REPORT ON THE BALANCE OF PAYMENTS

2024
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 allows for the earlier identification of economic problems, when they are developing, and thus steps can be taken to avoid such problems.

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

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

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

The Report is based on information pertaining to the period ending 22 December 2023.

Summary

The improvement in the external position continued *in 2023 Q3:* ***on a quarterly basis, the current account showed a surplus of 0.8 percent of GDP.*** *Based on the four-quarter balance, the deficit narrowed to 2.1 percent of GDP, while net borrowing dropped to 1.2 percent of GDP. The quarterly current account turned into a surplus mainly in relation to the* ***increase in the trade balance*** *to 2.9 percent of GDP, which reflected an* ***improvement in the terms of trade*** *driven by lower energy prices and the* ***adjustment of domestic sectors.*** *The rising profits of foreign companies and the increasing interest balance of foreign loans were reflected in the income balance deficit, which grew to 4.7 percent. The 0.6 percent surplus of the transfer balance remains low towards the end of the EU budget cycle but contributes positively to the country's external position. As in Hungary,* ***external balance indicators also improved in other countries of the region:*** *the Polish indicator turned to net lending, although net borrowing of Slovakia and Romania continued to range between 2 percent and 4 percent of GDP.*

Consistent with developments in the real economy, according to the financial account, the four-quarter value of the Hungarian economy's ***net borrowing also declined*** *to 4.2 percent of GDP in 2023 Q3. The economy's declining external imbalances were mainly financed by inflows of foreign direct investment, which reduced Hungary's net external debt. Besides the corporate sector, net debt outflows were* ***mainly driven by general government,*** *but borrowing by the banking sector also slowed significantly.*

Net external debt fell to 11.9 percent of GDP *at the end of September 2023. The sharp decline in the debt ratio can be attributed, in addition to debt outflows, to revaluation effects and was mainly linked to the reduction in general government debt.* ***Gross external debt*** *also* ***fell*** *significantly: the ratio stood at 64.4 percent of GDP at the end of September. After a moderate decline,* ***international reserves*** *amounted to EUR 39.7 billion, still close to an all-time* ***high****. At the end of the quarter, the MNB's international reserves exceeded* ***the level of short-term external debt, an indicator closely monitored by investors, by almost EUR 6 billion.***

Thanks to the rising net financial savings of the private sector, *the external balance position based on the savings of economic sectors* ***continued to improve with a parallel,*** *modest decline in the budget deficit. The deficit of general government improved slightly but remained high. At the same time, net savings of the private sector (households and corporations) increased significantly, continuing to reflect the decline in domestic consumption. In the high inflation environment,* ***holdings of inflation-indexed government securities*** *and mutual fund shares* ***increased further within total household savings,*** *while bank deposits fell.*

In our special topic, we compare ***two major crisis periods of recent decades,*** *with a focus on external balance developments. Both the financial crisis of 2008 and the energy crisis of 2022 had a significant impact on the external balance of the Hungarian economy. While the* ***current account improved substantially in both cases after the peak of the crisis,*** *there are important* ***differences between the two periods*** *in terms of external vulnerabilities, external and internal indebtedness, tightening financing conditions, rising unemployment and energy price developments.* ***At the same time, the adjustment of domestic sectors shows strong similarities:*** *while in the first phase consumption played a role in the deterioration in the external balance in both periods, it was followed by a significant external rebalancing effect driven by the adjustment of domestic demand items. Nevertheless, in contrast with the protracted slowdown during the financial crisis,* ***the economic downturn resulting from the energy crisis of the past year may prove temporary, owing to more favourable external and internal conditions.***

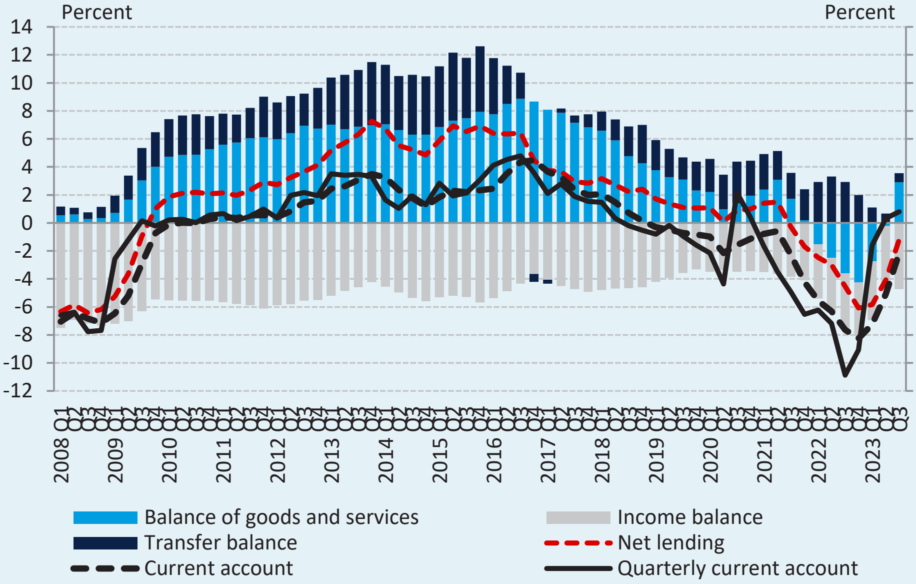
Contents

1 Real economy approach

According to the real economy approach, Hungary's quarterly adjusted current account balance showed a surplus of 0.8 percent, while the four-quarter net borrowing amounted to 1.2 percent of GDP and the current account deficit stood at 2.1 percent of GDP in 2023 Q3. The improvement in external balance indicators was mainly due to the goods balance turning into a surplus, reflecting, in particular, the adjustment of domestic sectors and the improvement in the terms of trade driven by lower energy prices. The surplus on services and the transfer balance as a percentage of GDP remained unchanged compared to the previous quarter, while the income balance deficit increased further. As in Hungary, external balance indicators continued to improve in the third quarter across the countries of the region, with the exception of Romania.

In 2023 Q3, the quarterly current account balance, which offers a better reflection of short-term developments, registered a surplus similar to the previous quarter, reaching 0.8 percent of GDP. According to the real economy approach, Hungary's four-quarter net borrowing amounted to 1.2 percent of GDP in 2023 Q3, while the current account deficit fell to 2.1 percent of GDP (Chart 1). According to unadjusted quarterly data, net lending in the third quarter amounted to over EUR 850 million, comprising a current account surplus of EUR 0.4 billion and a capital account surplus of nearly EUR 0.5 billion. The improvement in the external trade balance as a percentage of GDP played a key role in the decline in four-quarter net borrowing.

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

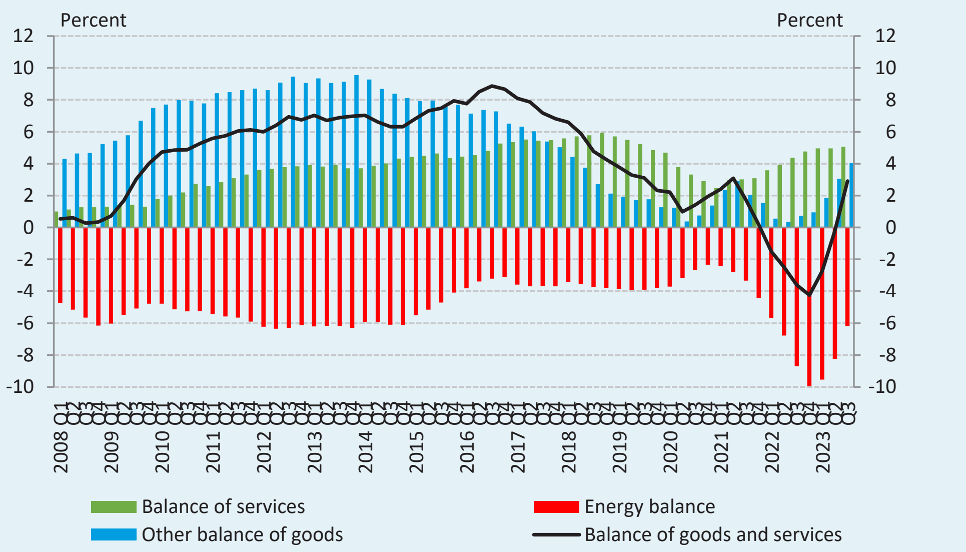


Source: . Income balance: earned income, income on equity and income on debt. Transfer balance: capital account, other primary incomes and secondary incomes.*
Quarterly current account balance, seasonally adjusted.
All charts by the MNB unless otherwise indicated.

