REPORT ON THE BALANCE OF PAYMENTS

2020
JANUARY

*‘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, Zsuzsa Nagy-Kékesi, Balázs Kóczián, Péter Koroknai, Dániel Simon, Balázs Sisak and Márton Varga. The Report was approved for publication by Márton Nagy, Deputy Governor.

This Report is based on information pertaining to the period ending on 20 December 2019.

Summary

In the third quarter of 2019, Hungary's net lending rose moderately, the four-quarter value of which thus amounted to 1.1 percent of GDP, **causing net external debt to fall to a historically low level**. Although **lower-than-estimated absorption of EU transfers** slightly reduced **net lending**, the level thereof **remains high in a regional comparison**. **Net exports** were still the main factor behind the **increase in the current account recorded in Q3**, driven by rising exports and import demand stemming from the strong investment dynamics, in conjunction with robust industrial production growth. The development of the current account was in line with the dynamics of the Visegrád countries.

According to the real economy approach, the **rise in net lending was mainly due to the increase in the trade balance**, which was supported both by the lower goods deficit and the steadily high services account. The improvement in the trade balance was also borne by the dynamically **rising industrial production and the decline in inventories**, while at the same time – in line with the historically **strong investment activity** – imports also grew, albeit at a more moderate rate than exports. The **absorption of EU transfers declined** during the quarter under review, and the impact of this was also reflected in the lower capital account surplus. The **income balance continued to improve moderately** in the third quarter again, with this development also facilitated by lower interest expenditure paid abroad and lower net expenditure related to income on equity.

Based on the financing data, four-quarter **net borrowing declined as the combined result of the fall in net external debt and the inflows of foreign direct investment**. In the third quarter, in addition to robust foreign direct investment, **Hungarian companies' investment abroad also rose significantly**. In parallel with this, the economy's **net debt-type liabilities declined moderately**, with the consolidated general government also contributing to this development via the rise in foreign exchange reserves, while the net external debt of the private sector increased. In addition to the outflow of funds, **strong nominal GDP growth also supported the decline in net external debt, which thus fell to 8.4 percent of GDP** at the end of the quarter. In addition to the rise in foreign exchange reserves as a result of transactions, the revaluation of reserves also supported the decline in net external debt. Hungary's gross external debt amounted to 57.7 percent of GDP, influenced by the banking sector's debt-type financing and the revaluation of the general government's gross external debt, mostly as a result of lower yields. **Short-term external debt rose to EUR 19 billion**, mainly owing to the temporary rise in the general government's short-term external debt vis-à-vis the EU. At the same time, **as foreign exchange reserves rose more than short-term external debt**, the volume of international reserves still **significantly exceeds the level expected and considered safe by investors**.

From the sectors' savings approach, the rise in net lending was **linked to the improvement in the private sector's four-quarter net position**, while the government's net borrowing remained low, in line with the strict fiscal policy. With the reduction in inventories, **the net saving position of corporations improved compared to the previous quarter**, while households' net financial savings remained at a high level, i.e. nearly 5 percent of GDP. Thanks to the robust demand for the new government security (MÁP+), **households' government securities holding continued to rise** in the quarter under review, and the structure of the retail government securities portfolio **shifted towards longer-term securities**, while the government substantially **reduced non-resident and foreign currency debt** using these funds.

In the **special topic** included in this Report on the Balance of Payments, we discuss **the changes in the funding of the corporate sector**. Examination of this topic is all the more timely, because since 2016 corporations have **been net borrowers to an increasing degree** again, i.e. the sector is also using the savings of other economic agents to support its operations. At the same time, compared to the pre-crisis period, one important difference is that in recent years the funds **have increasingly come from resident actors, while the role of external liabilities has declined**. In addition, the rise in corporations' external liabilities was **related to growth in FDI funds, while no material change was recorded in corporations' gross external debt**. On the whole, the **strong corporate investment activity** is occurring in an organic, sustainable fashion and **does not increase the external debt of the economy**.

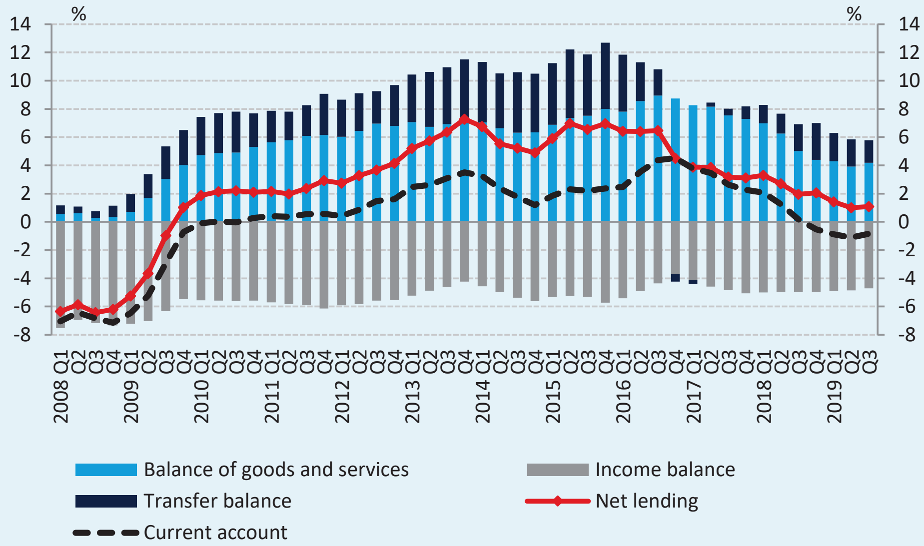
Contents

1 Real economy approach

According to the real economy approach, the four-quarter net lending of the Hungarian economy rose to 1.1 percent of GDP in 2019 Q3, while the current account deficit fell to 0.8 percent of GDP. This marks a major change compared to the decline in external balance indicators observed since 2016. The Hungarian economy's net lending remains high in a regional comparison, and the current account improved in line with other countries in the region. The rise in net lending was primarily attributable to the higher trade balance, while the transfer balance surplus declined due to lower absorption of EU transfers. The higher trade surplus in the third quarter was mostly linked to the goods balance, but the rise in the services balance also played a role to a smaller degree. In addition to exports expanding faster than imports, growth in net exports was also supported by favourable developments in the terms of trade. The changes in export dynamics also reflected the effect of stronger industrial production. In conjunction with decreasing net expenditures related to equity income, the income balance continued to improve.

In 2019 Q3, Hungary's four-quarter net lending according to the real economy approach rose to 1.1 percent of GDP, while the current account deficit fell to 0.8 percent of GDP (Chart 1). According to unadjusted quarterly data, net lending in Q3 amounted to EUR 112 million, as a result of the capital account surplus of EUR 342 million, less the current account deficit of around EUR 230 million. The improvement in external balance indicators is primarily attributable to the rise in the goods and services balance, while the absorption of EU transfers declined during the quarter under review.

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

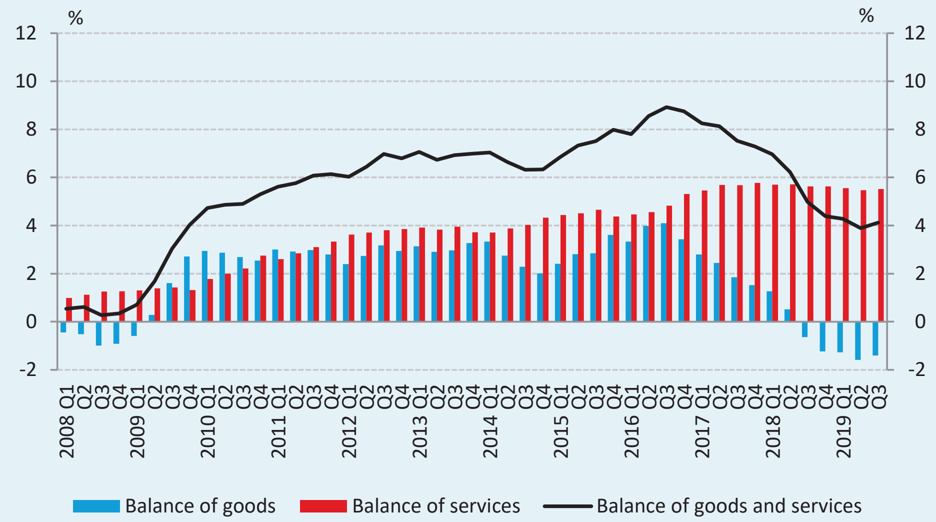


** Income balance: earned income, income on equity and income on debt. Transfer balance: sum of the capital account and other primary and secondary income.*
All charts by the MNB unless otherwise indicated.

1.1 Trade balance

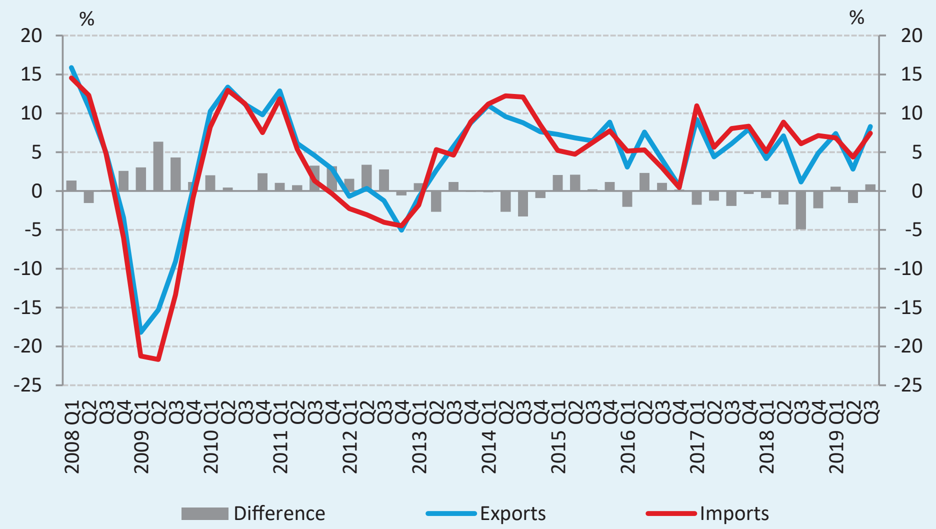
In 2019 Q3, the trade surplus increased, mainly due to the rise in goods balance owing to elimination of the poor base, while the surplus of the services balance remained high (Chart 2). The downtrend in the trade balance seen since early 2017 reversed in 2019 Q3, with the four-quarter index rising to above 4 percent of GDP again. The higher trade surplus was mostly attributable to the increase in the goods balance and to a lesser degree to the rise in the services balance. As a percentage of GDP, the goods balance rose by almost 0.2 percentage point, with the deficit falling to 1.4 percent of GDP. The rise in the indicator was partly due to the fact that it no longer contains the autumn months of 2018, when slower car exports resulting from new regulations in the automotive industry (WLTP) negatively impacted exports, while higher energy imports had an adverse effect on imports. Following a moderate rise, the trade balance of the services sector amounted to 5.5 percent of GDP, and thus it is still an important contributor to the trade surplus.

