REPORT ON THE BALANCE OF PAYMENTS

JUNE
2015

‘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 system of financial intermediation. Developments in the external balance are key to financial stability, as processes relating to the balance of payments allow for conclusions to be drawn concerning the sustainability of economic growth and relevant risks. Moreover, analysis of the balance of payments makes it possible to identify and take actions to avoid economic problems earlier, when they are developing.

To that end, the Magyar Nemzeti Bank carries out comprehensive analyses of trends relating to Hungary's external balance on a regular basis, examining a number of indicators to assess macroeconomic imbalances and identifying elements and processes of critical importance for Hungary's vulnerability.

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

This analysis was prepared by the MNB's Directorate Monetary Policy and Financial Market Analysis under the general guidance of Dániel Palotai, Executive Director in charge of Monetary Policy. Contributors: Anna Boldizsár, Csaba Csávás, Zsuzsa Kékesi, Balázs Kóczián, Péter Koroknai, Rita Lénárt-Odorán and Balázs Sisak. The Report was approved for publication by Dr Ádám Balog, Deputy Governor.

Present report covers relevant information pertaining to the period ending 24 June 2015.

SUMMARY

*In the first quarter of 2015, **the Hungarian economy's four-quarter net lending increased to 9 per cent of GDP,** which was achieved with a **EUR 4.9 billion surplus on the current account** and a EUR 4.5 billion surplus on the capital account, primarily consisting of EU transfers. **Hungary's net lending significantly exceeded that of its regional peers** and continues to contribute to the **reduction of the country's external vulnerability.***

The increase in net lending** calculated in terms of the real economy **stems from the rise in trade surplus and EU transfers.** The increase observed in the surplus on the balance of goods and services was partly the result of declining energy imports and partly due to the very dynamic performance of the automotive industry. With regard to the latter, the depreciation of the euro against the US dollar may have also played a role, which may have been reflected in higher growth of the European economy, and ultimately in a stronger expansion in exports of Hungarian goods. **As a result of mutually opposing processes, the income balance remained broadly unchanged.** Whereas the interest balance continued its mild downward trend as a result of declining yields, the income of corporations expanded moderately, due to improving profit prospects. Due to the rising trend in the drawdown of EU transfers, **the annual surplus on the balance of transfers reached another peak.

*Financing side processes continue to show a **considerable decline in net external debt,** while in FDIs to Hungary in the first quarter exhibited a slightly smaller increase compared to foreign investments of residents. The decline of close to EUR 1.4 billion in net external debt was attributable to the **consolidated general government**, mainly owing to foreign exchange reserves increasing due to the inflow of EU transfers, while in the course of the quarter the state also repaid a significant amount of foreign exchange bonds. Funds were raised by banks, presumably as a correction of the considerable outflow of funds at the end of the year, while external assets also expanded.*

***Financing data indicate a decline in external debt, but the external debt ratios did not decrease, as a result of valuation changes due to USD appreciation and declining yields.** Similarly to the previous quarter, Hungary's GDP-proportionate gross external debt amounted to 86 per cent of GDP, while its net external debt was 33 per cent of GDP. USD appreciation and falling market yields had a considerable impact on the development of external debt indicators. **Declining yields are favourable with regard to sustainability**, but in parallel to this the market price of government debt held by non-residents increased, which resulted in a shift of gross and net ratios opposite to transactions. **Short-term external debt** based on residual maturity, which is of key importance for Hungary's external vulnerability, **showed a slightly increasing trend and rose above EUR 22 billion. In spite of this, the country's reserve adequacy improved**, since the central bank's foreign exchange reserves increased to nearly EUR 37 billion by the end of the quarter, which significantly exceeds the level expected by investors.*

*Analysing the external balance with regard to the savings of individual sectors, it can be observed that **the rise in net lending at the beginning of the year mainly occurred in the context of modest financing needs of the state.** At the start of the year, the financing needs of the general government dropped to below 2 per cent of GDP, primarily due to the revenue-increasing impact of economic growth. The **financial savings of the private sector was considerably restructured by the settlement of foreign currency loans:** this temporarily increased households' net savings, while at the same time decreasing the savings of banks. In the first quarter of 2015, households' portfolio restructuring tapered off substantially, as reflected in the continued year-end expansion of bank deposits.*

***In our special topic, the development of the surplus on the balance of services is analysed in more detail**; in 2014, this amounted to as much as 5 per cent of GDP, and thus **played a significant and increasing role** in the net lending of the Hungarian economy. Hungary's service balance **can be regarded as high, in particular compared to its regional peers.** The fall in services exports was significantly lower in the first years of the financial crisis than the decline of goods exports, while the modest growth in services imports resulted in a considerable surplus. Within services tourism and transportation are of key importance. By international standards, it can be concluded that **in countries which joined the EU later, in general, the balance of services is higher**, which may be related to lower price levels and to higher disposable income in more advanced countries. International comparison shows that **in a crisis services tend to decline less than goods exports**, and therefore higher weight of services may cushion the impacts of a possible crisis.*

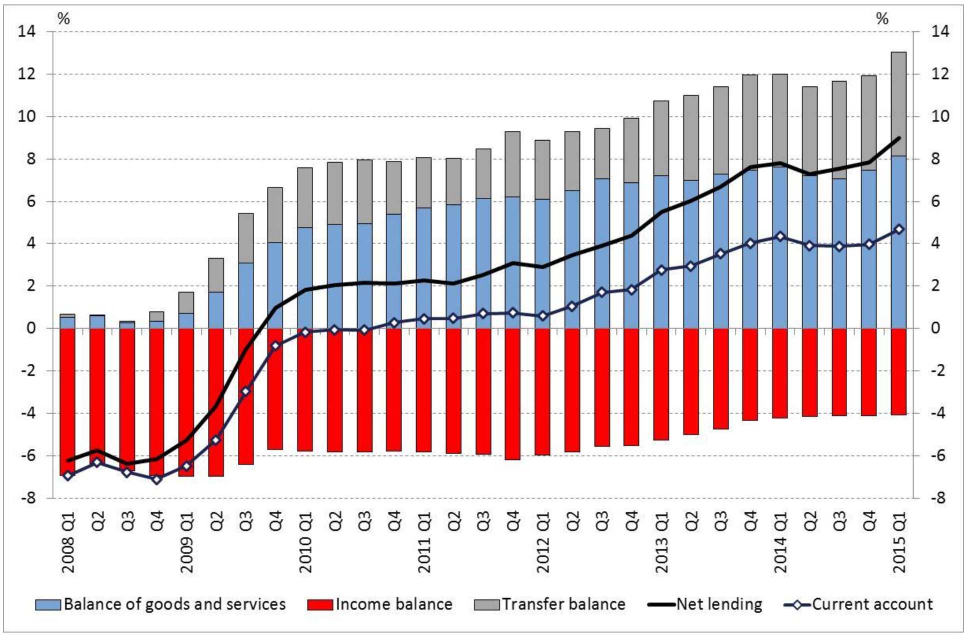
Content

1. REAL ECONOMY APPROACH

Hungary's net lending in Q1 2015 increased to 9 per cent of GDP. The improving trend in the external balance position primarily reflected the boom in net exports. In the first months of the year, external demand showed a favourable trend, which might have been further backed by the depreciation of the euro against the US dollar, and therefore, in this respect, automotive exports were of key importance. At the same time however, import growth slowed as a result of the drop in energy imports and the decline in investments of corporates primarily producing for the domestic market. Utilisation of EU transfers remained considerable, which mainly financed government projects, and only to a lesser extent helped to increase the net lending of the private sector. Moreover, the income balance, with slightly opposite changes in the individual factors, broadly remained stable.

Under the real economy approach, the four-quarter net lending of the Hungarian economy rose to 9 per cent of GDP. In Q1 2015, net lending showed an outstandingly high figure. The combined balance of the current and the capital accounts, based on seasonally unadjusted data, showed a figure close to EUR 3 billion, and thus the four-quarter current account balance increased to 4.7 per cent of GDP, while net lending reached 9 per cent of GDP. In Q1, the trade surplus showed a considerable expansion, with the transfer balance also continuing its improving trend. The deficit of the income balance stabilised at a relatively low level as compared to previous years. Thus, on the whole, all components contributed to the development of the very significant net lending (Chart 1). Hungary's net lending is considered to be outstanding even within the region: at the end of 2014 the comparable figures for the Slovakian and the Polish economies were around 1 per cent of GDP, while that of the Czech Republic was around zero.

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

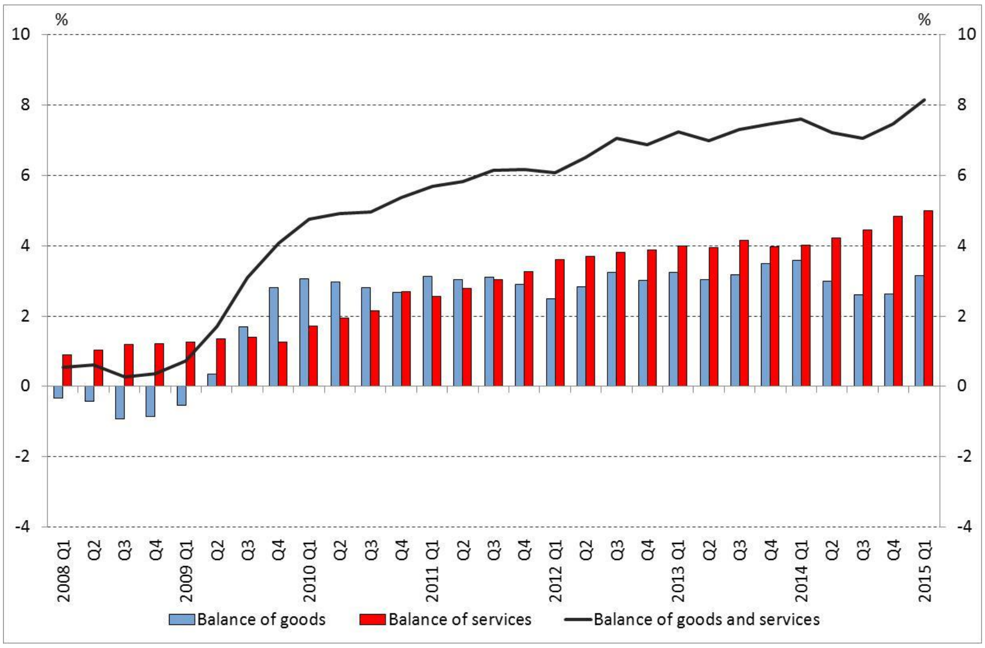


All charts by the MNB unless otherwise indicated.
**Income balance: labour income, income on equity and income on debt. Transfer balance: sum of the capital account, other primary income and secondary income.*

1.1. Balance of trade

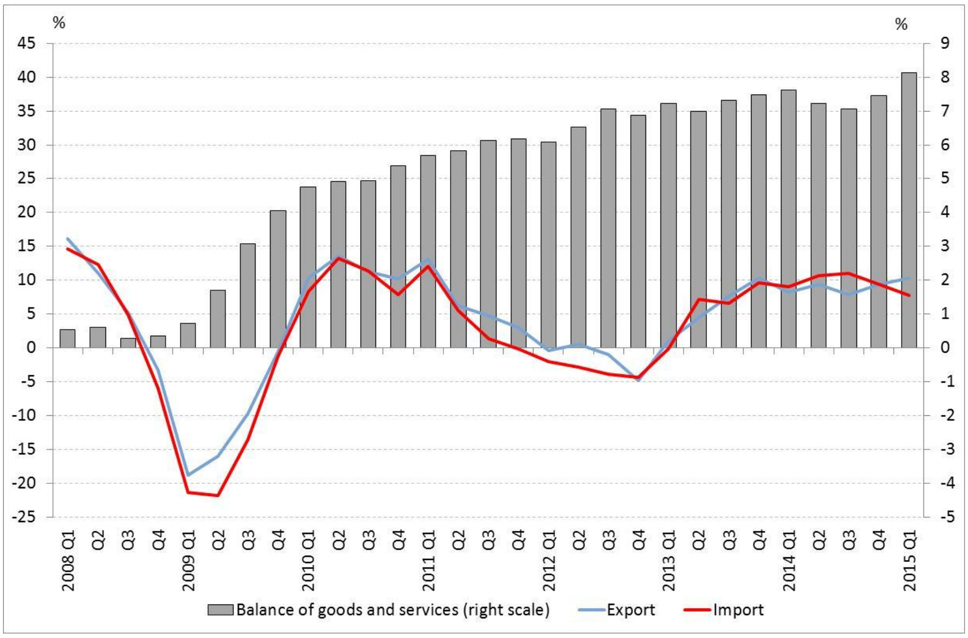
The rise in the trade surplus was achieved together with a surge in net goods exports and a further increase in the surplus on the service balance. The four-quarter trade surplus rose above 8 per cent of GDP. The balance of goods and services within net exports showed a different trend than observed in previous quarters. In the previous period, within total net exports the slowdown of the surplus of the goods balance was accompanied by the expansion of the service balance. In Q1, however, net goods exports showed a renewed and significant increase, together with the continued expansion of the service balance (for more details on previous trends and structure of the service balance please refer to special topic in Chapter 5). The surplus of the goods balance on a quarterly basis can be regarded as outstanding, reaching a level close to EUR 1.6 billion.

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



Automotive exports may have been reflected in the favourable export growth, while the slowdown in imports may have been the result of decreasing energy imports and the decelerating investments of enterprises producing for the domestic market. In Q1, export growth reflected the impact of the recovery observed in external demand, and in accordance with this, industrial production and exports (primarily by the automotive industry) also showed positive developments. The recovery in external demand may be related to the weakening EUR/USD exchange rate: since EUR depreciation may support euro-area exports, and supplier relations of the domestic export sector are close with the euro area, EUR depreciation might have represented a pull for the Hungarian export sector as well. Import growth also supported the increase in net exports, as the annual real growth rate of imports slowed down in Q1. On the one hand, energy imports declined in the first quarter, dropping by EUR 0.6 billion compared to the same period of the previous year, representing almost 2 per cent of quarterly GDP. On the other hand, while household consumption continued to expand, the increase in investments with higher import content slowed significantly. Investments declined in a wide range of industries, but the investments of corporations producing for the domestic market fell at a higher rate. The difference in the performance of corporations producing for exports and for the domestic market may also be reflected in the widening gap between export and import growth.

