REPORT ON THE
BALANCE OF PAYMENTS

SEPTEMBER
2014

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

Letters 27
Gábor Bethlen

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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 '*Report on the Balance of Payments*' is to inform market participants – by way of this regular analysis – about developments in the balance of payments and thus provide deeper insight into the workings of the economy.*

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

This Report is based on information pertaining to the period ending 23 September 2014.

SUMMARY

In 2014 Q2, similar to the previous quarter, the four-quarter surplus of Hungary's current account *stabilised at a high level of around* ***EUR 4.4 billion.*** *In addition to the substantial surplus on the current account, the four-quarter balance of the capital account also remained high, amounting to nearly EUR 3.5 billion. As a result,* ***in line with the trend observed in recent quarters,*** *the four-quarter* ***surplus of Hungary's external balance was around 8 per cent of GDP, surpassing the values recorded in neighbouring countries by a large extent.***

From the side of the real economy, ***the substantial net lending primarily reflected the historically high surplus of the foreign trade balance and the high transfer balance stemming from the elevated absorption of EU transfers.*** *Regarding the changes in Q2, the slight decline in the surplus on the foreign trade balance and the transfer balance was broadly offset by a decline in the deficit on the income balance associated with investments, which can be attributed to the reduction in interest payable on foreign loans.* ***At the end of Q2, the four-quarter absorption of EU transfers continued to exceed EUR 5 billion.***

As a result of quarterly data dissemination, ***the income balance deficit decreased significantly, which may facilitate a further reduction in the external debt and vulnerability of the Hungarian economy.*** *The moderate quarterly decline – which reflects the retrospective reduction of debt ratios and falling yields – is related to the* ***lower interest expenditure on foreign loans.*** *It is important to emphasise that the decrease in the income balance deficit was not limited to Q2; based on the data disclosure,* ***the HCSO revised non-resident employees' income on a retrospective basis as well.*** *As a result, in 2013 the income balance deficit fell by 1.4 per cent of GDP; consequently,* ***the annual deficit figure amounted to only 4.1 per cent of GDP in the past year ending with Q2,*** *that is significantly lower than the pre-crisis level, amounted to 7 per cent of GDP.*

Similar to the real economy approach, financing data also point to a high external balance surplus. ***At the same time, 2014 Q2 saw profound changes in the structure of external liabilities:*** *partly owing to the dividend payments typical of the second quarter and partly as a result of state acquisitions,* ***foreign direct investment contracted, in parallel with a small increase in the economy's debt liabilities after the marked debt reduction observed in previous quarters.*** *Debt liability inflows were predominantly associated with non-residents' government bond purchases, while corporations and the banking sector continued to reduce their external debt. It is noteworthy, however, that* ***preliminary monthly data for July point to another decline in external debt.***

After contracting steadily since mid-2011, net external debt increased slightly in 2014 Q2. In *this growth, however, the increase in debt liabilities played only a marginal role, which was more or less offset by the improvement in nominal GDP. However, by the end of June the forint exchange rate had depreciated by 1 per cent compared to the value recorded at the end of March, while* ***the yield on forint-denominated government bonds also fell significantly (by 150 basis points) in Q2.*** *This latter development is an important factor as, although the moderation of yields is* ***particularly favourable from a sustainability perspective, the decrease in yields also raised the value of the government bond holdings of non-residents and hence, increased external debt ratios.*** *As opposed to the rise in net external debt, due to the maturing of a previously pre-financed foreign currency bond, gross external debt did not change noticeably and remained at around 93 per cent of GDP.* ***Gross short-term external debt, a crucially important indicator in terms of Hungary's external vulnerability, declined by nearly EUR 2 billion to EUR 26.5 billion.***

Analysing the external balance from the aspect of the savings of individual sectors, ***the net lending of corporations decreased amid heightened investment activities in the sector, supported in part by EU transfers and the Funding for Growth Scheme.*** *At the same time, the net lending of households remained rather high, owing to precautionary savings and income growth stemming from the expansion in employment and rising real wages. As regards households' savings, in addition to downsizing their deposit portfolio, households increased their government security holdings, and the structure of households' government paper portfolio shifted to longer maturities.* ***Accordingly, the second-quarter data available on households still indicate that domestic financing of the general government strengthened further, which may facilitate the reduction of external debt ratios over the longer term.***

As a special topic, we analysed the earnings of foreign-owned corporations operating in Hungary. *Based on the balance of payments, non-resident companies did not reduce their dividend payments notably despite diminishing profits in the wake of the crisis, and consequently, the crisis entailed a drastic fall in reinvested earnings associated with foreign direct investment. Presumably, this is due to firms' efforts to restrain their investment projects in view of the deteriorating growth prospects and unused capacities, while parent undertakings may also have had a need for profits generated in Hungary in the difficult financing environment caused by the crisis. After the crisis, however,* ***in most European countries the dividend payout ratio typically increased in parallel with diminishing returns.*** *It is also noteworthy that,* ***as a percentage of capital invested, the profits paid by foreign-owned companies operating in Hungary are considered high by European Union standards.*** *According to the international methodology, balance of payments statistics do not present the profit after tax of foreign firms, but profits from normal business operations excluding one-off factors and revaluation. In recent years, domestic companies have faced several effects (e.g. the early repayment scheme or revaluations reflecting the depreciation of the exchange rate) that reduced the profitability of the sector; however, in view of their non-recurring nature, they were not included in the balance of payments. As a result,* ***the annual corporate profit figure presented in the official statistics is higher than corporations' after-tax profit by around 1–4 per cent of GDP.***

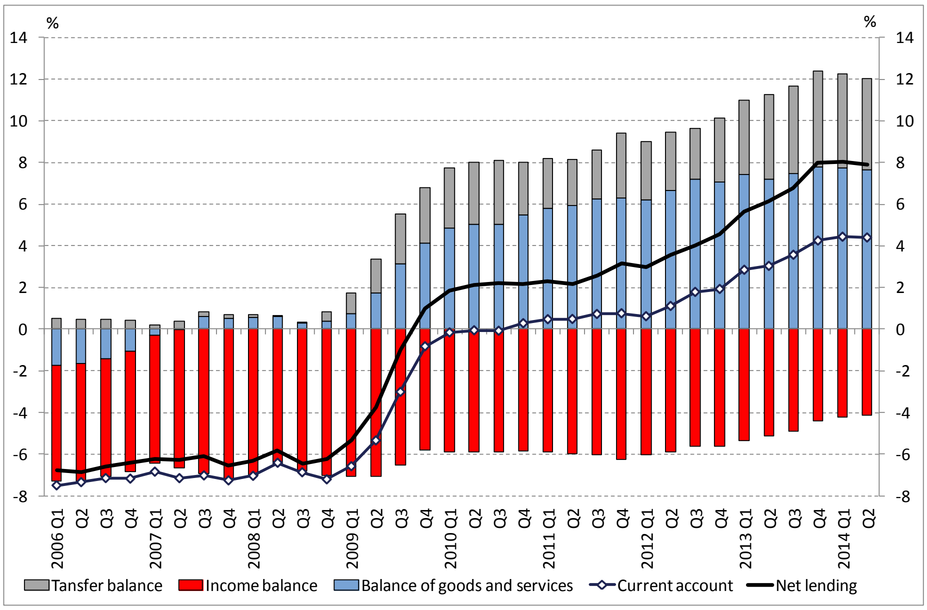
Contents

1. REAL ECONOMY APPROACH

In 2014 Q2, the GDP-proportionate surplus of Hungary's net lending stabilised, after revisions, at around the historical peak of 8 per cent which was reached in previous quarters. The four-quarter surplus on the current account amounted to EUR 4.4 billion, while the capital account surplus approached EUR 3.5 billion. To a large degree, the high surplus on the trade balance may reflect the dynamic growth in automotive manufacturing. As a result of quarterly data dissemination, the income balance deficit decreased significantly, to 4.1 per cent of GDP which may facilitate a further reduction in the external debt and vulnerability of the Hungarian economy. The deficit on the income balance sank mainly for two reasons: on the one hand it declined retrospectively due to revisions, on the other hand in Q2 the deficit declined linked to the reduction of interest payable on previously disbursed foreign loans. Domestic absorption of EU transfers and inflows to Hungary remained substantial in Q2, and the four-quarter amount still exceeded EUR 5 billion.

According to the real economy approach, in 2014 Q2 the four-quarter value of Hungary's net lending remained close to the level reached in previous quarters, amounting to 8 per cent of GDP. Similar to the same period of the previous year, seasonally unadjusted net lending stood at EUR 1.6 billion in Q2, including the EUR 0.8 billion surplus on the current account and the capital account which remained substantial, owing to EU transfers. Net lending stabilised as the net result of two opposing effects: the marginal decline in the trade surplus and the balance of transfers was more or less offset by the slight reduction in the income balance[1] deficit (Chart 1). Based on data available until the beginning of 2014, the surplus on the Hungarian economy's current account is still considered high by regional standards: compared to the 4 per cent value in Hungary, the annual balance of the current account remained in deficit in Poland and was close to zero in the Czech Republic, while the 2 per cent surplus of Slovakia emerged in the context of a declining trend.

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



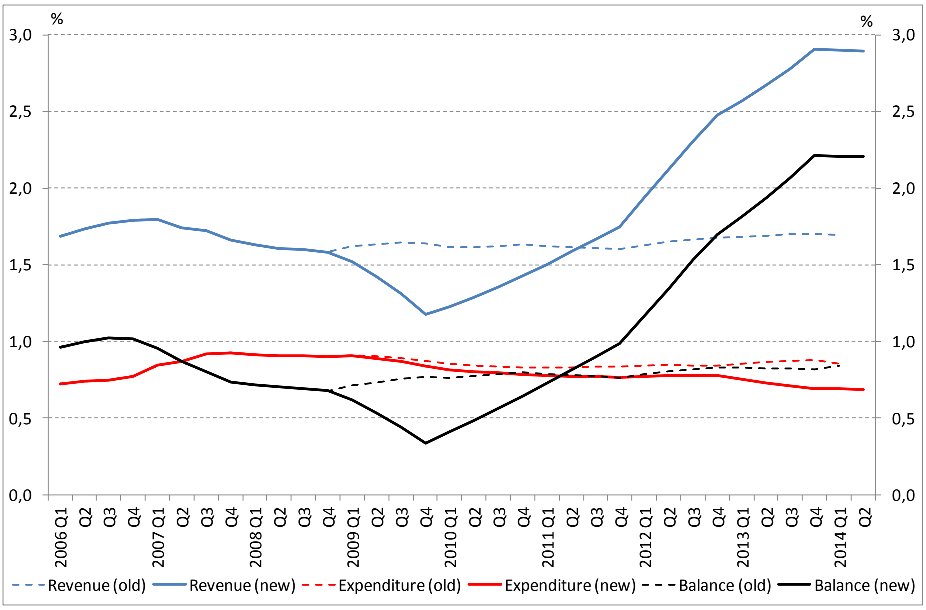
**Income balance: labour income, income on equity and income on debt. Transfer balance: sum of the capital account, other primary incomes and secondary incomes.*

[1] In our publication we attempted to match the new classifications of the balance of payments statistics applied in accordance with the new methodology with the formerly used transfer balance and income balance. In our view, the "other primary income" classified now as primary incomes and secondary income categories both represent unrequited transactions that correspond to the category of current transfers previously recognised under transfers. Accordingly, for the rest of this document – with due consideration to the purposes of the analysis – the balance of transfers includes, in addition to the capital account, other primary incomes and secondary incomes that correspond to the formerly used unrequited transfers, while the income balance comprises primary income excluding other primary incomes.

Box: Revision of the balance of payments

In its balance of payments data disclosure on 23 September 2014, the MNB revised the balance of payments data in the framework of regular and extraordinary revisions (Table 1). As a result of this revision, the trade balance for recent years was adjusted slightly downwards, reflecting the combined effect of methodological and data revision factors. The new information received on corporate incomes as part of the questionnaire-based survey was roughly in line with our previous estimates; therefore, it had no significant impact on the income balance. By contrast, the revised income figure of non-resident employees resulted in a major retrospective change in the income balance: for 2013, for instance, the income balance was adjusted by 1.4 per cent of annual GDP. This improvement in the balance mainly stemmed from increase in revenues from labour income (Chart 2). The change reflected the HCSO's review of its data sources which presumably resulted in a significant increase in the number of workers temporarily employed abroad and the income they earned (for more details about the HCSO's review, see the HCSO's publication entitled 'National accounts of Hungary, 2013 Preliminary estimation)'.

Chart 2: Revision of the income of non-resident employees (four-quarter values as a percentage of GDP)



On the financing side, there has been a negligible decline in net lending in recent years. Given the increase recorded in net lending according to the real economy approach, this means that, for the most part, the previously widely diverging net lending ratios calculated on the basis of the two approaches grew closer to each other. In addition, the revisions brought about a modification affecting the level of the external debt-to-GDP ratio: the classification of certain transactions into financial lease raised the level of Hungary's net and gross external debt by around 1 per cent of GDP, without a sizeable impact, however, on the dynamics of the ratios.