1.1 External trade balance

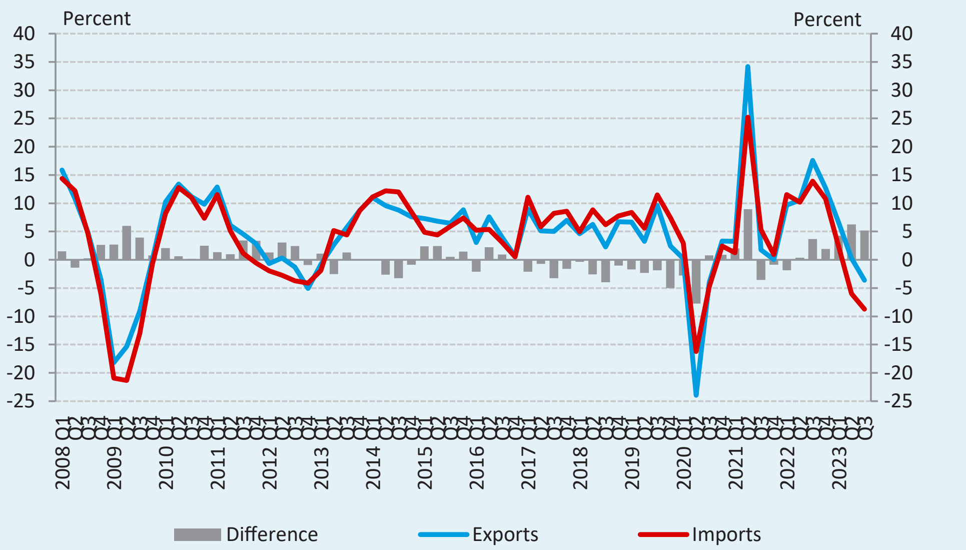
In 2023 Q3, the four-quarter trade deficit narrowed, owing to an increase in the energy balance and the balance of goods excluding energy. The main factors behind the improvement in the external trade balance were the positive impact of lower energy prices, significant adaptation by domestic sectors and the expansion of vehicle and battery exports (Chart 2). The gradual deterioration in the trend of the *balance of goods* was broken by the pandemic. However, in 2022, in line with strong household consumption and a surge in energy prices, the balance of goods once again registered an increasing deficit. The deficit started to narrow in 2023 Q1, and this trend accelerated in the second and third quarters, when improvement was seen not only in the goods balance but also in the energy balance. Nevertheless, the four-quarter deficit of the energy balance still stood at 6.2 percent of GDP, while the other goods balance registered a surplus of 4 percent in the third quarter. After the downturn driven by the pandemic, the *services* surplus, which is an important factor in the trade balance, advanced to 5 percent of GDP – i.e. close to pre-crisis levels – by 2023 Q1 after pandemic restrictions were lifted and remained at that level in the second and third quarters.

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



In 2023 Q3, export and import dynamics both continued to moderate, while the still high export-import gap contributed to an improvement in the trade balance (Chart 3). In parallel with subdued domestic industrial production, the annual change in export volumes turned into a decline, reflecting the weaker performance of most manufacturing sectors, with the main exception being the growth in vehicle and battery manufacturing. The further contraction in imports mainly reflects a significant fall in domestic demand, but the decline in exports has also reduced domestic imports. The volume of exports contracted by 3.6 percent year-on-year in the third quarter, while real imports shrank by nearly 9 percent.

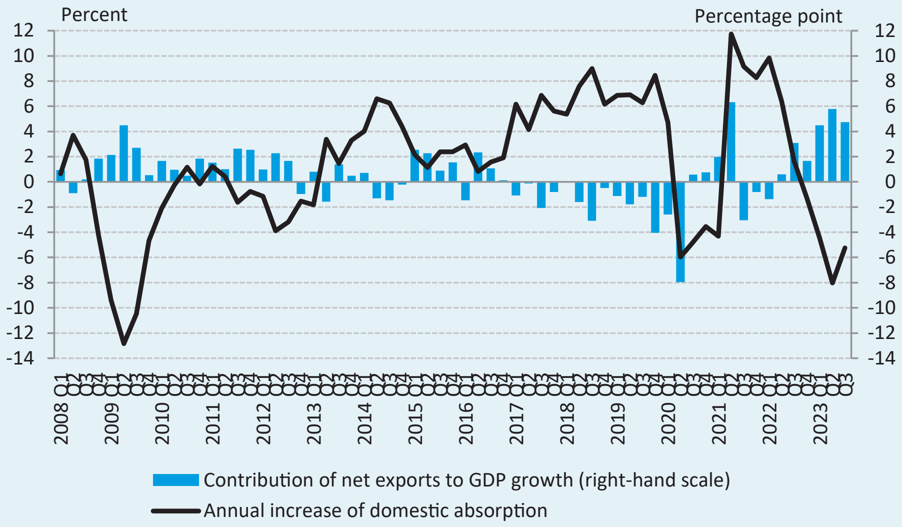
Chart 3: Annual real growth of exports and imports



Source: HCSO, MNB.

In this context, the contribution of net exports to growth decelerated somewhat in the third quarter, while the contraction in domestic consumption – although it moderated slightly – remains significant (Chart 4). A wide range of absorption items were responsible for the steep decline in domestic absorption: in addition to the decrease in household consumption, the volume of whole-economy investment and inventory accumulation also dropped. Slack domestic demand was mainly attributable to adjustment in response to falling real incomes amid the high inflation environment. In line with the decline in domestic absorption, net exports continued to make a significant contribution to GDP growth.

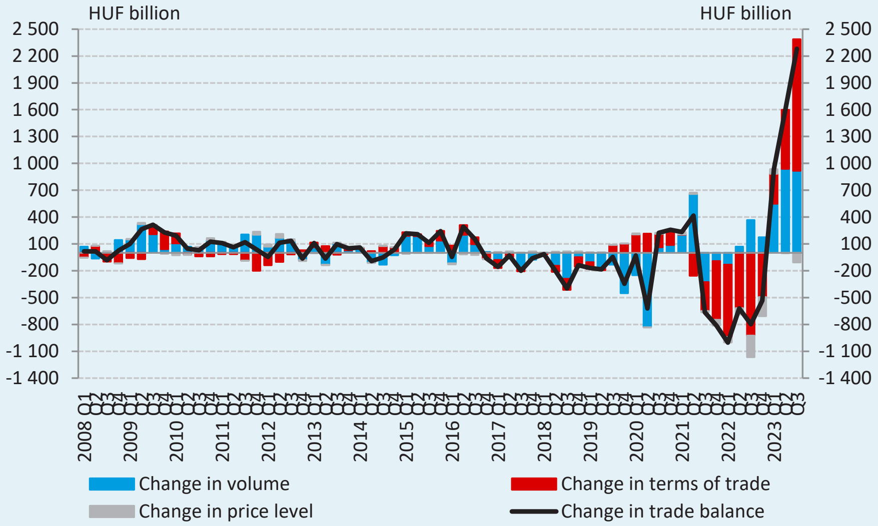
Chart 4: Annual rate of increase in domestic absorption and contribution of net exports to GDP growth



Source: HCSO.

The increase in the trade balance in 2023 Q3 was mainly driven by the favourable effect of falling energy prices on the terms of trade, but volume changes also exerted a very significant impact (Chart 5). In the third quarter, the decline in commodity and energy prices was reflected in a substantial improvement in the terms of trade, which had a positive impact on the nominal value of net exports. In 2023 Q3, the effect of the change in the terms of trade intensified significantly in comparison to the previous quarters. Complementing this, the trade balance was improved by a year-on-year decline in the value of imports, partly driven by subdued domestic demand.

Chart 5: Changes in external trade balance factors according to GDP (year-on-year)

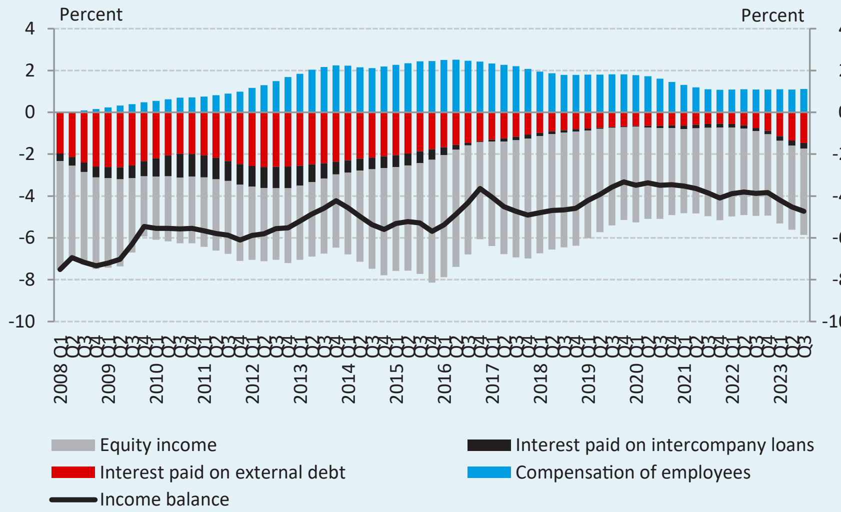


Source: HCSO.

1.2 Income balance

The deficit of the income balance as a percentage of GDP rose in 2023 Q3, which was attributable to increases in foreign companies' profits and in the deficit of the interest balance (Chart 6). In 2021, while the income of persons working temporarily abroad declined, the four-quarter deficit of the income balance reached 4.1 percent of GDP, before falling to 3.8 percent of GDP in 2022, primarily due to the lower profits of foreign-owned companies. However, the profits of foreign companies started to rise again in the first three quarters of 2023, in line with their higher profitability, which — combined with the increase in the deficit of the interest balance on foreign loans and inter-company loans — had a negative impact on the income balance, bringing the income deficit to 4.7 percent of GDP by 2023 Q3. Despite the lifting of restrictions related to the pandemic, Hungarian employees' income from abroad remained unchanged in 2023 at a low level of around 1 percent of GDP (compared to nearly 2 percent prior to the pandemic) and was therefore unable to mitigate the deterioration in the income balance.