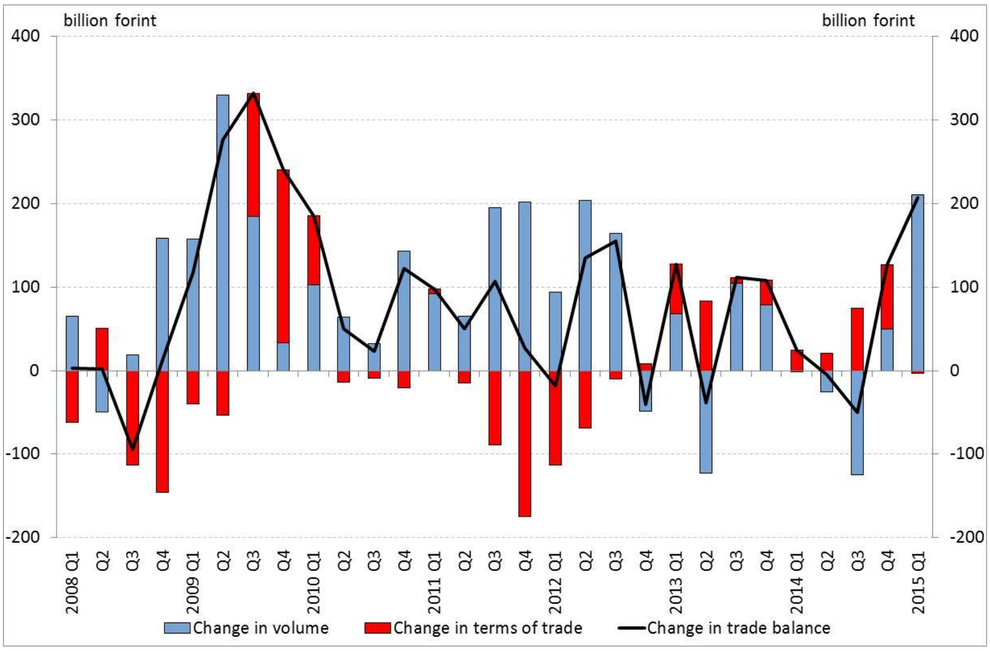
Chart 3: Annual real growth of exports, imports and the GDP-proportionate four-quarter trade surplus



Source: HCSO, MNB.

Rising net exports reflected the widening gap between the volumes of exports and imports, while the terms of trade did not change significantly. In Q1, both export and import prices declined, and thus there was no substantial shift with regard to the terms of trade.[1] However, the impact of declining oil prices is expected to significantly improve the terms of trade as well as net exports during the subsequent quarters of 2015.

Chart 4: Developments in the balance of trade according to GDP (year-on-year)

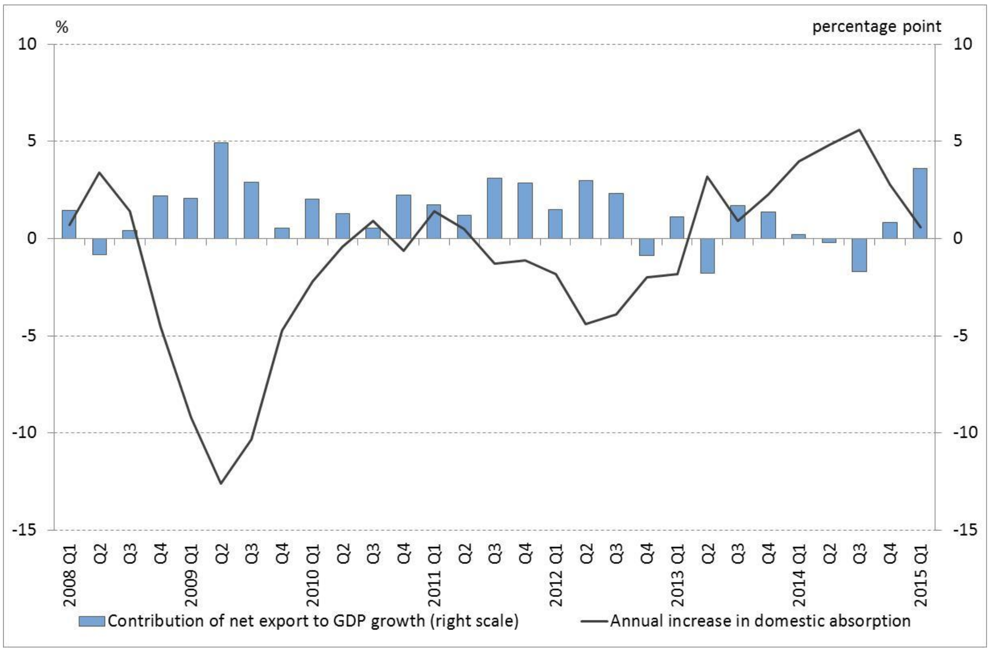


Source: HCSO.

[1] Based on the structure of externally traded products, the significant drop in oil prices is expected to increase the trade balance through improving terms of trade. This is because oil represents a larger weight within imported goods as compared to exported goods, and thus the price of imported goods may show a larger decline, thereby improving the trade balance.

Favourable export trends and the slowdown in investments with high import content were also reflected in the rising contribution of net exports to growth. In Q1 2015, the contribution of net exports reached a peak since the outbreak of the crisis: with 3.5 per cent GDP growth, the contribution of net exports to growth was 3.6 percentage points. Although favourable industrial and export developments caused higher import demand, as a whole the declining growth rate of investments and the related slowdown in domestic absorption resulted in lower import growth. At the same time, the expansion of household consumption remained relatively strong.

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



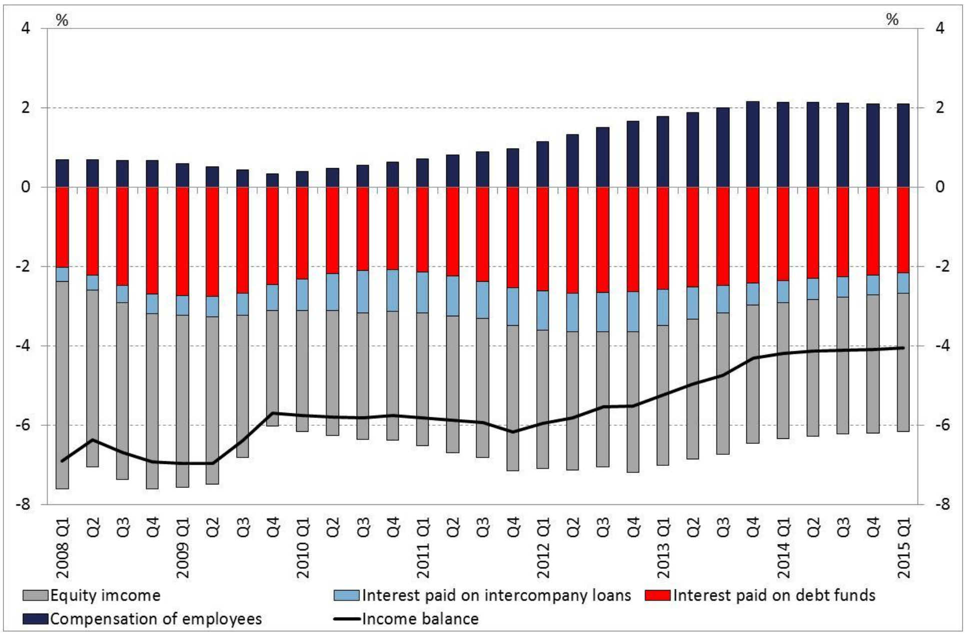
Source: HCSO.

1.2. Income balance

The deficit on the income balance remained relatively stable in conjunction with gradual repricing of external debt. In Q1, the interest balance of foreign loans slightly supported the declining deficit of the income balance, while the latter was negatively impacted to a small degree by developments in the compensation of employees and income on equity: as a result, the four-quarter value of the deficit on the income balance remained at 4.1 per cent of GDP. The downward trend in HUF and EUR yields which has been in place since 2011-2012, as well as the correction in external debt also influenced the outbound interest expense: net interest expenses have gradually decreased in recent years, and this decline continued to a small degree in the first quarter of 2015 as well. With regard to the profit of foreign-owned corporations for the period of 2014-2015, only estimates are available at the time being,[2] on the basis of which, in parallel with favourable external demand and export growth, GDP-proportional net profit expenses may already start to moderately increase in 2015.

[2] Quarterly data on the profitability of foreign-owned corporations operating in Hungary is limited, and therefore information on quarterly outflow of profits is based mostly on estimates. For more details, please refer to the statistical publication on the balance of payments, entitled "*Methodology for the compilation of the balance of payments and international investment position statistics*" available on MNB's website. 2014 corporate profit estimates will be replaced by actual data from corporate annual financial statements to be disclosed in September 2015.

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

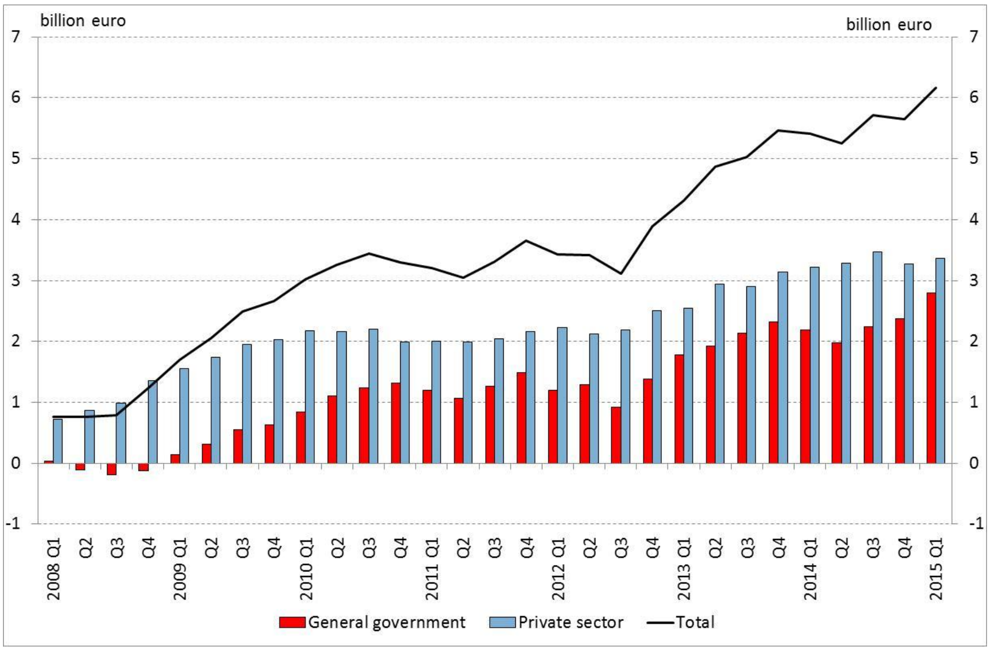


**Income balance: labour income, income on equity and income on debt.*

1.3. EU transfers

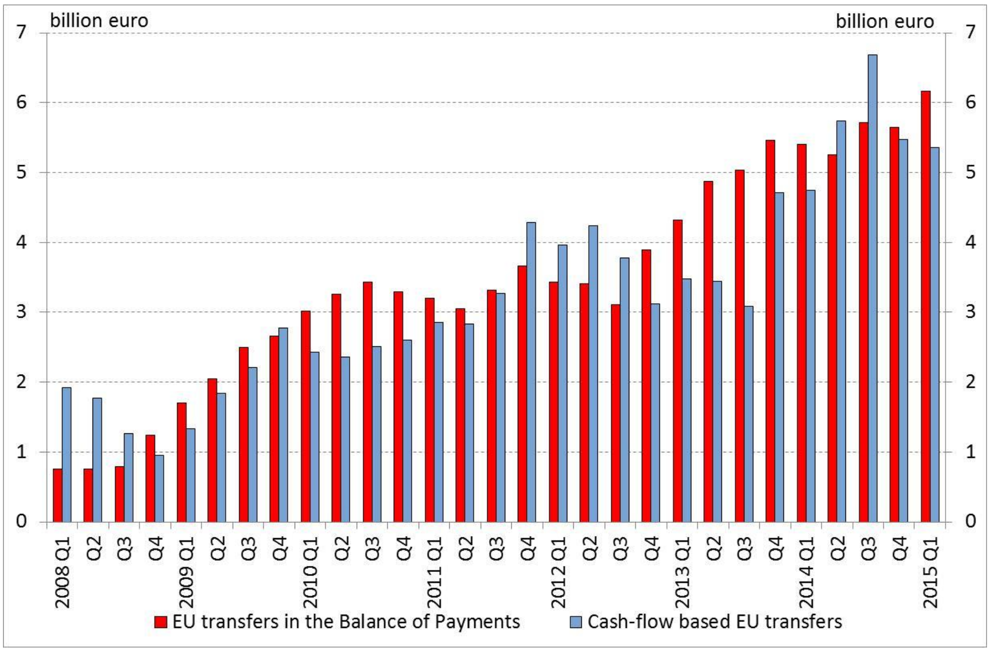
The still high utilisation rate of EU transfers predominantly reflected absorption by the private sector, while the expansion of transfers was basically related to the state. In Q1 2015, EU transfers amounting to EUR 1.3 billion were utilised, representing a rise compared to the same period of the previous year. Thus, the contribution of the transfer balance to net lending remains high. Capital transfers, typically financing investments and development of infrastructure, amounted to approximately EUR 1 billion, while net current transfers also including payments to the EU were around EUR 300 million. Looking at the breakdown of transfers by sectors, it can be concluded that it was once again the private sector which used a significant amount of EU funds, but at the same time the amount received by the general government increased at a higher rate. This is consistent with trends observed recently: EU funds received by the general government have increased rapidly since 2012, while a slower expansion of funds received by the private sector was observed in the last two years.

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



Funds paid out by the state to the applicants (transfer utilisation of balance of payments, accrual based) exceeded the amount paid by the EU to Hungary (cash-flow based) in the first months of this year. While in Q1 the four-quarter value of EU subsidies used, in other words actually received by the sectors, continued to increase, the annual value of funds transferred by the EU to Hungary declined. Namely, EU transfers (in Q1 close to EUR 1 billion in total) lagged behind the utilisation of the sectors (EUR 1.3 billion). All of this means that in this period the state paid more for the individual projects than the amount transferred by the EU to Hungary. State pre-financing is not unusual, since the assessment of EU funds and their subsequent payment is a longer process, and therefore the state performs payment at different points in time, typically earlier than payment is made by the European Commission, which has an impact on the cash-based deficit of the budget; however, the deficit calculated according to the ESA methodology is not affected by this settlement.