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



In 2019 Q3, exports grew faster than imports, resulting in higher net exports (Chart 3). The varying rates of increase for the two indicators was also supported by the fact that, similarly to 2019 Q2, inventories fell in the third quarter again, and thus export growth was accompanied by moderate import growth, despite the strong investment activity. Industrial production continues to expand dynamically, and the difference between the growth rates for Hungarian and German industrial production increased further (for more details on the possible causes of this, see the June 2019 Inflation Report). In line with the developments in industrial production, both goods exports and imports accelerated. Import-intensive domestic demand items (investments, consumption) grew further, but the impact of this may have been reduced by the fact that in recent years the import content of machinery investments declined, in parallel with the strengthening of domestic supplier chains.

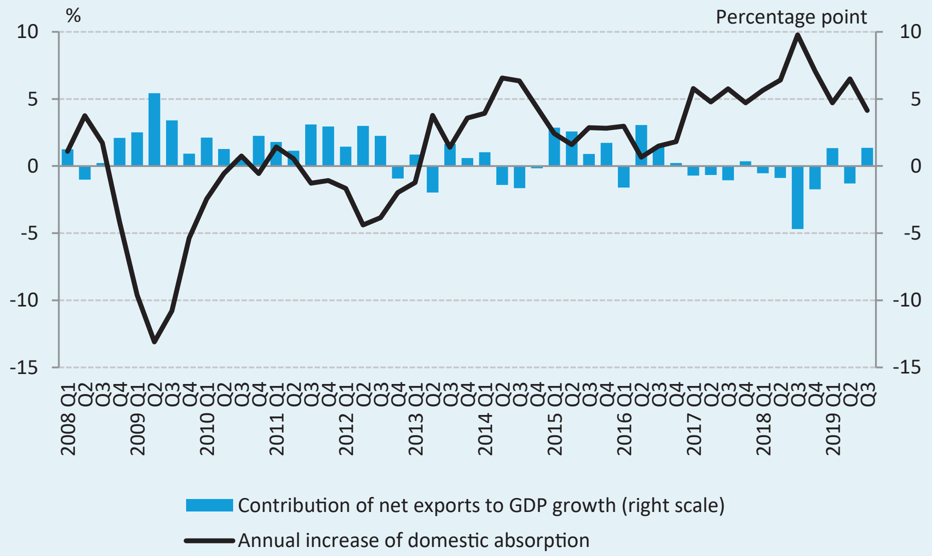
Chart 3: Annual real growth in exports and imports



Source: HCSO, MNB.

The annual growth rate of domestic absorption decelerated again, while net exports supported growth (Chart 4). In 2019 Q3, household consumption and whole-economy investments continued to grow at a slower pace than observed in the previous quarter, which was reflected in the more moderate rise in domestic consumption. The growth in investments was partly related to construction, and partly to expansions of manufacturing capacities. The slower growth in domestic demand items may have also contributed to the slower rise in imports than in exports, due to which the contribution of net exports to growth was once again positive in the third quarter.

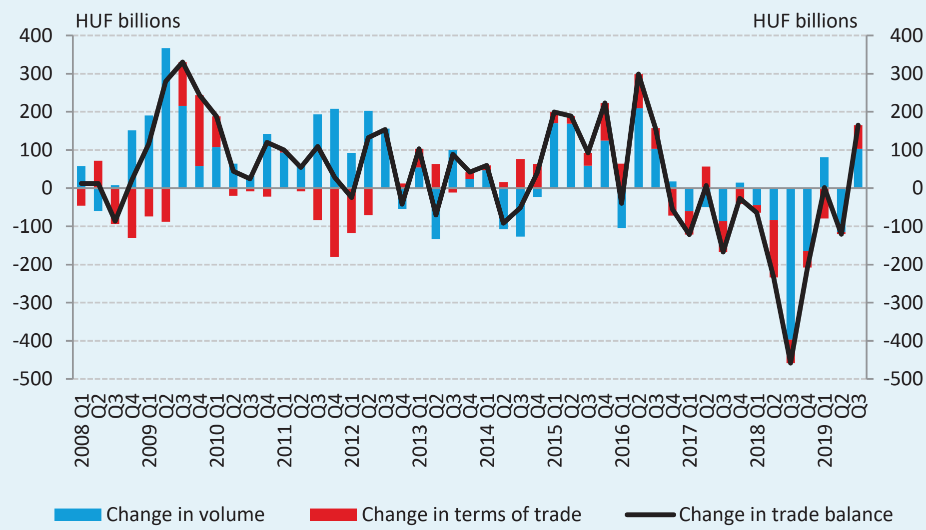
Chart 4: Annual growth rate of domestic absorption and contribution of net exports to GDP growth



Source: HCSO.

The trade surplus growth recorded in 2019 Q3 was also supported by the terms of trade, in addition to change in volumes. While the deterioration in the terms of trade had a considerable negative impact on the trade balance in 2018 as a result of rising oil prices, this effect increased the trade balance in 2019 Q3 again, partly also due to the higher base. Accordingly, in addition to the change in volume, developments in export and import prices also supported the rise in the goods and services balance surplus (Chart 5).

Chart 5: Developments in the balance of trade factors according to GDP (year-on-year)

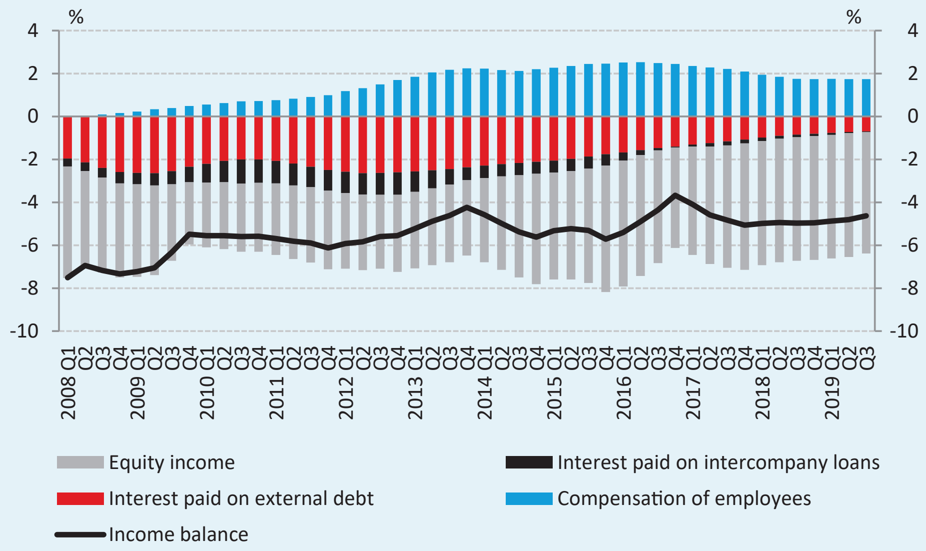


Source: HCSO.

1.2 Income balance

The deficit on the income balance continued to shrink in 2019 Q3, primarily due to the lower outflow of income related to equity (Chart 6). In the third quarter, the income deficit amounted to 4.6 percent of GDP. The improvement in the balance was connected to a larger degree to foreign-owned companies' income related to equity, representing the largest component within the income balance, the deficit of which fell below 5.7 percent of GDP. In addition, in line with the decline in net external debt and in the persistently low yield environment, net interest expenditure on foreign loans and intercompany loans continued to fall. The compensation of employees did not change materially in the past quarter, and they continued to improve the income balance by 1.7 percent of GDP.

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

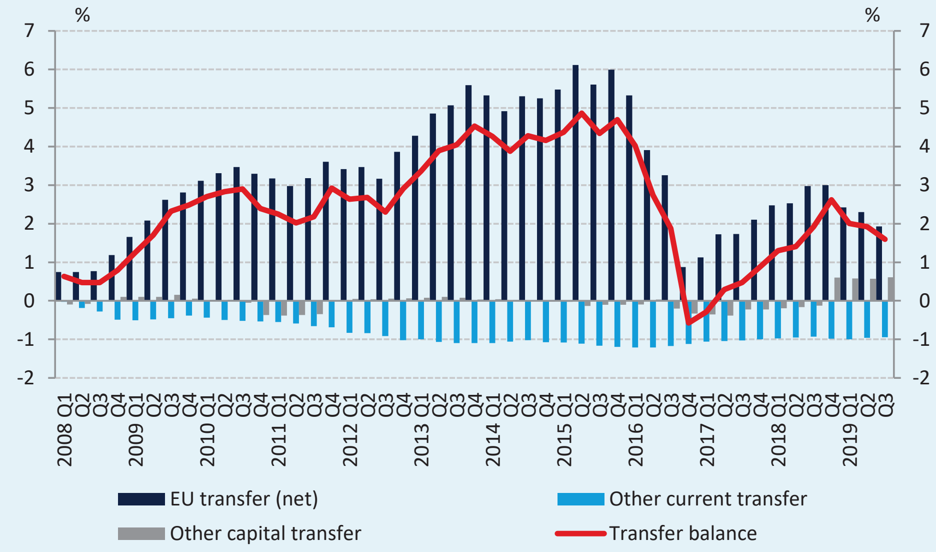


** Income balance: earned income, income on equity and income on debt.*

1.3 Transfer balance

The transfer balance surplus declined in the third quarter, reflecting the more moderate absorption of EU funds. In 2019 Q3, the transfer balance surplus dropped to 1.8 percent of GDP, owing to the moderate absorption of EU funds (Chart 7). The impact of the lower-than-estimated absorption is also reflected in the downward revision of the capital account data for the previous two quarters. The declining absorption of EU transfers may be attributable to the fact that the funds from the EU – also including large amounts of advances – are recognised in the capital account upon absorption rather than upon receipt, and thus their impact increasing net lending appears in line with the realisation of investments, i.e. with a timing different from the receipt of funds. The net EU transfer absorption observed in recent quarters, which amounts to about 2 percent of GDP annually, continues to contribute to sustaining Hungary's favourable external balance position. The balance of other current transfers and capital transfers remained practically unchanged during the quarter.