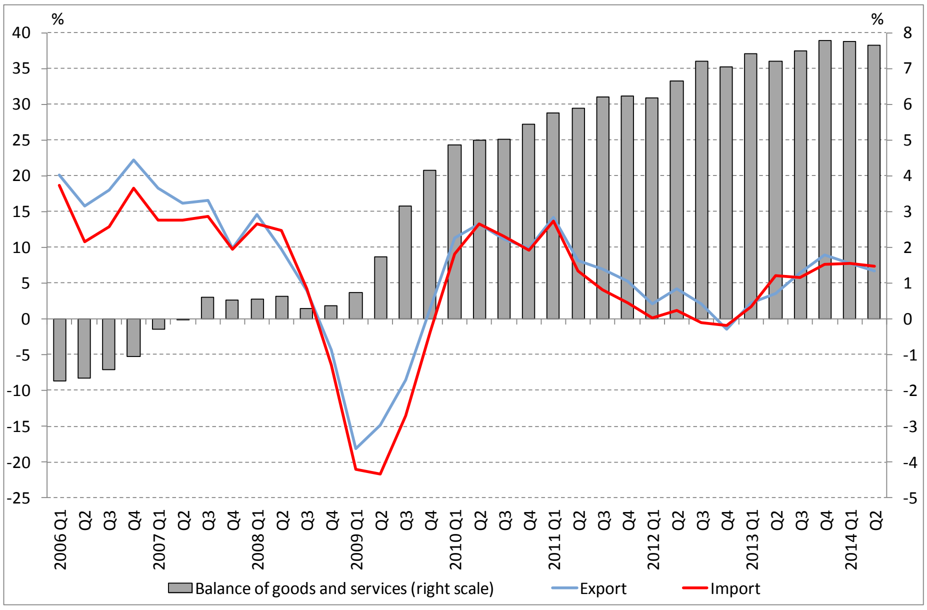
Table 1: The impact of the revisions on the components of net lending (EUR billions)

	2011	2012	2013	2014 Q1
Change in net lending form the real economy's side	**0,4**	**1,0**	**1,2**	**0,0**
Current account	***0,3***	***1,0***	***1,2***	***0,1***
Balance of goods and services	-0,1	0,0	-0,2	-0,2
Income balance	0,2	1,0	1,6	0,3
Transfer balance	0,2	0,1	-0,2	0,0
Captial account	***0,0***	***0,0***	***0,0***	***0,0***
Change in net lending from financial accounts's side	**-0,1**	**-0,1**	**-0,1**	**-0,3**
FDI	**0,0**	**0,0**	**0,0**	**0,0**
Portfolio investments	**0,2**	**0,4**	**0,1**	**-0,1**
Other investments	**-0,2**	**-0,5**	**-0,2**	**-0,2**
Errors and omissions balance	**-0,5**	**-1,1**	**-1,3**	**-0,3**

1.1. Balance of trade

In 2014 Q2, the trade balance surplus declined slightly along with a mild deceleration of exports and the unchanged growth dynamics of imports. In line with the slowdown in economic growth across the European Union, the annual real growth rate of exports – as presented in GDP statistics – continued to decelerate slightly in Q2. A drop in exports to Russia and Ukraine may have contributed to the slowdown in export dynamics. At the same time, dynamic exports by domestic vehicle manufacturing and the related sectors had a positive effect on the export performance of the Hungarian economy, resulting in relatively high export growth compared to the previous two years. At the same time, amid accelerating investment and consumption, the real growth of imports stalled. Taken together, the decline in the annual trade surplus was moderate.

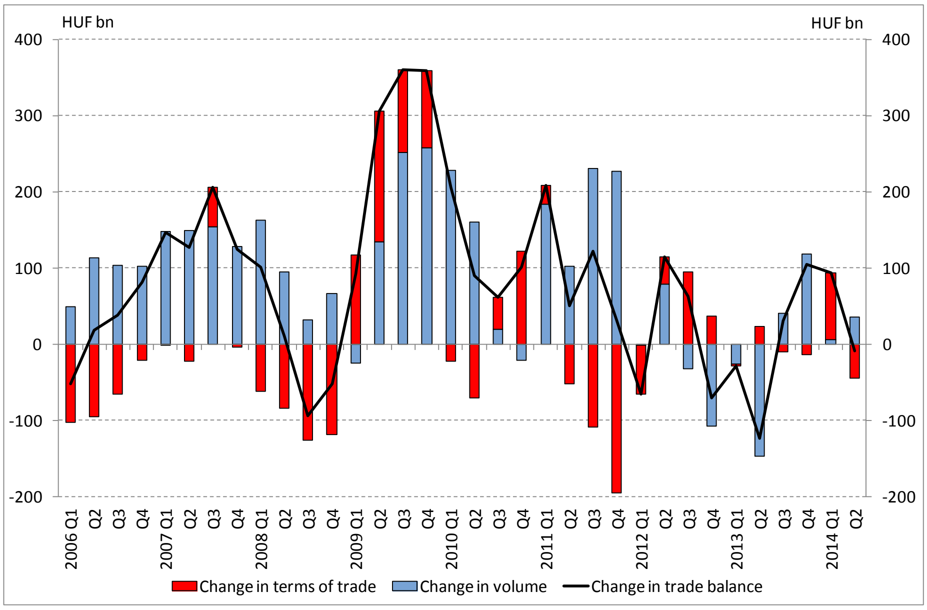
Chart 3: Annual real growth of exports and imports and the GDP-proportionate annual trade surplus



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

The continuing surplus on the balance of goods can be mainly attributed to changes in real growth rates: the significant improvement in the terms of trade observed in the previous quarter levelled off somewhat in Q2. Based on the value of trade in goods, after a significant improvement in 2014 Q1, the terms of trade deteriorated slightly in Q2, which can be considered as an adjustment to the improvement at the beginning of the year (Chart 4). The correction of the terms of trade was mainly driven by rising commodity prices in Q2 which, based on data pertaining to recent months, may prove to be temporary. Although the goods surplus was reduced by the changes in the terms of trade, this may have been offset by the improvement driven by changes in export and import volumes.

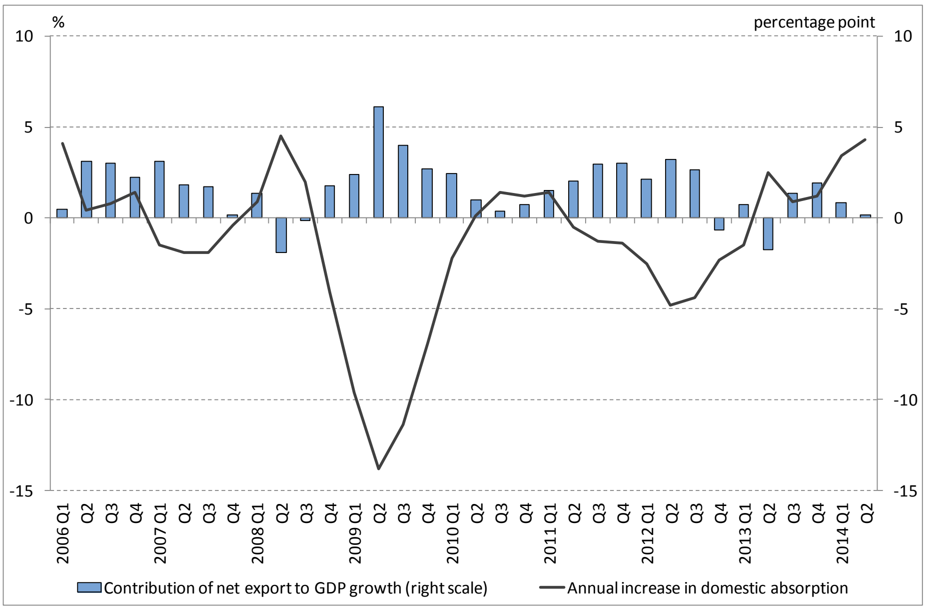
Chart 4: Developments in trade in goods and its components (annual change)*



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

In the context of accelerating domestic absorption, the contribution of net exports to growth tapered off. From mid-2013, there was an upswing in both household consumption and – buoyed by the FGS and increasing EU transfers – investment, which gave rise to a more balanced structure of economic growth. At the same time, due to heightened demand for imports, rising domestic consumption also increases imports, and accordingly the contribution of the trade surplus to economic growth declined gradually, in line with the acceleration of domestic consumption. As part of this trend, net exports' contribution to GDP growth was roughly neutral in 2014 Q2.

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

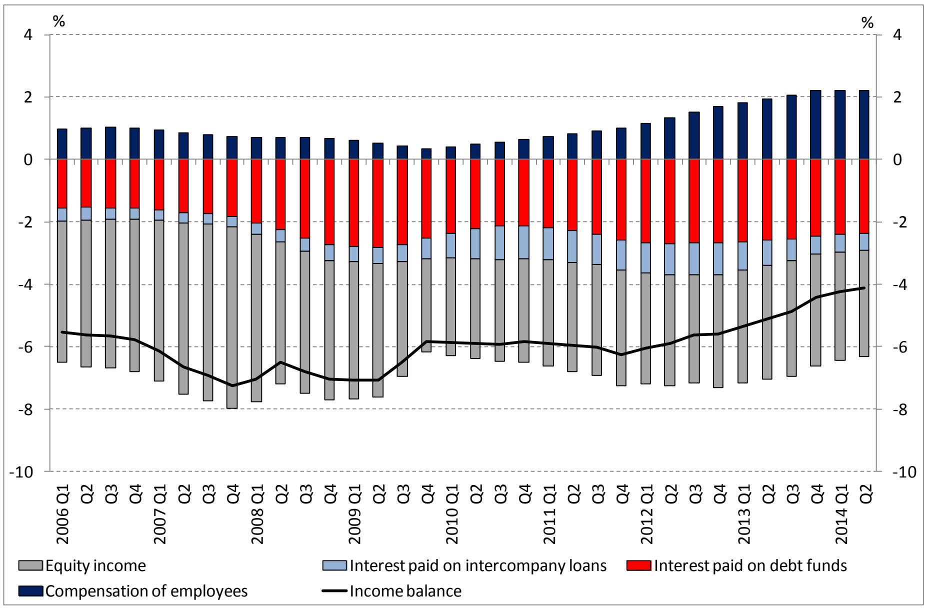


Source: HCSO

1.2. Income balance

In Q2, the four-quarter value of the income balance deficit declined to nearly 4 per cent of GDP, which may facilitate a further reduction in the external debt and vulnerability of the Hungarian economy. In analysing developments in the income balance, the effects of two factors should be evaluated separately: the retrospective increase in levels necessitated by the revision, and the reduction in recent quarters stemming from the improvement in the interest balance (Chart 6). On the one hand, therefore, as a result of the review carried out by the HCSO, the revenues collected from the income of non-resident employees increased, which reduced the income balance deficit to a great degree, by 1.4 per cent of GDP in 2013 on an annual basis, while other revisions prompted another downward adjustment by 0.2 percentage points (for further details, see the box dedicated to the revision of balance of payments data). On the other hand, the annual deficit on the income balance dropped somewhat further in Q2 compared to the previous quarter. This decline can be mainly attributed to the fact that the interest payable on foreign loans (intercompany, bank and other) continued to fall in Q2, while the outflow of funds relating to income on equity is estimated to have remained broadly unchanged.[2] In respect of the outflows of income on equity, data are only available for dividend payments concentrating on Q2, according to which dividends paid by non-resident enterprises – excluding outliers – were down EUR 0.2 billion compared to the amounts paid out in previous years. However, since the dividend amounts paid out remained much higher than the profit for the specific quarter, reinvested earnings were in the negative domain, which reduced domestic FDI. At the same time, the reduced level of dividend payments points to an improvement in reinvested earnings for 2014.

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



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

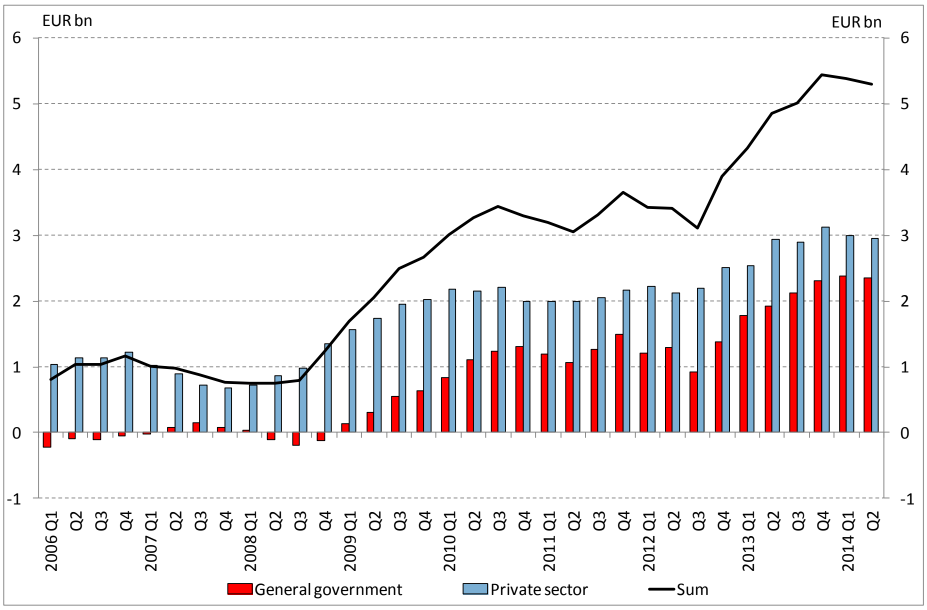
1.3. EU transfers

The absorption of EU transfers remained significant in 2014 Q2, and inflows to the private sector continued to surpass transfers to the state. On an accrual basis, balance of payments data indicate that the absorption of EU funds exceeded EUR 1.2 billion in 2014 Q2, which lags slightly behind the value recorded a year earlier. Consequently, the four-quarter value of transfer absorption decreased marginally to around EUR 5.3 billion (Chart 7). Based on a sectoral breakdown, the ratio of transfers to the general government and to the private sector remained largely the same; thus the private sector's absorption of EU transfers continued to surpass that of the government.

