REPORT ON THE BALANCE OF PAYMENTS

2019

APRIL

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

Letters 27
Gábor Bethlen

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In accordance with Act CXXXIX of 2013 on the Magyar Nemzeti Bank, the primary objective of the MNB is to achieve and maintain price stability and, without prejudice to its primary objective, the central bank is also responsible for maintaining the stability of the financial intermediary system. Developments in the external balance are key to financial stability, as processes relating to the balance of payments allow for conclusions to be drawn concerning the sustainability of economic growth and the relevant risks. Moreover, the analysis of the balance of payments 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. 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 for Monetary Policy and Economic Analysis. Contributors: Anna Boldizsár, Gabriella Csom-Bíró, Orsolya Csortos, Zsuzsa Kékesi, Gergely Kicsák, Balázs Kóczián, Péter Koroknai, Dániel Simon, Balázs Sisak and Noémi Végh. The Report was approved for publication by Márton Nagy, Deputy Governor.

This Report is based on information pertaining to the period ending 26 March 2019.

Summary

The external vulnerability of the Hungarian economy declined further in 2018. The current account and net lending continued to show a surplus. In parallel with the significant absorption of EU transfers and higher FDI inflows compared to previous years, the volume of investment increased dynamically, while the net and gross external debt ratios of the economy declined further. Hungary's net lending still exceeds the values typical in the countries in the region.

The current account surplus and the net lending of the economy amounted to 0.5 percent and 2.2 percent of GDP, respectively. The smaller surplus compared to previous periods is attributable to the trade surplus, which was affected by two factors: while the goods surplus declined (mainly due to a rise in import-intensive investment and partly due to expanding consumption and an increase in oil prices), the services surplus was at a high level. Despite the decline in the trade surplus, which is typical in the region, Hungary's trade surplus remains high and is a key element in the favourable external balance position. The current account was supported by a decrease in the deficit on the income balance, which was mainly related to interest paid to abroad. Net lending was increased by the fact that the absorption of funds belonging to the current EU programming period increased further.

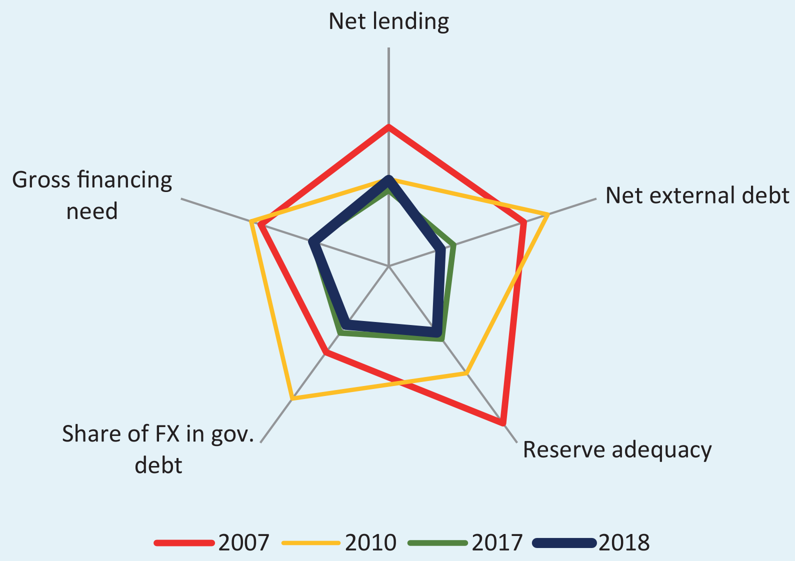
As net external debt continued to decline and FDI expanded significantly, the structure of liabilities in the economy shifted towards more stable financing in 2018. Net FDI inflows amounted to EUR 3.7 billion and this significantly exceeded the volumes observed in previous years, contributing strongly to the expansion in investment. The high ratio of reinvestment of corporate incomes produced in Hungary continued to play a major role in FDI inflows.

The net external debt ratio continued to fall, dropping to a new historical low of 8 percent of GDP by end-2018. This was mainly attributable to the government and banks. The decline in the government's net external debt was primarily related to the increase in FX reserves in connection with the absorption of EU transfers, the impact of which was mitigated by a modest rise in non-residents' holdings of government securities. The outflow of funds of the banking sector mainly occurred in parallel with an expansion in external assets, and thus banks' receivables vis-à-vis the rest of the world exceeded the value of their external liabilities at end-2018 as well. Gross external debt dropped to 57 percent of GDP. Short-term external debt, which is extremely important in terms of the external vulnerability of the country, decreased to EUR 17 billion by end-2018, while international reserves rose to above EUR 27 billion. Accordingly, the level of reserves exceeded the level expected and deemed safe by investors by more than EUR 10 billion.

Looking at net lending according to the savings position of sectors, its decline in 2018 was a result of contrasting developments. In parallel with the rising corporate investment activity, the net borrowing of the sector increased considerably. At the annual level, this impact was moderated by a rise in households' financial savings. Households' government securities purchases continued during the year, and by end-2018 nearly 20 percent of the government debt was directly financed by households, while also taking into account the government securities held through financial intermediaries (e.g. investment funds), financing by households increased to close to 30 percent, contributing significantly to the reduction in external vulnerability. The deficit of the general government was around the previous years' subdued levels in 2018 as well, also supported by a further decline in interest expenditures.

On the whole, external balance developments in Hungary improved in 2018 again (Chart 1: values closer to the centre – in practical terms, the shrinking of the 'net' – signal lower vulnerability from the given indicator). A slight deterioration is observed only in net lending, which primarily declined due to the import needs related to the dynamic investment growth. At the same time, the net position still shows a significant surplus, and thus both the net and gross external debt-to-GDP ratios declined further. Reserve adequacy improved as a result of both a decrease in short-term external debt and an increase in international reserves. In spite of the decline in short-term external debt, the gross financing need did not decrease further in 2018 due to the lower net lending. In parallel with an expansion in household savings, households' government securities holdings increased further, contributing to the continued decline in the share of foreign exchange within government debt.

Chart 1: Stylised depiction of Hungary's external balance position



Note: The chart presents the deviation of individual indicators from the long-term average scaled by dispersion; smaller values indicate the strengthening of fundamentals (e.g. lower net borrowing).

In the special topic presented in this Report, we compare the changes in Hungary's external balance indicators to developments in the countries of the region. Hungary's net lending once again exceeded the average of the countries in the region (and the European Union) in 2018, mainly due to households' higher savings compared to what is typical in the region. In most of the countries in the region, the current account balance fell mainly as a result of a decline in the goods balance. While in Hungary the fall in the current account surplus was partially offset by the inflow of funds belonging to the new programming period of the EU, in other countries in the region – with the exception of Poland – an improvement in the transfer balance was not typical. The ratio of FDI inflows to GDP in Hungary exceeded the regional average. Along with a further decline in debt indicators, Hungary's net external debt is already below the indicators of Poland and Slovakia.

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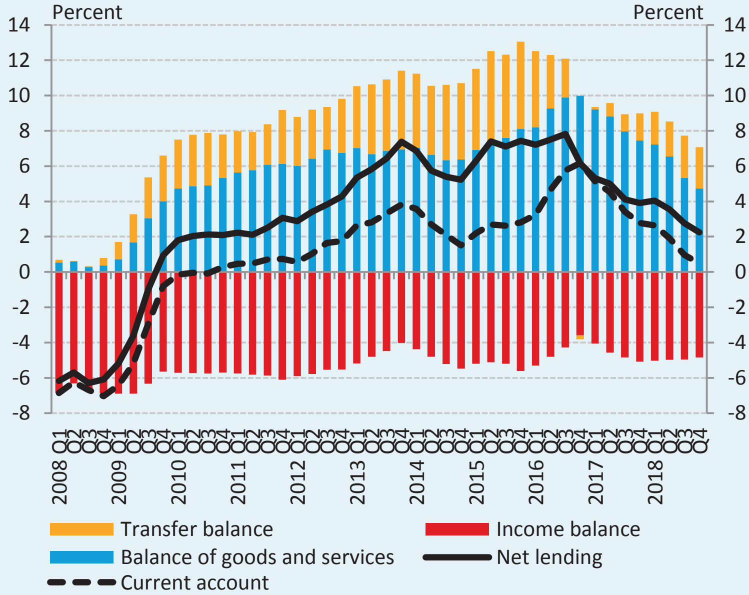
Box

1 Real economy approach

With the current account in surplus, net lending calculated according to the real economy approach amounted to 2.2 percent of GDP in 2018. During 2018, the balance of goods and services was shaped by two factors: the decline in the balance of goods resulted mainly from a rise in import-intensive investment, but this effect was moderated by the stable surplus of the balance of services. Along with the change in volume, developments in the terms of trade also increasingly pointed to a decline in the trade balance during the year, reflecting the rise in commodity prices. The income balance improved slightly in 2018 Q4 as a result of a decline in interest paid abroad. Looking at the year as a whole, the decrease in the profits of foreign-owned companies also resulted in a rise in net lending and the current account. Accordingly, the difference between GDP and GNI declined mildly during the year. The four-quarter transfer balance as a proportion of GDP remained practically unchanged at end-2018, but expansion was observed at the annual level as a result of fund inflows of nearly EUR 4 billion belonging to the new, 2014–2020 EU programming period.

Based on the real economy approach, in 2018 Q4 the four-quarter net lending of the Hungarian economy amounted to 2.2 percent of GDP (Chart 2). According to seasonally unadjusted figures, net lending in the fourth quarter amounted to EUR 100 million, with a current account deficit of EUR 350 million and a surplus of EUR 450 million on the capital account. Based on four-quarter data, net lending decreased to 2.2 percent of GDP as a result of developments in the trade balance; however, this was partially mitigated by the improvement in the income balance. The decline in the balance of goods and services is attributable to a slowdown in external demand, an expansion in domestic investment and the acceleration in households' consumption. The value of the income balance improved slightly at end-2018. The four-quarter transfer balance was stable at end-2018, which was primarily related to the absorption of EU funds amounting to nearly EUR 1 billion. Notwithstanding the decline in the trade balance, the four-quarter current account balance-to-GDP ratio still shows a surplus.

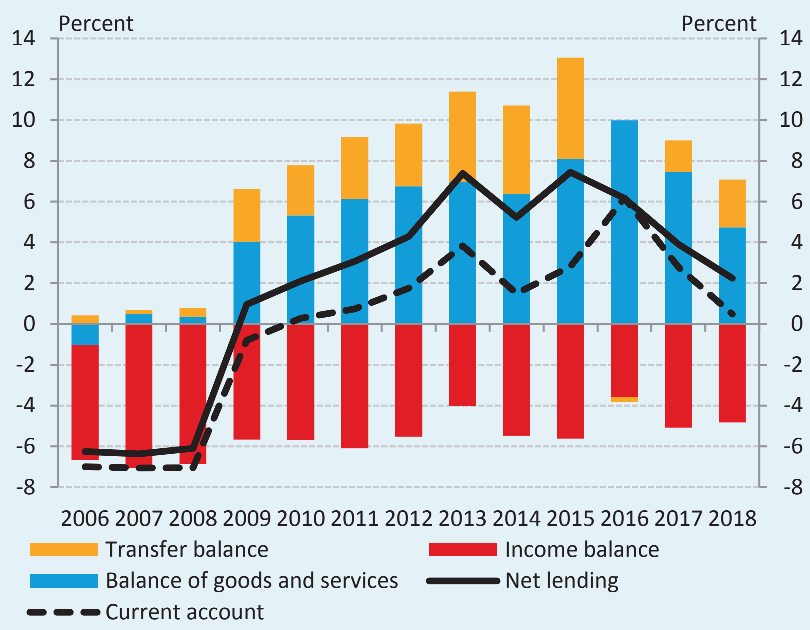
Chart 2: Developments in net lending and its components (four-quarter values as a percentage of GDP)



Source: All charts by the MNB unless otherwise indicated.

Both Hungary's net lending as a proportion of GDP and its current account balance showed a surplus in 2018 again (Chart 3). From the historical high of 6 percent recorded in 2016, the current account surplus fell to 0.5 percent of GDP by 2018 as a result of a decline in the trade surplus, the impact of which was somewhat moderated by a decrease in the deficit of the income balance. In spite of the downward trend, net lending and the value of the current account are around the average of the four years following the crisis, i.e. near a value that evolved during significant adjustment. The drop in the balance of goods and services observed in 2018 is attributable to weakening external demand and a rise in import-intensive investment. In 2018, the transfer balance surplus amounted to 2.4 percent of GDP, which substantially exceeds the level observed in the previous two years, but still falls short of the inflow of funds observed at the end of the previous EU programming period that amounted to 3–5 percent of GDP in annual terms.

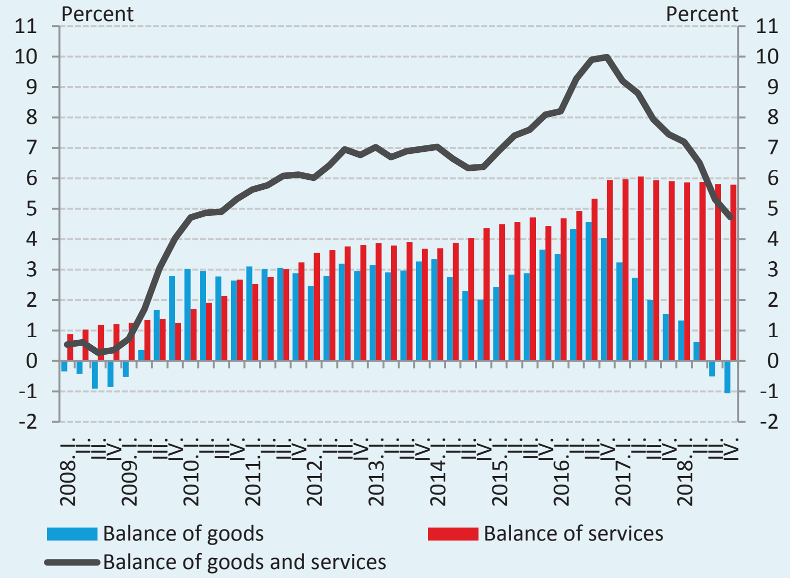
Chart 3: Developments in net lending and its components (annual values as a percentage of GDP)



1.1 Trade balance

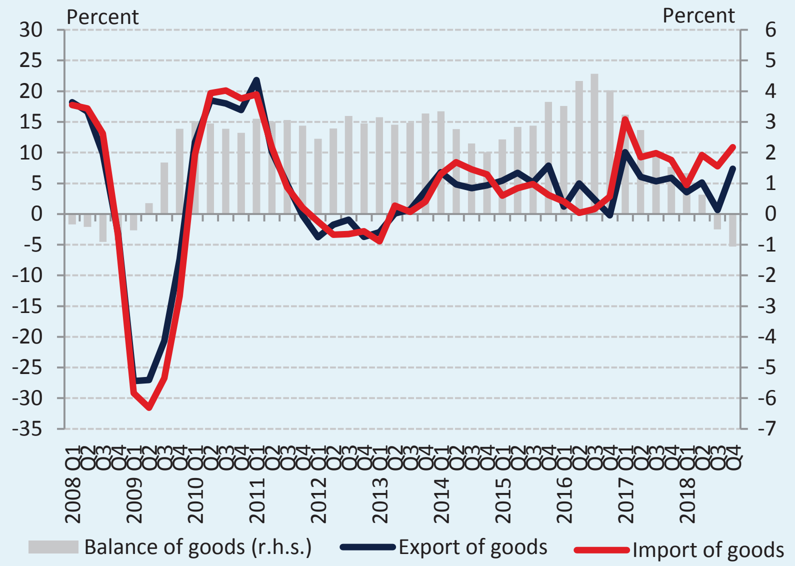
As a result of the stable surplus of the balance of services, the balance of trade amounted to nearly 5 percent of GDP in 2018 Q4 (Chart 4). The dynamic expansion in the goods and services surplus, which had lasted since 2014, stopped at the end of 2016. Although it subsequently embarked on a downward trend, it remains at around 5 percent of GDP. Owing to the lower balance of goods, the trade surplus decreased further in Q4, albeit more slowly than in the previous quarter. In addition to the slowdown in external demand, this was explained by the structural factors of the domestic economic growth: household consumption – mainly purchases of durable goods – expanded considerably as a result of favourable income developments, the pick-up in the household loan market and the high level of consumer confidence. In addition, the strong upturn in investment was stimulated by double-digit expansion in the corporate loan market and a rise in the absorption of EU funds. Accordingly, at end-2018 the balance of goods as a proportion of GDP showed a deficit of about 1 percent. By contrast, the services surplus was stable at around 6 percent of GDP for the whole year and at end-2018 as well. The services surplus was linked to exports of financial and other business services, in addition to tourism and transportation services.

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



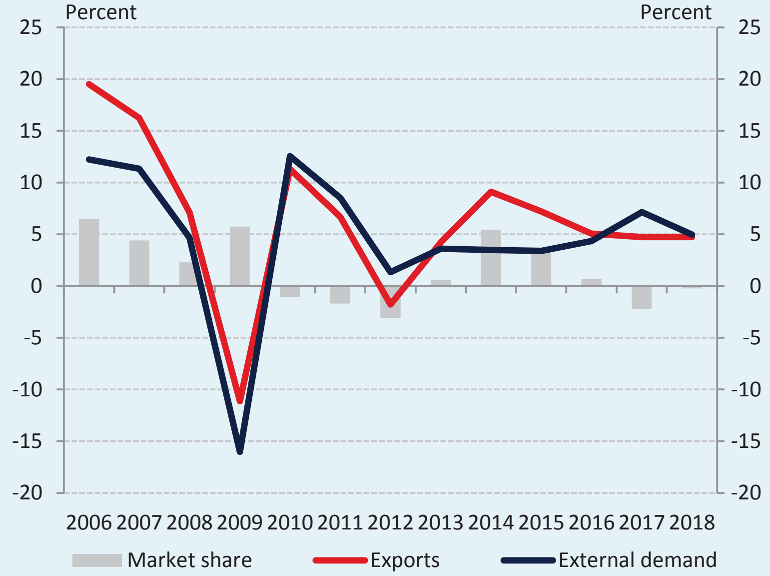
In 2018 Q4, the annual growth rate of goods imports still exceeded growth in goods exports, but to a smaller degree than in the previous period (Chart 5). Since end-2016, in line with the rise in domestic demand items, growth in goods imports has exceeded export growth, as a result of which the goods deficit was 1.1 percent of GDP at end-2018. At the same time, at end-2018 the difference between the annual growth rates of goods imports and goods exports declined, which is attributable to an expansion in industrial production, and within that to the growth in vehicle manufacturing and other machine industry, which have a high weight, as well as to the growth in the chemical industry. (Following a downswing related to temporary factors – e.g. changes in EU rules – in 2018 Q3, a major adjustment was observed in the case of vehicle manufacturing at the end of the year.)

Chart 5: Annual growth in goods exports and goods imports and the goods balance (four-quarter values as a percentage of GDP)



Despite weaker external demand, import growth did not decelerate, and thus – following a temporary fall in 2017 – Hungary's export market share stabilised in 2018 (Chart 6). As a result of a deceleration in annual real export growth, Hungary's export market share decreased in 2017. External demand declined in 2018, while Hungary's export growth was around 5 percent, similarly to the previous year. On the whole, Hungary's exports and the external demand of its export markets expanded to a similar degree, and thus Hungary's export market share remained unchanged in 2018.

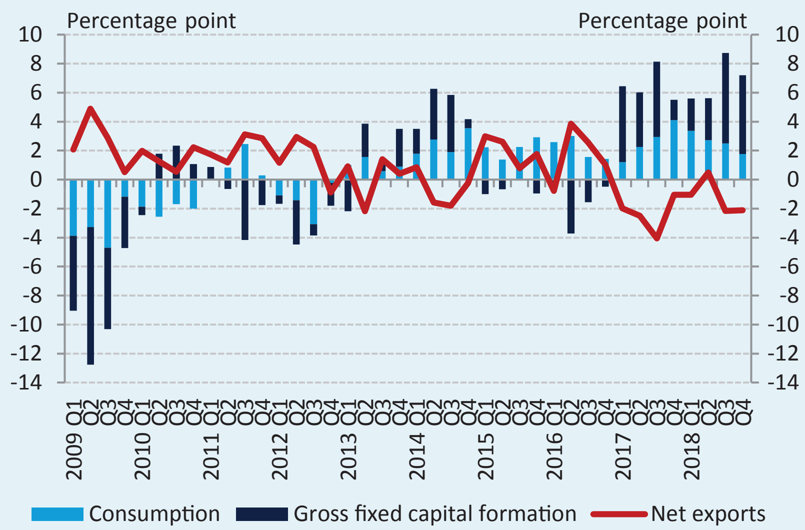
Chart 6: Real growth in exports and external demand* and developments in Hungary's export market share



Weighted by export markets.

As in the previous year, in 2018 the annual growth rate of domestic absorption was high, while net exports restrained growth (Chart 7). During the year, the strong expansion of GDP was primarily related to the rising level of investment, while the growth rate of consumption gradually declined in parallel. Both investment in buildings – related to the development of infrastructure, housing construction and commercial real estate development – as well as investment in machinery contributed to the dynamic expansion of investment. In addition, there was strong expansion in investment in public subsectors and in subsectors closely related to the public sector (e.g. transport, energy) – primarily as a result of developments implemented from EU funds. Growth in household consumption was borne by high consumer confidence, willingness to borrow and net financial wealth, as well as by a dynamic increase in wages and further employment growth. As we have pointed out before, due to the import need of domestic demand items, the annual dynamics of total exports was exceeded by the growth rate of imports, and thus on balance net exports had a negative impact on economic growth in 2018 as a whole.

