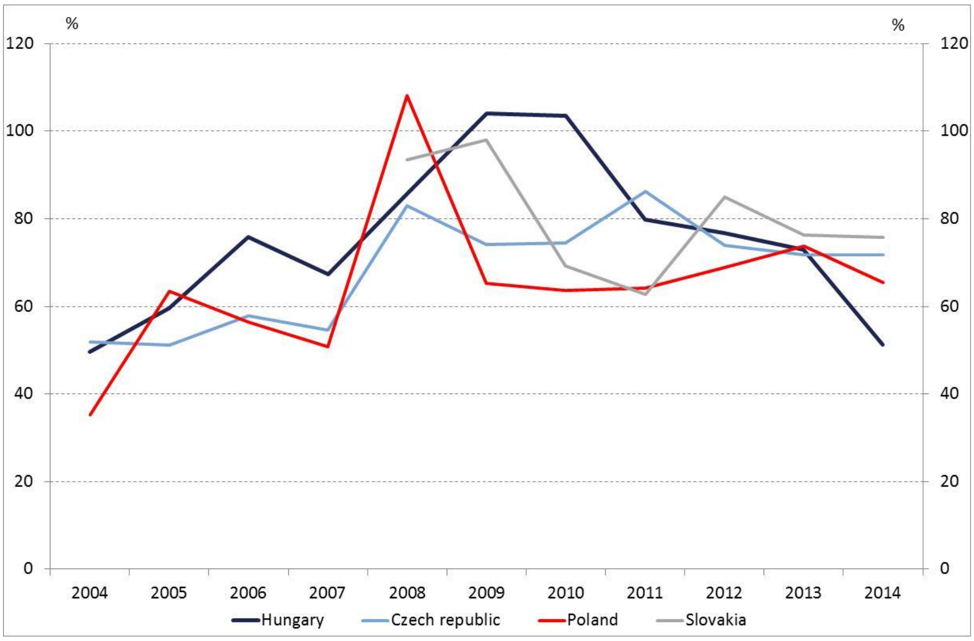
Chart 35: Breakdown of earnings from foreign direct investment in regional countries (as a percentage of FDI)



Source: Eurostat. In countries of the region, 2014 figures are presumed to be estimates for the time being.

Recent years have seen a continuous fall in foreign companies' dividend payments in Hungary: from around 100%, significantly above the post-crisis levels prevailing in the region, to the regional average in 2011–2013, and to 50% last year, already below other countries in the region. In the wake of the crisis, dividend payouts as a percentage of profits jumped in all countries, but the rate of around 100% measured in Hungary was seen as outstandingly high, and presumably occurred in the context of poor growth prospects. From 2011 onwards, the dividend pay-out ratio declined to the regional average, and the subsequent major drop in 2014 meant that foreign-owned firms operating in Hungary paid out a smaller portion of their profits to shareholders in the form of dividends than their peers in other Visegrád countries. Therefore, while previously in Hungary low returns were accompanied by a relatively high ratio of dividend payouts, in 2014 foreign companies repatriated a comparatively small portion of their capital on the back of average returns (Chart Chart 36:).

