REPORT ON THE BALANCE OF PAYMENTS

2023

OCTOBER

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

Letters 27
Gábor Bethlen

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

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

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

The analysis was prepared by the Directorate Monetary Policy and Financial Market Analysis. Contributors: Judith Balázs, Balázs Forgó, Péter Koroknai, Rita Lénárt-Odorán, Balázs Sisak and Daniella Tóth. The Report was approved for publication by Barnabás Virág, Deputy Governor.

The Report is based on information pertaining to the period ending 26 September 2023.

Summary

The positive trends in the external balance continued in 2023 Q2, with the current account showing a surplus of 1.1 percent on a quarterly basis. *As a result, the four-quarter deficit decreased to 5 percent of GDP, while net borrowing fell to nearly 4 percent. The external balance improved against the backdrop of an* ***increase in the trade balance****, primarily due to the* ***improving terms of trade*** *resulting from lower energy prices and the* ***adjustment*** *of domestic sectors, and,* ***to a lesser extent, an increase in the value of exports.*** *With profits increasing during the year, interest rates high and external debt rising, the income balance decreased slightly. The transfer balance also declined slightly, along with a drop in net EU transfers. Similarly to the trends seen in Hungary,* ***external balance indicators continued to improve in other countries in the region as well.***

In 2023 Q2, the four-quarter value of the net borrowing of the economy according to the financial account also ***fell,*** *in line with improving real economic trends. Net borrowing was still* ***mainly financed by inflows of debt liabilities,*** *while there was a continued outflow of net FDI, in parallel with the dividend payments typical for this season. Net debt inflow was driven* ***primarily by the general government****, but the banking sector also continued to borrow.*

Net external debt *amounted to* ***14.6 percent of GDP*** *at the end of June 2023. The slight increase in the debt indicator was driven by the new debt liabilities taken on in recent quarters as well as revaluation effects related to the decline in yields. The increase in net external debt was linked to a rise in the indicators of the banking sector and the general government.* ***Gross external debt stopped increasing in June 2023****, and as a percentage of GDP, the indicator fell slightly, to below 69 percent. Similarly to the previous quarter,* ***international reserves*** *were close to their* ***all-time high****, at around EUR 40 billion,* ***exceeding the level of short-term external debt, which is closely monitored by investors, by more than EUR 2 billion.***

The improvement in the external balance position based on the savings of economic sectors is attributable to ***higher net financial savings in the private sector****, countered by a moderately rising deficit on the side of the general government. Lower tax revenues and the increase in interest expenditures in an environment of high interest rates and high yields were the main factors contributing to the deterioration in the general government indicator. The net financial position of households and companies improved, owing mostly to a* ***decline in consumption and investment.*** *In an environment of high inflation,* ***holdings of inflation-indexed government securities*** *and mutual fund shares* ***continued to increase within total household savings****, while bank deposits fell.*

Our special topic in this issue focuses on the development of ***earnings of foreign-owned companies.*** *The actual figures supplied to us indicate that the earnings of foreign-owned companies as a percentage of GDP* ***fell in 2022,*** *a result of higher energy prices and the profit-reducing effects of the extra profit tax. As a result, the reinvestment rate of non-financial companies declined slightly but remains high, while the increase in banks' dividend payout ratios from the previous low levels is due to regulatory reasons.* ***Return on equity varied in the key sectors****, with a decline in the chemical industry and transportation, a slight increase in vehicle manufacturing and trade, and a more than twofold rise in this indicator in the field of financial intermediation. Profit growth at the foreign operations of resident companies rose to historic highs.* ***Several countries in the region recorded increases in return on equity****, which were typically reflected in higher reinvestments. The* ***GNI-GDP gap tended to widen in the region's countries****, in line with the rising profits of foreign companies.*

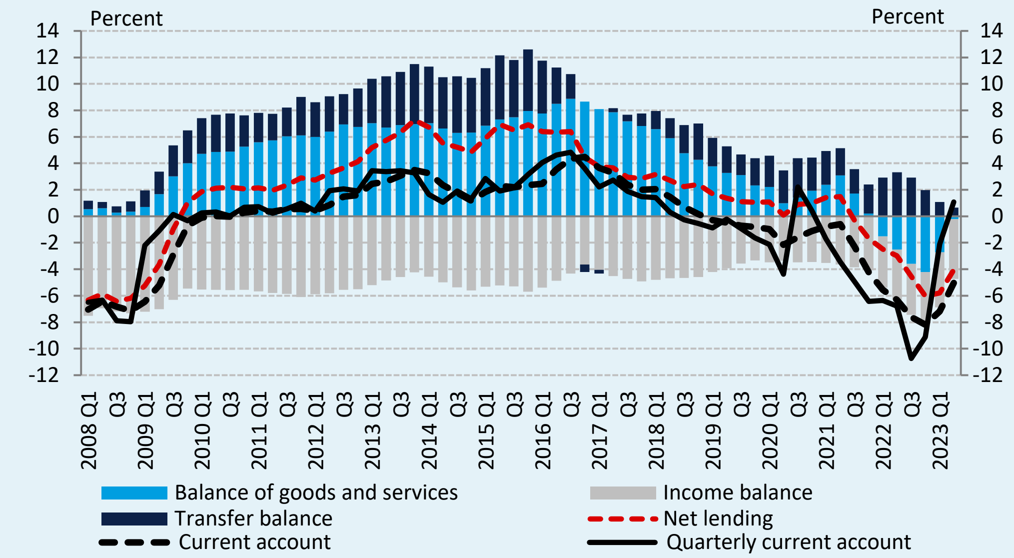
Contents

1 Real economy approach

According to the real economy approach, Hungary's four-quarter net borrowing amounted to 4.1 percent of GDP in 2023 Q2, while the current account deficit stood at 5.0 percent of GDP and the quarterly adjusted balance showed a surplus of 1.1 percent. The improvement in external balance indicators was mainly due to the smaller deficit on the goods balance, and within this in particular the adjustment of domestic sectors and the improvement in the terms of trade owing to lower energy prices and, to a lesser extent, an increase in the value of exports. The surplus on services as a percentage of GDP remained unchanged compared to the previous quarter, while the transfer balance narrowed slightly and the income balance deficit widened further. Similarly to Hungary, external balance indicators also continued to improve in the countries of the region in the second quarter.

According to the real economy approach, Hungary's four-quarter net borrowing amounted to 4.1 percent of GDP in 2023 Q2, while the current account deficit fell to 5.0 percent of GDP (Chart 1). The quarterly balance, which offers a better reflection of short-term developments, registered a surplus of 1.1 percent, versus the deficit of 2.1 percent in 2023 Q1. According to unadjusted quarterly data, net lending in the second quarter amounted to over EUR 1.2 billion, composed of a current account surplus of nearly EUR 0.7 billion and a capital account surplus of over EUR 0.5 billion. The improvement in the trade balance as a percentage of GDP played a key role in the decline in four-quarter net borrowing.

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



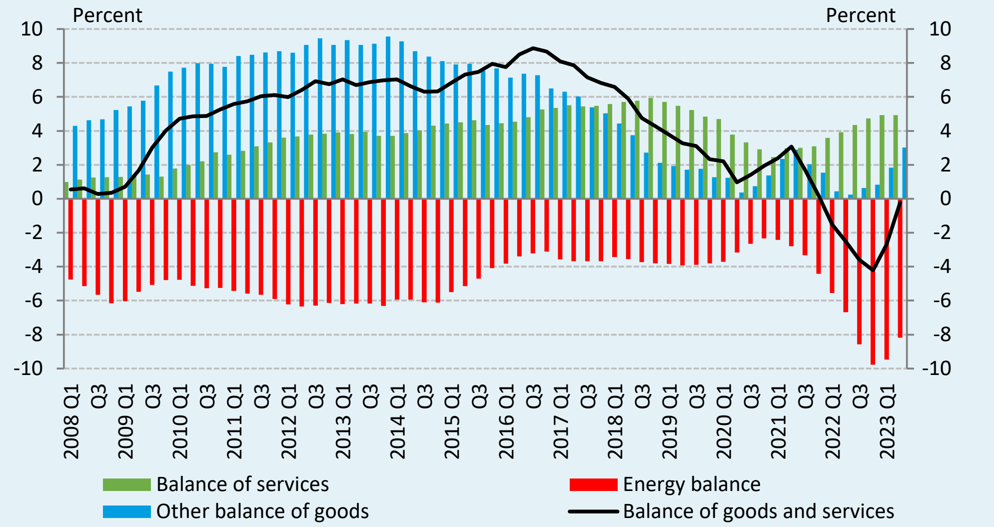
** Income balance: earned income, income on equity and income on debt. Transfer balance: capital account, other primary incomes and secondary incomes. Quarterly current account balance, seasonally adjusted.*
All charts by the MNB unless otherwise indicated.

1.1 Trade balance

In 2023 Q2, the four-quarter trade deficit narrowed, owing to a rise in the energy balance and the balance of goods excluding energy. The main factors behind the improvement in the trade balance were the positive impact of the lower energy prices, the significant adjustment by domestic sectors and the expansion in vehicle and battery exports (Chart 2). Following the rising deficits seen in past years (interrupted only by the temporary balance-improving effects of the pandemic), the balance of goods as a percentage of GDP registered an increasing deficit until the end of 2022, in line with strong household consumption and surging energy prices. The deficit started to narrow in 2023 Q1, however, and this trend accelerated in 2023 Q2, when improvement was measured not only in the balance of goods excluding energy, but in the energy balance as well. Nevertheless, the four-quarter energy balance continued to show a deficit in excess of

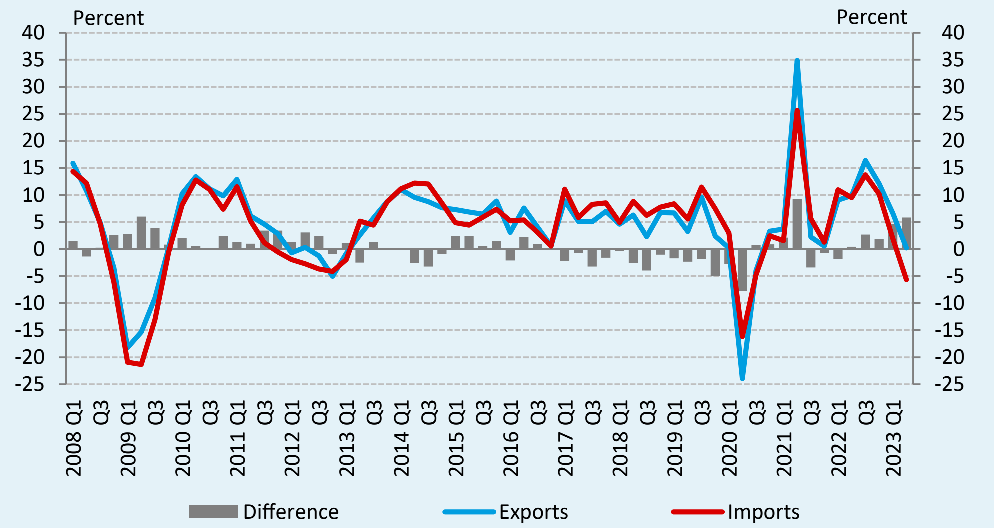
8 percent of GDP, while other goods balance registered a surplus of 3 percent in the second quarter. After falling due to the pandemic, the services surplus, which is an important factor in the trade balance, advanced to 4.9 percent of GDP by 2023 Q1 following the lifting of pandemic restrictions and remained at that level in 2023 Q2.

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



Export and import growth continued to slow in 2023 Q2, even as the increasing export-to-import ratio improved the trade balance (Chart 3). In parallel with the downturn in domestic industrial production, the annual change in export volumes decelerated further in the context of weaker performance in most manufacturing sectors, with the main exception being the growth seen in vehicle and battery manufacturing. Exports may have been underpinned by a decrease in inventories. The fall in imports primarily reflects the significant contraction in domestic demand, while the slowing of exports also contributed to the fall in imports. The volume of exports was essentially unchanged in year-on-year terms, while real imports fell by almost 6 percent in the second quarter.