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

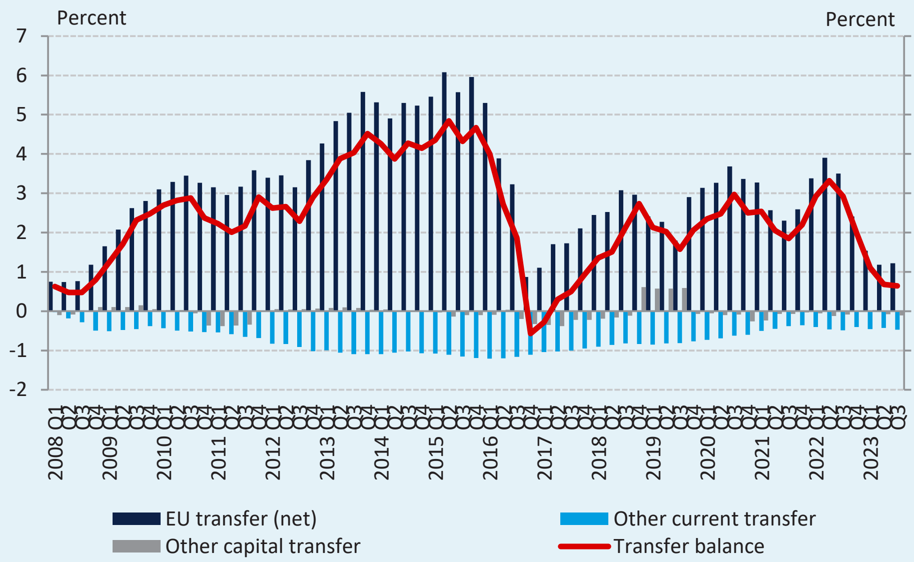


** Income balance: earned income, income on equity and income on debt.*

1.3 Transfer balance

The transfer balance surplus amounted to 0.6 percent of GDP in 2023 Q3, and thus continues to improve Hungary's external balance position (Chart 7). According to four-quarter data, net EU fund inflows corresponded to 1.2 percent of GDP in 2023 Q3. The last time the level of EU transfers was this low was in late 2016 and early 2017, when the inflows of funds were significantly lower than before due to the shift to a new seven-year EU budget period. Thus, part of the reduction is also due to the seven-year EU budget cycle. Other current and capital transfers only resulted in a mild deterioration in the transfer balance. As the combined result of the above factors, the four-quarter surplus of the transfer balance was significantly lower than in the previous quarters.

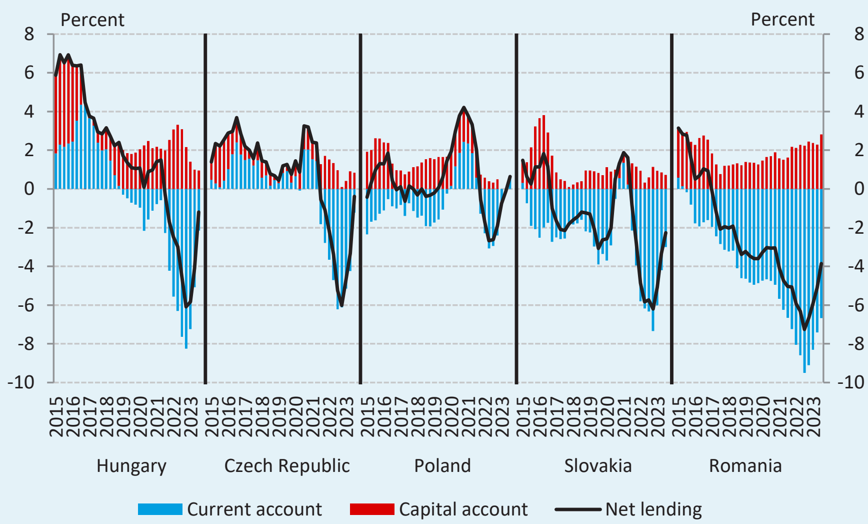
Chart 7: Four-quarter developments in transfer balance items (four-quarter values as a percentage of GDP)



1.4 Regional comparison

With the decline in global commodity and energy prices, external balance indicators, including net borrowing, continued to improve in the countries of the region, similar to the process observed in Hungary (Chart 8). Starting from 2021 H2, the trade balance — and thus the current account balance — deteriorated in all of the countries in the region due to disruptions in supply chains and global rises in commodity and energy prices. In 2023 Q3, external balance indicators improved across the region, primarily owing to better terms of trade leading to a lower energy deficit and a deceleration in domestic demand. By 2023 Q3, Poland's external position switched to net lending. In most countries in the region, including Hungary, the favourable developments in 2023 meant that the improvement in current account balances was coupled with a sharp fall in net borrowing in the third quarter, which thus typically reached around 1 percent of GDP. At almost 4 percent of GDP, Romania's net borrowing remains the highest among the countries in the region.

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



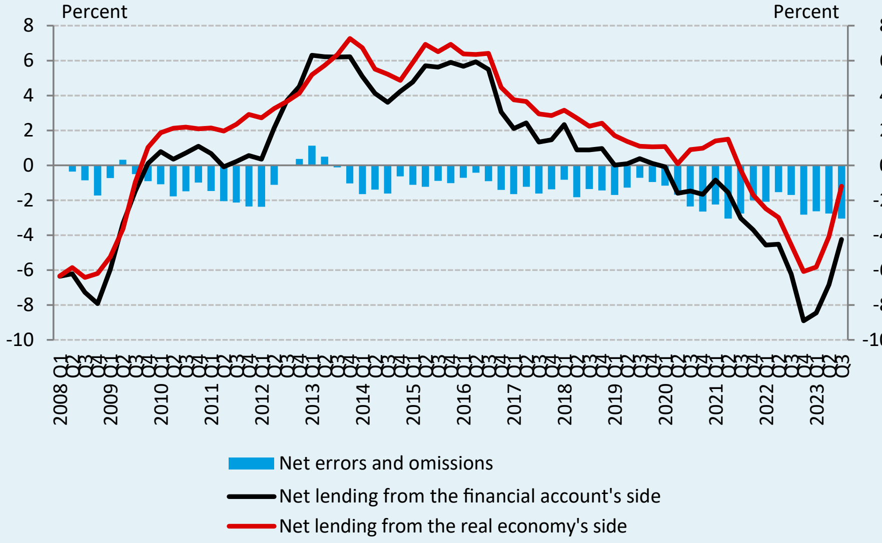
Note: Except for Hungary, the 2023 Q3 figures were calculated from monthly data.
Source: MNB, Eurostat.

2 Financing approach

In 2023 Q3, the four-quarter value of the net borrowing of the economy according to the financial account amounted to 4.2 percent of GDP, representing a considerable decline over the previous quarter. Net borrowing during the quarter was primarily financed by inflows of net FDI. Following net debt inflows in previous quarters, the main contributor to debt outflows in the third quarter was the general government, but corporate sector debt also continued to decline, while the banking sector's indicator rose somewhat.

As demonstrated by financing data, the external balance position continued to improve in 2023 Q3. The four-quarter net borrowing of the economy decreased to 4.2 percent of GDP from 6.8 percent in the previous quarter (Chart 9). Accordingly, four-quarter net borrowing according to both the real economy and financing approaches showed a significant improvement over the previous quarter. The difference between the external balance indicators calculated under the two approaches ('Net errors and omissions'[1]) was somewhat higher than in the previous quarters and amounted to 3.1 percent of GDP.

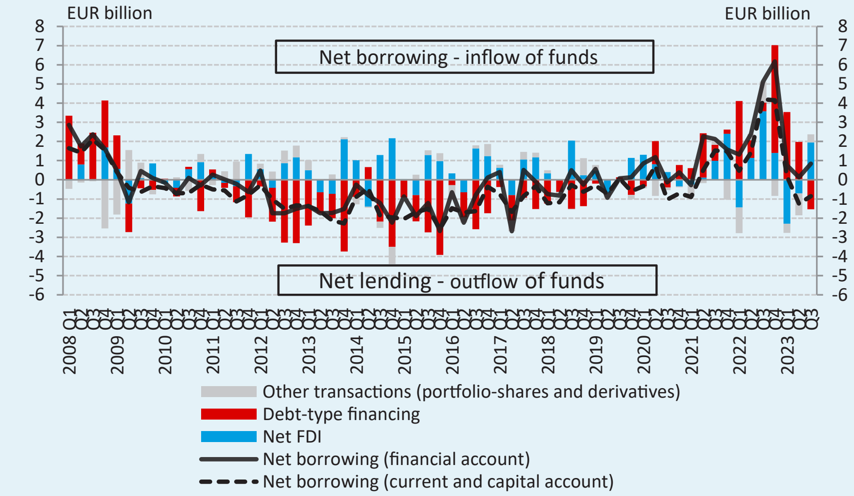
Chart 9: Two types of net lending (four-quarter data as a percentage of GDP)



According to quarterly data, the net borrowing of the economy was amply covered by net FDI inflows in 2023 Q3, which resulted in a decline in net external debt (Chart 10). At EUR 0.8 billion, net borrowing in 2023 Q3 was substantially lower than in 2022. The inflows of funds were mainly financed by net FDI inflows (amounting to EUR 2 billion). Unlike in the previous quarters, outstanding external debt due to transactions decreased by EUR 1.5 billion.

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

Chart 10: Structure of net lending (unadjusted transactions)

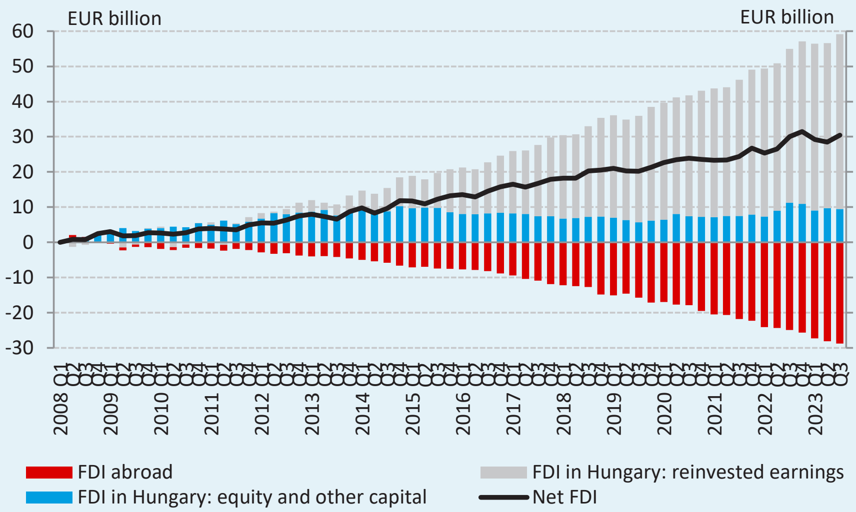


In economic terms, the fundamental development of the debt is not influenced by the conversion between account balance and bullion balances, and so this technical effect has been eliminated.