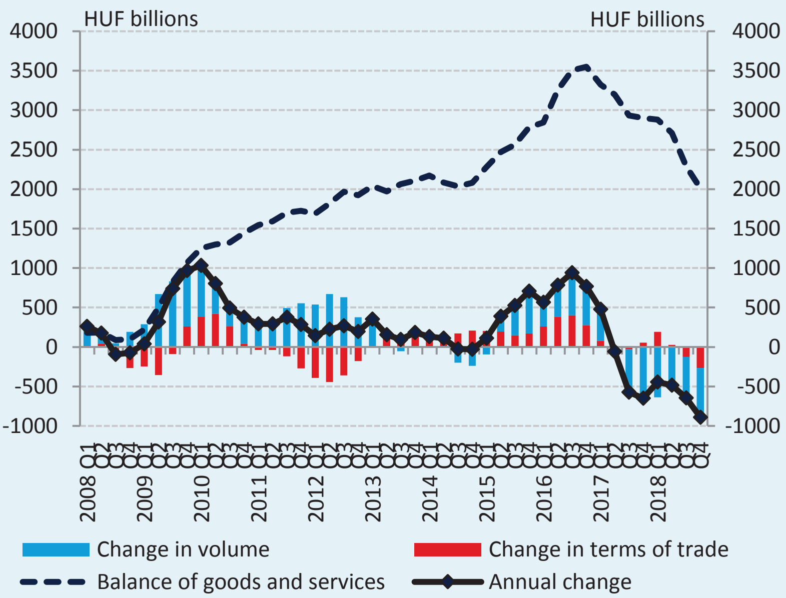
Chart 7: Contribution of domestic absorption and net exports to GDP growth



Source: HCSO.

The trade balance decreased in 2018 mainly as a result of a change in volume, but to a lesser extent the change in the terms of trade also contributed to this development (Chart 8). In the period between 2013 and 2016, improvement in the terms of trade contributed significantly to the expansion of Hungary's trade balance. In 2017, changes in the terms of trade did not have a major impact on the trade balance, as the effect of the price increases of energy were offset by the relative price changes of export products. Towards the end of the year, the energy price increases observed in the first three quarters of 2018 increasingly resulted in a deterioration of the terms of trade, but its degree was exceeded by the volume effect all the time.

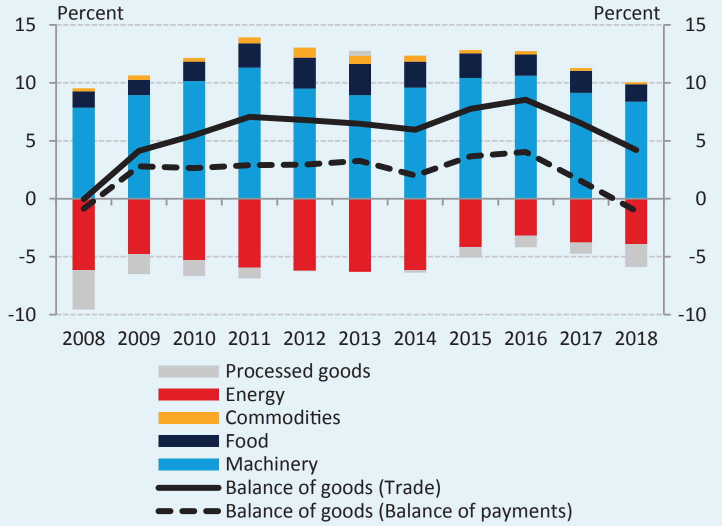
Chart 8: Developments in the balance of trade factors according to GDP (year-on-year)



Source: HCSO.

The drop in the balance of goods was primarily attributable to lower net machinery exports and a modest expansion in net energy imports (Chart 9). The decline in net machinery exports was related to the import demand of the dynamic investment growth in 2018. Nevertheless, net exports of machinery remain a key factor behind developments in Hungary's goods balance. Another reason for the decline was that – in line with commodity price increases – net imports of energy have been increasing slightly since 2016. At the same time, net energy imports remain significantly below the level typical until 2014. The increase in net imports of processed products seen in 2018 may be attributable to rising household consumption.

Chart 9: Net external trade in goods by main groups (as a percentage of GDP)

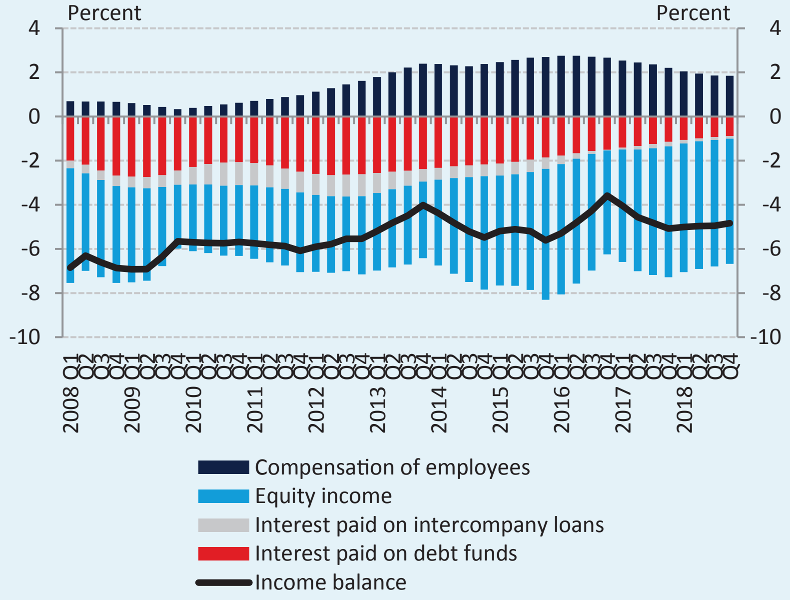


Note: The difference between trade in goods based on external trade and the balance of payments depends on the different requirements of the methodologies and the content of the data sources. We obtain the trade in goods figures for the balance of payments by means of adjustment factors derived from external trade statistics (for more details, see the publication on the methodology for the balance of payment statistics). The two types of data have been similar in recent years, so they are suitable for analysing the trends. Sources: HCSO and MNB.

1.2 Income balance

By end-2018, the deficit on the income balance as a percentage of GDP declined slightly, standing at 4.8 percent at the end of the year (Chart 10). Profits of foreign-owned companies,[1] which were persistently around 5.7–5.8 percent of GDP in 2018, account for a large portion of the income balance. Earned income of employees working temporarily abroad was practically unchanged at around 2 percent of GDP at the end of the year. The interest balance of loans borrowed from abroad declined slightly, which is attributable to the low yield environment and a fall in external debt indicators.

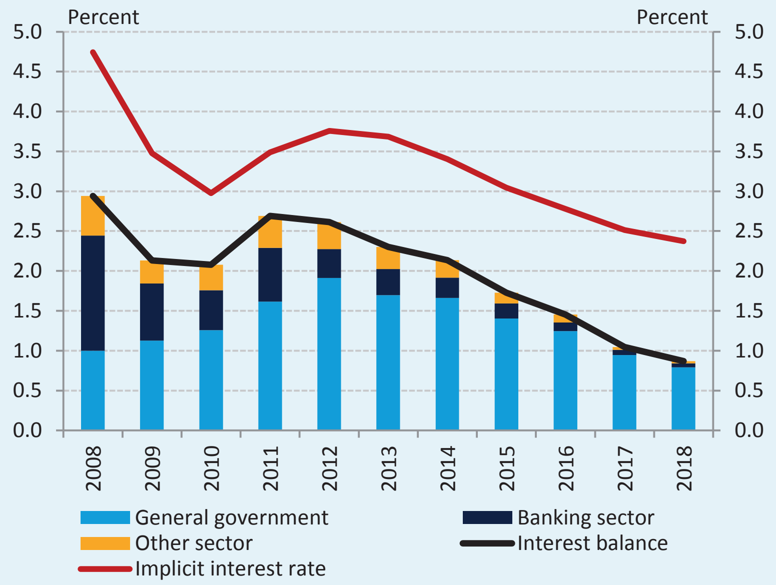
Chart 10: Developments in the items of the income balance (four-quarter values as a percentage of GDP)



[1] We only have limited quarterly data concerning the profits of foreign-owned companies. Therefore, the information on profit outflows is based on estimates. For more details, see the publication 'Methodological notes to the balance of payments and international investment position'.

The declining trend in the net interest balance observed since 2012 continued in 2018, and thus its value decreased to below 1 percent of GDP by the end of the year (Chart 11). The decline in interest paid on external debt observed since 2012 continued in 2018 as well, supported by the drop in outstanding external debt and the low yield environment (the implicit interest rate on external debt was 2.4 percent at the end of the year[2]). In a sectoral breakdown it can be seen that the value of banks' and other sectors' (mostly non-financial corporations) net interest balance as a percentage of GDP was around zero, i.e. the net interest expenditure, which amounted to 0.9 percent of GDP, is almost entirely related to the interest balance of the general government.

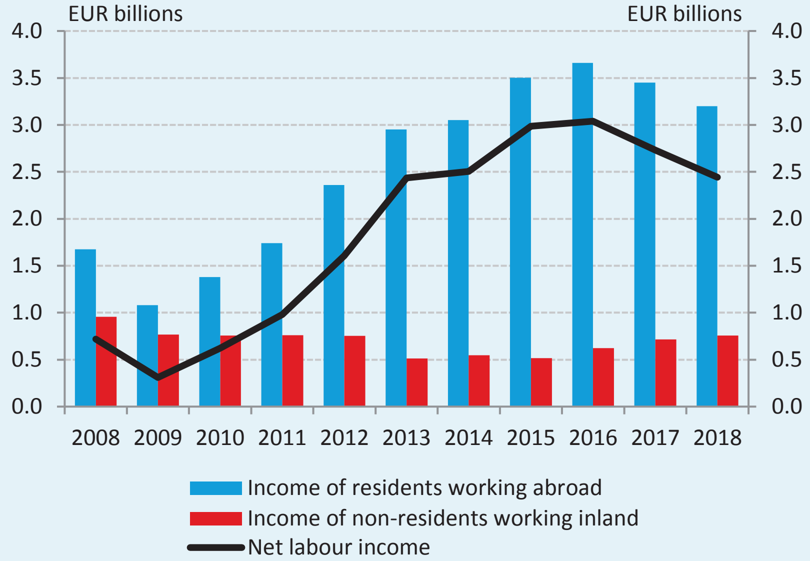
Chart 11: Changes in net interest expenditure (as a percentage of GDP) and in the implicit interest rate



The gradual decline in compensation of employees working temporarily abroad continued in 2018 (Chart 12). After the crisis, the earned income of resident economic agents working temporarily abroad rose dynamically, which helped improve the income balance deficit. This trend reversed in 2017, and the balance started to decline, which is attributable to a decrease in the earned incomes of Hungarian residents working temporarily abroad as well as to the rise in the earned incomes of foreigners working in Hungary for less than a year. These developments may be explained by the decline in taking jobs abroad due to the double-digit rise in wages since 2017 as well as by the moving abroad for an extended period of time of those who work abroad temporarily (statistically, those who work abroad for more than a year belong to another category).

[2] Developments in the implicit interest rates (i.e. average interest paid on debt) do not necessarily reflect the changes in the current interest levels, because at present interest must also be paid on debt originating from earlier periods at the applicable rates (for example, fixed-rate debt); in other words, the repricing of the total debt volume to the new interest rates may prove to be a lengthy process in view of the multi-year average maturity.

Chart 12: Compensation of employees working abroad temporarily



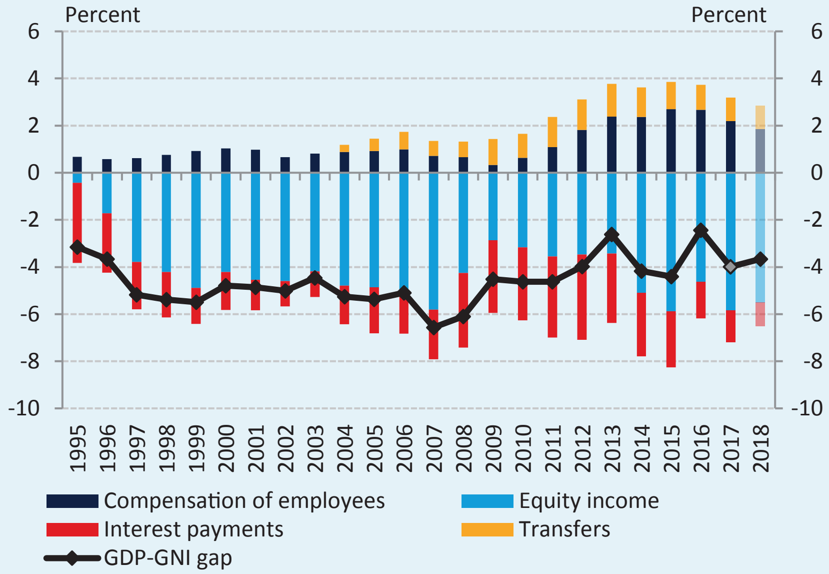
Sources: HCSO and MNB.

Box 1: The GDP–GNI gap

The gap between the gross domestic product and the gross national income is of outstanding importance, as the difference between the two ratios shows the balance of the income flows vis-á-vis the non-resident sector, and thus approximates the actually disposable income of resident actors better than the GDP. At present, the indicator most often used in economics for measuring the economic development of a country is the gross domestic product (GDP), but there are a number of other indicators that may provide a more accurate picture of a nation's income position. One of them is the gross national income (GNI), which – in contrast to GDP – is closer to the resident sector's disposable income. The factor in which it effectively differs from GDP is that while the gross domestic product measures the income generated by the resident economic agents within the territory of a country, the GNI also considers the income of non-resident owners from the respective country, as well as the income of resident economic agents from abroad. Such incomes include the items stated in the balance of payments under primary incomes: compensation of employees, capital and interest income and current transfers related to products and production, which in the case of Hungary are mostly represented on the income side by the agricultural subsidies received from the EU. During the economic convergence of a country it is a natural phenomenon that as a result of the capital income paid abroad GDP exceeds GNI; however, above a certain level this may reflect external vulnerability and dependence on foreign funds, and may even hinder convergence.

In Hungary, the GDP–GNI gap tended to decrease after the crisis, while in recent years it has usually fluctuated between 2–4 percent of GDP (Chart 13). In the period prior to the crisis, the difference between gross national income and gross domestic product was around 5 percent of GDP. In 2007–2008, the indicator rose to a historical high of above 6 percent of GDP, partly due to the surge in interest expenditure because of the external indebtedness and the depreciation of the exchange rate. In the post-crisis years, the decline in the profit of foreign-owned companies and the rise in compensation of employees working temporarily abroad reduced the gap between GDP and GNI. In recent years, in parallel with the decline in external vulnerability, interest expenditures paid to abroad fell significantly, while the rising profits of foreign-owned companies resulting from the favourable business conditions raised the difference between GDP and GNI. In 2016, mainly as a result of one-off corporate developments, the profit balance fell, just like the GDP–GNI gap in parallel with that. According to preliminary 2018 data, the difference between GDP and GNI declined slightly as a result of a decrease in foreign-owned companies' profits and the interest balance, the impact of which was offset to some extent by the fall in compensation of employees working temporarily abroad.

Chart 13: The GDP–GNI gap in Hungary (as a percentage of GDP)

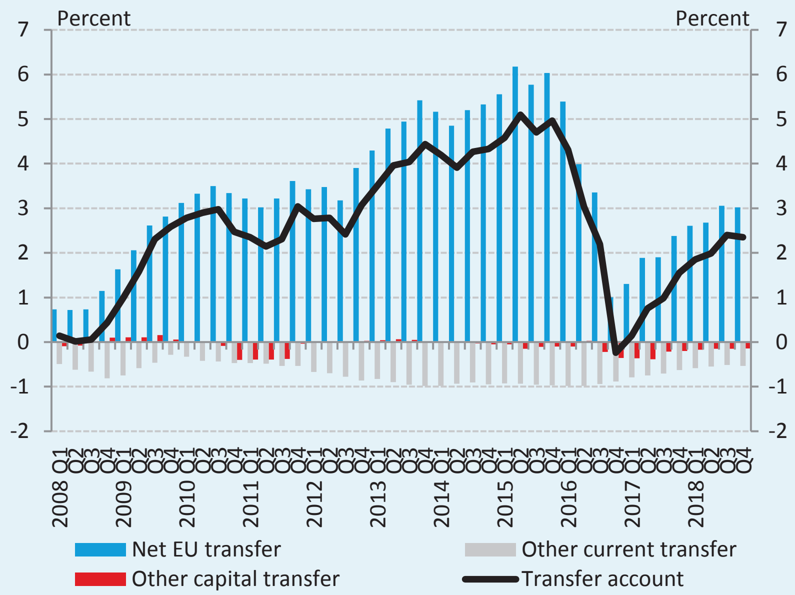


Note: At present, no official GNI data (published by the HCSO) related to 2018 is available; the 2018 figure was calculated from the balance of payments data release primary incomes (without SPEs, and the profit of foreign-owned companies is only an estimate for the time being).

1.3 Transfer balance

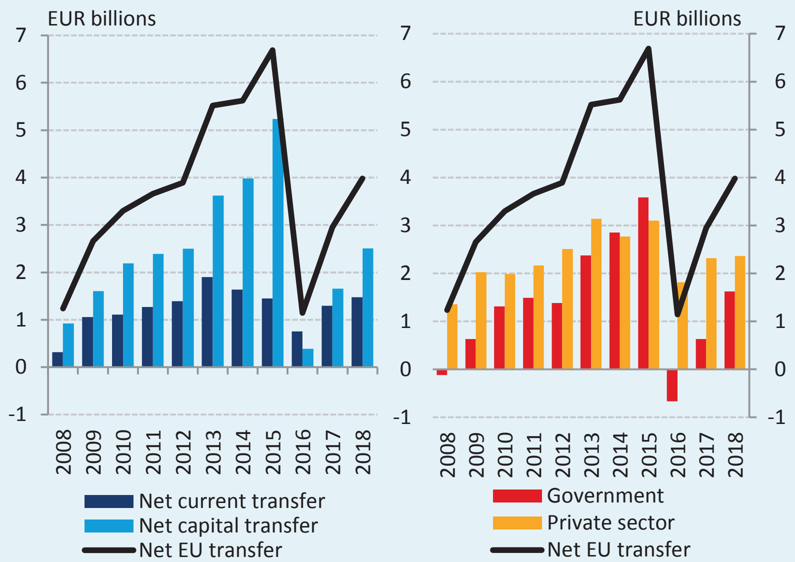
At the end of 2018, the transfer balance – which is mostly determined by the absorption of EU funds – steadily amounted to 2.4 percent of GDP, which is favourable in terms net lending (Chart 14). At end-2016, with the closing of the 2007–2013 programming period of EU funds and the moderate inflow of funds from the new period, the transfer balance contributed somewhat to the decline in net lending. EU transfer inflows started to rise again as of 2017, which had a favourable impact on Hungary's external balance position. Based on four-quarter data, in 2018 H2 the inflow of EU funds reached 3 percent of GDP, which substantially exceeds the values observed in the previous two years, but still falls short of the level measured at the end of the previous period. On the whole, at end-2018 the transfer balance amounted to 2.4 percent of GDP, with the inflow of EU transfers remaining as the key factor.

Chart 14: Developments in the transfer balance (four-quarter values as a percentage of GDP)



In 2018, the absorption of EU funds rose to nearly EUR 4 billion, which was mostly related to an expansion in the capital transfers of the government (Chart 15). In 2016, in line with the closing of the previous EU programming period, net current and capital transfers fell from the previous EUR 6.7 billion to close to EUR 1 billion, which primarily reflects the decline in the capital transfer balance. Following this fall, EU transfer inflows increased by nearly EUR 2 billion and a further EUR 1 billion in 2017 and 2018, respectively. As a result, EU fund absorption rose to nearly EUR 4 billion in 2018. Last year, this was mostly attributable to the capital transfer absorption of the general government, in parallel with which current transfers were also increased, while the absorption of the private sector remained practically unchanged.

Chart 15: Developments in net EU current and capital transfers and the breakdown thereof by sectors



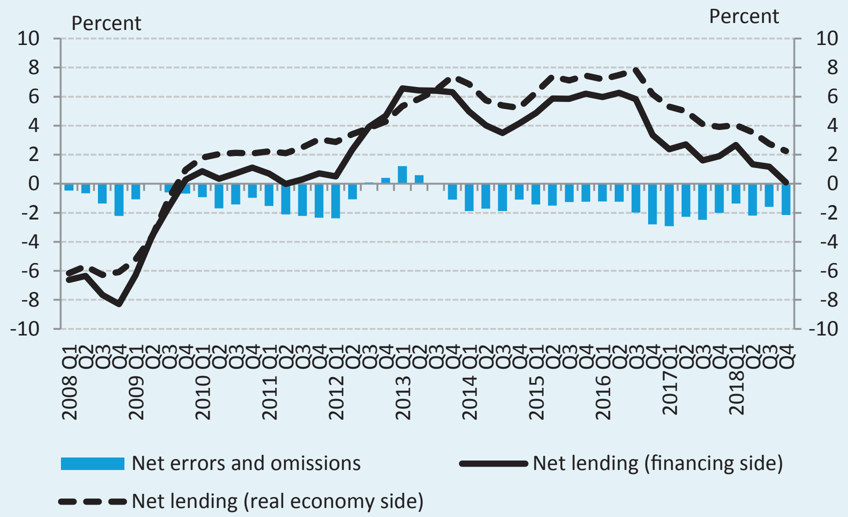
2 Financing approach

In the final quarter of 2018, according to the four-quarter net lending calculated on the basis of financing items, the external position of the economy was close to zero. The decline in the outflow of funds was primarily related to net FDI inflows, which exceeded those of the previous year. In the fourth quarter, the rise in the external funds of the economy was attributable to FDI inflows, while net debt liabilities declined further. The decline in net external debt took place in parallel with a decrease in banks' external liabilities and, in the case of the consolidated general government, a rise in FX reserves.