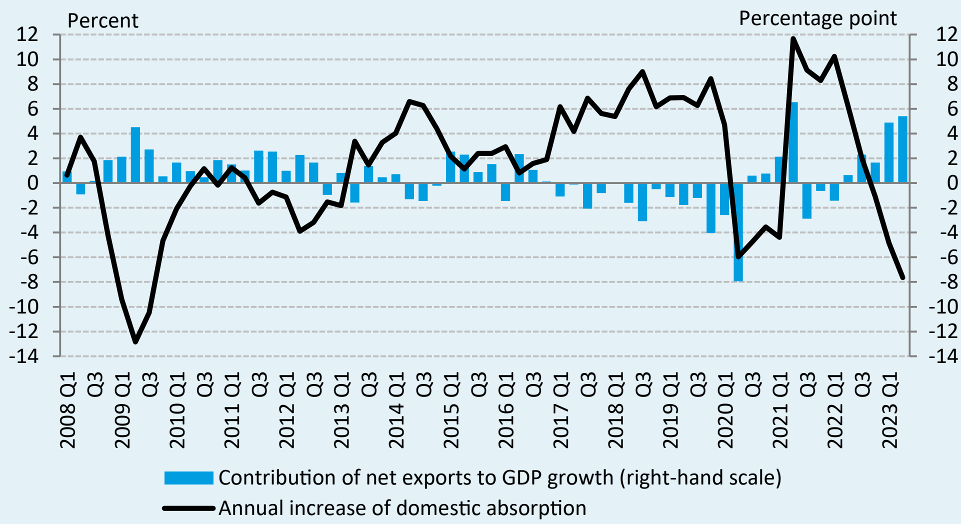
Chart 3: Annual real growth of exports and imports



Source: HCSO, MNB

In relation to the above, the contribution of net exports to growth continued to strengthen in 2023 Q2, while the decline in domestic absorption is becoming increasingly significant, in parallel with subdued demand from domestic economic agents (Chart 4). A wide range of absorption items was responsible for the steep decline in domestic absorption: in addition to the decrease in household consumption, the volume of whole-economy investment and inventory accumulation also dropped. Weak consumption was mainly attributable to consumer adjustment in response to falling real incomes due to high inflation. In line with the decline in domestic absorption, net exports contributed to GDP growth to an increasing degree.

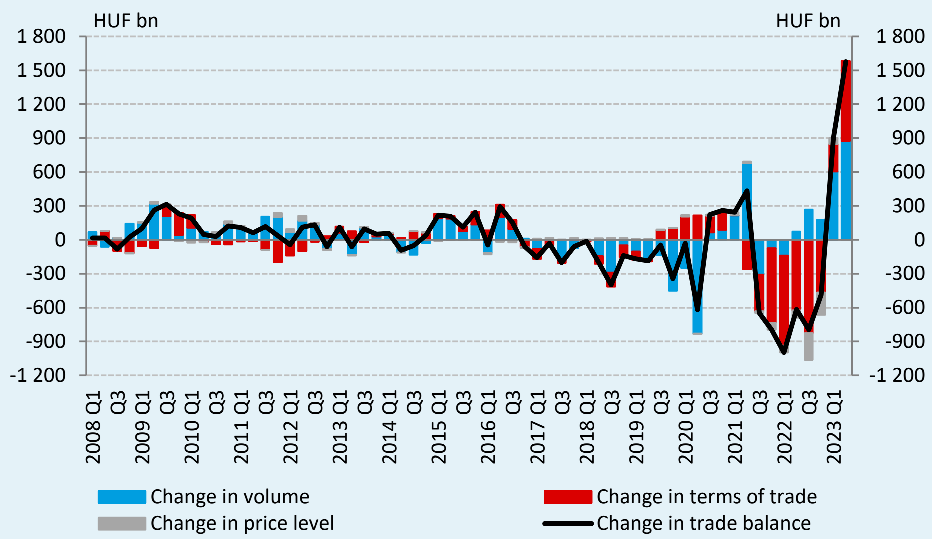
Chart 4: Annual growth rate of domestic absorption and contribution of net exports to GDP growth



Source: HCSO

The increase in the trade balance in 2023 Q2 can mainly be traced back to the impact of volume changes, but the beneficial effect of falling energy prices on the terms of trade was also significant (Chart 5). In the second quarter, the volume change of exports exceeded that of imports (in line with the growth contribution of net exports) and thus improved the trade balance. This was complemented by the decrease in commodity and energy prices (while export prices rose further year-on-year), which was reflected in a major improvement in the terms of trade and had a positive effect on the nominal value of net exports. In 2023 Q2, the terms of trade change effect intensified significantly in comparison to the previous quarter.

Chart 5: Development of trade balance factors according to GDP (year-on-year)

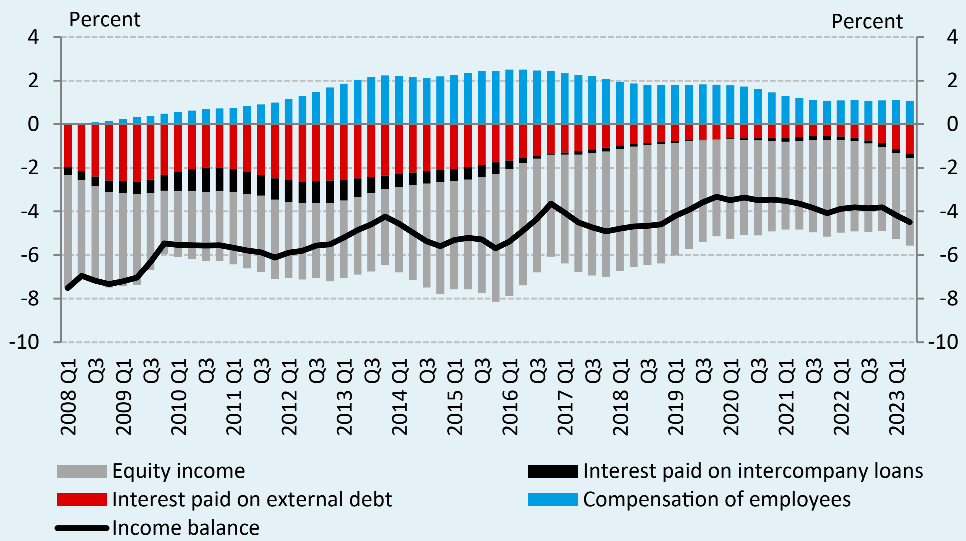


Source: HCSO

1.2 Income balance

The deficit on the income balance as a percentage of GDP rose in 2023 Q2, due to increases in foreign companies' profit and the interest balance of foreign loans (Chart 6). In 2021, while the income of persons working temporarily abroad declined, the four-quarter deficit of the income balance reached 4 percent of GDP, before falling to 3.8 percent of GDP in 2022, primarily due to the lower profits of foreign-owned companies. However, in 2023 Q1 and Q2, the profit of foreign companies started to rise again, which, combined with the increase in the interest balance of foreign loans and intercompany loans, had a negative impact on the income balance. As a result, income balance deficit reached 4.5 percent of GDP by the middle of 2023, versus a 3.8-percent deficit a year before. Despite the lifting of restrictions related to the pandemic, Hungarian employees' income from abroad remained unchanged in 2023 at a low level of around 1 percent of GDP (compared to nearly 2 percent prior to the pandemic) and was therefore unable to mitigate the deterioration in the income balance.

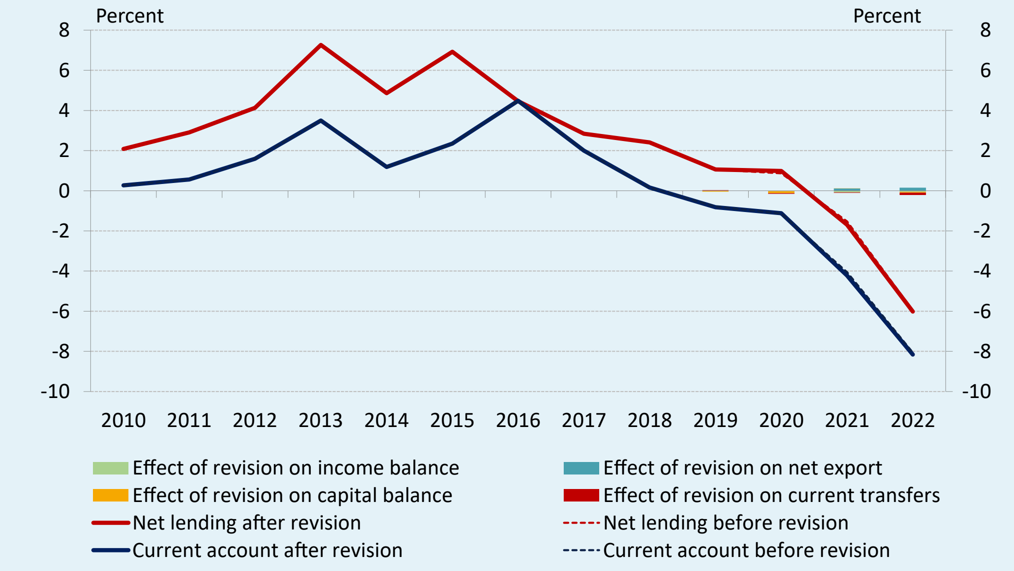
Chart 6: Development of income balance* items (four-quarter values as a percentage of GDP)



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

The revision of the balance of payments was relatively small and did not substantially influence the situation with the external balance trends. For the first time, the balance of payments figures in 2023 Q2 incorporate information on the 2022 earnings of foreign-owned companies; this information is based on company questionnaires. On this occasion, however, the retrospective data review concerning earlier years and other items as well was so limited in its extent, that this, in essence, confirmed the trends already identified in relation to the development of the current account and net lending (Chart 7). Overall, the revision resulted in a reduction of the current account balance in 2022 by around EUR 0.2 billion (0.1 percentage point as a percentage of GDP) compared to the earlier reporting, with the net borrowing of the economy altered to the same degree.

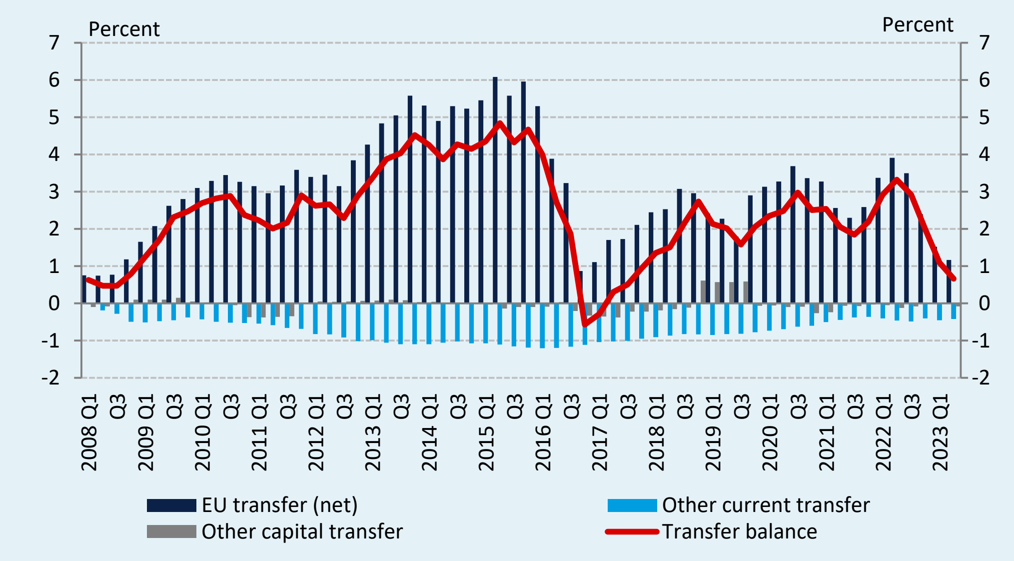
Chart 7: Effect of revisions on net lending and some of its items (as a percentage of GDP)



1.3 Transfer balance

Following the declines in the preceding quarters, the transfer balance surplus amounted to a mere 0.7 percent of GDP in 2023 Q2; nevertheless, the transfer balance surplus continues to improve Hungary's external balance position (Chart 8). According to four-quarter data, net EU fund inflows corresponded to 1.2 percent of GDP in 2023 Q2. The last time the level of EU transfers was this low was at the end of 2016 and in early 2017, when the inflows of funds were significantly lower than before due to the shift to a new seven-year EU budget period. Other current and capital transfers only resulted in a mild deterioration in the transfer balance. As the combined result of the above factors, the four-quarter surplus of the transfer balance was significantly lower than in the previous quarter.

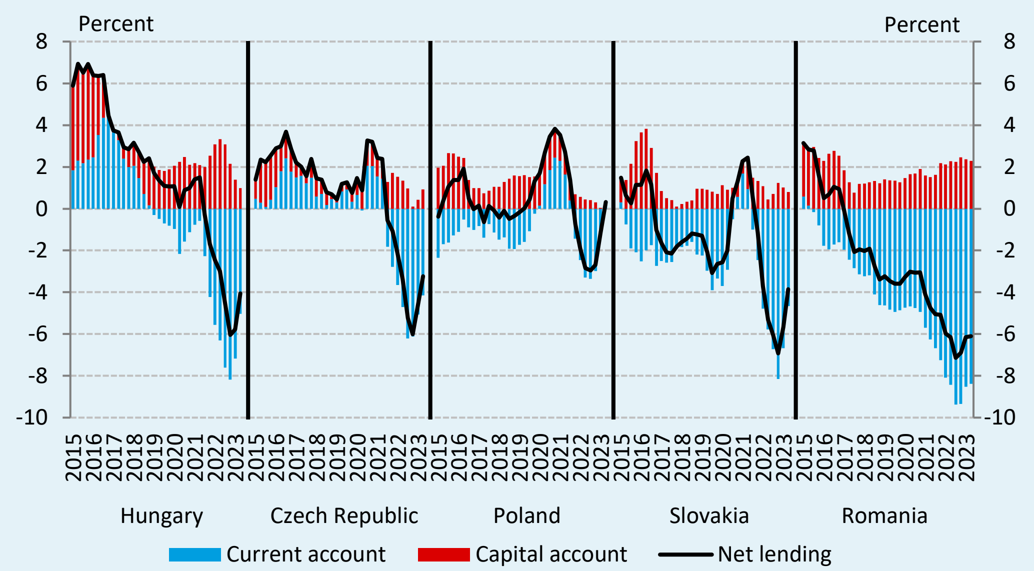
Chart 8: Four-quarter development of transfer balance items (four-quarter values as a percentage of GDP)



1.4 Regional comparison

With the decline in global commodity and energy prices, external balance indicators, including net borrowing, improved in the countries of the region, similarly to Hungary (Chart 9). Starting from 2021 H2, the trade balance, and thus the current account balance, deteriorated in all of the countries in the region, due to disruptions in supply chains and global rises in commodity and energy prices. In 2023 Q2, external balance indicators improved across the region, primarily due to better terms of trade leading to a lower energy balance deficit and, with the exception of Romania, a decrease in domestic demand. In 2023 Q2, Poland's external position switched to net lending. In several countries in the region, including Hungary, favourable developments during 2023 meant that the improvement in current account balances was coupled with a significant decrease in net borrowing, which nevertheless remained at around 3 to 4 percent of GDP. The net borrowing of Romania is still the highest among the countries in the region, corresponding to approximately 6 percent of GDP.