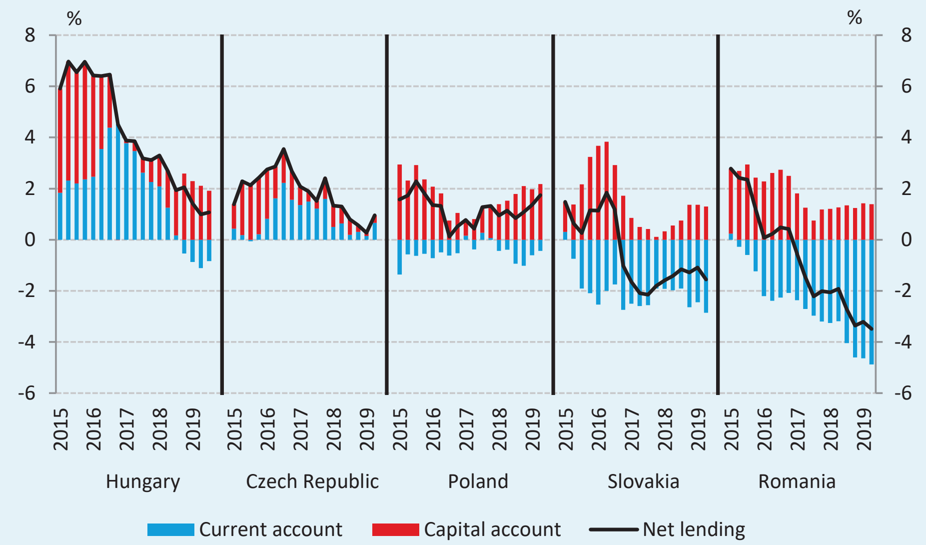
Chart 7: Four-quarter developments transfer balance items (four-quarter values as a percentage of GDP)



1.4 Regional review

The net lending of the Hungarian economy remains significant in a regional comparison and exceeds the level observed in the CEE region (Chart 8). The favourable balance position is supported by the significant surplus of the capital account, whereas the current account balance is around the average for the region. External balance indicators have typically declined in the regional countries since 2016, partly due to the decreasing capital account at the boundary of the two EU budget cycles, and partly due to the decline in the countries' current account balances. The four-quarter current account deficit in Romania exceeded 5 percent of GDP, while in Slovakia it came close to 3 percent of GDP. By contrast, in the Czech Republic and Poland – similarly to Hungary – the current account balance improved, and the positive impact of this on net lending in Poland was also corroborated by the improvement in the capital account (presumably attributable to EU transfers). In spite of the decline and the stabilisation observed in Hungary in the past quarter, its net lending is still considered high in the region, which is attributable to the considerable surplus of the services account and – similarly to Poland – to the high surplus of the capital account.

Chart 8: Four-quarter net lending in region (as a percentage of GDP)



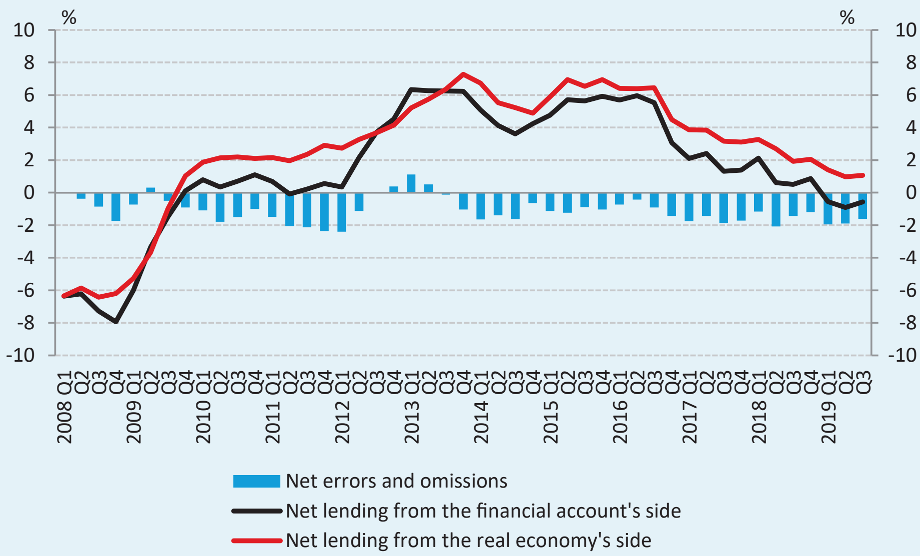
Source: MNB, Eurostat.

2 Financing approach

The four-quarter net borrowing calculated on the basis of the financial account amounted to 0.6 percent of GDP in Q3. Against the background of moderate outflows of debt-type liabilities and continued inflows of non-debt liabilities, four-quarter net borrowing declined on the whole in the third quarter. In Q3, debt-type liabilities – following a moderate rise in the previous quarter – fell slightly, explained by the lower net external debt of the general government, and particularly by the rising foreign exchange reserves. By contrast, the net external debt of the private sector increased considerably, attributable to banks' rising external indebtedness.

According to financing data, in 2019 Q3 the four-quarter net borrowing of the economy declined slightly and was thus around 0.6 percent of GDP (Chart 9). According to the real economy approach, four-quarter net lending rose slightly. Similarly to the previous two quarters, the combined current and capital account balance still shows a surplus, while the four-quarter value of the financing items indicate the inflow of foreign funds.[1] In Q3, the net errors and omissions item was slightly below its historical average of 2 percent of GDP.

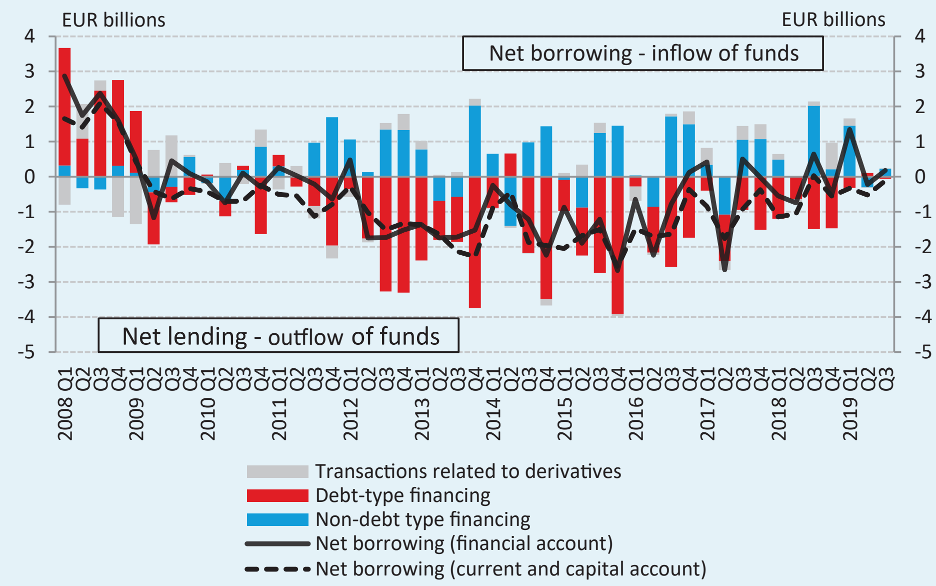
Chart 9: Two types of net lending and 'Net errors and omissions'
(four-quarter values as a percentage of GDP)



The Q3 value of net borrowing calculated based on the financial account fell significantly short of the previous year's figure, leading to a decline in the four-quarter value (Chart 10). The outflow of debt-type liabilities amounted to around EUR 100 million, while non-debt liabilities rose by more than EUR 200 million, following the outflows linked to dividend payments in the previous quarter. Accordingly, net borrowing calculated on the basis of the financial account was around EUR 200 million.

