REPORT ON THE BALANCE OF PAYMENTS

OCTOBER
2016

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

Letters 27
Gábor Bethlen

REPORT ON THE BALANCE OF PAYMENTS

OCTOBER 2016

Published by the Magyar Nemzeti Bank

Publisher in charge: Eszter Hergár

H-1054 Budapest, Szabadság tér 9.

www.mnb.hu

ISSN 2064-8707 (print)

ISSN 2064-8758 (on-line)

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. The evolution of the external balance is key to financial stability, as developments relating to the balance of payments allow conclusions to be drawn concerning the sustainability of economic growth and relevant risks. Moreover, the analysis of the balance of payments enables 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. Therefore, the primary goal of the Report on the Balance of Payments is to inform market participants about the developments in the balance of payments by way of this regular analysis, and thus provide deeper insight into the workings of the economy.

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

This Report is based on information for the period ending 23 September 2016.

SUMMARY

External balance indicators developed favourably again in the second quarter of 2016. In line with the very high net lending, **Hungary's external debt ratios decreased, thus reducing the external vulnerability of the Hungarian economy.** As a result of data revision, **the net FDI inflow for 2015 was higher** than previously estimated, which improves the picture of domestic processes in the context of longer-term growth as well. The **current account surplus rose to 4.5 per cent of GDP**, while the economy's net lending stabilised around 7.5 per cent of GDP, **which is well above the value observed in the neighbouring countries**.

With the September report, the **2015 balance of payments data were revised significantly.** The largest change is attributable to the fact that – according to the received corporate questionnaires – the increase in the **profit of foreign-owned corporations was significant, at over 15 per cent, last year as well, and the income of people working abroad increased as well**. The revisions alter the picture of the external balance processes in two aspects. **On the one hand**, as a result of the higher profit and larger foreign income, the **income balance deficit rose by 1 per cent of GDP, which also reduced 2015 net lending. However, the net lending rate of around 8 per cent of GDP is still an outstandingly high value.** On the other hand, along with the higher profit, the corporations' reinvested earnings also rose, and **thus the revision raised net direct investments as well**. According to the new data, net FDI inflow continued in 2015 as well.

As for developments in Q2, according to **the real economy approach**, **net lending stabilised at a high level, while the current account surplus increased considerably**. The high net lending developed because **the rise in trade surplus and the improvement in the income balance was roughly offset by the decline in the transfer balance surplus**. The increase in exports of goods is attributable to the **rising industrial output**, while the rise in the trade surplus was also supported by the **substantial improvement in the terms of trade**. The drop in the income balance deficit is still attributable to the **declining foreign interest payment** resulting from the contracting debt and interest rates. The relatively low transfer balance can be linked to the moderate absorption of EU funds, which is typical in the first years of the EU's programming periods.

From the financing side, **the second quarter was characterised by a decline in FDI attributable to dividend payments and a larger fall in net external debt than observed in the previous quarter**. The **EUR 1.1 billion decrease in net debt liabilities** can be ultimately attributed to the EU transfers, the sale of government securities by non-residents and the decrease in debt, along with corporations' substantial export revenue. Meanwhile, **the structure of the decline in net external debt was determined** by the foreign currency liquidity provided by the central bank to the banking system **due to the conversion of FX loans into forints: banks' net external debt decreased sharply, while that of the consolidated general government rose**. On the other hand, in parallel with households' substantial government securities purchases, **the gross external debt of the general government continued to decrease**.

In the second quarter, Hungary's external debt ratios decreased further, as net external debt fell by almost 2 percentage points to 23 per cent of GDP, while gross external debt dropped to 73 per cent of GDP. The decline in gross external debt was primarily attributable to the continued contraction in non-residents' government securities holdings and the repayment of the last instalment of the EU loan. In parallel with gross external debt, **short-term external debt** – which is important in terms of external vulnerability – also continued to **fall, dropping below EUR 20 billion**. As a result of maturing foreign currency government debt and the provision of foreign currency liquidity linked to the conversion of FX loans into forints, **foreign exchange reserves amounted to EUR 24.8 billion at the end of the quarter, and thus remain well above the benchmarks closely monitored by investors**.

Net lending stabilised at a high level according to the sectoral approach as well: the continued fall in the government's net borrowing was offset by the decline in the net savings of the private sector. Households' moderately decreasing net savings is due to the absence of the one-off savings-increasing effect arising from the settlement of foreign currency loans, while in the case of corporations the income growth was reduced by the moderate absorption of EU transfers, which entailed a decrease in net lending. **Households still typically channel their new savings into government securities**, which – similarly to the previous quarters – may have substantially **supported the reduction**

in the government's external liabilities. Due to the rising revenues related to consumption and wages and falling interest expenses, the net borrowing of the general government once again decreased and thus remains historically low.

In our special topic, we present a more detailed analysis of **developments in the income of foreign-owned companies** operating in Hungary. According to the corporate questionnaires, underlying the revision of the 2015 data, **the profit of foreign-owned corporations in 2015 rose to almost 7 per cent of GDP**, which represents a higher profit than in the pre-crisis years. From the increasing income, corporations **raised both their dividend payments and their reinvested earnings**. Income growth **characterised a wide range of industries** and was exceptionally high in some sectors. In addition, the extremely large income of a multinational corporation also played a significant role in the rise of profit. Furthermore, the income balance deficit was additionally increased by the decline in the 2015 profit of foreign companies in Hungarian ownership. Our international comparison shows that, while earlier the rate of return achieved by foreign corporations operating in Hungary lagged behind that of the countries in the region, **with the income growth realised in 2015 it already reached the regional level, whereas the ratio of reinvested earnings continued to exceed the rate observed in the rest of the Visegrád countries.**

CONTENT

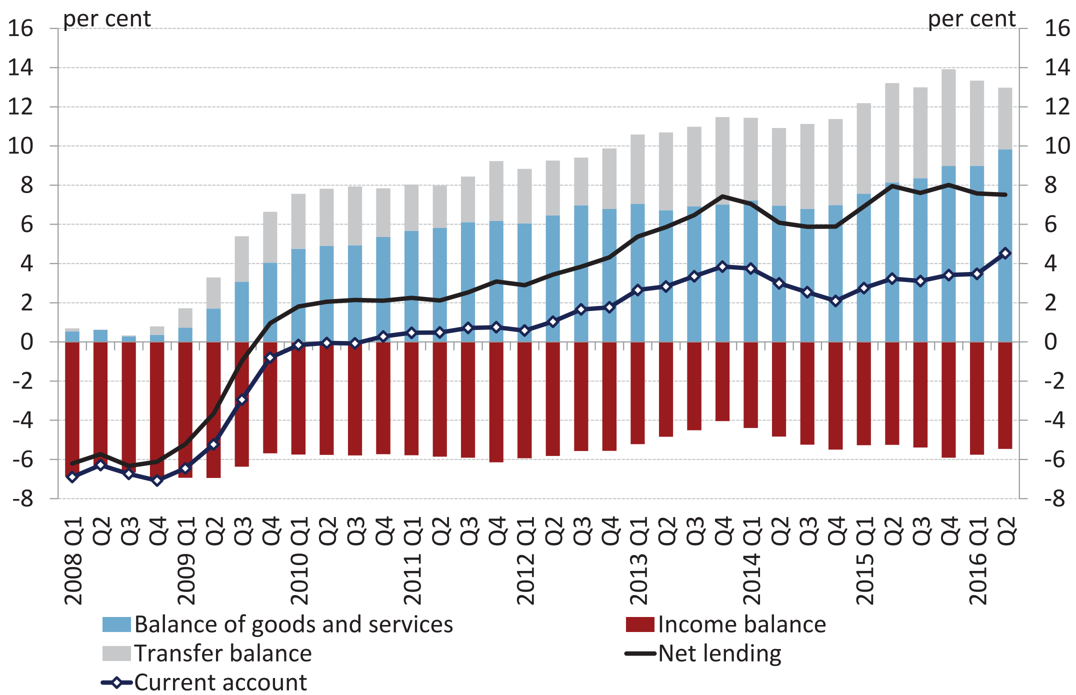
LIST OF BOXES

1. REAL ECONOMY APPROACH

From the real economy side, in the second quarter of 2016 the four-quarter net lending of the Hungarian economy stabilised at a high level of around 7.5 per cent of GDP, while the current account surplus increased considerably. The high net lending was achieved in the context of a decrease in the transfer balance surplus, which was counterbalanced by the rise in the trade surplus and the improvement in the income balance. The significant trade surplus can be attributed to the dynamic growth in the net exports of goods and the persistently high balance of services. The rise in goods exports was essentially the result of the expanding industrial output, and thus the growth in exports outstripped the import growth rate, while the increase in trade surplus was also supported by the improved terms of trade. In the second quarter, the deficit on the income balance continued to decline modestly, which is still attributable to the improving interest balance of foreign loans. The shrinking transfer balance surplus can be linked to the moderate absorption of EU funds, typical in the first years of the EU's programming periods.

From the real economy side, in the second quarter of 2016 the four-quarter net lending of the Hungarian economy stabilised at a high level of at 7.5 per cent of GDP, while the current account surplus rose to 4.5 per cent. During this period, seasonally unadjusted net lending exceeded EUR 1.8 billion, which was dominated primarily by the high surplus on the current account balance, while the capital account balance was around EUR 0.1 billion. Following the decrease in the first quarter, based on the revised data, Hungary's four-quarter net lending did not change significantly and amounts to 7.5 per cent of GDP. The substantial rise in the goods and services balance continued, along with a modest improvement in the income balance, while the slower inflow of funds resulting from the new programming period of the European Union was reflected in the decrease of the transfer balance.

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



All charts by the MNB unless otherwise indicated.

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

Box 1: Revision of the balance of payments

In the publication on the balance of payments, the balance of payments figures were modified retrospectively, and as a result, net lending was lowered by 0.8 per cent of GDP in 2015 in comparison to the figures estimated earlier. Some of data included in the balance of payments can be regarded as preliminary data until the September data publication. The annual, final figures related to the profit of foreign-owned corporations are also revealed in the September data disclosure. The actual figures on corporate profit are available in the income balance with a delay of nine months; pending the receipt of the actual figures, the relevant figures of the balance of payments are based on an estimate. Thus, the profit figures for 2015 first appeared in the present publication of balance of payments in September 2016, as part of the revision. In addition, the goods and services balance also changed along with the income of employees temporarily working abroad, which also influences the picture we had so far on net lending. The most important changes are as follows:

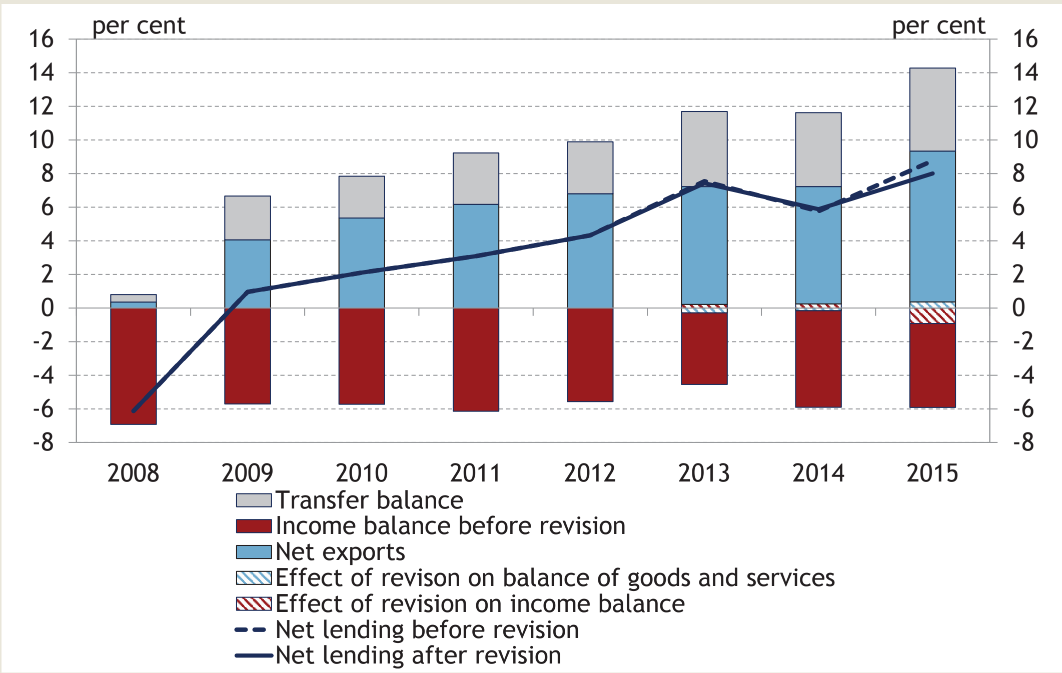
– The size of the goods and services balance was modified mainly by the regular revisions related to the national accounts, which also have an impact on net lending. This shift slightly decreases the net export balance, and thereby lowers net lending in 2013 and 2014, while it increases these items in 2015 and 2016 Q1.

– According to the questionnaire-based actual figures on corporate profits, in 2015 the profit of foreign-owned corporations may have exceeded the earlier estimation by roughly EUR 1.3 billion. On the one hand, this increases the income balance deficit, thereby reducing net lending, and on the other hand, while dividend payments rose only to a small degree, it increases the net inflow of FDI funds almost at the same rate (see later).

–In line with the HCSO data communication, the income of employees working temporarily abroad rose retrospectively between 2013 and 2015, and this reduces the income balance deficit and points to a rise in net lending.

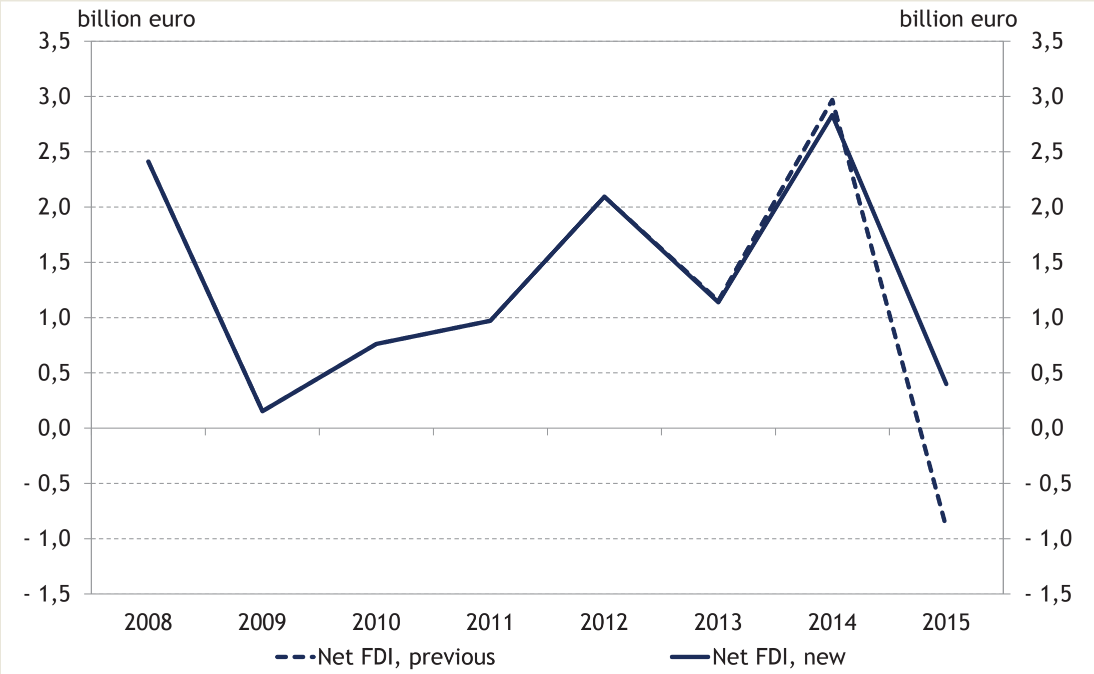
Taken together, based on the real economic transactions, net lending fell short of the preliminary disclosed data by 0.8 per cent of GDP in 2015, but its level was still significant, amounting to 8 per cent of GDP. Based on the quarterly data, net lending also remained high in the beginning of 2016.

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



Due to the revision of the balance of payments, net FDI inflow in 2015 exceeded the previously estimated figure by 1.3 per cent of GDP. Since the dividend data related to 2015 were actual data before as well, the higher profit of foreign-owned corporations also means that within foreign direct investments the reinvestment of earnings – i.e. income not paid as a dividend – increases, resulting in higher foreign direct investments. Accordingly, while in the earlier data disclosure net FDI funds in Hungary showed a decrease of EUR 0.9 billion, according to the actual data the rise in foreign direct investments continued in 2015 as well. The rise of EUR 0.4 billion in foreign direct investments last year (Chart 3) falls short of the figure observed in 2014, but that year's outcome also reflected one-off effects, such as acquisitions by the state. This also means that net lending calculated from the financing side shifted downwards to the degree of this higher inflow of funds, and thus it is in line with the decrease in the position calculated using the real economy approach.

Chart 3: Impact of revisions on FDI



The revisions in 2016 Q1 affected the transfer balance and the balance of goods, while the balance of net errors and omissions increased. The decrease in the transfer balance was mainly attributable to the shortfall in the absorption of EU transfers early in the year compared to the previously released figure. Despite the higher level of 2015 corporate profit, the income balance deficit rose only modestly in 2016 Q1, resulting from two opposite effects. On the one hand, the higher estimated profit of foreign corporations increased the income balance deficit. On the other hand, however, the impact of this was offset by the fact that the income of employees working temporarily abroad may have been higher in 2016 as well due to the carry-over effect of the 2015 data.