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

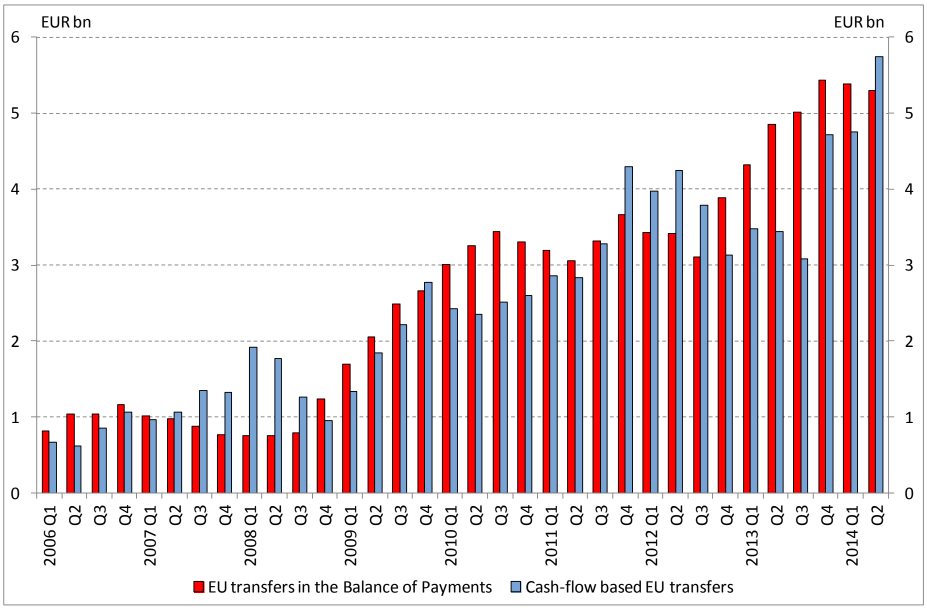
(It is important to note, however, that infrastructure developments financed from the funds received by the general government may have partly increased the private sector's income). In Q2, the absorption of capital transfers was the most predominant (EUR 0.8 billion), while the value of EU transfers recognised under primary income – those deriving from product and production taxes, aids and leases – was smaller.

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



Although the European Commission temporarily suspended the payment of *new* invoices owing to due diligence performed in relation to the new institutional structure, this was not reflected in either transfer absorption or the amounts transferred in Q2 . In Q2, the transformation of the Hungarian institutional system of grants was reviewed by the European Commission, and consequently the Hungarian authorities could not submit new payment requests until the conclusion of the review. That notwithstanding, the (accrual-based) absorption of EU transfers as presented in the balance of payments did not decrease significantly, while the cash-accounting-based value of EU transfers (which increases the foreign exchange reserves) continued to increase during Q2, which may be explained by a number of factors. On the one hand, since the balance of payments is calculated according to an accrual-based accounting approach (i.e. transfers from the EU are recognised when they are spent and not when the funds are transferred), the absorption of EU transfers may have continued by way of pre-financed projects (and already submitted invoices). On the other hand, invoices submitted before the Commission's request may have still been paid, which may have contributed to the increase in transfers. On balance, the level of EU transfers significantly exceeded absorption in Q2, which is also reflected in the developments observed in the state's net lending position (see the Financing approach).

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

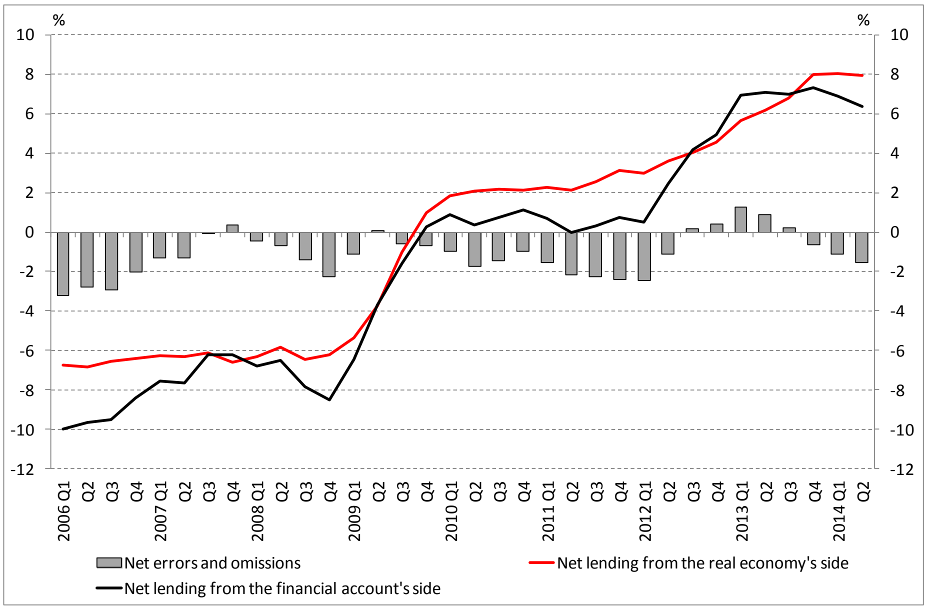


2. FINANCING APPROACH

Financing data also point to a massive net lending position in Q2, resulting from the combination of a marked contraction in non-debt liabilities due to one-off and seasonal factors, and a minor increase in debt liabilities. Developments in individual sectors demonstrate that banks and firms reduced their debt liabilities, while the general government increased its net external debt during the second quarter.

In Q2, the four-quarter net lending figure derived from financing data shrank to around 6 per cent of GDP, lower than the value calculated from the side of real economy transactions.[3] The negative statistical error indicates that the external debt ratios of the economy declined at a slower rate than would have been suggested by real economy data. It should be noted that, except for 2012 and early 2013, the balance of net errors and omissions has typically been negative in Hungary since 2006; in other words, the value registered in Q2 merely indicates a return to the level experienced in the past.

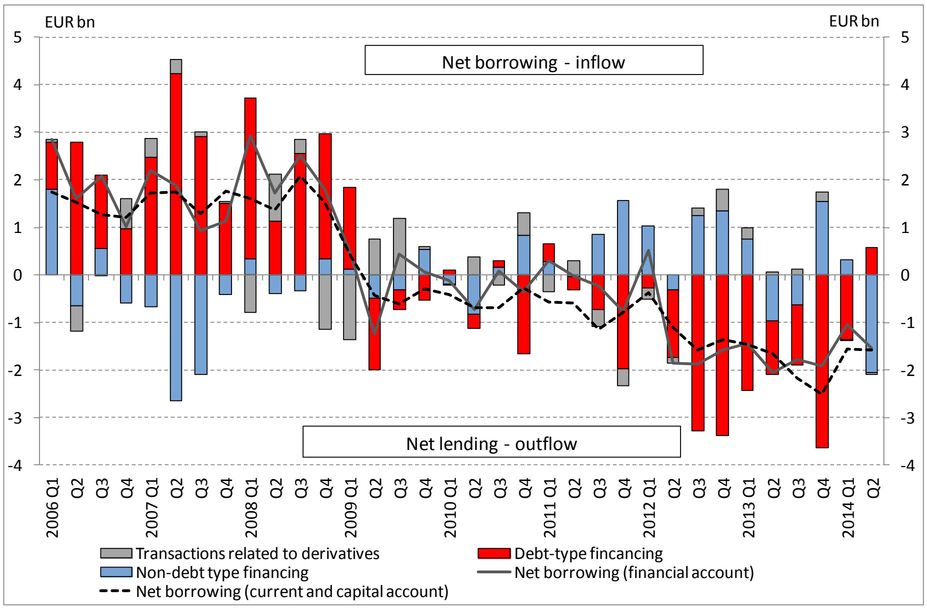
Chart 9: Two types of net lending and "Net errors and omissions" (four quarterly data as a percentage of GDP)



The outflow of seasonally unadjusted funds increased in Q2. This growth emerged amid a marked decline in non-debt type liabilities and a more moderate, presumably temporary, increase in debt-type financing (i.e. foreign loans and bonds). The increase in the seasonally unadjusted net lending figure calculated in accordance with the financing approach means that the contraction in external liabilities accelerated in Q2 in quarter-on-quarter terms (Chart 10). The change recorded for Q2 is fully attributable to the reduction of non-debt liabilities, while debt-liabilities, in terms of transactions, increased slightly. At the same time, the upward drift in debt-type funds cannot be considered significant and should be viewed as only temporary, in light of the trends observed in previous years and the preliminary data for July. Within non-debt type financing, the outflow of foreign direct investments partly reflects seasonal factors (dividend payment) and partly one-off effects (public sector acquisitions).

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

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



2.1. Non-debt type liabilities

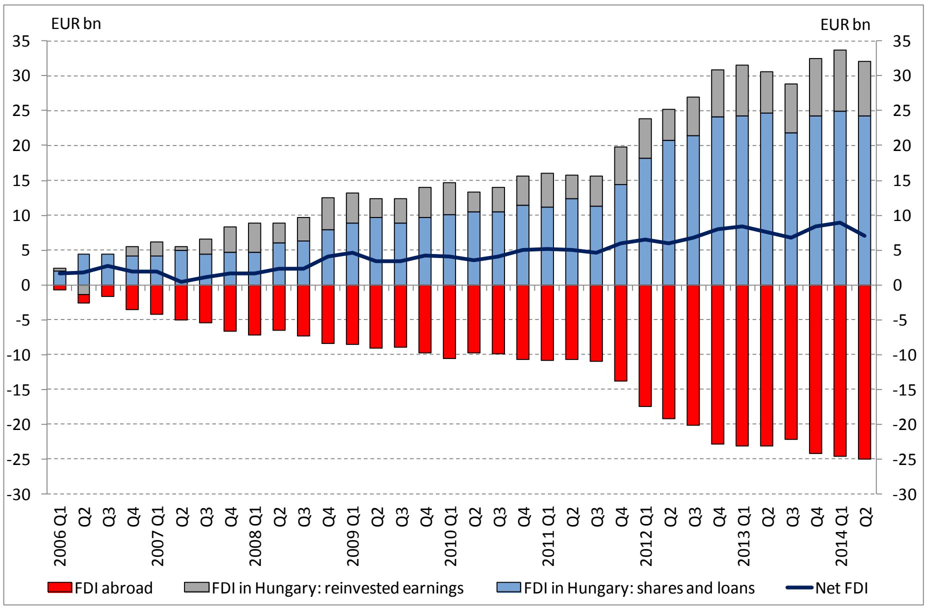
In 2014 Q2, net foreign direct investments contracted by EUR 2 billion as a result of an increase in outflows on the one hand and the reduction of reinvested earnings due to seasonal effects and the decline in equity investments due to one-off effects, on the other hand. Owing to a number of factors affected both by one-off and seasonal effects, net foreign direct investments declined during the quarter in Hungary.

- Firstly, the decline in direct investment resulted from non-residents' declining equity investments in Hungary, in which some public sector acquisitions taking place in Q2 also played a role. MVM's acquisition of a stake previously held by non-residents in Fővárosi Gázművek Zrt. generated a decline in foreign direct investment in 2014 Q2. In addition, the state purchased Antenna Hungária Zrt. from its non-resident owner, which also entailed an outflow of funds.

- Secondly, non-residents' reinvested earnings also declined, although this was mainly due to seasonal effects. Indeed, in the business sector the size of dividend payouts is typically determined in the second quarter, which results in negative reinvested earnings (given that the dividends paid exceed the profits generated in the given quarter) and thus reduces foreign direct investment.

- Thirdly, residents moderately increased their investments abroad, which also put upward pressure on the net outflow of funds (Chart 11).