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

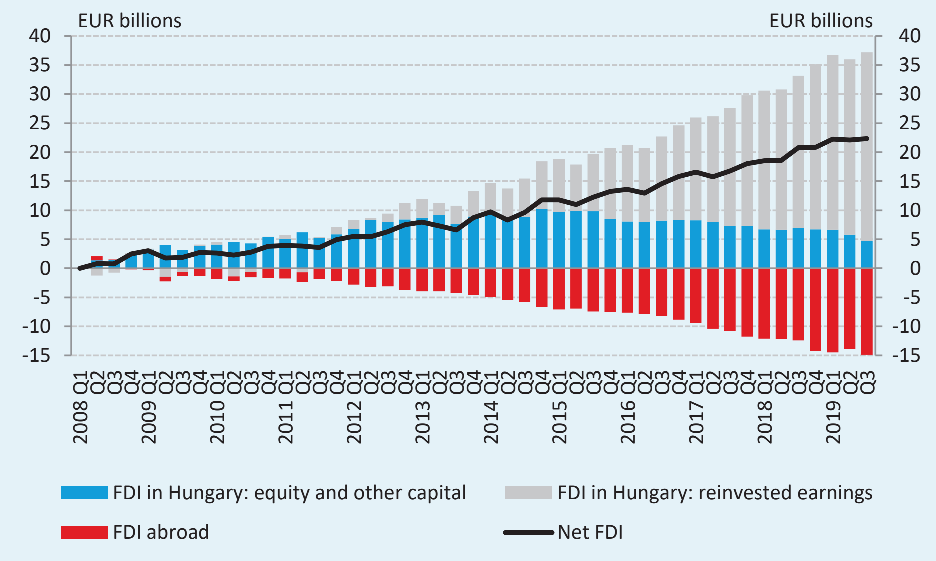
Chart 10: Structure of net lending (unadjusted transactions)



2.1 Non-debt liabilities

Following the decline resulting from dividend payments in Q2, FDI funds increased slightly in Q3 (Chart 11). Based on data net of capital-in-transit transactions and asset portfolio reallocation, foreign direct investments rose by almost EUR 200 million in net terms in Q3. Foreign direct investments in Hungary rose by more than EUR 1.2 billion, while Hungarian companies' investments abroad were up by almost EUR 1 billion.

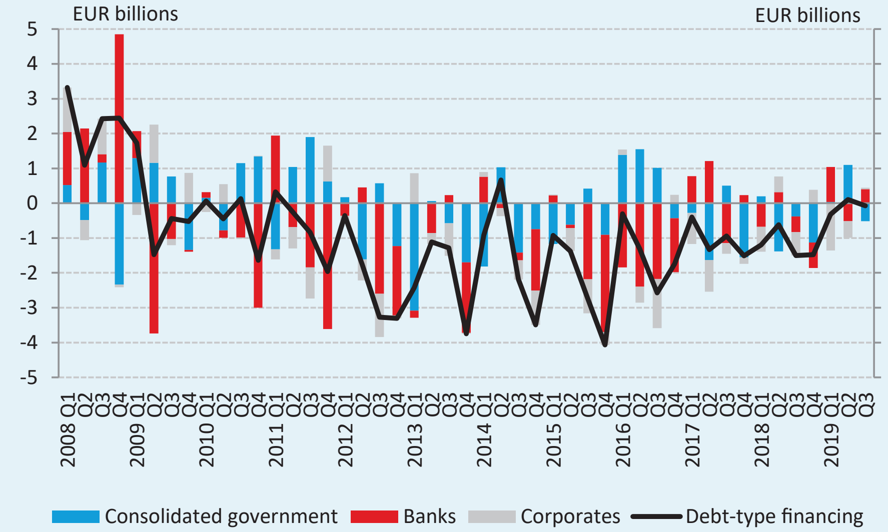
Chart 11: Developments in FDI without capital-in-transit transactions (cumulative transactions)



2.2 Debt liabilities

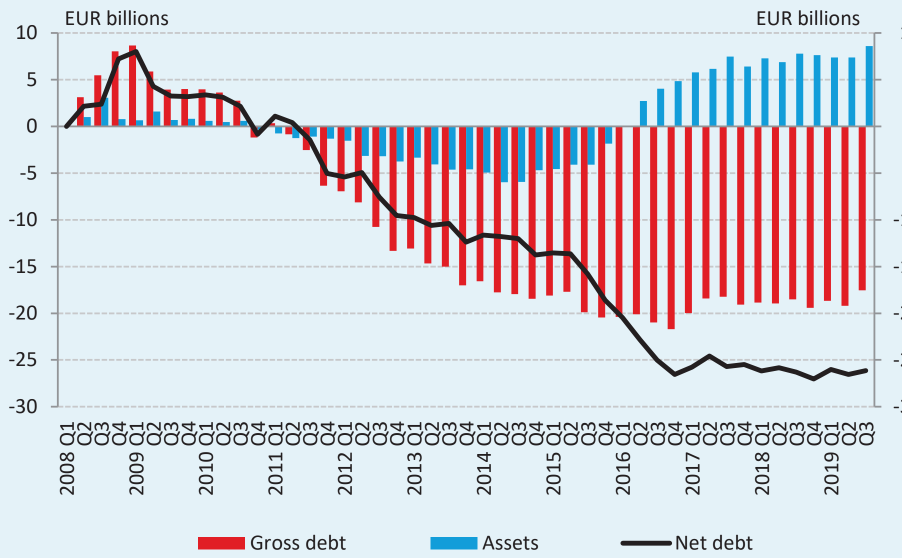
In Q3, as a result of transactions, the stock of debt liabilities moderately decreased, which was completely related to the state, while the net external debt of the private sector increased (Chart 12). The decline of more than EUR 500 million in the net external debt of the consolidated general government was primarily attributable to the rise in foreign exchange reserves. The net external debt of the banking sector rose by EUR 400 million as a result of the rise in external liabilities in excess of receivables. Net external debt of the corporate sector slightly increased.

Chart 12: Developments in net debt-type financing by sector



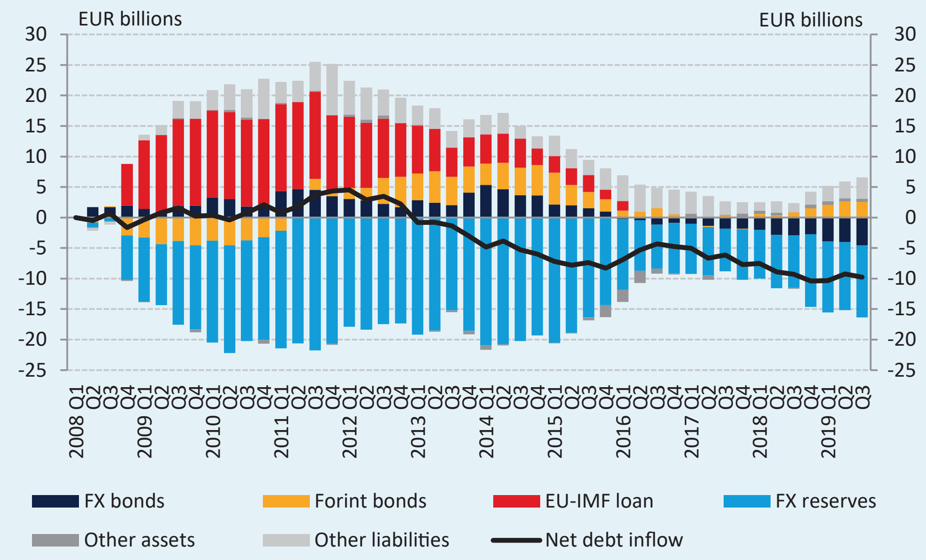
Banks' net debt raising from transactions amounted to EUR 400 million and external liabilities rose by more than EUR 1.6 billion as a result of transactions, while receivables were up by EUR 1.2 billion in Q3 (Chart 13). Banks' gross external debt is the result of the parallel rise in short- and long-term liabilities. The rise in banks' external debts may have been related to the increase in central bank FX swap holdings.

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



The decrease in the debt-type external liabilities of the consolidated general government including the MNB was attributable to the rise in foreign exchange reserves (Chart 14). The net external debt of the general government fell by more than EUR 500 million in Q3, as the combined result of opposite effects. Non-residents' declining holdings of foreign currency government securities reduced both external liabilities and foreign exchange reserves, and thus had no effect on net external liabilities. A maturing Premium Euro Hungarian Government Bond also supported the decrease in foreign exchange reserves. Despite the declining foreign currency bond portfolio, in Q3 the foreign exchange reserves rose significantly, increasing by roughly EUR 700 million in Q3, which was related to the absorption of EU transfers and the expansion of the central bank's fine-tuning foreign currency instruments.

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



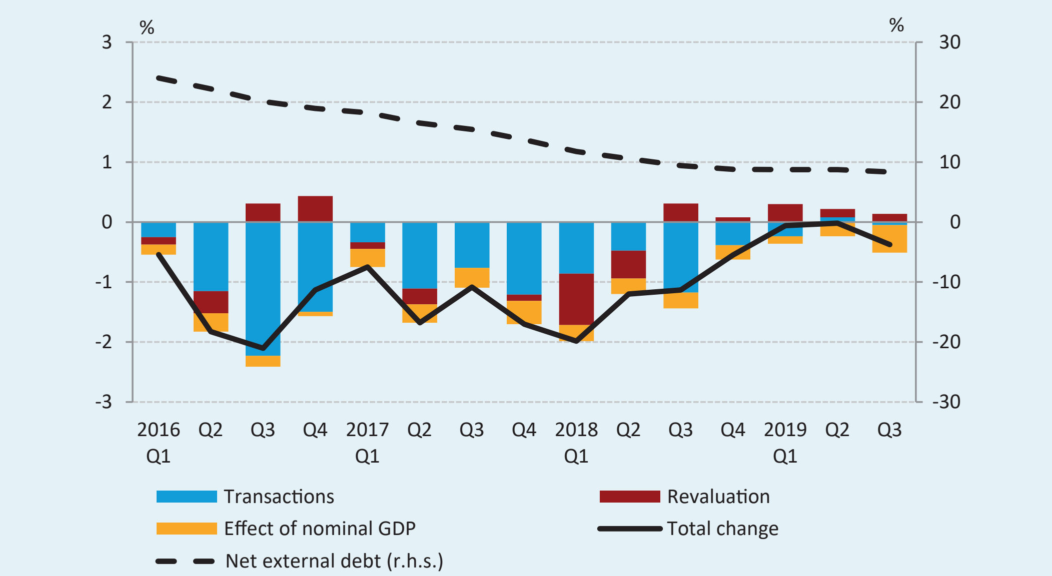
3 Developments in debt ratios

Owing to the continued rise in external assets, Hungary's net external debt declined further, while gross external debt increased moderately. Net external debt fell to 8.4 percent of GDP by the end of the quarter, whereas the gross indicator stood at 57.7 percent of GDP. The modest decline in net external debt occurred in conjunction with a small volume of transactions and is mostly attributable to the growth in nominal GDP, while revaluation effects raised the indicator slightly. The fall in net external debt was mostly linked to the general government, also supported by the revaluation of reserves, in addition to the rise in foreign exchange reserves as a result of transactions. The net external debt of the banking sector rose in parallel with the increase in external liabilities. In contrast to the net indicator, gross external debt increased, owing to the banking sector's fund raising and revaluation of the general government's gross external debt. Short-term external debt increased by EUR 0.9 billion to EUR 19 billion, mainly due to the rise in the general government's short-term external debt vis-à-vis the EU. At the same time, as foreign exchange reserves increased more than short-term external debt, the volume of international reserves still significantly exceeds the level expected and considered safe by investors.