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

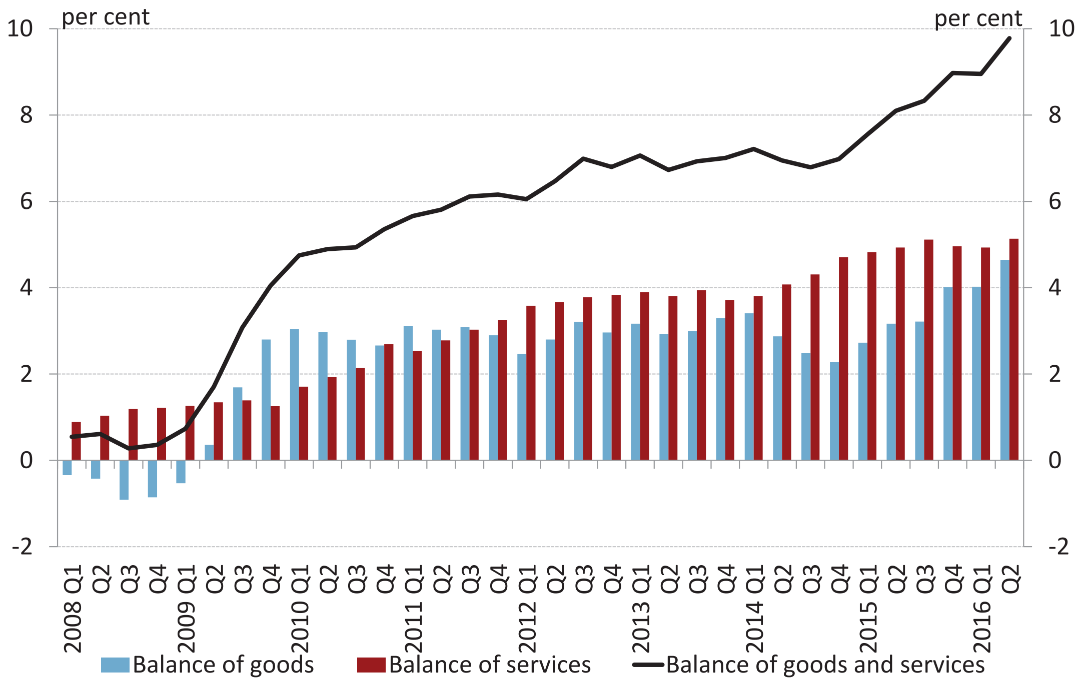
	2013	2014	2015	2016. Q1
I. Change in net lending from the real economy side (1+2+3)	**-0.1**	**0.1**	**-0.8**	**-0.4**
1. Balance of goods and services	-0.3	-0.2	0.4	-0.1
2. Income balance	0.2	0.3	-1.0	0.0
3. Transfer balance	0.0	0.0	-0.2	-0.2
Current account	**-0.1**	**0.1**	**-1.1**	**-0.2**
II. Change in net lending from the financing side -(5+…+8)	**0.0**	**-0.2**	**-1.6**	**-0.5**
5. Foreign direct investment	0.0	0.1	-1.3	-0.2
6. Portfolio shares	0.0	0.0	0.0	0.0
7. Derivatives	0.0	0.0	0.0	0.0
8. Net debt flows	0.0	-0.3	-0.3	-0.3
Net errors and ommissions (I.-II.)	***-0.2***	***0.3***	***0.8***	***0.1***

In the financing side, the negative values represent larger inflow of funds

1.1. Balance of trade

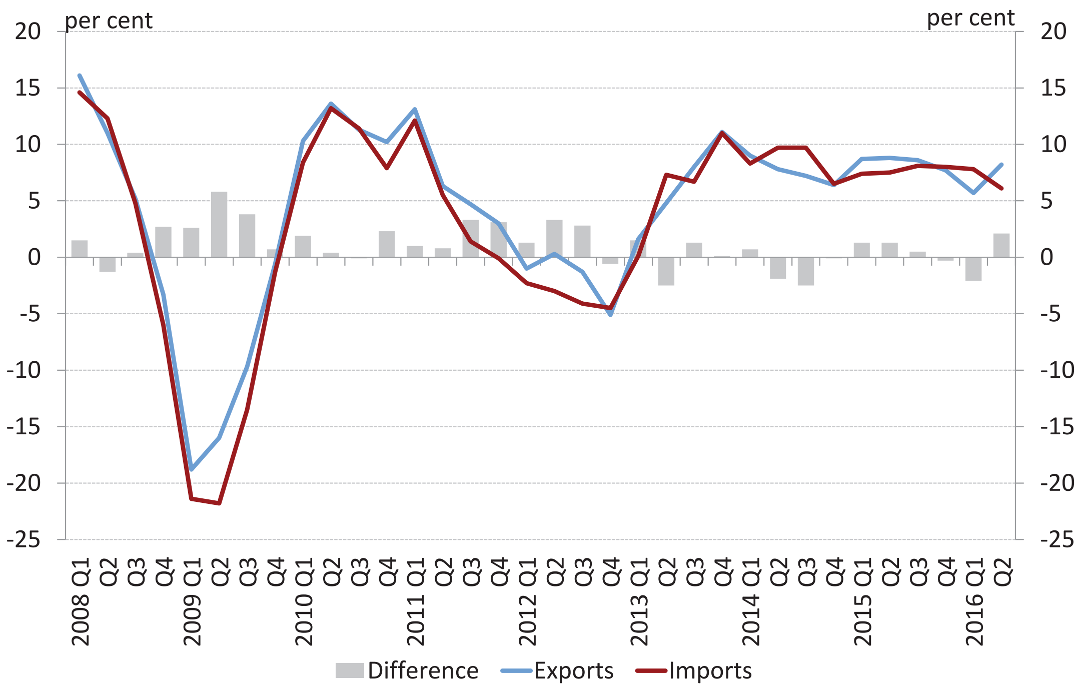
In the second quarter, the balance of trade reached a historic high of almost 10 per cent of GDP, due mainly to the significant rise in the balance of goods (Chart 4). Hungary's trade surplus increased dynamically in the second quarter compared to the high value observed in the first quarter. In the context of improving terms of trade, the goods surplus increased substantially as a result of rising exports backed by stronger engineering industry output, and it approximated the persistently high services balance surplus. The persistently high level of services export was supported by the significant income from transport services and tourism, as well as by the operation of shared service centres (SSC) in Hungary.

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



In 2016 Q2, faster growth in exports was observed, while annual real growth in imports slackened. In the second quarter the slower real growth in imports was exceeded to a large degree by the rise in exports, and thus the volume of net exports increased. The improved export growth was due to rising industrial output – mainly stemming from the better capacity utilisation in vehicle manufacturing – compared to the previous periods, while the modest increase in external demand also supported this growth. In addition to the improving industrial output, economic growth in the euro area, and in particular the economic performance of Germany – Hungary's key trading partner – exceeded the expectations and this may have also contributed to the expansion of Hungarian exports. The real growth in imports decelerated slightly, which may be regarded as an adjustment of the import expansion, which had reached a high level even despite the deceleration of export growth observed in the previous quarter, and may be linked to the moderate level of investments (Chart 5).

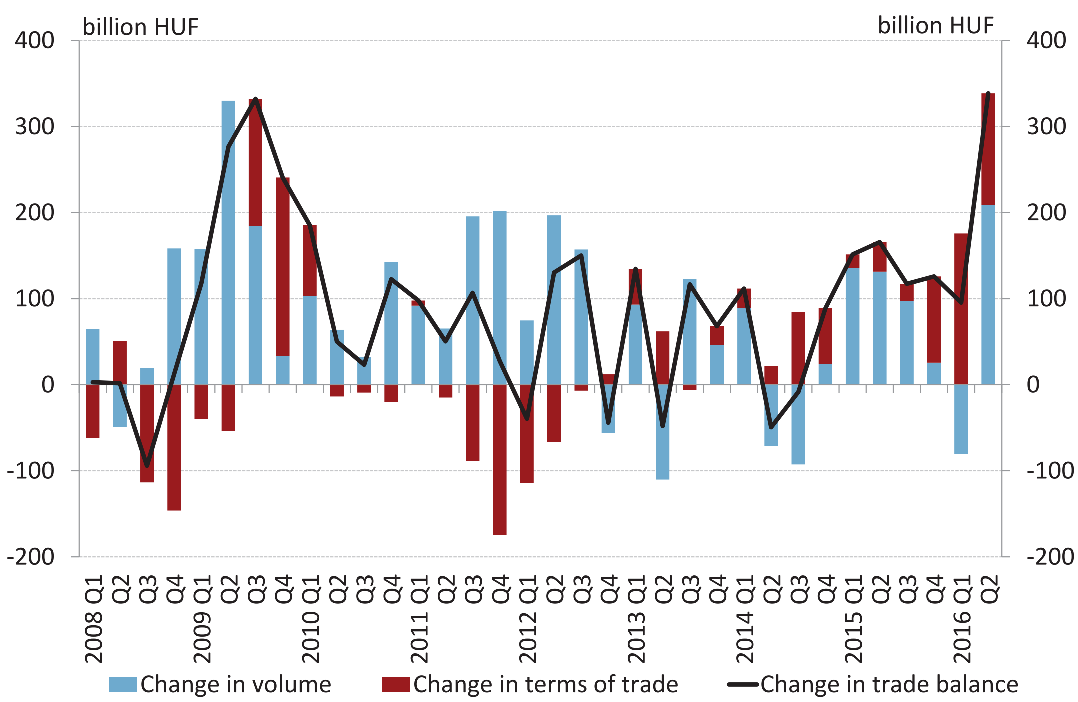
Chart 5: Annual real growth of exports and imports



Source: HCSO, MNB

Changes in volumes and in the terms of trade both contributed to the rise in the trade surplus in the second quarter (Chart 6). The annual rise in the goods and services balance in excess of HUF 300 billion was also attributable to the improved terms of trade, in addition to the substantial increase in the volume of exports. The contribution of the terms of trade to the trade surplus decreased slightly quarter on quarter, but remains significant, which may be attributed to the moderate commodity prices and import prices falling to a greater degree than export prices. As a result of the improved terms of trade, the trade surplus rose by almost 1 per cent of GDP in the first half of the year.

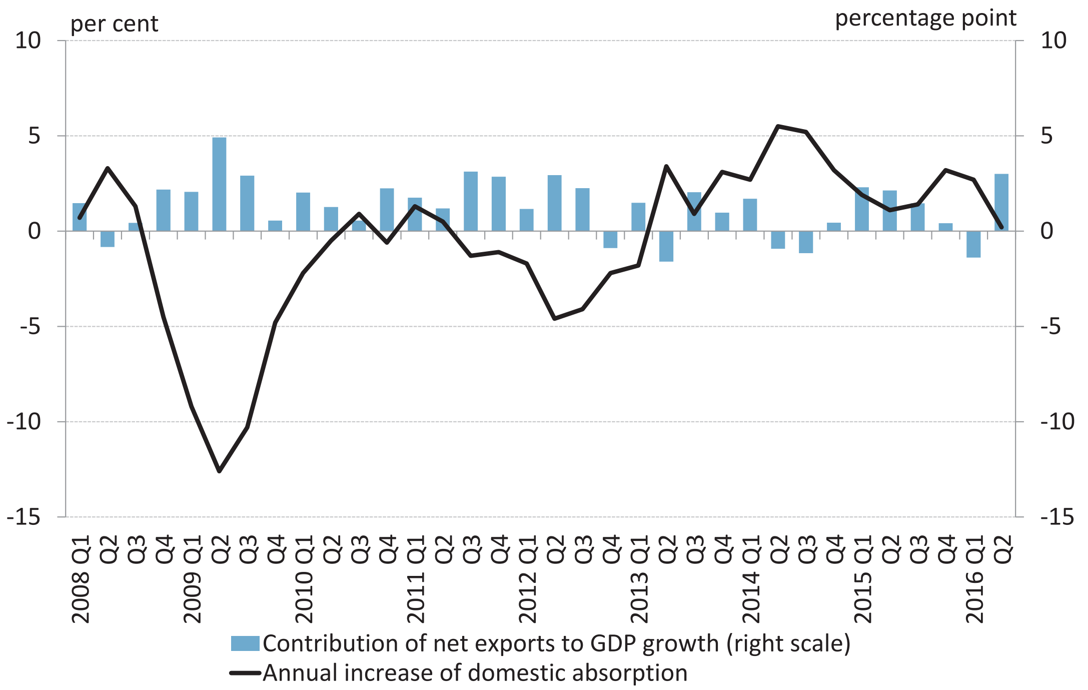
Chart 6: Developments in the balance of trade factors according to GDP (year-on-year)



Source: HCSO

In line with the declining growth of domestic absorption, the contribution of net exports to GDP growth increased substantially in the second quarter (Chart 7). Q2 GDP growth is linked almost entirely to the increase in net exports, while annual growth in domestic absorption decline, and the negative growth impact of the decline in investments resulting from the decrease in EU funds was roughly offset by the rise in consumption due to increasing real wages. However, it should be also noted that in the past the growth contribution of net exports was similarly high as measured in the second quarter only when domestic absorption showed massively negative growth, which implies improving performance by the export sector in the longer run

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

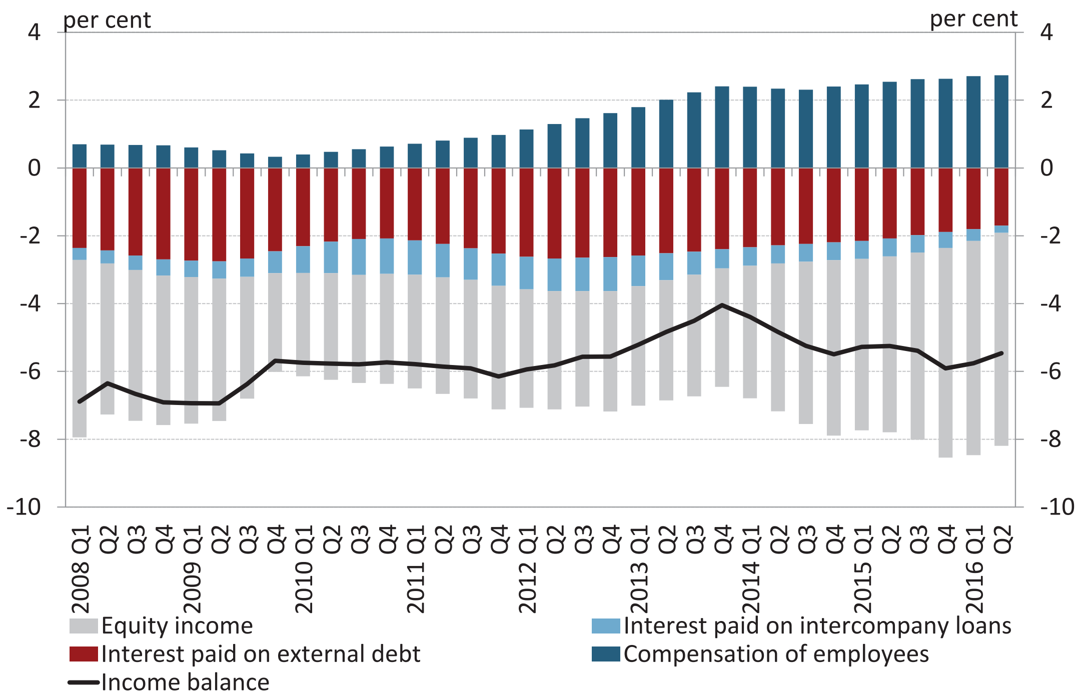


Source: HCSO

1.2. Income balance

The income balance deficit decreased in the second quarter, due primarily to the improved interest balance of foreign loans. After showing a moderate increase in 2015, the income balance deficit decreased to 5.5 per cent of GDP in the first half of 2016. The decline in the net outflow of income related to foreign liabilities and assets was mainly attributable to the decrease in the interest burdens of foreign and inter-company loans, resulting from repricing in the low interest environment and the reduction of the external debt. Despite the continuous decrease in net interest expenses, the overall income balance worsened slightly in 2015, as the profit of foreign-owned corporations also increased last year (for more details, see the special topic). On the other hand, at the end of 2015 a large corporation sold one of its branches, which generated substantial revenues, which (*ceteris paribus*) has a decreasing effect on the profit of foreign companies, and thus in 2016 the decreasing trend in net interest expenses may also be reflected in the developments in the income balance. According to the revised data, the income of employees working abroad for less than one year rose to 2.7 per cent of GDP, which improves the income balance to a greater degree than previously estimated.