In 2018 as a whole, the value of fund outflows calculated on the basis of financing items declined to nearly zero, as the expansion in companies' external liabilities was offset by the declining external liabilities of the state and banks. The net lending of the corporate sector took place against the background of accelerating FDI inflows, which also play a role in the dynamic investment growth and rose to nearly EUR 4 billion. The reinvestment of incomes produced by foreign-owned companies played a major role in the increase in corporate funds in 2018 as well. In parallel with the higher FDI inflows, net external debt outflows also accelerated in 2018, amounting to EUR 4.7 billion, which was mainly related to the consolidated general government and banks. The decline in the net external debt of the state is attributable to an increase in FX reserves, which is explained by EU fund inflows. As opposed to the declines observed in previous years, non-residents increased their HUF-denominated government securities holdings in 2018, which contributed in turn to a further reduction in the foreign exchange debts of the state. In 2018, banks' net external debt fell by some EUR 1.5 billion, which was mainly attributable to an expansion in external assets, but was also supported by a modest drop in external liabilities.

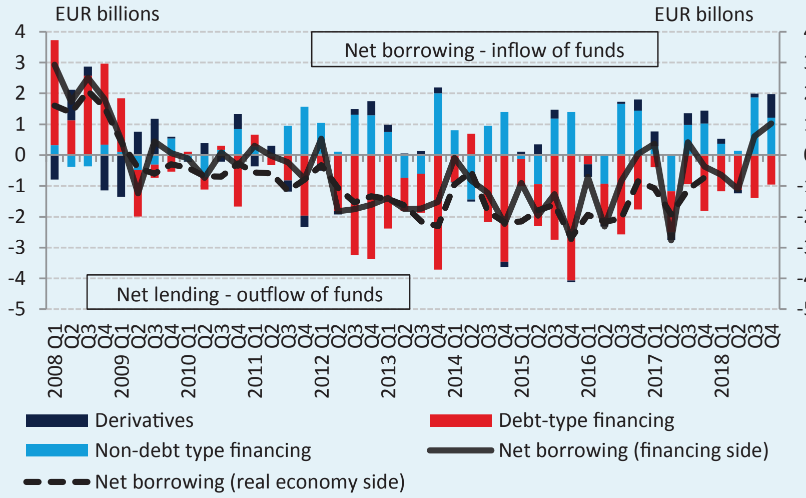
In 2018 Q4, the net lending of the economy according to the financing approach was around 0 percent of GDP. The four-quarter net lending calculated on the basis of real economy data was down to 2.2 percent of GDP, in line with which the indicator calculated from the financing side also declined, and amounted to 0.1 percent of GDP (Chart 16). This means that – in spite of the net lending, which is significant according to the real economy indicator – the country's external funds on the basis of transactions did not change. The difference between the two indicators, i.e. the balance of net errors and omissions, was around 2 percent of GDP, which corresponds to the average of the previous years, and remained within the band typical for the countries in the region (for more details, see Section 5).

Chart 16: Developments in the two types of net lending (four-quarter data as a percentage of GDP)



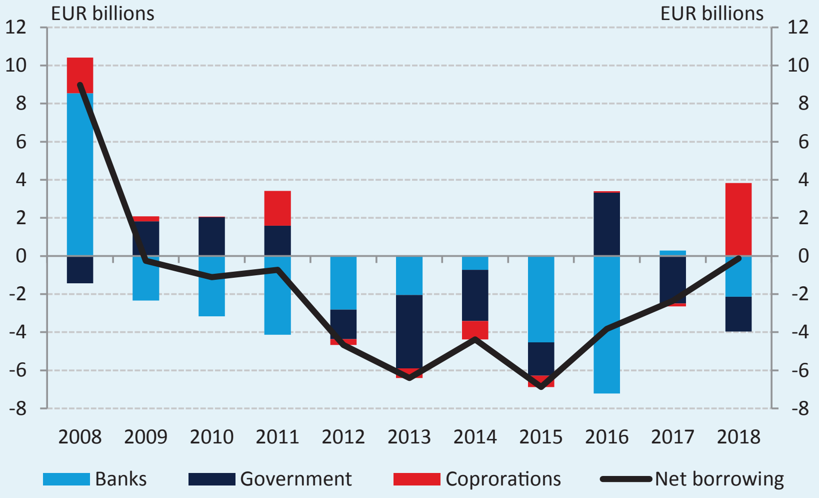
The net borrowing of the economy increased further at end-2018, against the background of outflows of debt liabilities and inflows of non-debt liabilities. Debt liabilities declined by roughly EUR 1 billion in Q4, which was related to the state and the banking sector, and was reflected both in the drop in the country's external debt and in the expansion in external assets (primarily FX reserves). By contrast, the external non-debt liabilities of the economy rose by more than EUR 1 billion in Q4, mainly due to foreign direct investment. On the whole, the net borrowing of the economy was around EUR 1 billion in Q4 (Chart 17).

Chart 17: Structure of external financing (unadjusted transactions)



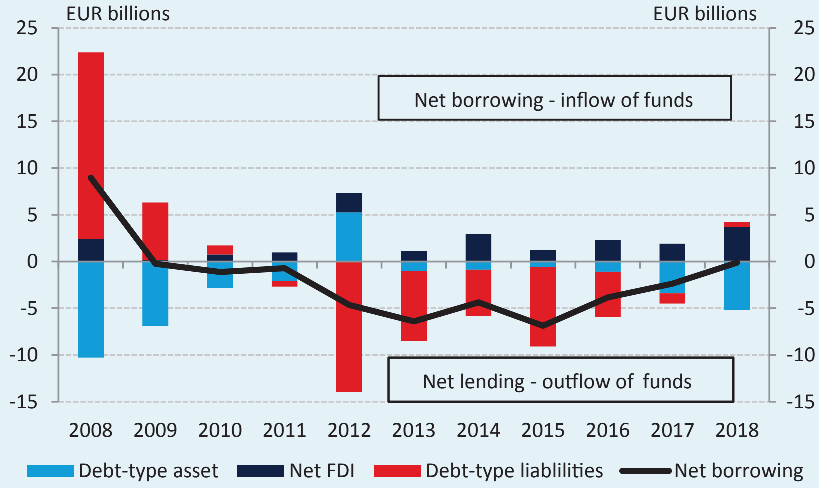
In 2018, the external position of around zero calculated from the financing side evolved against the background of an increase in the external liabilities of companies and a decline in the net external liabilities of the general government and banks. In line with the deleveraging seen in past years, the external liabilities of the economy had declined gradually since the crisis (Chart 18). In 2018, in parallel with dynamic investment growth, the decline in external liabilities decelerated and the net external position of the economy according to financing items was balanced. This occurred because, as opposed to the declining external liabilities in previous years, some of the funds necessary for the investment growth in the corporate sector came from external financing (and within that mainly from a rise in FDI), while the general government and banks continued to reduce the value of their net external liabilities.

Chart 18: Net inflow of funds by sector



In 2018, in parallel with a further decline in net lending, net outflows of debt liabilities and inflows of net foreign direct investment accelerated (Chart 19). In 2018, the economy's debt liabilities dropped by some EUR 4.7 billion, exceeding the value recorded in the previous year. In contrast to previous years, the fall in net external debt resulted exclusively from an expansion in external assets, while the slight increase in external liabilities had an opposite effect. In 2018, in line with the corporate sector's expanding external liabilities, FDI inflows rose to EUR 3.7 billion, considerably exceeding the values observed in the previous years.

Chart 19: Developments in foreign direct investment and debt liabilities*



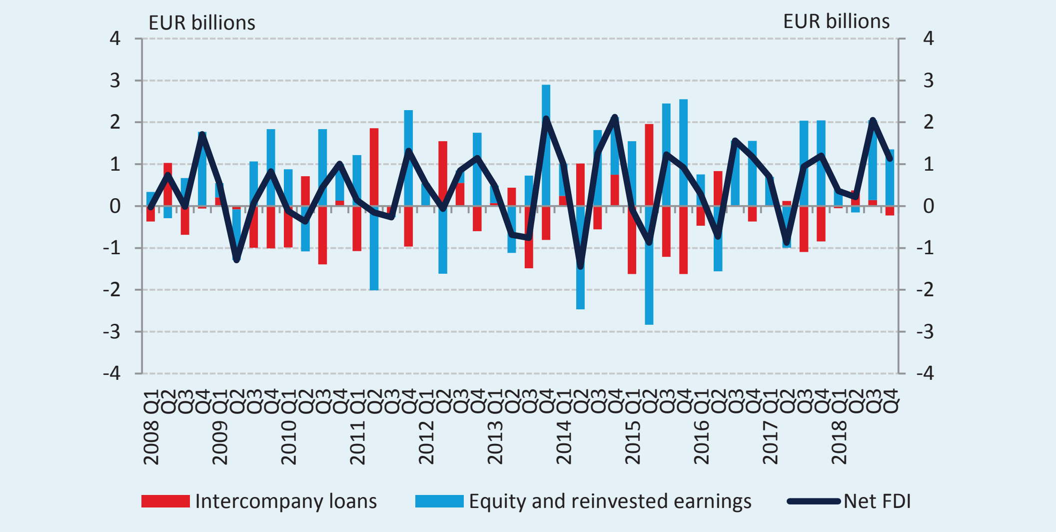
** In addition to the components presented on the chart, the net borrowing also includes the equity transactions of portfolio investments and transactions associated with derivatives.*

2.1 Non-debt liabilities

In recent years, it was mainly the increase in reinvestments that contributed to the rise in net foreign direct investment, while intercompany loans decreased (Chart 20). Instead of the seasonally-expected decline, net FDI inflows expanded again in 2018 H1 and then accelerated in H2, which was primarily attributable to foreign-owned companies' reinvestments. Following the crisis, in terms of the structure of foreign direct investment, the changes in equities and intercompany loans often offset one another, which was reflected in the significant slowdown in net FDI inflows.[3] In the past few years, the inflow of reinvestment type funds accelerated, while equities and intercompany loans continued to decrease. The decline in equities is partly explained by the reducing effect of acquisitions by the state (MOL, E-On, Antenna Hungária Zrt., Főgáz, Budapest Bank, ÉGÁZ-DÉGÁZ Földgázelosztó Zrt.), while the decrease in intercompany loans may have been related to the balance sheet adjustment of the corporate sector (entailing the repayment of domestic and foreign loans). The decline in intercompany loans slowed down in 2018. The major expansion in reinvestments continued in Q4, while equities and loans within groups of companies were slightly down. The considerable increase in domestic companies' investment abroad contributed to the decline in net FDI. Non-debt financing other than FDI, i.e. net portfolio equity investment, was not significant in 2018.

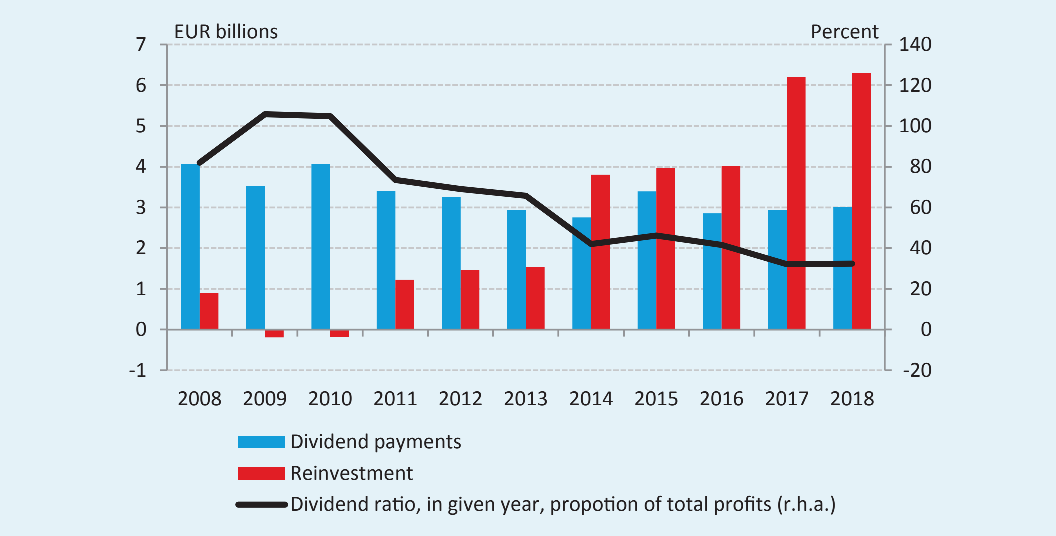
[3] In 2018, the total value of capital in transit transactions was insignificant, amounting to just EUR 0.1 billion. Consequently, there was no major difference between the underlying developments and the capital movements that also contain the capital in transit transactions.

Chart 20: Developments in net direct investment (net of capital in transit)



With the profitability of foreign-owned companies remaining high, reinvested earnings continued to exceed EUR 6 billion, contributing significantly to the expansion in foreign direct investment. Foreign-owned companies' profitability was close to the high level of the previous year in 2018 again, and amounted to EUR 9.3 billion.[4] As the dividend disbursement-to-profit ratio was still at around 30 percent, i.e. at a level that is low in a regional comparison (for more details, see Section 5.6 in the October 2018 Report on the Balance of Payments), reinvestment of the incomes shown in the balance of payments statistics continued to contribute significantly to the inflow of foreign direct investment (Chart 21).

Chart 21: Distribution of profits generated by foreign-owned companies in Hungary



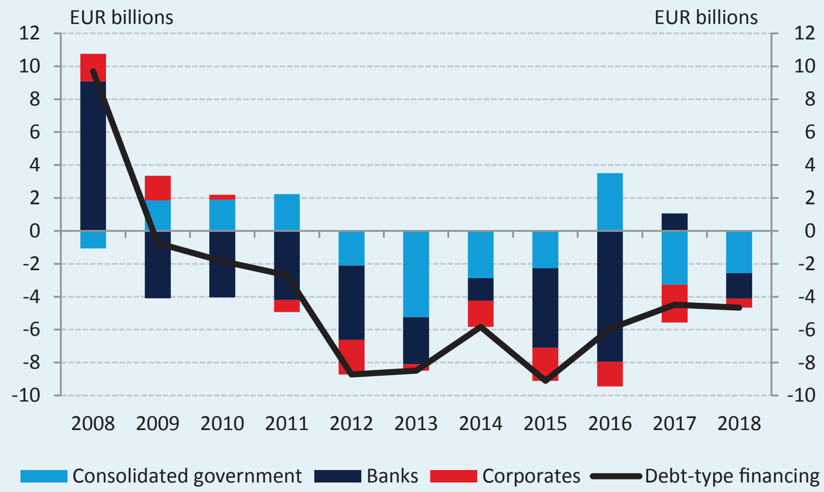
2.2 Debt liabilities

Based on transactions, the net external debt of the economy declined by EUR 1 billion in Q4 and by nearly EUR 5 billion for the year as a whole, with major contributions from the general government and the banking sector in both periods (Chart 22). In 2018, the adjustment of the economy related to external debt accelerated slightly: the decline of roughly EUR 4.7 billion in net external debt as a result of transactions slightly exceeded the value recorded in the previous year.

[4] Profit of foreign owned companies, as well as the reinvested income shown in the income balance are based on an estimate for 2018, which will be replaced by actual figures based on corporate surveys together with the publication in September 2019.

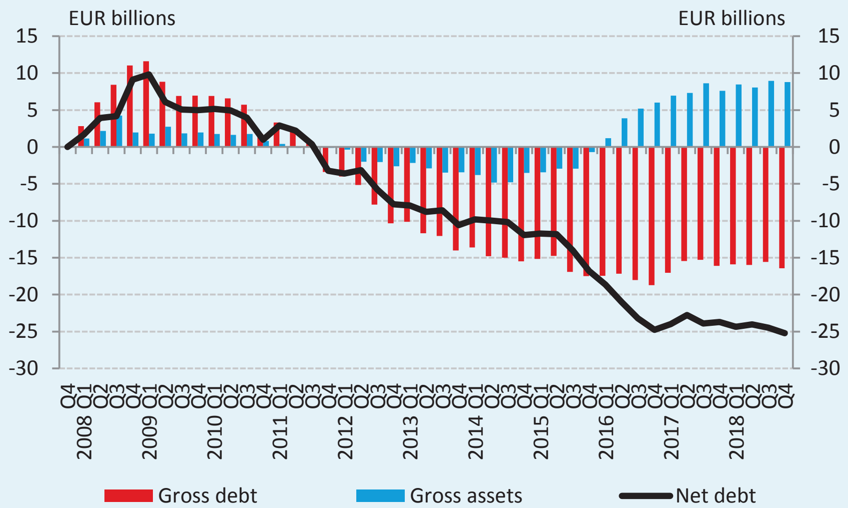
However, the structure of the decline in external debt changed significantly compared to the previous year. In 2017, the banking sector's net external debt grew, while that of the consolidated general government declined, with the contribution from the central bank's forint liquidity providing fine-tuning swap facility. In 2018, however, all of the three sectors contributed to the decline in net external debt: in the case of the general government it was mostly the absorption of EU transfers, whereas in the case of the banking sector and the corporate sector it was the expansion in external assets that reduced external indebtedness. In Q4, the general government and the banking sector reduced net external debt nearly to the same degree, while companies increased net external debt to a lesser extent than that.

Chart 22: Changes in the debt liabilities of individual sectors (annual transactions)



In 2018, the net external debt of the banking sector declined considerably: to a lesser extent, this resulted from a decrease in gross external debt and to a greater extent from an expansion in external assets (Chart 23). In 2018 Q1 and Q3, as a result of transactions, the FX deposits of the corporate sector increased significantly, which was reflected in an expansion in banks' external assets. In Q4, however, banks' external assets declined slightly, while banks' gross external debt fell considerably, dropping by nearly EUR 0.9 billion: on the whole, this resulted in a decline in net external debt of more than EUR 0.7 billion. The fall in liabilities affected short-term external liabilities exclusively, suggesting year-end balance sheet optimisation by banks. Looking at the year as a whole, the banking sector's gross external debt was down by EUR 0.3 billion, while external assets expanded by EUR 1.2 billion. As a result, banks' net external debt declined by some EUR 1.5 billion.

Chart 23: Developments in the banking sector's external debt and receivable transactions (cumulative transactions)



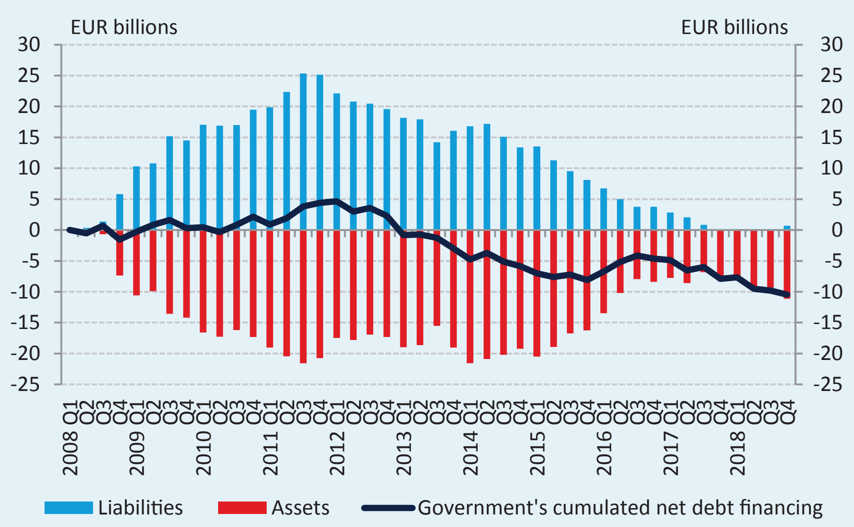
In line with the rise in FX reserves, the net external debt of the consolidated general government including the MNB declined by EUR 0.7 billion in Q4, while the gross external liabilities of the state increased. The government's external debt was influenced by the following key items.

- The absorption of EU transfers significantly reduced net external debt for the year as a whole and particularly in Q4. In addition to absorption, the EU transferred considerable amounts of funds as well at the end of the year, resulting in an increase of more than EUR 3.3 billion in FX reserves, while receivables of the general government from the EU declined.

- In Q4, the net external debt of the state rose as non-residents' boosted their government securities holdings by nearly EUR 0.9 billion, which primarily involved HUF-denominated government securities.

Accordingly, the decline in the net external liabilities of the state resulted from the significant increase in FX reserves, a decrease in receivables from the EU and a rise in gross debt liabilities (Chart 24).