3.1 Developments in net and gross external debt

The net external debt of the economy continued to fall in Q3: due to higher nominal GDP, the indicator dropped by 0.2 percentage point to 8.4 percent of GDP. In addition to the rise in nominal GDP, the outflow of debt-type liabilities also generated a decrease in net external debt, while revaluation effects moderately increased the indicator. The fall in debt-type liabilities resulted in a decline of 0.1 percentage point in outstanding net external debt as a percentage of GDP, while the rise in nominal GDP generated a decline of 0.2 percentage point. On the whole, the revaluation of outstanding stocks raised the ratio by 0.2 percent of GDP, which is attributable to the repricing of outstanding government securities due to rising yields (Chart 15).

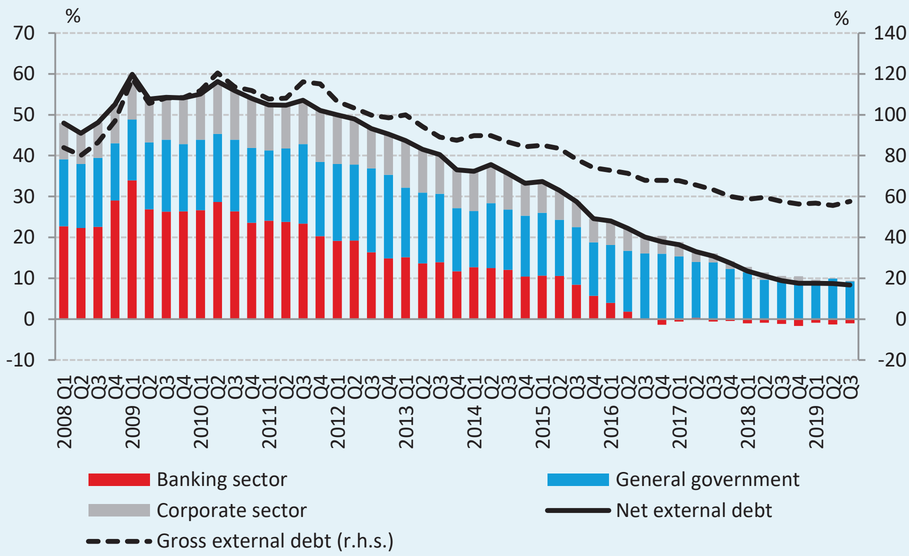
Chart 15: Components of the change in net external debt
(values excluding intercompany loans as a percentage of GDP)



The decline in net external debt in Q2 was primarily related to the general government (Chart 16). Net external debt fell to the largest degree in the general government sector, decreasing by almost 0.4 percent of GDP. The decline in the debt observed in the general government was primarily supported by the rise in foreign exchange reserves as a result of transactions, which was mostly related to the inflow of EU transfers. In addition, the higher foreign exchange reserves resulting from revaluation effects, and particularly from the depreciation of forint, also contributed to the decline in the indicator. Banks' outstanding net external debt slightly increased, on the heels of a decline observed in the previous quarter. In addition, corporations' net external debt also rose moderately, which is related to the slight decline in the sector's external receivables. The net external debt of the private sector amounted to -0.9 percent of GDP at the end of the quarter: the negative indicator observed in the banking sector more than offsets the corporations' minimal (0.2 percent) net external debt.

Hungary's gross external debt-to-GDP ratio rose in Q3 and amounted to 57.7 percent of GDP at the end of September. The rise in the indicator was primarily related to borrowing by the banking sector and, due to decreasing yields, the revaluation of the gross external debt of the general government. Borrowing by the banking sector – mostly for longer maturities – increased the gross external debt-to-GDP ratio by 1.3 percentage points. The general government gross debt-to-GDP ratio rose by 0.6 percent of GDP: in addition to the slight increase resulting from transactions, revaluation effects also generated higher gross external debt. Corporations' gross external debt did not change materially during the quarter under review.

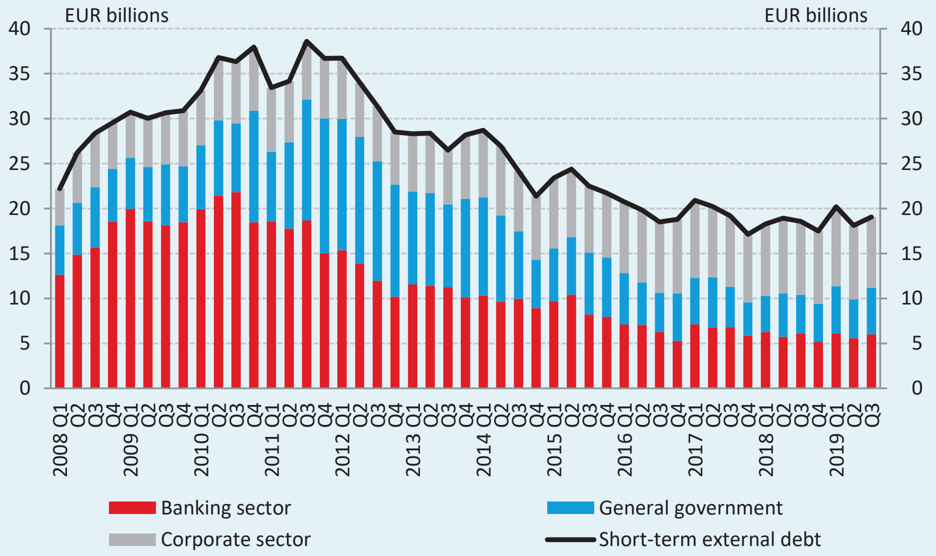
Chart 16: Net external debt in a sectoral breakdown and gross external debt (as a percentage of GDP, excluding intercompany loans)



3.2 Developments in short-term external debt

At the end of 2019 Q3, following a rise of EUR 0.9 billion, short-term external debt amounted to EUR 19.1 billion (Chart 17). This rise in short-term external debt is partly related to the general government, and to a smaller degree to the banking sector, the effect of which was mitigated by the moderate decrease observed in the corporate sector. The rise of EUR 0.9 billion in the general government's short-term external debt is mainly attributable to the growth in short-term external debt vis-à-vis the EU (the amounts transferred by the EU have not yet been absorbed) and to the rise in the MNB's short-term external debt, based on original maturity, as a result of customer deposits. The short-term external debt of the banking sector increased by EUR 400 billion, which is mainly related to the one-off transaction of a credit institution. The sector's short-term external debt of EUR 6 billion falls short of the year-on-year values registered in previous years. Corporations' short-term external debt declined by EUR 400 million, which is mainly attributable to the fall in commercial loans.

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



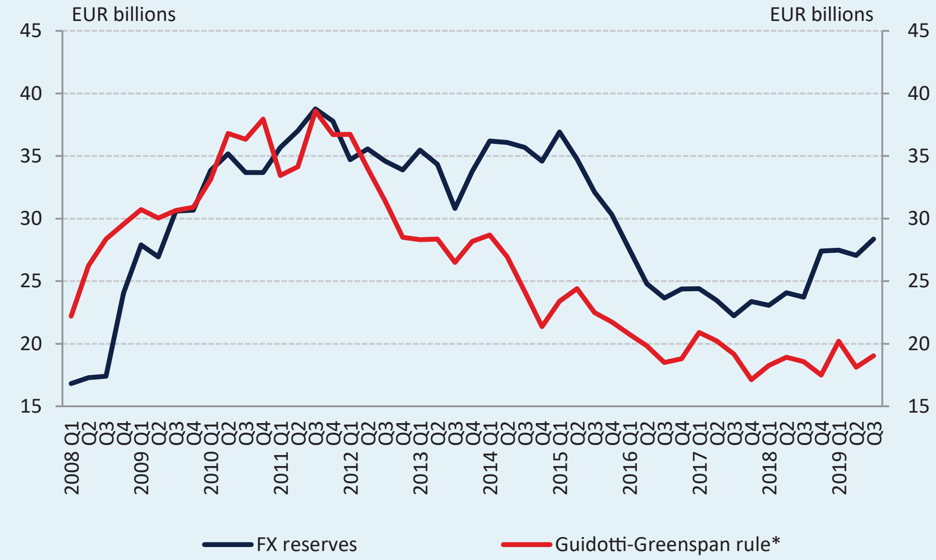
3.3 Developments in foreign exchange reserves and reserve adequacy

In 2019 Q3, the level of foreign exchange reserves rose substantially, as a result of the inflow of EU funds and the rise in FX swaps providing forint liquidity. At the end of September 2019, international reserves amounted to EUR 28.4 billion, representing an increase of EUR 1.3 billion compared to end-June. The main items that influenced the changes in foreign exchange reserves were the following:

- The MNB increased its *foreign exchange swaps providing forint liquidity* throughout the period, as a result of which foreign exchange reserves rose by EUR 870 million.
- The inflow of *EU funds* contributed EUR 800 million to the rise foreign exchange reserves in Q3, and thus nearly EUR 2.7 billion was disbursed in net terms in the first nine months of the year.
- As result of market trends, the *revaluation of foreign currency and gold reserves* contributed to the rise in total reserves by roughly EUR 600 million.
- *The net foreign currency financing of the Government Debt Management Agency (ÁKK)* reduced the level of reserves by roughly EUR 640 million in total. In the quarter under review, the Government Debt Management Agency had no maturing foreign currency bonds issued abroad; the decline was mostly attributable to repurchases of international foreign currency bonds before maturity, in addition to the redemption of retail foreign currency bonds in the amount of almost EUR 200 million.
- The *FX expenditures of the Hungarian State Treasury* reduced the level of foreign exchange reserves by EUR 250 million in the period under review.