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

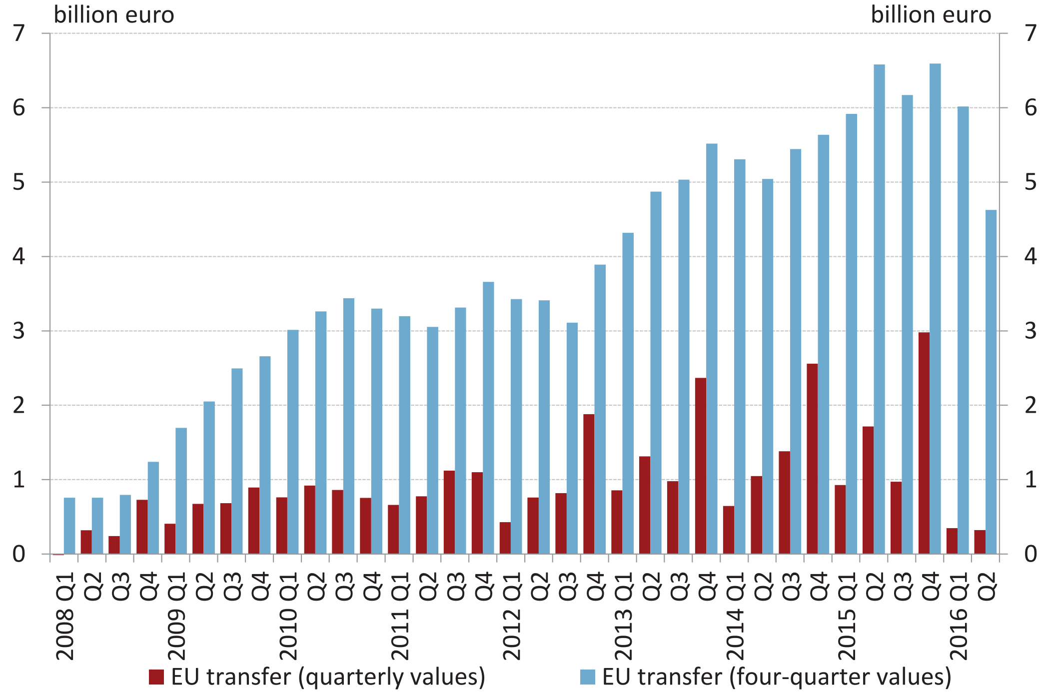


* Income balance: labour income, income on equity and income on debt.

1.3. Transfer balance

In 2016 Q2, the transfers absorbed in Hungary fell short of the high values observed in the previous period, and thus the four-quarter surplus of the transfer balance fell substantially (Chart 9). In the first two quarters of 2016, the volume of EU transfers used amounted to EUR 300-350 million, and thus on the whole – according to the four-quarter figures – the use of EU transfers was moderate, i.e. EUR 4.6 billion, which falls well short of the high value observed in previous years. This is related to the fact that the strong inflow of funds attributable to the end of the 2007-2013 EU programming period finished in early 2016, while the inflow of funds related to the 2014-2020 cycle is expected to rise more slowly, only commencing in the second half of the year.

Chart 9: Developments in the absorption of EU transfers

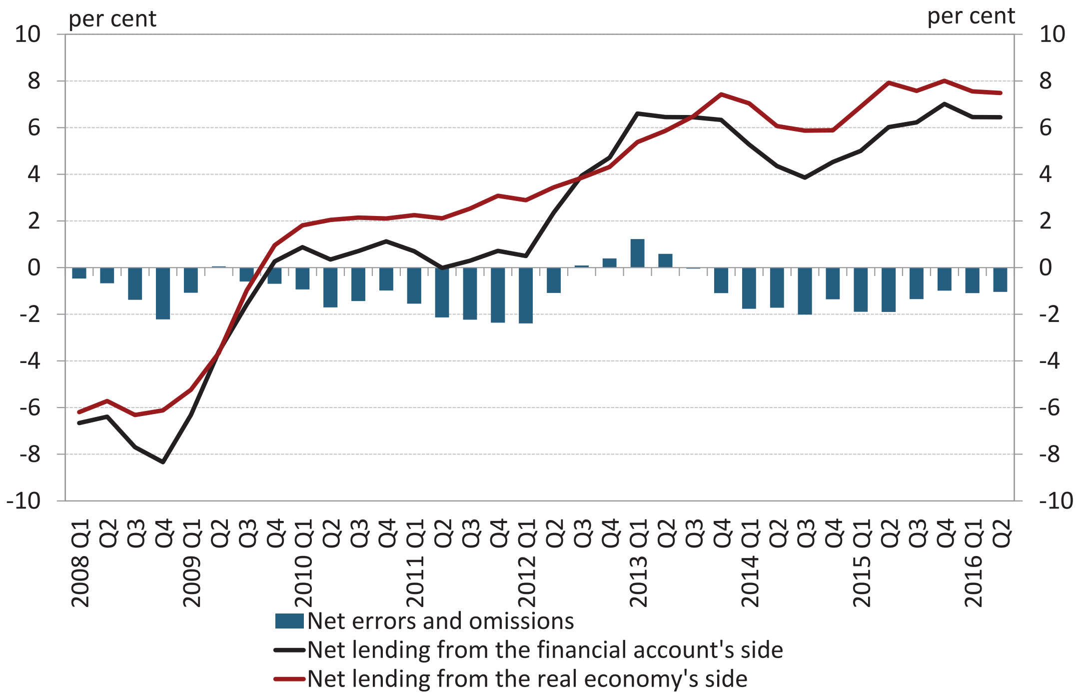


2. FINANCING APPROACH

Hungary's net lending has also not changed substantially according to the financial account. In addition to the fall in FDI, which is usual in the second quarter and primarily attributable to dividend payments, the decline in net external debt continued at a faster rate compared to the previous quarter. The structure of the decrease in debt was influenced to a great degree by the foreign currency liquidity provided to the banking system in connection with the conversion of FX loans into forints and settlement: banks' net external debt fell substantially, while that of the consolidated general government rose. At the same time, the banking system slightly increased its gross funds, which was also reflected in the rise of the external debt with originally short-term maturity. The increase in the net external debt of the consolidated general government may be linked to the decline in foreign exchange reserves, while the state's gross external debt continued to decrease.

The four-quarter net lending from the financing side stabilised at around 6.5 per cent of GDP in the second quarter, and thus the difference compared to the value from the real economy approach did not change significantly.[1] In line with the context characterising the Hungarian and the regional economies in the longer run, the decrease in external debt ratios fell short of the net lending according to the real economic transactions. As regards the previous years, an inverse relation was observed only at the end of 2012; since then the financial account data consistently show a lower outflow of funds than would be derived from the current and the capital account. This difference fluctuated around 1 per cent of GDP in the past years, which is low by international standards (for more details see the March 2016 Report on the Balance of Payments).

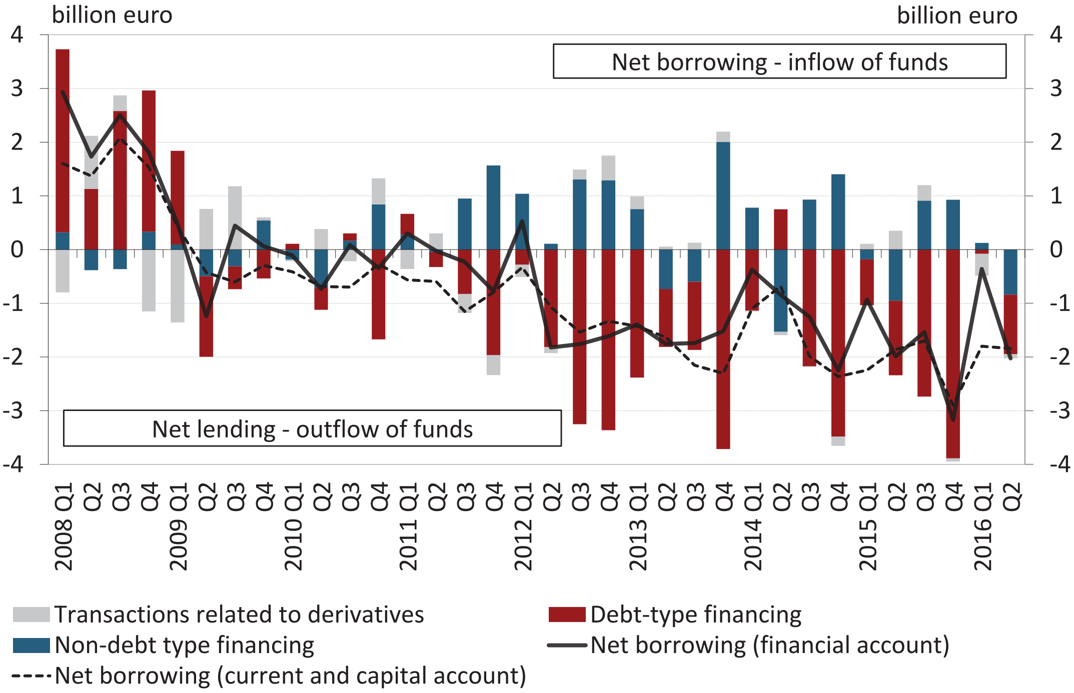
Chart 10: Two types of net lending and "Net errors and omissions"
(Four-quarter values as a per cent of GDP



Unadjusted net lending from the financing side increased substantially in the second quarter, which resulted in a decline in the net debt indicators amounting to EUR 2 billion. The outflow of funds in the second quarter increased significantly compared to the previous quarter, the larger part of which is attributable to the rise in the outflow of debt liabilities, while non-debt liabilities also decreased as a result of dividend payments (Chart 11), the decline in FDIs was almost fully attributable to the decreasing investments in Hungary as a result of this..

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 actors to finance transactions in the real economy that had an effect on net financial worth. While data derived from the real economy approach and the financing approach should be identical in theory, differences are likely to arise in practice due to non-integrated data sources, incomplete observation and the different treatment of the exchange rates, as indicated by the category "Net errors and omissions".

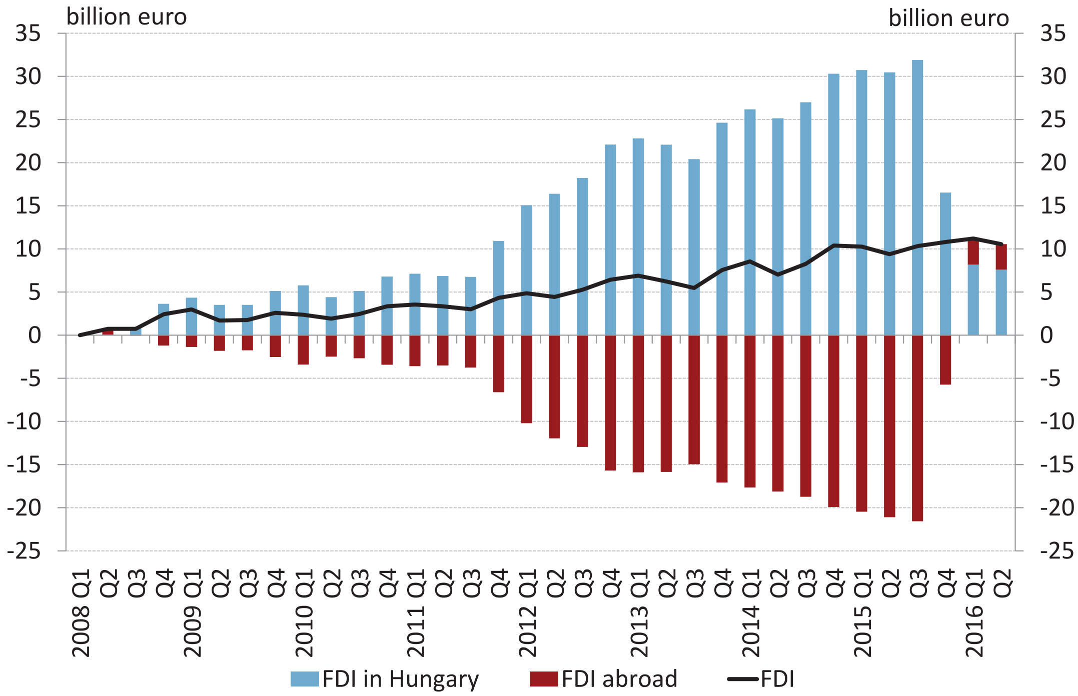
Chart 11: Developments in the structure of external financing (unadjusted transactions)



2.1. Non-debt liabilities

Contrary to the previous period, the Hungarian and foreign FDI stock was not influenced by capital in transit transactions in the second quarter. In 2015 Q4 and 2016 Q1, capital in transit transactions reduced the Hungarian and foreign FDI stock by a total amount of EUR 25 billion (Chart 12). Capital in transit transaction have no impact on the magnitude of net investments, as they have no real effect on the real economy, but they substantially distort the gross FDI data. In the second quarter, capital in transit transactions hardly changed the gross components; nevertheless, due to the substantial role of these transactions, it is practical to examine the net changes.

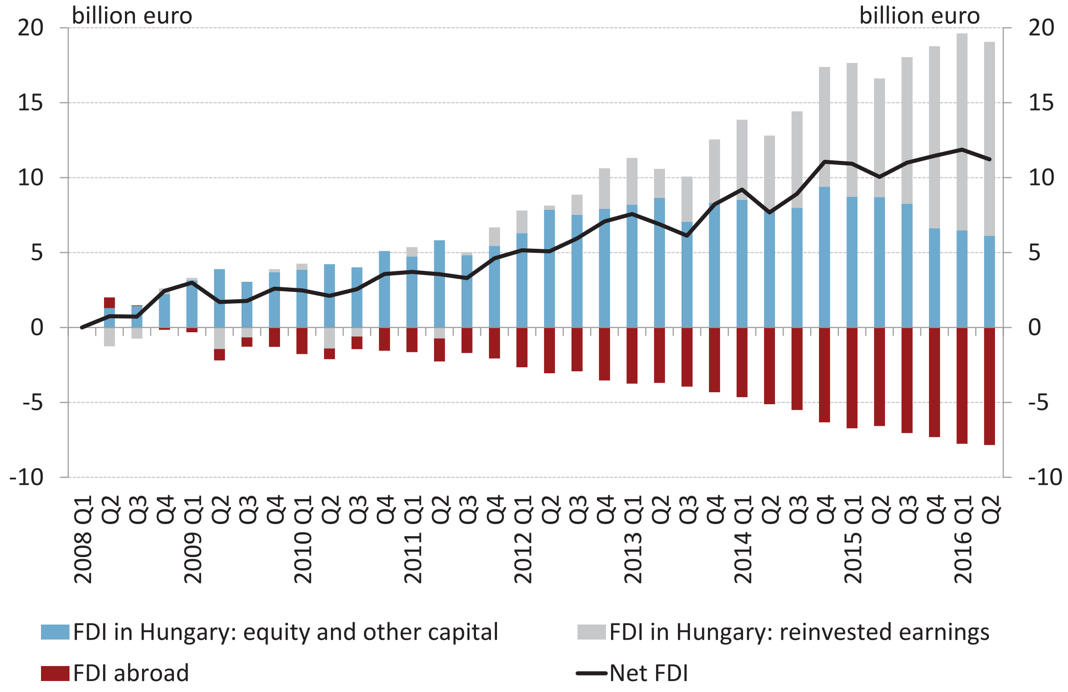
Chart 12: Developments in foreign direct investment (cumulative transactions[2])



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

According to the revised data, net direct investments increased in 2015 and also at the beginning of 2016, followed by a decline of roughly EUR 0.6 billion in the second quarter, as a result of the usual seasonal dividend payments. According to the corporate questionnaires received, the profit of foreign-owned companies was higher in 2015 than the preliminary estimate, and thus due to the higher reinvested earnings the 2015 figures once again showed a net FDI inflow (for more details see Box 1 and the special topic). The net outflow of funds in the second quarter essentially related to dividend payments. Part of this was reflected in reinvested earnings, the decline in which, however, was substantially reduced by the profit realised by the corporations. On the other hand, another part of the dividend payments can be regarded as superdividend – where the sum thereof exceeded last year's profit – which resulted in a fall in equity investments. Meanwhile, the investments of Hungarian-owned corporations operating abroad expanded slightly, and thus on the whole this also contributed to the decline of roughly EUR 0.6 billion in net direct capital funds in the second quarter.

Chart 13: Developments in FDI without capital in transit transactions (cumulative transactions)

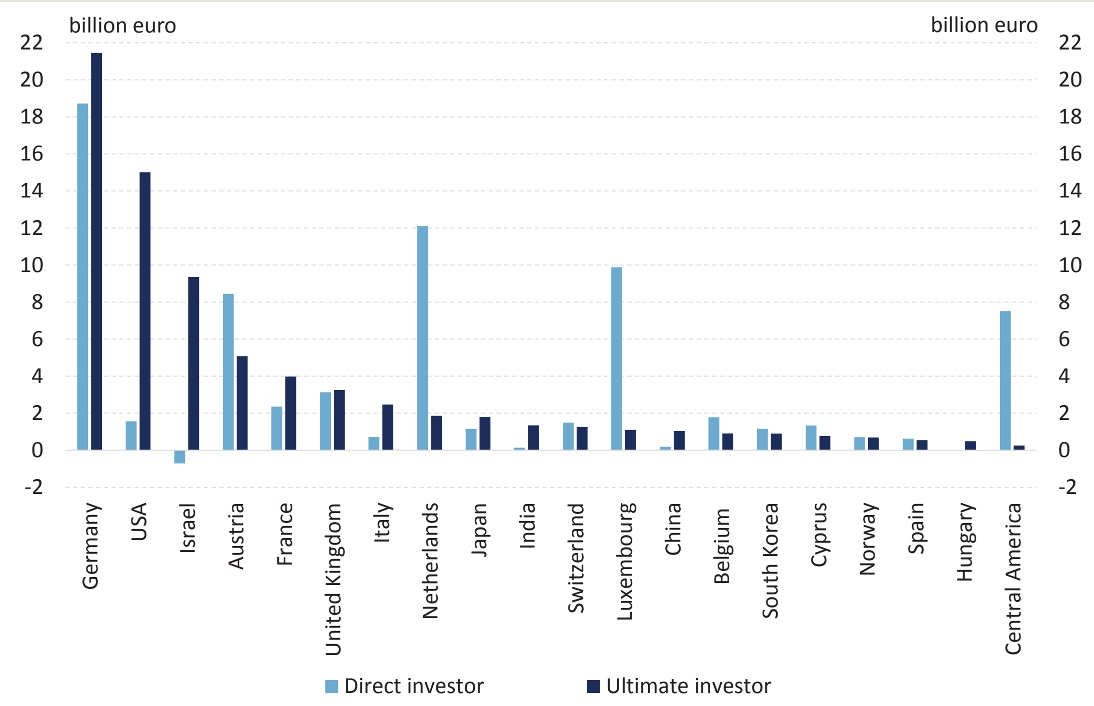


Box 2: Breakdown of FDI stock by ultimate investors

Since September 2016, FDI by non-residents in Hungary are published broken down not only by the country of the direct investor, but also that of the ultimate investor. Up to now, the FDI stock and flow data were presented primarily by indicating the countries of the direct investors. However, starting from the September data release, the direct investment position data as of end-2014 are presented – with a delay of 21 months – also by the countries of the ultimate investors.[3] These data show the country of residence of the investor exercising ultimate control over the FDI in Hungary.