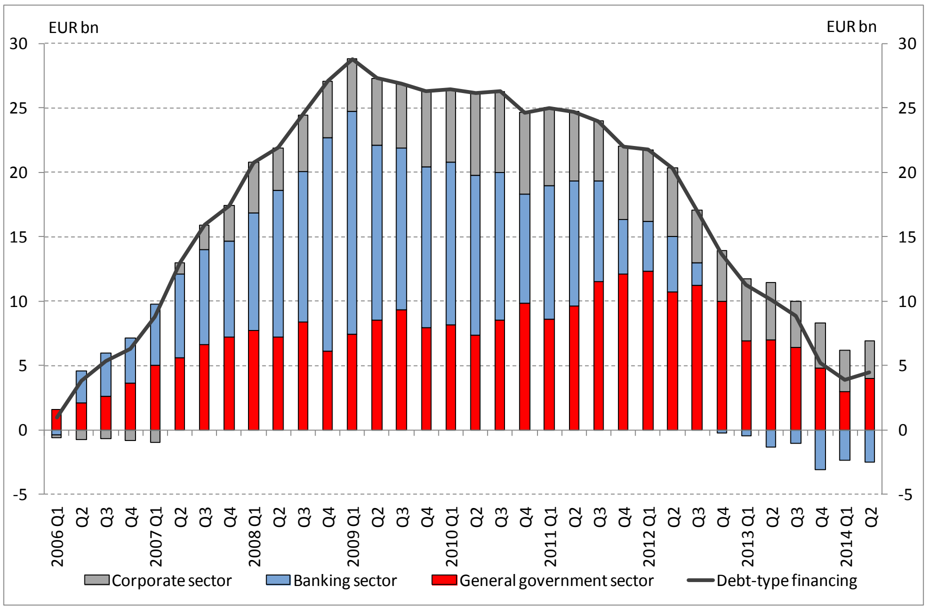
Chart 11: Developments in foreign direct investment (cumulative transactions)



2.2. Debt liabilities

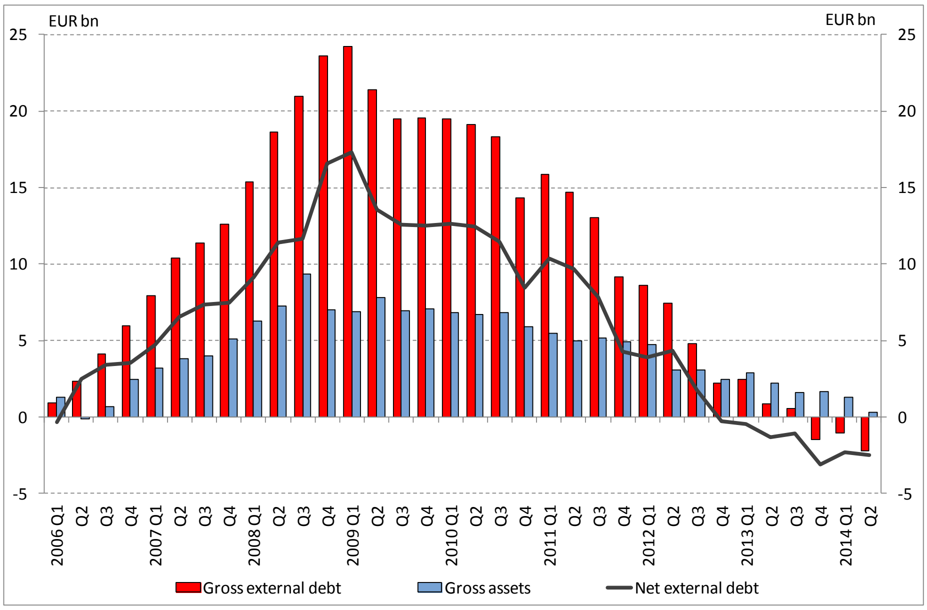
In Q2, along with more sizeable non-debt outflows, debt liabilities rose to a lesser degree, increasing by approximately EUR 0.5 billion. Compared to the larger average declines recorded in recent years, the net debt liabilities of the economy increased to a lesser extent in 2014 Q2. Similarly, the financing developments of different sectors point to a turnaround in the trend observed in previous quarters. While – after several quarters of a steady decline – the net external debt of the general government consolidated with the MNB increased by nearly EUR 1 billion, banks and firms scaled back their external debt by a total of EUR 0.5 billion (changes in the size of the columns illustrating cumulated data on Chart 12 show the change in net external debt for each sector).

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



Following an expansion in Q1, the net external debt of the banking system started to decline again in 2014 Q2. The decline in the banking sector's net external debt stems from the fact that the sector scaled back its gross external debt faster than its external assets. Since 2013 Q1, the contraction in debts has decelerated compared to previous years: in Q2, the four-quarter average of net debt reduction shrank to EUR 0.3 billion from the EUR 1 billion level observed in previous years. As a result, the relatively moderate EUR 0.2 billion net debt reduction in 2014 Q2 is only a continuation of the trend seen in the past year and a half. The decline in outflows may be connected to the portfolio shifts observed in the household sector, which have resulted in a sharp fall in households' deposit holdings in recent periods, generating a sizeable fall in the funds available for banks. In respect of the maturity structure of bank funding, it is important to note that in line with previous trends the decline was far more prominent in the long-term funds of the banking sector, while short-term funds did not change materially.

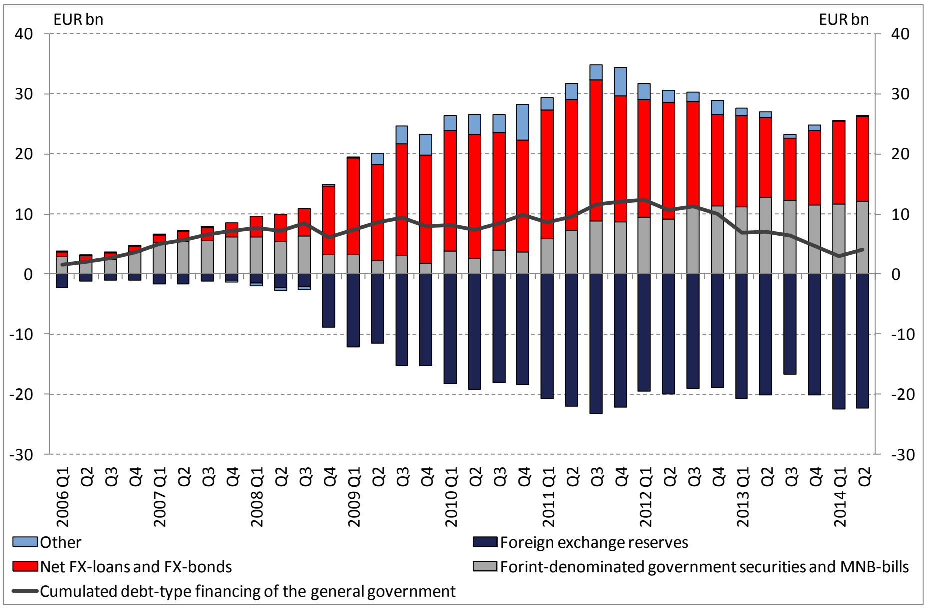
Chart 13: Developments in the banking sector's gross external debt and asset transactions (cumulative transactions)



In contrast to the steep decline recorded in the past year and a half, the net external debt of the general government consolidated with the MNB increased by around EUR 1 billion in Q2. This growth can be attributed primarily to the expansion of non-residents' forint-denominated government bond portfolio, which was only partly offset by non-residents' declining holdings of two-week MNB bills (Chart 14). The increase in non-residents' forint instruments raised the consolidated general government's net external debt by nearly EUR 0.5 billion, which emerged as the net result of diverging trends: in parallel with the purchase of forint-denominated government bonds, the portfolio of MNB bills declined, partly owing to adjustments spurred by the self-financing programme of the MNB. In Q2, the gross external debt of the general government consolidated with the MNB was driven by a number of transactions which did not influence net external debt. On the one hand, grants pre-financed by the European Commission generated an increase in the gross external debt of the government, as disbursed but yet unused transfers are recognised as debt vis-à-vis the European Union. At the same time, settlements against the EU did not affect the net external debt of the consolidated general government, as the effect of transfers was reflected in the level of the foreign exchange reserves.[4] On the other hand, the repayment of the foreign currency bond in May only affected the gross external debt of the general government without any changes in its net external debt, given that the foreign currency liquidity required for the repayment was available from the MNB's reserves. In addition, net external debt was also pushed up by the EUR 0.2 billion drop in the foreign exchange reserves that mainly resulted from FGS swaps.

[4] It is noteworthy that the government's claims vis-à-vis the European Union also declined as a result of the fact that, in line with the balance of payments methodology, the European Commission transferred the grants for projects that had been pre-financed by the state earlier. Likewise, the settlement of post-financing had no impact on the net external debt of Hungary, as the growth in foreign exchange reserves emerged with a parallel decline in the general government's claims vis-à-vis the EU.

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

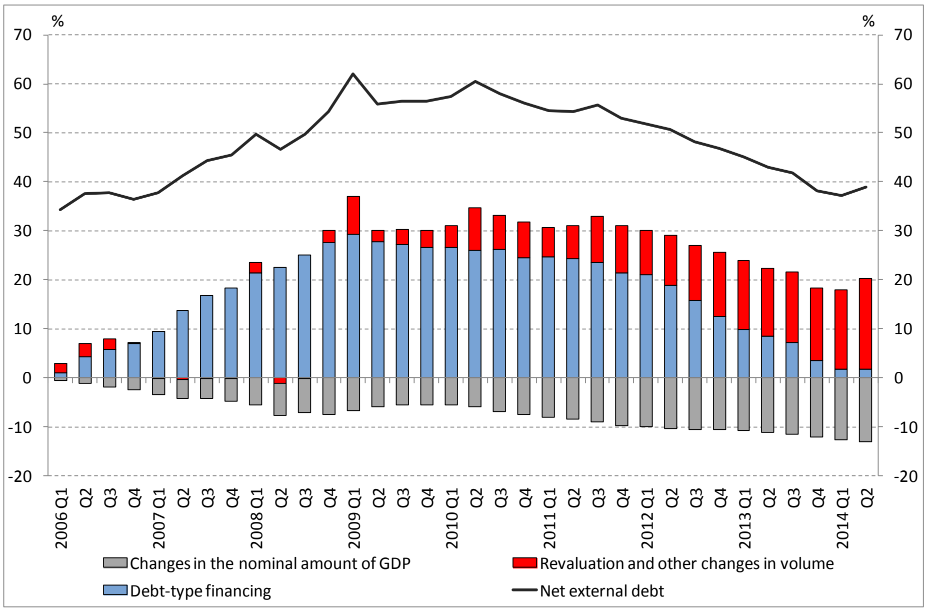


3. DEVELOPMENTS IN DEBT RATIOS

Driven mainly by the maturity of amortised long-term debt components, Q2 saw a large decline of nearly EUR 2 billion in the short-term external debt of Hungary. Despite the depreciation of the forint, gross external debt remained largely the same, at levels close to 93 per cent of GDP. At the same time, net external debt – which also includes external assets – rose slightly and amounted to 39 per cent of GDP at the end of Q2. This increase was caused mainly by the appreciation of government securities in the context of declining yields, the depreciation of the forint, and the inflow of debt liabilities.

The decline observed in net external debt since mid-2011 came to a halt in Q2, with the indicator rising to nearly 39 per cent of GDP. The rising level of net external debt resulted from the combined effect of diverging developments. The indicator was pushed strongly upwards by revaluation effects mainly stemming from the repricing of government securities, as the market value of government bonds held by non-residents increased in parallel with the yield decline seen in the market of government securities.[5] Moreover, the nearly 1 per cent depreciation in the forint exchange rate by the end of Q2 vis-à-vis the main currencies relevant in terms of external debt composition (euro and Swiss franc) supported the increase in the debt ratio. Besides revaluation effects, following the substantial outflows registered in previous quarters, the build-up of debt liabilities available for the Hungarian economy also generated a slight increase in the level of net external debt (see the chapter on the financing approach). At the same time, GDP growth exerted a downside impact on the external debt ratio excluding intercompany loans.

Chart 15: Components of changes in net external debt (cumulated, GDP-proportionate values, end-2005 = 0)*



** As a result of the revision, some items have been removed from operating leases and included in financial leases, which increased debt ratios retrospectively by nearly 1 per cent of GDP.*

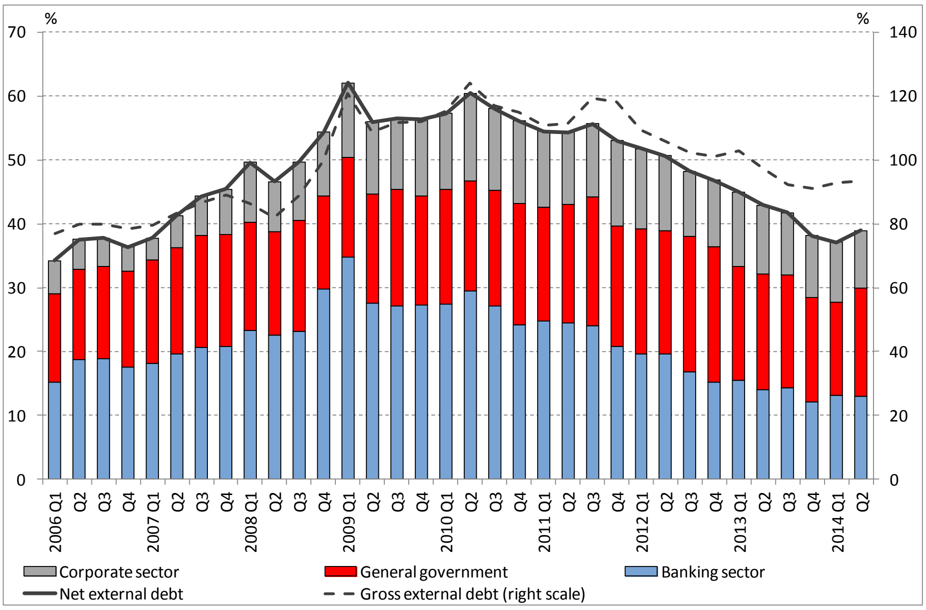
The increase in net external debt emerged in the context of diverging sectoral behaviour patterns: the rise in the net external debt of the general government was only partly offset by the decline in banks' external debt. The more than 2 per cent GDP-proportionate increase in the net external debt of the consolidated general government raised the stock indicator. Besides the depreciation of the forint and the repricing of government securities, financing developments also contributed to the increase. The transaction-related rise in the external debt of the general

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

government may be partly attributed to the expansion of non-residents' government bond holdings, which was only partly offset by the contraction of non-residents' MNB bill portfolio (prompted, for the most part, by the self-financing programme). Liability inflows and the growth of net external debt were also boosted by the reduction of Hungary's foreign exchange reserves (by nearly EUR 200 million) after the substantial increase seen in previous quarters. Meanwhile, the rise in net external debt was dampened by the reduction of net external debt in the banking sector and the corporate sector in Q2. After a spike in the previous quarter, the external debt of the banking sector contracted again, mainly resulting from a decline in the sector's foreign loans.