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

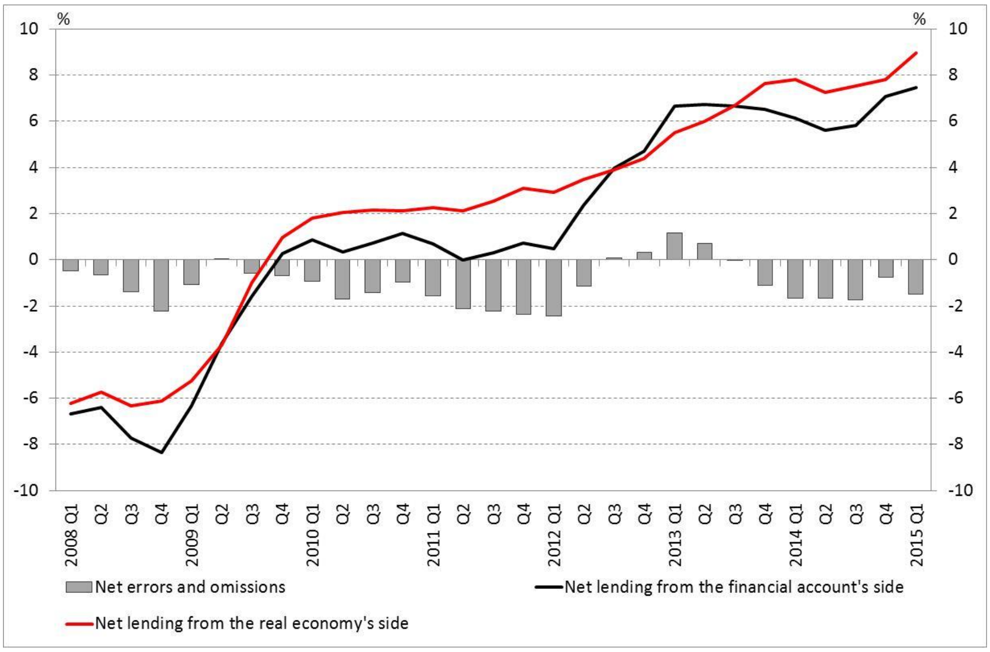


2. FINANCING APPROACH

Net repayments of external funds continued in accordance with the economy's net lending. In Q1, primarily debt type funds decreased, which however was coupled with a slight outflow of net FDIs. It is important, however, that even in the course of this quarter there was an inflow of foreign direct capital to the economy, but the outward investments of domestic actors exceeded the amount of inflows. Debt outflow was effected predominantly from the part of the consolidated general government, mainly reflecting the impact of EU transfers on increasing reserves. The net external debt of the private sector remained broadly unchanged. In the case of banks, external debt increased in January (as a correction of the significant decline at the end of 2014), but in February and March the trend again was characterised by the outflow of funds, also representing the balance sheet adjustments related to settlement and conversion into forint of FX loans.

In Q1 2015, the four-quarter net lending from financing approach rose to 7.5 per cent of GDP, but it still lags well behind the value of the real economy approach.[3] Net errors and omissions representing the difference of the two approaches show that the decrease of external debt ratios is persistently lower than the amount which could have been received by the sum of trade, transfer and income balances.

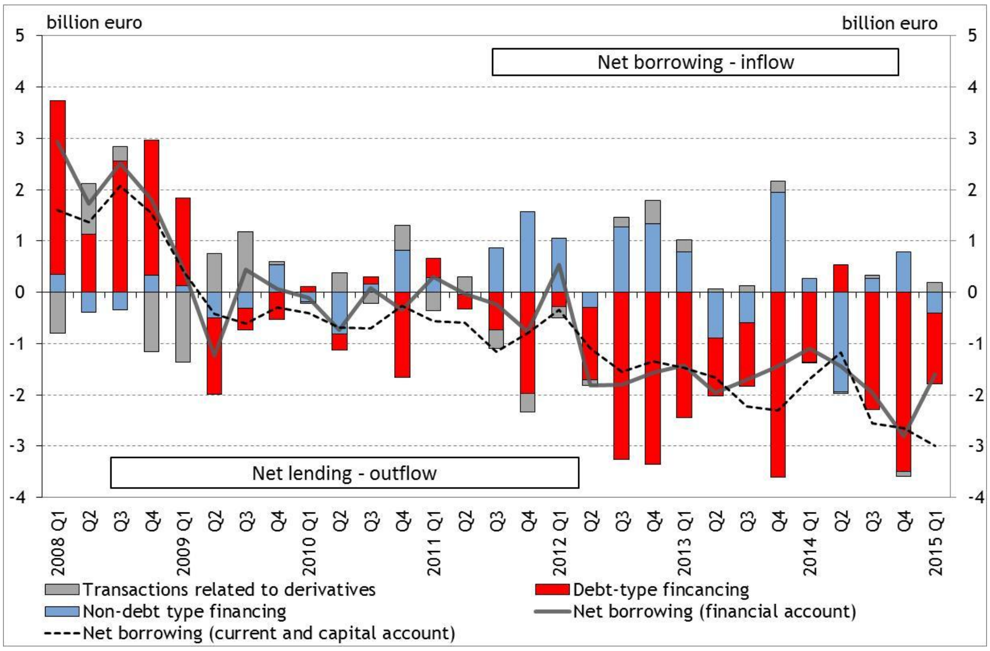
Chart 9: Two types of net lending and "Net errors and omissions"
(four-quarter data as a percentage of GDP)



In Q1, the outflow of funds amounted to almost EUR 1.6 billion, the majority of which is the result of declining debt type funds. Following a larger outflow of funds in the previous quarter, in Q1 seasonally unadjusted net lending declined to around EUR 1.6 billion, which still represents a significant amount. The predominantly debt type outflow of funds was related to the general government. In the quarter, there was a net FDI outflow, which was the result of the fact that the expanding investments abroad of residents exceeded investments of non-residents.

[3] Trends in the balance of payments can also be analysed by examining the financing of real economy transactions. The financial account shows the types of transactions used by resident market participants to finance transactions in the real economy with an effect on net financial worth. Although data derived from the real economy approach and the financing approach should be identical in theory, non-integrated data sources, incomplete observation and different treatment of the exchange rates may give rise to differences, as indicated by the category of "Net errors and omissions".

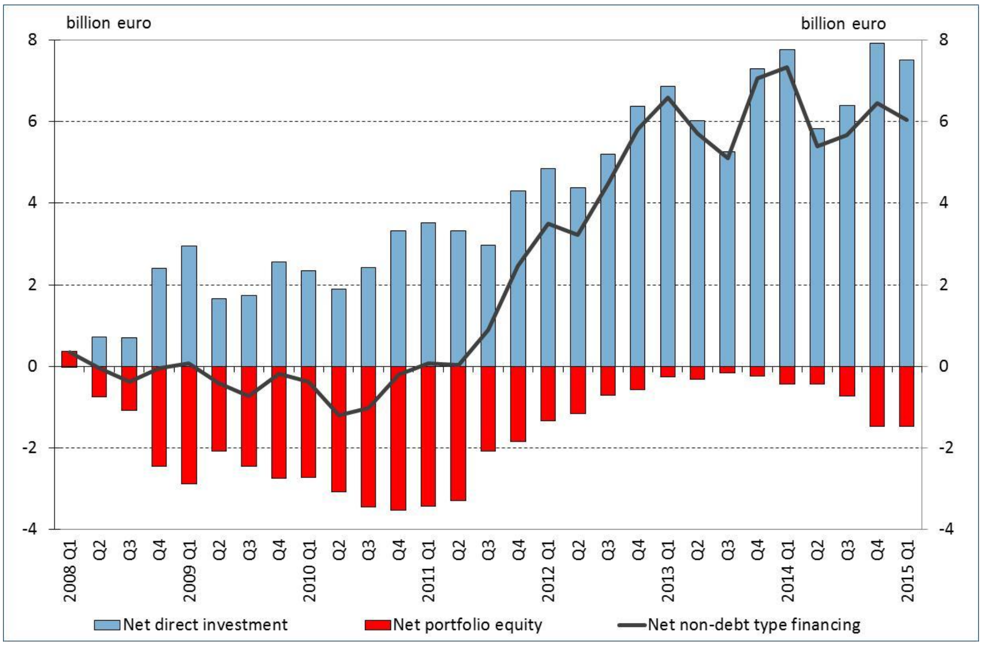
Chart 10: Developments in the structure of net lending (unadjusted transactions)



2.1. Non-debt liabilities

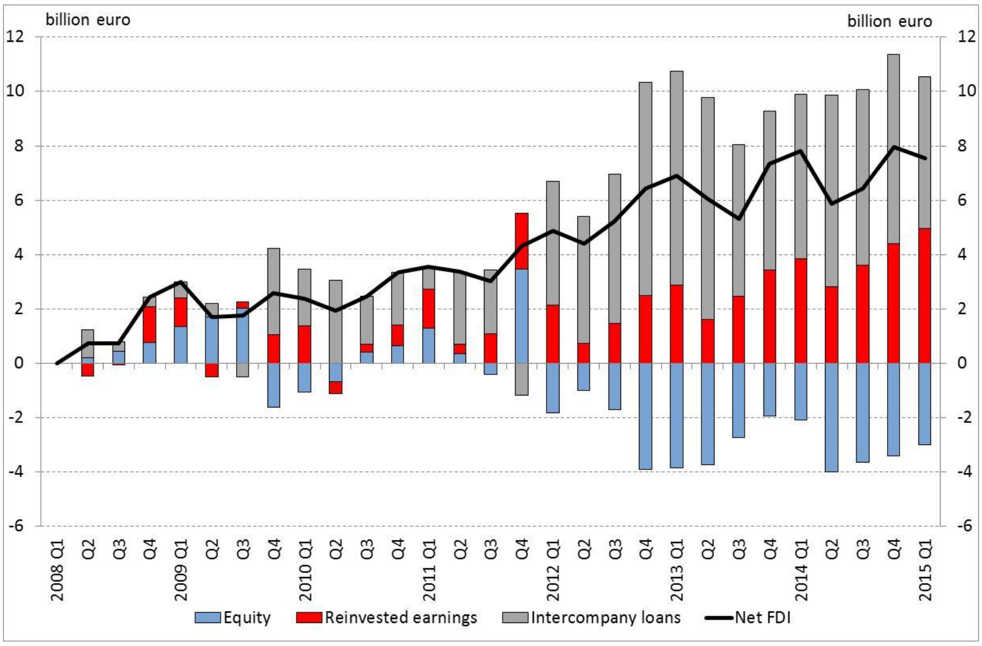
The decline in non-debt type funds was the result of decreasing net foreign direct investments, while portfolio equity investments in total remained broadly unchanged (Chart 11). With regard to portfolio equity investments, looking at the gross components, it should be noted that the stock of foreign equity and mutual fund shares held by residents continued to increase, consistent with the trend observed since 2014. It was observed last year that investment funds restarted their purchases of foreign instruments, which continued in the course of Q1 2015 as well. In previous quarters, this was reflected in the trend of the outflow of funds observed with regard to portfolio equities. This, on the one hand may have been be related to the relatively strong demand of the private sector for mutual fund shares. On the other hand, from 2014 the sale of foreign instruments of investment funds, observed in previous years (which might have been related to the changes in the private pension system), no longer decreased the portfolio investments of domestic investors. In the first quarter of this year, however, this outflow was offset by domestic purchases of foreign investors. In Q1, the amount of direct capital investment of residents abroad exceeded the investments of non-residents, as a result of which the stock of net foreign direct investment in Hungary declined slightly.

Chart 11: Inflow of non-debt liabilities (cumulative transactions)



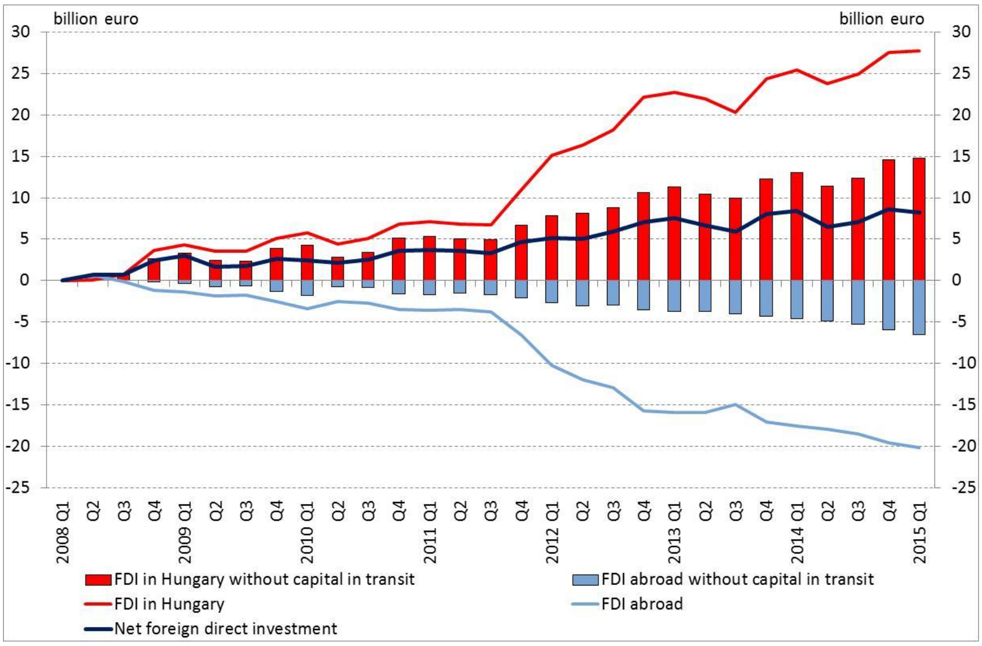
In Q1 2015, net foreign direct investments fell by EUR 0.4 billion, which occurred in conjunction with a slight increase in the reinvested earnings of non-residents and larger decline in intercompany loans. Nevertheless, there was still an FDI inflow into the economy in Q1 as well: the increase in the reinvested earnings and shareholdings of non-residents, however, was offset by a decline in inter-company loans in excess of EUR 1 billion. Thus, in total net foreign direct investment in Hungary as a result of the transactions declined by EUR 0.4 billion.

Chart 12: Trend in FDIs (cumulative transactions)



Net FDI funds declined as a result of significant expansion of investments of residents abroad and only a slight increase of investments. Hungarian FDI funds declined along with an increase in the gross components, that is, the investments of non-residents in Hungary and the foreign investments of residents. Capital in transit continued to distort the development of the gross components. In the course of the quarter, net of these impacts, the investments of non-residents in Hungary increased by almost EUR 200 million, while the outward investments of residents grew by approximately EUR 600 million.