2.1 Non-debt liabilities

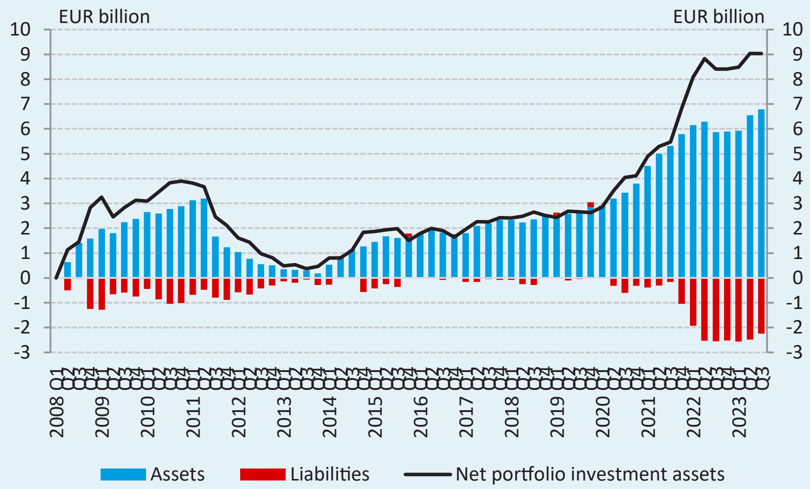
Unlike in the previous two quarters, as a result of transactions net foreign direct investments registered an inflow of funds in 2023 Q3 (Chart 11). Net FDI inflows, excluding capital-in-transit, amounted to EUR 2 billion in the third quarter, mainly due to an increase in reinvested earnings, but also reflecting substantial new investments by multinational corporations in manufacturing, which also increased their equity.

Chart 11: Developments in FDI, excluding capital-in-transit transactions (cumulative transactions)



In 2023 Q3, net portfolio investments remained essentially unchanged (Chart 12). The trend of significant net outflows of funds seen in portfolio investments in 2020–2021 (which was related to an increase in domestic actors' investments abroad) stopped in 2022, but then started to increase substantially in 2023 Q2 again on the back of a government measure in June (introduction of social contribution, new regulations on investment funds entering into force), the effect of which was still perceived in the third quarter. As a result, residents increased their holdings of foreign equities and mutual fund shares by around EUR 235 million, while non-residents stepped up their holdings of portfolio investments in Hungary by a similar amount (EUR 238 million).

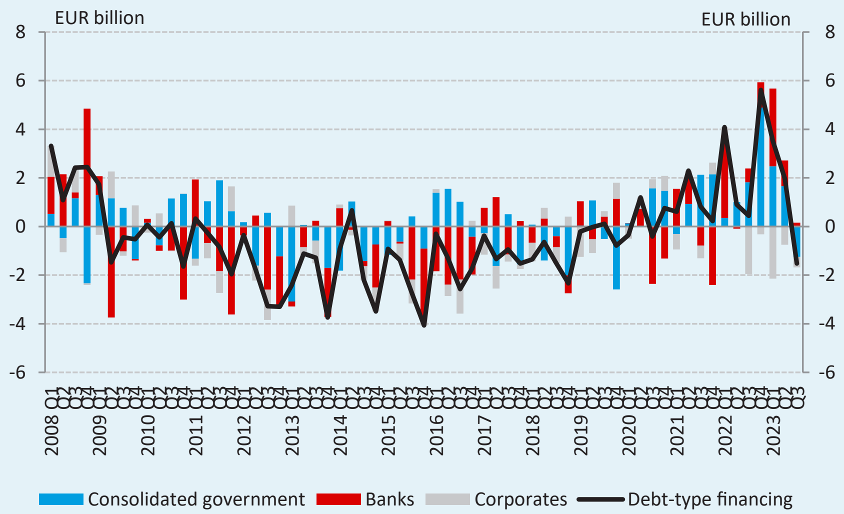
Chart 12: Developments in net portfolio equity and mutual fund share assets (cumulative transactions)



2.2 Debt liabilities

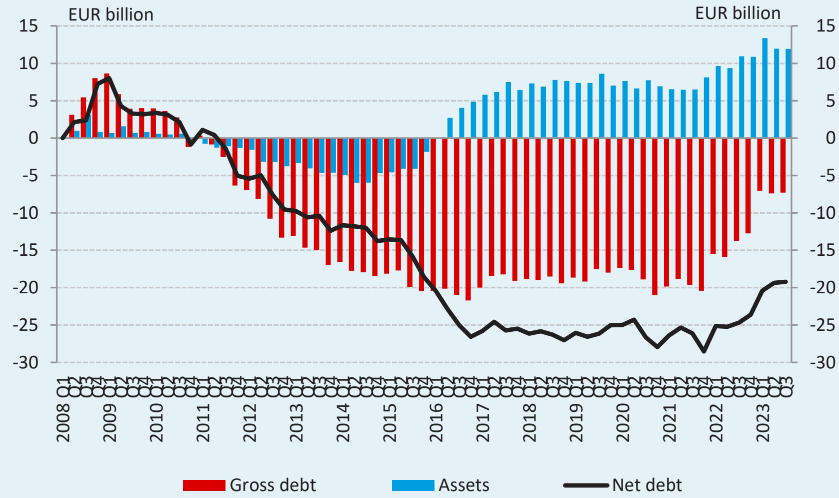
The third quarter saw the first outflow of debt liabilities in three years (Chart 13). Net outstanding external debt fell by around EUR 1.5 billion due to transactions, which was mainly related to the consolidated general government and, to a lesser extent, to the corporate sector, while the banking sector's indicator rose somewhat. The net external debt of the consolidated general government decreased by nearly EUR 1.3 billion during the quarter, while that of corporations contracted somewhat more slowly than in the previous two quarters, falling by EUR 0.4 billion.

Chart 13: Developments in net debt-type financing by sector



The banking sector's net external debt increased in the third quarter, albeit to a much lesser extent than in previous quarters (Chart 14). The growth of almost EUR 0.2 billion in the net indicator was mainly due to an increase in the gross external debt of banks. The increase in debt was mainly linked to shortterm liabilities.

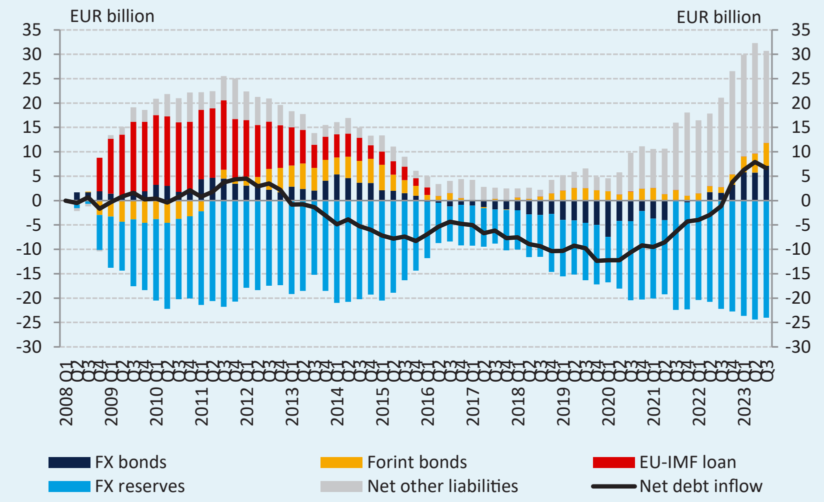
Chart 14: Changes in the banking sector's external debt and assets since early 2008 (cumulative transactions)



Due to transactions, the contraction in the net external debt of the consolidated general government including the MNB amounted to almost EUR 1.3 billion in the third quarter. The change in the net external debt of the government was the combined result of contrasting effects (Chart 15):

- Non-residents' holdings of long-term HUF-denominated government securities increased by EUR 0.4 billion during the quarter.
- Foreign exchange expenditures of the Hungarian State Treasury reduced the FX reserves, contributing to the rise in net external debt.
- Contributing to the reduction in banks' external debt, the central bank FX swaps providing FX liquidity have a neutral effect on net external debt at the whole-economy level, but the facility results in a rearrangement across the net debt indicators of economic sectors. Recourse to the swap instrument at the end of September was significantly lower than at the end of the previous quarter, and this contributed to the increase in the net external debt indicator of banks and to the sharp decline in the net indicator of the government.
- The increase in non-residents' holdings of foreign currency debt securities due to the issuance of foreign currency bonds raised the level of both external liabilities and foreign exchange reserves, and thus did not affect net external liabilities.
- The absorption of EU transfers also contributed to the decrease in the net external liabilities of the government.