Chart 9: Four-quarter net lending in the countries of the region (as a percentage of GDP)



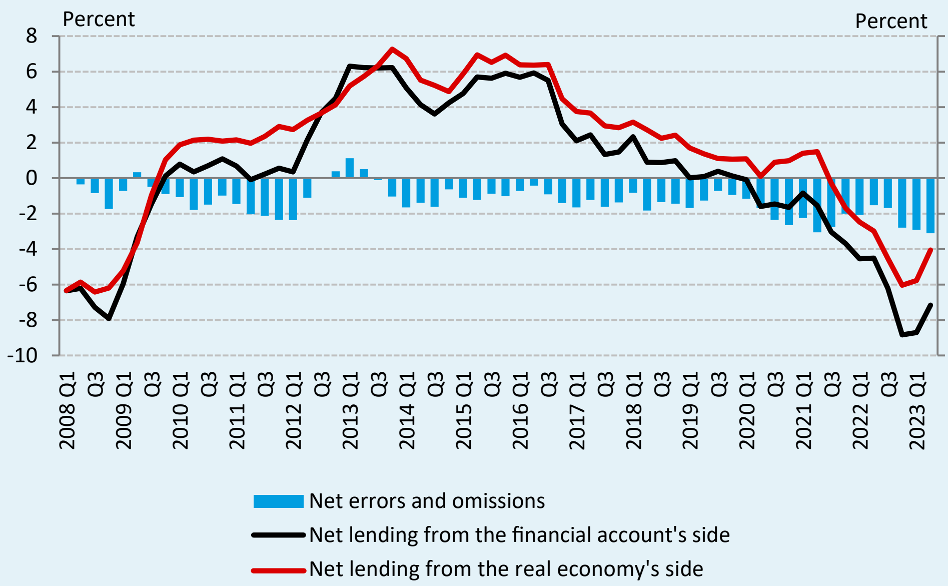
Note: Except for Hungary, the 2023 Q2 figures were calculated from monthly data.
Source: MNB, Eurostat

2 Financing approach

In 2023 Q2, the four-quarter value of the net borrowing of the economy according to the financial account amounted to around 7 percent of GDP, representing a considerable improvement over the previous quarter. Net borrowing during the quarter was primarily financed by inflows of debt liabilities, while there was an outflow of net FDI. The main contributor to net debt inflow, which was below the previous quarter's figure, was the general government. The banking sector also continued to borrow, albeit at a slower pace than in the previous quarter, while the indicator for the corporate sector fell substantially.

In 2023 Q2, the external balance position continued to improve, as demonstrated by the financing data. The four-quarter net borrowing of the economy decreased to 7.2 percent of GDP from 8.7 percent in the previous quarter (Chart 10). Accordingly, four-quarter net borrowing according to both the real economy and financing approaches showed significant improvement over the previous quarter. However, since the indicators calculated under the two approaches improved at similar rates, the difference between the four-quarter external balance indicators ('Net errors and omissions'[1]) remained similar to the previous quarter and stood at 3.1 percent of GDP.

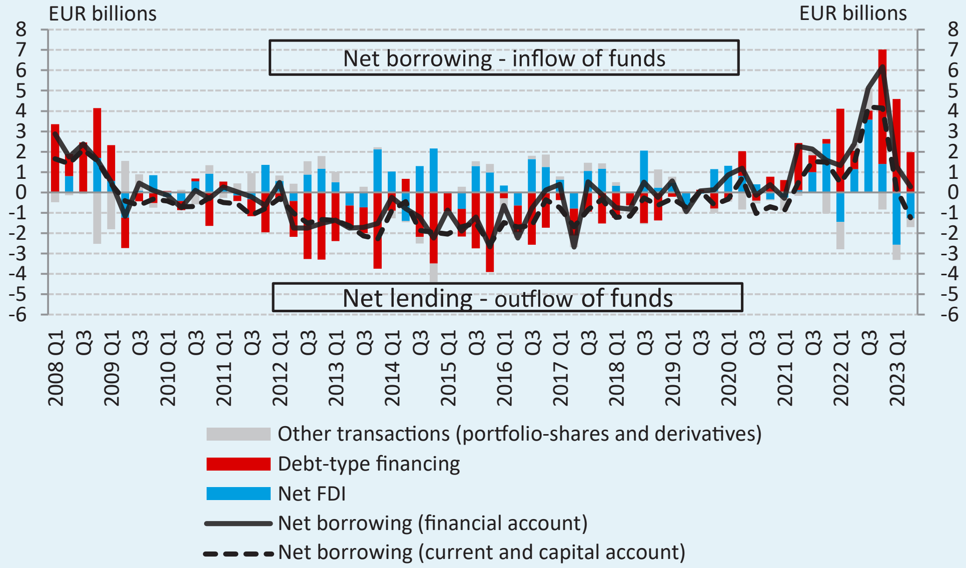
Chart 10: Two types of net lending (four-quarter data as a percentage of GDP)



According to quarterly data, the net borrowing of the economy amounted to EUR 0.3 billion in 2023 Q2, financed by inflows of debt liabilities, while net FDI outflows had a contrasting effect (Chart 11). Compared to the previous quarters, net borrowing in 2023 Q2 was significantly lower at EUR 0.3 billion. Fund inflows were financed by debt liabilities, which was partly offset by net FDI outflows (EUR 1.3 billion). Net outstanding debt due to transactions increased by EUR 2 billion, substantially less than in the last quarter.

[1] 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 11: Structure of net lending (unadjusted transactions)

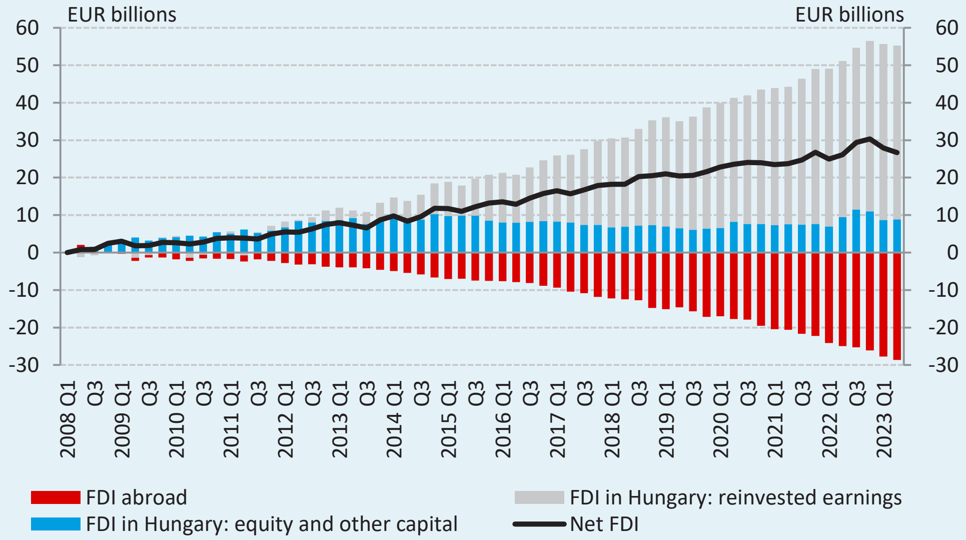


In economic terms, the fundamental development of the debt is not influenced by the conversion between account balance and bullion balances, and so this technical effect has been eliminated.

2.1 Non-debt liabilities

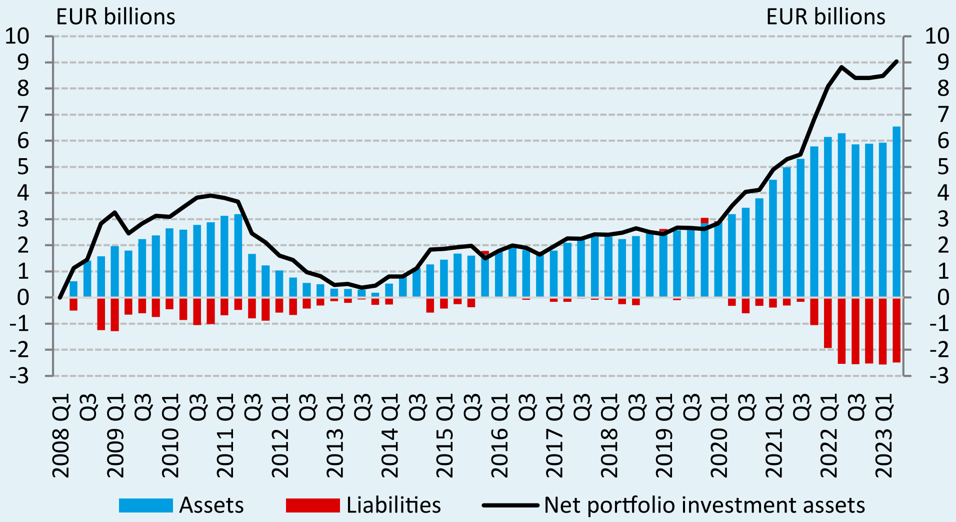
Similarly to the previous quarter, net direct investments registered an outflow in 2023 Q2 (Chart 12). Net FDI outflows excluding capital-in-transit amounted to EUR 1.3 billion in the second quarter, which was partly related to a Hungarian financial institution's acquisition of shares in a bank located in a country in Central Asia. Ordinary dividend payments approved in the quarter reduced FDI equities (via the fall in reinvested earnings); nevertheless, most of these have not been paid yet, which in turn increased intercompany loans. As a combined result of the above factors, net FDI inflows contracted. Following significant growth in previous quarters, investment outflows rose at a slower rate in the second quarter.

Chart 12: Development of FDI, excluding capital-in-transit transactions (cumulative transactions)



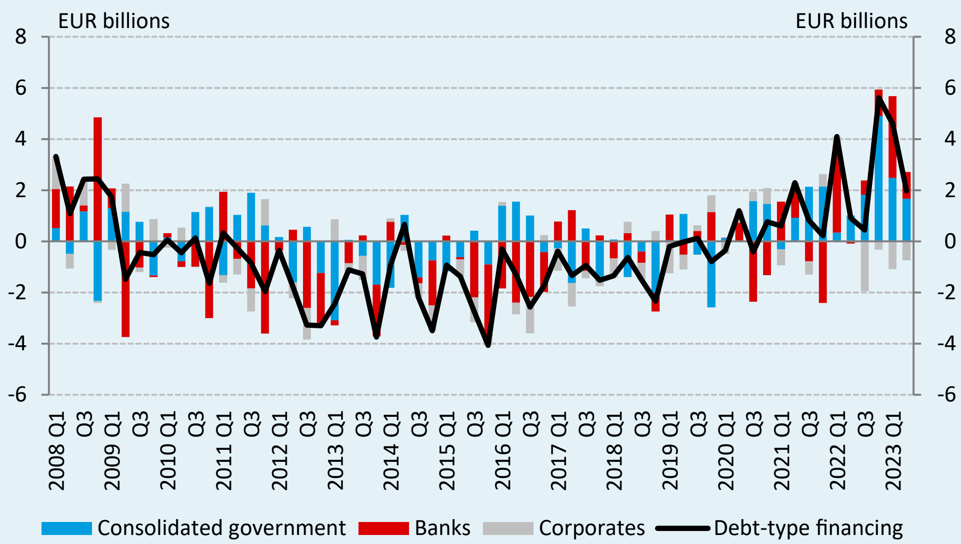
In 2023 Q2, outflows of net portfolio investments were higher, at nearly EUR 540 million (Chart 13). The trend of significant net outflows of funds seen in portfolio investments in 2020–2021 (which was related to an increase in domestic actors' investments abroad) stopped in 2022, but then started to increase substantially again in 2023 Q2. This increase was primarily due to a government measure in June (introduction of social contribution tax, new rules on investment funds entering into force), resulting in significant inflows into investment funds, which continued later as well. As a result, residents increased their holdings of foreign equities and mutual fund shares accumulated in the previous quarters by nearly EUR 630 million, while non-residents slightly increased their holdings of portfolio investments (by EUR 73 million).