The breakdown by ultimate investor facilitates the tracking of the original source of the FDI funds arriving in Hungary. The breakdown by ultimate investors helps to present a more precise picture of the original investors of the funds arriving in Hungary and also permits identification of the investment funds that in fact originate not from abroad.[4] The grouping by direct and ultimate investors shows major differences by countries, but in a few cases it almost corresponds to the aggregate FDI stock. The discrepancies in the breakdown by direct and ultimate investors may often be attributable to tax optimisation objectives. In Hungary, the statistics reflect this as capital in transit transactions, as a result of which in other countries the country of the direct and ultimate investor may differ. Capital in transit transactions had a major impact on FDI in Hungary, particularly at the end of 2015 and the beginning of 2016.

Chart 14: 2014 FDI stock by direct and ultimate investors



A substantial part of the direct capital stock, i.e. more than 40 per cent thereof, arrived in Hungary via transit countries. A substantial part of the Hungarian FDI funds do not arrive in Hungary directly, but rather through a third, typically European, country. The two most important such countries for Hungary within Europe are the Netherlands and Luxembourg, where the difference between the direct and ultimate investor funds is more than EUR 20 billion. The countries of Central America are also significant players. Naturally, in the case of multinational corporations in addition to tax optimisation reasons, other organisational or structural reasons may also contribute to the fact that more than 40 per cent of the direct investments differ from the country of the ultimate investor.

3 Ultimate investor is an investor of the corporate group with indirect or direct voting rights in excess of 50 per cent which is not controlled by other investors. The ultimate investor may be an individual, legal person or unincorporated organisation.

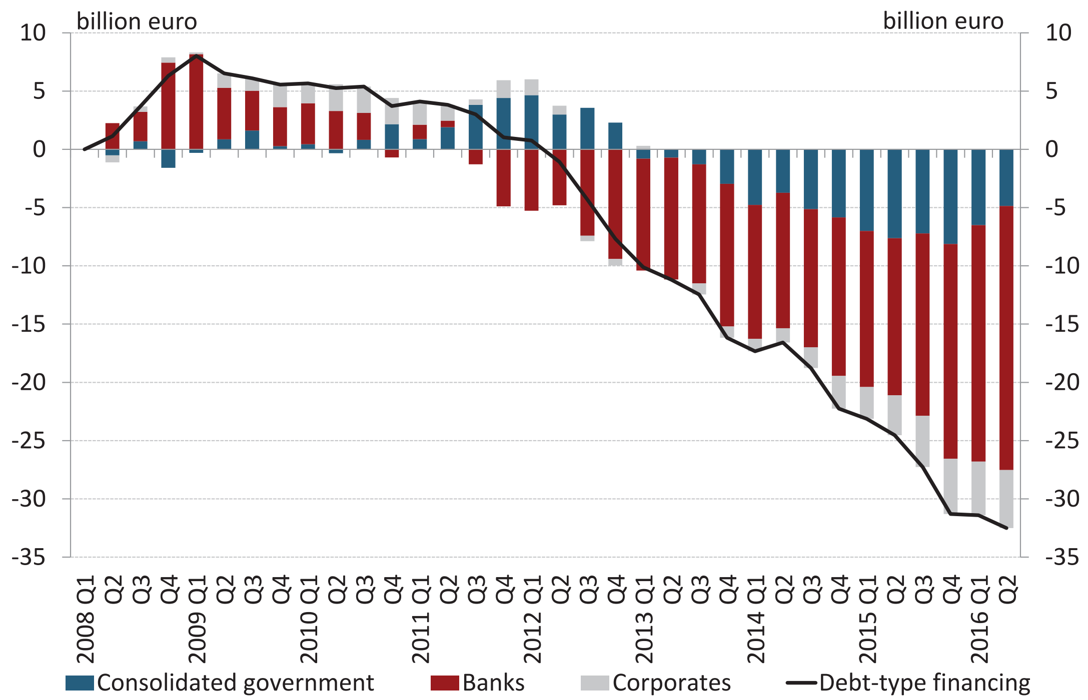
4 It may happen that a Hungarian economic actor – presumably hoping for more favourable treatment of what is deemed a foreign investment – is the ultimate investors of the FDI arriving in Hungary via a company registered in another country (the Hungarian FDI stock includes such FDI amounting to almost EUR 0.5 billion.)

The role of Germany is outstanding in both the direct and ultimate investor breakdown, while the United States and Israel – with lesser significance as direct investors – are the most important ultimate investors after Germany. Based on the foreign investment stock data from the end of 2014, the largest investor in Hungary – both as a direct and ultimate investor – is Germany, exceeding the value of EUR 20 billion. The difference may be attributable to the fact that certain German majority investors invest in Hungary via their firms registered in Austria or in the Netherlands. The foreign direct investment of certain countries was negligible according to the previously known data. Such countries included the United States and Israel. However, the decomposition by ultimate investor reveals that these countries channelled major investments into Hungary, totalling more than EUR 20 billion. Accordingly, the importance of certain countries – for the purpose of Hungary's economy – should be examined by the ultimate investor rather than by the direct investor breakdown.

2.2. Debt liabilities

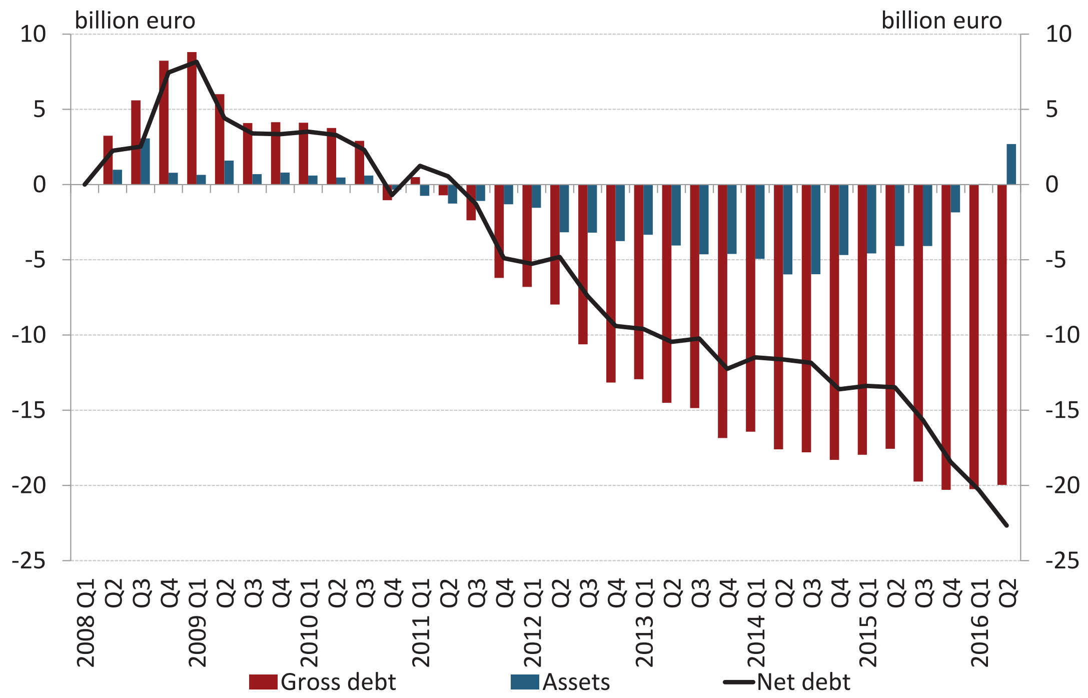
In the second quarter, the decline in external debt accelerated, while the structure of debt outflow was still strongly influenced by the foreign currency liquidity provided by the MNB to the banking sector, due to the conversion of foreign currency loans into forints. In the second quarter, economic agents substantially reduced their net external debt by roughly EUR 1.1 billion. Similarly to the first quarter, the foreign currency liquidity provided by the central bank to the banking system had a major influence on the sectoral distribution of the outflow of funds in the second quarter as well. The transactions related to the conversion into forints raised the net external debt of the consolidated general government through the decrease in foreign exchange reserves, and reduced that of the banking system. Overall, the net external debt of the state increased by EUR 1.7 billion, while that of the banking system decreased by EUR 2.4 billion (changes in the size of the columns illustrating cumulative data Chart 15 show the change in net external debt for each sector). Meanwhile, corporations' net external debt decreased by EUR 0.4 billion, primarily due to the increase in foreign receivables.

Chart 15: Developments in net debt-type financing by sector (cumulative transactions)



The decline of EUR 2.4 billion in the banking system's net external debt was attributable to the increase in external assets, while external liabilities also rose slightly (Chart 16). The increase in external assets is attributable, to a great degree, to the closing of the foreign exchanges swap transactions related to the conversion into forints and the settlement. Banks' external assets were further increased by the foreign currency liquidity that appeared due to the Premium Euro Hungarian Government Bond expiring in the quarter. In parallel with this, gross external liabilities increased by roughly EUR 0.2 billion. In contrast to the previous quarters, this occurred in conjunction with a rise in the originally short-term liabilities, while there was no substantial change in long-term liabilities.

Chart 16: Developments in the banking system's external debt and receivables (cumulative transactions)



The net external debt of the state consolidated with the MNB increased by EUR 1.7 billion, while the decrease in the state's gross external debt continued (Chart 17). Since the beginning of 2012 there has been a considerable fall in the net external debt of the consolidated general government. The is primarily the result of the sale of government securities by non-residents, which amounted to almost EUR 8 billion in total since the end of 2014. In parallel with this, the financing of the general government was typically dominated by domestic actors, also supported by the self-financing programme (for more details see the section on the sectors' savings). In the second quarter, the decline in the general government's gross external debt continued, while the foreign exchange reserves decreased with the closure of the foreign currency swap transactions primarily related to the conversion into forints. Consequently, the state's net external debt increased by EUR 1.7 billion in total.

In the second quarter, the general government's net external debt was increased by the following factors:

- during the quarter, a redemption of the Premium Euro Hungarian Government Bond was performed in the amount of EUR 1 billion (since these bonds were predominantly owned by resident actors, the decrease in the foreign exchange reserves was not offset by the decrease in Hungary's external debt);
- foreign currency liquidity provided to banks in the amount of EUR 0.8 billion for the conversion of foreign currency loans into forints;
- in addition, the interest paid by the state on foreign currency bonds and the state's other foreign currency payment obligations (e.g. foreign pension payments) also reduced foreign exchange reserves.

The following factors curbed the growth in the net external debt of the general government:

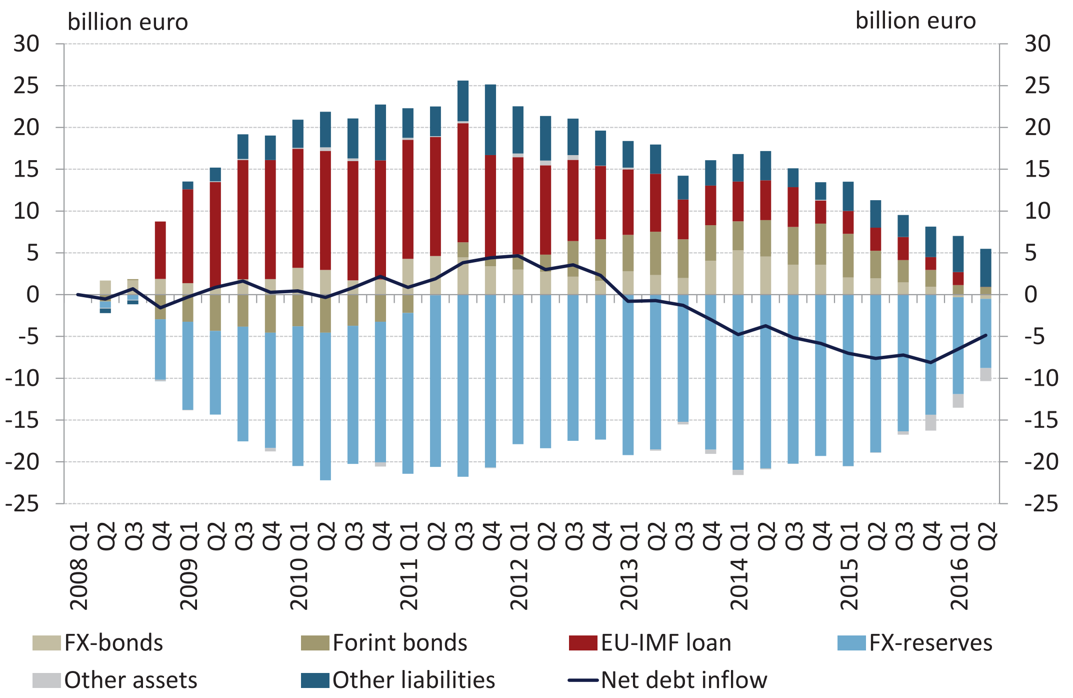
- compared to the previous quarter the absorption of EU transfers declined further – the EU transfer in the amount of EUR 0.3 billion reduced the net external debt by increasing foreign exchange reserves;

- non-residents continued to sell their HUF-denominated government securities during the quarter (EUR 0.2 billion);
- the net external debt of the general government was also reduced by the increase in foreign exchange reserves due to the fact that part of the currency swap transactions concluded in relation to the Funding for Growth Scheme expired during the quarter.

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

- the last instalment of the EU loan was paid in April, which reduced both the general government's gross external debt and the reserves (EUR 1.6 billion), further exacerbated by the maturity of a foreign currency government paper (EUR 0.2 billion);
- due to the appreciation of the US dollar, foreign deposits on the margin account placed with the state increased, which raised both the gross external debt of the state and the foreign exchange reserves.

Chart 17: Breakdown of net external debt of the general government consolidated with the MNB (cumulative transactions)



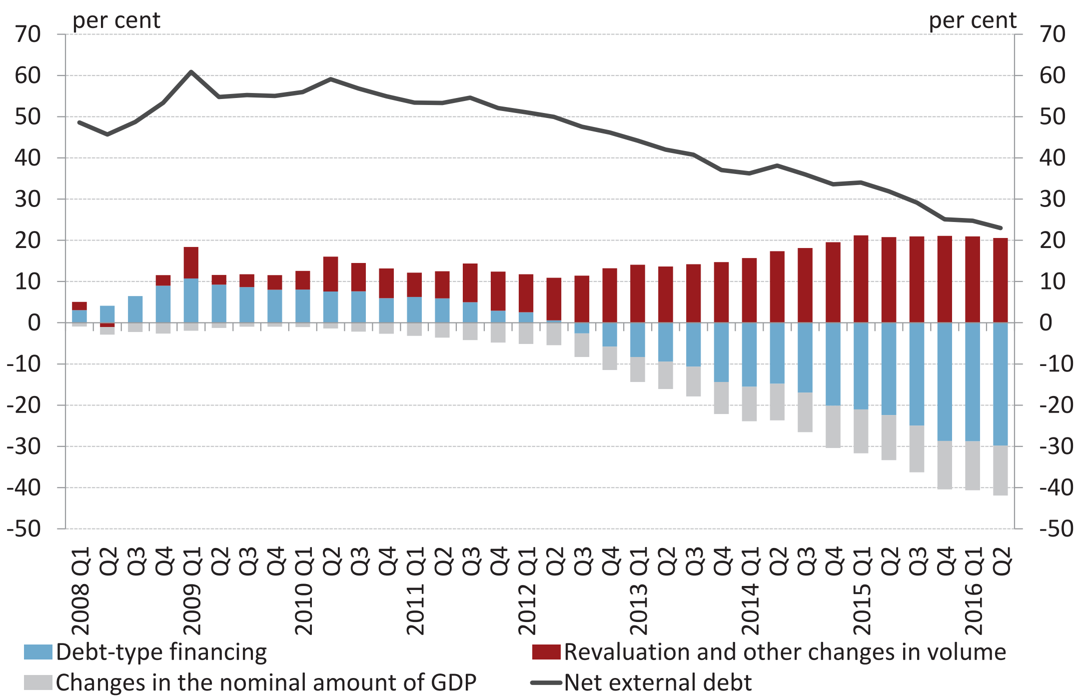
3. DEVELOPMENTS IN DEBT RATIOS

In the second quarter, Hungary's external debt ratios decreased further, as net external debt fell by almost 2 percentage points to 23 per cent of GDP and gross GDP-proportionate external debt dropped to 73 per cent of GDP. The largest contribution to the decrease in the net external debt was made by the outflow of debt-type liabilities, but the rise in nominal GDP and the revaluation of outstanding stocks also resulted in a decrease to a minor degree. In the second quarter, the fall in net external debt was primarily linked to the banking system, while the general government's net external debt increased slightly and that of the corporations decreased moderately. The net external debt of the banking system was reduced by the increase in the sector's foreign currency assets resulting from the expiry of the foreign currency swaps linked with the conversion into forints. This, however, also entailed a decrease in foreign exchange reserves, and thus on the whole it had no impact on the size of the economy's net external debt and only affected the distribution between sectors. Gross external debt also continued to decrease in the second quarter, with the decline in the general government's external debt playing a key role in this development, while the external debt of the private sector increased slightly. Short-term external debt fell below EUR 20 billion in the second quarter, due to the decrease in the general government's external debt. Despite the decrease in the second quarter, the level of foreign exchange reserves is still well above the level expected by investors.