Chart 15: Breakdown of change in net external debt of consolidated general government (cumulative transactions)



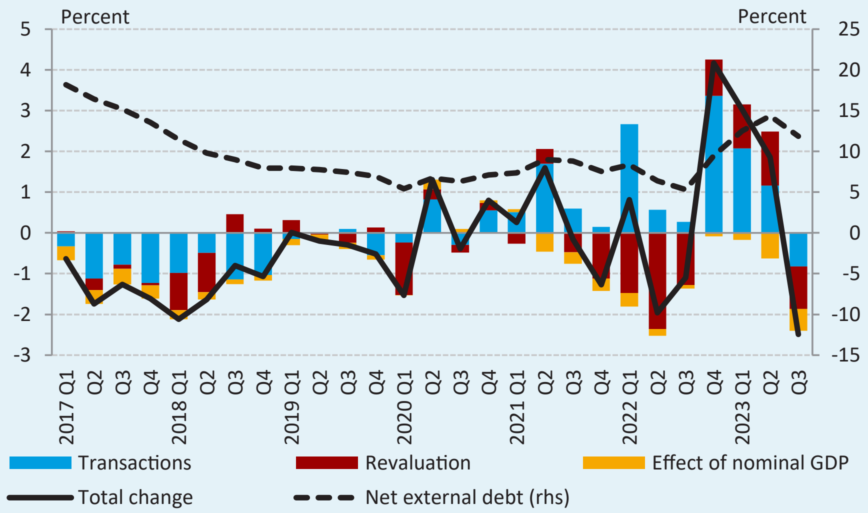
3 Developments in debt ratios

According to the underlying trends, net external debt amounted to 11.9 percent of GDP at the end of September 2023. In addition to the outflows of debt liabilities, the third-quarter decline in the debt ratio was supported by revaluation and nominal GDP growth. The reduction in net external debt was mainly related to a decline in the general government's indicator, but the debt ratios of the banking sector and non-financial corporations also improved somewhat. Linked to the consolidated general government, gross external debt declined substantially, and stood at 64 percent of GDP at the end of September 2023. The level of international reserves was close to its historic high at nearly EUR 40 billion at the end of the quarter, exceeding the level of short-term external debt, which is closely monitored by investors, by close to EUR 6 billion.

3.1 Developments in debt indicators

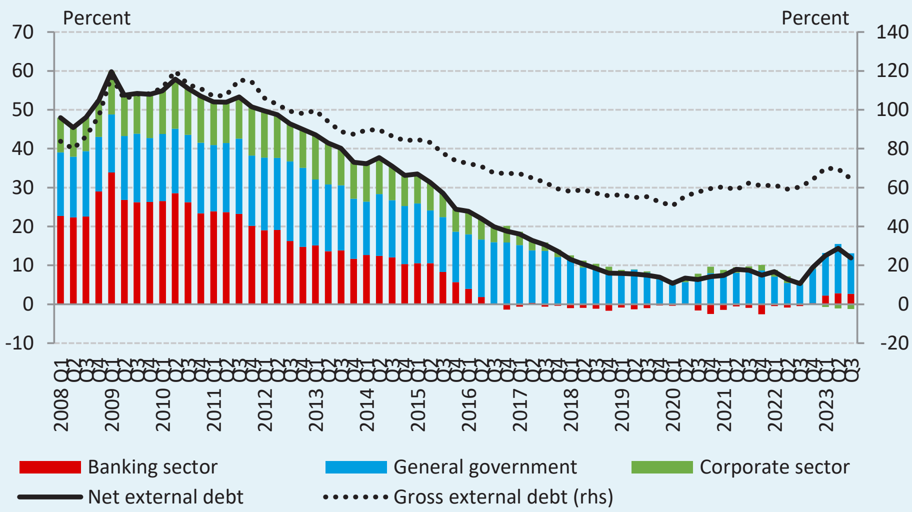
Following an increase since the end of 2022, in 2023 Q3 the economy's net external debt according to underlying trends fell to 11.9 percent of GDP. In addition to the substantial outflows of debt liabilities described earlier, the indicator was also moderated by the revaluation of portfolios, which was also influenced by the modest expansion of nominal GDP (Chart 16). Outflows of debt liabilities reduced net external debt by 0.8 percentage points, which was primarily related to the general government. The adjustment of the earlier revaluations with a stock-reducing effect seen in 2021 and 2022, relating mainly to higher yields and exchange rate depreciation, continued in the first two quarters of 2023, in parallel with the decline in yields, while the opposite effect was observed in the third quarter. As in the previous quarter, the rise in nominal GDP reduced the ratio of net external debt to GDP by one half of a percentage point in the third quarter.

Chart 16: Components of the change in net external debt (as a percentage of GDP, exclusive of intercompany loans)



The decline in the net external debt ratio was mainly associated with the general government, but the debt ratios of the banking sector and non-financial corporations also improved moderately (Chart 17). The net external debt of the *consolidated general government including the MNB* fell by 2.2 percent of GDP, primarily reflecting the effect of the debt liabilities outflows of the government (e.g. the net debt reduction related to the decline in the MNB's euro liquidity-providing swaps and discount bond holdings). In addition, to a lesser degree, revaluations linked to yield and exchange rate changes during the quarter also reduced the debt indicator. The net external debt-to-GDP ratio of the private sector declined overall, with the debt indicator of banks and the corporate debt indicator falling to very similar degrees. *Banks'* net external debt decreased somewhat, reflecting a larger increase in receivables than the decline in foreign liabilities. In a continuation of a trend that started at the end of 2022, the *banking sector's* foreign liabilities still exceed its foreign receivables, i.e. the sector's net debt indicator remains in positive territory, in contrast to the negative, close-to-zero level seen since 2017. The net external debt-to-GDP ratio of *companies* fell by 0.1 percentage point: mainly in relation to purchases of equity, mutual fund shares and bonds, foreign liabilities increased, but foreign receivables also contracted in relation to trade credits. The net external debt indicator for companies remained somewhat negative at the end of the third quarter, i.e. their foreign assets exceeded their foreign liabilities.

Chart 17: Breakdown of net external debt and gross external debt (as a percentage of GDP, excluding intercompany loans)



At the end of the third quarter, Hungary's gross external debt-to-GDP ratio dropped to 64 percent. Following a rise at the end of 2022, the upward trend reversed in 2023 Q3, and the debt indicator fell by 5 percentage points, which for the most part reflected the decline in the external debt of the *general government.* The indicator of the *consolidated general government including the MNB* contracted, partly as a result of the decrease in the short-term (less than one year) liabilities mentioned above, while the impact of the aforementioned revaluation and nominal GDP expansion also contributed to the decline in outstanding debt. As regards the *banking sector,* external liabilities declined primarily in relation to banks' long-term lending. The gross external debt-to-GDP ratio of *companies* fell due to a drop in short-term trade credit.

3.2 Foreign exchange reserves and reserve adequacy

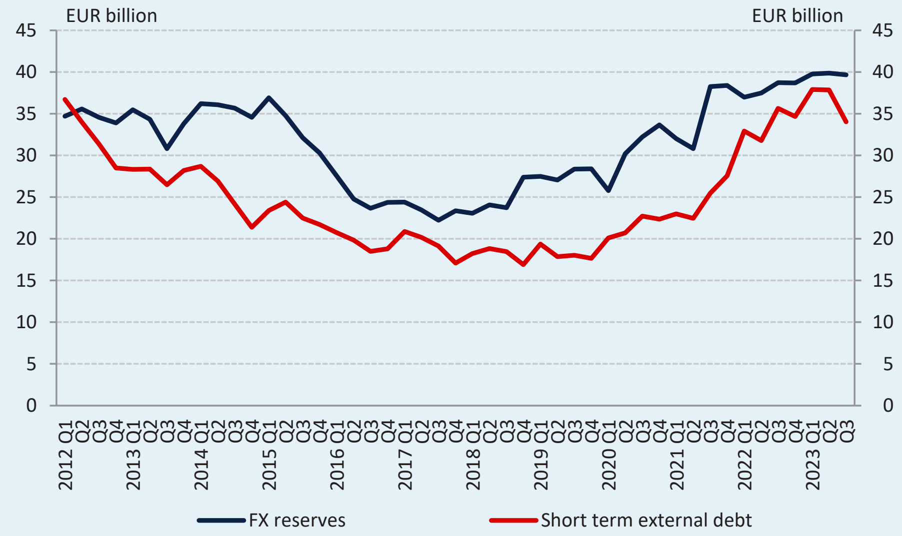
At the end of 2023 Q3, international reserves amounted to EUR 39.7 billion, which is consistent with the levels prevailing in the previous period of the year. After EUR 39.9 billion at the end of June 2023, the MNB's international reserves amounted to EUR 39.7 billion at the end of September 2023, with reserves remaining steady during the quarter. Developments in reserves were influenced by numerous factors, the most important of which were the following:

- The net reserve-increasing effect of *EU funds* amounted to EUR 0.5 billion, which was primarily related to 2014–2020 cohesion funds and agricultural financing inflows, and also included, to a lesser degree, advance payments for the new programming period.
- The *net FX financing operations of the Government Debt Management Agency (GDMA)* increased the reserve level by a total of EUR 1.1 billion. In September, the GDMA issued foreign currency bonds in the amount of EUR 1.75 billion. In addition, in July the GDMA launched a Euro Commercial Paper Programme, under which it envisaged issuing a foreign currency instrument with a maturity of up to 1 year for the purposes of liquidity management. Accordingly, EUR 0.5 billion of short-term dollar securities were sold in September. The reserve-increasing effect of raising foreign currency funds was dampened by the prepayment of a foreign currency bond, foreign currency interest expenditures paid on debt and other financing transactions.

- The reserve-reducing effect of the *Hungarian State Treasury's foreign currency transactions* amounted to EUR 0.7 billion.
- Due to changes in the exchange rate, the *revaluation* of reserve items denominated in currencies other than the euro increased the reserves by nearly EUR 0.2 billion.
- The *utilisation of the swap facility providing euro liquidity at the end of the quarter and the balance of international repo drawdowns* lowered the level of reserves compared to the end of June 2023.

At the end of 2023 Q3, the MNB's international reserves exceeded the level of short-term external debt, which is closely monitored by investors, by nearly EUR 6 billion. At the end of September 2023, international reserves and short-term external debt amounted to EUR 39.7 billion and EUR 34 billion, respectively. The leeway above the Guidotti-Greenspan indicator, which is closely followed by both the central bank and investors, amounted to EUR 2.1 billion at the end of June 2023 (Chart 18).