Chart 24: Breakdown of the change in the net external debt of the consolidated general government including the MNB (cumulative transactions)



The net external debt of non-financial corporations increased slightly in 2018 Q4, which was mainly attributable to a decline in commercial credit claims vis-à-vis the rest of the world. At an annual level, corporations' net external debt declined significantly, which – as in the previous year – was mainly the result of an expansion in external assets, while external liabilities stagnated. Since 2015, liabilities increased by a mere EUR 0.5 billion, while external assets rose by more than EUR 5 billion. In 2018, the net external debt of the corporate sector fell by a total of almost EUR 0.5 billion.

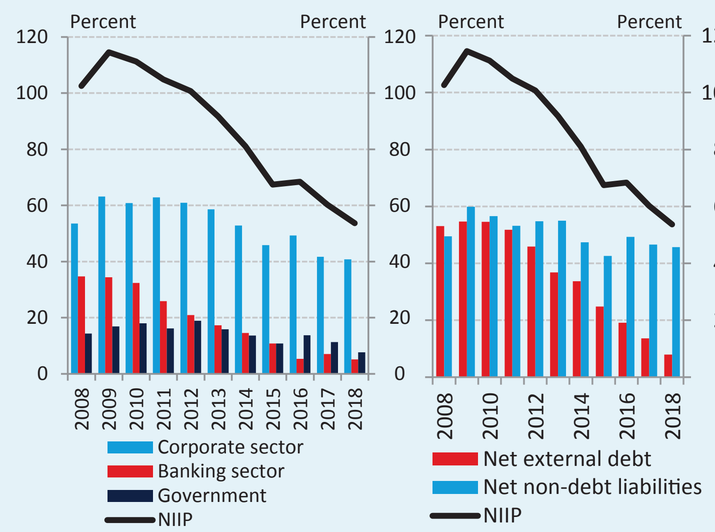
3 Developments in debt ratios

By end-2018, external debt indicators sank to historical lows, resulting in a further decline in the external vulnerability of the economy. The decline in net external liabilities stemmed from a decrease in non-debt liabilities and net external debt. Net external debt fell to 8 percent of GDP, while gross external debt declined to below 57 percent, mainly due to outflow of funds as well as, to a lesser extent, nominal GDP growth and higher yields. In 2018, the general government was the main contributor to the decline in net external debt primarily due to the increase in FX reserves, but indicators for the banking and corporate sectors also declined. As in the case of the general government, the main factor behind the lower net external debt indicator for the banking sector was also the expansion in external assets. In connection with that, gross external debt fell to a lesser degree than net debt in 2018. Short-term external debt based on residual maturity, which is monitored in terms of the country's external vulnerability in particular, amounted to EUR 17 billion at end-2018, with the banking sector's indicator dropping to a historical low. Simultaneously with that, the international reserves of the MNB increased significantly. As a result, at end-2018 the reserves considerably exceeded (by more than EUR 10 billion) the level expected by investors.

3.1 Net external liabilities

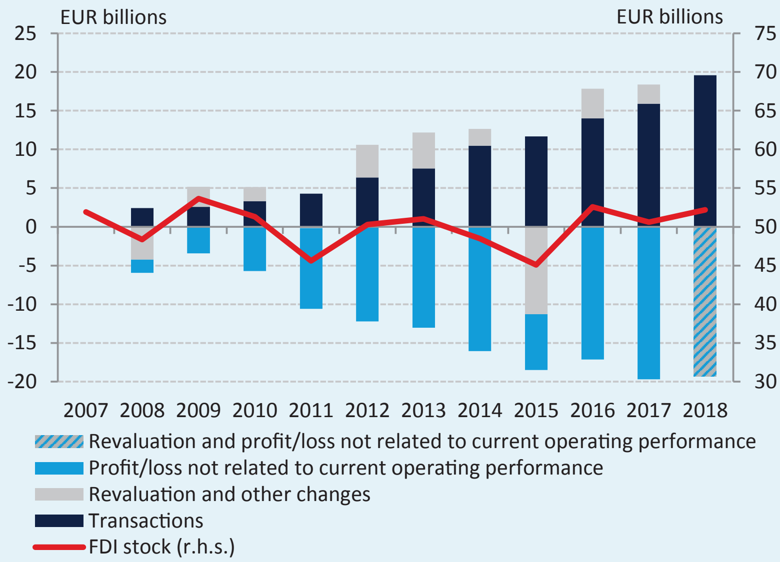
Hungary's net external liabilities continued to contract in 2018, driven by the decrease in both debt liabilities and non-debt liabilities (Chart 25). The net external liabilities of the Hungarian economy – which also contain external debt and non-debt liabilities (foreign direct investment, portfolio equity and derivative liabilities) – fell from the historical high of 115 percent of GDP at end-2009 to 54 percent of GDP by end-2018. The decrease in Hungary's net external liabilities since the crisis – as a result of a significant rise in foreign direct investment – was temporarily interrupted in 2016, but then continued in 2017 and 2018. In 2018, both debt liabilities and non-debt liabilities declined, resulting in a reduction of 6.5 percentage point of GDP in net liabilities. The decline involved all the three sectors, but it was the government that reduced its net liabilities to the greatest extent.

Chart 25: Developments in net external liabilities (period-end values as a percentage of GDP)



Hungary's net FDI stock increased slightly in 2018, owing to FDI inflows being partly offset by the revaluation and companies' losses not related to current operating performance (Chart 26). There was an inflow of foreign direct investment transactions in the past years, but in comparison the net FDI stock of non-residents rose to a smaller degree. The underlying causes of this mainly included losses not linked to the normal course of business and the change in the portfolio resulting from revaluation. Between 2008 and 2018, these items reduced the foreign direct investment portfolio by almost EUR 19 billion in total (for more details on the extraordinary profit/loss, see the October 2018 Report on the Balance of Payments).

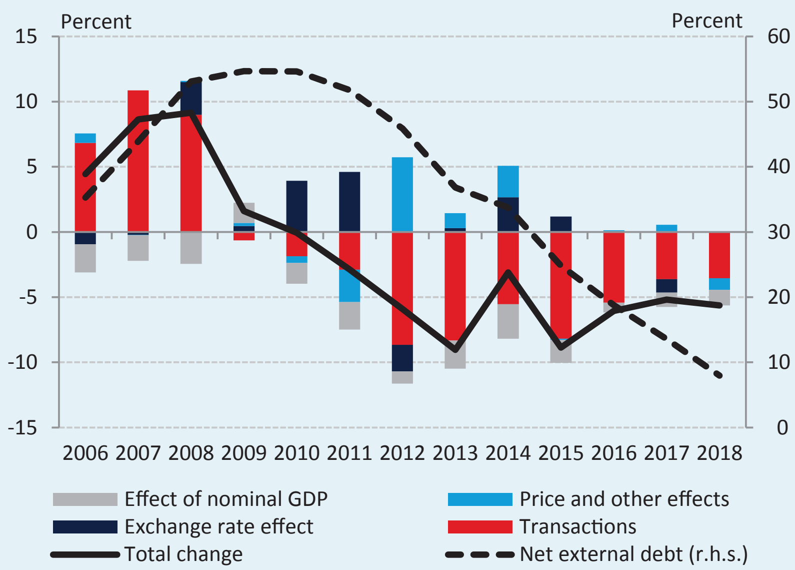
Chart 26: Decomposition of the change in net FDI stock (cumulative transactions and stock)



3.2 Net external debt

In 2018, the further decline in net external debt was mainly linked to transactions, but the expansion in GDP and a rise in yields also contributed to this (Chart 27). The decline in the debt ratio in recent years was primarily driven by the outflow of debt liabilities. After the outbreak of the crisis, the adjustment of net external debt was curbed by the decline in nominal GDP in 2009, and later on by the depreciation of the forint. Hence, adjustment of the debt overhang observed in the pre-crisis years could start only from 2011: in connection with the outflow of debt liabilities, net external debt fell by more than 45 percentage points, which was also supported to a smaller degree by the increase in nominal GDP. In 2018, Hungary's net external debt contracted by 5.6 percentage points, mainly due to the outflow of debt liabilities and GDP growth, and to a lesser degree owing to government securities holdings, the market value of which was declining as a result of the rise in yields.

Chart 27: Decomposition of the change in net external debt (as a percentage of GDP)



At end-2018, net external debt amounted to 8 percent of GDP, after falling by 5.6 percentage points compared to the end of the previous year (Chart 28). The improvement in the debt indicator was mainly related to the general government and to a lesser degree to the banking sector and corporations. The expansion in external assets played a stronger role in reducing the net external debt of the banking sector (Chart 29), but external liabilities also fell, as a result of which the net external debt of banks decreased by more than 1 percent of GDP, i.e. its value became even more negative. The net external debt of the general government declined by 4 percent of GDP during 2018, which was primarily the result of the rise in FX reserves. Non-financial corporations' net external debt was down slightly in 2018. On the whole, net external debt fell to 8 percent of GDP by the end of the year, the lowest level for this indicator to date.

Chart 28: Breakdown of net external debt by sectors (as a percentage of GDP, excluding intercompany loans)

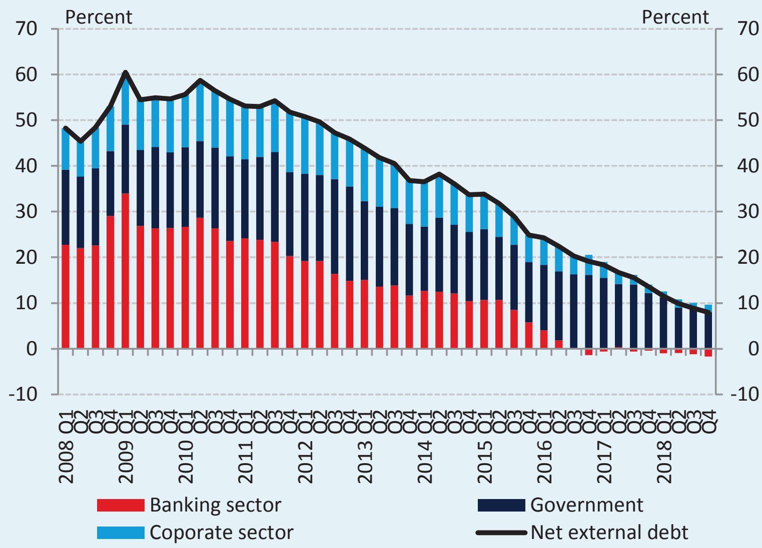
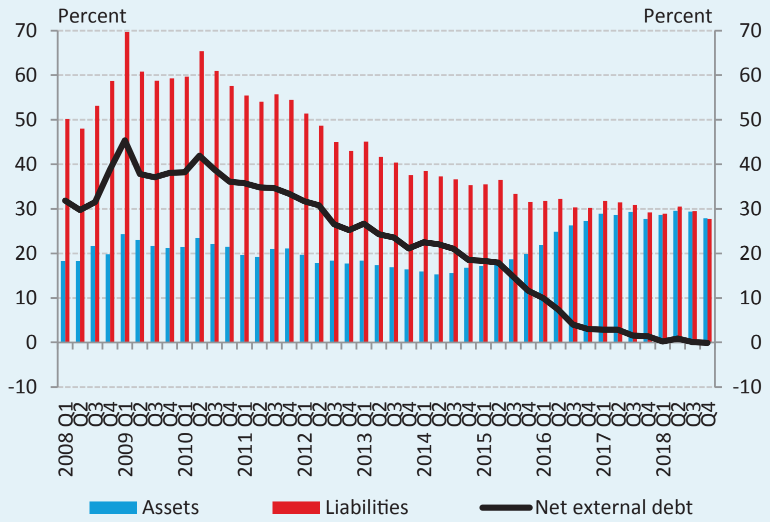


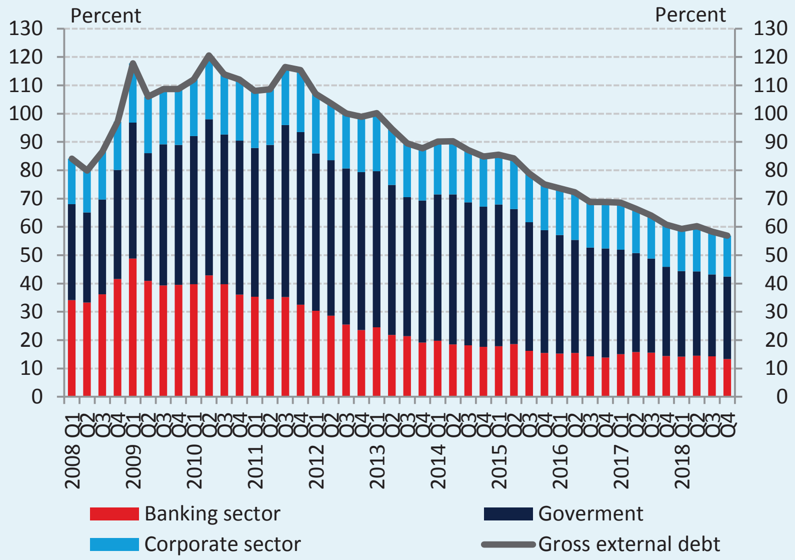
Chart 29: Developments in the private sector's external assets and debt (as a percentage of GDP)



3.3 Gross external debt

As a result of a reduction in banks' liabilities, Hungary's gross external debt declined further, falling by an annual 4 percentage points to below 57 percent of GDP (Chart 30). The annual 4-percent fall in the gross external debt indicator is mainly related to the government, but banks' gross debt also declined to some extent. The improvement in the indicator was primarily attributable to economic growth, while the stock stated in euros contracted only slightly. In 2018, the decline in gross external debt fell short of that of net debt, which is attributable to the rise of nearly EUR 5 billion in external assets, mainly as a result of EU fund inflows to FX reserves. In Q4, gross external debt dropped by 1.4 percent of GDP. This drop was mainly attributable to the (transaction-related) decline in banks' debt, which was strongly reflected in lower short-term liabilities. To a very small degree, the corporate sector also contributed to the decline in the indicator. By contrast, liabilities of the general government continued to increase in connection with purchases of HUF-denominated government securities by non-residents. However, the impact of this was strongly mitigated by GDP growth, and thus the debt-to-GDP ratio for the sector rose only slightly.

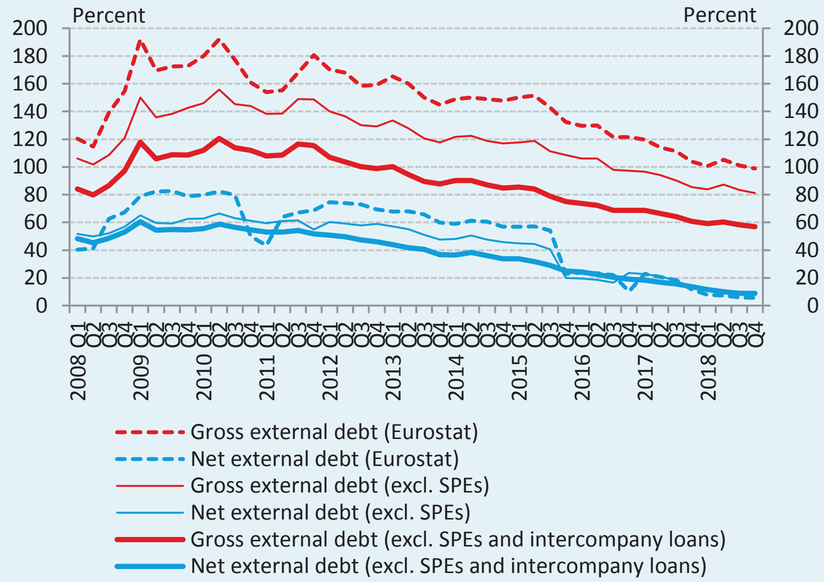
Chart 30: Breakdown of gross external debt by sector (market value as a percentage of GDP, excluding intercompany loans)



Box 2: Changes in external debt from various points of view

While net external debt is at a low level irrespective of SPEs and intercompany loans, the underlying development of gross debt still falls short of the indicator that takes into account the SPEs and intercompany loans. Based on economic considerations, the MNB's analyses and publications analyse the debt indicators excluding SPEs (special purpose entities) and intercompany loans. However, in the Eurostat database only indicators calculated together with these factors are available at the international level. SPEs do not perform genuine real economy activity in the given country, and they typically have less than 5 employees. Their activity typically does not have an impact on the net external liabilities of the country, as in parallel with their liabilities they have external assets of the same value as well, and thus they only influence the gross debt indicators significantly. Based on their fundamentals, intercompany loans are considered as non-debt liabilities (for more details see the April 2014 Report on the Balance of Payments). In line with this, balance of payments statistics show intercompany loans among foreign direct investments. In accordance with the net external debt according to underlying trends, net external debt including SPEs and intercompany loans also declined to a similar level, i.e. below 10 percent of GDP in the past years. By contrast, there are considerable differences between the levels of gross indicators according to the individual methodologies, whereas in terms of dynamics all three reflect a major decline in gross external debt (Chart 31).

Chart 31: Developments in net and gross external debt (as a percentage of GDP)

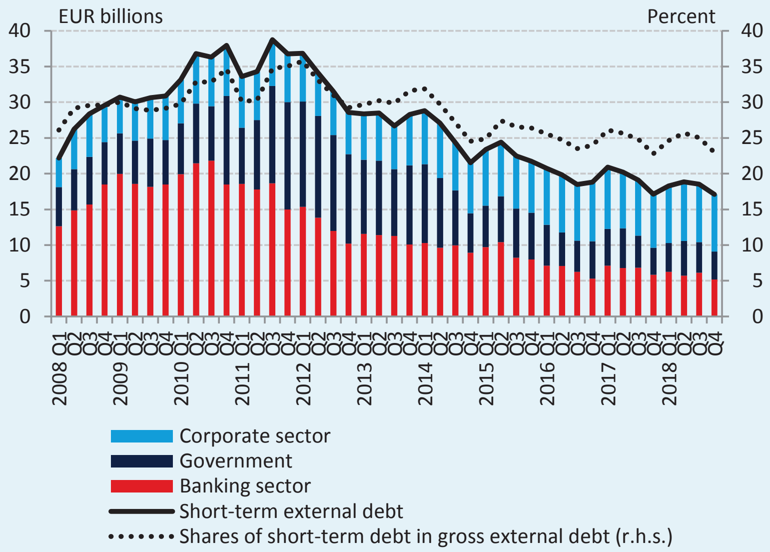


Sources: Eurostat, MNB.

3.4 Short-term external debt and gross financing need

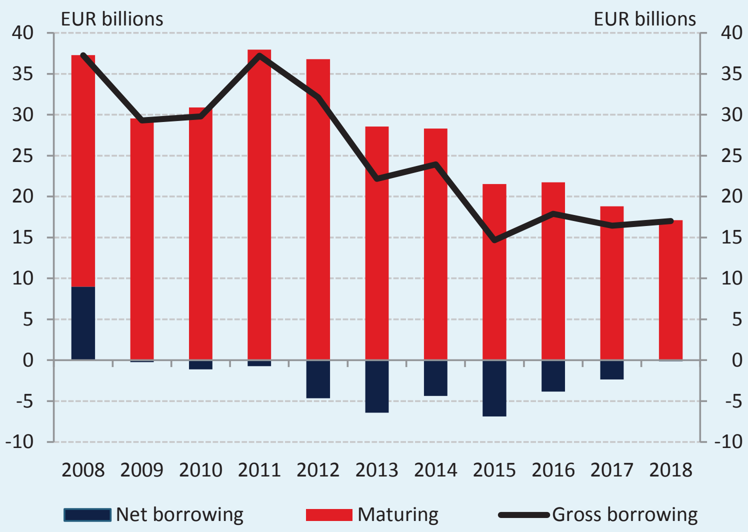
Hungary's short-term external debt declined further in 2018, sinking to nearly EUR 17 billion by the end of the year (Chart 32). The indicator fell EUR 1.4 billion in Q4, mostly due to agents in the banking sector. Simultaneously with that, in addition to the decrease of EUR 350 million in the case of the general government, the short-term external debt of corporations also declined by EUR 110 million. By end-2018, the short-term external debt of the banking sector was at a historical low of EUR 5.2 billion, owing to banks' balance sheet optimisation at the end of the year and other banking developments. In the case of the general government, the decline is explained by the decrease in the shortening stock, which is attributable to both bond maturities and bond sales; its impact was attenuated to some extent by a rise in short-term external debt according to original maturity. On the whole, the decline in short-term external debt at end-2018 close to the previous historical low is favourable in terms of the investor assessment and external vulnerability of the economy.

Chart 32: Developments in short-term external debt based on residual maturity



Following a slight increase, Hungary's gross financing need amounted to EUR 17 billion in 2018. Short-term external debt at end-December 2017 amounted to EUR 17.1 billion, i.e. the external debt maturing in 2018 was approximately EUR 1.7 billion lower than the level at the end of the previous year (Chart 33). Net lending, which shows the country's financing need and is calculated from the items of the financial account, declined to a greater degree, dropping by EUR 2.2 billion in 2018. Accordingly, the financing need, which is the difference between the two indicators and shows the value of a country's external liabilities to be renewed in a given year, rose slightly to EUR 17 billion.

Chart 33: Developments in the gross financing need



3.5 Reserve adequacy

In 2018 Q4, the level of international reserves rose, primarily as a result of the EU transfers received from the European Commission, the revaluation of foreign currency assets other than the euro and the revaluation of the EUR-denominated price of gold. At the end of 2018, the international reserves of the MNB amounted to EUR 27.4 billion, representing an increase of EUR 3.7 billion compared to the level recorded at the end of Q3. Changes in the reserves were influenced by a number of factors, most importantly, the following:

- *European Union funds* boosted the reserves by EUR 3.2 billion, consisting predominantly of the European Commission's payment of performance-based invoices under the 2014–2020 programming period and, to a lesser degree, the settlement of a significant portion of the financial part remaining from the 2007–2013 period.