Against the background of the significant rise in foreign exchange reserves and the increase in short-term external debt, the level of foreign exchange reserves continued to considerably exceed the level expected by investors. Based on the Guidotti–Greenspan rule, which is closely followed by both the central bank and investors, the foreign exchange reserves of EUR 28.4 billion at the end of September 2019 significantly exceeded the level of short-term external debt, which amounted to EUR 19.1 billion. In parallel with the rise in foreign exchange reserves by EUR 1.3 billion, short-term external debt also increased, but the rate thereof fell short of the growth in foreign exchange reserves, and thus reserve adequacy improved on the whole. Accordingly, based on the Guidotti–Greenspan rule, foreign exchange reserves at the end of September 2019 exceeded the short-term external debt by roughly EUR 9.4 billion, which still represents a safe level

Chart 18: Short-term external debt and FX reserves of the Hungarian economy



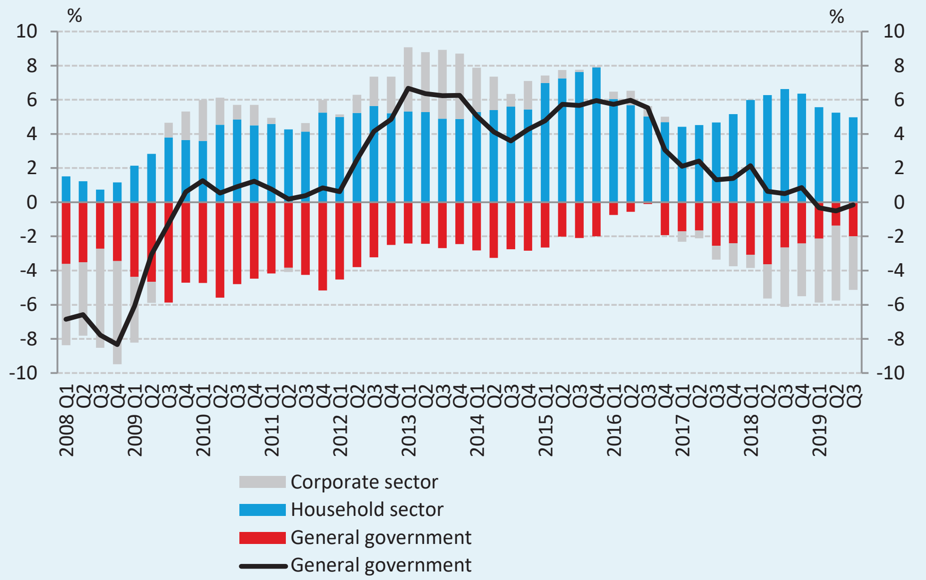
** Guidotti–Greenspan indicator: short-term external debt based on residual maturity.*

4 Sectors' savings approach

The rise in net lending according to the sectors' savings approach was related to the increase in the private sector's savings position, while the government's net borrowing remained low, in line with the strict fiscal policy. Corporations' declining net borrowing made the largest contribution to the private sector's rising position, while net financial savings of households remained at a high level, amounting to around 5 percent of GDP. The changes in the household savings ratio may be connected to the high credit demand, also supported by the package of demographic measures. In the quarter under review, households' government securities holdings increased substantially, which was primarily related to purchases of the long-term Hungarian Government Security Plus (MÁP+), introduced in June.

According to the savings of sectors, the improvement in the Hungarian economy's external balance position was mainly connected to the private sector (Chart 19). Corporations' net borrowing declined during the period under review, and thus households' net financial saving covered the annual borrowing of the government and corporations. Four-quarter government net borrowing remained low, and increased slightly to 2 percent of GDP. The moderate rise in the budget deficit is partly attributable to the expenditures stemming from the family protection measures. The decline in corporation's net borrowing was primarily related to the decline in inventories. In conjunction with the slower rise in household consumption, households' four-quarter net lending amounted to 5 percent of GDP. The considerable accumulation of financial assets is in line with the strong wage dynamics and households' increasing borrowing.

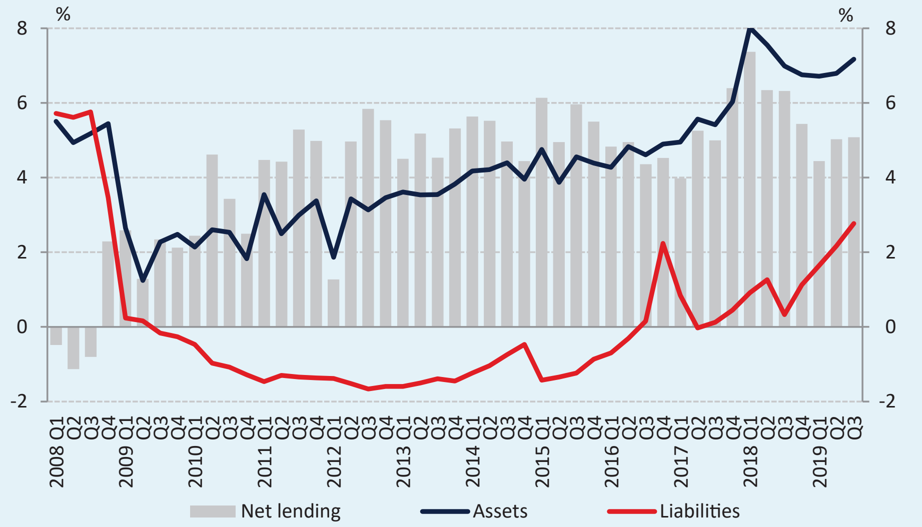
Chart 19: Net lending of sectors*(four-quarter values as a percentage of GDP)



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

Households' net financial savings according to seasonally adjusted, underlying developments stabilised at close to 5 percent of GDP in Q3 (Chart 20). In the quarter under review, households' credit demand continued to increase, with the introduction of prenatal baby support loans playing a major role in this development, while the rise in housing loans made a smaller contribution to the trend. Households' seasonally adjusted net borrowing was around 2.7 percent of GDP in the third quarter. In line with the borrowing and the strong wage dynamics, households' accumulation of financial assets rose, which primarily resulted in stronger growth in government securities.

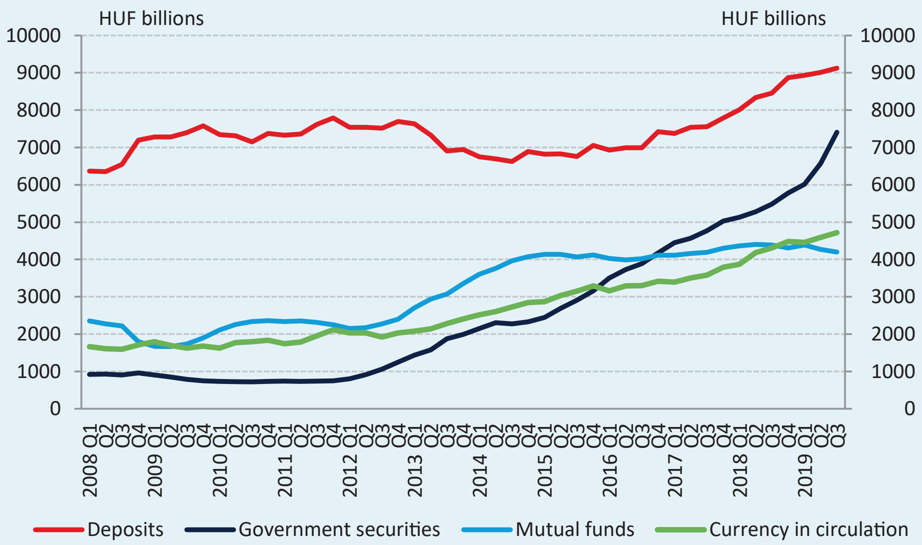
Chart 20: Net lending of households (seasonally adjusted revised* values, as a percentage of GDP)



**Figures showing underlying trends, adjusted for the impact of pension savings, the early repayment scheme and the real yield payment, the indemnification of the depositors of liquidated mutual savings banks as well as the forint conversion and settlement. Time series are adjusted separately.*

Within households' financial assets, government securities holding rose to an outstanding degree, partly financed from new savings and partly from the redemption of mutual fund shares (Chart 21). Household demand for government securities continued to grow dynamically in the quarter under review, and the sector's total holdings were close to HUF 7,500 billion at the end of the quarter. Households' short-term retail government securities holdings declined, while the growth in the holdings of long-term securities reached yet another historical high, which can be explained by the robust demand for the Hungarian Government Bond Plus Scheme. Households continue to play an increasing role in financing the state from domestic resources and made a major contribution to the government reducing the non-resident and foreign currency ratio of the government debt in the third quarter by repurchases. As in previous quarters, the holdings of mutual fund shares, which are less liquid, declined further, which was primarily attributable to the withdrawal of funds from the bonds funds that hold government securities and from other investment funds. Part of the savings that flowed out from mutual fund shares presumably financed the rise in the government securities portfolio directly held by households. In Q3, households' bank deposits and cash holdings increased further.

Chart 21: Developments in households' key financial assets



5 Changes in the funding of corporations

This special topic in the Report on the Balance of Payments deals with the funding of the corporate sector. The post-crisis deleveraging by corporations manifested itself in a sharp rise in net financial savings and in the repayment of foreign and domestic loans. At the same time, starting from mid-2016, in parallel with the dynamic rise in investments and also supported by the FGS programme, corporations' net borrowing has increased considerably. However, compared to the pre-crisis period, one important difference is that – in addition to the rise in funds provided by Hungarian banks – non-resident funding already predominantly comprises inflows of foreign direct investments rather than loans. Namely, corporate investments boost Hungary's external debt neither through direct foreign borrowing, nor indirectly, through loans taken from banks. A substantial portion of the corporate sector's domestic borrowing was related to manufacturing industries, which are of outstanding importance for exports, and thus the dynamic rise in investments is considered sustainable.