In line with trends in recent quarters, gross external debt stood at around 93 per cent of GDP at the end of Q2. In contrast to net external debt, gross external debt remained roughly the same in Q2. The maturity of the foreign currency government bond in May was hedged by the issue of a foreign currency bond in Q1. Thus, compared to the change in net external debt, the increase in gross external debt was only moderate (and was mainly due to revaluation effects).[6] The increase in the general government's external debt was offset by the contraction in gross bank debt, while the external debt of corporations did not change notably. As a result of these developments, Hungary's gross external debt to GDP remained roughly the same.

*Chart 16: Net external debt in a sectoral breakdown and gross external debt (as a percentage of GDP, excluding intercompany loans)**

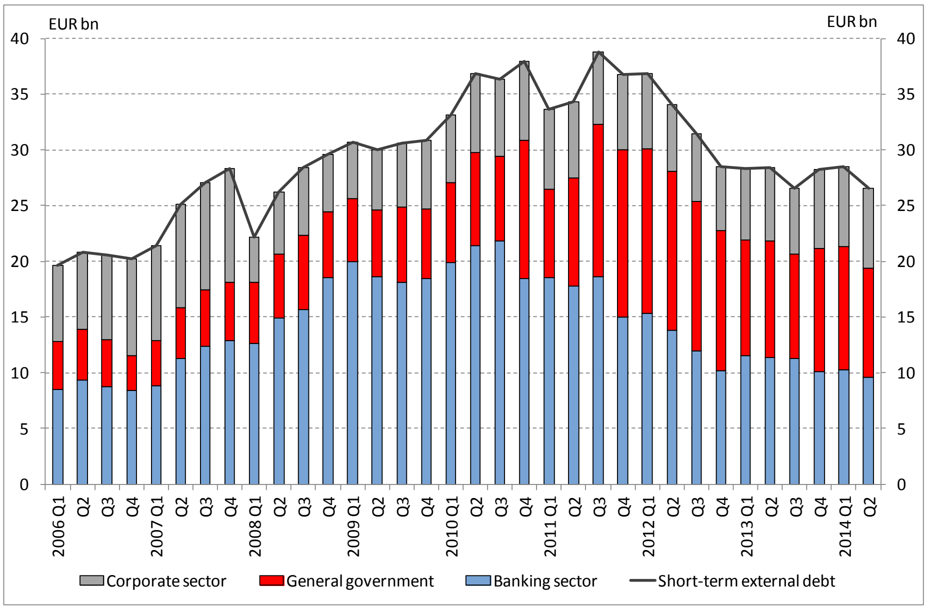


** As a result of the revision, some items have been removed from operating leases and included in financial leases, which increased debt ratios retrospectively by nearly 1 per cent of GDP.*

Driven primarily by a decline in long-term amortised debt, short-term external debt – an essential factor from the perspective of external vulnerability – dropped to around EUR 26.5 billion in Q2. Compared to the previous quarter, there were no material changes in the general government's short-term debt based on original maturity; it remained at a level close to EUR 17 billion. Thus, the decline in the level of short-term external debt – which is particularly important from the aspect of foreign investors' expected level of the central bank's foreign exchange reserves – can be primarily attributed to the reduction of amortised long-term debt, i.e. the maturity of loans taken out much earlier. According to the maturity ladder published along with the quarterly balance of payments, amortising long-term debt fell by nearly EUR 2 billion between March and June, dropping to a level of EUR 9.5 billion.

[6] The repayment of a foreign currency bond does not impact a country's net external debt (as it also lowers the level of foreign exchange reserves); it only reduces gross external debt.

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



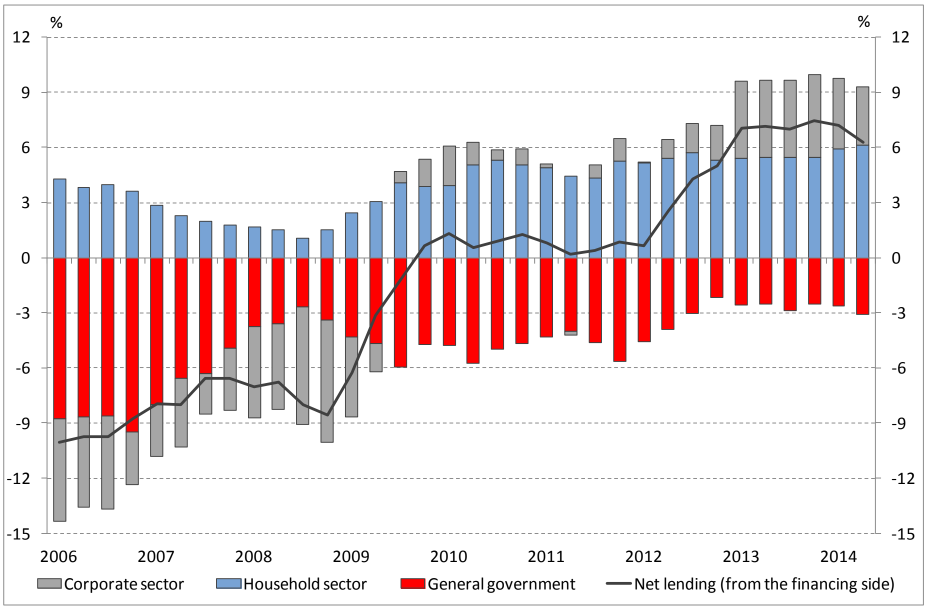
The sectoral breakdown of short-term external debt reveals that, besides the banking system, the decline is linked to the general government. Following a moderate increase in the previous quarter, the banking sector's short-term external debt portfolio contracted by nearly EUR 0.6 billion, with the decline completely attributable to the reduction of amortised long-term external debt. Banks' total short-term external debt based on residual maturity amounted to around EUR 9.6 billion in June, roughly corresponding to the level recorded in 2006. In respect of the banking sector's external debt, it should be noted that the total portfolio of short-term bank debt with an original long-term maturity has shrunk to a mere EUR 1 billion. In Q2, the short-term external debt of the consolidated general government continued to contract, partly driven by a decline in long-term amortised government debt. The main contributor to this decline was the maturity of a foreign currency bond held mainly by non-residents in May. The stagnating level of the general government's short-term external debt based on original maturity resulted from the combined effect of diverging developments: the contraction of non-residents' MNB bill holdings was offset by an increase in the general government's short-term debt vis-à-vis the EU (resulting from the disbursement of EU transfers in excess of absorption). External short-term debt within the corporate sector rose marginally only as loans with longer-term original maturities turned into short-term debt.

4. SECTORS' SAVINGS APPROACH

According to the financing approach, the net lending position of the economy weakened, primarily reflecting the reduction in corporations' net savings in parallel with an expansion in investment projects. This decline in net lending was supported to a small degree by the state's mildly increasing borrowing requirement, while – driven by precautionary motives – the financing capacity of households continued to increase. Portfolio shifts within the household sector also continued, but the downsizing of bank deposits tapered off somewhat compared to previous quarters.

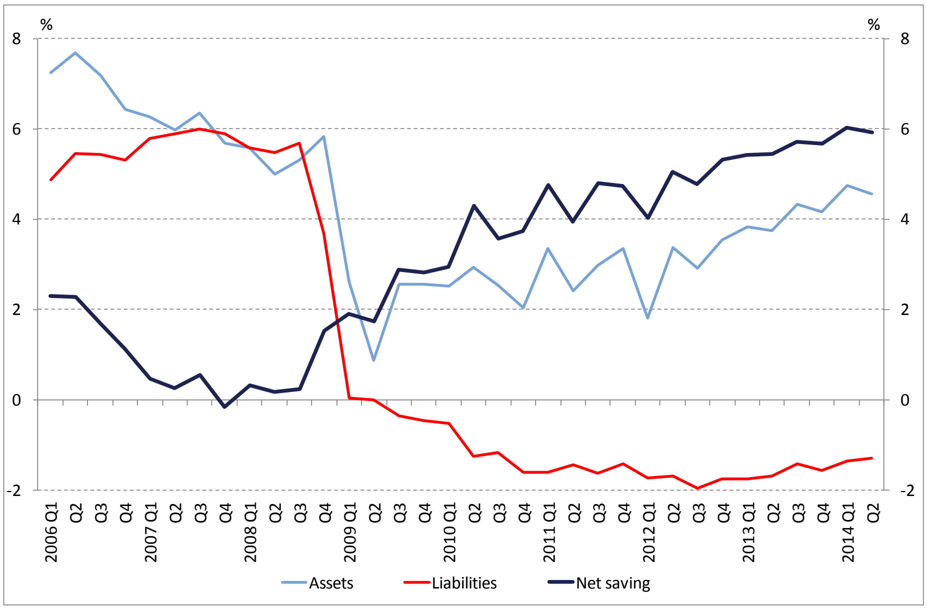
Based on four-quarter financing data, from the side of savings, the weakening of the economy's net lending position was mostly determined by the decline in corporations' net lending, while households' financing capacity improved further. In parallel with the significant improvement in corporate investment in the context of EU transfers and the Funding for Growth Scheme, corporations reduced their net savings in Q2; nevertheless, the sector remains an important contributor to the net lending position of the economy. Meanwhile, four-quarter data reveal that the borrowing requirement of the general government increased slightly in Q2, although its level remained moderate. For the most part, this reflects the increase in wage expenditures (in relation to the career path model for teachers and expansion of the public labour programme). At the same time, households' four-quarter net savings increased further. Besides the improvement in real wages, this historically high net saving position stems partly from the repayment of previously accumulated loans, and partly from the precautionary motives that continue to dominate households' behaviour.

Chart 18: Net lending of specific sectors (four-quarter values as a percentage of GDP)



According to the data in the preliminary financial accounts, the four-quarter value of households' net financial savings rose to 6 per cent of GDP in 2014 Q2, and the seasonally adjusted data stabilised at the same level. This historically high net saving position emerged in the context of households' continuing debt repayment and the increase in their financial instruments, the rate of which is comparable to that seen in the previous quarter (Chart 19). With the expansion of employment, households' real income is on the rise, but the sector continues to save a substantial portion of this income, primarily due to the precautionary motives that have dominated the sector's behaviour since the onset of the crisis. In addition, the liabilities side adjustment of the households is still significant, and consequently household debt continued to decline markedly in 2014 Q2, dropping by 1.3 per cent of GDP after seasonal adjustment.

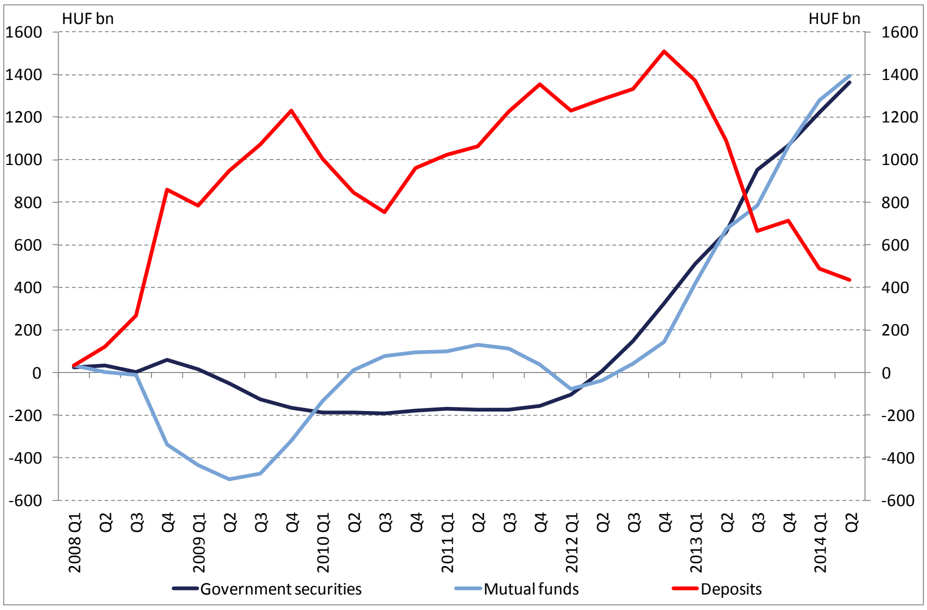
Chart 19: Net saving of households (seasonally adjusted revised values, as a percentage of GDP)*



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

In the course of Q2, households increased their security holdings, but the decline in households' bank deposits decelerated compared to previous quarters. The structure of households' accumulation of financial instruments continued to change, with a shift from bank deposits to government securities and investment fund shares/units. The low yields on bank deposits may have encouraged households to invest their savings in instruments promising higher returns over a longer time horizon. At the same time, outflows from bank deposits decelerated during the past quarter, which is consistent with the slight reduction of the preferential interest rate on Treasury Notes, the instrument favoured by the population in recent quarters. At the end of the quarter, the structure of households' government paper portfolio shifted to longer maturities, which may have strengthened domestic sectors' contribution to the financing of public debt. In conclusion, second-quarter information available on households continues to indicate that the domestic financing of the general government strengthened further, which may facilitate the reduction of external debt ratios over the longer term.