Chart 13: Developments in net portfolio equity and mutual fund share assets (cumulative transactions)



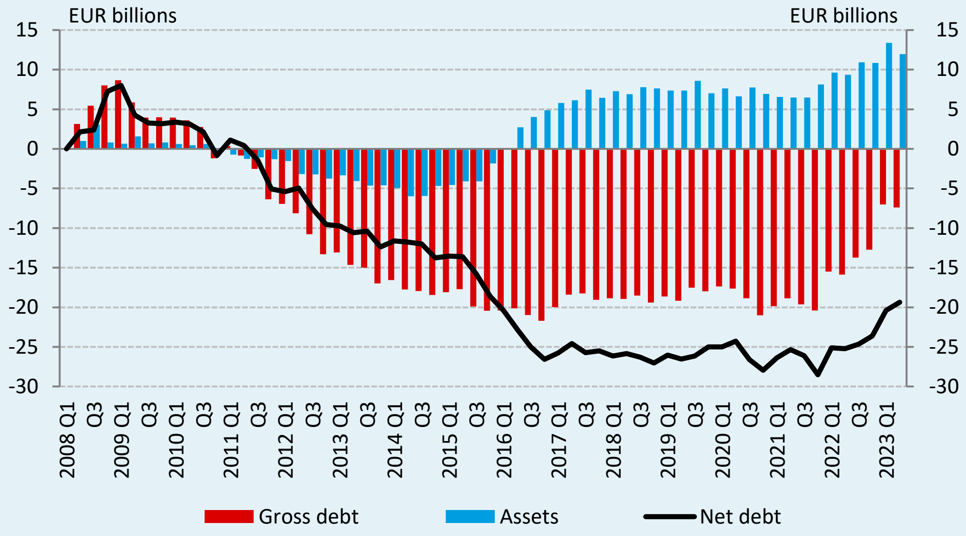
Compared to the previous quarter, the inflow of debt liabilities continued at a slower pace in Q2 (Chart 14). Net outstanding external debt rose by EUR 2 billion due to transactions, which was partly related to the consolidated general government and partly to the banking sector, while the indicator for companies declined. The net external debt of consolidated general government grew by EUR 1.7 billion, while that of the banking sector increased by EUR 1.1 billion during the quarter.

Chart 14: Development of net debt-type financing by sector



The net external debt of the banking sector rose, although at a lower rate than in the previous quarter (Chart 15). The growth of more than EUR 1 billion in the net indicator was due to the fact that the contraction in banks' assets was substantially larger than the decline in liabilities. The decline in liabilities was primarily related to short-term instruments.

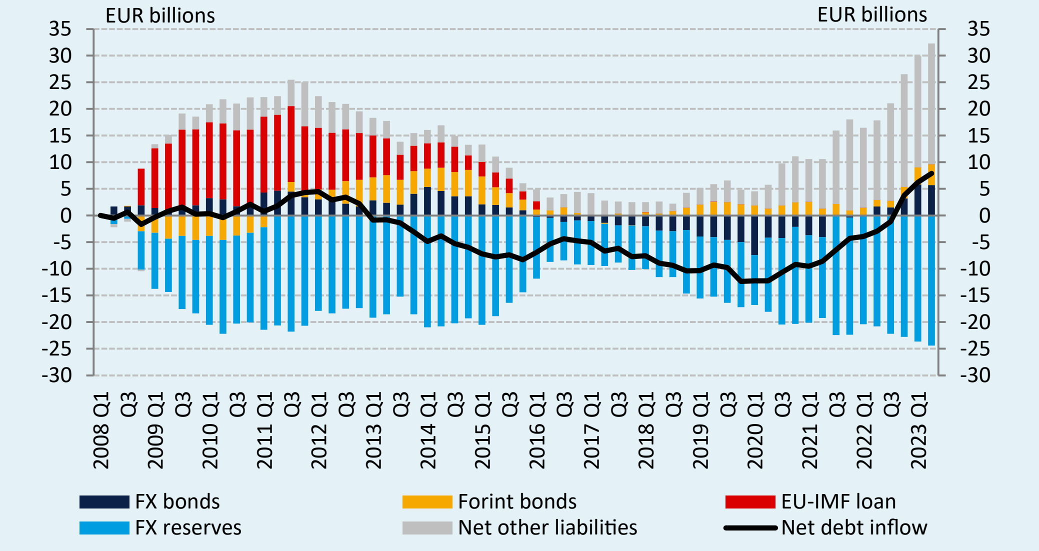
Chart 15: Changes in the banking sector's external debt and assets since early 2008 (cumulative transactions)



Due to transactions, the net external debt of the consolidated general government including the MNB expanded by EUR 1.7 billion in the second quarter, reflecting more subdued borrowing compared to the previous quarter. The change in the net external debt of the state was the combined result of contrasting effects (Chart 16):

- Non-residents' holdings of long-term HUF-denominated government securities increased by EUR 0.6 billion during the quarter.
- Foreign exchange expenditures of the Hungarian State Treasury reduced the FX reserves, contributing to the rise in net external debt.
- Contributing to the reduction in banks' external debt, the central bank FX swaps that provide FX liquidity have a neutral effect on net external debt at the whole-economy level, but the facility results in a rearrangement across the net debt indicators of economic sectors. Recourse to the swap instrument at end-June was higher than in the previous quarters, and this contributed to the fall in the net external debt indicator of banks and a rise in the net indicator of the government.
- Applied to ease swap market tensions, one-off central bank discount bonds were issued for an amount that was EUR 0.1 billion lower than in the previous quarter, reducing the net external debt of the state.
- The absorption of EU transfers also contributed to the decrease in the net external liabilities of the government.

Chart 16: Breakdown of the change in the net external debt of the consolidated general government including the MNB (cumulative transactions)



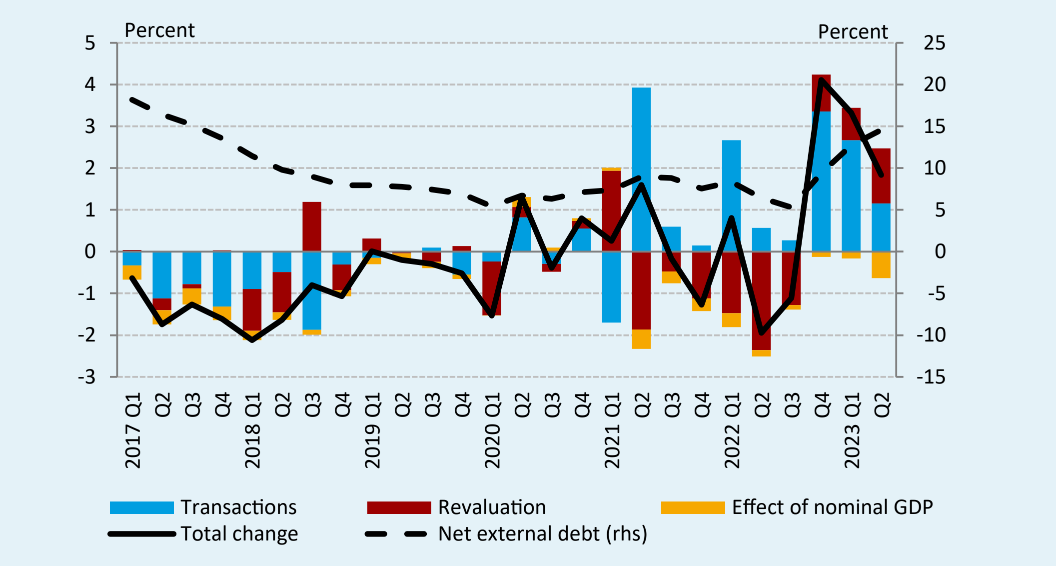
3 Developments in debt ratios

According to the underlying trends, net external debt amounted to 14.6 percent of GDP at the end of June 2023. The increase in the debt indicator since end-2022 is attributable to the fact that the effect of the debt-type financing, which is part of the external funding of the country, has no longer been offset by revaluation since end-2022, as the adjustment following the period of major yield increases and exchange rate weakening contribute to the growth in net outstanding debt. The expansion in nominal GDP continues to reduce the debt indicators slightly. The increase in net external debt was related to the rise in the indicators of the general government and the banking sector, while the debt ratio of non-financial corporations improved somewhat. Gross external debt decreased marginally in relation to the banking sector and corporates and stood at 69 percent of GDP at the end of June 2023. International reserves were close to their historic highs at nearly EUR 40 billion at the end of the quarter, exceeding the level of short-term external debt, which is closely monitored by investors, by more than EUR 2 billion.

3.1 Developments in debt indicators

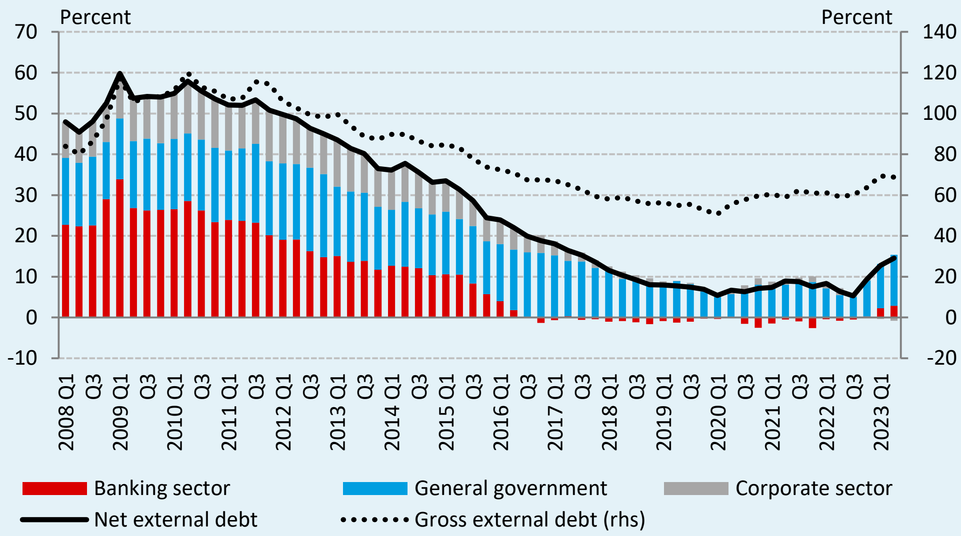
In the second quarter, the net external debt of the economy according to underlying trends rose to 14.6 percent of GDP. In parallel with the significant inflows of debt liabilities noted above, the revaluation of stocks also increased the indicator, which was offset slightly by the effect of the expansion in nominal GDP (Chart 17). Inflows of debt liabilities increased the net external debt by some 1.2 percentage points, which was primarily related to the general government. The adjustment of the former revaluations with a stock-reducing effect seen in 2021 and 2022, relating mainly to higher yields and exchange rate depreciation, continued in the first and second quarters of 2023, in parallel with the decline in yields. As in the previous quarters, the rise in nominal GDP moderately reduced the net external debt-to-GDP ratio by around half a percentage point in the second quarter.

Chart 17: Components of the change in net external debt (as a percentage of GDP, exclusive of intercompany loans)



The rise in the net external debt ratio was mainly linked to the general government and the banking sector, while the debt indicator of non-financial corporations declined (Chart 18). The net external debt of the *consolidated general government including the MNB* increased by 1.7 percent of GDP, which primarily reflected the effect of the debt liabilities inflow of the state (e.g. increase in non-residents' forint government securities holdings, transactions contributing to the decline in foreign exchange reserves). In addition, the revaluation related to the yield decline and exchange rate changes during the quarter also raised the debt indicator, to a lesser degree. On the whole, the private sector's net external debt-to-GDP ratio increased: the rise in the banks' debt indicator slightly exceeded the decline in the indicator for companies. The net external debt of banks rose by 0.6 percentage points, as a combined result of receivables falling to a greater degree than foreign liabilities. Accordingly, in a continuation of a trend that started at the end of 2022, the banking sector's foreign liabilities now exceed its foreign receivables, i.e. the sector's net debt indicator remains in positive territory, in contrast to the negative, close-to-zero level seen since 2017. *Companies'* net external debt-to-GDP ratio dropped by 0.4 percentage points: foreign receivables rose, related mostly to bond purchases, with foreign liabilities, related to commercial loans, falling as well. The net external debt indicator for companies remained slightly negative at the end of the second quarter, i.e. its foreign assets exceed its foreign liabilities.

Chart 18: Breakdown of net external debt and gross external debt (as a percentage of GDP, excluding intercompany loans)



At the end of the second quarter, Hungary's gross external debt as a percentage of GDP amounted to 69 percent of GDP. Following a rise at the end of 2022, the debt indicator fell slightly in 2023 Q2, which was attributable mainly to similar declines in the indicators for the banking sector and *companies.* In the *banking sector,* foreign liabilities decreased primarily in connection with short-term deposits and lending. *Companies'* gross external debt as a percentage of GDP fell due to a drop in short-term commercial loan liabilities. The indicator of the *consolidated general government including the MNB* rose, partly as a result of the expansion in liabilities due to the increase in the forint government securities holdings of non-residents, while the aforementioned revaluation effects also contributed to the rise in outstanding debt.