Chart 18: Short-term external debt of the Hungarian economy and its foreign exchange reserves

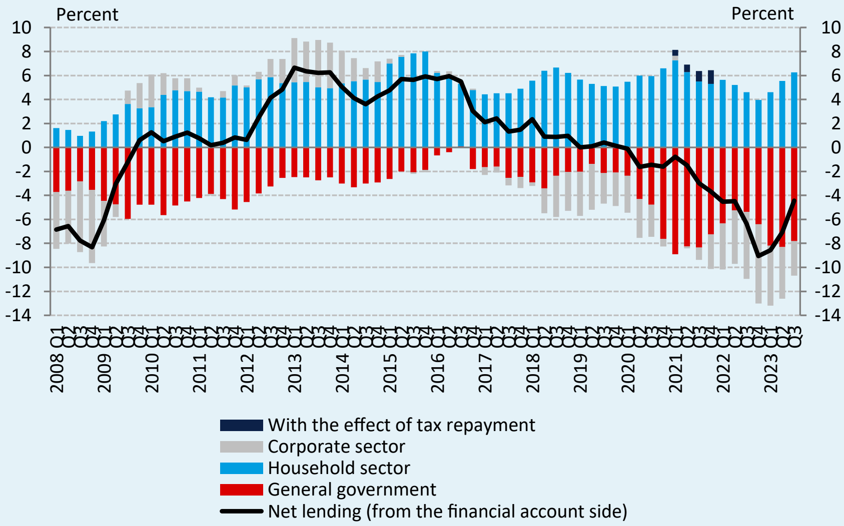


4 Sectors' savings approach

In 2023 Q3, the net savings position of economic sectors improved significantly, with contributions from all sectors. The net borrowing of the general government declined somewhat, primarily as a result of nominal GDP growth. The net financial position of households and companies also improved, mainly owing to subdued consumption and investment, but also supported by rising corporate profits. Within household savings, demand for inflation-indexed government bonds remains strong, but there were also steady inflows in mutual fund shares, while household bank deposits declined.

Sectoral savings trends suggest that the net position of households improved further amid the decline in the net borrowing of the public sector and corporations, and accordingly the net borrowing of the economy decreased sharply, narrowing to less than 4.5 percent of GDP in the third quarter (Chart 19). In the third quarter, mainly as a result of nominal GDP growth, the four-quarter general government deficit sank to 7.8 percent of GDP after the modest increase observed in the previous quarter. On the back of rising nominal incomes and continued subdued household consumption, net household savings rose further quarter-on-quarter to 6.3 percent, returning to levels close to those seen at the end of 2021. At the same time, as a result of waning domestic demand, companies restrained their investment activity and reduced their inventories amid growing profits, and accordingly the sector's net borrowing declined. On the whole, as a result of the significant improvement in the private sector's position and the moderately lower net borrowing of the government, net borrowing by economic sector savings declined tangibly.

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

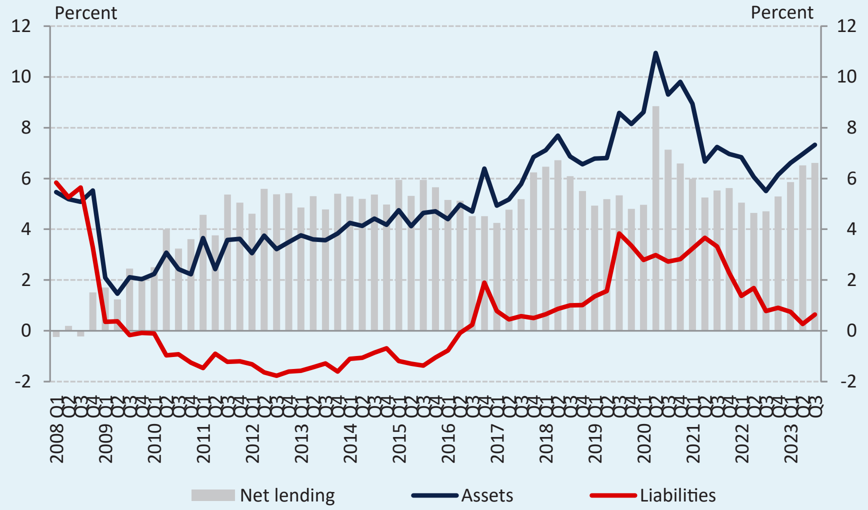


** General government represents net borrowing according to the financial accounts. Corporates based on the residual principle.*

According to the underlying trends, households' four-quarter net financial savings increased somewhat in 2023 Q2 versus the previous quarter, in parallel with an expansion in financial assets and a modest decline in liabilities (Chart 20). Due to economic considerations, the MNB excludes one-off effects (such as pension fund savings, early repayment, real yield disbursement, indemnification of the depositors of liquidated mutual savings banks, forint conversion and settlement, personal income tax refunds) from the indicator based on underlying trends. One-off effects also influence the net indicator via the accumulation of financial assets and liabilities, and therefore the underlying trends are presented using net data along with the gross legs.

According to the seasonally adjusted indicator, which is expressed as a percentage of GDP and captures the underlying trends, households' financial asset accumulation increased as a combined result of rising nominal wages, subdued consumption and higher interest income. Households' net borrowing as a percentage of GDP remains subdued, for the most part reflecting lower demand for housing loans and the lower level of other borrowing.

Chart 20: Households' net lending according to underlying trends (seasonally and otherwise adjusted* data, as a percentage of GDP)

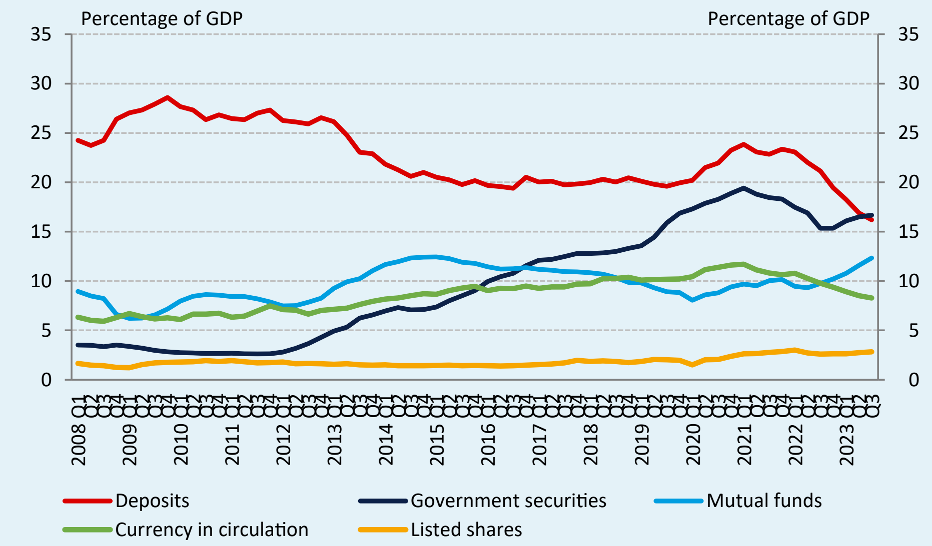


** Figures showing underlying trends, adjusted for pension fund savings, the early repayment scheme and the real yield disbursement, the indemnification of the depositors of liquidated mutual savings banks, the effect of forint conversion and settlement, and the PIT refund. Time series adjusted separately.*

The rearrangement of asset types within the moderately declining financial asset accumulation continued (Chart 21).

- Overnight and other deposits decreased to a lesser degree than in the previous quarter, dropping by HUF 100 billion.
- In 2023 Q3, households' demand for government bonds was more subdued than previously, but remained significant: households' government bond holdings rose by HUF 450 billion overall, due to transactions. Demand was still high especially for long-term securities; as regards short-term paper, discount treasury bills declined sharply on a transaction basis. Within the government bond portfolio, redemptions of MÁP+ government securities continued, although at a much slower pace: holdings of MÁP+ securities declined by around HUF 200 billion in the third quarter. In an environment of high inflation, demand for inflation-indexed PMÁP securities continued to increase (partly as a result of outflows from MÁP+), with net inflows into this asset category approaching HUF 750 billion in the third quarter. However, growth in BMÁP decelerated compared to previous quarters, as holdings grew by HUF 50 billion during the quarter. After decelerating inflows in the previous quarters, the third quarter saw an outflow of euro-denominated PEMÁK securities. Overall, households' total holdings of government securities approached 16.7 percent of GDP in the third quarter.
- The decline in the banknote and coin holdings of households observed in previous quarters came to a halt in the third quarter: households raised their cash holdings marginally, by HUF 35 billion; and accordingly the cash holdings of households amounted to 8 percent of GDP.
- Following the surge due to the entry into force of the social contribution tax rule in the second quarter, demand for mutual fund shares increased further and, similar to the first quarter, showed a significant inflow of HUF 500 billion in the third quarter as well. Since 2022 H2, households have increased their financial wealth held in mutual funds.

Chart 21: Developments in households' key financial assets



5 Improving external balance position in light of developments after the financial crisis

In this special topic, we compare the two major crisis periods of the past decades, mainly from the perspective of external balance trends. Both the financial crisis of 2008 and the energy crisis of 2022 have had a significant impact on the external balance of the Hungarian economy. However, despite the similarities in the strong current account improvement, a closer look at the trends reveals significant differences between the two periods. Prior to the financial crisis, the Hungarian economy's vulnerability was at a critical level due to high external and internal indebtedness, which, combined with tightening financing conditions and rising unemployment, led to a deep, protracted economic crisis. By contrast, Hungary's external vulnerability was far lower before the energy crisis, and the external imbalances resulting from skyrocketing energy prices and the external shock of the war were only temporary, as the normalisation of commodity prices alone led to a large improvement in the current account balance, which was complemented by the effect of falling domestic demand in the high inflation environment. At the same time, the adjustment of the domestic sectors shows strong similarities to the developments in the 2008 financial crisis: during both periods, consumption growth played a role in the deterioration of the external balance, followed by a significant external rebalancing effect driven by the adjustment of domestic demand items.