Chart 20: Cumulative transactions of household instruments



5. CORPORATE INCOMES

This special topic provides an overview of changes in the profitability of foreign-owned companies. According to balance of payments data, before the crisis, the earnings of foreign-owned companies generated increasing income outflows, a part of which, however, was reinvested by the foreign owners, thereby increasing Hungarian FDI. Following the outbreak of the crisis, corporate profitability dropped, while dividends paid to owners were not reduced considerably, leading to a steep decline in reinvested earnings in Hungary. Presumably, this is due to the declining need for capital in the context of deteriorating growth prospects and excess capacity, as well as parent undertakings' rising needs for funds in a financing environment debilitated by the crisis. With regard to the profit of firms owned directly by foreign owners, it is important to know that, according to the international methodology, balance of payments statistics do not present firms' profit after tax, but profits from normal business operations excluding one-off factors and revaluation. Based on firms' profit after tax, the net lending of the Hungarian economy as a proportion of GDP would have been 1-4 percentage points higher. Our international comparison indicates that EU countries experienced similar trends than those observed in Hungary: the return on direct investment fell after the outbreak of the crisis with a parallel increase in dividend payments.

5.1. Introduction

As a special topic, we provide an overview of developments in corporate earnings based on various aspects. This is a particularly topical subject, in light of the fact that non-resident corporate earnings will be revised with the disclosure of 2014 Q2 data: estimates pertaining to 2013 will be replaced by actual data provided in corporations' annual reports. Until the processing of annual reports and corporate statistical questionnaires is completed, data on corporate profitability are limited; therefore, until September of the year following the current year the figures presented in balance of payments statistics on quarterly profits are, for the most part, estimates. It is worth noting, however, that we do have quarterly data available for another important component of the income balance, namely, dividends, while the level of reinvested earnings is determined on the basis of the residual principle as the difference between profits and dividends.

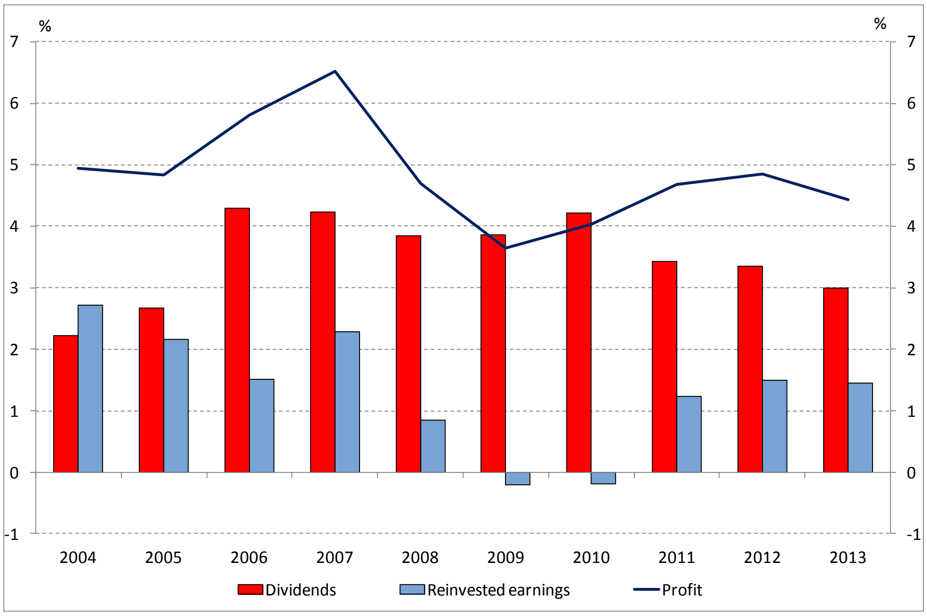
International statistics rely on two methods to account for corporate earnings and profits. One of the methods takes into account all corporate income elements, i.e. all of the items linked to revaluation and extraordinary events are recognised as corporate income or profit (all inclusive concept). The other approach is when the balance of payments statistics include only profits from normal business operations. According to international methodological recommendations (such as the BPM6 methodology applied across the EU, including Hungary), in order to avoid distortions, only the latter, the so-called current operating performance concept (COPC) should be used for accounting purposes, which excludes non-recurring profit items from after tax profits.

In the first part of the chapter, we present the income position of foreign-owned firms and banks operating in Hungary, analysing in detail the effect of the COPC adjustment recommended by international statistical standards. We then proceed to examine the subject in an international context. As the crisis affected the income position of foreign-owned companies and banks differently, we devote a separate section to each sector in the first point of the chapter. While the crisis reduced firms' profit immediately, banks did not see a drastic dip in their earnings until 2012. If the sectors were examined without the COPC adjustment, in other words, if we considered the actual after tax profits of corporations, the income balance deficit would be smaller and accordingly, the net lending would be bigger than presented in the balance of payments. A separate chapter is dedicated to the underlying reasons. Finally, we give an account of the rate of return and dividend payout ratio of foreign-owned subsidiaries operating in Hungary, as well as their changes resulting from the crisis.

5.2. Income reported in the balance of payments

The profits of foreign-owned companies decreased during the crisis; dividend payments, however, remained high, which reduced the amount of reinvested earnings. From 2011, corporate profits began to increase again and in parallel with this, reinvested earnings rose. During the years preceding the crisis, foreign-owned companies reinvested 40 per cent of the profits generated in Hungary on average. As for the composition of this percentage, while banks reinvested 70 per cent of their income, non-banks reinvested only a smaller portion of their earnings. Following the onset of the crisis, foreign owners reinvested less than 20 per cent of the profits generated in Hungary on average. In some years, dividends paid to foreign owners even exceeded the profit generated, which means that – despite the deterioration in firms' profitability immediately after the onset of the crisis – dividend payments remained high, presumably due to the liquidity needs of parent undertakings, which in turn reduced the amount of reinvested earnings and indirectly the level of foreign direct investment. However, in parallel with the improvement in the growth outlook, a gradual increase has been seen in this regard in recent years. At the same time, this was typical only for two years after the start of the crisis; from 2011 foreign owners' reinvested earnings were on the rise again in line with improving profits.

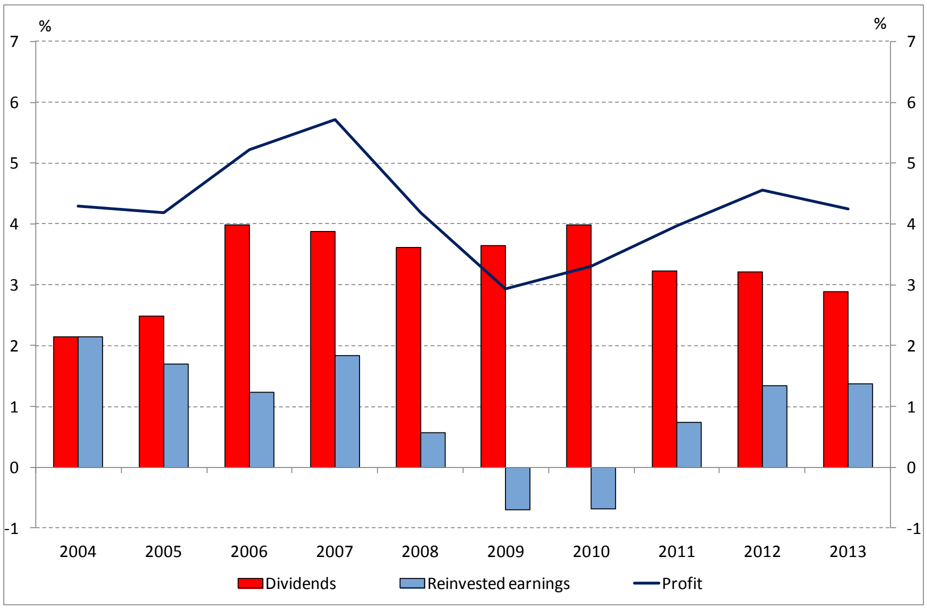
Chart 21: Utilisation of income generated in Hungary by foreign-owned companies and banks (as a percentage of GDP)



5.2.1. Non-financial corporations

Despite falling profits during the crisis, foreign-owned non-financial corporations only reduced dividend payments slightly, and thus dividends were partly paid from accumulated reinvested earnings. Since 2004, foreign-owned non-financial corporations have accounted for around 88 per cent of the profits generated by all foreign direct investment (i.e. by banks and non-financial corporations), and reinvested nearly a quarter of their profits in Hungary. Changes in reinvestment were largely consistent with the utilisation of the earnings generated by all foreign direct investment. Corporate profitability was hit hard by the crisis; by 2009 corporate profits had declined to one half of the values reported in 2007. In parallel with this, however, dividend payments declined only slightly. This may have been partly due to the fact that, in response to deteriorating growth prospects, firms suspended investment projects to a large degree and, amid tightening financing opportunities in the wake of the crisis, parent undertakings needed more internal funds. As a result, in 2009–2010, previously accumulated reinvested earnings and retained earnings became, in part, the sources of firms' dividend payments. After 2009, corporate profitability began to climb gradually and by 2012-2013 it approached the values recorded in 2006 as a percentage of GDP. Since dividend payments were cut back in parallel with this, the level of reinvested earnings began to rise steeply.

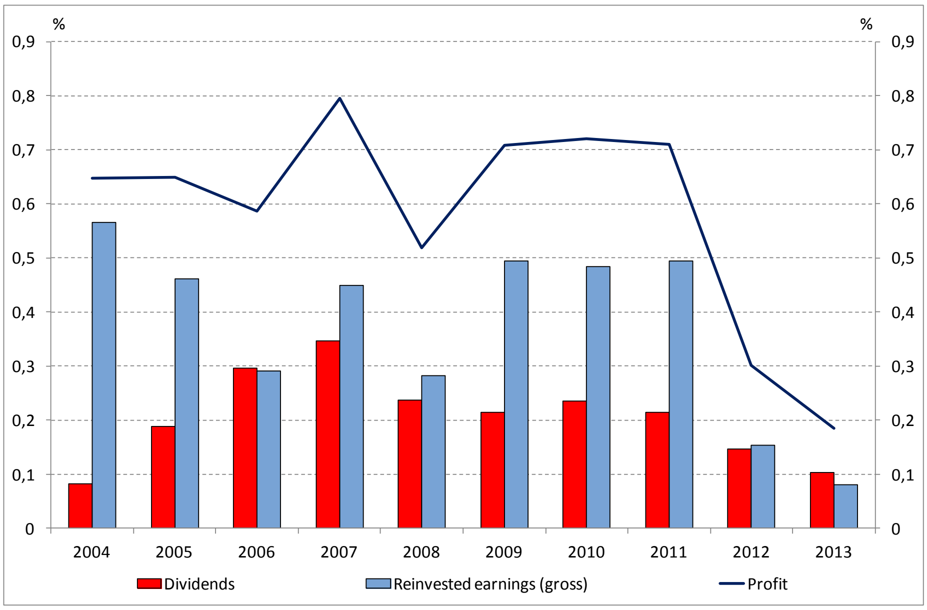
Chart 22: Utilisation of income generated in Hungary by foreign-owned non-financial corporations (as a percentage of GDP)



5.2.2. Banking sector

The earnings of credit institutions owned by non-residents reported in the balance of payments only started to fall drastically from 2012, but – similar to corporations – they responded primarily by reducing reinvested earnings (Chart 23). Banks' GDP-proportionate profits from normal operations reached a historical peak in 2007 before declining considerably in 2008 as a result of the crisis. During the next three years, however, profitability returned to pre-crisis levels. In this period, the increase in profits boosted reinvested earnings, which partly reflects banks' increased need for capital during the period. In 2012, however, the dip in profits resulted in a substantial fall in reinvested earnings. Several factors may have contributed to the protracted downturn in banks' profitability, most importantly, the special tax imposed on banks, the decreasing interest margin – in parallel with the decreasing central bank base rate, and the reduction in loan disbursements. Increasing NPL rates and the early repayment scheme also affected the profits of the banks, but did not affect the banks' profit on normal operations (see the part on after tax profits).

Chart 23: Profits, gross dividend payments and reinvested earnings of foreign-owned banks as a percentage of GDP

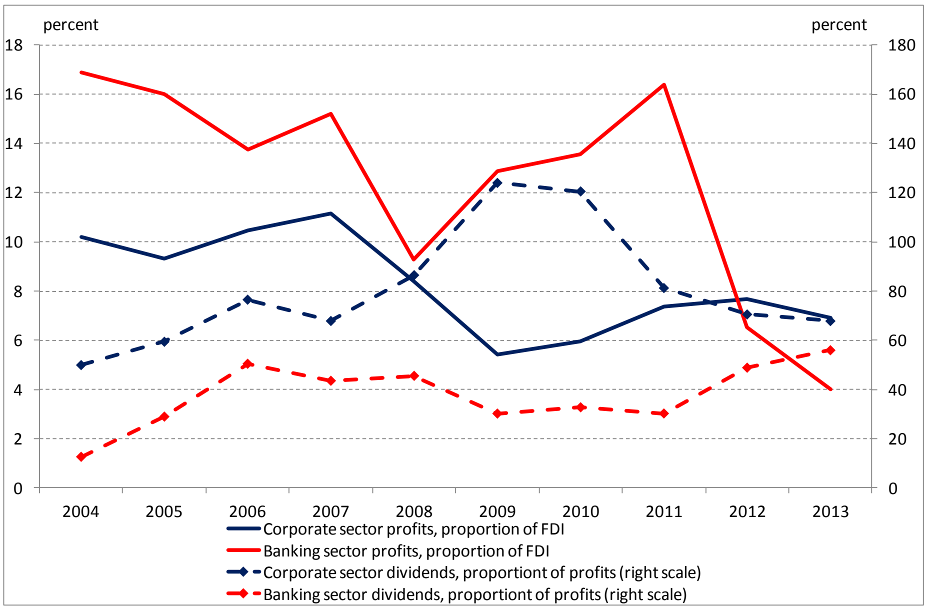


5.2.3. Profitability of banks in comparison to the profitability of non-financial corporations

Despite the fact that corporations generated more profits as a percentage of GDP, banks' return on capital invested was higher until 2012. Between 2004 and 2011, banks' profits as a percentage of direct investments by the owners exceeded the profits realised by corporations (Chart 24). However, since the amount of capital invested by corporations is significantly higher than the direct investments in banks, corporations still generated more profits as a percentage of GDP. It is also important to note that, while the crisis dampened the profitability of both banks and companies, in parallel with the downturn in GDP corporate profitability declined steeper than banks' profitability. Similarly, banks' return on investment recovered faster: as early as 2010–2011, foreign banks' ratio of net income from normal business operations as a percentage of shareholder equity varied around pre-crisis levels already, while in the case of companies it still fell significantly short of the levels observed in previous years. During 2012, banks' profits fell substantially, which was also reflected in their return. In the course of 2012–2013, foreign banks' return on equity from normal business operations plunged lower than the deepest trough recorded during the crisis and, in contrast to previous trends, underperformed even the corporate ratio.