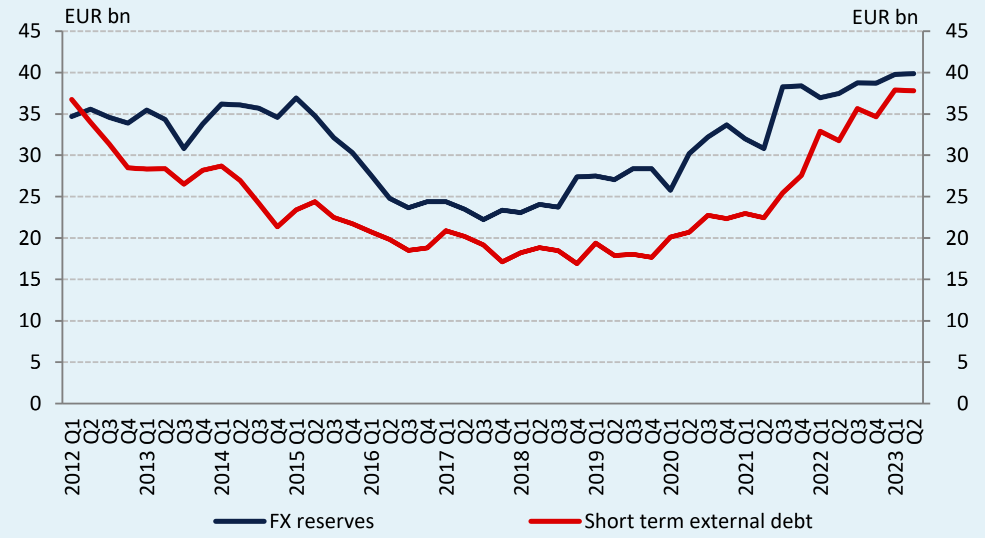
3.2 Foreign exchange reserves and reserve adequacy

At the end of 2023 Q2, international reserves amounted to EUR 39.9 billion, close to a historic high. Following EUR 39.8 billion at the end of March 2023, the MNB's international reserves amounted to EUR 39.9 billion at the end of June 2023, with reserves remaining steady during the quarter. The development of reserves was influenced by multiple factors, the most important of which were the following:

- The net reserve-increasing effect of *EU funds* amounted to EUR 0.9 billion, which was primarily related to 2014–2020 cohesion funds and agricultural financing inflows, and also included advance payments for the new programming period.
- The *net FX financing operations of the Government Debt Management Agency* had an overall neutral effect on reserve levels; there were no significant FX funds inflows or outflows during the quarter.
- The reserve-reducing effect of the Hungarian *State Treasury's foreign currency transactions* amounted to EUR 0.3 billion.
- Due to changes in the exchange rate, *revaluation* of reserve items denominated in currencies other than the euro reduced the reserves by nearly EUR 0.6 billion.

At the end of 2023 Q2, the MNB's international reserves exceeded the level of short-term external debt, which is closely monitored by investors, by EUR 2.1 billion. At end-June 2023, international reserves and short-term external debt amounted to EUR 39.9 billion and EUR 37.8 billion, respectively. The leeway above the Guidotti-Greenspan indicator, which is closely followed by both the central bank and investors, amounted to EUR 2.1 billion and was thus slightly higher compared to end-March 2023 (Chart 19).

Chart 19: Short-term external debt of the Hungarian economy and its foreign exchange reserves

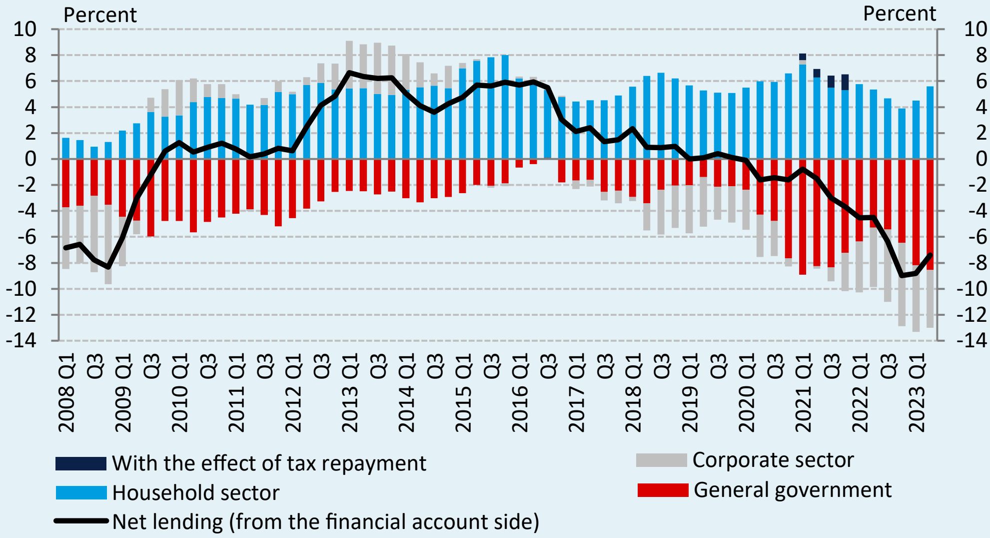


4 Sectors' savings approach

In 2023 Q2, the moderate growth in the general government deficit was more than offset by the improving net position of the private sector, and thus the external balance according to the savings of economic sectors improved. Lower tax revenues and the increase in interest expenditures in an environment of high yields contributed to the deterioration in the general government indicator. The net financial position of households and companies improved significantly, mainly owing to the decline in consumption and investment, but this was also supported by rising corporate profits. In an environment of high inflation, holdings of inflation-indexed government securities continued to increase within total household savings and, due to a regulatory change, holdings of mutual fund shares also rose, while bank deposit holdings of households contracted.

Based on developments in sectoral savings, the net borrowing of the state continued to grow slightly, but this was more than offset by the private sector's improving net position, and thus the net borrowing of the economy declined substantially in the second quarter of the year (Chart 20). In the second quarter, the general government deficit continued to rise, albeit at a slower rate, reflecting the decline in tax revenues due to falling consumption and higher interest expenditures. The four-quarter deficit of the general government rose to 8.5 percent of GDP, nearly reaching the outlier seen two years ago due to the need to address the effects of the pandemic. By contrast, as high inflation continues to dampen household consumption and nominal income growth, households' net savings rose further in quarter-on-quarter terms and now stand at 5.6 percent, almost returning to the levels measured in the first half of 2022. At the same time, companies restrained their investment activity and reduced their inventories as a result of waning domestic demand, and thus, with their profits increasing, the sector's net borrowing decreased. On the whole, the improvement in the position of the private sector exceeded the slightly rising net borrowing of the state, and thus net borrowing according to economic sector savings declined significantly.

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

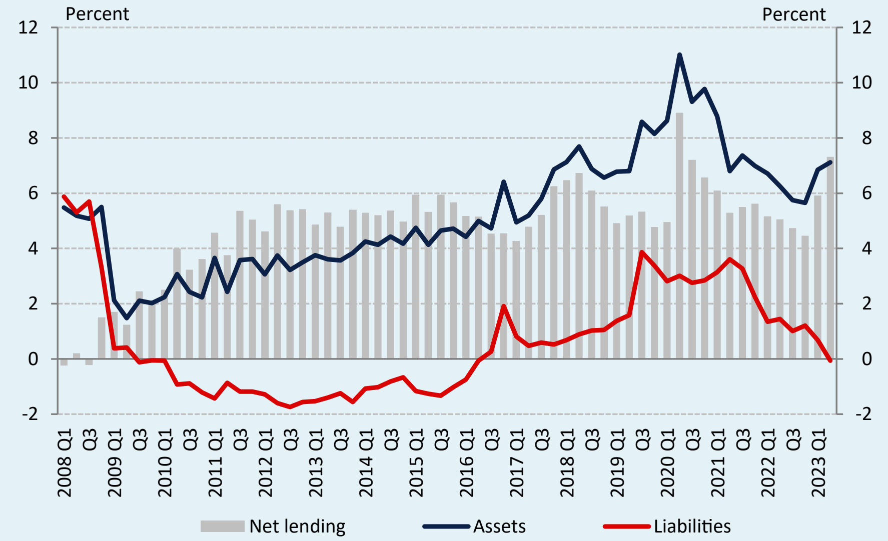


** General government represents the net borrowing according to the financial accounts. Corporates based on the residual principle.*

According to the underlying trends, households' four-quarter net financial savings increased in 2023 Q2 versus the previous quarter, in parallel with an expansion in financial assets and a decline in liabilities (Chart 21). Based on economic considerations, the MNB excludes one-off effects (such as pension fund savings, early repayment, real yield disbursement, indemnification of the depositors of liquidated mutual savings banks, forint conversion and settlement, personal income tax refunds) from the indicator based on underlying trends. One-off effects also influence the net indicator via the accumulation of financial assets and liabilities, and therefore the underlying trends are presented using the net data along with the gross legs.

According to the seasonally adjusted indicator, which is expressed as a percentage of GDP and captures the underlying trends, households' financial asset accumulation increased as a combined result of increasing nominal wages and high inflation, the decline in domestic absorption (including falling consumption) and a rise in interest income. Households' net borrowing as a percentage of GDP continued to fall, mainly in view of the lower demand for real estate loans. The subdued development of housing loans was attributable to the decrease in demand due to high interest rates and the fall in housing market activity in view of the elevated uncertainty.

Chart 21: Households' net lending according to underlying trends (seasonally and otherwise adjusted* data, as a percentage of GDP)



** Figures showing underlying trends, adjusted for pension fund savings, the early repayment scheme and the real yield disbursement, the indemnification of the depositors of liquidated mutual savings banks, the effect of forint conversion and settlement, and the PIT refund. Time series adjusted separately.*

The rearrangement of asset types within the slightly declining financial asset accumulation continued (Chart 22).

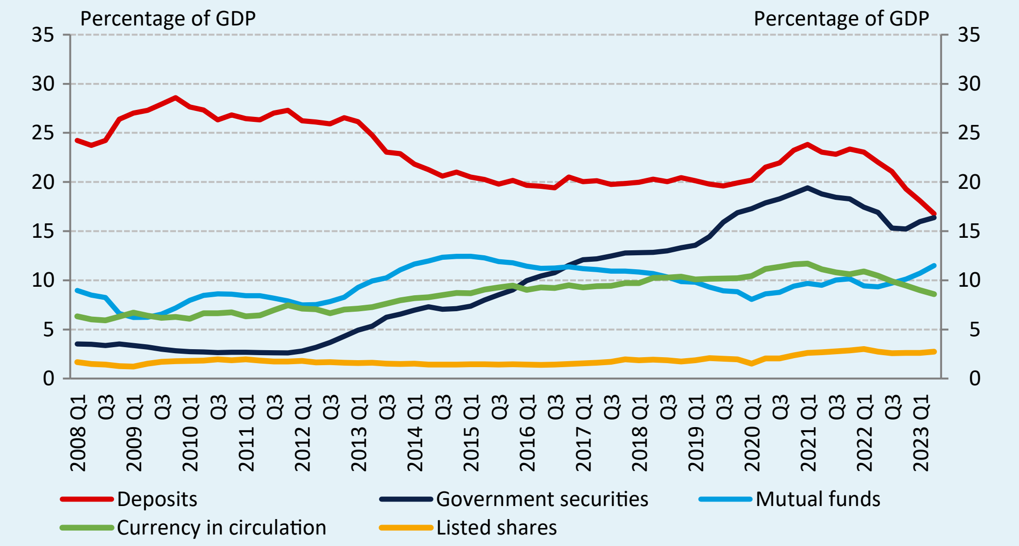
- Overnight and other deposits decreased more significantly than in the previous quarter, dropping by nearly HUF 450 billion. This may have been partly due to the change in the regulatory environment, as a result of which households effected a substantial reallocation of assets at the end of the second quarter.

- Households' demand for government securities remained dynamic in 2023 Q2: on the whole, households' government securities holdings increased by more than HUF 600 billion due to transactions. Demand remained high especially for long-term securities, while holdings of short-term papers (e.g. discount treasury bills) fell on a transaction basis. Within the government bond portfolio, the redemptions of MÁP+ government securities continued, although at a much slower pace: holdings of MÁP+ securities declined by some HUF 350 billion in the second quarter. In an environment of high inflation, demand for inflation-indexed PMÁP securities continued to increase (partly as a result of outflows from MÁP+), with net inflows into this asset category surpassing HUF 750 billion in the second quarter. However, growth in BMÁP decelerated compared to previous quarters, as holdings grew by HUF 150 billion during the quarter. Households' total holdings of government securities represented nearly 16.5 percent of GDP in the second quarter.

- The banknote and coin holdings of households continued to fall in the second quarter, albeit less steeply than in the previous quarter: households reduced their cash holdings by HUF 80 billion, which therefore amounted to 9 percent of GDP.

- Prior to the entry into force of the social contribution tax rule in July, demand for mutual fund shares increased steeply, so that holdings grew by HUF 630 billion, in excess of even the levels measured in previous quarters. In the last two years and especially since 2022 H2, households have increased their financial wealth held in mutual funds. After a period of deceleration in the first quarter, inflows into foreign mutual funds started to accelerate again in 2023 Q2.