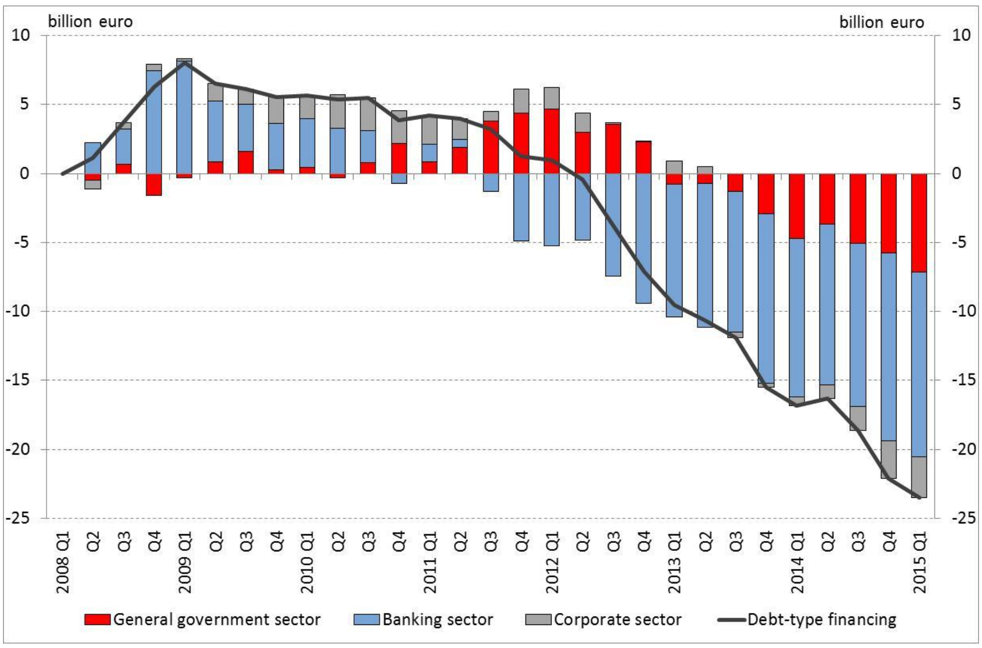
Chart 13: Quarterly foreign direct investment without capital in transit (cumulative transactions)



2.2. Debt liabilities

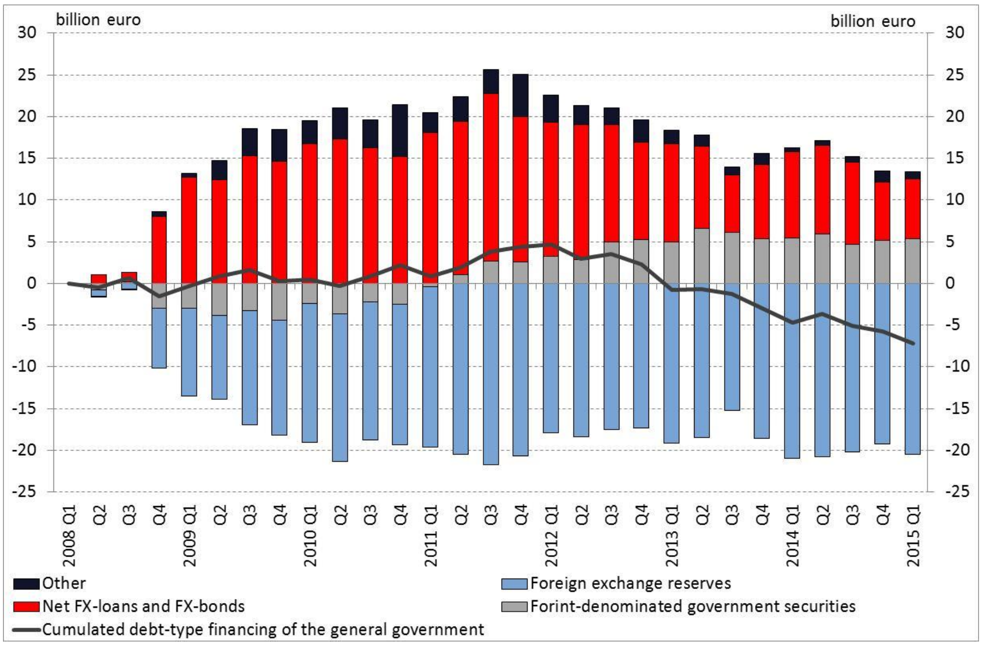
In Q1, the outflow of debt type funds amounted to EUR 1.4 billion, which was predominantly attributable to the consolidated general government; the debt of the private sector remained unchanged. In Q1, the general government consolidated with the MNB further decreased its outstanding external debt by about EUR 1.4 billion. The net decline in government debt may primarily be related to rising central bank reserves due to EU transfers. The banking sector has slightly increased its external debt, which however, based on monthly time profile can primarily be regarded as a correction of the year-end balance sheet optimisation of banks. Conversion and settlement of foreign currency loans may have caused the decline in banks' net external debt. Since the decrease in corporate debt compensated the increase in banks' debt, the decline of debt-type funds of the economy in the course of Q1 was around EUR 1.4 billion emerging at the general government.

Chart 14: Developments in net debt-type financing by sector (cumulative transactions)



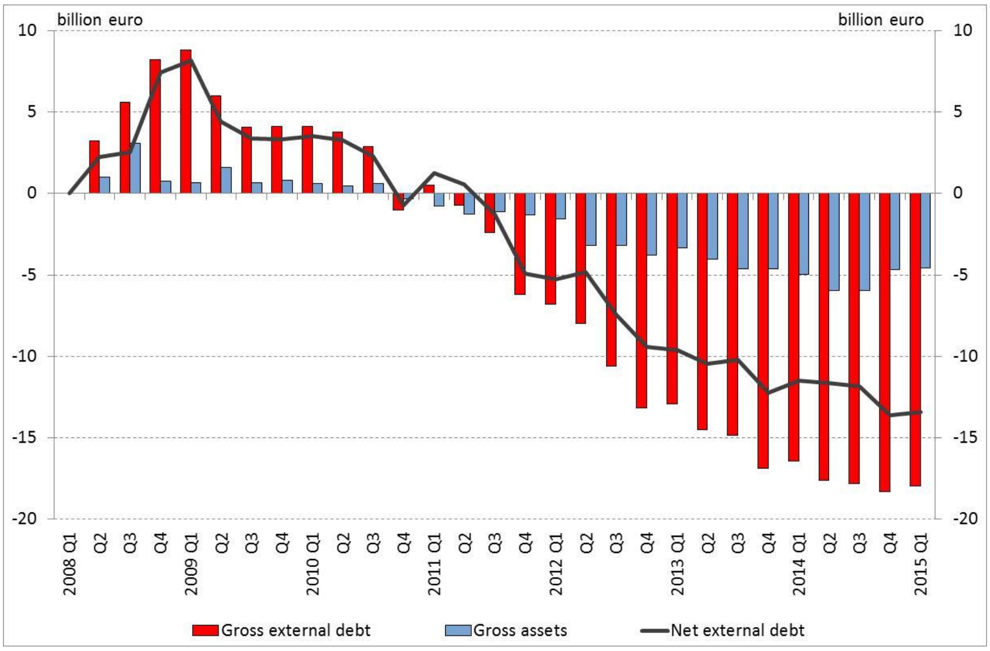
In Q1, the falling trend of net external debt of the consolidated general government continued. The net outflow of funds represented the impact of EU transfers on increasing reserves. Consequently, EU transfers on the real sector side contribute to net lending through the surplus of the transfer balance, and on the financing side, to the external outflow of funds through increasing central bank reserves and decreasing net liabilities to the EU. Apart from that, other significant factors also influenced the processes of financing the general government in Q1, which affected both foreign assets and liabilities of the sector, and thus on balance they did not cause any shift. There was repayment of an FX bond in February, with which both gross external debt of the general government and central bank reserves declined (since the state purchases the FX for repayment from the central bank). The external debt of the general government and the foreign exchange reserves were both increased by the margin deposits related to the state's derivative transactions (see below in more details). It should also be noted that the stock of HUF government securities held by non-residents in total showed an increase of EUR 300 million in Q1; at the same time however this represents the growth in January, since the stock already declined in February and March.

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



The net external debt of the banking sector increased slightly in Q1 2015, as a result of the correction in the significant decrease in debt at the end of the year, as well as decreasing external debt of banks partly related to banks' settlement and conversion into forint of FX loans. At the end of 2014, the gross external debt of the banking sector declined by EUR 0.5 billion; at the same time, the decrease in net external debt due to increasing external assets was even higher, reaching a figure close to EUR 1.8 billion. In the first month of Q1, however, the external debt of banks increased significantly, which could be regarded as correction of the year-end balance sheet adjustment. However, in February and March external debt decreased, which was partly the result of the outflow of external funds related to the banks' settlement of foreign currency loans and conversion into forint. Impact of the latter may also occur in a prolonged manner over the subsequent quarters.

Chart 16: Trend of the banking sector's external debt and asset transactions (cumulative transactions)

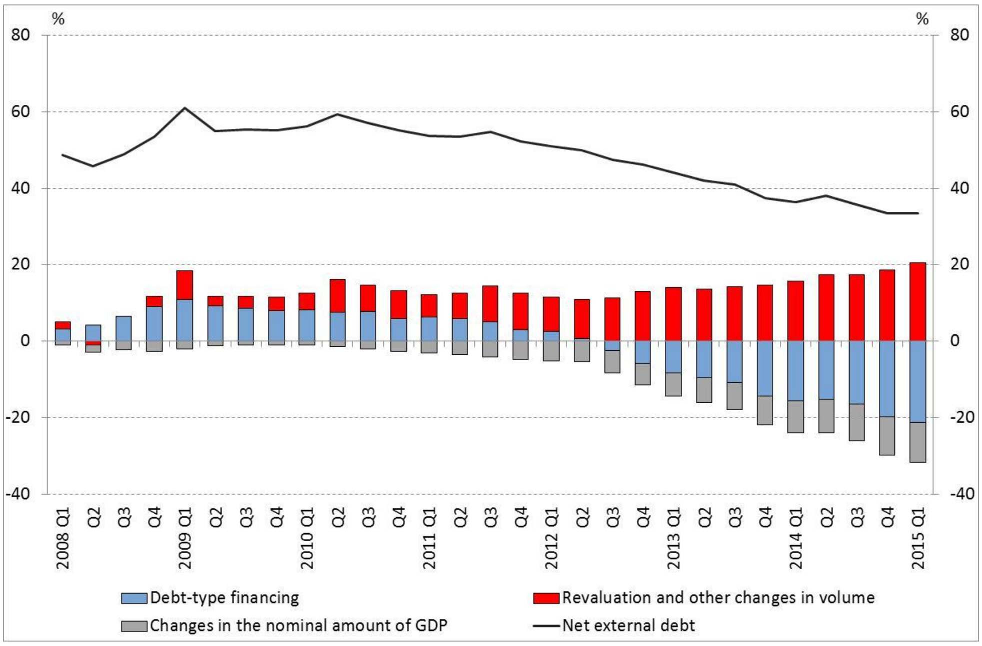


3. DEVELOPMENT OF DEBT RATIOS

In spite of continued debt outflow and significant GDP growth in Q1, the external debt ratios of the Hungarian economy remained unchanged: net external debt was 33 per cent, while gross external debt amounted to almost 86 per cent of GDP at the end of March. While there was a considerable net outflow of funds with regard to consolidated general government, the external debt of the sector was also adversely affected by the increasing market prices of government securities, due to weakening of the Hungarian forint against the US dollar and decreasing yields. Short-term external debt, which is monitored carefully due to its key importance with regard to external vulnerability, also increased, with the majority of this primarily related to the general government: on the one hand, the Government Debt Management Agency's margin account balance increased, and on the other hand the amortised long-term debt of the government also rose. Apart from that however, there was a slight increase of banks' short-term external debt, probably reflecting corrections in January of year-end money market processes as the decline of banks' liabilities continued in February and March. In Q1 2015, the foreign reserves of the MNB continued to expand, and thus in total Hungary's reserve adequacy improved, and the amount of FX reserves still significantly exceeds the level expected by investors.

The net external debt-to-GDP ratio remained unchanged in Q1: the impacts of debt outflow and GDP growth were offset by changes in exchange rates and prices. Similarly to the previous quarter, net external debt amounted to 33 per cent of GDP in Q1. While the net outflow of funds and GDP growth contributed to decreasing the debt ratio, developments in exchange rates and yields increased net external debt. Within net external debt outstanding, the weight of the US dollar, together with the HUF, is significant, while the share of the euro, also taking into account the central bank's international reserves, is smaller. Although the HUF strengthened against the euro as compared to the year-end figure of 2014, it depreciated against the US dollar, representing a bigger weight within net debt outstanding. Consequently, the above impact was reflected in the revaluation due to changes in exchange rates, which had a direct impact on net external debt. In Q1, in addition to changes in exchange rates, changes in the market price of government securities held by non-residents also contributed to increasing the debt ratio. This is because, in addition to the decrease in yields, which is favourable in particular with regard to sustainability, the market value of bonds, which are gradually being repriced, increased significantly in this period, affecting both HUF and FX bonds.

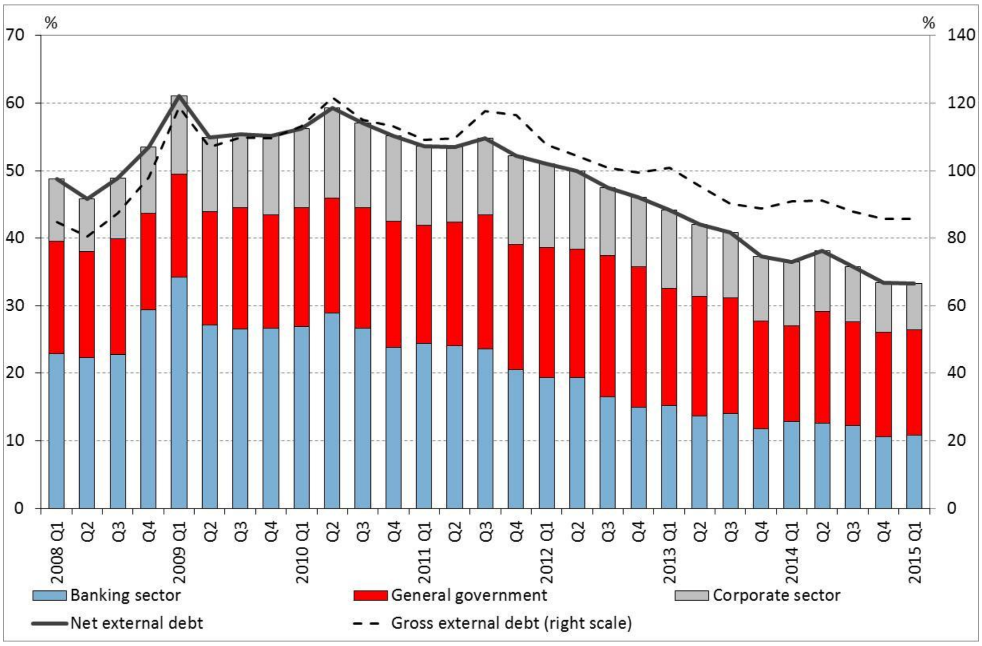
Chart 17: Components of net external debt changes
(cumulative, without inter-company loan GDP-proportionate value, end of 2007 = 0)



Revaluation effects increasing net external debt occurred primarily with regard to the general government; besides that, however, the net external debt of the banking sector also rose to a minor extent. In the case of the consolidated general government, the impact of the substantial net outflow of funds observed in Q1 was more than offset by the revaluation of external debt outstanding. Consequently, the previously decreasing debt dynamics in the public sector did not continue in the quarter. In Q1, the net external debt of banks showed a slight increase on aggregate. Quarterly developments in debt outstanding of the banking sector are typically influenced by end-of-year financial market trends, as well as the corrections thereof. Similarly to previous years, in early 2015 as well, the external debt of banks started to increase, while in subsequent months banks' external debt already started to decline. At the same time, the net external debt of the corporate sector decreased.