- *A payment flow* of around EUR 600 million in relation to the *MNB's derivative transactions* and the almost EUR 100 million increase in the *foreign currency deposits of Hungarian credit institutions* also raised the level of the reserves.

- The *revaluation* of other currencies appreciating against the euro and the *revaluation* of the EUR-denominated price of gold boosted the reserves by nearly EUR 350 million. In October 2018, the MNB purchased gold. As the foreign exchange reserve, *monetary gold* is also part of the international reserves, and the purchase transaction increased bullion holdings to 31.5 tons from 3.1 tons.

- The level of reserves was raised by around EUR 110 million by the *net foreign currency financing of the Government Debt Management Agency (ÁKK),* which was the combined result of several items of diverging directions during the quarter. In early October, the ÁKK issued new eurobonds with a maturity of 7 years in the amount of EUR 1 billion, at an annual interest rate of 1.25 percent. From the proceeds, it refinanced prior to their maturity EUR 900 million worth of foreign currency bonds exchangeable for Richter stock issued by the Hungarian State Holding Company. With this move, the ÁKK supported the reduction of the foreign currency debt ratio. In December, Hungary issued foreign currency bonds targeted at the Chinese onshore market in an amount of RMB 2 billion (around EUR 260 million) under the RMB 3 billion Panda Bond Programme. The reserves were reduced by the expiry of the first series of residency bonds by more than EUR 100 million and by another EUR 100 million through the year-end redemption of eurobonds maturing in January 2019. Premium Euro Hungarian Government Securities (PEMÁP) retail sales partly offset the foreign currency amounts allocated to repay foreign currency loans.

- *Other foreign currency expenditures of the ÁKK and the Hungarian State Treasury (MÁK)* lowered the level of reserves by almost EUR 700 million.

In 2018 as a whole, the international reserves of the MNB rose by EUR 4 billion. The reserve-boosting effect of EU transfers and the liquidity providing foreign exchange swap instrument were only partly offset by other factors. By the end of 2018, the MNB's international reserves rose to EUR 27.4 billion from EUR 23.4 billion registered in December 2017, mainly as a result of the following factors:

- Foreign exchange reserves were boosted by the net annual *transfers from the European Commission*, which amounted to more than EUR 4.6 billion thanks to the year-end concentration of the transfers.

- In 2018 Q2, the reserve-increasing effect of the *forint liquidity providing FX swap instrument* announced from mid-October 2016 added EUR 1.3 billion to the reserves. In line with the MNB’s monetary policy stance, the foreign exchange swap portfolio was subsequently maintained at a stable level.

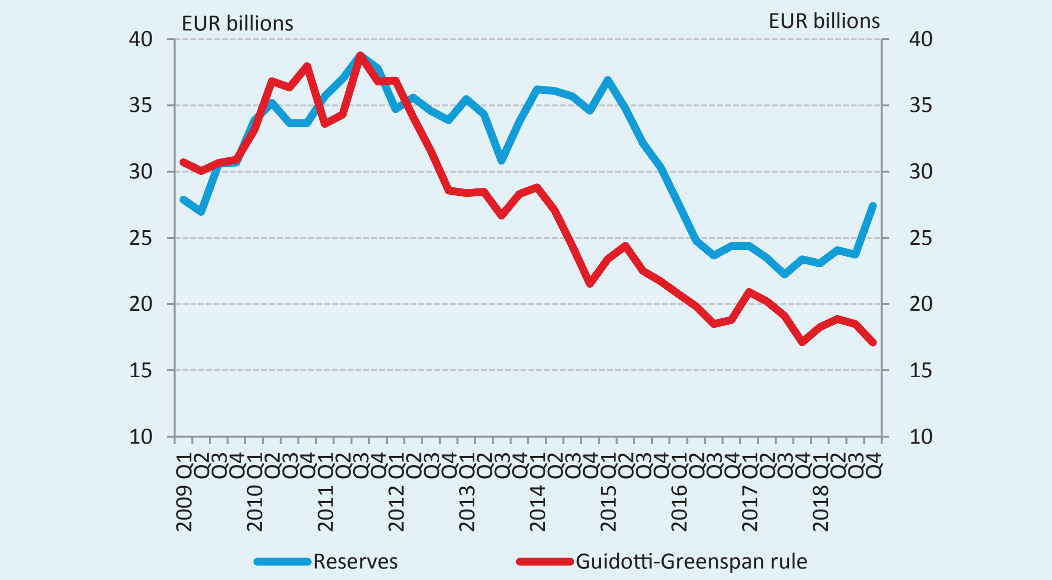
- *Net financial flows linked to the MNB’s derivative transactions and the foreign currency deposits of Hungarian credit institutions placed with the MNB* raised the level of international reserves by around EUR 700 million, and the *revaluation* of currencies other than the euro and of the EUR-denominated price of gold added EUR 500 million to the MNB’s international reserve holdings.

- *Items related to the repayment of public debt,* especially the public sector’s net foreign currency interest expenditures and the *ÁKK’s net foreign currency financing* reduced the reserves by around EUR 3 billion in total. The latter includes, in addition to the abovementioned items falling due in Q4, USD and eurobonds maturing mainly in the first half of the year and, in Q3, the instalments of loans under the credit line granted by the European Council’s Development Bank and instalments of the EIB loans covering co-financing for grants received under the Structural Fund in the 2004–2006 and 2007–2013 programming periods.

- As a result of raising the gold reserves in October 2018, the EUR-denominated value of *monetary gold* within the international reserves rose by around EUR 1 billion in 2018 as a whole.

As a result of the significant decline in short-term external debt and the substantial increase in the reserves, at the end of 2018 the MNB’s international reserves exceeded the level expected by investors by more than EUR 10 billion. In consideration of the Guidotti-Greenspan rule – which is closely followed both by the central bank and investors – the international reserves of EUR 27.4 billion recorded at the end of 2018 significantly exceed the volume of short-term external debt, which stands at EUR 17.1 billion. The changes in the reserves in 2018 Q4 were mainly influenced by the European Commission’s EU transfers concentrated at the end of the year, the MNB’s derivative transactions and the revaluation. The reserve-increasing effect of these items was offset mainly by the foreign currency expenditures of the ÁKK and MÁK. The decline in short-term external debt can be attributed primarily to the decrease in banking sector debt, but by the end of the year the general government and corporations also cut their short-term external debt compared to the end of September 2018. Accordingly, in 2018 Q4 the reserve adequacy in proportion to short-term external debt improved by EUR 4.7 billion, and thus the margin above the Guidotti-Greenspan indicator exceeded EUR 10 billion at the end of the year, which continues to represent a safe level (Chart 34).

Chart 34: Short-term external debt of the Hungarian economy and international reserves

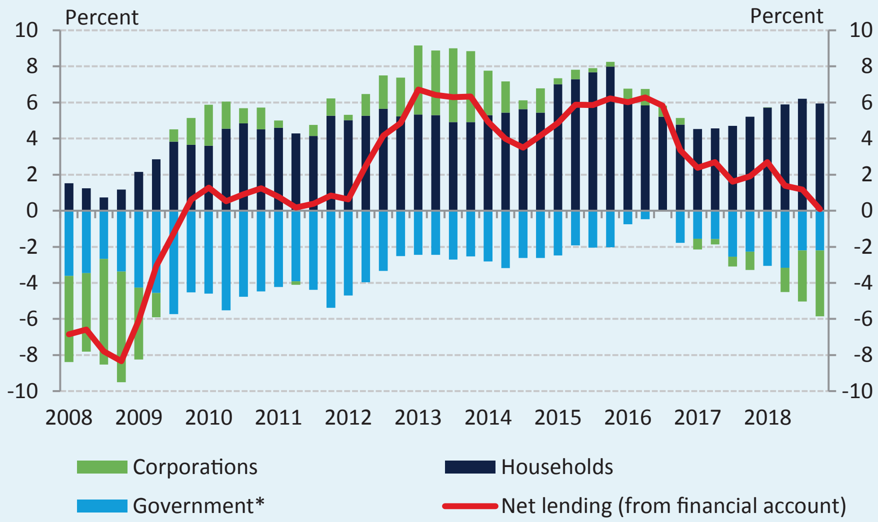


4 Sectors' savings approach

The main contributor to the decline in net lending in 2018 was the contraction in the net financial savings of the corporate sector, while the net borrowing of the general government remained at a level similar to last year and households' financial savings increased in year-on-year terms. At the same time, the net borrowing of the corporate sector increased with a parallel, minor decline in households' net lending in Q4. The continuous rise in companies' investment activity and the upswing in households' appetite to borrow made an important contribution to the decline in the private sector's net lending. As a combined result of tax expenditures and tax revenues significantly exceeding the appropriations, the general government's net borrowing stabilised at around 2 percent of GDP.

Against the backdrop of lower household savings and higher net borrowing by the corporate sector, the Hungarian economy's net lending amounted to around zero in 2018 Q4 (Chart 35). The change in the financial savings of the individual sectors is ultimately reflected in external funding, and thus changes in the external balance can also be captured as the sum of the sectors' savings – which corresponds in turn to financing side processes. Based on preliminary data, the annual net borrowing of the consolidated general government remained moderate and was close to the level seen last year. Once again this year, the extremely low budget deficit is attributable to rising tax revenues from higher employment and consumption, and to the continued decline in interest expenses. The contraction in households' net lending reflects the expansion in households' borrowing with a parallel decline in the sector's gross financial savings, which may point to a gradual weakening of precautionary considerations. Mainly as a result of rising investment and, to a lesser degree, declining revenues, the net borrowing of the corporate sector increased continuously.

Chart 35: Net lending of specific sectors (four-quarter values as a percentage of GDP)



** General government represents net borrowing according to the financial accounts. Corporate savings are obtained as a residual.*

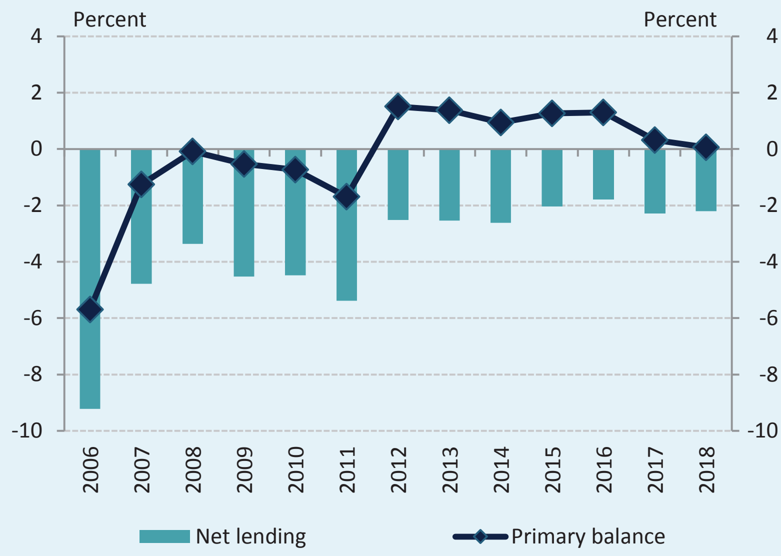
4.1 General government

The general government's net borrowing remained moderate in 2018 as well (Chart 36). Based on the preliminary data from the financial accounts, in 2018 the net borrowing of the general government amounted to 2.2 percent of the gross domestic product, i.e. the budget deficit is around the average of the past six years.[5] Tax revenues increased in excess of the statutory appropriation, which was partly offset by the fact that fiscal expenditures were also above the budgeted figure. In line with the wage agreement concluded in 2016, following the previous, 5-percentage point reduction, the

[5] Data regarding the ESA balance of the budget is not yet available for 2018, but in general, there is only a minor difference between preliminary net lending data calculated according to the financial accounts and the ESA balance.

social contribution tax rate was cut by another 2.5 percentage points in 2018, bringing down the tax rate to 19.5 percent. At the same time, the rise in gross wages and employment partly offset the effect of the tax cut. On the expenditure side, due to the persistently low interest rate environment and the gradual repricing of debt, interest expenses declined further and the GDP-proportionate value of financial transfers also decreased.

Chart 36: Developments in the net lending of the general government (as a percentage of GDP)

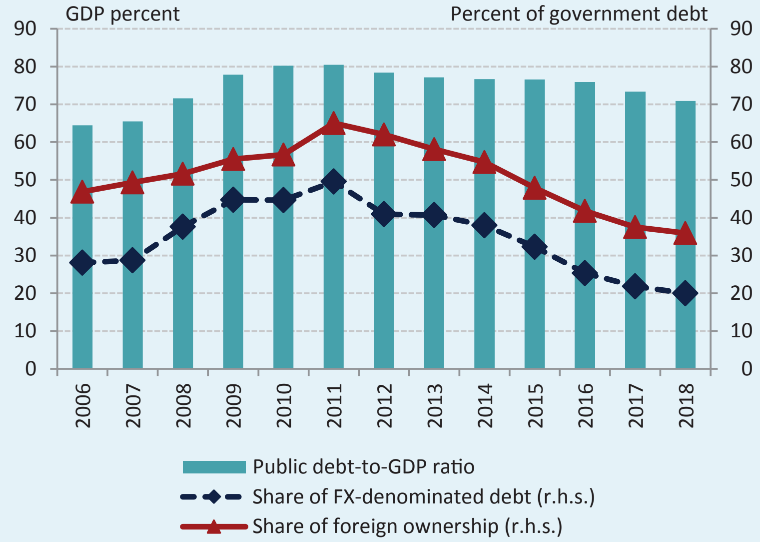


Note: 2018 data based on the preliminary financial accounts of the MNB.
Source: MNB, European Commission.

The trend decline observed since 2011 in gross public debt as a percentage of GDP continued again in 2018 (Chart 37). By the end of 2018, the level of GDP-proportionate public debt fell to 70.9 percent, which represents a 2.5-percentage point decrease compared to the figure recorded at the end of 2017. In addition to dynamic economic growth, the low level of net borrowing also contributed to the decline. The required net issue of debt was also moderated by the fact that, contrary to the previous practice, some unused budgetary expenditures did not leave the State Treasury accounts. EU advances for market participants belonging to the sub-systems of the general government were transferred to the payment accounts held with the Hungarian State Treasury, and participants were required to transfer any previously transferred but so far unused EU advances over HUF 50 million to these accounts by 30 September 2018.

The drop in the foreign currency ratio and the contraction in non-resident holdings within public debt supported the reduction of external vulnerability. One of the key objectives of the public debt management strategy is to strengthen internal financing, which was also supported by the central bank's self-financing programme. As a result, the proportion of non-residents' holdings within government debt decreased sharply, dropping from 65 percent at the end of 2011 to the vicinity of 35 percent by the end of 2018. Meanwhile, the foreign currency ratio within general government debt fell to 20 percent from its historic high of 50 percent recorded at the end of 2011. The trend decline in non-resident holdings and the foreign currency ratio make a considerable contribution to the continuous reduction of external vulnerability and the upgrading of Hungary's credit rating.

Chart 37: Developments in gross public debt, the proportion of non-resident holdings and foreign currencies



Note: Ratio of non-resident holdings based on nominal value; the 2018 value is an MNB estimate.
Source: ÁKK, MNB

Households' holdings of government securities continue to grow at a fast pace. In 2018, households' holdings of government securities rose by more than HUF 750 billion to reach HUF 5,800 billion by the end of the year (Chart 38). As a result, households directly hold almost 20 percent of the securities issued by the government (this figure reaches 30 percent when one takes into consideration government securities holdings through mutual funds, insurers and pension funds), which can be deemed high by EU standards. With a view to supporting households' holdings of government securities, in the course of 2018 the Government Debt Management Agency reduced the customer base of retail government securities: from mid-April 2018 only private individuals are eligible to purchase retail government securities in the primary market. As local governments were thus crowded out of the market of retail government bonds, a new scheme – the Hungarian Municipal Government Bond – was made available to local governments.

Against the backdrop of consistently high household participation, the government securities holdings of non-residents increased again in 2018. In 2018, non-residents' Hungarian (FX- and HUF-denominated) government bond holdings rose by HUF 500 billion **(Chart 39)**; as a result, non-residents' share in the total Hungarian government securities portfolio stood at around 35 percent, which roughly corresponds to the value recorded at the end of the previous year. Non-residents' long-term HUF-denominated government securities and short-term government securities rose by HUF 300 billion and nearly HUF 200 billion, respectively, whereas non-residents' holdings of foreign currency bonds fell by almost HUF 300 billion as a result of transactions. The HUF-denominated government securities holdings of the banking sector rose by almost HUF 500 billion. In addition, households also made a stable contribution – close to HUF 800 billion – to the financing of the government from internal funds. The two sectors' strong demand in the government securities market supported the decline in the country's external vulnerability, while non-residents' purchases of forint bonds also contributed to the decline the foreign currency debt ratio.

Chart 38: Government securities holdings of households, banks and non-residents

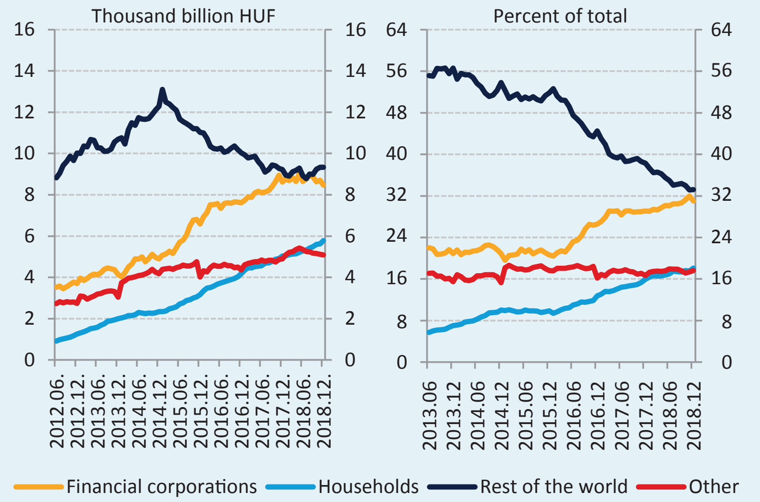
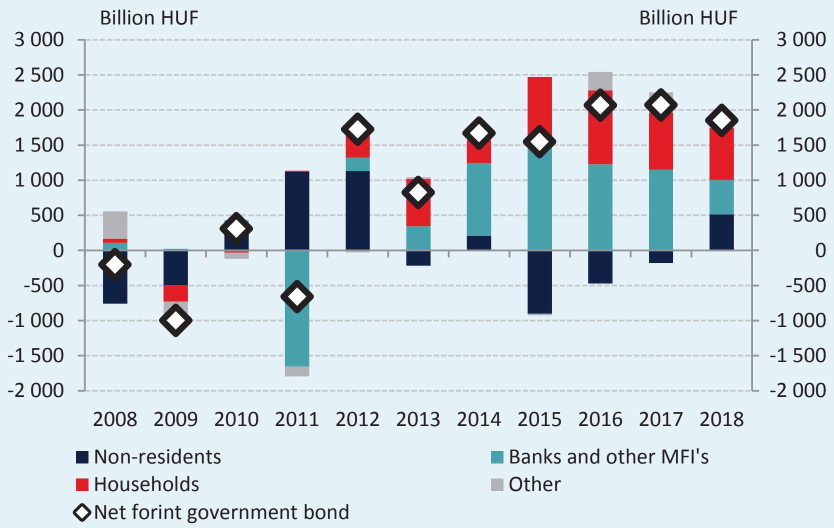


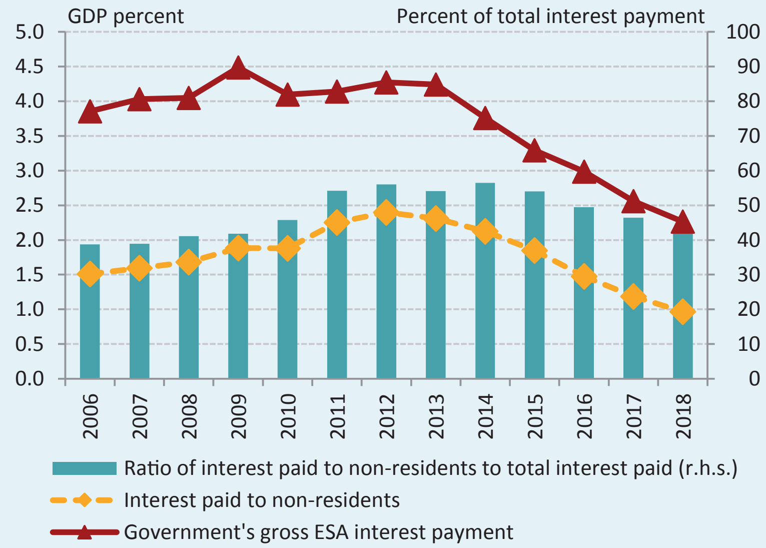
Chart 39: Changes in the forint government securities portfolio by sectors



Despite a moderate increase in the yield of long-term government securities, the government's interest expenditures dropped further. As a result of the continuing low yield environment and the gradual repricing of debt, the general government's GDP-proportionate gross interest expenditures continued to decline in 2018 (Chart 40). Compared to the level of 4.3 percent registered in 2012, the general government's interest expenditures decreased to 2.3 percent of GDP in 2018. The stable macroeconomic situation in Hungary, the central bank's programmes (easing cycles, self-financing programme, transformation of monetary policy instruments), the upgrades of Hungary's credit rating and the supportive international environment all contributed to the decrease in gross interest expenditures. By the end of the year, the yield on 10-year government bonds dropped to the vicinity of 3 percent, while that on 5-year bonds rose to 2.5 percent. At the same time, the yield on 3-month and 12-month discount T-bills hovered around zero in 2018.