Chart 22: Development of households' key financial asset



5 Earnings of foreign-owned companies

The special topic in this Report on the Balance of Payments focuses on the development of earnings at foreign-owned companies. The actual figures indicate a fall in the earnings of foreign-owned companies as a percentage of GDP in 2022, which may have been related to an increase in expenditures due to surging energy prices and the profit-reducing effects of the extra profit tax. The reinvestment rate of non-financial companies fell slightly but remains high, whereas the substantial increase in banks' dividend payout ratios after years of low levels is due to regulatory reasons. Across the key sectors, returns on equity varied, declining in the chemical industry and transportation, slightly increasing in vehicle manufacturing and trade, and more than doubling in the financial intermediation sector. Profit growth at the foreign operations of resident companies rose to historic highs. Three of the countries in the region also recorded increases in return on equity, which was typically reflected in higher reinvestments. The GNI-GDP gap tended to widen in the countries of the region, in line with the rise in the profits of foreign companies.

Using the annual data reports, the September balance of payments report replaces the earlier estimates for 2022 corporate income with actual figures.[2] The data show that the balance of profits in the income balance was similar to that previously reported. The nominal growth of the profits of foreign-owned companies operating in Hungary slowed, due to the extra profit tax and to falling export volumes, while profit growth at the foreign operations of Hungarian companies continued to accelerate.

With regard to the subject of corporate profits as our special topic, it is important to note that the balance of payments statistics reflect the companies' income from normal business activities, excluding outlier (one-off) profit items. According to the balance of payments methodology,[3] profits other than those from normal business activities, such as gains from exchange rate changes, are not included in earnings. Gains and losses from such sources are reported under changes in stocks outside transactions. The first subsection presents the development of the earnings of foreign-owned companies and its absorption in accordance with the balance of payments. This is followed by an overview of the earnings of foreign-owned non-financial companies and banks, after which the background to the changes in profits in 2022 is examined. After presenting companies' balance-of-payments and after-tax profits, the final subsection concludes the discussion of this special topic of the Report on the Balance of Payments with a regional comparison.

5.1 Earnings of foreign-owned companies in the balance of payments

In 2022 the balance of foreign-owned companies' income from participating interests shrank to 5.4 percent of GDP (Chart 23). **Dividends paid to shareholders as a percentage of GDP remained at around the level measured in the previous year, and thus the fall in income was reflected in a 0.5-percentage point decline in reinvestment.** Following the 2008–2009 crisis, foreign companies' profits as a percentage of GDP fell as demand slowed. However, after 2013, income generated by foreign companies increased in line with the acceleration in economic growth and supported by external demand, which also helped exports to expand dynamically. The fall in profits starting in 2018 was exacerbated in 2020 by the effect of pandemic shutdowns through reduced profitability, although profits as a percentage of GDP remained relatively high and dividend payments[4] were subdued, resulting in significant reinvestment; this has played an important role in the inflows of foreign direct capital in recent years and thus presumably also in the dynamic expansion of investments by companies. Overall, the post-pandemic recovery and stronger export revenues led to an increase in corporate profits. However, the profits of foreign-owned companies as a percentage of GDP dropped slightly in 2022, reflecting the extra profit tax in addition to lower export volume growth, with the rapid growth of nominal GDP also contributing to this effect. The dividend payout-to-GDP ratio barely changed, resulting in a small increase in the dividend payout ratio to 45 percent, and thus the level of reinvested earnings fell to 3 percent of GDP.[5] The profits of foreign companies were predominantly generated by non-financial companies (almost 87 percent).

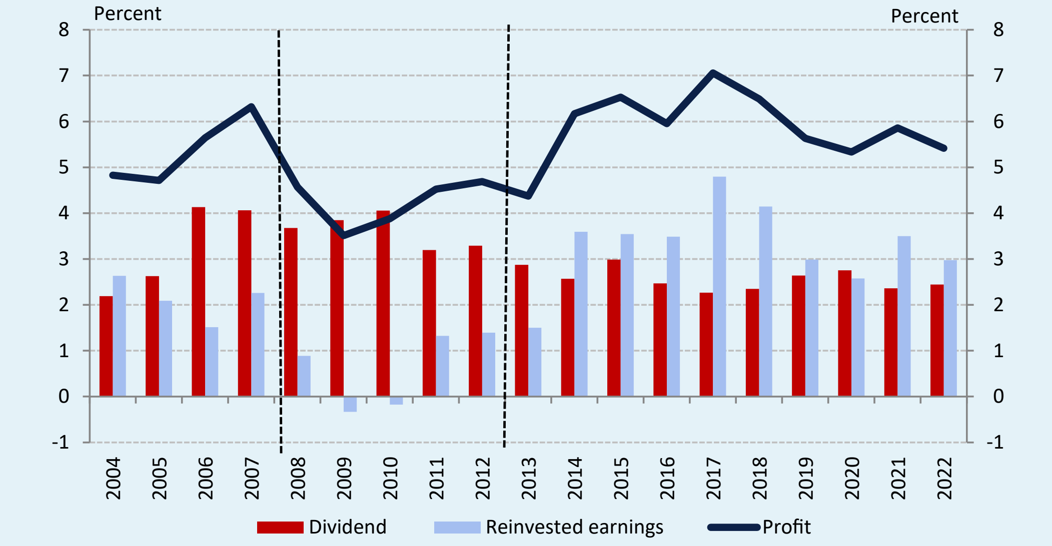
[2] For more details, see: Hungary's balance of payments and international investment position statistics, MNB (2014).

[3] Balance of Payment Manual, 6th edition.

[4] It is important to note here that, in balance of payments statistics, dividend payments in excess of the profit for the year are not included in the income balance, as they are recorded as a divestment in the financial account. The extent of this is reflected in the exceptional dividend figure, which, at above EUR 7 billion, was significantly higher in 2021 than in previous years. A major contributor to the exceptional dividend figure was the dividend payment by a multinational operating in Hungary, which had not paid dividends to its shareholder for an extended period prior to this, so that the dividend payment in fact reflected profits generated over the course of multiple years.

[5] Since reinvested earnings are the difference between the profits generated and the dividends paid, the COPC adjustment and the treatment of exceptional dividends have a significant impact on the value of reinvested earnings (for more details see the July 2017 Report on the Balance of Payments).

Chart 23: Earnings of foreign-owned companies and their absorption[6] (as a percentage of GDP)



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

The profit margin of banks rose steeply in 2022, whereas that of non-financial companies registered a slight decrease. Prior to the 2008–2009 crisis, the rate of return on direct investments was around 10 percent for companies and 13 percent for banks. After the crisis, the profit margin of non-financial companies fell, while banks' margins only contracted to a substantial degree in 2012.

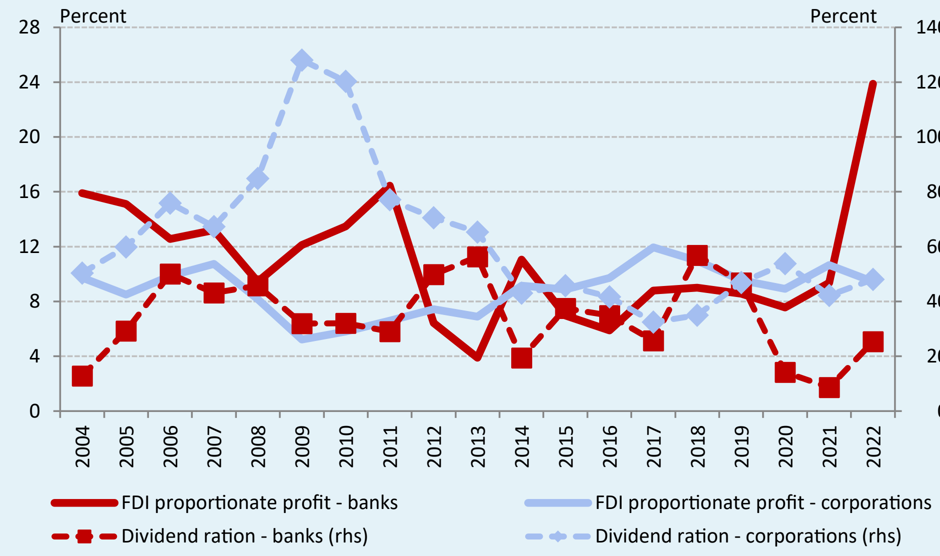
- Foreign banks' profit margins from normal business activities rose to nearly 9 percent in the 2017–2019 period as banks cleaned up their balance sheets and lending picked up in line with the economic cycle, before falling to below 8 percent in 2020 as a result of the pandemic. The increase in profit margins in 2021 was followed by a spectacular rise in 2022, mainly due to higher interest income due to the rising yield environment.

- After the crisis, the profits of non-financial companies increased gradually to approximate 12 percent by 2017, but then started to decline again due to high wage outflows and high investment spending, before falling even further in 2020 to nearly 9 percent due to restrictions and closures related to the pandemic and lost production due to disruptions in supply chains. Although the profit margin increased in 2021 due to rising export revenues in line with stronger external demand, it declined slightly in 2022 due to lower export volume growth and the extra profit tax.

In 2022, dividend payout ratios for both non-financial corporations and banks increased. Banks saw their dividend payments fall sharply in 2020 and then correct in 2022, which was mainly due to regulatory decisions. In March 2020, the MNB's Financial Stability Board adopted a comprehensive package of measures to mitigate the impact of the Covid-19 crisis on the financial intermediary sector, including a temporary restriction on dividend payments, which strengthened the liquidity and financial position of the Hungarian banking sector. The restriction was lifted at the end of 2021, resulting in an increase in dividend payments by banks in 2022. The dividend payout ratio of non-financial corporations rose again after declining last year and reached almost 50 percent. The increase in dividends may be an indication of the parent companies' mounting demand for funds in an uncertain economic environment. In addition, falling investment may also have had the effect of reducing reinvested earnings and increasing dividends.

[6] Any analysis of the time series must take into account that, from 2008 onwards, profits (and hence reinvested earnings) only include the profits from normal business activities. However, it may be assumed that profit and loss items resulting from the significant shifts in exchange rates, i.e. not generated by the normal business activities, may have grown even after the crisis, so the time series is presumably suitable for comparisons with the earlier period. As a further complication, since 2013 dividends paid to foreign shareholders have been adjusted for exceptional dividends, which are then accounted for as a reduction in shareholding rather than as a dividend payment; this in turn has an effect on the allocation of profits between dividend payments and reinvestment.

Chart 24: Profits of foreign companies and banks as a share of FDI and approved dividends as a share of profits

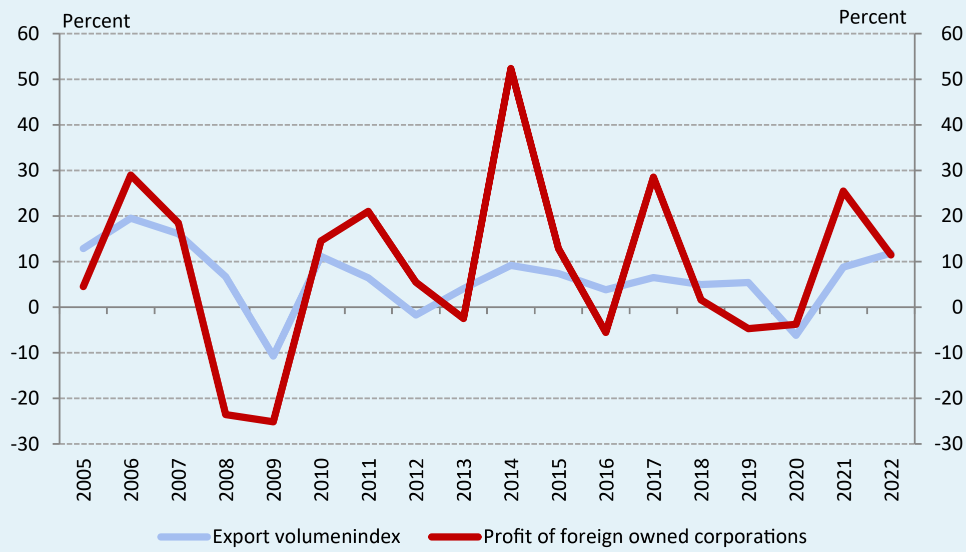


Note: The profit ratio is calculated from year-end balances.

5.3 What are the factors behind the changes in corporate profits?

In 2022, slower export volume growth was accompanied by a slowdown in the growth of a relatively closely correlated factor, corporate profits. Given the fact that a significant proportion of foreign-owned companies are exporters and based on past experience, it is appropriate to compare the profits of foreign companies with export performance. Over the past decade, exports and profits have generally changed in the same direction, with rising or falling export revenues largely determining the evolution of profits (Chart 25). After the pandemic, export volumes expanded sharply in 2021, rising at their steepest rate since the early 2000s, and companies' profits increased significantly in parallel. In 2022, while export growth continued in real terms, higher costs due to the surge in energy prices and the extra profit tax reduced foreign companies' earnings substantially, and accordingly their profits fell overall.