3.1. Developments in net and gross external debt

In the second quarter, Hungary's net external debt continued to decline, which was primarily attributable – similarly to the previous periods – to the outflow of debt-generating liabilities (Chart 18)**.** In the period under review, the GDP-proportionate indicator decreased by almost 2 per cent, and thus net external debt amounts to 23 per cent of GDP. The outflow of debt-type liabilities was the main contributor to this reduction, but the increase in nominal GDP also resulted in a decrease in the debt ratio due to the denominator effect. The revaluation effect – in contrast to the previous quarters – also resulted in a decrease in the net external debt to a small degree, which presumably can be attributed to the falling government securities prices resulting from the slight increase in the government securities yields in the second quarter, as well as to the revaluation of foreign exchange reserves, owing to the appreciation of certain other currencies against the euro.[5]

Chart 18: Components of changes in net external debt* (cumulated, GDP-proportionate values, end-2007 = 0)

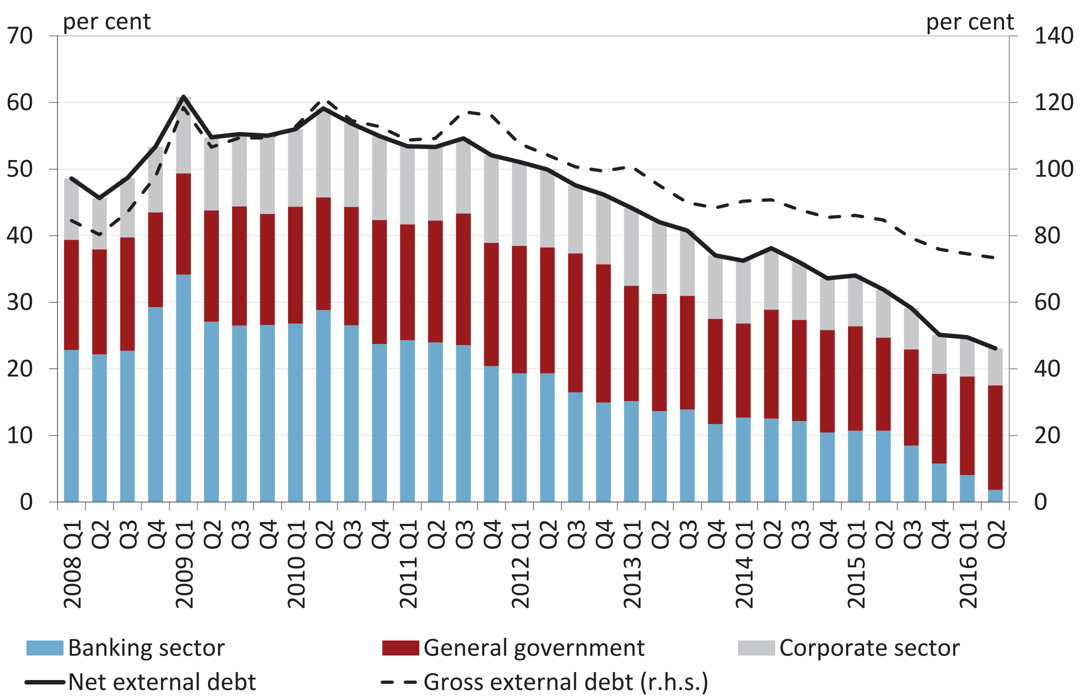


5 The depreciation of the forint exchange rate against the euro had no material impact on net external debt, as the EUR-denominated debt is roughly offset by the almost same level of EUR-denominated foreign exchange reserves.

As regards the sectors, the decrease in net external debt in the second quarter was primarily the result of the decline in the banking system's net external debt (Chart 19). The banking system's net external debt fell by 2.2 per cent of GDP, achieved in conjunction with a strong rise of 2.4 per cent of GDP in banks' external assets and a minor increase of around 0.2 per cent in the system's liabilities, resulting in the fall in banks' net external debt to below 2 per cent of GDP. In the period under review, foreign currency liquidity in the amount of almost EUR 1 billion appeared in the banking system from the swaps related to the conversion into forints, which resulted in an increase in external assets. The redemption of the Premium Euro Hungarian Government Bond in May may have also increased the banks' external assets, since the foreign currency liquidity originating from this appeared as a rise in banks' short-term deposits. The general government's net external debt rose in the second quarter as result of several contrasting impacts. The foreign exchange reserve-increasing effect of the swaps expiring as part of Pillar 3 of the Funding for Growth Scheme and the sales of government securities by non-residents reduced the general government's net external debt, while redemption of the Premium Euro Hungarian Government Bond – primarily held by domestic actors – and the foreign currency liquidity provided to the banking system in connection with the conversion into forints raised it via the decrease in foreign exchange reserves. The debt ratio applicable to the corporate sector decreased by 0.4 per cent of GDP in the second quarter.

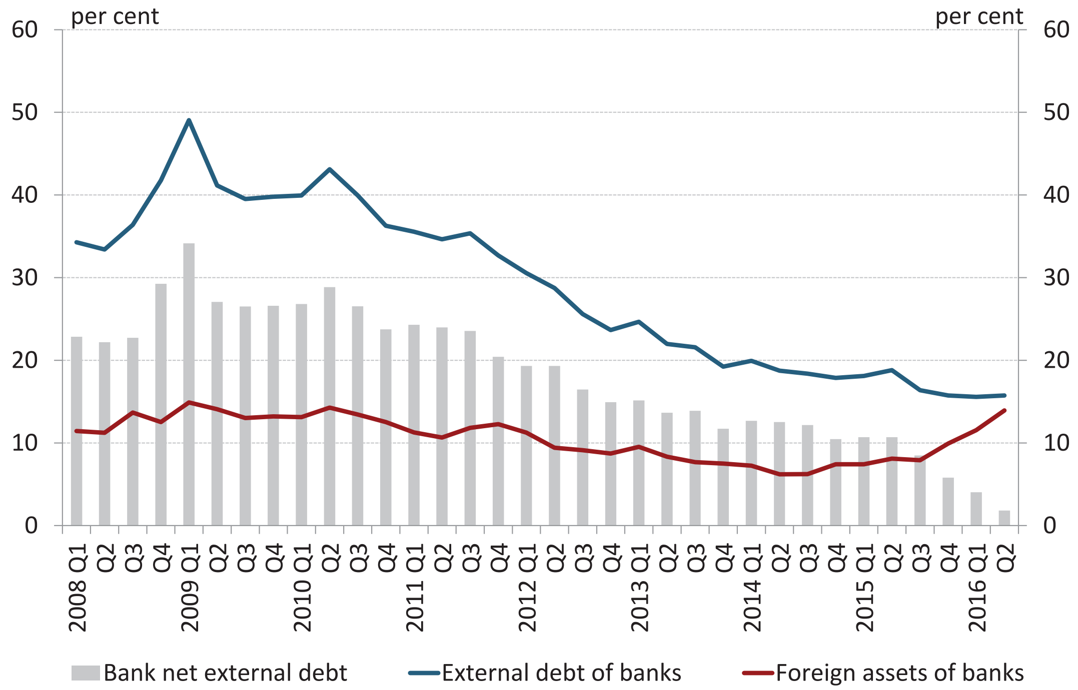
By the end of the second quarter, gross external debt had dropped to 73 per cent of GDP (Chart 19). The decrease in the ratio continued at almost the same rate as the decrease in net external debt, which is attributable to the continued outflow of the general government's debt-type liabilities. The contraction of the general government's gross external debt was achieved in conjunction with a decrease in non-residents' government securities holdings. In addition, the redemption of a foreign currency bond in the amount of almost EUR 0.2 billion and the repayment of the last instalment of the EU loan in the amount of EUR 1.6 billion also resulted in a decrease in gross external debt, which – due to the parallel contraction of the foreign exchange reserves – had no impact on the level of net external debt. On the other hand, the rise in the margin balance of the consolidated general government slightly restrained the decrease in the debt ratio. The private sector's gross external debt rose to a small degree in the second quarter, which offset the decrease in the state's gross external debt to a small degree.

Chart 19: Net external debt in a sectoral breakdown and gross external debt (as a percentage of GDP, excluding intercompany loans)



The net external debt of the banking system has been decreasing since 2009, and in recent years this trend is attributable – in addition to the fall in external liabilities – to the faster increase in external assets (Chart 20). The expiry of the foreign exchange swap, related to the conversion of the households' foreign currency loans into forints, plays an important role in the large increase in banks' foreign currency assets, which has been observed since mid-2015. The conversion of the foreign currency loans into forints entailed a rise in the banks' exchange rate exposure, the hedging of which through the foreign exchange market would have exerted substantial pressure on the forint exchange rate. With a view to preventing this, the MNB provided the banking system with the foreign currency liquidity necessary for closing the foreign exchange position, partially through foreign exchange swaps. As a result of this, the banks were able obtain the necessary foreign currency at the swap maturity dates close to the maturity of their foreign currency liabilities, and thus the banking system's substantial foreign currency need generated no tensions in the money market. The maturity of the MNB's swaps concluded with the banking sector commenced in the second half of 2015, and a large part of it expired in 2016 Q1 and Q2, which entailed a rise in the banks' foreign currency liquidity and a parallel decrease in the MNB's foreign exchange reserves. The foreign currency thus appearing at the banks increased their external assets, which – together with the decrease in external liabilities, which has lasted for several years – contributed to the further decline in banks' net external debt.

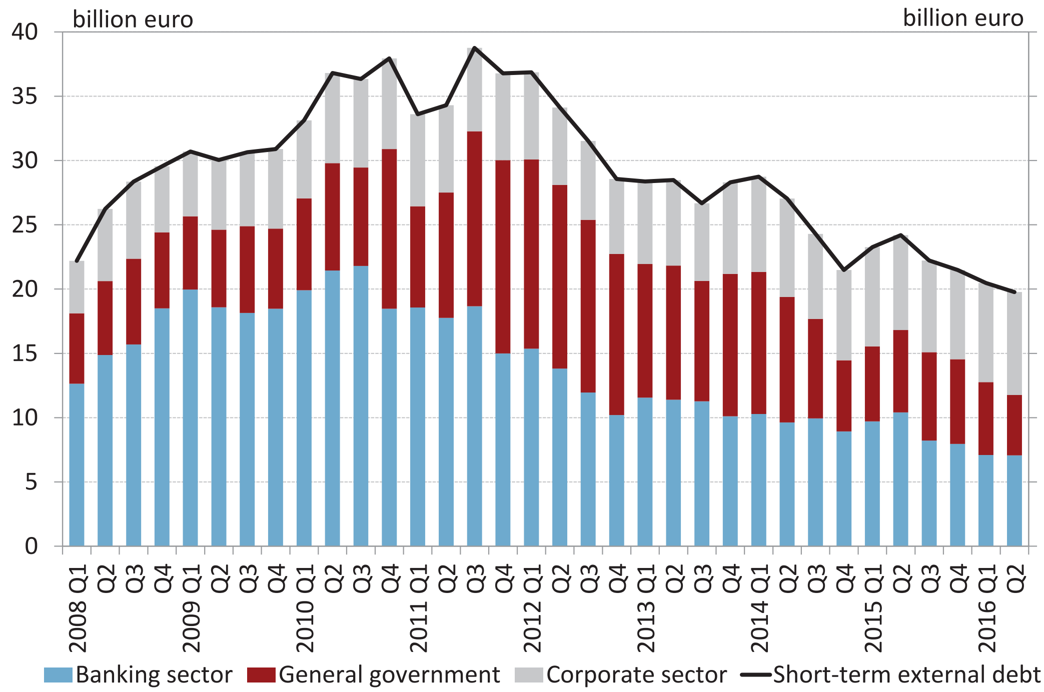
Chart 20: Developments in the banking system's external assets and liabilities (as a percentage of GDP)



3.2. Developments in short-term external debt

In the second quarter, as a result of the repayment of the EU loan by the state, Hungary's short-term external debt fell below EUR 20 billion (Chart 21). The decline in short-term external debt is linked to the decrease of over EUR 1 billion in amortising debt, which was only partially offset by the rising originally short-term external debt. The reduction in short-term external debt was mainly the result of the repayment of the last instalment of the general government's amortising debt to the European Union. The decrease in the general government's short-term external debt is fully attributable to the decrease in the outstanding debt becoming short-term debt, while the debt based on original maturity increased slightly, which is due to the rise in the margin accounts. Corporations' short-term external debt rose by EUR 0.3 billion in the second quarter, which was mostly attributable to the rise in amortising debt. The short-term debt of the banking system did not change materially and the rise in the originally short-term external debt was offset by the decrease in the amortising debt.

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



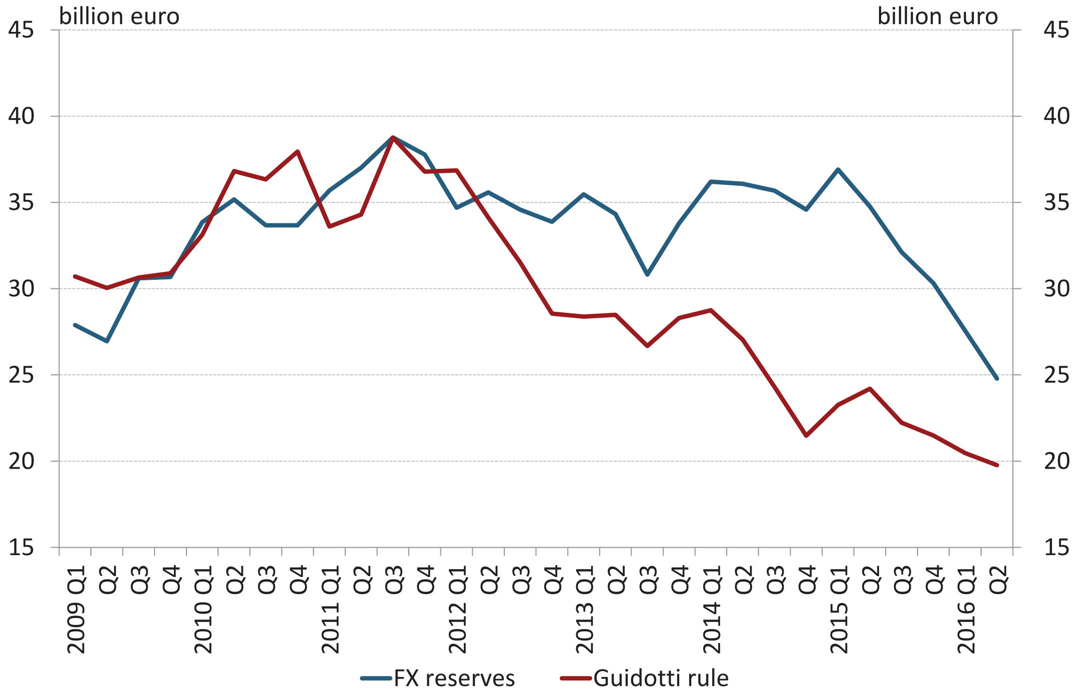
3.3. Developments in foreign exchange reserves and reserve adequacy

Foreign reserves decreased in 2016 Q2, primarily due to the repayment of the Government Debt Management Agency's foreign currency debts and the maturity of swap instruments in connection with the conversion of households' foreign currency loans. At the end of June, foreign reserves amounted to EUR 24.8 billion, which represents a decrease of EUR 2.8 billion in quarter-on-quarter terms; of this EUR 2.4 billion related to the transactions of the Government Debt Management Agency. Key factors influencing the reserve level:

- Among the foreign currency transactions of the Government Debt Management Agency, the repayment of the last instalment of the foreign currency loan taken from the European Commission was a major factor (EUR 1.6 billion).
- In April, the maturity of a CHF-denominated foreign currency bond (about EUR 0.2 billion) appeared as an additional reserve-reducing item, while in May the maturity of the Premium Euro Hungarian Government Bond, in the amount of almost EUR 1 billion, reduced the reserve level.
- The issue of Hungary's first renminbi-denominated bond, in the amount of almost EUR 140 million, in April had an opposite effect.
- In June, the maturity of the swap instruments related to the conversion of the households' foreign currency loans reduced the foreign exchange reserves by further EUR 0.8 billion.
- The MNB's programmes were accompanied by other reducing items, such as the foreign currency transactions of the Hungarian State Treasury (HST) and the Government Debt Management Agency's other foreign currency expenditures.
- This was only partially by the reserve-increasing effect of the inflow of EU funds, the change in the stock of the mark-to-market deposit of the Government Debt Management Agency linked to its hedging swap transactions, the maturity and closing of part of the foreign currency FGS, and the revaluation resulting from the appreciation of certain other currencies against the euro in a total amount of more than EUR 1 billion.