Revaluation effects adversely affected gross external debt indicators as well, which consequently remained at the level observed in the previous quarter, at around 86 per cent of GDP at the end of Q1. Debt outflow and GDP growth reduced gross external debt, while price changes due to decreasing yields increased it. At the same time, the impacts of changes in exchange rates offset each other. Within gross debt, debt outstanding in euro has a substantial weight, and thus strengthening of HUF against EUR could be more significant in the gross indicator.

Chart 18: Breakdown of gross external debt by sectors (as a percentage of GDP)

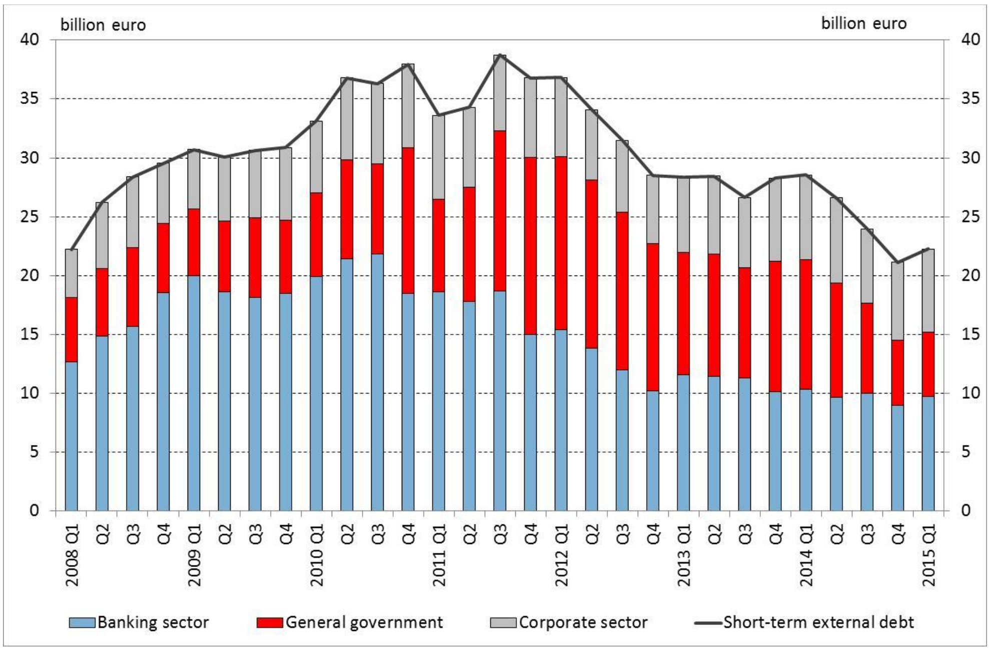


In Q1 2015, the economy's short-term external debt based on residual maturity rose to EUR 22.3 billion, however part of this growth can be considered temporary. Growth in short-term debt can partly be attributed to the correction of outflow of funds of banks at the end of 2014. In January there was an inflow of short-term funds of similar scale to the end-of-year figure, which determined the dynamics of banks' debt in Q1. However, it is important to add that in February and March already banks' short-term funds declined again. On the other hand, the uptrend in short-term debt in Q1 may be explained by the increase of amortised government debt. This is because in the course of the previous year a EU loan of a significant amount, as well as several FX bonds were repaid, and thus by the end of 2014 the external debt of the general government maturing within a year declined to a very low level. In early 2016, the state will have another significant stock of maturing FX bonds, which, also taking into account maturities of HUF bonds, increased short-term external government debt based on residual maturity. Government debt originally with short term also rose, predominantly due to the increase in Government Debt Management Agency's margin deposit balance, which was only partly offset by the decrease in short-term debt due to the EU.[4] It is important to

[4] Developments in short-term debt due to the EU is also affected by a change in methodology. The debt balance, previously treated in a uniform manner, will be split in the balance of payments statistics as of Q1 2015 into short-term and long-term debt, as a result of which in March the short-term stock declined by EUR 400 million.

underline that the economy's high net lending, the self-financing programme of the MNB as well as conversion of FX loans into forint have all contributed to the decrease of the economy's external debt, part of which may occur in the short term.

Chart 19: Developments in gross short-term external debt based on residual maturity



In Q1 2015, foreign exchange reserves continued to increase, partly as a result of the depreciation of the euro against major currencies. At the end of Q1 2015, international reserves amounted to EUR 36.9 billion, representing a EUR 2.3 billion increase as compared to the figure from the end of December 2014. Several factors influenced the development of foreign exchange reserves. The increase in reserves was caused by European Union transfers, the Government Debt Management Agency's mark-to-market deposit changes related to hedging swap transactions,[5] the maturity of other central bank swap transactions, as well as changes in revaluation differences due to exchange rate fluctuations of major currencies[6]. In Q1, foreign exchange reserves decreased as a result of the US dollar bond maturing in February 2015 and the maturing swap transactions related to conversion into forint.

[5] The Government Debt Management Agency (ÁKK) hedges its FX bonds issued in currencies other than the euro with swap transactions to euro, and the banks contracting with ÁKK in order to reduce counterparty risk place a **mark-to-market deposit** with ÁKK, which is held by ÁKK on its FX account held at the MNB. The amount of deposits placed depends on the market value of the swap transaction. If the market value of the transaction is positive for ÁKK, then its partners have deposits with ÁKK, while in the opposite case ÁKK has deposits with its partners. In Q1 2015, the euro weakened against the US dollar by 12-13 per cent, and thus the partners of ÁKK placed deposits with ÁKK in a larger amount than previously.

[6] Although the MNB only undertakes exposure to exchange rate risk in euro, the level of the FX reserves is temporarily affected by the changes of the stock of portfolio elements outstanding in currencies other than the euro (US dollar, British pound, Japanese yen) expressed in euro. It is temporary because – although the derivative transactions covering exposure do not form part of the gross FX reserves – the currency exchanged upon maturity of the swap transaction is transferred to the FX reserve at its exchange rate pre-fixed, previous to the revaluation, and thus over the long term the impact of the revaluation on the FX reserves is neutral.

Chart 20: Short-term external debt and the stock of foreign exchange reserves of the Hungarian economy

In Q1 2015, the reserve adequacy relative to short-term external debt improved. While foreign reserves increased by EUR 2.3 billion, short-term external debt increased at a smaller rate, by EUR 1.1 billion. The increase in foreign reserves exceeding short-term external debt is related to the fact that while certain items affecting the reserves also increase short-term external debt in parallel, other reserve-increasing factors are not coupled with the increase in short-term external debt. Examples for the former factors may include the increase in ÁKK's mark-to-market deposits, which not only increase foreign reserves, but by the same extent increase short-term external debt as well. On the other hand, part of short-term external debt is denominated in currencies other than the euro, and thus depreciation of the euro not only increases gross foreign reserves, but to a smaller extent, also the value of the short-term external debt calculated in euro. Other items improving the reserve adequacy are EU transfers, the inflow of which does not increase short-term external debt, provided that residents utilise these incoming EU funds.

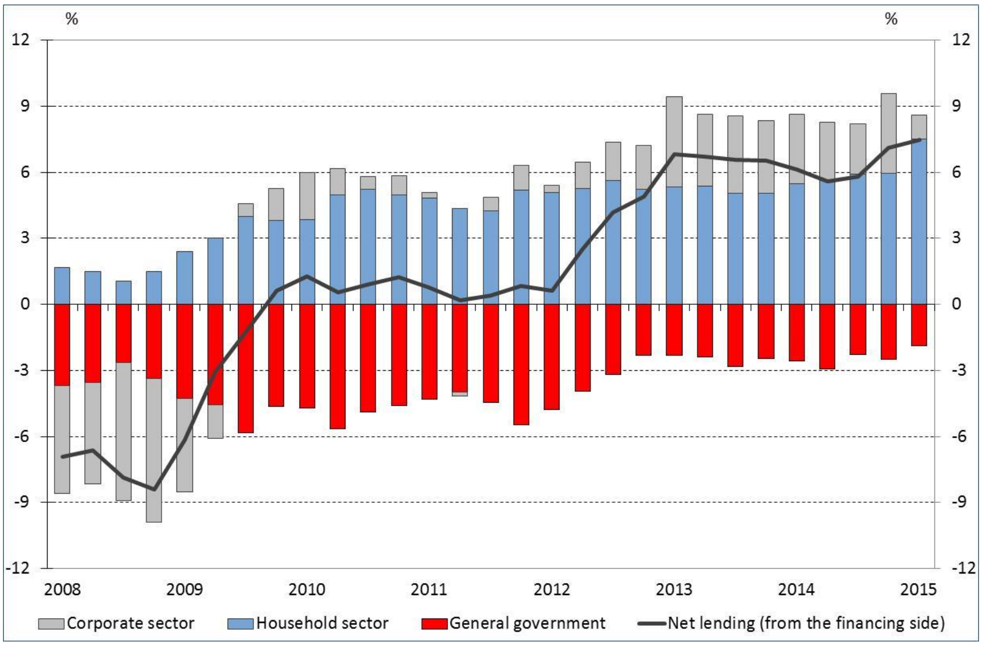
The amount of international reserves still significantly exceeds the level expected by investors. Based on the Guidotti–Greenspan rule, which is strictly followed by both investors and the central bank, the close to EUR 37 billion reserves at the end of March 2015 significantly exceeds the level of short-term external debt amounting to EUR 22.3 billion. Looking ahead, it is appropriate to take into account the fact that in addition to FX maturities, the FX assets related to conversion into forint will reduce the level of international reserves until the end of 2017 by an amount of EUR 8.6 billion, while EU transfers are expected to continue to increase the international reserves; thus taking into account the impacts of only these two factors the FX reserve would still exceed the level of short-term external debt. The international reserves, when considering other reserve indicators (for example the import rule) still significantly exceed the level expected by investors.

4. SECTORS' SAVINGS APPROACH

The economy's net lending from financing approach continued to increase slightly in Q1 2015, due to the decreasing borrowing of the general government, while the settlement of FX loans restructured the savings positions of households and companies. The decreasing borrowing of the state may be related to expanding revenues as a result of rising economic growth; expenditures remained roughly the same. The decrease in the savings of corporations and the increase in households' net savings are due to settlement related to foreign currency loans. The net saving of households, even after eliminating one-off impacts, can be considered as rather high, which was supported by both the liabilities side adjustment and the financial asset accumulation. In Q1, the stock of deposits and government securities held by households further expanded, while the increase in mutual fund shares slowed down. Overall, these processes may further decrease the dependence of the state on external funds.

In Q1 2015, the increase of the economy's four-quarter net savings analysed in terms of the savings of the sectors is primarily due to the decline of net borrowing of the general government (Chart 21). The low level of four-quarter borrowing of the general government can be explained regarding revenues by increasing tax revenues due to expanding wages and employment and in the context of the whitening of the economy by increasing VAT revenues. In terms of expenditures, the borrowing of the general government was permanently reduced by the local government sub-sector being in balance, and temporarily by the accumulated receivables of social insurance. In Q1 2015, the savings of corporations declined as a result of settlements related to FX loans causing a decrease in profits, while the settlement of FX loans and indemnification of the deposit holders of DRB banking group in Q1 temporarily[7] increased the savings of households' at a higher rate.

Chart 21: Net lending of specific sectors (four-quarter values as a percentage of GDP)

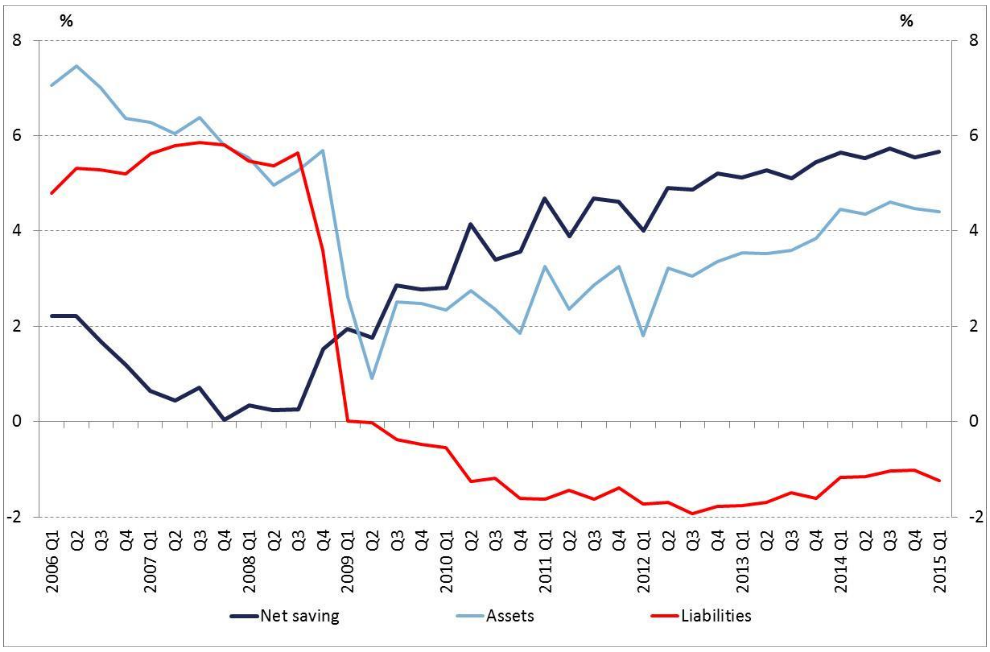


According to the fundamental development, the financial savings of households was probably around 6 per cent of GDP, but the data in preliminary financial accounts were influenced by conversion into forint and settlement of FX loans. The high level of net savings of households is attributable to increasing real income and moderate credit demand, as precautionary considerations are still of key importance. In Q1, the data in financial accounts were significantly affected by conversion to forint and settlement of FX loans, and thus for the purpose of presenting the

[7] In the statistics, the decrease of household deposits held at banks undergoing liquidation is not part of financial transactions of households, while indemnification paid by the Deposit Insurance Fund forms part thereof. Thereby as a result of indemnification household savings increased temporarily by the amount of indemnification.

underlying developments these impacts had to be corrected. Determining the underlying development of savings and lending is rendered more difficult by the fact that current correction is partly based on estimates. Nevertheless, it is though that even in Q1 2015 there were net repayments, although a gradual easing was observed with regard to household borrowing which is manifested in new HUF real estate borrowing and trends observed on the real estate market.[8] No substantial changes occurred with regard to the underlying development of financial asset accumulation, as households further increased their financial instruments as a result of expanding real income.