5.1 Different initial structure of the economy

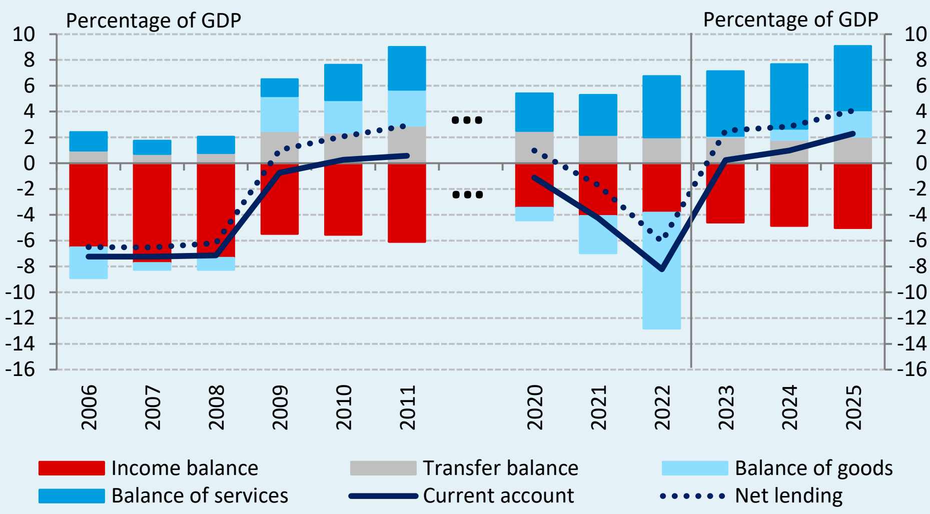
Before the 2008 crisis, Hungary's economic policy was partly based on a consumption-driven growth model financed by foreign currency-denominated loans. The high import content of consumption that dominated the structure of the economy contributed significantly to the persistence of the trade deficit, while the profits of foreign companies and rising interest expenses kept the income deficit high. In the years preceding the financial crisis, shortly after Hungary's accession to the EU, the transfer balance did not significantly improve the external position due to the low absorption of EU transfers. This led to a net borrowing requirement of 6–8 percent of GDP in the economy between the early 2000s and the financial crisis.

The severe imbalances that built up before the financial crisis contributed significantly to increasing vulnerability and the deepening of the economic crisis. Rising unemployment, the tightening credit market and soaring instalments on foreign currency loans due to forint depreciation reduced disposable income. The ensuing fall in domestic demand and the associated decline in investment reduced imports, significantly improving the trade balance (Chart 22). The decline in external and domestic demand curbed corporate profits, leading to a significant improvement in the income balance in the year of the financial crisis. At the same time, following the accession to the European Union in 2004, Hungary was able to draw down and use more and more funds from the new seven-year programming period, which also improved Hungary's balance position. As a combined result, following the current account deficits of over 7 percent of GDP typical in the preceding years, in 2008 the current account balance approached equilibrium (–0.7 percent of GDP), and Hungary even boasted a positive net lending figure (1 percent of GDP).

In contrast to the trends before the financial crisis, the situation with Hungary's external vulnerability was far more favourable prior to the energy crisis of 2022. Although government indebtedness increased substantially as a result of the management of the pandemic, the indebtedness of the private economy and its currency structure was considered healthy. From 2016, investment growth was the main contributor to the steady decline in the goods balance through the expansion of imports (making the investment rate in the Hungarian economy one of the highest in Europe), while real consumption growth was typically consistent with income (GDP) growth. That notwithstanding, the surge in consumption driven by the significant one-off income surplus recorded in 2022 also contributed strongly to the widening current account deficit. In addition, global trade frictions ('chip shortages') and the impact of the Russia-Ukraine war also reduced net exports. These effects were partly offset by high surpluses (although initially below pre-epidemic levels) in the services and transfer balances. It should be noted that the income deficit was also lower compared to the years of the financial crisis, which, besides lower corporate profits, was linked to lower interest expenses due to lower external indebtedness relative to the 2008 levels.

In 2021–2022 the energy crisis undermined the current account directly via the terms of trade, but the external balance quickly recovered in 2023 as adjustments set in and energy prices normalised. In several respects, when hit by the external shocks of the energy crisis, the Hungarian economy was in a more favourable position than it was at the time of the financial crisis. As a result of skyrocketing and then normalising energy imports, the rise in energy prices only had a temporary negative impact on the external trade balance, which may thus turn into a surplus again in the longer term. At the same time, the continued high surpluses of the services and transfer balances contributed significantly to Hungary's external position. In the longer turn, however, the opposite effect may set in: higher interest expenses from external indebtedness that has risen moderately from a low level and corporate profits in an inflation environment also driven by profits are likely to lead to an increase in the deficit of the income balance. That notwithstanding, the current account balance will turn back into a surplus in 2023 and continue to improve over the forecast horizon (Chart 22)

Chart 22: Changes in the external balance broken down by key factors



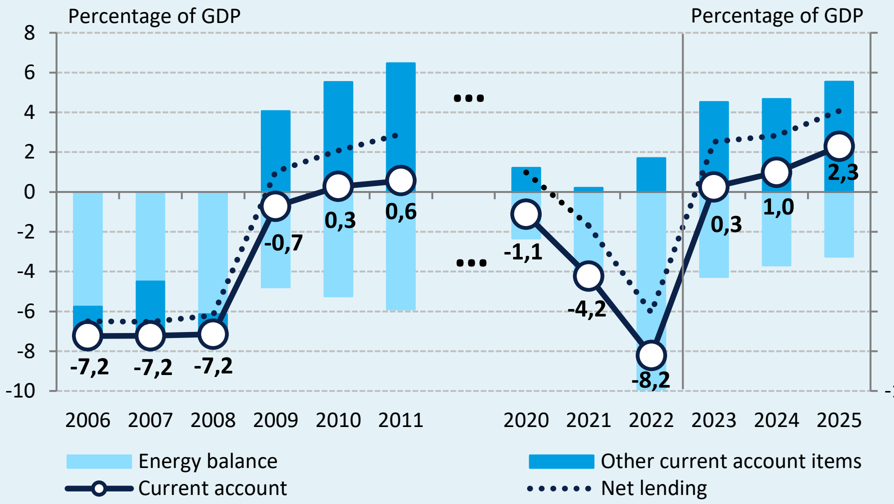
Note: 2023-2025 data of this section is based on the December 2023 Inflation Report.

5.2 The energy balance played a key role

The deep, persistent fall in demand in the wake of the 2008 financial crisis also significantly reduced the high energy deficit, but after the crisis net energy imports resumed their upward path. The energy deficit amounted 6 percent of GDP before the financial crisis, which is fairly high compared to the level of around 4 percent of GDP before the energy crisis, but as can be seen above, this did not give rise to a current account adjustment. This is also demonstrated by the fact that net energy imports fell below 5 percent of GDP during the post-2008 recession before rising again as the economy started to expand.

In contrast to the above, the temporary surge in the current account deficit in 2022 was linked to a decline in the energy balance. The upward trend in net energy imports started as early as in autumn 2021 due to rising oil and gas prices. In addition, the non-energy goods balance contributed to the deterioration in the current account balance at the time, reflecting falling motor vehicle exports due to global semiconductor shortages and friction in production chains resulting from the Russia-Ukraine conflict, while high consumption and investment growth due to strong income outflows also contributed. This year, the significant improvement in the external balance is mainly due to an increase in the foreign trade balance, the surplus of which is also gradually rising as a share of GDP (Chart 23). This is driven by the favourable impact of the fall in energy prices, a significant adjustment in the domestic sectors (lower household consumption and investment point to a deceleration in imports) and an expansion in exports of vehicles and batteries.

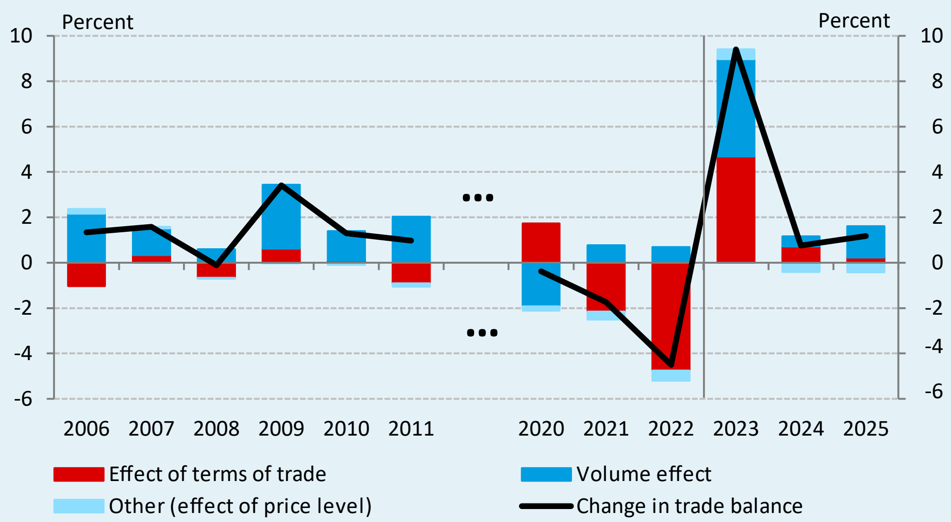
Chart 23: Changes in the current account balance by energy balance and other items



5.3 Terms of trade and volume both improved the balance to a greater degree in 2023

While last year's significant deterioration in the trade balance was mainly linked to adverse changes in the terms of trade, prices did not have a similar impact during the financial crisis. By contrast, the volume effect pointed to an improvement in both periods, to a roughly similar extent. The changes observed in the energy balance are also reflected in the decomposition of the foreign trade balance into price and volume effects. During the financial crisis, oil prices and the closely related gas prices worsened Hungary's external position somewhat in 2008 and improved it to almost the same degree in 2009. At the same time, falling imports amid the subdued domestic demand contributed significantly to the improvement in the trade balance via the surge in volume effects. By contrast, rising energy prices led to a significant deterioration in the terms of trade in 2021 even before the energy crisis. This only intensified in 2022 when, decoupling from oil prices, gas and electricity prices rose to unprecedented highs. As a result of normalisation on the energy markets, the terms of trade effect corrected in 2023, significantly improving Hungary's trade balance (Chart 24). At the same time, falling domestic demand, the adjustment in energy consumption and the boom in battery and vehicle production entailed an increase in the volume effect, contributing to a rise in the trade balance to a similar degree as that seen during the financial crisis.