In addition to the decrease in foreign exchange reserves, short-term external debt also declined, and the volume of foreign exchange reserves still considerably exceeds the level expected by investors. Although the decrease in foreign exchange reserves compared to the end of March exceeded the decline in the short-term external liabilities of roughly EUR 0.7 billion, the level of foreign exchange reserves of EUR 24.8 billion significantly exceeds the outstanding short-term external debt of EUR 19.8 billion. The change in foreign exchange reserves of more than EUR 3 billion, related to the MNB programmes, could be forecast based on the foreign currency swap maturities and the Government Debt Management Agency debt policy supporting a negative net foreign currency issue, and consequently in the context of reserve adequacy this may be regarded as the result of a planned process. In parallel with this, due to the repayment of the EU loan by the state, the short-term external debt of the general government also contracted, while the corporations slightly raised their short-term liabilities. Thus, the room for manoeuvre over the Guidotti indicator is roughly EUR 5 billion, which is still a safe level.

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



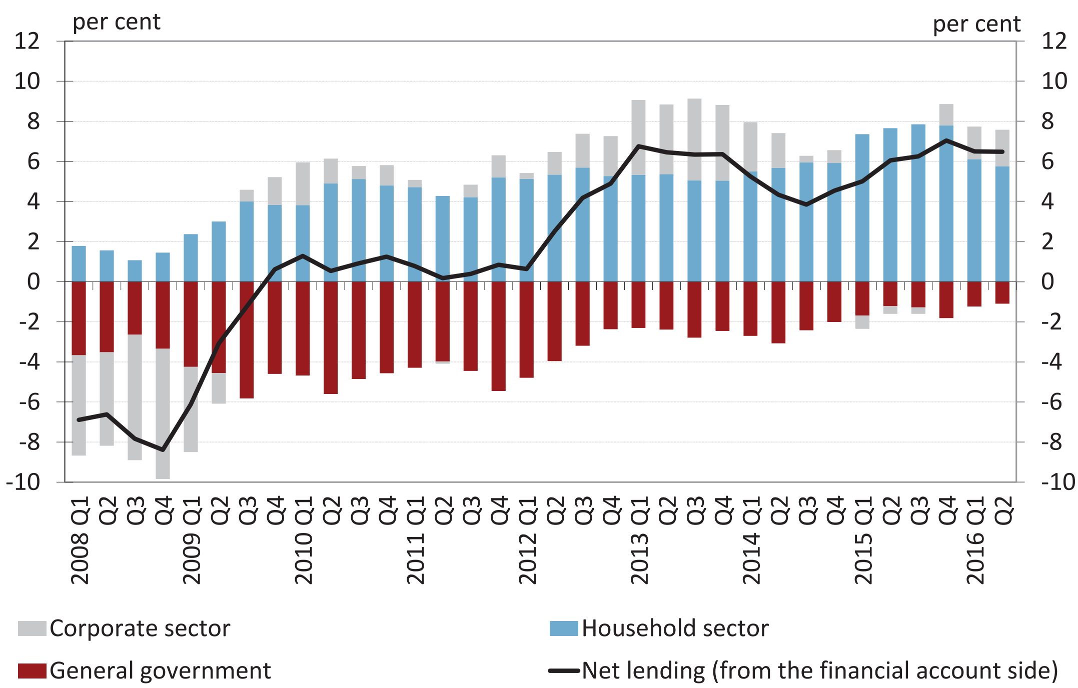
* Guidotti indicator: short-term external debt based on residual maturity.

4. SECTORS' SAVINGS APPROACH

In 2016 Q2, the economy's net lending based on the sectors' savings stabilised at around 6.5 per cent of GDP. The continued fall in the general government's net borrowing was offset by the minor decline in the net savings of the private sector. The drop in households' four-quarter net savings is attributable to the absence of the one-off effect arising from the settlement of foreign currency loans which boosted savings, while in the case of corporations the income growth was reduced by the more moderate absorption of EU transfers than earlier, which entailed a decrease in net lending. Households still typically channel their new savings into government securities, which – similarly to the previous quarters – may have substantially supported the fall in the government's external liabilities.

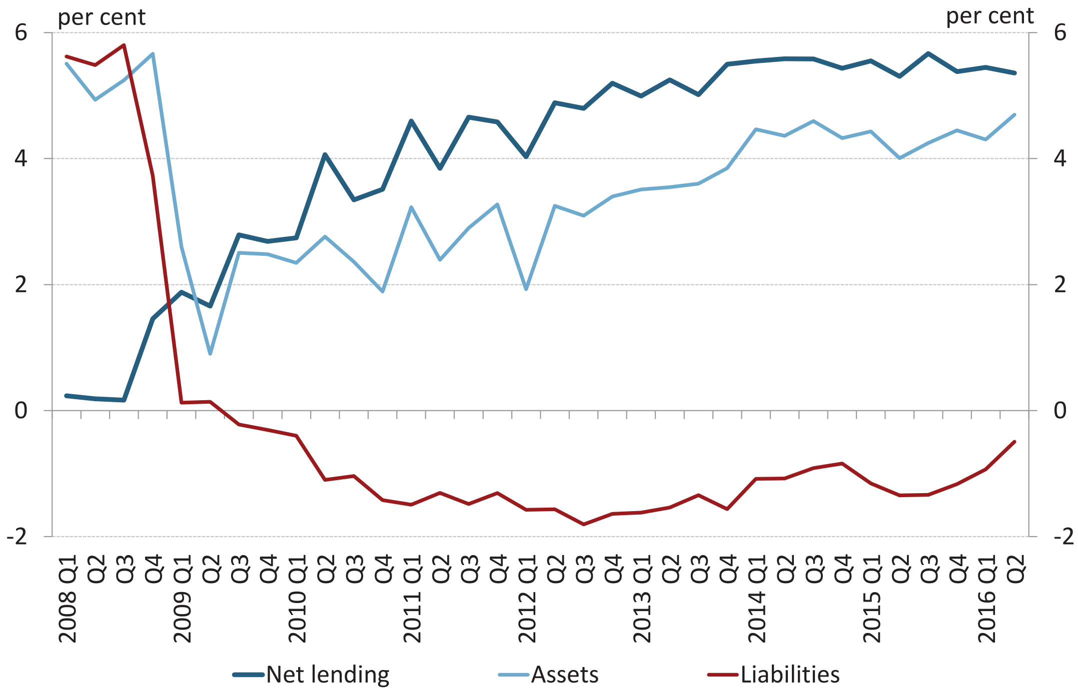
In the second quarter, the economy's four-quarter net lending stabilised at around 6.5 per cent of GDP, which was achieved with decreasing private sector net lending and a decline in the general government's borrowing requirement to a historic low (Chart 23). The low general government deficit on the revenue side is mainly attributable to rising tax revenues resulting from expanding employment and higher wages, as well as increasing consumption. In addition, the measures aimed at combating the shadow economy and the tax credit for growth also had a significant revenue-increasing effect. On the expenditure side, the persistently decreasing interest expenses and the lower co-financing of EU transfers also resulted in more favourable net borrowing. The household sector's declining net lending is mainly due to the absence of the one-off effect related to the settlement of foreign currency loans, which boosted savings.

Chart 23: Net lending by sectors (four-quarter values relative to GDP)



The underlying trends show that households' seasonally adjusted net savings stabilised at over 5 per cent of GDP, which was influenced both by rising net new borrowing and the accumulation of assets. As a result of the rising incomes, households' savings attitude is about to change. Although the household sector is still a net repayer, new borrowing is starting to slowly rise as a result of mounting consumption. In parallel with this, the increasing wages and employment resulting from the tightening labour market gave rise to an increase in financial instruments. The drawdown of housing loans, which showed a moderately upward trend in recent months, may have also resulted in an increase in financial instruments, as the consideration for used homes purchased from loans typically appeared at the seller households in the form of financial instruments.

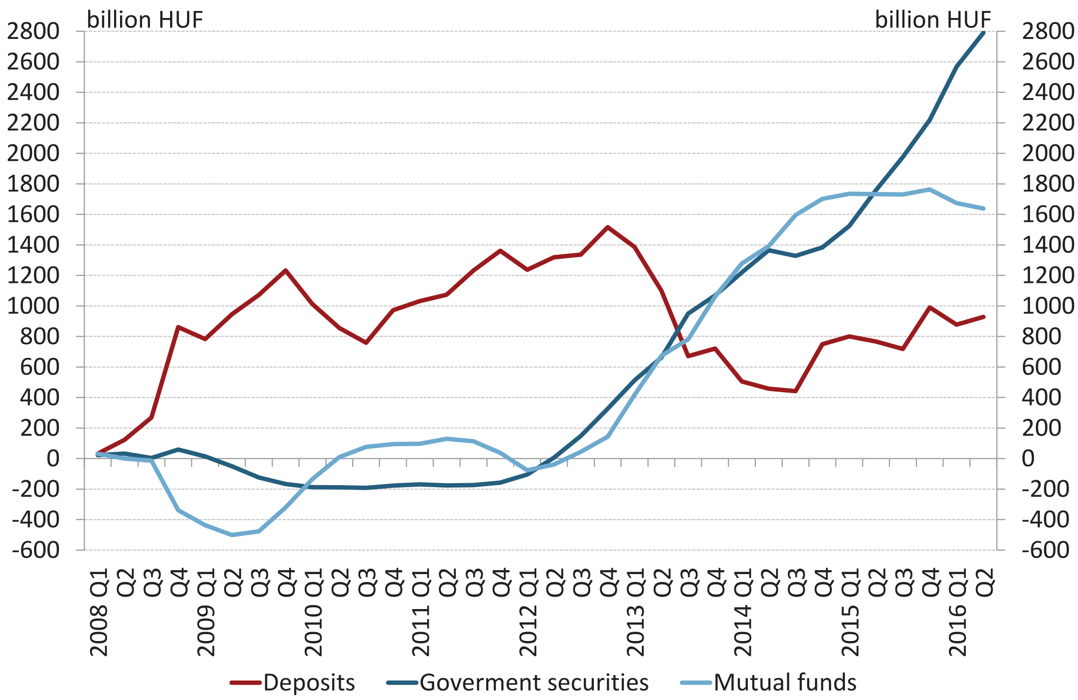
Chart 24: Underlying trends in household net lending (seasonally adjusted data relative to GDP)



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

In recent years, the rise in the households' government securities holding provided substantial financing for the general government deficit, contributing to a continuous decrease in the state's external debt. In the second quarter, the households' government securities saving continued to increase at a fast rate. In past years, due to the persistently declining bank yields, households continued to withdraw their bank deposits, while savings in securities offering a yield premium were on the rise. However, recently the growth in investment units halted, which was attributable to the less and less attractive historic yields, which are monitored by households. The relatively low yields on the capital markets and with bond funds can be explained by the steadily low interest environment. Although real estate funds continued to rise in the second quarter as well, on the whole investment fund holdings declined further in the second quarter. In the second quarter, the Government Debt Management Agency made another cut to the yields of household instruments, but the still significant yield differential diverted households toward savings in government securities. Accordingly, the government securities holdings of households increased significantly in the second quarter and already exceeded HUF 3,700 billion at the end of the quarter. At the same time, there was no significant change in households' deposit portfolio.

Chart 25: Cumulative transactions of household instruments



In the second quarter, the fall in corporations' GDP-proportionate bank loans continued, while deposits remained constant. Corporations' GDP-proportionate outstanding borrowing from banks declined further in the second quarter, which affected primarily foreign currency loans. In line with the absence of the revenue-increasing effect of decreasing EU transfers, there was no major change in corporations' deposits. Accordingly, on the whole the corporations reduced their indebtedness towards both the non-resident and the resident (bank) actors.

5. DEVELOPMENTS IN THE INCOME OF FOREIGN CORPORATIONS

The special topic in this report is the developments in the 2015 income of foreign-owned corporations operating in Hungary. Based on the corporate questionnaire-based data, in 2015 the profit of foreign-owned companies in the balance of payments was close to 7 per cent of GDP, which signals a profit that is even higher than in the pre-crisis years. Using this increasing income, corporations raised both their dividend payments and their reinvested earnings. Income growth characterised a wide range of industries and was particularly strong in some sectors. More than half of the profit increase observed in recent years could be linked to just three sectors, which was further reinforced by the fact that in 2015 the rise in profits was attributable to a great degree to the extremely high income of one multinational corporation. In addition, the income balance deficit was further increased by the fall in the 2015 profit of domestic-owned corporations operating abroad. With regard to the profit of foreign-owned corporations, it is important to note that the balance of payments statistics does not show the corporations' profit after tax, but the profits from the ordinary course of business excluding one-off factors and revaluation (COPC correction). In 2015, the unadjusted after-tax profit of corporations exceeded that observed in the balance of payments by more than 6 per cent of GDP, which may be attributed to the sale of a business line of a multinational corporation. Our international comparison shows that, while earlier the rate of return achieved by foreign corporations operating in Hungary lagged behind that of the countries of the region, with the income growth realised in 2015 it already reached the regional level, whereas the ratio of reinvested earnings continued to exceed the rate observed in the rest of the Visegrád countries.

5.1. Introduction

In our special topic, we present the 2015 profitability of foreign-owned corporations operating in Hungary and domestic-owned corporations operating abroad, based on the data on corporate incomes. Until the receipt of the questionnaire data in September following the reporting year, the data in the balance of payments related to the corporate revenues of foreign-owned corporations are based on estimates, which will be replaced by the actual data calculated on the basis of the corporate questionnaires received in September.[6] Accordingly, upon the receipt of the questionnaires in September it is timely to review the profitability of foreign-owned corporations. In the present questionnaire, the actual data – which is relevant in terms of the net profit included in the income balance –exceeded the preliminary estimate, which in part is attributable to one-off effects and in part reflects the lower profitability of Hungarian-owned foreign companies. It should be pointed out that the balance of payments statistics contains the profit/loss of the companies related to their normal course of business and eliminates one-off profit/loss items from the profit after tax. While in the post-crisis years, these items typically reduced the profit of corporations – i.e. due to one-off items corporations' profit after tax was lower than that realised in the ordinary course of business – this phenomenon turned around in 2015. Last year, corporations' profit after tax substantially exceeded the profit realised in the ordinary course of business – i.e. they realised significant profits outside the ordinary course of business. As regards the structure of this section, we first review the income position of foreign-owned corporations and banks and then examine the factors underlying the 2015 income growth. Thereafter, we compare the corporations' profit realised in the ordinary course of business with their profit after tax. Finally, we analyse the profit trends of the foreign-owned corporations operating in Hungary in a regional and then in a European Union comparison.

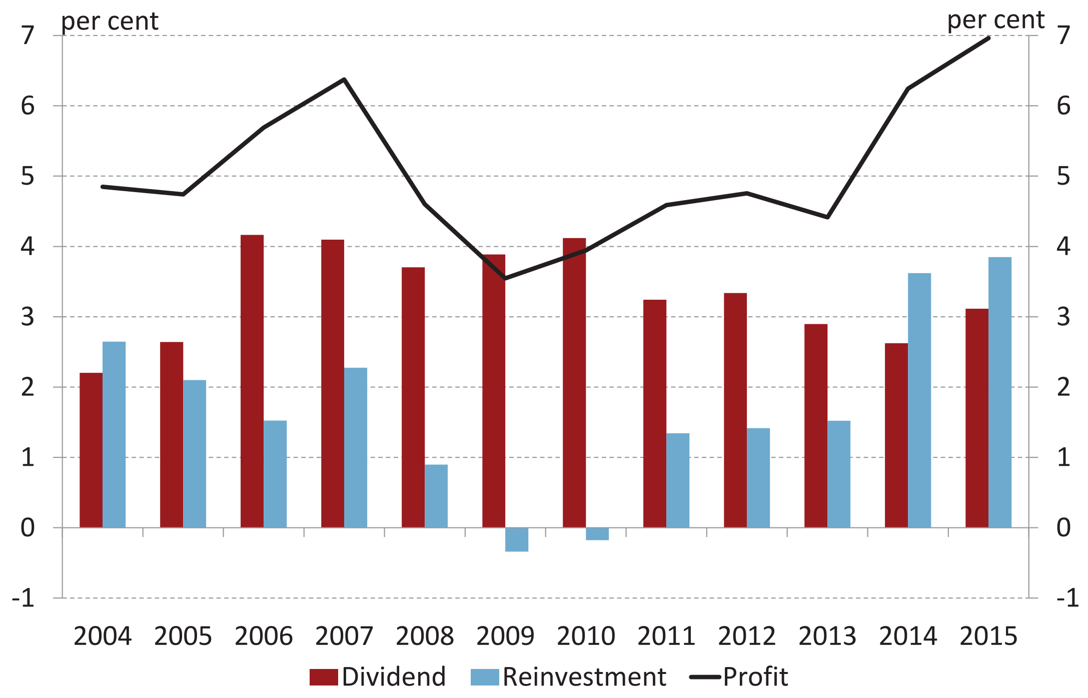
5.2. Income of foreign-owned corporations in the balance of payments

In 2015, the profit of foreign-owned corporations rose to almost 7 per cent of GDP, which exceeds the level observed in the pre-crisis years; however, while in the past the major part of this was transferred to the home country in the form of dividends, in recent years the larger part of the income was reinvested in Hungary. In the first years of the crisis, the profit of foreign companies fell from 6 per cent to below 4 per cent of GDP, which took place under almost unchanged dividend payment and a major decline in reinvested earnings. The substantial decrease in reinvestments may have been linked with the consequences of the crisis: on the one hand, corporate investments fell drastically, due to the deterioration in growth prospects, and on the other hand, in addition to the post-crisis increasing distrust and falling willingness to lend, the funding requirements of the parent companies were also high. In 2014 and 2015, corporate investments increased, which – in addition to the expanding absorption of EU funds – may have been attrib-

6 Hungary's Balance of Payments and International Investment Position Statistics, MNB (2014).

utable to rising reinvestments by foreign-owned corporations. In the last two years, the fall in oil prices also contributed to the rise in the profitability of foreign-owned corporations. The increase in profits continued in 2015 as well, albeit at a slower rate compared to the previous year. Thus, in 2015, the profit of foreign-owned corporations rose to almost 7 per cent of GDP, a major part of which was still reinvested. A substantial part of foreign corporations' profit (over 90 per cent) can be linked to non-financial corporations. The profit of these continued to rise in 2015, while the profit of foreign banks decreased slightly, and thus the increase in profits reflects the improving profitability of non-financial corporations.