Chart 22: Households' net lending (seasonally adjusted revised values, as a percentage of GDP)*



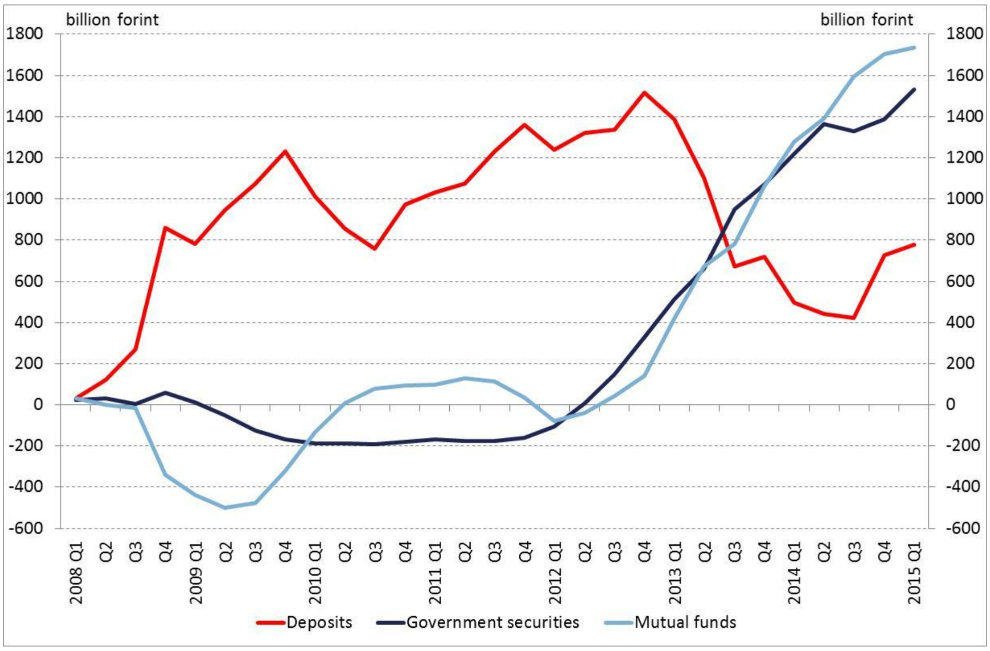
** The revised net savings figure of households excludes transactions which boost the savings of the sector related to the early repayment scheme, the disbursement of real yields, the indemnification of the deposit holders of defaulting cooperative banks, and the estimated impact of the settlement related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

In Q1, households placed their additional savings primarily in government securities and bank deposits; the expansion of mutual fund shares continued to slow down. As a result of these developments, the trend of decreased dependency of the state on external funds may continue. The restructuring of households' portfolio has been going on for two years and has resulted in a considerable decrease in bank deposits with gradually decreasing yields, and the increase of securities promising relatively higher returns. In the second half of 2014, however, an important change was observed: the stock of bank deposits stopped declining and subsequently started to increase significantly. The increase in bank deposits was probably the result of the fact that in a low-yield environment the liquidity of bank deposits became more appreciated. Thus, household deposits allow banks to continue reducing their external funds. In Q1 2015, the low-yield environment and the yields on retail government securities increased by ÁKK resulted in a situation in which the relative yield advantage of government securities as opposed to mutual fund shares made the direct financing of the general government more attractive for households. Consequently, the stock of government securities increased considerably again in Q1, while the expansion of mutual fund shares slowed down. Within mutual fund shares, the fall in demand was observed primarily with regard to money market and bond funds, retrospective yield of which has the closest link with low market yields. In addition, demand for investment funds may have also been reduced as a result of uncertainties with regard to other investment firms; it is believed, however, that yield considerations may have had a stronger effect on the structure of household savings. The spread of retail government securities may reduce the dependency of the general government on external

[8] Based on estimates, in terms of liabilities quarter on quarter, there was a higher rate of repayment. The fact that in the beginning of 2015 at credit institutions lending might have decreased as a result of switching over to new lending rules and settlement related to foreign currency loans, may have played a role in the above.

funds, which in turn might be offset by possible further decrease in indirect retail financing through bond and money market funds.

Chart 23: Cumulative transactions of household instruments



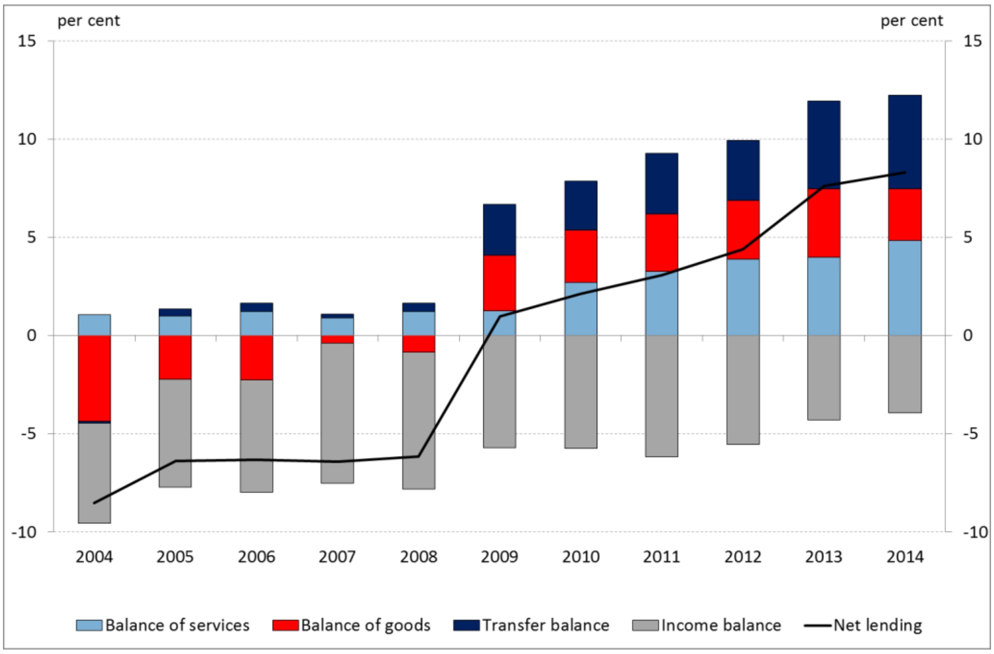
5. SPECIAL TOPIC: THE BACKGROUND OF THE INCREASE IN THE BALANCE OF SERVICES

Within the Hungarian economy's net exports, the balance of services accounts for an increasingly larger portion (approximately 5 per cent of GDP last year) – while exports of services within total exports account for a far smaller portion. The rise in the balance after the crisis was mainly driven by subdued growth in services imports, while the growth rate of services exports only declined slightly, in other words the crisis had a far smaller impact on foreign trade in services compared to trade in goods. Within services, the surplus stemming from tourism and transportation is predominant, but the expansion of manufacturing services on physical inputs owned by others and other business services also played a role. An international comparison shows that new member states typically feature a higher balance of services surpluses compared to advanced economies, which may be linked to higher price levels and greater disposable income. It should be noted nevertheless that Hungary's balance of services is salient within the region, the latter characterised by a rate of net services exports that has remained relatively stable in recent years, as opposed to the significantly rising services exports prevailing in Hungary. For Hungary, the fact that exports of services declined to a far smaller degree in the wake of the crisis compared to exports of goods may be a key factor – in other words, the recent rise in services exports may significantly cushion the impacts of a potential future crisis.

5.1. Introduction

The surplus of the balance of goods and services is a defining factor in the economy's net lending, and the balance of services account for an increasingly large portion (around two thirds by late 2014) of this balance. Whereas before the crisis the balance of services only slightly decreased the economy's net borrowing, it has continued to rise gradually since the crisis, reaching nearly 5 per cent of GDP by late 2014. Of the 7-percentage point rise in net lending relative to GDP since 2009, 4 percentage points can be linked to the expansion in the balance of services. The following section presents a detailed analysis of the developments in the Hungarian balance of services, its key elements and a comparison within the region and Europe.

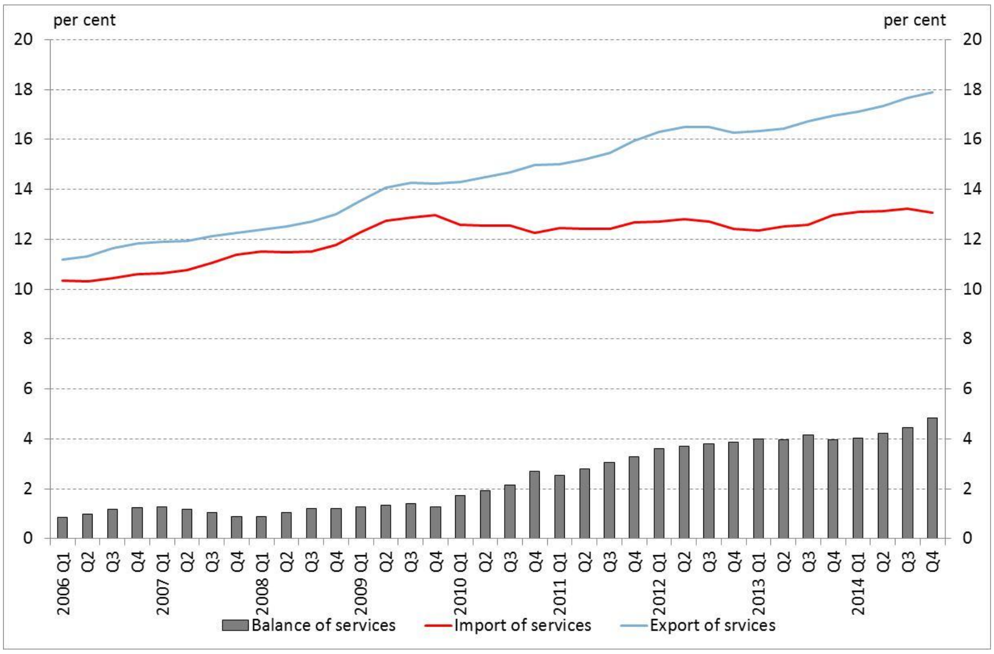
Chart 24: Main components of net lending (as a percentage of GDP)



5.2. Developments in gross flows

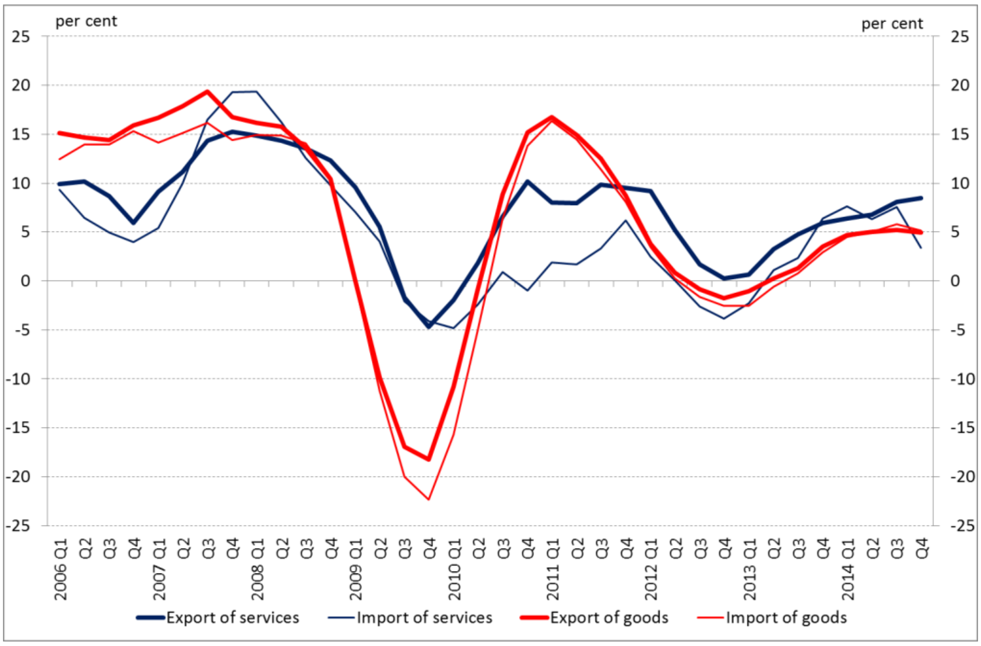
The continuously increasing surplus has clearly reflected rising revenues, while imports relative to GDP have essentially stagnated. While before the 2008 crisis, the balance stood at around 1-1.5 per cent of GDP stemming from the similar growth in the exports and imports of services, after the crisis the stagnation of imports as a percentage of GDP was coupled with a continued rise in exports, driving an increase in the balance of services surplus to nearly 5 per cent of GDP. In other words, the underlying factor of the growing balance of services surplus may be the subdued dynamics of imports (the more in-depth development of these items is discussed later on).

Chart 25: Developments in exports and imports of services and the balance of services (four-quarter values as a percentage of GDP)



The growth rate in services exports after the crisis fell to a much smaller degree than exports of goods. Expansion in items of the exports and imports of goods and services typically co-varies. During the onset of the crisis, exports and imports of goods and services saw a marked decline and then a subsequent reversal, the degree of which was substantially higher in the case of the balance of goods compared to the balance of services. While the reversal of trade in goods emerged alongside roughly identical export and import growth, the growth rates diverged in the case of services. The closer covariance observed in the trade of goods may be driven by the fact that a significant portion of exports of goods is derived from the manufacturing and export of imported goods. By contrast, exports and imports of services are less closely related. If for instance Hungary's tourism attraction were to increase during a specific period, spurring a rise in travel revenues, it would not necessarily trigger an increase in travel expenditures.