Chart 36: Dividend pay-out ratio to total earnings



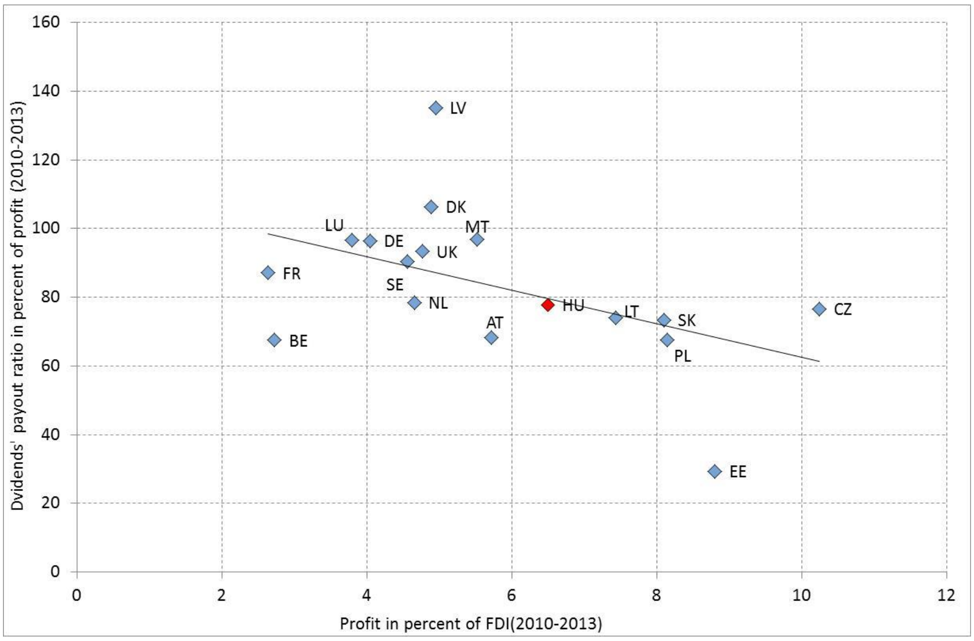
Source: Eurostat

5.4.2. European Union comparison

The tendency in the European Union is that in more profitable countries, a smaller portion of the earnings is repatriated in the form of dividends, while the majority is reinvested. Countries of the European Union are seen to be following a trend that is similar to the industry breakdown of foreign-owned companies operating in Hungary: in more profitable countries, a larger share of earnings is reinvested by investors in the given country, which also means that dividend pay-out ratios are lower (Chart 37). Overall, this may lead to a dependency of reinvested earnings on the country's profitability, which may also determine the country's ability to attract capital in more general terms.

The comparison across the EU also highlights the fact that while the profits generated by foreign-owned companies in Hungary is low by regional comparison, Hungary has the potential for much higher returns than what is seen in more advanced economies of the EU. The profits and dividend payments of foreign companies operating in the EU are rather heterogeneous, given the significant difference between older and more recent Member States. While more advanced economies offer relatively low returns on equity, the profit rate in CEE countries is typically higher, as a natural consequence of these countries' convergence processes and the higher marginal utility of undercapitalised economies. Among the recently joined countries, while the return on investment is relatively low in Hungary, it is quite high in the case of the Czech Republic (Chart 37). It should also be noted that although Hungary's dividend pay-out ratio was relatively high in the region, more advanced economies were characterised by even higher levels of dividend payments.

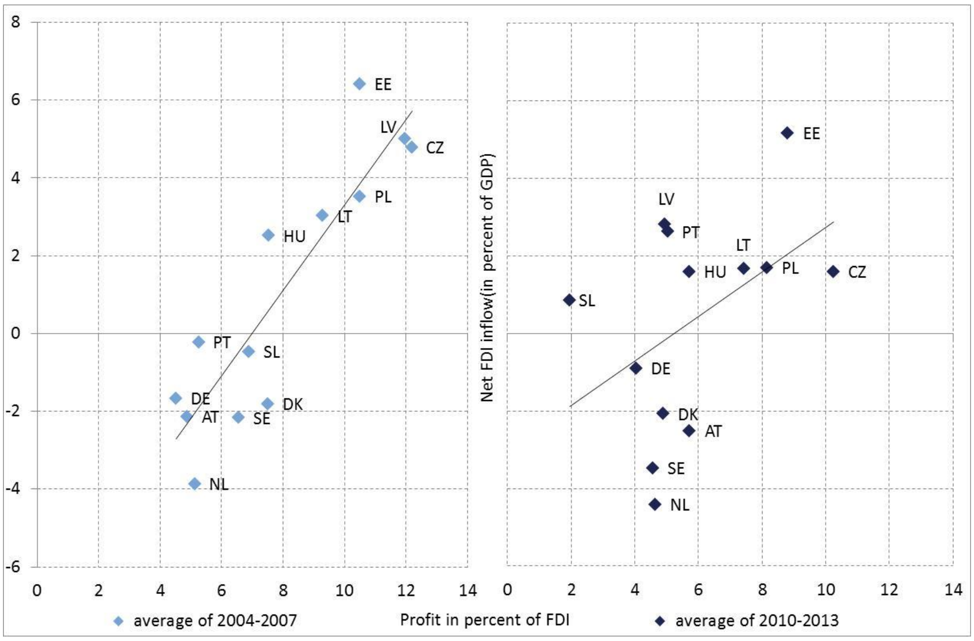
Chart 37: Profit rates and dividend payments on FDI (average of 2010–2013)



Source: Eurostat

In an international comparison, both in the years preceding and following the crisis, net FDI inflow was arguably greater where returns were higher; however, the inflow of funds slowed during the crisis. For both the years preceding and following the crisis, international data indicate that FDI inflow is greater (i.e. foreign investors are more willing to invest) in countries where the returns on investments are higher. At the same time, reinvested earnings may have a major role in this. It should also be pointed out that although the crisis did not change the direction of the relationship, there has been a setback in the inflow of funds. This also means that in comparison with previous years, post-crisis FDI inflows declined while returns remained stable.

Chart 38: FDI inflows (as a percentage of GDP) and returns on FDI



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.

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