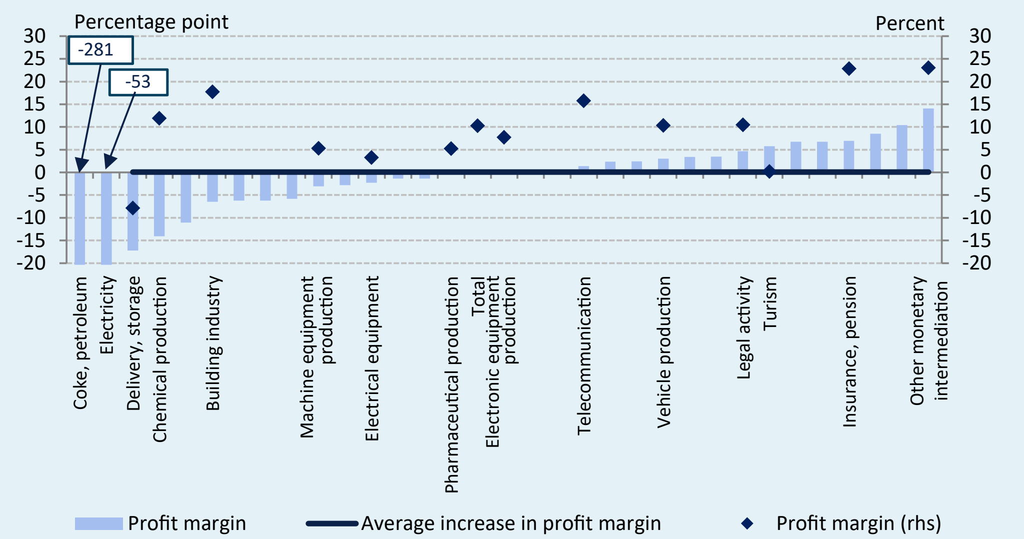
Chart 25: Growth of foreign-owned companies' profits (in HUF) and export performance (volume index)



After a good year in 2021, the return on equity figures of companies in the main sectors varied in 2022; financial companies stood out but, with the effects of the pandemic fading, there was further improvement in the performance of hotel and catering providers as well. The average profit margin to FDI of foreign-owned companies calculated by sector increased by an average of 0.1 percentage points between 2021 and 2022 (the outlying negative performance of the low-weight energy and oil sector was linked to the surge in energy prices and is not included in our calculation of the average figure). In an uncertain economic environment, a larger share of sectors saw their gross margins fall than in 2021 (Chart 26), but most sectors with significant FDI of more than EUR 2 billion recorded rising corporate profits. The biggest improvements were seen in the sectors financial intermediation, insurance and information services, while corporate profits fell in electrical equipment manufacturing and the chemical industry.

The average profit margin of the major foreign companies operating in Hungary was above 3 percent in 2022, although with significant dispersion. Profit margins in the vehicle manufacturing sector, the largest foreign-invested sector, continued to expand in 2022. The rise was probably linked to a recovery in industrial production and exports, but this was restrained by soaring energy prices and mounting external economic uncertainty. With a profit margin of around 10 percent, the vehicle manufacturing sector ranks in the middle of the range of the sectors with significant foreign invested capital. In retail trade, which is the second largest foreign-invested sector, profit margins remained above 20 percent in 2022, driven by strong domestic demand in the context of a rebound in consumption and investment activity, which was accompanied by favourable changes in earnings at the beginning of last year. Overall, the profit margin of the larger foreign companies operating in Hungary was typically close to 10–12 percent of invested capital, although there was a relatively widespread in the range between 5 to 25 percent. However, in the transport and warehousing sector, which also has substantial FDI, profits turned into losses in 2022 after falling in the preceding years.

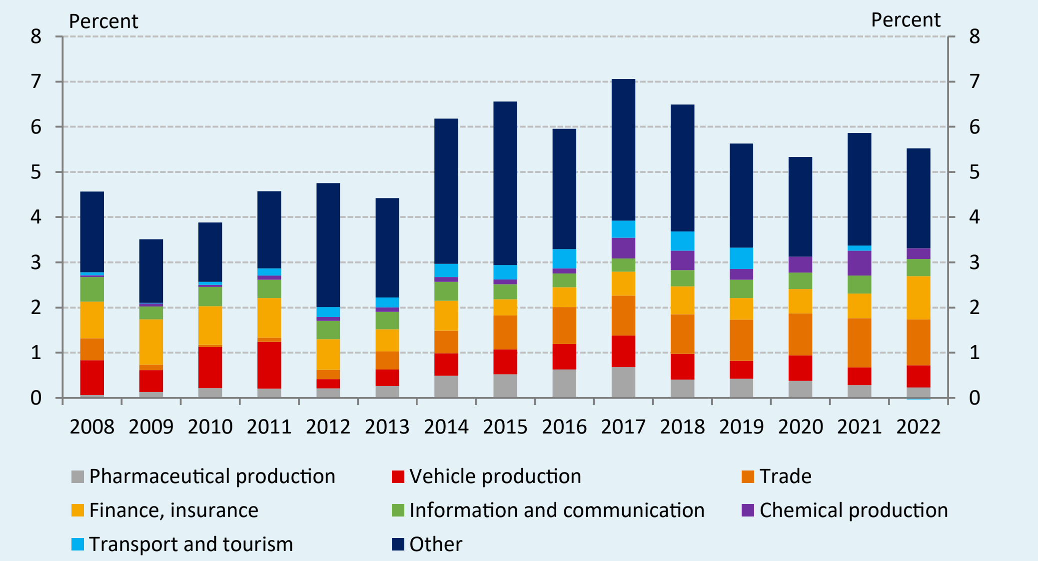
Chart 26: Growth of foreign companies' profits versus FDI in various sectors in 2022



Note: For sectors with an FDI of more than EUR 2 billion and sectors showing outlier results, the profit margin of the sector is indicated.

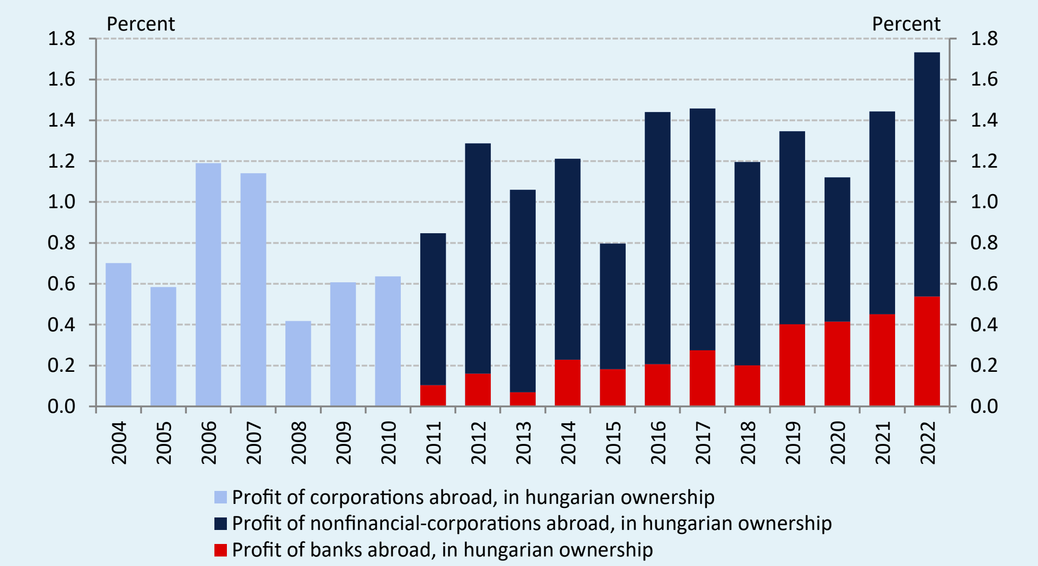
Foreign companies' profits from foreign direct investment remain fairly concentrated, with the largest seven sectors accounting for nearly 60 percent of profits. Until 2017, the increase in the profits of foreign-owned companies affected a wide range of sectors, although the profitability of the largest sectors was especially high. The decline in the profit-to-GDP ratio in 2018–2019 was also observable across the board, as it affected both sectors of larger and smaller weight. In terms of sectoral profitability, there were more significant and more concentrated changes in 2020: while the profitability of most of the major sectors (e.g. chemicals and vehicle manufacturing, finance and insurance) improved, the economic impact of the pandemic hit transport and tourism particularly hard, which saw their profits falling to zero. By 2022, as the effects of the pandemic faded, losses in tourism had been eliminated, but profitability was still well below the levels seen in the late 2010s. By contrast, the transport sector became loss-making again in 2022, and the chemical industry and pharmaceuticals also registered a substantial decline, while retail profits as a percentage of GDP contracted to a lesser degree. Income as a percentage of GDP rose substantially in vehicle manufacturing and especially in the financial and insurance sectors; the former was due to the favourable change in the export environment and the latter due to the prevailing high yields. Other sectors registered minor losses. In terms of profitability, there was no significant change in the weight of sectors, with large sectors still accounting for around 60 percent of the total profits of foreign companies operating in Hungary.

Chart 27: Profits of foreign-owned companies (as a percentage of GDP)



While the growth in earnings of foreign-owned companies operating in Hungary slowed, the growth in profits of foreign subsidiaries of resident companies accelerated in 2022. In addition to the earnings of foreign companies operating in Hungary, the balance of payments income balance[7] also includes the profits of the foreign operations of Hungarian companies. As a percentage of GDP, this rose to an all-time high in 2022, following the increase seen in 2021. The increase was mainly linked to a significant improvement in the foreign profits of resident non-financial companies, although banks' profits also rose. Consistently high since 2019, the profits of foreign banking subsidiaries rose further in 2022, despite the fact that market uncertainties in Ukraine and Russia reduced profits.

Chart 28: Profits of foreign operations of resident companies (as a percentage of GDP)

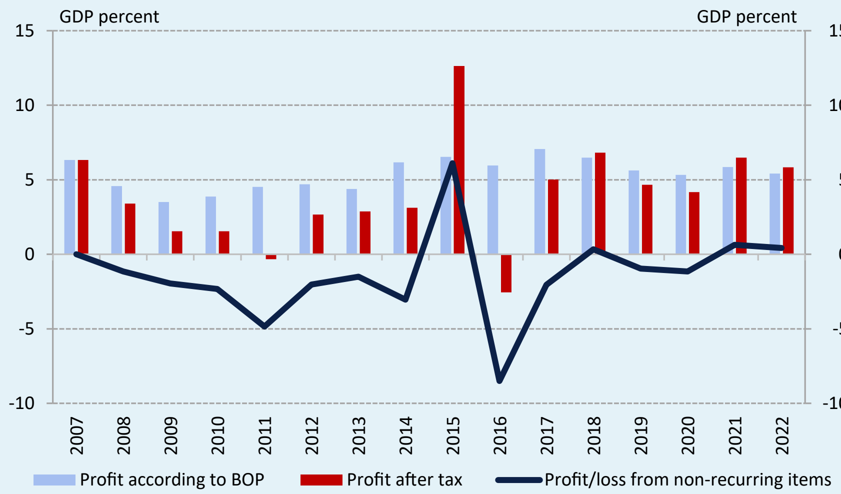


[7] For analytical purposes, primary income is shown in the income balance, except for other primary income, which in the previous methodology was part of unrequited transfers and is therefore included in the transfer balance.

5.4 After-tax profit of foreign-owned companies

Similarly to 'earnings from normal business activities', the after-tax profits of companies, as shown in the balance of payments, also decreased in 2022, and thus the difference between the two indicators (mostly due to individual items) remains narrow (Chart 29). In line with international rules, the balance of payments statistics only present the profits of foreign-owned companies from normal business activities, i.e. one-off effects are excluded (these tend to relate to revaluation).[8] As a result, the profit figure in the balance of payments (the profit from normal business activities) is much more stable: In 2015 and 2016, for example, the outlier profitability figures of a multinational company operating in Hungary had a strong effect on the development of the after-tax profit figure, while the earnings figure in the balance of payments, where individual effects are eliminated, remained stable. The data available since 2008 show that items which are not from normal business activities tended to reduce corporate profits, and thus the elimination of these items in the balance of payments statistics has led to higher earnings figures (and thus higher reinvested earnings at a given amount of dividends paid) and a larger deficit in the income balance. In recent years, the divergence between the two indicators has been relatively small, i.e. there have been no single large items not related to normal business activities that would have significantly affected earnings, and accordingly the balance of payments profit (profit from normal business activities) only differed from the after-tax profit by about 1 percent of GDP. In 2022, both the balance-of-payments (normal-business) and the after-tax profit-to-GDP ratios declined slightly, to 5.4 percent and 5.8 percent, respectively.