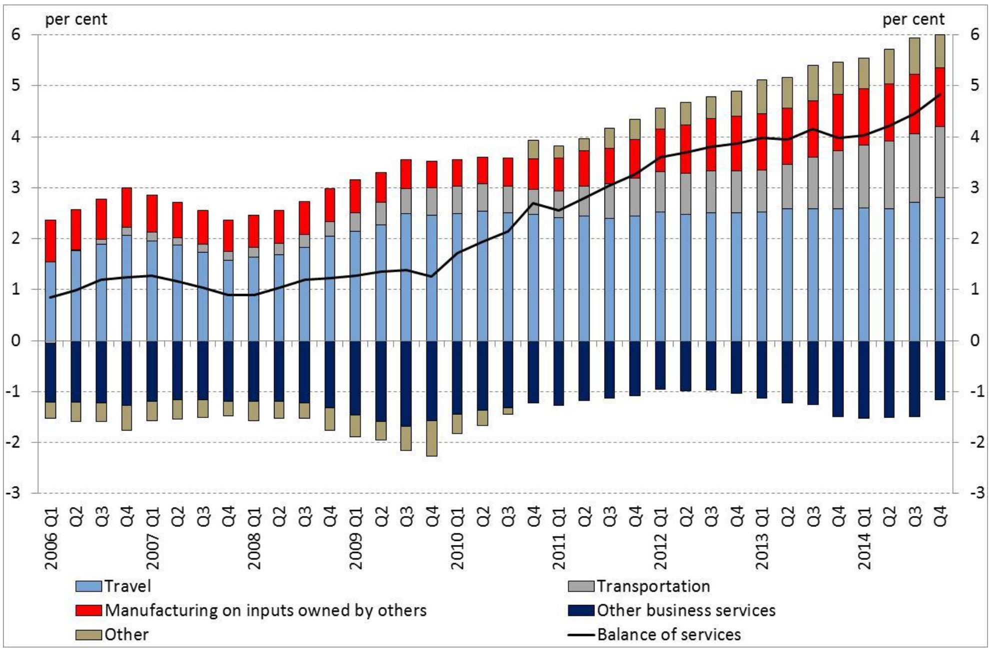
Chart 26: Growth rate of exports and imports of goods and services (percentage change in four-quarter values, year-on-year)



5.3. Breakdown by activity

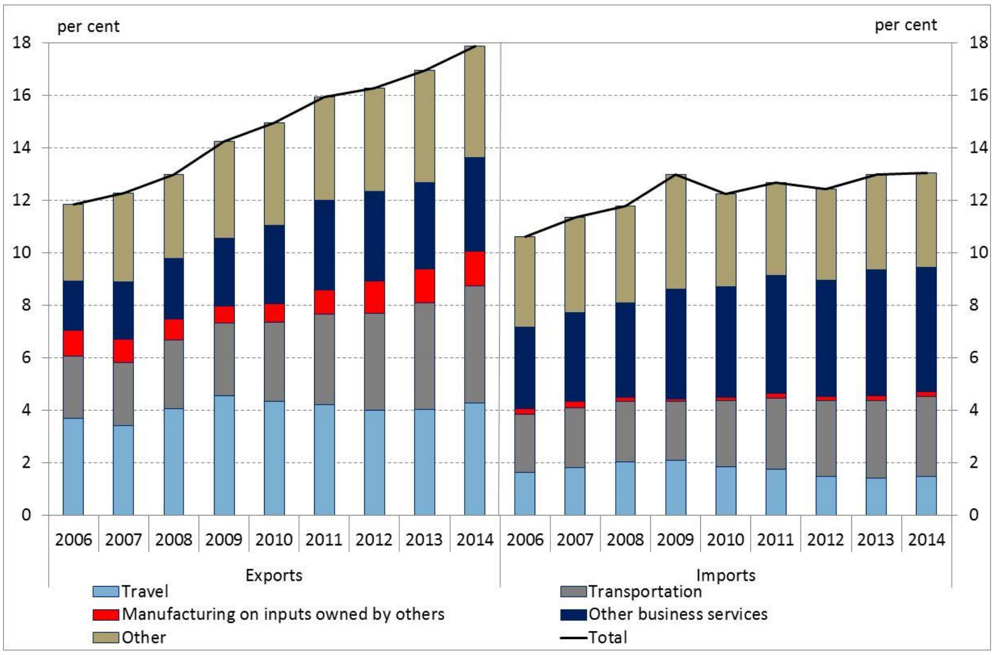
Travel (tourism) exhibits the highest surplus within the balance of services, while transportation played one of the largest roles in the expansion of the past two years. The Hungarian economy's net export linked to tourism stabilised at a relatively high level in the period following the crisis, at around 2.5-3.0% of GDP and has thus significantly contributed to the balance of services. At the same time, other partial items shaped the expansion of services in recent years. The dynamic rise that started in 2010 may be linked to manufacturing services on physical inputs owned by others, other business services (such as legal and accounting services) and concurrent improvements in other minor items. After 2012, the balance of transportation services surplus exhibited a substantial improvement.

Chart 27: Key items of the balance of services (four-quarter values as a percentage of GDP)



The gradual improvement in the balance of services was driven by rising revenues, but the improving balance was also fostered by falling imports linked to tourism. Although tourism plays the biggest role in the balance of service, it has a smaller weight within the exports of services. In other words, the pronounced surplus stems from low imports and the restrained spending of residents abroad. Revenues linked to tourism rose during the onset of the crisis in 2008-2009, however, this increase also reflects the change in statistical methodology introduced in 2014.[9] Thereafter, revenues linked to tourism remained relatively stable, while travel expenditures declined in the wake of the crisis (presumably due to the tightening of formerly relatively lax credit terms), thus contributing to the improving balance of services. A breakdown of import and export flows shows that the improvement in the balance of services also reflects the export revenues of the aforementioned components (transportation and other business services). Transportation should be emphasised within the increase in services exports, which also contributed significantly to the balance of services surplus, although to a smaller extent than tourism. Imports of other business services also had a significant role in rising expenditures before the crisis, but this expansion slowed after the onset of the crisis.

Chart 28: Key items of the export and import of services (as a percentage of GDP)



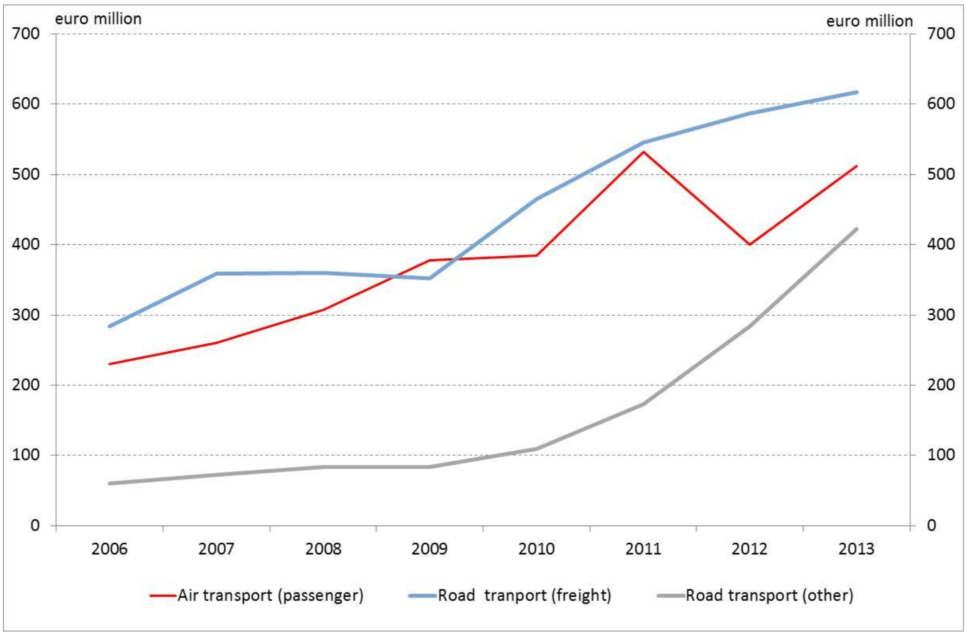
Hungary's geographic location may have played a role in the rise of transportation revenues. As presented above, transportation was the main contributor to the expansion in Hungary's balance of services over the past years. Three subsectors should be highlighted within transportation: carriage of passengers by air, road transport of freight and other road transport. The surplus of these three subsectors accounts for the total transportation surplus. Hungary's prime geographic location may be a significant factor from the perspective of carriage of goods by road. More international transport corridors (four) traverse Hungary than the other countries in the region. Accordingly, in terms of the motorways and carriageways per 100 km^2, Hungary also ranks highest in the region.[10] From 2013 onwards, the revenues from road tolls also boosted the rise in services exports.[11] Although the continuous increase in air carriage revenues slumped temporarily in 2012 – presumably linked to Malév's bankruptcy – the sector nevertheless contributed significantly to transportation.

[9] For more detail, see: Hungary's Balance of Payments and International Investment Position Statistics, 2014.

[10] CSO: Characteristics of road transport (August 2013).

[11] CSO: The situation of the transportation sector (December 2014).

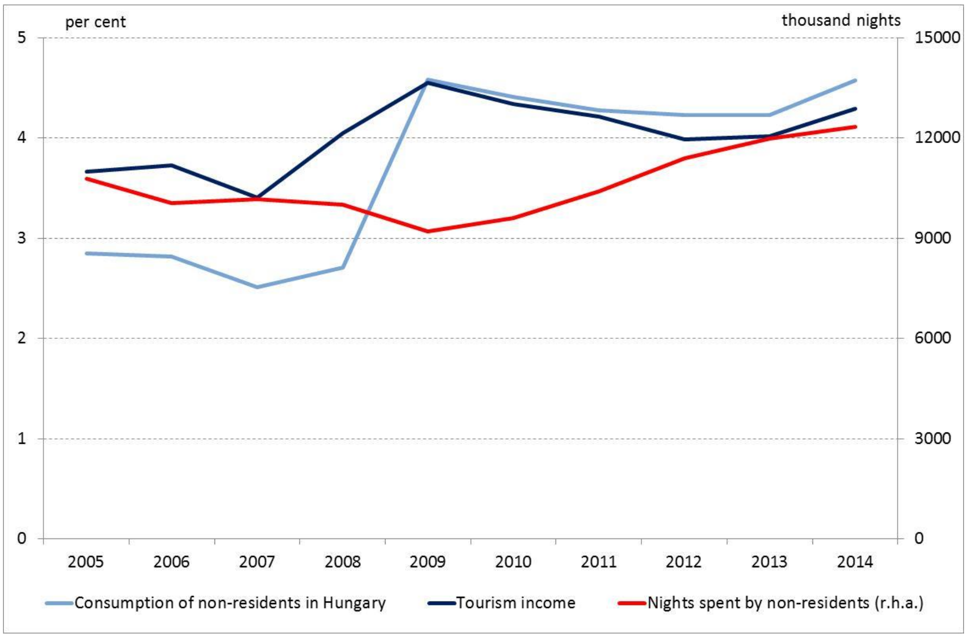
Chart 29: Net exports of various transportation types



Source: HCSO.

Developments in the number of nights spent at tourist accommodation do not reflect the rise in tourism revenues at the start of the crisis. Revenues linked to tourism stem from spending by non-residents in the context of visits to Hungary, however purchases by non-residents from neighbouring countries also qualify as tourism revenue, as long as the items are not of substantial value (the latter are statistically classified as goods). In other words, the degree of tourism is linked to consumption by non-residents in Hungary. The rise in revenues linked to tourism in 2008-2009 emerged without any rise in the nights spent by non-residents at tourist accommodation facilities, with even a decrease in this figure in 2009 based on the indicator. In other words, despite rising consumption by non-residents in Hungary, there was no increase in the nights spent by non-residents at tourist accommodation establishments in Hungary. This suggests that developments in revenues linked to tourism may have been driven by other factors. Developments in revenues linked to tourism do not explain the number of nights spent by non-residents at tourist accommodation establishments after the crisis: the rise in the latter coincided with falling travel receipts.

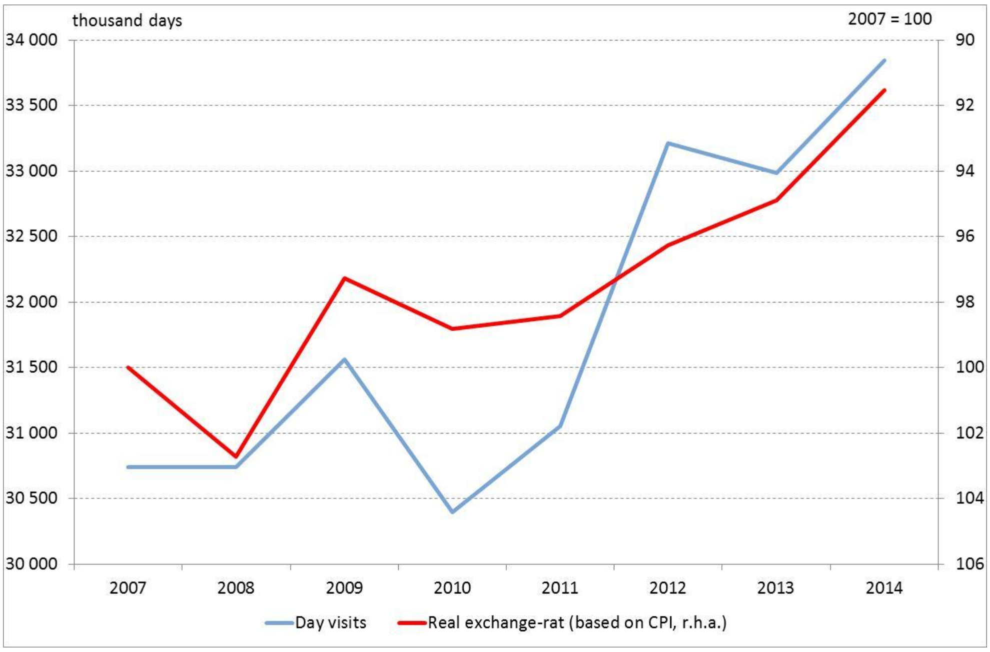
Chart 30: Developments in revenues linked to tourism (as a percentage of GDP)



Source: HCSO.

Day visitors and shopping may have played a larger role in the dynamics of revenues arising from tourism. Along with the number of nights spent, so-called day visitors may also be related to developments in travel. Day visitors account for over 30% of days spent by non-residents in Hungary. At the time of the onset of the crisis in 2009, the number of same-day visits by non-residents increased, which suggests that the visits were geared towards shopping. This may have been fostered by the weakening forint exchange rate: the number of short-term tourists to Hungary rose in parallel to depreciation of the forint exchange rate. A similar correlation also prevailed in subsequent years. By contrast, developments in the exchange rate had a smaller impact on longer-term visits. Therefore, shopping tourism may have a significant role in day visitors, while the pull of tourist attractions may override smaller fluctuations in the exchange rate.

Chart 31: Same-day visits of non-residents to Hungary and developments in the average annual real exchange rate



Source: HCSO, Eurostat.