While the dividend payout ratio mostly moved in the same direction in both the corporate and banking sectors before the crisis, it has followed diverging trends since the onset of the crisis. In the corporate sector, there was a jump in the dividend payout ratio after 2008, as reinvested earnings decreased in line with a decline in investment projects in the context of waning profits and the deteriorating growth outlook, which also meant a proportionate increase in dividend payments. Banks, however, faced a different situation: in many cases, they needed additional capital for prudent operations, which they tried to achieve through parent bank capital injections on the one hand, and through a higher ratio of reinvested earnings on the other hand. Consequently, banks' reinvested earnings were on the rise during the years of the crisis, while dividend payments were slightly reduced.

Chart 24: Profits generated by foreign-owned corporations and banks in Hungary

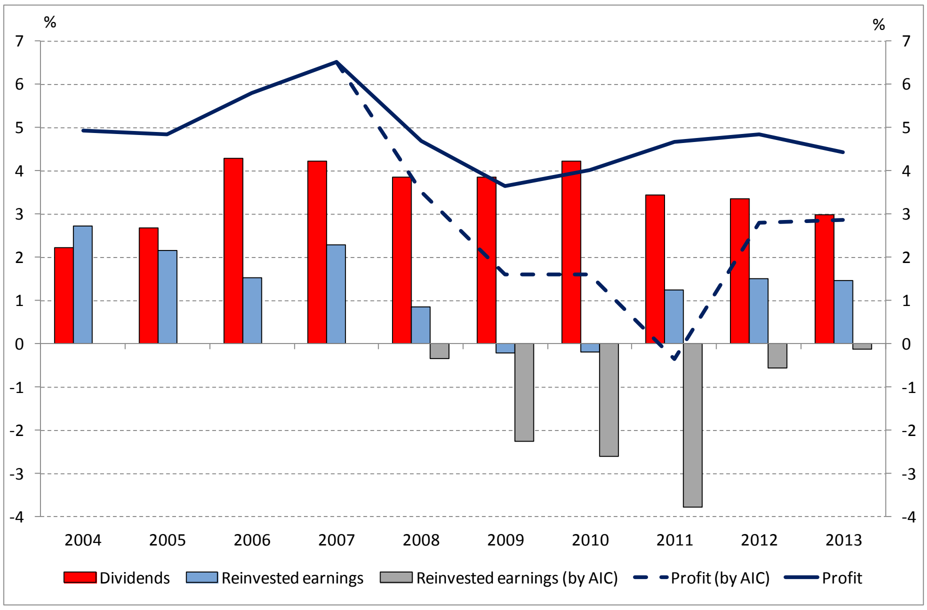


5.3. After-tax profit of companies in foreign ownership

In accordance with international statistical requirements, the balance of payments statistics of Hungary report income from normal business operations. Before 2008, the Hungarian balance of payments statistics included all corporate profit and loss account categories. However, owing to the new, questionnaire-based survey, it is now possible to separate the gains and losses linked to events other than normal business operations. With the questionnaires, accounting gains and losses can be broken down according to whether they induced a change in equity as income, revaluation or other change in stocks from a statistical point of view. Profits excluding non-recurring effects and revaluations are called profits from normal operations; this is the item included in the balance of payment statistics (for more details on the profit items taken into account during the so-called COPC adjustment, see the statistical publication entitled *"Methodology for the compilation of the balance of payments and international investment position statistics"*).

The profits of foreign-owned banks and corporations operating in Hungary according to normal operations declined to a lesser degree than the profit after tax included in the annual reports of enterprises. Owing to the new corporate questionnaires, since 2008 the balance of payment statistics have recognised profits from normal operations as property income. Based on the data available, it can be established that profits from normal operations only declined moderately at the onset of the crisis, and subsequently remained around the previous levels. By contrast, the profit after tax presented in annual reports fell steeply until 2011 reflecting, to a large degree, the decline in banks' after-tax profits – mainly as a result of charge-offs and early repayments – and, in case of non-financial corporations, the revaluation losses realised during the depreciation of the exchange rate and the profit-reducing effect of the sale of financial investments (Chart 5, blue dotted line).[7] After 2011, total profit after tax including revaluation effects rose faster than profits from normal operations, but still lagged behind profits from normal operations and thus, pre-crisis levels.

Chart 25: Utilisation of the earnings generated by foreign-owned banks and corporations based on normal operations and profit after tax (as a percentage of GDP)



Despite the decline in earnings, dividend payments decreased only to a lesser degree due to the crisis, which thus resulted in the contraction of retained earnings. While EUR 17 billion was paid out in dividends between 2009 and 2013, the actual after-tax profit of corporations only amounted to almost EUR 8.5 billion during the same period. In other words, in spite of lower profits, firms continued to pay dividends in similar amounts as in previous years (and subsequently a reduced amount), which resulted in highly negative actual reinvested earnings (Chart 26, grey column). In practice, negative reinvested earnings mean that companies used previously accumulated retained earnings for the payment of dividends during the loss-producing periods. Implicitly, however, this implies that the reinvested profits of previous years were used, to a large degree, to replenish retained earnings and ultimately, in retrospect, to pay dividends.

Based on firms' profit after tax, the net lending of the Hungarian economy as a proportion of GDP would have been 1-4 percentage points higher in recent years. For the purposes of balance of payments statistics, non-recurring items and revaluations are deducted from the profit after tax included in the annual reports, and only profits from

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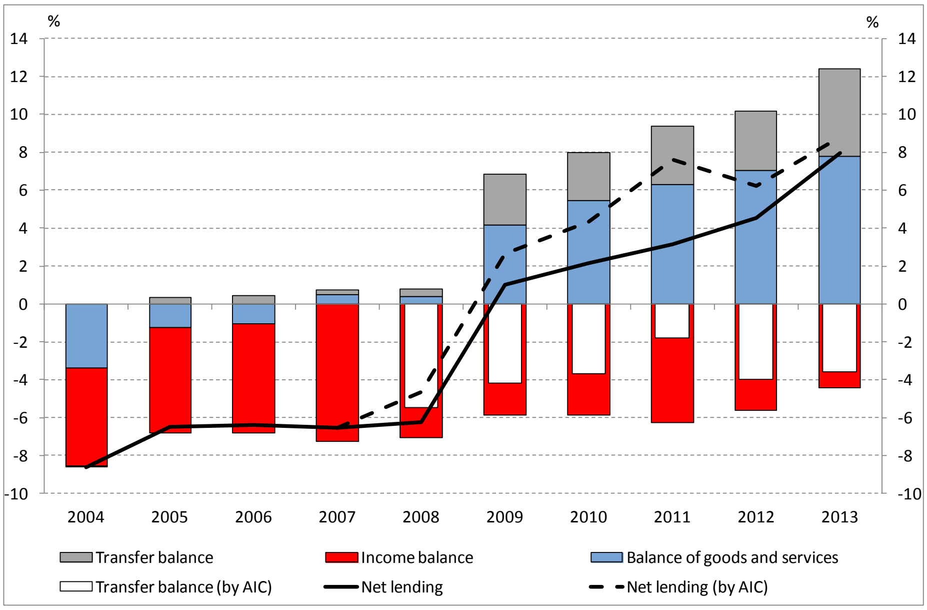
[7] For lack of a sectoral breakdown for the COPC adjustment, its effect cannot be identified separately for banks and non-financial corporations.

normal operations are taken into account. If extraordinary profit items indicate losses, as has been typical in Hungary in recent years, the profit from normal operations will be higher than the after-tax profit. In other words, the balance of payment statistics do not recognise extraordinary profits, and extraordinary losses increase income. Accordingly, in the case of extraordinary losses (which is typical in Hungary, e.g. the early repayment scheme), the income balance, which constitutes a part of the net lending, shows a higher deficit than would have been the case if the balance of payments statistics had used the after-tax profit included in the annual reports. Balance of payment statistics use earnings from normal operations in the financial account as well, and the reinvested earnings received in the form of dividends deducted are presented on the liability side; i.e. the COPC adjustment does not influence the value of net errors and omissions in the financial account. Finally, it is important to note that the developments presented in the official statistics better reflect the underlying trends, and the use of the international methodology allows for a reliable comparison between trends in individual countries.

Chart 26: Net lending based on the balance of payments and on profit after tax (as a percentage of GDP)

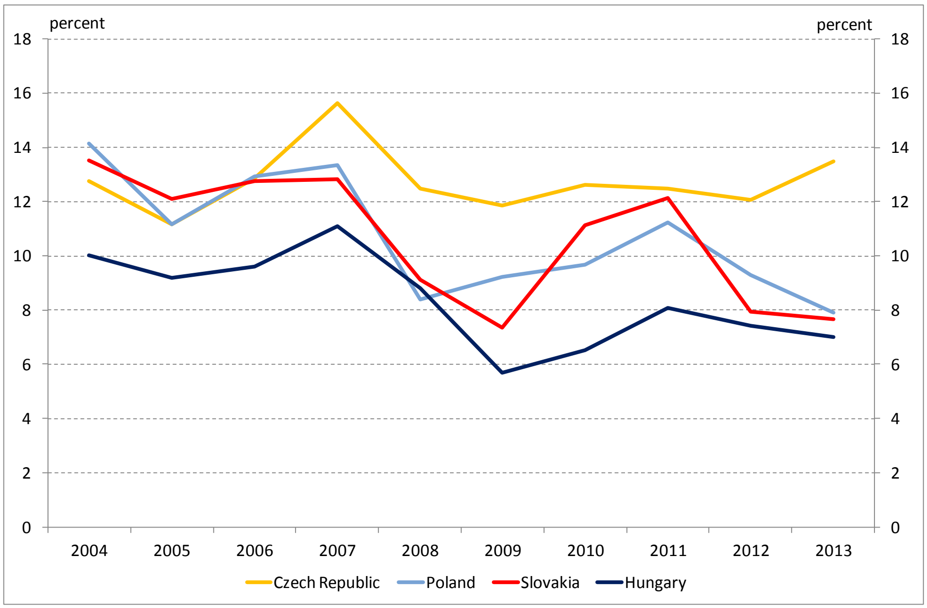


5.4. International comparison

5.4.1. Regional comparison

Profits realised on foreign direct investment decreased everywhere in the region, but Hungary recorded the lowest levels of return on investment over the entire time horizon (Chart 27). It is worth comparing the return on foreign direct investment in Hungary to the values of other countries in the region. Of the Visegrád countries, for instance, the Czech Republic reported income outflows similar to those observed in Hungary, despite the fact that the Czech Republic has no net external debt. This is because in the Czech Republic the high deficit of the income balance is caused by the high profit levels achievable on foreign direct investment (Report on the Balance of Payments, July 2014); consequently, among the countries reviewed, the Czech Republic ensured the highest return on equity for non-residents. By contrast, from 2004 Hungary reported the lowest rate of return on direct investment in proportion to the total portfolio, yet – as will be shown below – foreign companies withdrew more capital on average from Hungary than from the rest of countries in the region (Chart 29). The effects of the financial crisis manifested themselves in all countries of the region: the return on foreign direct investments as a percentage of capital typically dropped by 4–6 percentage points on average in regional countries.