In 2018, government interest paid to non-residents fell to 1.0 percent of GDP. In terms of the income balance of the balance of payments it should be noted that, in line with the decline in the public debt holdings of non-residents and the forint yields, the rate of the interest paid to non-residents dropped further. Based on the debt management strategy, the decline in non-residents' debt holdings may continue in coming years, and thus the rate of interest paid to non-residents may keep falling.

Chart 40: Developments in the interest expenditures of the general government

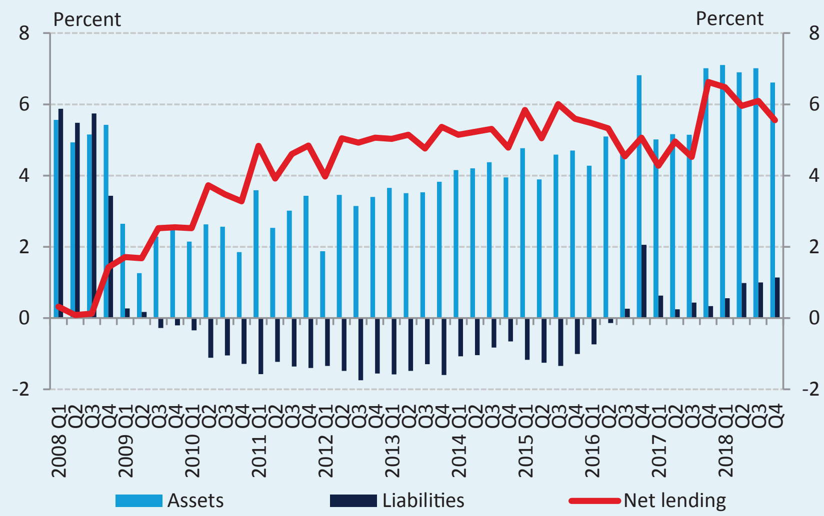


Note: Data do not contain the imputed interest expenditures incurred since 2012 due to the pension system reform. 2018 data are MNB estimates.

4.2 Households sector

According to underlying trends, households' net lending dropped to below 6 percent of GDP in 2018 Q4 (Chart 41). The mild upward trend observed in 2017 in households' seasonally-adjusted net financial savings came to a halt in 2018, and this indicator edged down to 5.6 percent of GDP in the last quarter. Nevertheless, the indicator was still around 6 percent for 2018 as a whole. The decline in the net position reflects the increase in net borrowing in 2018, which is primarily related to stronger demand for housing loans. In addition, there was an expansion in the portfolio of consumer loans as well. The level of gross financial savings remained high, which can be explained by a number of factors: in conjunction with rising real wages amid the increase in employment and the tightening labour market, loans for the purchase of used homes may have ultimately boosted the financial assets of households. The housing loan portfolio expanded in a prudent manner, subject to the debt cap rules and in the context of a rising share of loans with interest rates fixed for a longer period. Consequently, the increase does not jeopardise the operation of banks and hence, the external balance of the economy.

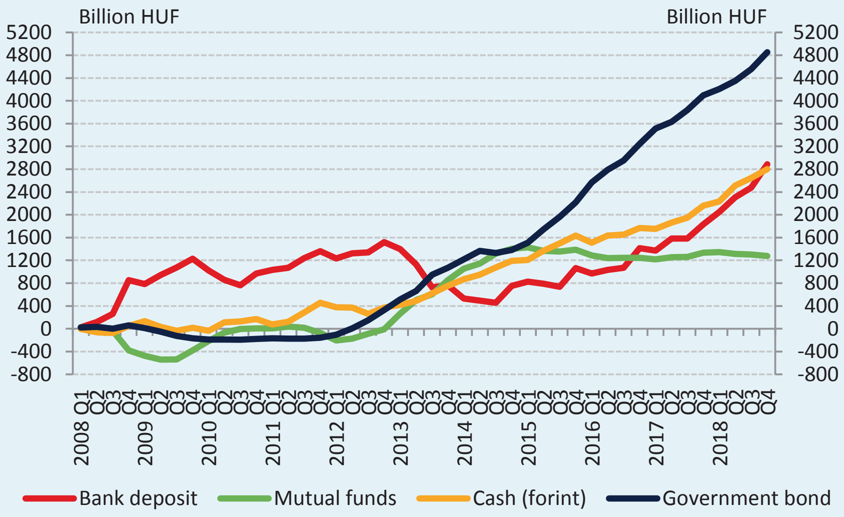
Chart 41: Net lending of households (seasonally-adjusted, revised* values, as a percentage of GDP)



** The values reflect underlying trends and are adjusted for the effect of pension savings, the early repayment scheme, real yield payments, the indemnification of the depositors of liquidated savings cooperatives and the forint conversion and settlement.*

Households' government bond holdings continued to rise dynamically in 2018 as well, which contributed to reducing Hungary's external vulnerability by increasing the internal financing ratio of the general government (Chart 42). The uninterrupted growth in households' government securities holdings since 2012 continued in 2018 as well, thanks primarily to these securities' significant yield advantage over other forms of investment in the low yield environment. By the end of 2018, households' government securities holdings exceeded HUF 5,800 billion. In 2018 as well, households allocated a large portion of new savings to government bond purchases and increased their cash and bank deposit holdings, but – after the growth observed in 2017 – the holdings of mutual fund shares moderately declined in 2018. The asset value of money market and bond funds composed of lower-risk securities – with lower retrospective yield – contracted further, while the holdings of higher-risk mixed and real estate funds increased. This suggests that in the low yield environment fewer investors turned to riskier forms of investment with potentially higher yields; nevertheless, the preference for liquid forms of investment and government securities is still strong. Households' strong demand for government securities increased the internal financing ratio of the general government, which is favourable with respect to Hungary's external vulnerability.

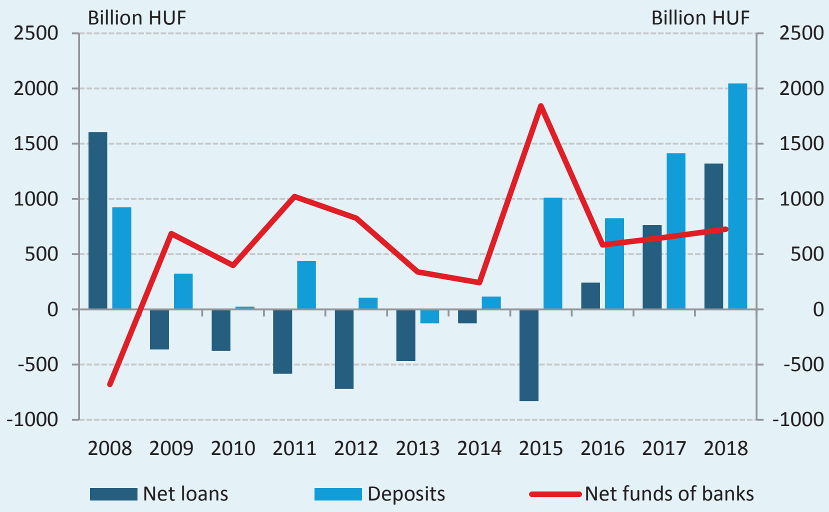
Chart 42: Developments in households' key financial assets (cumulative transactions)



Box 3: Developments in the private sector's bank loans and deposits

In 2018, the private sector continued to raise its outstanding borrowing significantly, and with a similar increase in new deposits the funds deposited with banks remained substantial in net terms. The bank loans of households and companies contracted continuously in the post-crisis years, but there was a turnaround on the credit side in 2016, and the net borrowing of the private sector continued its upward drift in 2018. Meanwhile, the private sector's new deposits also increased. Taken together, there has been a moderate, steady rise in banks' net liabilities since 2016 (Chart 43); in other words, private sector savings not only provide substantial financing for the government, but also contribute to increasing banks' internal financing and reducing their external debt. The private sector's position vis-à-vis banks may have resulted in a decline in banks' net external debt.

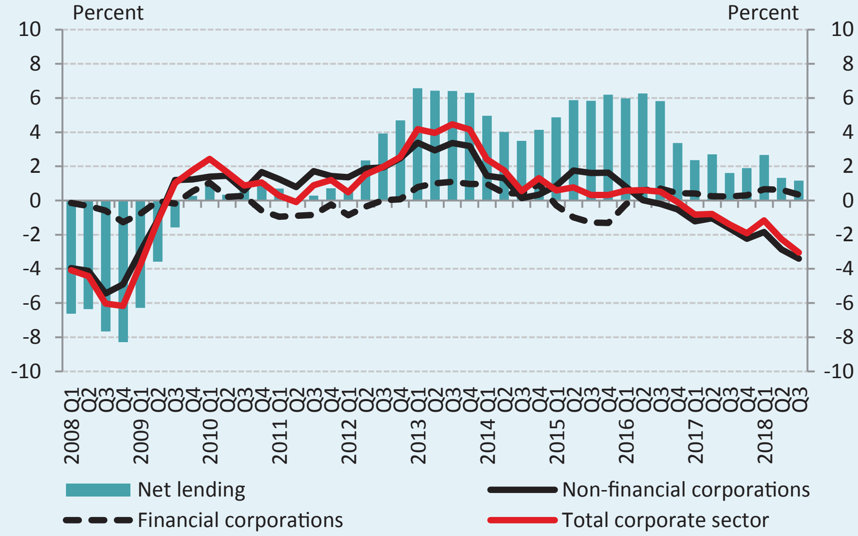
Chart 43: Developments in the private sector's bank loans and deposits



4.3 Corporate sector

The net borrowing of the corporate sector continued to increase, contributing to the contraction in net lending. According to four-quarter data, the net lending of the corporate sector as a whole rose continuously from 2018 Q1.[6] The rise may be linked to the reduction in non-financial corporations' net borrowing, which was somewhat offset by financial corporations' stable net lending: as in the previous year, the net lending of financial corporations was moderately positive in 2018 (Chart 44).[7] Overall, however, the corporate sector contributed to the contraction in the economy's net lending.

Chart 44: Net lending of companies and external surplus (four-quarter values as a percentage of GDP)

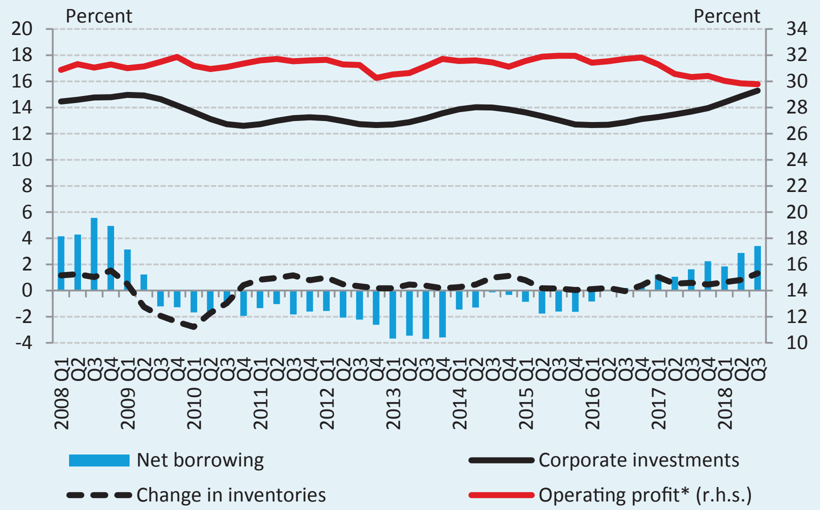


[6] Financial accounts for 2018 Q4 will only be published after the editorial deadline for this report.

[7] The net lending of financial corporations is mainly influenced by the profits or losses of the sector and by the change in their non-financial assets (e.g. real estate). However, besides the above, the position of the sector was also strongly influenced by the crisis and later by the losses incurred during the early repayment scheme and the foreign currency settlements: the difference between the market rate and the fixed exchange rate and the foreign currency settlements as a capital transfer provided to the household sector reduced banks' net lending while simultaneously raising households' net financial savings.

Non-financial corporations' net borrowing rose to 3.4 percent of GDP, mainly as a result of growing investment and inventories, and also supported by a decline in revenues. The operating surplus of non-financial corporations decreased continuously, due in part to rising wages and oil prices. In addition, the persistent increase in the investment activity of companies – which surpassed its pre-crisis level by the end of the year – also contributed to the expansion in net borrowing. Moreover, in contrast to the stagnation seen in previous years, companies also raised their level of inventories (Chart 45).

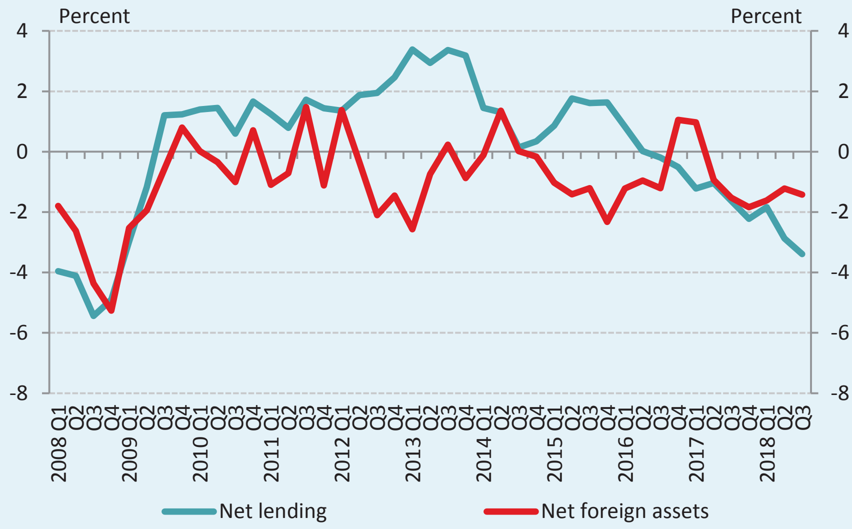
Chart 45: Non-financial corporations' net borrowing relative to GDP and the main underlying real economic factors (four-quarter values calculated from the national accounts)



** Indicator adjusted for companies' interest and shareholder incomes. Data related to the net borrowing are only available until the third quarter.*
Source: HCSO, MNB.

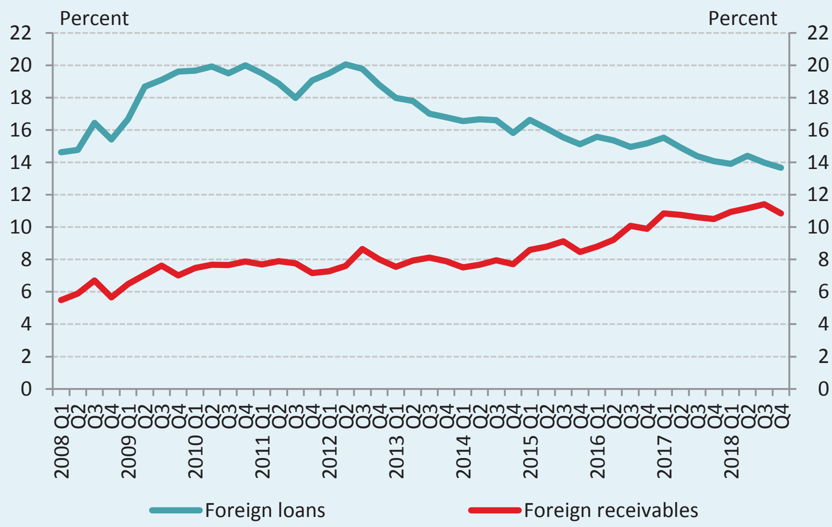
The trend increase in the net borrowing of non-financial corporations evolved in conjunction with moderately declining borrowing from the non-resident sector (Chart 46). The main contributors to the increase in debt were rising bank loans and growing participations from reinvested earnings. The rise in foreign loans in 2018 Q2 resulted from the transitional effect of a transaction linked to a large international corporation (in parallel with this, external assets also increased). By contrast, domestic loans grew continuously, which pointed to a decline in companies' net savings. At the same time, the repayment of FGS loans was significant in 2018, which in turn reduced the corporate sector's net borrowing. The financial assets of the corporate sector continued to expand dynamically, but this growth decelerated in 2018 Q3. As regards financial assets, the sector mostly increased domestic bank deposits and non-resident participations in 2018.

Chart 46: Net lending and net external transactions of non-financial corporations (four-quarter data, as a percentage of GDP)



The decline in companies' foreign loans continued in 2018, while their external assets decreased in Q4. By 2018 Q4, companies' foreign loans outstanding fell below 14 percent of GDP, which was also supported by the adjustment affecting companies' external liabilities and dynamic GDP growth. The rise in external assets observed since end-2017 continued until 2018 Q3, with this indicator dropping to 11 percent of GDP in the final quarter (Chart 47).

Chart 47: Foreign loan liabilities and receivables of non-financial corporations (as a percentage of GDP)*



** Based on financial account data, which also include inter-company loans.*

5 International comparison

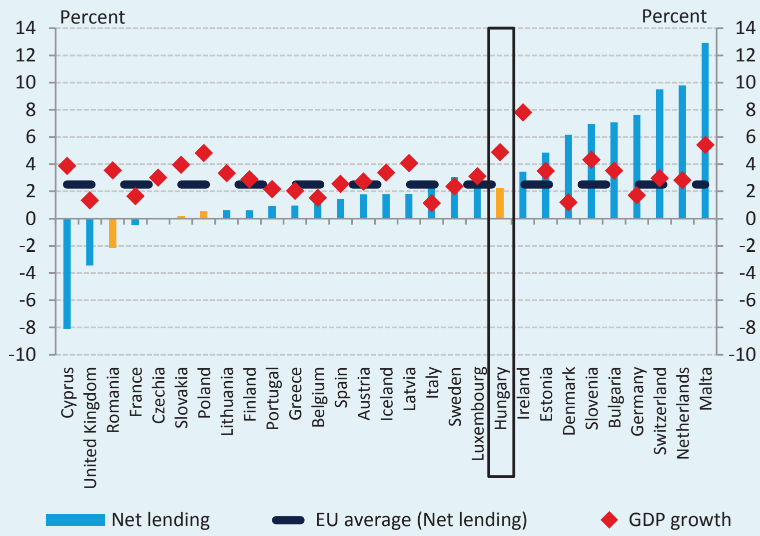
In 2018, Hungary's net lending continued to surpass the levels typically seen in European Union Member States and the regional countries. Despite the decline, in 2018 Hungary once again recorded the highest net lending in the Central and Eastern European region as a percentage of GDP. The fall in the indicator can be attributed primarily to a decline in the goods balance both in Hungary and elsewhere in the region, which is related to the dynamic rise in import-intensive investment. The income balance deficit did not change noticeably in the countries of the region as the profit balance of non-resident companies – a determinant of the deficit – was roughly the same as in previous years. While in Hungary the fall in the current account surplus was partially offset by the inflow of funds allocated under the new programming period of the EU, in other countries of the region – with the exception of Poland – the transfer balance did not show an improvement. It should be mentioned that foreign direct investment inflows in Hungary also exceeded the regional average as a share of GDP. Hungary's remarkable net lending was supported by household savings, which can be considered high even by regional standards, while the budget deficit was in line with the level observed in the region. In spite of the high net lending of Hungarian households, households' balance sheet adjustments have come to a close and their borrowing shows a gradual increase. Nevertheless, the rate of credit growth continues to lag behind the region. In parallel with this, the decline in external debt indicators continued, which benefits Hungary's external vulnerability and risk perception.

In the section entitled "International comparison", we present the developments in Hungary's external balance in comparison to the countries in the region. In terms of balance of payments figures, Hungary should be compared primarily to countries which are at a similar level of development and face similar challenges. Accordingly, our international outlook is mainly based on these aspects. For this purpose, the most ideal group of countries comprises the countries in the region which acceded to the European Union at the same time, plus Romania, which joined the EU later and does not always show the same trends as those observed in the Visegrád countries.

5.1 Net lending

Based on the estimates for 2018, Hungary's net lending still exceeds the average values prevailing in the region and in the Member States of the European Union (Chart 48). Hungary's net lending amounted to 2.2 percent of GDP in 2018, which is consistent with the level anticipated by the European Commission's estimate for the countries in the region. In most countries of the EU-28, GDP-proportionate net lending – and thus the EU-28 average – is expected to decrease compared to 2017. The highest net lending in the European Union is still observed primarily in export-oriented countries, but in these developed countries the favourable external balance position is usually accompanied by lower GDP growth. Hungary's economic growth amounted to 4.9 percent in 2018 which, according to the estimates, is one of the highest values recorded in EU Member States.