5.1 Introduction

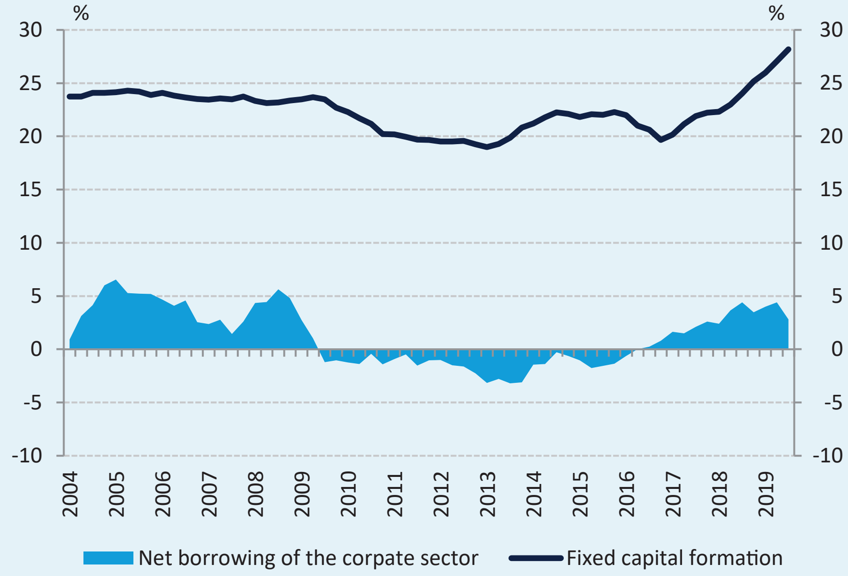
In our special topic, we present the trends in the corporations' net lending, and particularly developments in their external liabilities Analysis of this topic is particularly timely, because while the general government deficit is still at its historic low and households' net financial savings are consistently at a high level, from 2016 corporations once again became net borrowers to an increasing degree. In relation to this, the question may arise whether in parallel with the pickup in domestic lending there has been any change in the stock of the sector's other liabilities (e.g. foreign loans). In this section, we review the net financial savings of corporations and the factors contributing to the decline in the indicator. On the other hand, we examine how corporations' position vis-à-vis the non-resident sector has developed in the past period and how this may have influenced the changes in the sector's net financial savings. Then we also briefly touch on the structure of external funding: in addition to the change in debt-type liabilities, we also present which industries' funding position was improved by foreign direct investments. Finally, we point out the fact that domestic borrowing through the banking sector did not entail a rise in the Hungary's external vulnerability.

5.2 Net financial savings of corporations

Since 2016, non-financial corporations have once again become net borrowers. The deleveraging y non-financial corporations, lasting since the start of the crisis, was reflected in the sharp rise in net financial savings. Examined in the real economy approach, the change in corporations' financial position was partly due to the absorption of EU transfers, and partly due to the decline in investments. However, the net lending of corporations fell from 2014 and from mid-2016 it turned into net borrowing. On the one hand, one factor contributing to the decrease was that the sector's investment activity rose dynamically, as a result of which by the end of 2018 it exceeded the pre-crisis level. On the other hand, the growth in the inventories of corporations until the end of 2018 also pointed in this direction. In addition to these items, the decline in net lending was also influenced by the decrease in operating surplus, partly due to rising wages and higher oil prices.

The increasing borrowing of corporations developed in line with the high investment ratio in recent years, which was also high by European standards (Chart 22). Since mid-2016, corporations have been net borrowers, i.e. based on their financial account, the sector uses the savings of the other economic agents for its operation. One of the important underlying items is the Hungarian investment ratio is deemed outstanding within Europe. In connection with the investment dynamics, the economy's fixed capital formation has been dynamically increasing since 2016 and in 2019 Q3, following a rise of roughly 8 percentage points, it already exceeded 28 percent of GDP. This means that for the development of its new production capacities and implementation of its manufacturing investments, the corporate sector relies on external funding to an increasing degree. With rising corporate investments, the increasing demand for funding may be deemed natural in the sector, since the growth in the capital goods stated on the assets side of the companies' balance sheet may be realised in the financial accounts in conjunction with an increase in the liabilities side or a decrease in liquid assets. Furthermore, the rise in investments – through the growth in production capacities or improved efficiency – increases the earnings potential of corporations, and thus they provide cover in the future for the repayment of the larger stock of liabilities.

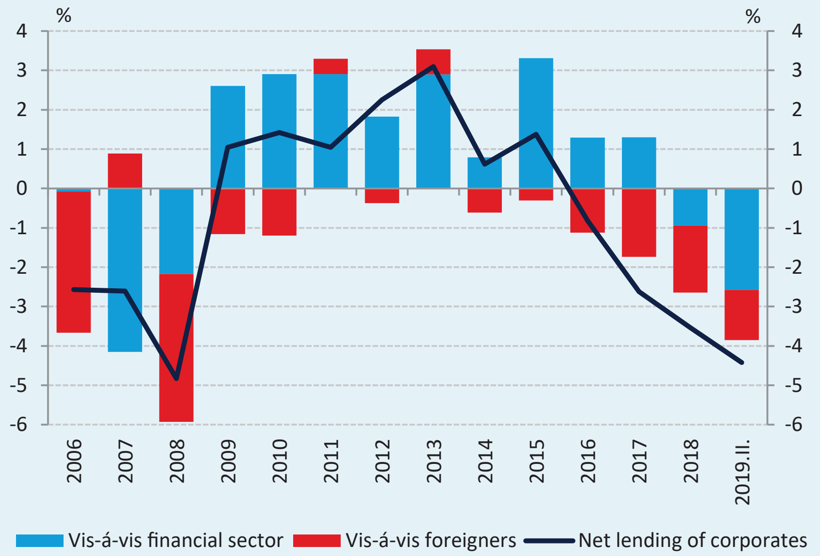
Chart 22: Four-quarter fixed capital formation and corporate net borrowing (as a percentage of GDP)



Source: MNB, HCSO.

As a result of the moderate domestic interest environment and the central bank programmes, in recent years the net borrowing of corporations came from domestic actors to an increasing degree, while the role of external liabilities declined (Chart 23). Following the outbreak of the financial crisis, the net lending of the economy increased strongly. This also meant that whereas before the crisis economic agents relied on external liabilities for the operation of the economy, in line with the rise in lending, they started to reduce their external debts. At the same time, in the past period the net lending of the economy declined, mostly in conjunction with a rise in investments. This was also reflected in the decline in the net lending of corporations. However, it should be noted that the funding needs of corporations, which rose in recent years – in contrast to the pre-crisis situation – came from the domestic banking sector, allocating the savings of domestic sectors, while the rise in external liabilities decelerated. As regards the financing data, the development of corporations' net borrowing is primarily attributable to the rise in liabilities in excess of that in financial assets.

Chart 23: Net lending of non-financial corporations vis-à-vis key sectors (as a percentage of GDP)

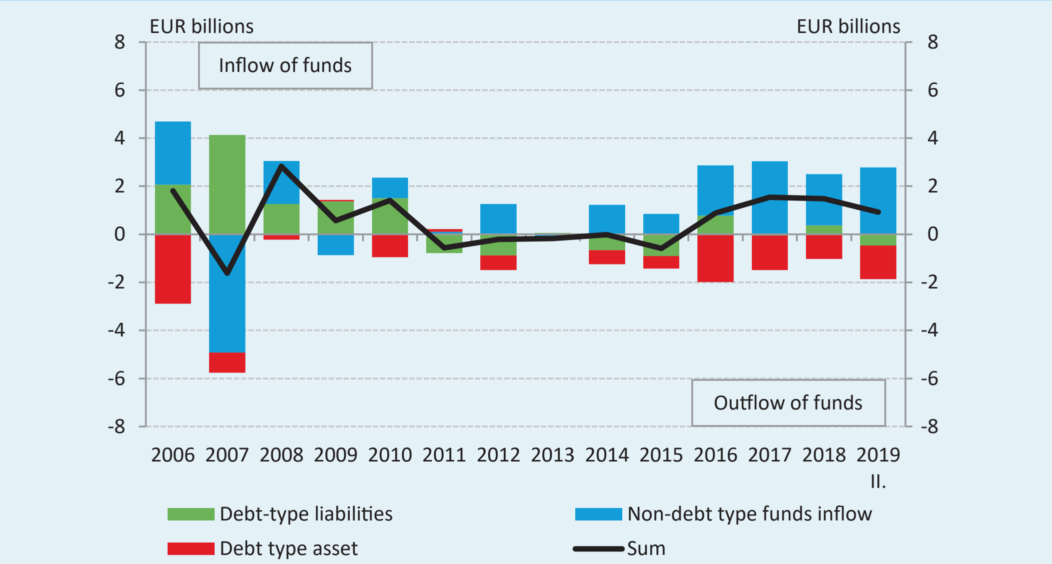


Four-quarter value in 2019 Q2.

5.3 External funding of corporations

The rise in corporations' external liabilities was related to the growth in FDI funds, while no major change was recorded in corporations' gross external debt (Chart 24). In the post-crisis years, the outflow of funds was primarily linked to the banking sector, and from 2012 the role of the general government and corporations also gradually rose in the reduction of external liabilities. In addition to the repayment of foreign loans, the purchases of mutual fund shares by households – partly flowing into external assets – may have also contributed to corporations' outflow of funds between 2013 and 2014. The rise in corporations' external funding observed from 2015 is primarily attributable to the rise in foreign direct investments. In 2016, corporations already became borrowers of external funds, which was due to the fact that – in contrast to the declining external liabilities recorded in the previous years – the portion of the funds necessary for the investment dynamics in the corporate sector came from external funding, and particularly from the increase in foreign direct investments. Despite the borrowing of external funds, the sector continues to reduce its net external debt, which is primarily attributable to the rise in corporations' external assets, mostly foreign currency deposits, while the sector's external debt changed only slightly (at the beginning of 2019 the sector's gross external debt actually declined).