Chart 26: Utilisation of income generated in Hungary by foreign-owned companies and banks[7]
(as a percentage of GDP)

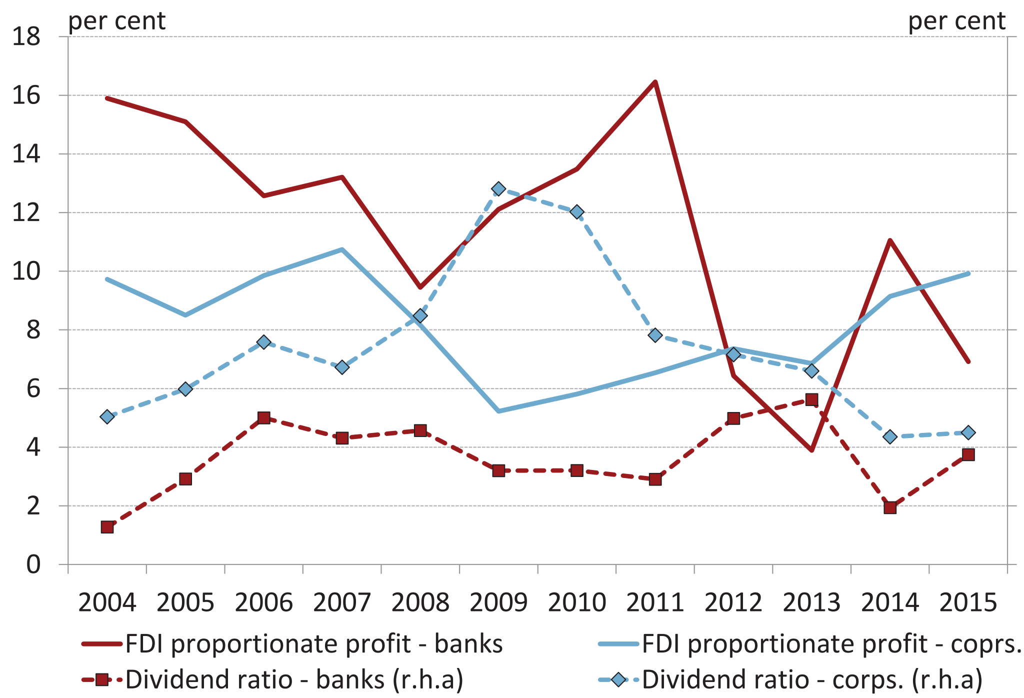


5.3. Comparison of the profitability of banks and non-financial corporations

In contrast to the pre-crisis years, in 2015 corporations' profitability rate once again exceeded that of banks, which was also attributable to the fall in banks' profit from ordinary items. The dividend ratio of corporations and banks continues to be low. As regards the pre-crisis return on capital invested, the banks' profit exceeded that realised by non-financial corporations. This correlation prevailed in the first years of the crisis as well, but it changed with the decline in banks' profit observed in 2012-2013. Although in 2014 the profit of banks once again exceeded that of corporations, it decreased in 2015, while the profit of corporations continued its rise. As a result of this, foreign-owned non-financial corporations realised a higher return on capital invested than banks (Chart 27). The introduction of the rules of the "fair banking" in 2015 reduced banks' profit. The dividend ratio is still low, with an unchanged dividend ratio at non-financial corporations and an increasing dividend ratio at banks. The continued substantial reinvestment by non-financial corporations may suggest that Hungary's longer-term growth prospects have improved compared to the post-crisis years, and thus it may be worth reinvesting the realised profit in Hungary. The increase in banks' dividend ratio may be attributable to the fact that after the 2014 losses – primarily linked to the settlement – the banks were profitable in 2015, which resulted in lower supplementary capital requirement and thereby necessitated the reinvestment of earnings to a lesser degree.

7 It is worth noting that from an analytical standpoint there is a trend change in the time series: since 2008 the profit (and thus the reinvested earnings as a residual) only contains the income according to current operating performance concept (COPC). However it can be presumed that the income not related to the COPC increased after the crisis, and thus is comparable to the previous periods. Furthermore, since 2013 super-dividends are filtered out from profits, which is not accounted as a dividend payment but as a decline in equity and thus it has an effect on the partition of the corporates' profit between the dividend payment and the reinvestment.

Chart 27: Profits of foreign-owned corporations and banks in Hungary



The 2015 profit rate of the corporate sector is a value calculated from the annual average balance

5.4. What are the underlying factors of the rising profit?

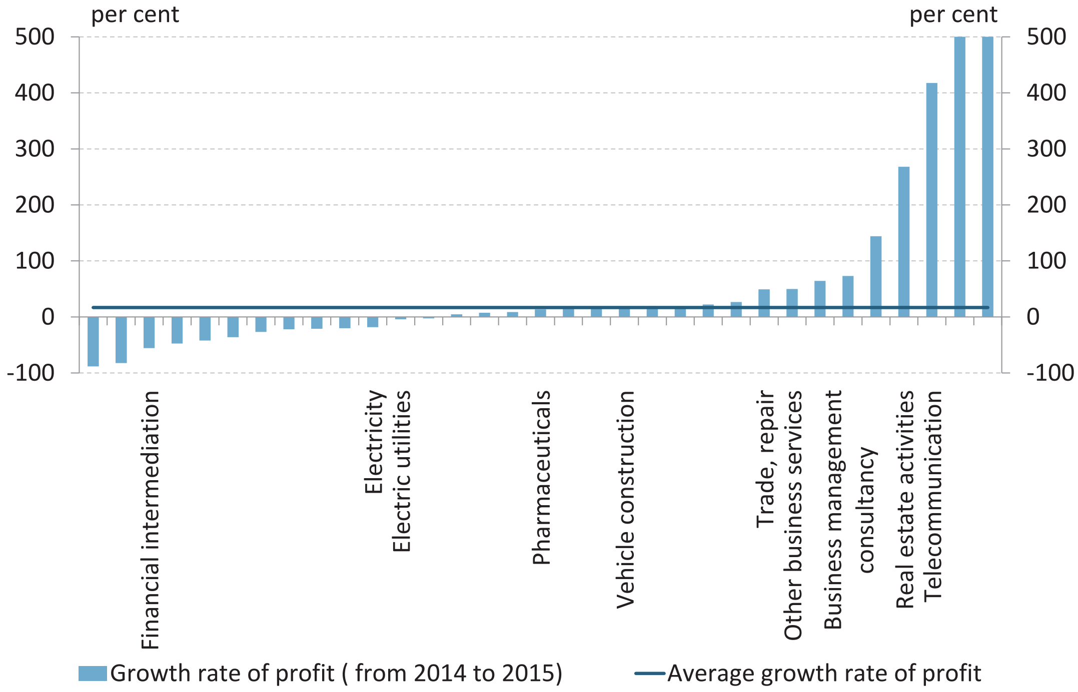
The rise in the foreign corporations' profit – in contrast to the previous years – was not line with the dynamics of growth in exports in 2015, which was also attributable to one-off corporate effects. A large part of foreign-owned companies are active in external trade and produce for the export markets. Hence, it is justified to draw conclusions from the export performance with regard to profitability trends. In 2014, the rise in the profit of corporations substantially surpassed the growth in exports due to one-off effects and to the composition effect.[8] A foreign-owned large corporation, whose export revenue increased by 50 per cent, from HUF 1,000 billion in 2014 to HUF 1,500 billion in 2015, may have contributed to this. In 2015 the rise in profit continued, albeit decelerated, and it still outstripped export dynamics(Chart 28) Presumably it can be explained by the fact that, the above mentioned company sold its large export turnover branch to a foreign owner. In addition to the anticipated further expansion of exports, the elimination of this sector may have the effect that the profit of foreign-owned corporations will continue to be high, but somewhat lower compared to 2015.

8 For more details, see the Report on the Balance of Payments, September 2015.

Chart 28: Profit of foreign-owned companies and developments in exports (annual growth rates)

The growth in the profit of foreign-owned companies was observed in several sectors, with outstandingly high increase in some sectors of higher weight. In 2015, the profit of foreign-owned companies rose roughly by 17 per cent. Expansion was observed in a number of larger-sized sectors (i.e. with FDI over EUR 2 billion): within manufacturing, vehicle production and pharmaceutical manufacturing continued to expand at a rate similar to last year. In the services sector, the key drivers included telecommunication, with a fourfold growth in profit, business management consultancy, as well as other business services with a total increase in profit in excess of HUF 200 billion. In the trade and repair sector, a wide range of service providers also realised increasing profit. The impact of these was mitigated by the fact that in almost one third of the sectors the profit of foreign corporations decreased; however, these typically have lower weight in direct investments, and thus it curbed growth only to a smaller degree (Chart 29).

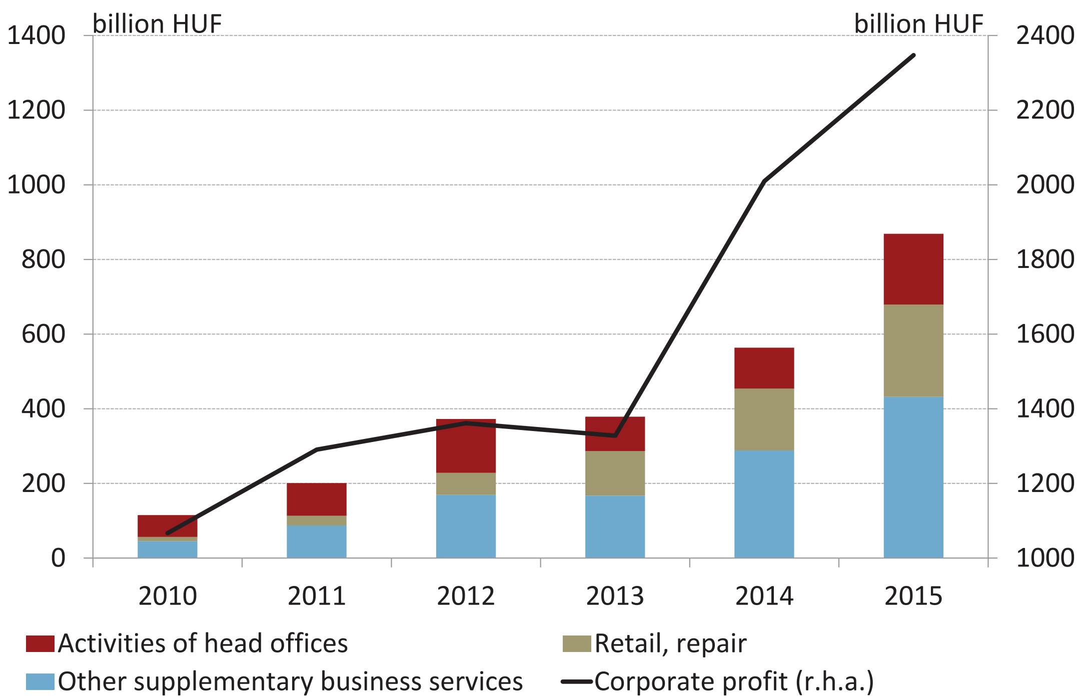
Chart 29: Growth in the profit of foreign corporations in certain sectors in 2015



The sectors with FDI stock over EUR 2 billion were specified by name. We made adjustments for the sectors that were loss-making in 2014.

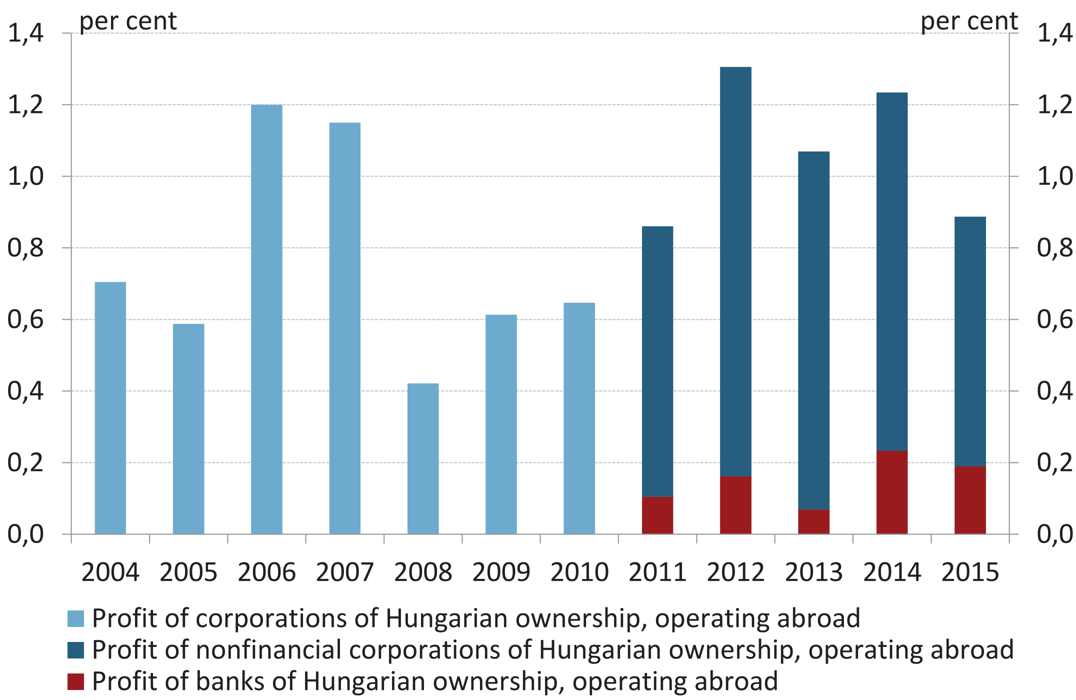
In the context of the sectors, it can be also stated that a substantial part of the profit growth realised in recent years was concentrated in a few sectors. The profit of foreign corporations increased by roughly HUF 1,000 billion in the last two years, while the increase since 2010 was close to HUF 1,300 billion. Having examined the profit of three sectors (Other supplementary business services; Trade and repair; Business and management consultancy) it can be stated that since 2010 their profit rose by almost HUF 750 billion, so these three sectors account for more than half of the total increment in the profit of foreign-owned corporations.

Chart 30: Changes in the income of three key sectors and of all foreign corporations



The lower profit realised by Hungarian-owned companies operating abroad also contributed to the higher deficit on the net income balance in the balance of payments. The income balance in the balance of payments takes into consideration not only the profit of foreign-owned companies operating in Hungary, but also that of Hungarian-owned companies operating abroad. The profit/loss of these companies declined between 2014 and 2015, which also increased the deficit on the income balance. The lower profitability of the enterprises operating abroad with Hungarian background may have been also attributable to the geopolitical tensions in the neighbouring countries and to the decline of the Russian economy in 2015. The declining profit of the outward investments of residents was mainly linked to the non-financial corporations operating abroad (i.e. while the profit of foreign-owned companies operating in Hungary increased, the profit of the Hungarian-owned companies operating abroad decreased); in addition, there was a slight decline in the profit of subsidiary banks with Hungarian background. All in all, while the profit of foreign-owned companies operating in Hungary increased, the profit of Hungarian-owned companies operating abroad declined.