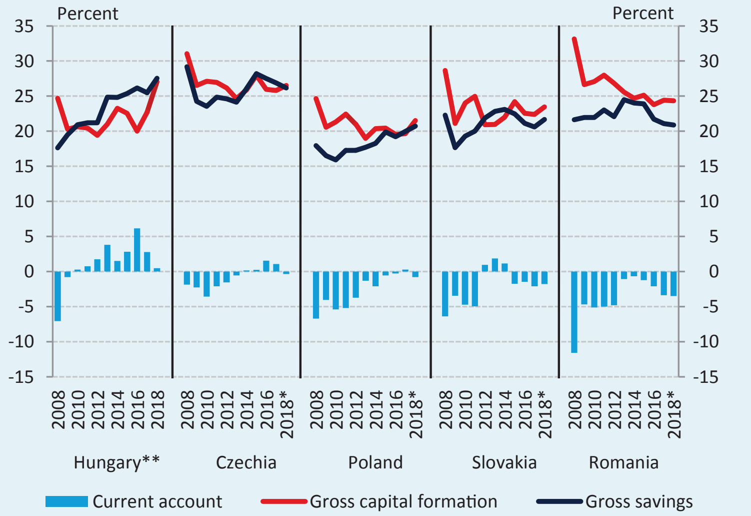
Chart 48: Developments in net lending in 2018



Source: Actual data for Hungary and based on the European Commission's estimates for the rest of the countries

Hungary's high net lending – in excess of the values recorded elsewhere in the region – can be attributed to high gross saving, while the rise recorded in the gross capital formation ratio puts downward pressure on the indicator (Chart 49). An economy's current account balance is derived by deducting gross capital formation (fixed capital formation and changes in inventories) from gross saving (i.e. the difference of income and consumption). Following the outbreak of the crisis, the current account balance improved in all countries of the Central and Eastern European region due to the declining investment ratio and, thanks to the deleveraging process, gradually rising gross saving. Besides Hungary, the favourable trend reversed course in other countries as well, and the current account balance showed a decline in the past 1–2 years. In Hungary, this development is related to a dynamic rise in fixed capital since 2016; as a result, by 2018 the value of total gross capital formation including changes in inventories surpassed the regional average. In addition, the level of Hungarian savings is also very high by regional standards. Fixed capital accumulation also increased in the Czech Republic, Poland and Slovakia, but the savings rate falls behind this growth and according to the IMF's forecast, the current account balance of these countries turned negative in 2018. In Romania, the current account balance has been deteriorating since 2014 owing to a stagnating investment ratio with a parallel, sharp decline in gross savings.

Chart 49: Developments in gross savings and total investment ratios (as a percentage of GDP)



** For 2018, the gross savings rate is derived from the total investment and current account data. 2018 values in other countries of the region are based on WEO estimates.** The source of the Hungarian data is the HCSO and the MNB.*
Source: MNB, HCSO, WEO.

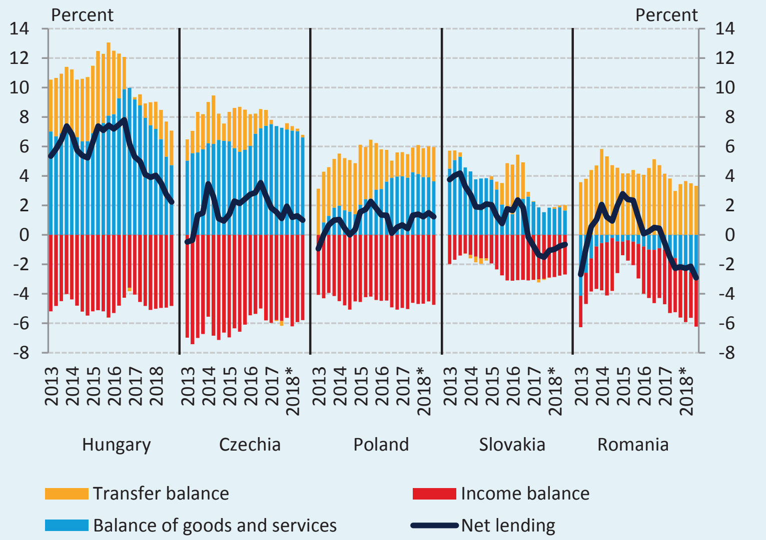
5.2 Net lending and its real economic factors

Despite the recent drop in the indicator, in 2018 Hungary once again recorded the highest GDP-proportionate net lending in the region (Chart 50). According to the four-quarter data calculated in accordance with the real economy approach, Hungary's net lending still exceeds the values observed in other countries of the region. However, while the surplus fell in Hungary, it has mostly stagnated in the other countries in the region. The decline in Hungary's net lending mainly reflects the decreasing surplus of the balance of goods and services, even though the surplus is higher than the regional average.

Developments in the factors of net lending in the region:

- In 2018, the four-quarter surplus of the **balance of goods and services** as a percentage of GDP declined in all countries in the region. A closer look at the balance reveals that, as opposed to the decline in the balance of goods, the balance of services exhibits a stable surplus, and Hungary recorded the highest GDP-proportionate value in the region.
- The **income balance** – which shows a substantial deficit in neighbouring countries – did not change materially in 2018.
- The **transfer balance** typically supports the economy's external balance position in the countries of the region, and Hungary recorded the largest growth in the absorption of EU transfers in 2018.

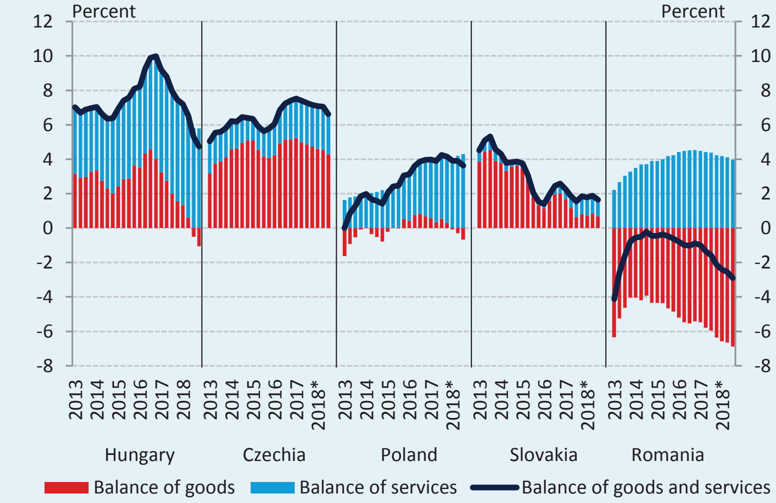
Chart 50: Current accounts and capital accounts of the Visegrád countries (as a percentage of GDP) (four-quarter values as a percentage of GDP)



** The value stated for 2018 is the four-quarter value calculated up to 2018 Q3.*
Source: Eurostat, national central banks.

Although the balance of goods typically decreased in the region, in most countries this effect was countered by the expansion observed in the balance of services in recent years (Chart 51). Similar to Hungary, vehicle manufacturing is a significant contributor to exports in most countries of the region. Consequently, the tightening of emissions standards with respect to diesel engines may have had a detrimental impact on all of the economies of the region in 2018 H2. In addition, the surplus may also have been reduced by decelerating growth in the export markets: compared to the previous year, the growth rate of developed economies is expected to have slowed in 2018. Moreover, until 2018 Q3 the trade surplus may have been curbed by the deterioration in the terms of trade in the wake of rising oil prices. Finally, it is important to mention the dynamic investment growth, which may also have contributed to the decline in the surplus of the goods balance. At the same time, the balance of goods and services is bolstered by the surplus of the balance of services across the region, with the highest value (6 percent of GDP) recorded in Hungary.

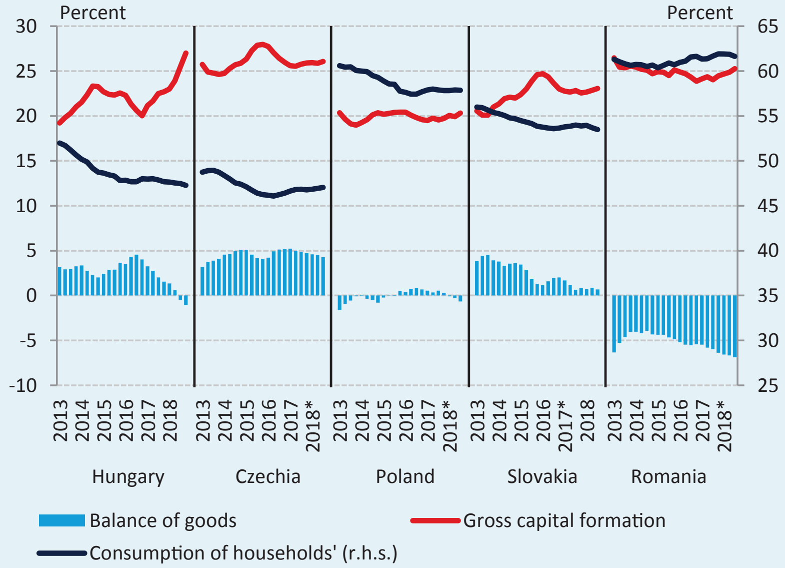
Chart 51: Distribution of the balance of goods and services (four-quarter values as a percentage of GDP)



** The value stated for 2018 is the four-quarter value calculated up to 2018 Q3.*
Source: Eurostat.

In line with the absorption of EU funds, driven by investment, Hungary recorded the fastest growth in capital expenditure among its peers in the region, and its GDP-proportionate value was also the highest. All of this may have played a role in the fact that Hungary reported the sharpest decline in the balance of goods (Chart 52). Besides the external environment, internal effects also contributed to the drop in the surplus of the balance of goods. While the decrease in the balance of goods was accompanied by a moderate increase in internal capital formation in most of the countries in the region, the level of internal capital formation rose sharply in Hungary, and by the end of 2018 it exceeded 27 percent of GDP. In addition to a significant, 3-percentage point GDP-proportionate rise in investment year-on-year, the considerable expansion of inventories also contributed to this increase. In parallel with this, households' consumption expenditure did not grow and in fact it declined slightly. Consequently, the ratio of household consumption-to-GDP fell to the lowest level recorded in the region, which can be regarded as a positive development from the perspective of Hungary's external balance, because it indicates that households' savings continue to contribute significantly to the external balance position of the economy, while the decline in the surplus is mainly related to import demand tied to corporate investment.

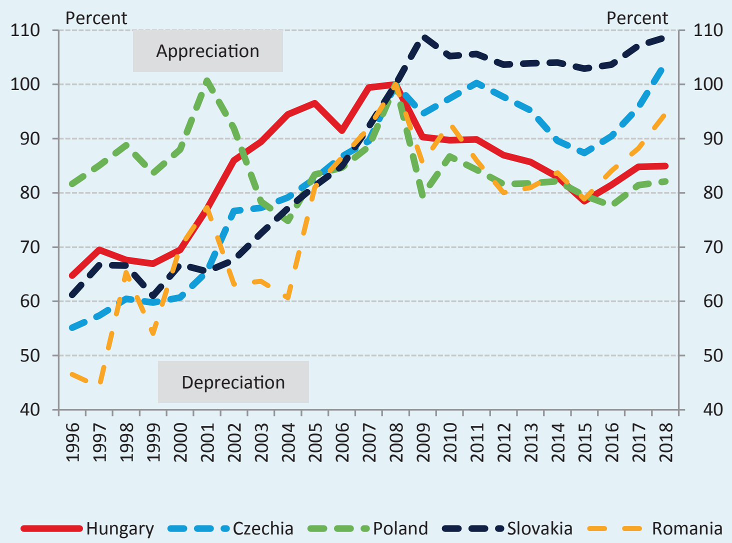
Chart 52: Household consumption and total investment (as a percentage of GDP)



**The data series last until 2018 Q3.*
Source: Eurostat.

Against the backdrop of dynamically rising wages, in 2018 the labour cost-based real exchange rate edged up in the Czech Republic and Romania, and remained practically unchanged in Hungary (Chart 53). Although Hungarian wage growth remained above 10 percent[8] in 2018, this effect may have been offset in the real exchange rate by rising productivity, the 3-percent depreciation of the forint exchange rate against the euro and the reduction of employers' social contribution. Thus, taken together, the dynamic rise in wages did not lead to appreciation of the real exchange rate in 2018. Similarly, the indicator did not change noticeably in Poland. By contrast, the Czech real exchange rate appreciated significantly even with a lower nominal increase in wages (8 percent[9]). The difference compared to Hungary is partly due to the modest appreciation of the Czech koruna's nominal exchange rate against the euro, as a result of which nearly all of the nominal wage increase was reflected in the appreciation of the real exchange rate.

Chart 53: Changes in labour cost-based real exchange rate (2008 = 100; vis-à-vis 37 countries)

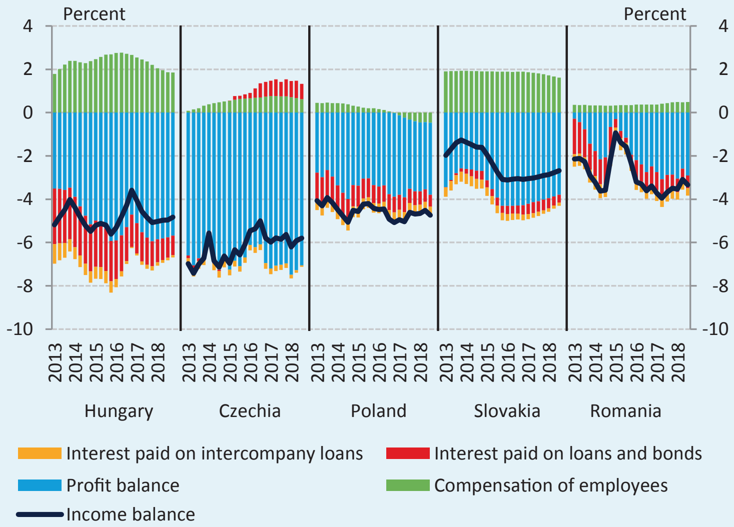


*Note: *The 2018 value is based on the European Commission's forecast.*
Source: European Commission

The income balance deficit did not change noticeably in the countries of the region as the profit balance of non-resident companies – a determinant of the deficit – remained at roughly the same levels as in the previous year (Chart 54). Non-resident companies – e.g. motor vehicle manufacturers – have accumulated significant production capacities in all of the countries in the region. Consequently, the profit balances of these non-resident companies account for the bulk of the income balance deficit in the countries in the region. Moreover, in line with the value of net external debt, the income balance is also deteriorated by the interest paid abroad in most of the regional countries. This is usually moderated by the incomes of employees temporarily working abroad. Some exceptions, however, should be noted in both cases. Assets vis-à-vis non-residents exceed the country's external debt in the Czech Republic; in other words, the Czech net external debt is negative. As a result, the Czech Republic is the only country in the region where the interest balance shows a net income, i.e. it reduces the income balance deficit. The second exception is Poland with regard to the compensation of employees: a large number of Ukrainian employees[10] arrived in Poland, and the incomes received by Ukrainian employees in Poland already surpass the incomes of Polish workers employed temporarily abroad, which – as another unique phenomenon in the region – deteriorates the income balance.

[8] https://www.mnb.hu/letoltes/hun-ir-14.pdf
[9] http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/en/monetary_policy/inflation_reports/2018/2018_IV/download/ir_IV_2018.pdf
[10] http://www.nbp.pl/en/publikacje/raport_inflacja/iraport_march2019.pdf

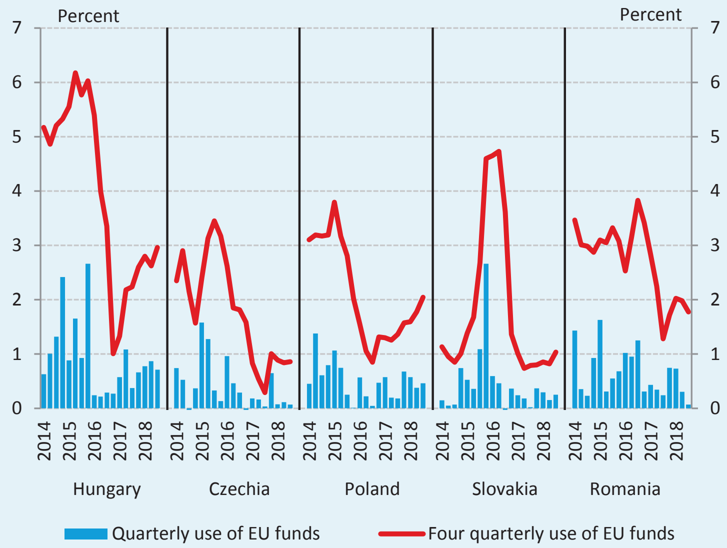
Chart 54: Developments in the components of the income balance* (four-quarter values as a percentage of GDP)



** The value stated for 2018 is the four-quarter value calculated up to 2018 Q3.*
Source: Eurostat.

Hungary recorded the strongest growth in the absorption of EU transfers in 2018 (Chart 55). The extent to which the transfer balance supports the economy's external balance position varies across the countries of the region, largely determined by the inflow of funds under the EU's 2014–2020 programming period. Since 2017, Hungary has recorded the highest growth in this regard. The four-quarter absorption of EU transfers was close to 3 percent of GDP in Hungary, compared to around 2 percent of GDP in Poland and Romania and 1 percent in the Czech Republic and Slovakia. Although the transfer balance of the region's countries is primarily determined by the absorption of EU transfers, it also includes the remittances of employees working abroad on a long-term basis. Its value is a key part of the transfer balance surplus in Romania as almost half of the balance – 1.5 percent of GDP – is linked to the remittances of employees working abroad on a long-term basis.

Chart 55: Absorption of EU transfers in the countries in the region (as a percentage of GDP)

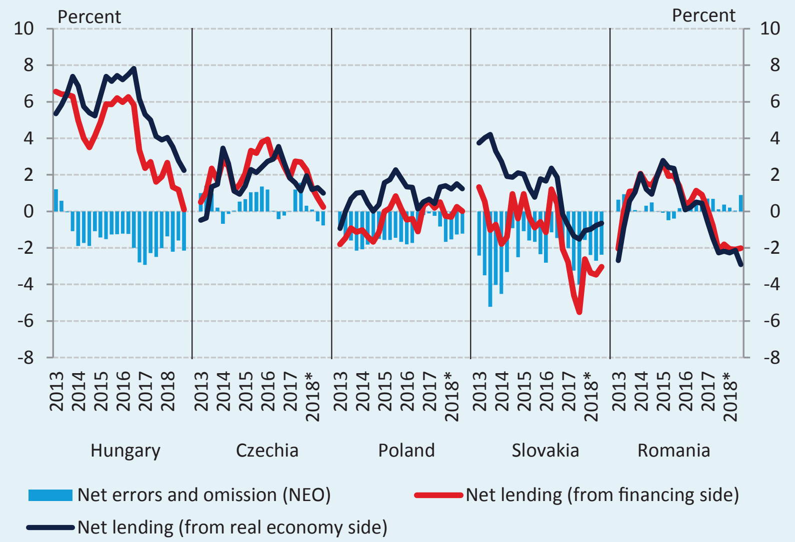


Source: Eurostat.

5.3 Financing side developments

Net lending stated in the financial account is typically lower than the external position calculated in accordance with the real economy approach in all of the countries in the region (Chart 56). The item "Net errors and omissions" (NEO) shows the discrepancy between net lending calculated from the financing side and from the real economy side. Except for Romania, net lending calculated from the real economy side significantly exceeds the value obtained on the basis of the financial account in all of the countries in the region. In 2018, the difference was around 1 percent of GDP in Poland and in Czechia and around 2 percent of GDP in Hungary and in Slovakia. In Romania, net lending calculated from the financing side is nearly the same as net lending calculated from the real economy side.

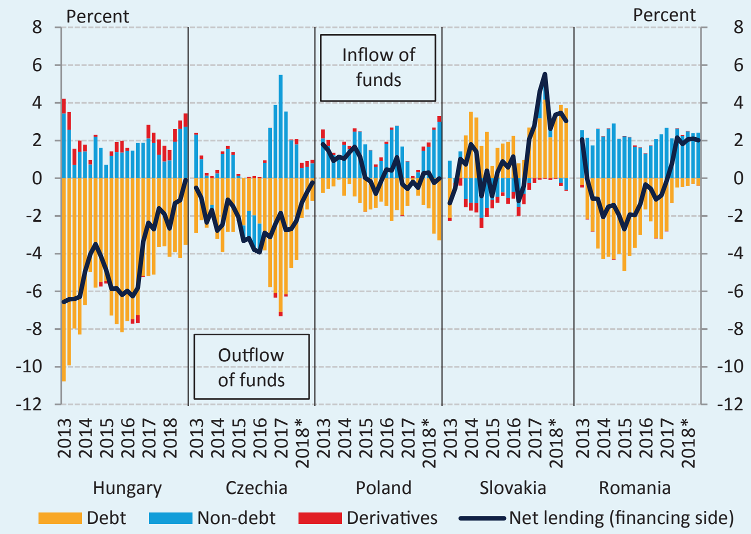
Chart 56: Net errors and omissions (four-quarter values as a percentage of GDP*)



** In the case of the countries of the region, until 2018 Q3.*
Source: Eurostat, national central banks.

In 2018, the net borrowing of the regional economies grew considerably but at the same time, the outflow of debt liabilities continued in most of the countries in the region (Chart 57). In 2018, Hungary and Czechia saw the strongest increase in the net borrowing in the region, while the rest of the countries only experienced minor shifts. It is important to note that the net position was around zero in Hungary, Czechia and Poland, while net borrowing amounted to more than 2 percent of GDP in Romania. Based on the financial account, in 2018 the economy's net borrowing was also high in Slovakia, but its level subsided somewhat. With respect to the structure of net borrowing, the inflow of non-debt liabilities permitted Hungary, Czechia and Poland to further reduce their net external debt. By contrast, net external debt continued to increase in Slovakia, while the economy's external net borrowing was financed by non-debt liabilities in Romania.