Chart 29: Profit from normal business activities and after-tax profit* (as a percentage of GDP)



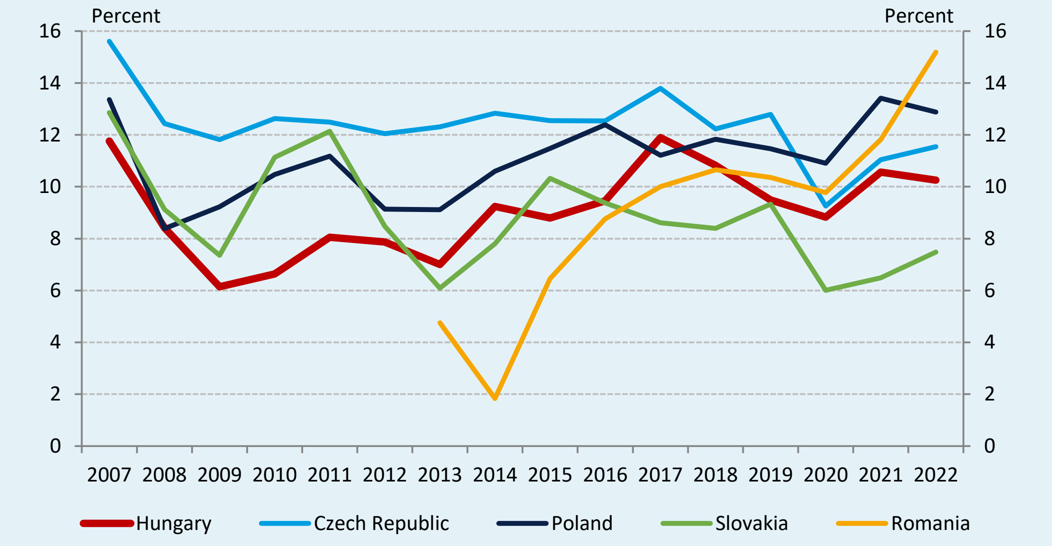
** The profits generated by foreign-owned companies have a negative effect on the income balance, in line with the balance of payments income balance.*

5.5 International comparison

While the profitability of foreign companies varied across the region in 2022, Hungary recorded a return on FDI of around 10 percent, which outperforms only Slovakia. After the 2008 financial crisis, the profitability indicators of the countries in the region moved broadly in line with each other, driven by common external developments, with a slight upward trend after 2013. In 2020, the pandemic drove down corporate profitability along with economic growth, but profit margins corrected the following year and continued to do so in 2022, with the exception of Hungary and Poland (in contrast to the upward regional trend, the developments in Hungary were partly due to the profitability-reducing effect of the extra profit tax, while in Poland the previous level had been relatively high and the decrease was relatively mild). According to the latest information, which is presumably still just an estimate, the highest profit margin, of 15 percent, was achieved in 2022 by foreign companies operating in Romania, making this country, which had had the lowest profitability in the years 2013 to 2016, into the most profitable in just a few years. Hungarian and Czech profit margins have been on a similar trajectory for several years, reaching 10 and 12 percent, respectively, in 2022. Despite slight growth, the profitability of foreign companies in Slovakia remained relatively low at less than 8 percent.

[8] Such one-off effects include, for example, losses due to exchange rate revaluations by companies, or early repayments at preferential rates or settlements related to retail loans in the case of credit institutions.

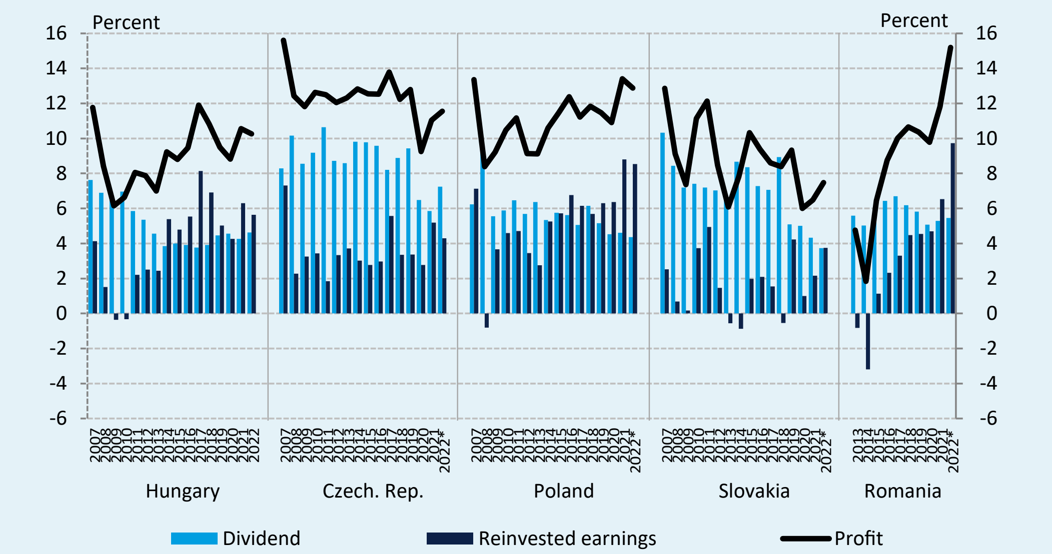
Chart 30: Return on direct investment versus share of equity (income from FDI versus FDI holdings)



*Source: Eurostat *For the rest of the countries in the region, the 2022 figure is likely an estimate.*

The increase in the profitability of foreign-owned companies was typically accompanied by an increase in reinvestment; nevertheless, while profitability declined slightly, reinvested earnings rose in Hungary as well (Chart 31). While the countries in the region used to be characterised by relatively high dividend payouts (especially the Czech Republic and Slovakia), Hungary's dividend payout ratio stabilised at a low level after a period of declines lasting until 2014.[9] Over the past few years, the dividend payout ratio has fallen in the other countries in the region as well. Preliminary data suggest that the dividend payout ratio remained low in 2022, accompanied by rising profitability and an increase in reinvested earnings. Only in the Czech Republic did dividend payments increase at the expense of reinvestment, which may have been influenced by the lifting of the dividend restriction applicable to the country's banking sector, in which foreign ownership is high (around 90 percent).[10] In Romania, a large increase in profitability was accompanied by a similar rate of increase in reinvested earnings, meaning that foreign companies tended to reinvest the additional earnings.

Chart 31: Breakdown of earnings from FDI (as a share of FDI)



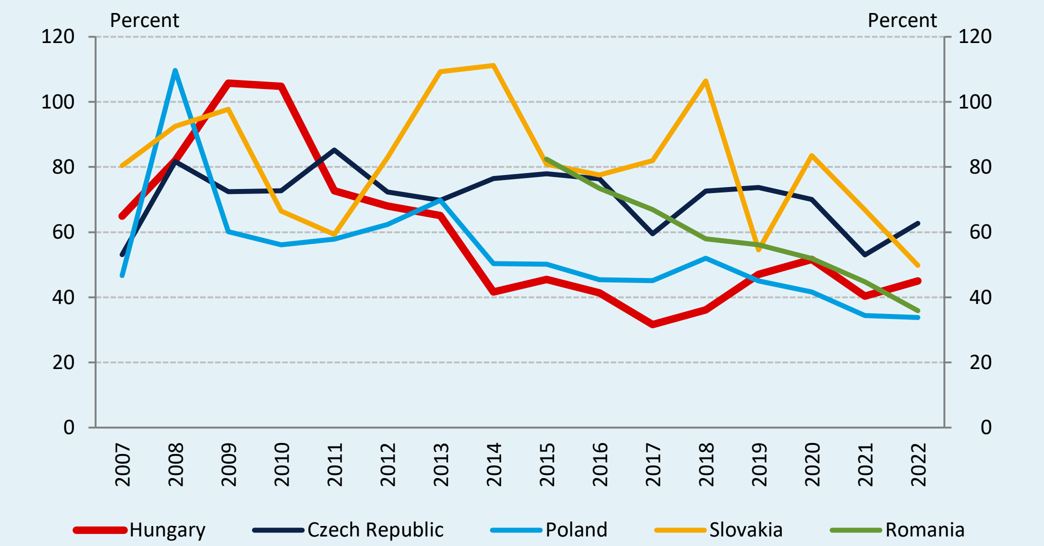
*Source: Eurostat *For the rest of the countries in the region, the 2022 figure is likely to be an estimate.*

9 However, from 2013, the Hungarian accounting of exceptional dividend payouts may have played a role in this.

10 A further factor boosting reinvested earnings, measured as a share of profits, may be the treatment of exceptional dividends, as it increases the weight of reinvested earnings as a share of profits and reduces that of dividends. This may also play a role in the higher reinvestment of foreign-owned companies operating in Hungary as a share of profits; as for the other countries in the region, there is no information available on whether the IMF recommendations on the use of exceptional dividends are taken into account.

In 2022, dividend payout ratios tended to decline in the region, with Poland, Romania and Hungary still showing the lowest dividend payout ratios, although the dividend payout ratio fell to below 50 percent in Slovakia as well last year (Chart 32). The dividend-to-income ratios of foreign companies had been on a steady upward trend in the region before 2009–2010. As a result of the increased liquidity needs of foreign parent companies due to the crisis and the downturn in the growth prospects of the countries in the region, companies in several countries paid dividends to their foreign shareholders against retained earnings accumulated in previous years. The dividend payout ratio declined in all countries by the end of the decade, most notably in Hungary, where foreign companies paid out only 32 percent of their earned income as dividends in 2017. Subsequently, the dividend ratio for foreign-owned subsidiaries embarked on an upward trend to reach 45 percent in 2022. In 2022, the dividend payout ratio declined in most of the countries in the region, with only the Czech Republic and Hungary increasing their dividend-to-profit ratio. Overall, the Czech Republic is the only country in the region where the dividend-to-income ratio has risen above 50 percent; all other countries measure levels below that mark.

Chart 32: Dividend payouts versus profits

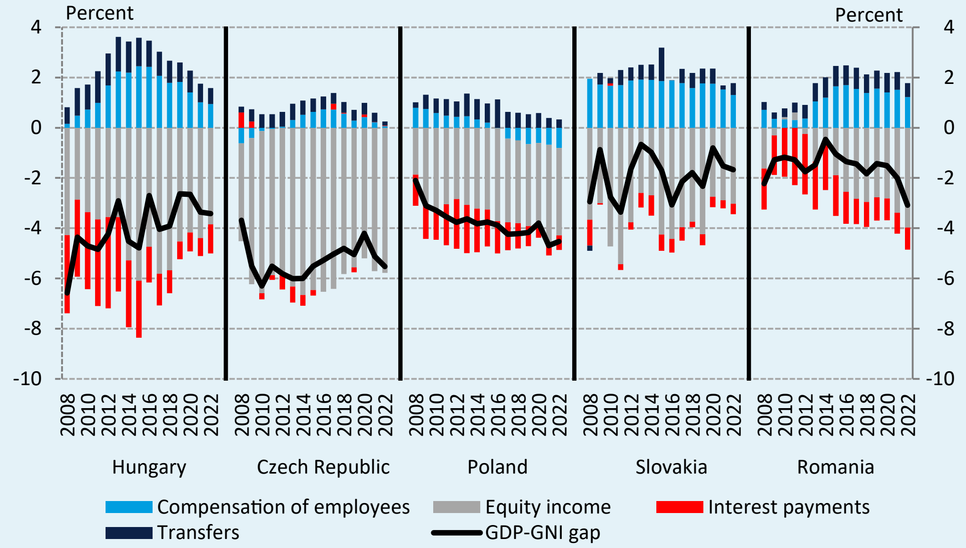


*Source: Eurostat *For the rest of the countries in the region, the 2022 figure is likely an estimate.*

The GDP-GNI gap in Hungary stabilised at above 3 percent in 2022, with a declining trend over the longer term, placing it in the middle of the regional range (Chart 33). The difference between gross domestic product (GDP) and gross national income (GNI), i.e. the GDP-GNI gap, is the result of the sum of income payments to the rest of the world. The components of the indicator are: foreign interest payments (interest), net profits of foreign companies (income from FDI holdings), foreign compensation of employees (wages) and transfers recorded as foreign primary income (transfer). Disposable income lags behind the value of gross domestic product because of the profits from large foreign direct investment (FDI) in the countries of the region. By contrast, EU transfers accounted for between the net income of foreign workers and primary income typically reduce the gap between GDP and GNI in the countries of the region. Following the 2008 crisis, improved corporate profitability led to a substantial increase in equity-related profit outflows in the countries of the region, partly offset by rising foreign employee wage and transfer inflows. In addition, falling interest expenditure also contributed significantly to narrowing the GDP-GNI gap.

In 2022, the gap between GDP and GNI increased in the region, with the exception of Hungary and Poland. The higher income outflows are partly due to an increase in FDI-related profit outflows and partly to a decrease in the wage balance of temporary expatriates (it is worth noting that in Poland, unlike in the rest of the region, the earned income of expatriate workers increases rather than reduces the gap between the two indicators, as the number of Ukrainian guest workers in the country exceeds the number of Polish workers employed abroad). However, the interest balance deteriorated to a significant degree only in Hungary, as a result of higher interest rates, while in the other countries the interest balance did not change substantially. In 2022, Romania's GDP-GNI gap increased significantly, but was still one of the lowest in the region.

Chart 33: Breakdown of the GNI-GDP gap* (as a proportion of GDP)



*Source: MNB, KSH, Eurostat *For the rest of the countries in the region, the 2022 figure is likely to be an estimate.*

List of charts

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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H-1013 BUDAPEST, KRISZTINA KÖRÚT 55.