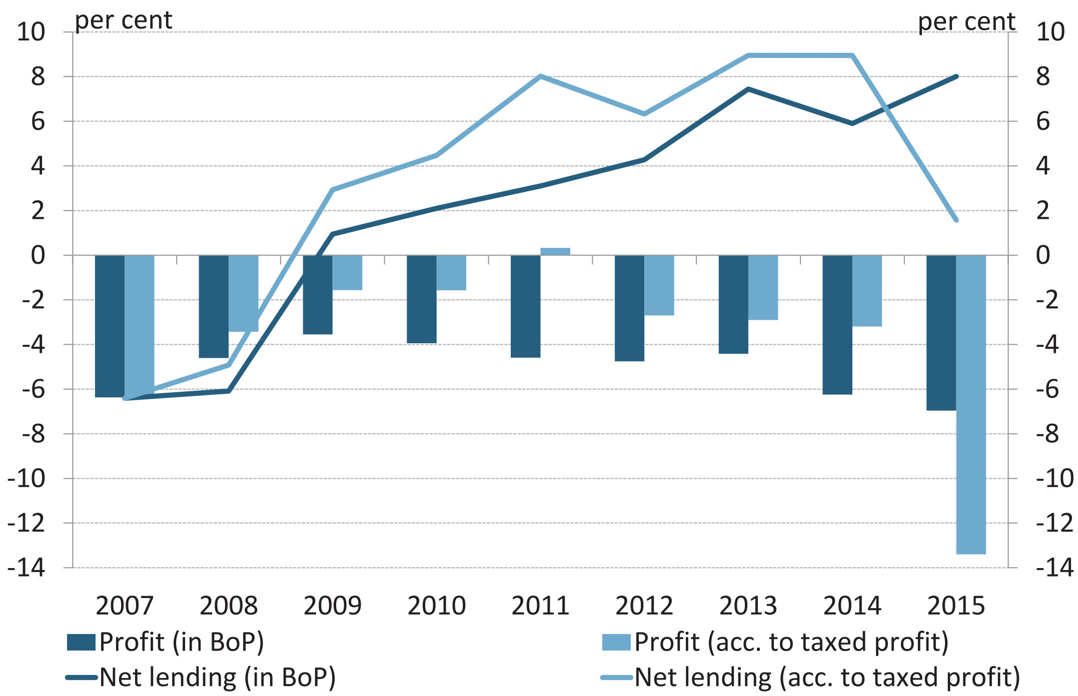
Chart 31: Profit of Hungarian-owned companies operating abroad (as per cent of GDP)



5.5. After-tax profit of foreign-owned corporations

In 2015, in contrast to earlier years, corporations' profit after tax – predominantly due to the sale of company's branch – was well above the income according to current operating concept, appearing in the balance of payments. Accordingly, the corporations' profit on after-tax basis exceeds that stated in the balance of payments. The balance of payments presents the profit of foreign-owned corporations according to COPC,[9] which represents the profit net of the one-off impacts, better capturing the underlying processes. Recently, such one-off impacts at corporations included the losses from the exchange rate revaluation and at the credit institutions the early repayment at preferential exchange rate or the settlements related to household loans. As since the crisis the extraordinary items typically reduced the profit of corporations, the elimination of these items resulted in higher income in the balance of payments statistics, thereby generating the higher deficit on the income balance and, compared to corporations' profit after tax, to lower stated net lending (Chart 32). By contrast, in 2015 a one-off[10] – extraordinary – profit was realised at the foreign-owned corporations operating in Hungary, mostly due to the sale of a branch of a multinational corporation. As a result of this, corporations' profit after tax became higher than seen in previous years, and thus the sign of the ordinary business adjustment item also changed. That is, based on the income balance calculated on the basis of the corporations' profit after tax, the external surplus would have declined considerably. On the other hand, this lower net lending based on the profit after tax would be reflected on the financing side in the rise of foreign direct investments (higher degree of reinvested earnings).

Chart 32: Profit* from the ordinary course of business and based on the profit/loss after tax, and net lending (as per cent of GDP)



* The profit realised by corporations is stated with negative sign to make the presentation consistent with the income balance of the balance of payments.

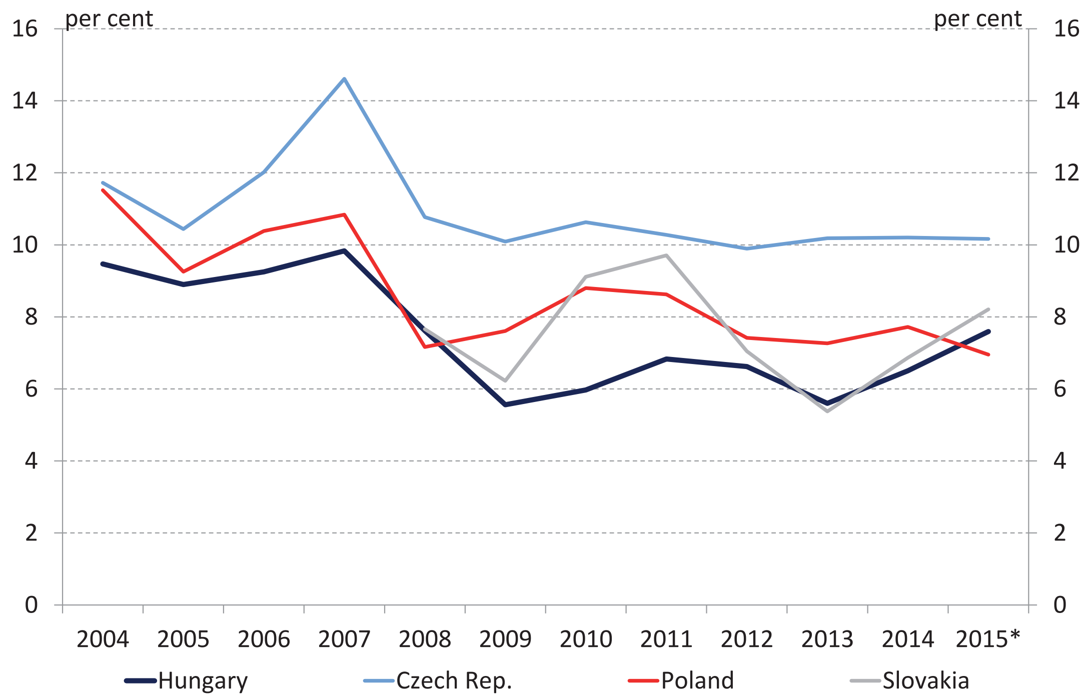
9 Hungary's Balance of Payments and International Investment Position Statistics, MNB (2014)

10 For more details see the press release entitled "Report on the Balance of Payments based on the 2016 Q1 data".

5.6. International comparison

The return on FDI in Hungary has been increasing since 2013, and thus Hungary outpaced Poland and caught up with the average of the region (Chart 33). The return on FDI in Hungary should be examined in the context of the countries of the region with similar conditions. After the outbreak of the crisis, foreign corporations' return on FDI fell in all countries of the region, but it was still the lowest in Hungary,[11] while in the Czech Republic – which did better than the rest of the EU Member States – the profit realised on one unit of direct investment reached the highest level, at steadily close to 10 per cent. The high Czech figure has not changed in recent years, but in Hungary foreign corporations' return on FDI rose by roughly 2 percentage points between 2013 and 2015, surpassing Poland and reaching the regional average. In this period, not only Hungary but Slovakia also experienced a major expansion. It is worth noting that in the more developed West European countries the profit realised on the FDI stock is around 3 per cent, which falls well short of the average of the region.

Chart 33: Return on foreign direct investment
(value of the profit realised on the FDI stock relative to total FDI stock)



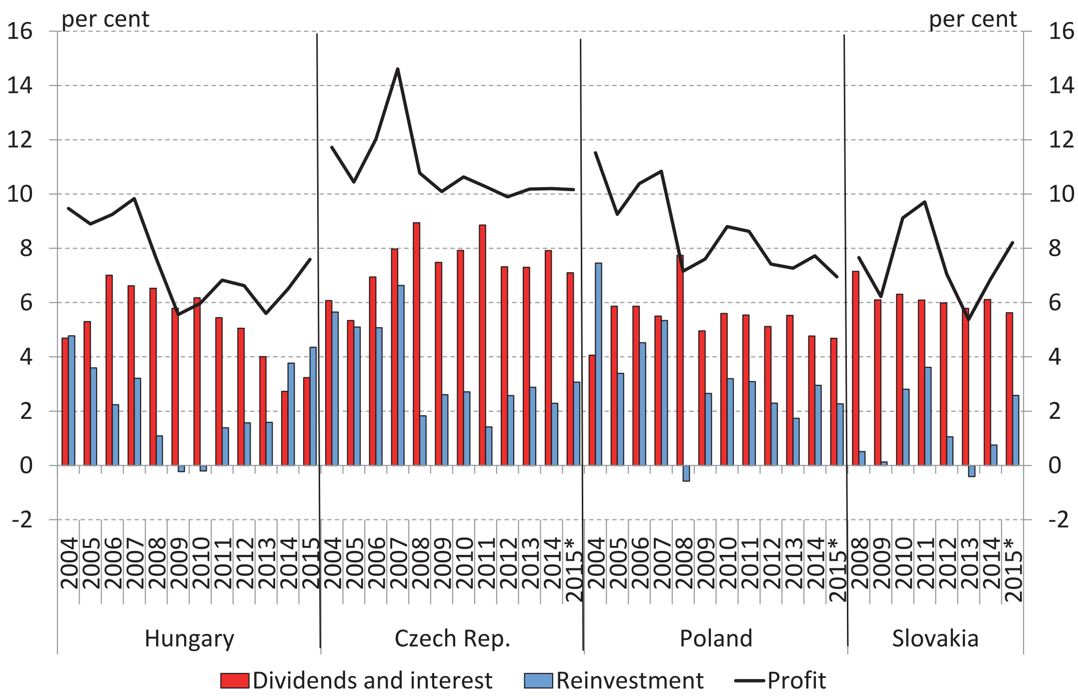
Source: Eurostat. *The 2015 value in the countries of the region is presumably an estimate only.

In 2015, foreign companies operating in Hungary reinvested more than half of their profits, which is an extraordinarily high value among the Visegrád countries (Chart 34)**.** Foreign companies operating in the region mostly responded to the post-crisis fall in profits by curbing their reinvestments; as a result of this, their dividend and interest payments – which substantially exceed their reinvested earnings – were relatively stable. By contrast, in Hungary the share of dividend and interest payments gradually declined between 2010 and 2014, while reinvested earnings as a per cent of FDI rose to the highest level in the region.[12] In 2015, the increased profit of foreign corporations in Hungary resulted in the parallel increase in dividend payments and reinvestments. Despite the fact that in 2015 the profit of foreign corporations increased in all countries of the region, this was accompanied by a rise in reinvested earnings only in Hungary and Slovakia.

11 It is worth noting that the lower rate of the profit of the corporations operating in Hungary compared to the region may be attributed to several factors. On the one hand, capital in transit can significantly influence profits in Hungary, while on the other hand superdividends reduce corporations' profit. Finally the effect of the COPC correction may be reflected in the reduced profit as well.

12 Superdividends could also increase the profit proportionate reinvested earnings, because through the smaller profit it can raise the role of the reinvestment earnings compared to the profit. Thus, superdividends may have an effect on the relatively high profit proportionate reinvestments of foreign-owned corporations operating in Hungary.

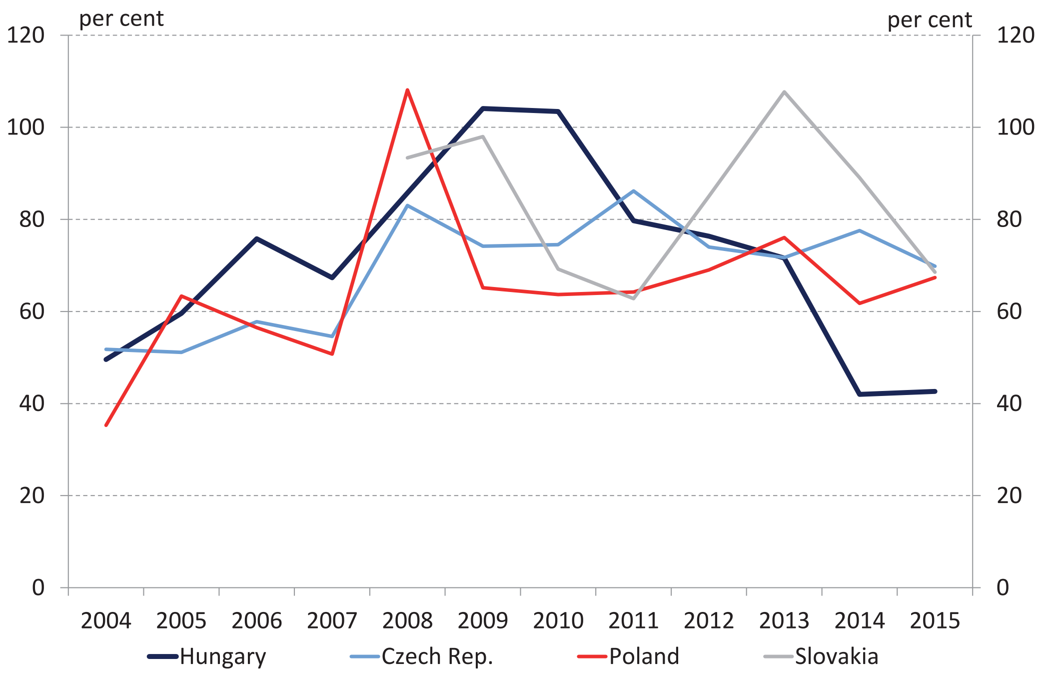
Chart 34: Breakdown of FDI earnings in the countries of the region (as a per cent of FDI)



Source: Eurostat. The 2015 value in the countries of the region is presumably still an estimate only.

In 2015, in Hungary the profit proportionate dividend payments remained at the low level seen in previous year, which still falls far short of the regional level. In the pre-crisis years, the ratio of dividend payments was high in Hungary in a regional comparison, which – after increasing further during the years of the crisis – exceeded the total profit of corporations. In the post-crisis period, the income-proportionate capital outflow gradually decreased, and in 2014 it was well below the regional average. In 2015, dividend payments a per cent of profit in the Czech Republic, Poland and Slovakia was close to 75 per cent, while in Hungary it remained below 50 per cent. Thus, among the Visegrád countries the ratio of reinvested earnings exceeds the dividend payment ratio only in Hungary, which may have a positive impact on the country's growth prospects through the higher foreign direct investment.

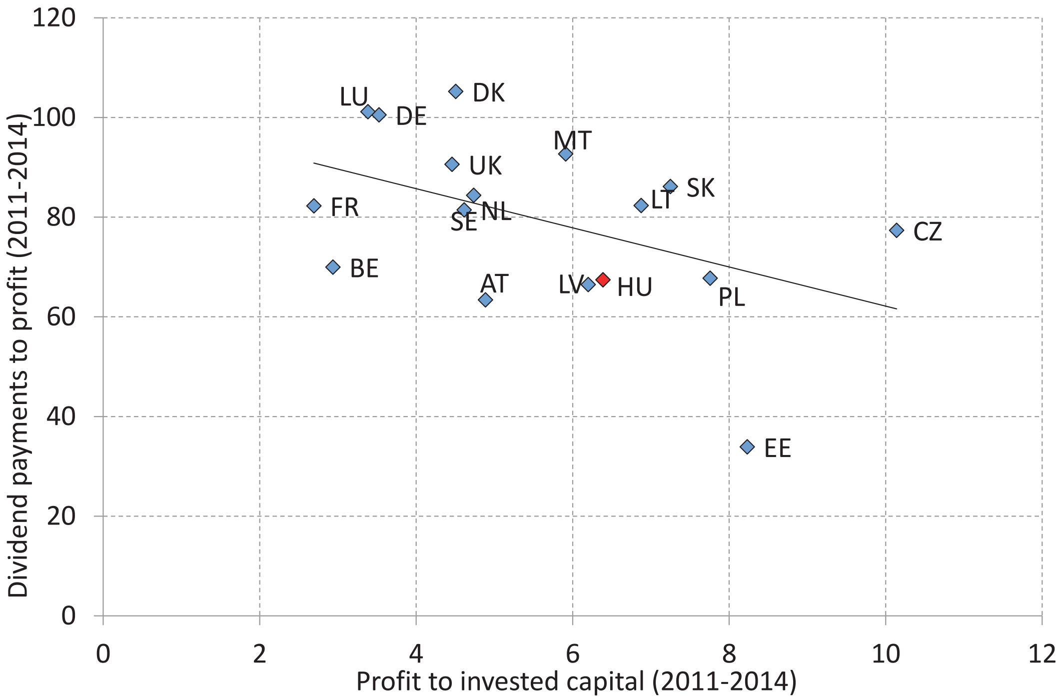
Chart 35: Ratio of dividend payment to total profit



Source: Eurostat.

In the countries that joined the European Union in 2004, foreign corporations typically realise higher profit, which is usually accompanied by a higher rate of dividend payment. In the Central and Eastern European countries that joined the EU, the profit rate of foreign-owned corporations is higher than in the Western European countries. This difference is attributable to the higher marginal benefit offered by the weakly capitalised economies, which makes these countries attractive for foreign working capital. It is also typical for these countries that non-resident corporations reinvest the realised earnings at a higher rate. As reflected by the chart, on average for the 2011-2014 period the return on FDI realised by foreign corporations in Hungary was low in regional terms, but it still exceeds the profit rate realised in the more developed Western European countries. Furthermore, it is also clear that while in the more developed countries, such as Germany or Denmark, the foreign investors paid dividends in excess of their profit – which may have been funded from the retained earnings of previous years – the dividend ratio is lower in the countries of the region.

Chart 36: FDI profit rates and dividend payments (average of 2011-2014)



Source: Eurostat.

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.

REPORT ON THE BALANCE OF PAYMENTS

October 2016

Print: Prospektus–SPL consortium

H-8200 Veszprém, Tartu u. 6.

mnb.hu