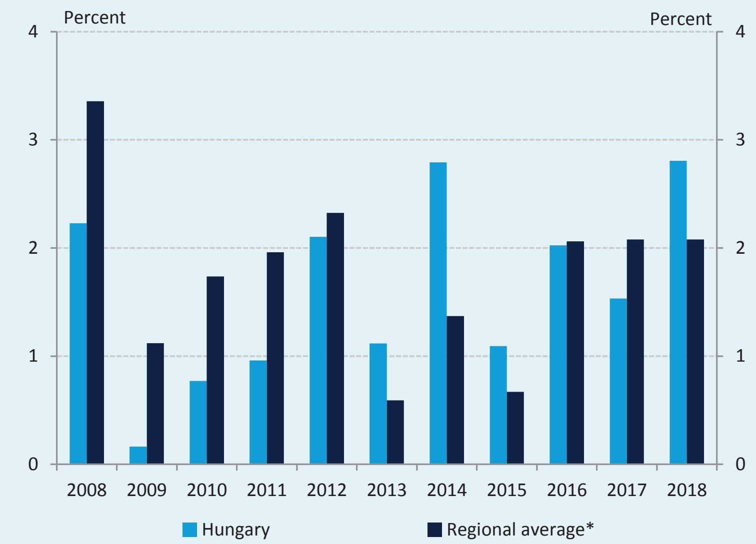
Chart 57: Net borrowing and the form of financing (four-quarter data, as a percentage of GDP)



** Data for the countries of the region were available up to 2018 Q3 (Czech Republic, Poland, Romania and Slovakia).*
Source: MNB, Eurostat.

In Hungary, the GDP-proportionate value of foreign direct investment significantly exceeded the regional average in 2018 (Chart 58). In the past ten years, net FDI inflows were fairly similar in the countries in the region. After a downturn following the crisis, FDI inflows shifted upwards from 2010 and following a temporary decline in 2013, they then began to rise again. Between 2015 and 2017, FDI inflows ranged between 1 and 2 percent of GDP in Hungary, and the regional average exhibited a similar trend. In 2018, FDI inflows rose above 2 percent of GDP in Hungary, as a result of which the value of FDI inflows exceeded the regional average. The correlation between the net foreign direct investment inflows of the regional economies indicates that, in line with global economic trends, foreign participants essentially judge these countries similarly for investment purposes.

Chart 58: Net FDI inflows in the Visegrád countries (as a percentage of GDP)

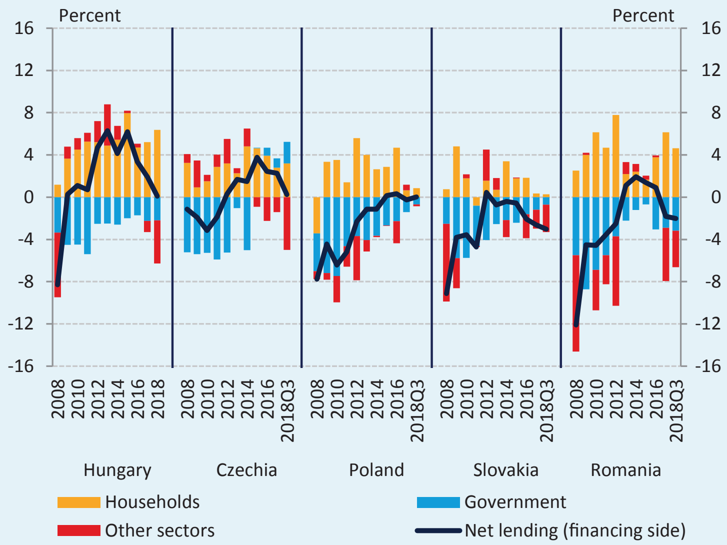


** For regional countries four-quarter data were available until 2018 Q3. (The regional average does not include Hungary).*
Source: Eurostat

5.4 Savings side developments

The countries in the region continue to be characterised by low general government deficits and companies' expanding net borrowing (Chart 59). The contraction observed in the net lending of the region's countries can be generally attributed to the rise in companies' net borrowing in the context of substantial investment growth, while the general government deficit remains at fairly low levels (in fact, it has shown a moderate surplus in Czechia in recent years). It should also be noted that households' net financial savings remained consistently high in Hungary, whereas a decrease was observed in the rest of the Visegrád countries in the past few years; in fact, household savings dropped to a level close to zero in Poland and Slovakia. This is why only Hungary's net lending – calculated on the basis of the financial account – remained positive in the region.

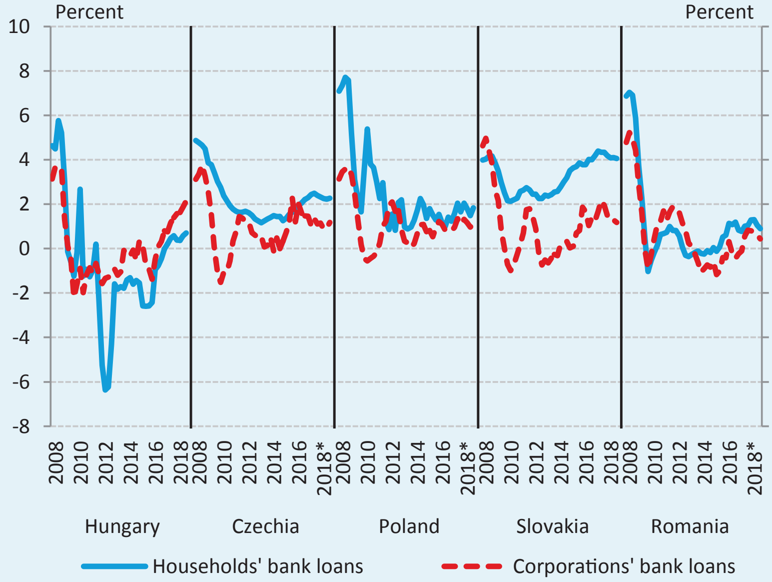
Chart 59: Net lending of the economy in a breakdown by sector (as a percentage of GDP) (as a percentage of GDP)



In Romania, there were extreme shifts in the value of households' other receivables (from employers and insurance firms) in 2013, 2016 and 2017 – the Chart displays the underlying trend without these outliers.
Source: MNB, Eurostat.

Borrowing from banks by the Hungarian private sector is on the rise, but in an international comparison this increase is incongruous: while the credit growth of companies exceeds the corresponding regional value, households' borrowing still falls behind the rest of the region (Chart 60). In 2018 Q3, the net new borrowing of Hungarian households from banks rose to 0.7 percent of GDP. This also means that the sector's balance-sheet adjustment – induced by its changed borrowing behaviour after the crisis – has come to an end and borrowing has embarked on a gradual rise. In the rest of the region, households' net borrowing from banks generally declined, but its level still surpasses the credit growth of Hungarian households considerably. As regards the borrowing of non-financial corporations, their credit growth – supported, in part, by the central bank's programmes – amounts to 2 percent of GDP, which exceeds the regional average of around 1 percent. On balance, the high level of borrowing from banks put downward pressure on net lending in the countries in the region as well.

Chart 60: Four-quarter net borrowing of companies and households as a percentage of GDP

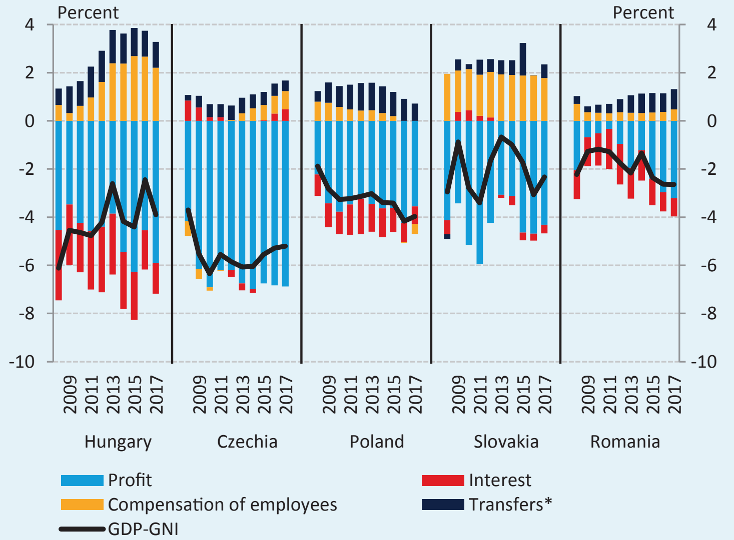


* *Until 2018 Q3.*
Source: ECB, Eurostat

The 4-percent difference between Hungarian GDP and GNI roughly corresponds to the regional average. Although Hungary was the only country in the region where the difference between output and income decreased compared to the pre-crisis level, the shorter-term 2017 trends exhibited diverging shifts. As opposed to the widening observed in the GDP–GNI gap in Hungary, the gap did not change noticeably elsewhere in the region (Chart 61). One determinant of the GDP–GNI gap, capital incomes (the profit balance) reflect the strong foreign direct investment of the countries in the region: as a result, the profit balance was around 4–8 percent of GDP in the Visegrád countries and around 3–4 percent of GDP in Romania, which joined the EU later. While the profit of resident companies in foreign ownership present in Hungary increased in 2017, due to one-off effects[11] on the one hand and to the corporate income tax cuts on the other hand, the corresponding value was more likely to stagnate in the rest of the Visegrád countries. In addition, the level of the difference is less and less increased by the interest balance vis-à-vis non-residents in the region as a whole: besides declining interest levels, this process is also supported in Hungary by the preference for internal financing in the new financing model. The compensation of employees and the transfer balance typically reduce the GDP–GNI gap, which is attributable to the EU funds flowing into the region and to the income of residents working abroad for less than one year. It should be stressed, however, that after years of gradual decline, by 2017 the balance of compensation of employees temporarily working abroad edged into negative territory in Poland, and thus the wages of Polish workers employed abroad point to an increase in the GDP–GNI gap.

[11] For further details, see: Report on the Balance of Payments, October 2017, Section 5.
http://www.mnb.hu/letoltes/fizetesi-merleg-hu-2017-oktoberboritoval.pdf

Chart 61: Factors of the GDP–GNI gap

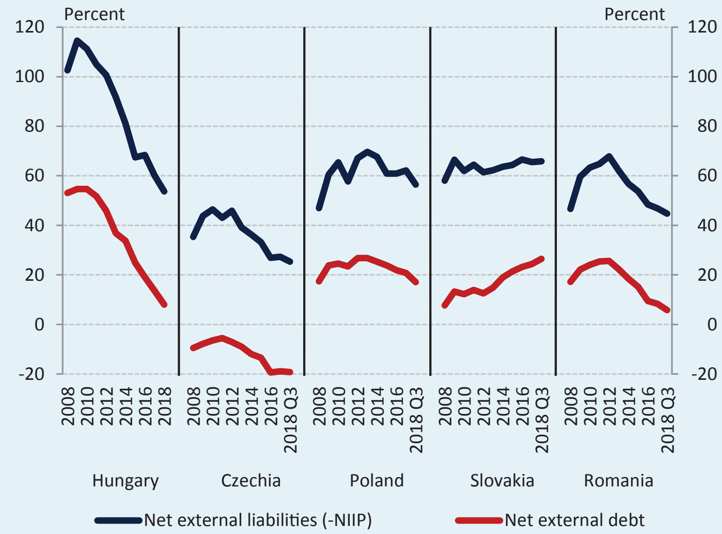


** Transfers included among other primary incomes.*
Source: Eurostat, HCSO.

5.5 External debt indicators

Net external debt indicators typically declined in the region. As a result of a more dynamic decline in Hungary compared to the rest of the region, by 2018 Hungary's net external debt and net foreign liabilities were in line with the values observed in the region (Chart 62). In the course of 2018, Hungary's net foreign liabilities dropped even further and amounted to around 50 percent of GDP. Thanks to the dynamic decrease observed in recent years, the Hungarian indicator is now lower than the corresponding Polish and Slovakian values, but it is still slightly higher than the Romanian value and exceeds the Czech value more noticeably. Accordingly, only the Czech Republic posted a significantly lower net external debt figure than Hungary in the region, which can be predominantly attributed to the negative net external debt of the Czech Republic. The high level of net lending emerging in Hungary after 2008 was also reflected in the decline in the country's net external debt, which fell from the extremely high post-crisis level of over 50 percent of GDP to below 10 percent of GDP by 2018. In the rest of the region, net lending lowered net external debt to a far lesser degree than in Hungary, while the net external debt of Slovakia has increased in recent years. Between 2008 and 2018, Hungary's net external debt fell by more than 40 percent of GDP overall, representing the sharpest decline observed in the region. Based on the debt indicators, the external vulnerability of the rest of the regional countries did not change considerably compared to previous years.

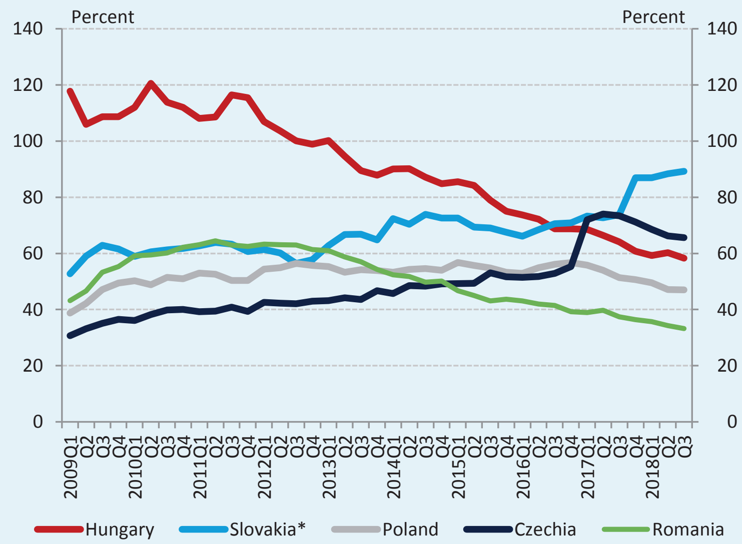
Chart 62: Developments in net external liabilities and external debt (as a percentage of GDP, net external debt without intercompany loans)



** The data series last until 2018 Q3.*
Source: MNB, Eurostat (data including SPEs).

Hungary's gross external debt is in the middle of the regional ranking (Chart 63). By the end of 2018, Hungary's gross external debt fell below 60 percent of GDP, and thus its value is now consistent with those observed in the rest of the region. While Hungary's gross external debt was extremely high compared to its peers (120 percent of GDP) at the outbreak of the crisis, as a result of the downward trend in the past few years it is now in the middle of the regional ranking. Among other things, the decline reflects the fact that households were engaged in repaying their loans instead of borrowing until 2017, the general government deficit decreased and the government's foreign debt was reduced continuously partly owing to households' government bond purchases and partly to the MNB's Self-Financing Programme. At the same time, there was no need for such adjustment in the rest of the region; only Romania recorded a sizeable decline. After the crisis, gross external debt actually increased in the Czech Republic and Slovakia: while in the Czech Republic the central bank's FX market intervention raised the indicator indirectly through banks' gross external debt, in Slovakia – against the backdrop of the country's accession to the euro area – the rise in gross external debt was caused by the accumulation of TARGET liabilities in relation to the payment system of the euro area.

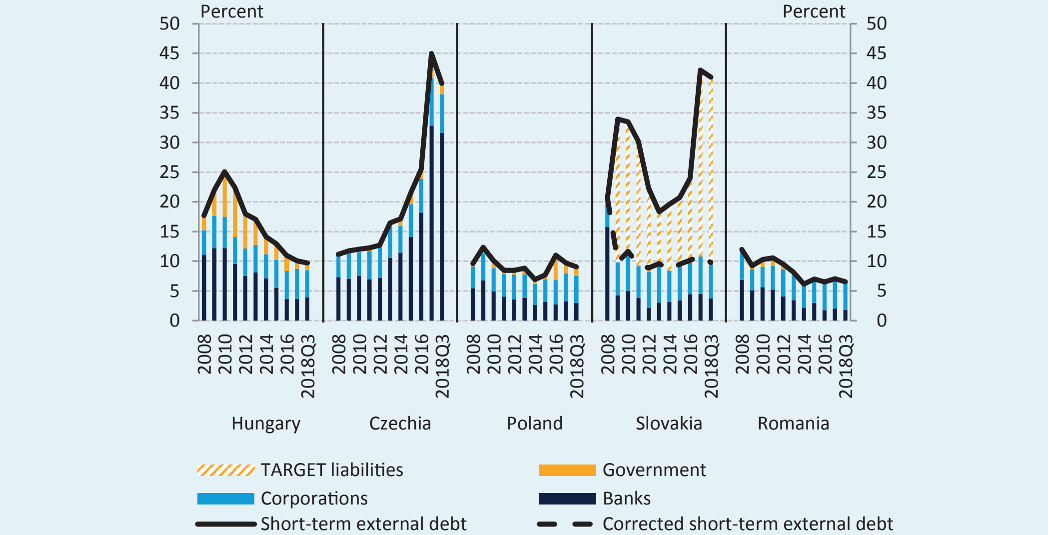
Chart 63: Developments in the gross external debt of the countries in the region (as a percentage of GDP, without intercompany loans)



** The rise in Slovakia's gross external debt also reflected its rising liabilities in relation to the payment system of the euro area.*
Source: Eurostat.

Hungary's short-term external debt based on original maturity – a component of gross external debt – has been declining since 2009 and is consistent with the values observed in the region (Chart 64). Developments in Hungary's short-term external debt based on original maturity[12] are similar to the changes in gross external debt: short-term external debt already exceeded the regional level in the pre-crisis years, but after the outbreak of the crisis – partly due to the hike following the depreciation – it surged to levels significantly higher than those recorded in the rest of the region. Thanks to the remarkable declines observed in recent years, however, Hungary's short-term external debt has dropped to the vicinity of 10 percent of GDP, i.e. its value now corresponds to the regional average. As regards the rest of the region, a similar picture emerges as in the case of gross external debt: while the sharp increase observed in the Czech Republic was caused primarily by the central bank's FX market intervention, in Slovakia the rise was induced by the technical items arising from the country's accession to the euro area. The central bank's intervention aimed at the maintenance of the koruna's exchange rate played a significant role in the rise of the short-term external debt of the Czech Republic: a large volume of Czech koruna was obtained by non-residents, and investors deposited a large part of these funds as short-term liabilities in the banking sector. In Poland, the banking sector carried out a smaller balance sheet adjustment than seen in Hungary, but this effect was partly offset by the increase in the short-term external debt of the Polish government and the business sector during this period. The external debt of the general government should also be mentioned: while the short-term external debt of the Hungarian government was high by regional standards in previous years, in more recent years this debt has declined – partly as a result of the Self-Financing Programme – and dropped to the level of the regional average – around 1 percent of GDP.

Chart 64: Short-term external debt based on original maturity (as a percentage of GDP)

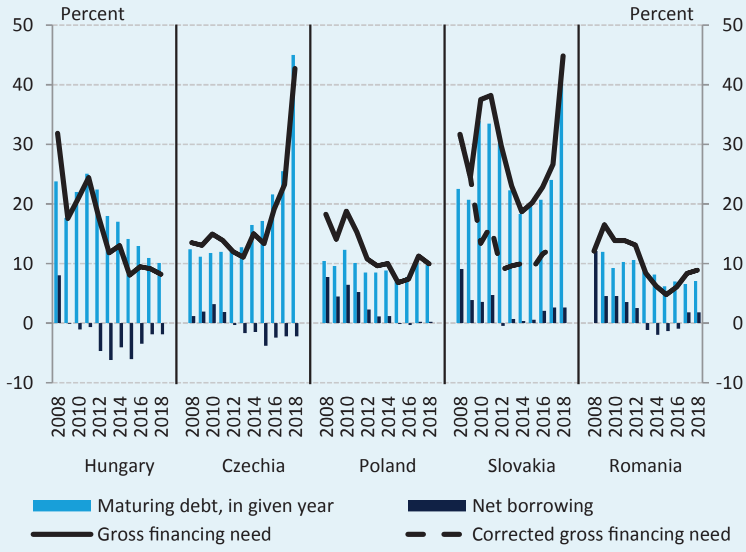


Note: Data for 2018 are available until Q3.
Source: World Bank Database, WEO.

After a moderate increase compared to the previous year, Hungary's gross financing need amounted to 10 percent of GDP in 2018, but it still remains favourable by regional standards (Chart 65). A country's gross financing need is the sum of its maturing external debt in the given year (corresponding to the short-term debt one year earlier) and its net borrowing. A country's net lending mitigates the country's gross financing need. Hungary's gross financing need – calculated from its short-term external debt based on original maturity[13] – rose moderately compared to the previous year and amounted to around 10 percent of GDP: the decline in maturing debt was more than offset by the contraction in net lending. The gross financing need of Poland and Romania corresponded to the Hungarian data, but Romania's gross financing need has been on a continuous rise in recent years, reflecting both an increase in Romania's short-term external debt and the decline in its net lending into negative territory. Similarly, the gross financing need of the Czech Republic and Slovakia also increased in the past few years: while the rise in the indicator was caused by the central bank's intervention in the Czech Republic, in Slovakia it can be attributed to the technical debt incurred in relation to the euro area accession.

[12] There are no data available for the countries of the region on amortising debt.
[13] For the sake of comparability, the gross financing need was calculated by using short-term external debt based on original maturity.

Chart 65: Changes in gross financing need
(based on short-term external debt, as a percentage of GDP)



Source: MNB, Eurostat, World Bank Database, WEO.

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Gábor Bethlen

(15 November 1580 – 15 November 1629)

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

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

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

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

REPORT ON THE BALANCE OF PAYMENTS

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