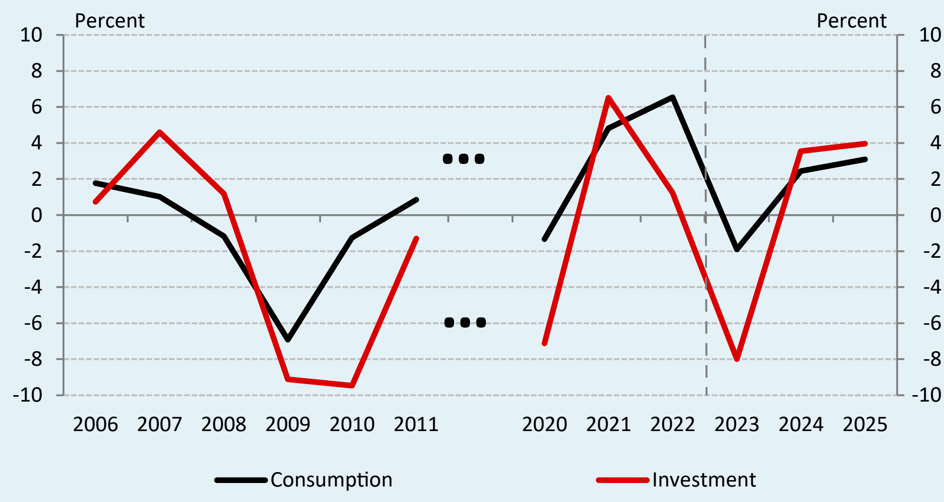
Chart 24: Decomposition of the trade balance to price and volume effects



5.4 The fall in demand is less severe and only temporary

After the financial crisis, a long adjustment process commenced, which resulted in years of weakening domestic demand. Domestic demand also fell sharply due to rising inflation following the energy crisis. Nevertheless, with real wages rising as inflation declines, economic growth is likely to resume from 2024 (Chart 25). Before the financial crisis, the Hungarian economy was extremely vulnerable. Rising forint yield spreads due to high budget deficits pushed private sector agents towards foreign currency lending. On the whole, this process led to a drastic exacerbation of vulnerability via rising external indebtedness. Soaring interest rates on foreign currency loans in the wake of the financial crisis resulted in a decline in disposable income, which the government – in dire financial straits – was unable to compensate for. The resulting credit crunch entailed a deep, prolonged decline in consumption and investment. Adjustment to both internal and external imbalances during the financial crisis constrained the growth potential of the Hungarian economy for many years thereafter. In 2022, consumption expanded strongly partially due to financial transfers from the central budget to the population. Increased demand and rising inflation in the wake of the energy price surge entailed a steep fall in real wages from 2022 H2, the extent of which was well above the European average. Parallel to the decline in incomes, domestic demand contracted and led to a decline in consumption and investment in 2023; in other words, external balance was achieved, to a large extent, at the cost of curbing economic growth. However, as inflation is expected to moderate further in the future with real wages rising again from 2024, internal growth drivers may gradually start to recover.

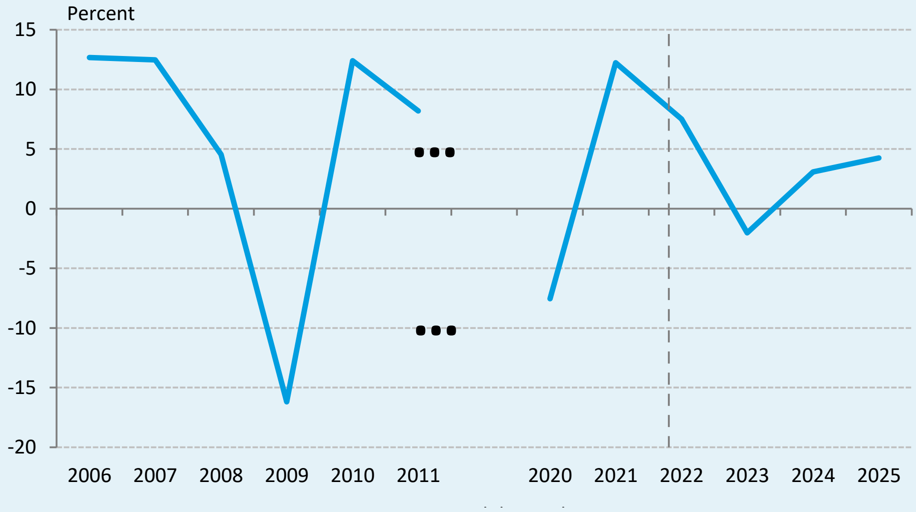
Chart 25: Annual real growth in the main absorption items of GDP



5.5 The decline in external demand has a modest impact

During the financial crisis, external demand exhibited a sharp drop before a fast-paced adjustment, while in 2023 the decline was moderate, but external demand is expected to remain subdued in the coming years (Chart 26). Import-driven external demand shows the volume of goods and services imports of Hungary's main export markets, which captures the cyclical conditions of the country's external trading partners and hence, the potentials of the sectors producing for the export market. The financial crisis resulted in a sharp downturn that was followed by a rapid adjustment; indeed, external factors supported a fast recovery through exports. By contrast, recent years have been characterised by steadily weakening external demand reflecting the protracted war, rising geopolitical tensions and a decelerating Chinese economy. In the coming years, external activity may pick up somewhat, but it is expected to remain subdued, which may pose significant challenges for the domestic sectors. At the same time, the export market share of the Hungarian economy may continue to increase thanks to strong investment and FDI inflows in the past, which also supports further improvements in the external balance.

Chart 26: Volume change in import-based external demand

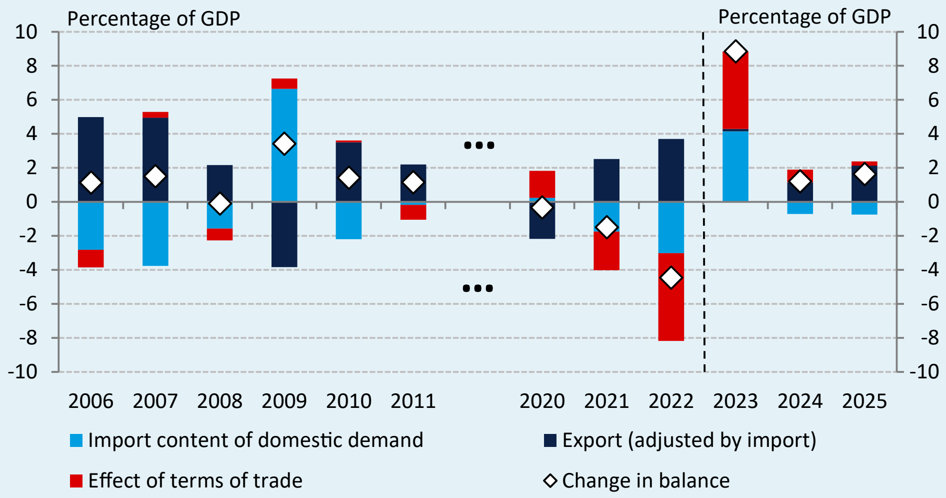


5.6 The path to lasting rebalancing is through export growth

In the period of the financial crisis, the improvement in trade balance was restrained by developments in exports. By contrast, the increase in the trade balance in 2023 was probably far more significant because, in addition to the improvement in terms of trade, exports also improved the balance somewhat during the first half of the year. The differences and similarities between the financial and energy crises can also be captured in changes in the trade balance (Chart 27). Prior to 2008, the narrowing goods and services deficit led to a substantial improvement in the current account, driven by buoyant exports fuelled by a favourable global economic environment. In parallel, the expansion in domestic demand was reflected in an increase in imports. However, the financial crisis reversed the trends: declining external demand weighed on exports (net of imports), while the sharp fall in imports driven by waning domestic consumption strongly boosted the trade balance. Initially, the situation was similar in the period preceding the energy crisis: the favourable external environment was reflected in the upswing in exports, while strong domestic demand was demonstrated by an increase in imports. As these two effects almost cancelled out each other, the net effect was unable to dampen the effect of surging energy prices on the terms of trade significantly. In the year following the crisis, the normalisation of prices improved the external balance, with falling domestic demand contributing to the improvement to a similar degree. From 2024, as global trade normalises and Hungary's export market share is expected to expand as previous investment projects begin production, and export growth may improve the goods balance again, as it did during the episode of the financial crisis, while strengthening domestic demand will have a moderately opposite effect.

In summary, similar to the period of the financial crisis, in the post-energy crisis period sustainable growth in domestic demand is also a prerequisite for current account stabilisation; in other words, domestic processes must be balanced for external balance, and growth in consumption must be consistent with income growth. However, in addition to the foregoing and above and beyond the recovery of the external environment, a sustained improvement in external balance trends requires an increase in the competitiveness of the domestic economy, which is the only way to ensure sustained export growth, a key element for sustainable and balanced economic growth.

Chart 27: Changes in the trade balance as a percentage of GDP



List of charts

Gábor Bethlen

(15 November 1580 – 15 November 1629)

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

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

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

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

REPORT ON THE BALANCE OF PAYMENTS

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