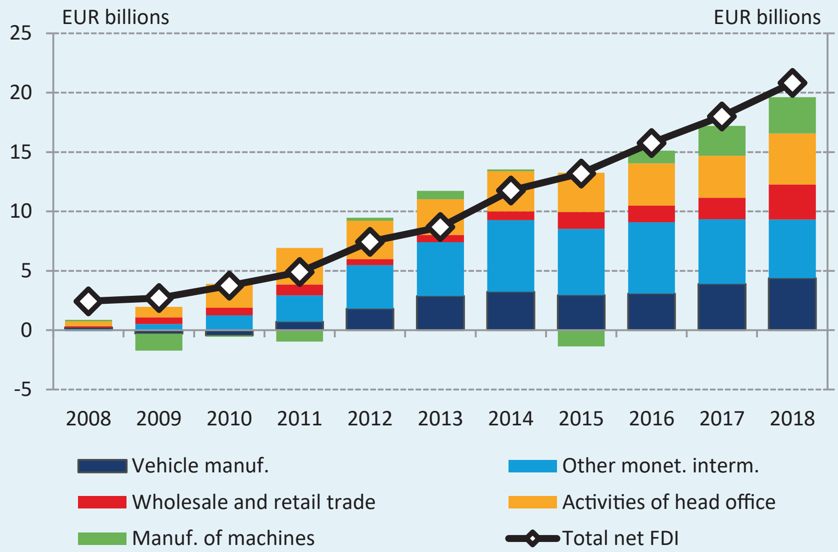
Chart 24: Changes in the outflow of net external funds of non-financial corporations



Four-quarter value in 2019 Q2.

In terms of foreign direct investments, at the sector level, trade, manufacture of machinery and manufacture of transport equipment should be highlighted, as these play a key role in the rise in external liabilities (Chart 25). Based on the data, a major increase was observed in the trade, repair and manufacture of machinery sectors: since 2014 working capital of over EUR 5 billion flowed into these industries. On the other hand, the manufacture of transport equipment also received a high volume of capital, while one of the largest automotive industry investments of the recent period was partly implemented from a foreign loan – it should be noted here that, according to a corporate announcement, significant additional FDI can be expected in the sector (for more details, see the Inflation Reports). In addition, in 2018 foreign capital flowing into the business administration consulting sector also rose to a larger degree – at the same time, industry statistics are substantially influenced by the transfers of multinational corporations between sectors, namely, the capital received by other sectors may also appear here.

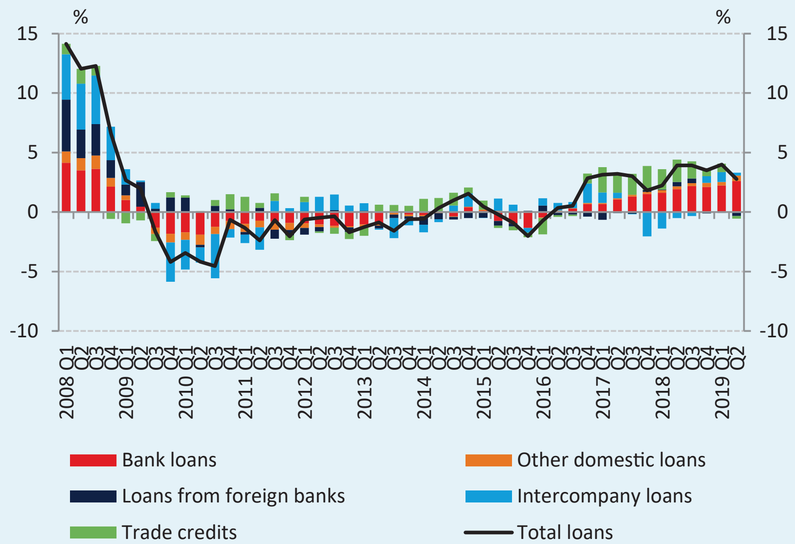
Chart 25: Changes in foreign direct investments in certain key sectors, cumulative transactions



5.4 Domestic funding of corporations

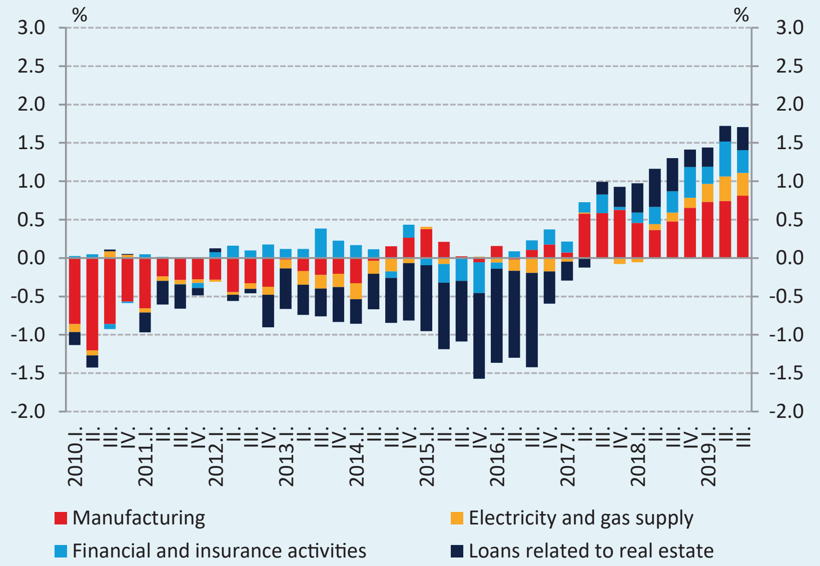
In conjunction with the inflows of foreign direct investment, the rapid growth in investments observed since 2016 was essentially financed by domestic bank loans. Following the outbreak of the crisis, corporations' domestic borrowing declined, but thereafter the range of fund-raising opportunities available to the sector broadened substantially. The decline in domestic corporate loans was prevented by the MNB's Funding for Growth Scheme (FGS) launched in June 2013, the purpose of which was to restart lending to SMEs and restore the corporate credit market; in 2013, the scheme amounting to 2-3 percent of GDP played a major role in stopping the decrease in corporations' bank loans. From the end of 2016, the borrowing of domestic bank loans made the largest contribution to the rise in the sector's outstanding borrowing (Chart 26). In addition, commercial loans related to corporate production also rose in the past quarter. Thus, it is clear that the raising of external liabilities (foreign bank loans and intercompany loans) only played a minor role among the loans. On the whole, the growth in loans to enterprises, and thus the development of corporate net borrowing, was mainly caused by the rise in domestic bank loans, and particularly by FGS loans.

Chart 26: Gross borrowing of non-financial corporations (four-quarter transactions net of capital-in-transit transactions, as a percentage of GDP)



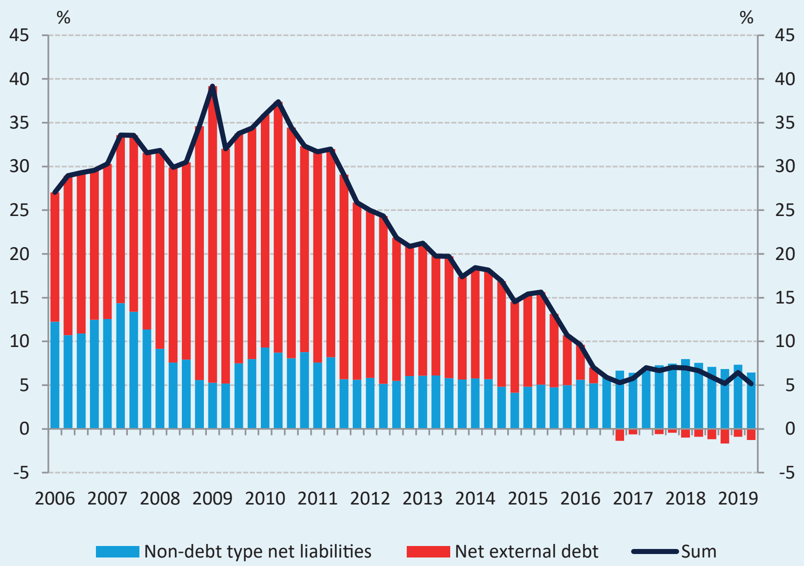
A substantial portion of the corporate sector's domestic borrowing was related to the manufacturing industries, which are of outstanding importance for exports. A large part of the growth in the domestic loans of non-financial corporations was related to manufacturing companies, i.e. they presumably served the financing of the funding-intensive investments implemented in the sector. In addition, compared to the decline in 2016, the credit expansion connected to real estate transactions is a major change, which is attributable to the boom in real estate market activity.

Chart 27: Borrowing of domestic bank loans by the key sectors of non-financial corporations (Four-quarter values as a per cent of GDP)



Owing to the high household savings and the FGS programme, the weight of the non-resident sector also declined substantially in the financing of the banking sector, and thus corporations increase external debt neither directly nor indirectly through the loans taken from banks. Non-financial corporations have less and less direct non-resident funding and more and more domestic (partly bank) funding. In respect of domestic bank funds, one important development is that banks' net external liabilities have also showed major decline since the crisis, falling from the previous level of almost 40 percent of GDP close to 5 percent of GDP. Moreover, according to the sector's net external debt, derivable from the balance of payments data, since 2016 the sector is a net lender to the non-resident sector (i.e. the sector's net external debt is negative). Based on this, it can be stated the sources of the corporate sector's domestic borrowing were also provided mostly by domestic sectors, relying on households' savings, which rose after the crisis and have been at a high level ever since.

Chart 28: Developments in the banking sector's net external liabilities



List of charts and tables

Gábor Bethlen

(15 November 1580 – 15 November 1629)

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

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

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

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

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