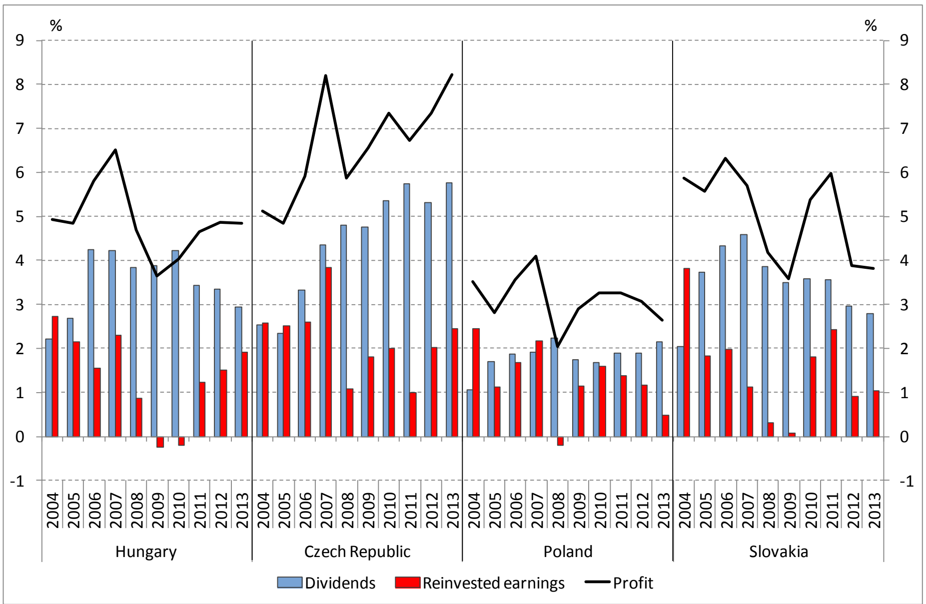
Chart 27: Return on working capital (profits on FDI stock in relation to the total FDI portfolio)



Source: Eurostat

After the crisis, foreign-owned companies operating in countries in the region offset their declining profits by reducing their reinvested earnings, while repatriated earnings remained at high levels. Before the crisis, the GDP-proportionate profits of companies in foreign ownership rose steadily across the region. The financial crisis in 2008, however, reduced companies' profitability in all countries in the region (Chart 28). This downturn typically led to a decline in reinvested earnings in the Visegrád countries, while dividend payments remained at pre-crisis levels. It was only in Hungary and Poland that the decline in reinvested earnings entailed, even on a consolidated basis, the payment of dividends by foreign-owned companies from previously accumulated capital. It is also obvious that, in respect of the GDP-proportionate profit of foreign-owned corporations, the performance of the Czech Republic was outstanding by regional standards; in the Czech Republic profit levels steadily increased after the crisis, and by 2013 they reached their pre-crisis value of more than 8 per cent of GDP. As regards Hungary, corporate profits rose during the years following the crisis before they stabilised at the levels observed in 2004–2005. By contrast, in Poland and Slovakia profits began to decline again during 2012 and 2013 after a steady increase following the crisis.

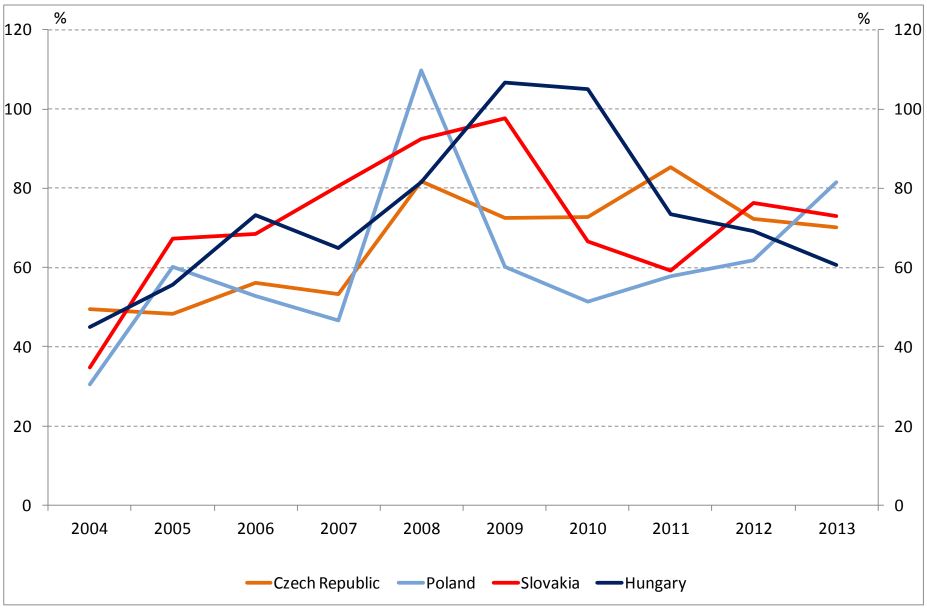
Chart 28: Utilisation of earnings from foreign direct investment in regional countries



Source: Eurostat

While dividend payments were higher in Hungary than the regional average during the years preceding the crisis, they fell behind the average as a result of the developments observed in 2012–2013. Following the crisis, profit-proportionate dividend payments were on the rise; however, their level in Hungary outstripped the comparable ratios of other regional countries, which can be primarily attributed to Hungary's poor growth outlook. In the past two years, however, the dividend payout ratio declined and accordingly, in 2013 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. If the relatively higher ratio of reinvested earnings is retained in the coming years – amid increasingly rising profits – it may have a positive impact on Hungary's growth outlook.

Chart 29: Dividend payout ratio to total earnings



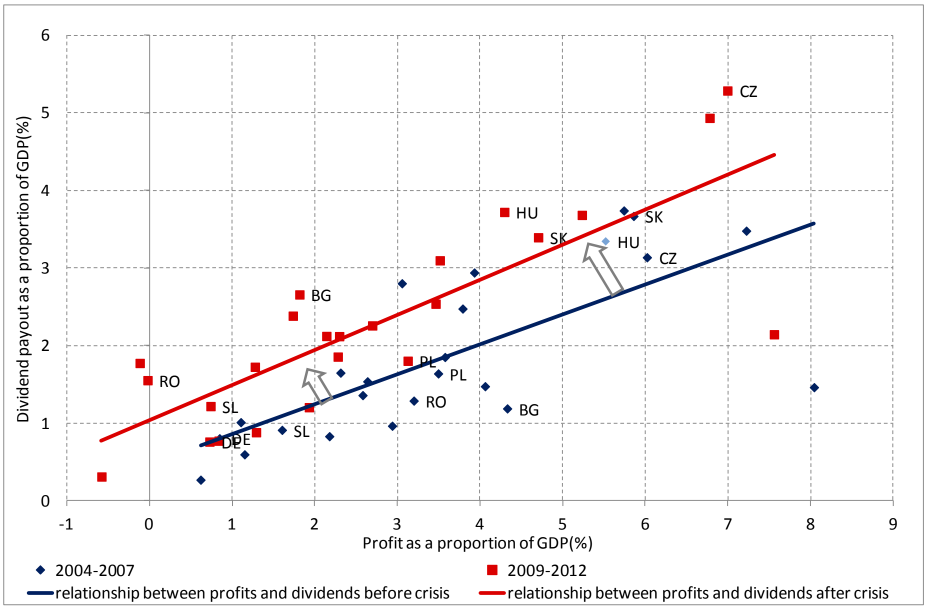
Source: Eurostat

5.4.2. European Union comparison

Foreign-owned companies in EU countries tended to pay out a higher ratio of their earnings to shareholders, while the share of reinvested earnings decreased. The response of European Union Member States to the crisis showed heterogeneity in respect of GDP-proportionate profits and dividend payments. On the one hand, in more than half of the EU Member States – typically in countries joining the European Union from 2004 – the increase in dividend payments was combined with a substantial decline in the GDP-proportionate profit mark-up. This may be consistent with the developments described in the case of Hungary: on the one hand, after 2008 diminishing return on investment and deteriorating growth prospects may have led to a decline in domestic investment projects and consequently, foreign-owned companies transferred their profits to their home countries. On the other hand, the parent undertakings of foreign-owned firms may have had a higher need for funds from their subsidiaries, which may have shifted the utilisation of earnings to higher dividend payments. This also entailed a general decline in the share of reinvested earnings following the crisis.

In Hungary, profits generated and dividends paid by foreign-owned firms is high by European Union standards. Before the crisis, profits generated by foreign-owned companies in the Czech Republic were comparable to the levels observed in Hungary; after the onset of the crisis, however, companies in foreign ownership realised more profits in the Czech Republic, while their dividend payments underperformed in comparison to Hungary before the crisis and outstripped Hungary, to a substantial degree, in the years following the crisis. By contrast, in Germany – a larger, more developed economy less reliant on foreign capital and less affected by the crisis – GDP-proportionate profits generated by foreign investments were substantially lower in the years both before and after the crisis, and dividend payments remained more or less unchanged.

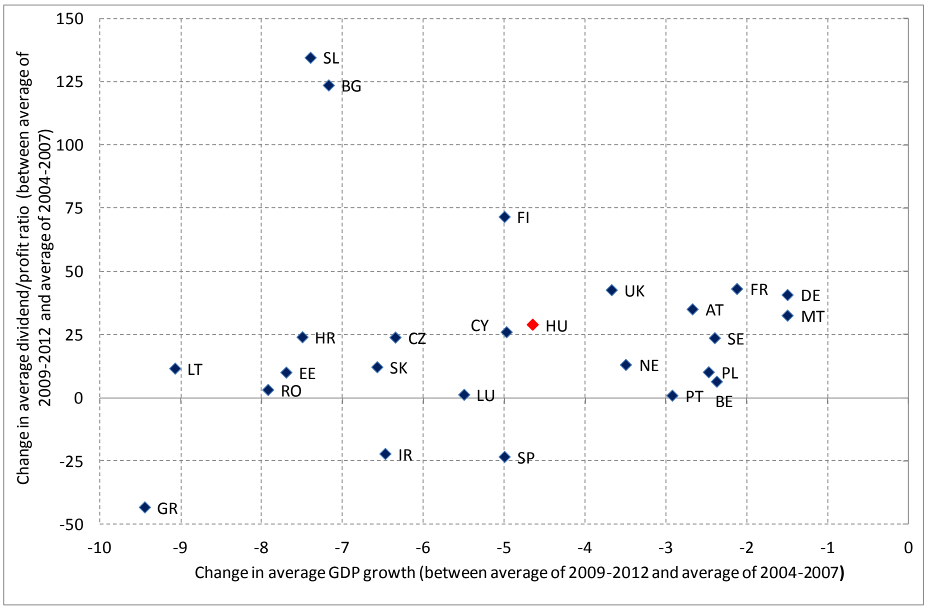
Chart 30: Profits and dividend payments of foreign-owned firms as a percentage of GDP (average data for 2004–2007 and 2009–2012)



Source: Eurostat

In the years following the crisis, more restrained economic growth may have also contributed to higher dividend payments by foreign-owned companies. The decline in investment resulting from the economic slowdown may have reduced reinvested earnings, which may have entailed higher dividend payments than the previously observed levels (Chart 31). The chart indicates the differences between average GDP growth in pre-crisis and post-crisis years and changes in average profit-proportionate dividend payments during the same periods. Amidst slight economic expansion, the dividend payout ratio increased during the years following the crisis in most countries, which implied a contraction in reinvested earnings. This correlation also suggests that growth developments affect the dividend policy of foreign owners. At the same time, it should be remembered that, through restrained investment projects, the decline in reinvested earnings may contribute to subdued economic growth in and of itself.

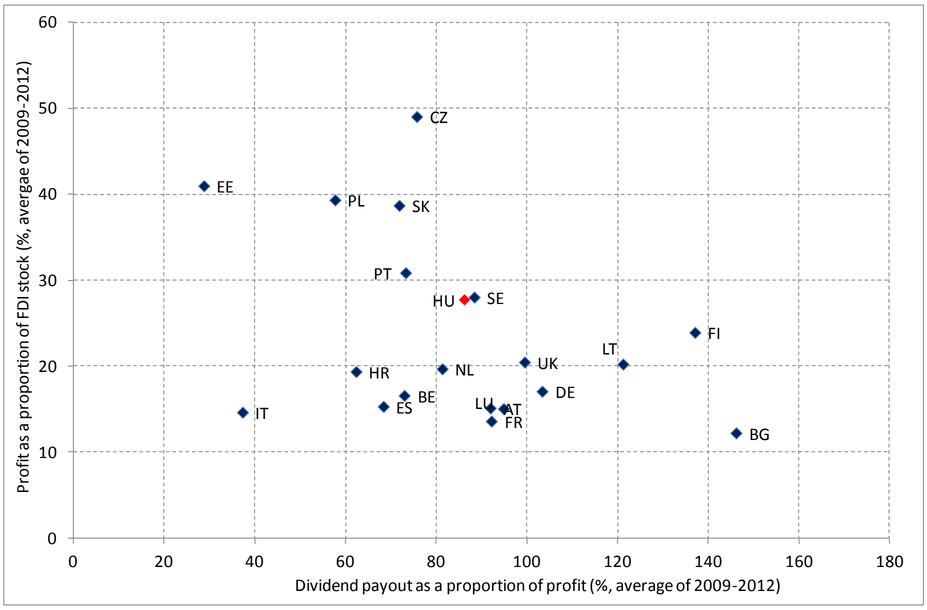
Chart 31: Effect of average GDP growth on the average dividend payout ratio of foreign-owned firms before and after the crisis



Source: Eurostat

According to 2009–2012 data, in respect of foreign-owned firms operating in Hungary it can be established that, while the ratio of profits to investments is relatively low compared to countries joining the EU from 2004, the ratio of dividend payments to profits can be considered high relative to the same countries. It is worth noting that the ratio of dividend payments in relation to invested capital compared to the members of the Union was relatively high in Hungary. Profits generated and dividends paid by foreign-owned companies in EU Member States vary between recently joined countries and older EU Member States. While corporations in developed countries typically have smaller returns on equity than their peers in less developed countries, profits on FDI stock are typically higher in countries joining the EU in 2004 and later, which, obviously, may be also related to the convergence of developing countries. Among the recently joined countries, while the return on investment is relatively low in Hungary, it is expressly high in the case of the Czech Republic. Profit-proportionate dividend payments are higher in older members of the EU, while the average is smaller in the case of recent members. Dividend payments in Hungary are considered high in regional comparison. In respect of dividends paid as a percentage of investment we find that foreign-owned companies operating in Hungary paid dividends to shareholders in amounts exceeding those paid by most of their peers in the European Union as a proportion of capital invested.

Chart 32: Profits generated and dividends paid by foreign-owned firms in European Union Member States (as a percentage of capital invested and profits generated)



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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