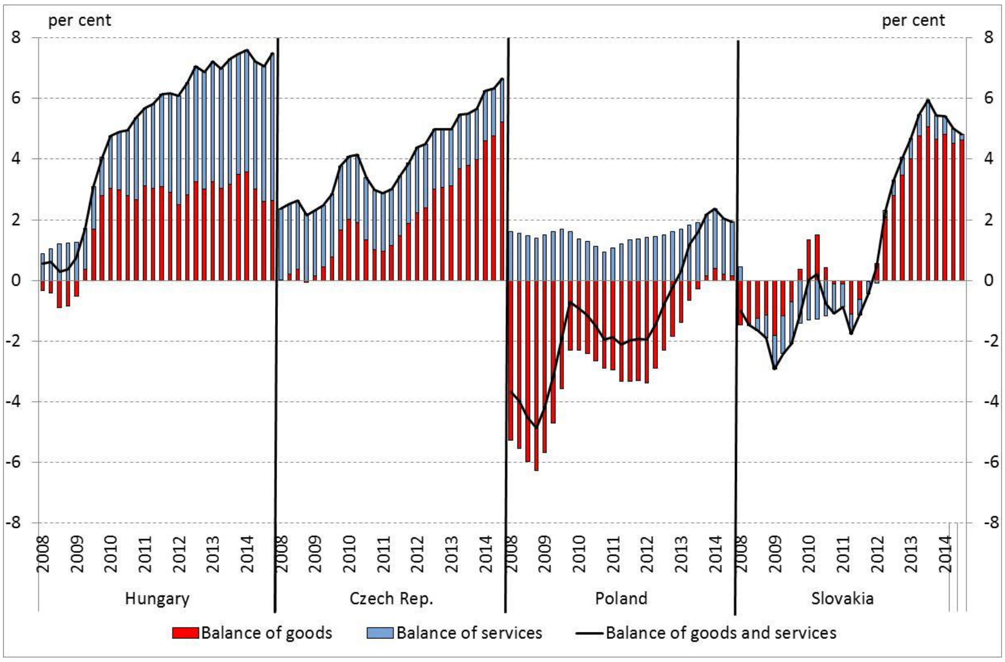
5.4. International comparison

The balance of goods and services across the region contributes to different extents to net lending: while the balance of goods remains relatively stable in Hungary and the balance of services is improving, countries in the region are instead exhibiting stronger improvement in their balance of goods. A similarity to the net export of Visegrad countries is the spiking improvement in the balance of exports and imports of goods. One key difference, however, is that while the rest of the region saw a continued marked improvement in the balance of goods during the later years of the crisis, Hungary did not, and its balance of goods surplus levelled out. The diverging developments in the balance of goods compared to other countries in the region may have also been shaped by the economic downturn and the process of recovery from the crisis. The sudden fall in GDP affecting Hungary at the onset of the crisis was more pronounced compared to other countries, and consumption and investment only resumed a growth path in earnest in 2014. Thus Hungary saw a strong adjustment in the net export of goods during the initial phase of the crisis, while the improving dynamics of domestic demand – featuring high import content – may have been reflected in the falling balance of goods in recent quarters.[12] Another difference compared to other countries in the region is the weight of the balance of services within net exports: the surplus in the balance of services was stable in neighbouring countries following the crisis, but rose significantly in Hungary (see the previous chapter for more detail). The adjustment that has been underway since the crisis was pronounced across the entire

[12] This impact may have been exacerbated in H2 2014 by the rise in import linked to the filling up of gas reservoir, due in part to the Russian-Ukrainian conflict.

region, but the Hungarian economy's net exports reached the highest level in the region. The balance of services contributed to a far greater proportion in 2014 to the Hungarian balance of trade.

Chart 32: Distribution of the balance of goods and services in Visegrad countries (four-quarter values as a proportion of GDP)

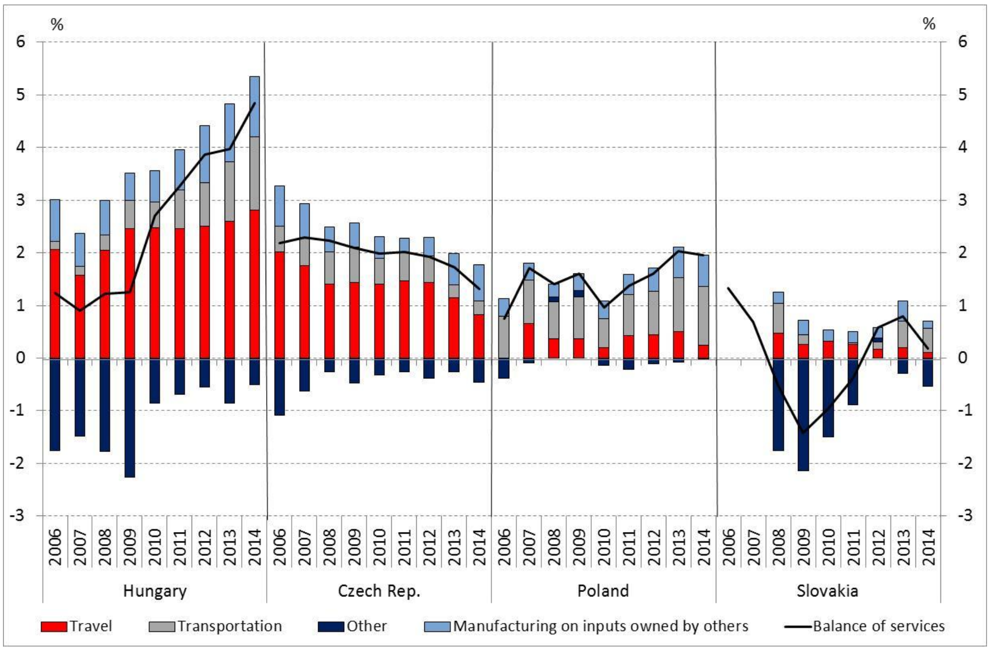


Source: Eurostat.

Hungary's balance of tourism and transportation services is significant even by regional standards. The steadily rising balance of goods is coupled with a stable balance of services surplus in the Czech Republic, the latter driven by tourism and telecommunications. The Polish trade surplus has been associated with the service sector in recent years, specifically transportation. In Slovakia, the balance of goods surplus has accounted for the bulk of the trade surplus in past years. The balance of services relative to GDP exhibits a surplus throughout region, but was the highest in 2014 in Hungary. While the balance of services exhibited subdued dynamics in other countries since the 2008 crisis and a decline in all three countries since 2013, it has been rising continuously and significantly in Hungary. The gradual expansion in tourism and transportation since 2007 contributed the most to this trend.[13] The balance of tourism also significantly shapes developments in the balance of services in the Czech Republic alongside Hungary, while its impact is less pronounced in Poland and Slovakia.

[13] In the period since 2007, charges for the use of intellectual property have also contributed to the improving balance.

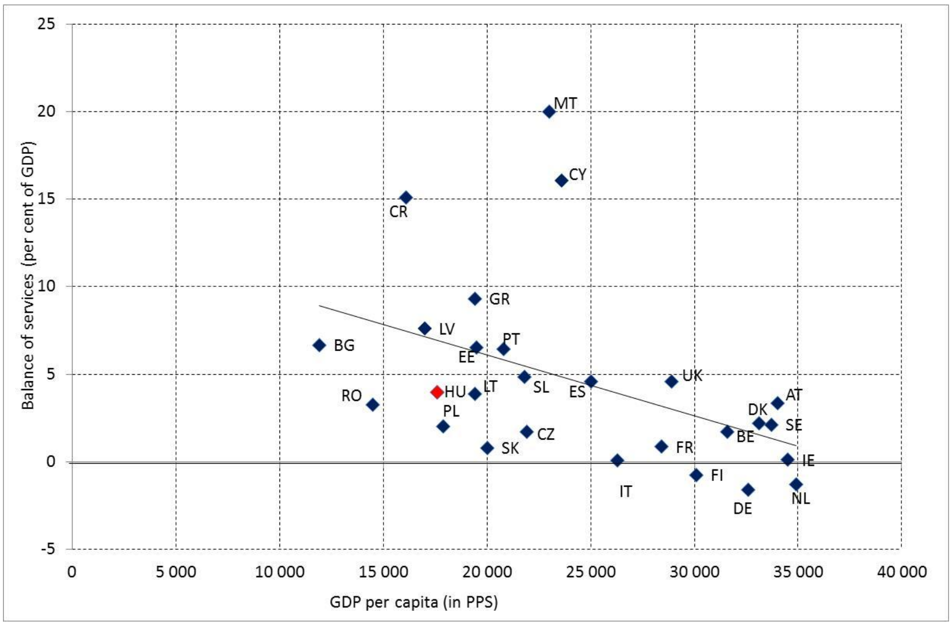
Chart 33: Developments in the components of the balance of services (as a percentage of GDP)



Source: Eurostat.

The balance of services is characteristically lower in more developed countries. Exports of services exceeds their level of import in the majority of European Union member states, yielding a positive balance of services. A negative correlation can be established between the level of the balance of services and the level of development, in other words the higher the income per capita, the smaller the contribution of service export to GDP (Chart 10). The higher price levels prevailing in advanced economies may play a role in this, alongside their higher GDP per capita, which – compared to developed countries – may presumably drive higher spending during trips abroad.

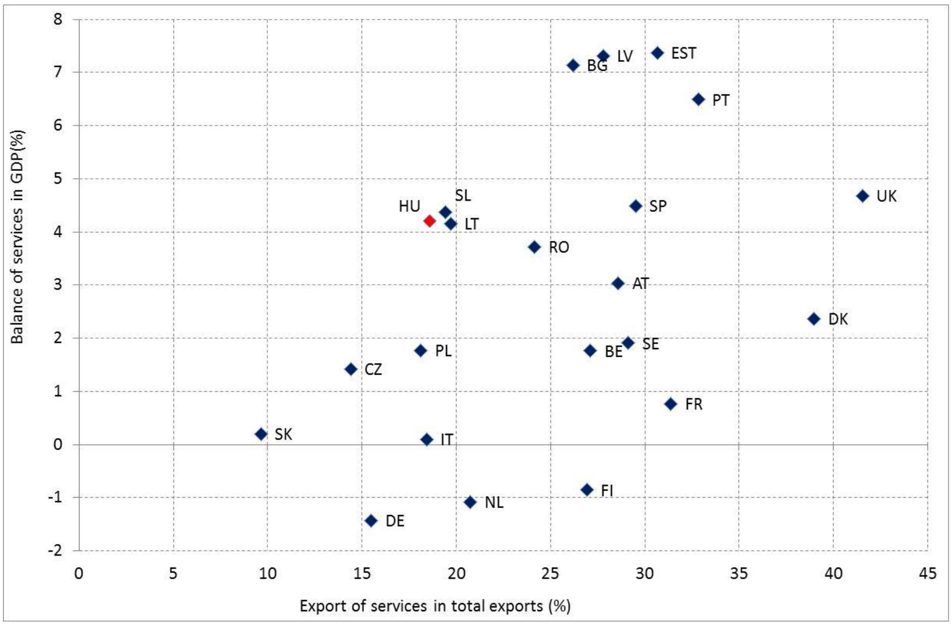
Chart 34: Balance of services in EU member states and developments in GDP per capita (2013)



Source: Eurostat.

In Hungary, services account for a smaller proportion of total exports compared to the EU average, but net exports of services is still relatively high as a percentage of GDP. Based on the data of European countries, the proportion of services exports within total exports exhibits a slight positive correlation with the balance of services relative to GDP – in other words, relatively higher services exports are coupled with higher net exports relative to GDP. It should nonetheless be noted that in terms of the specific proportion of services exports, advanced economies typically exhibit lower net exports relative to GDP, while countries in the region exhibit higher values. This may be linked to the fact that more advanced economies have higher wage levels, and so they outsource many services to countries with lower costs. Accordingly, the relatively high ratio of services within the balance of trade may be linked to the relative cheapness of Visegrad countries. The chart also suggests the (seemingly logical) observation that the import content of exports of goods is far higher than that of services, which may result in the relatively lower net exports value.

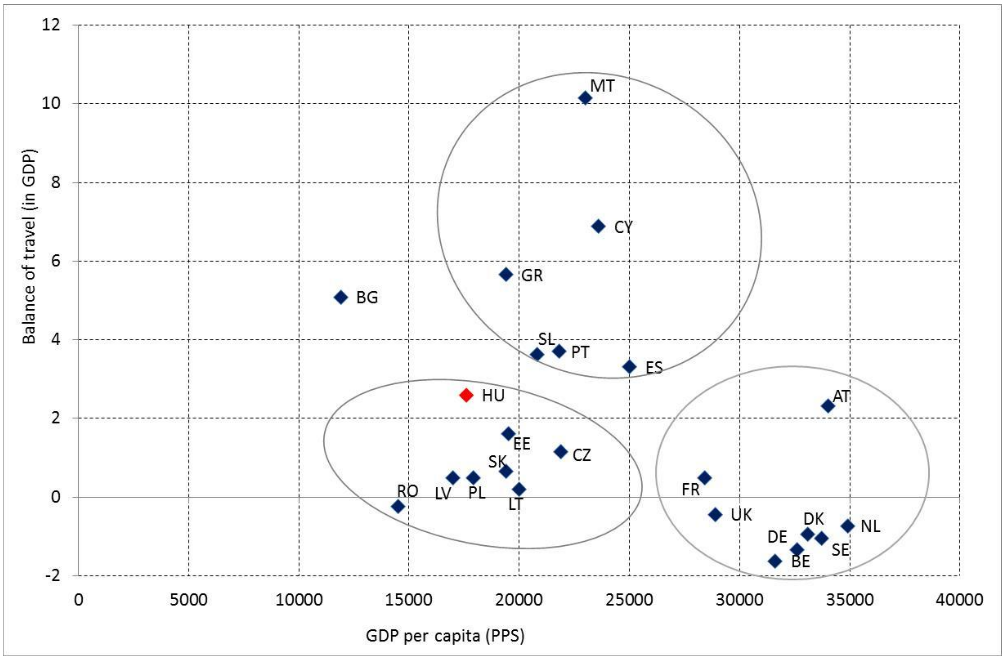
Chart 35: Balance of services in GDP, and export of services among total exports (average four-quarter data, 2014 Q3)



Source: Eurostat.

In European Union countries, the surplus in tourism relative to GDP typically decreases in line with higher income per capita. Similarly to services, this suggests that the higher price levels prevailing in more developed countries drive a greater number of tourists to travel to other countries, and the ratio of persons travelling abroad may be higher in more developed countries with higher income per capita. At the same time, some countries with significant tourism attraction, typically Mediterranean ones, exhibit a rate of tourism revenues that exceeds the rates prevailing in countries of similar development.

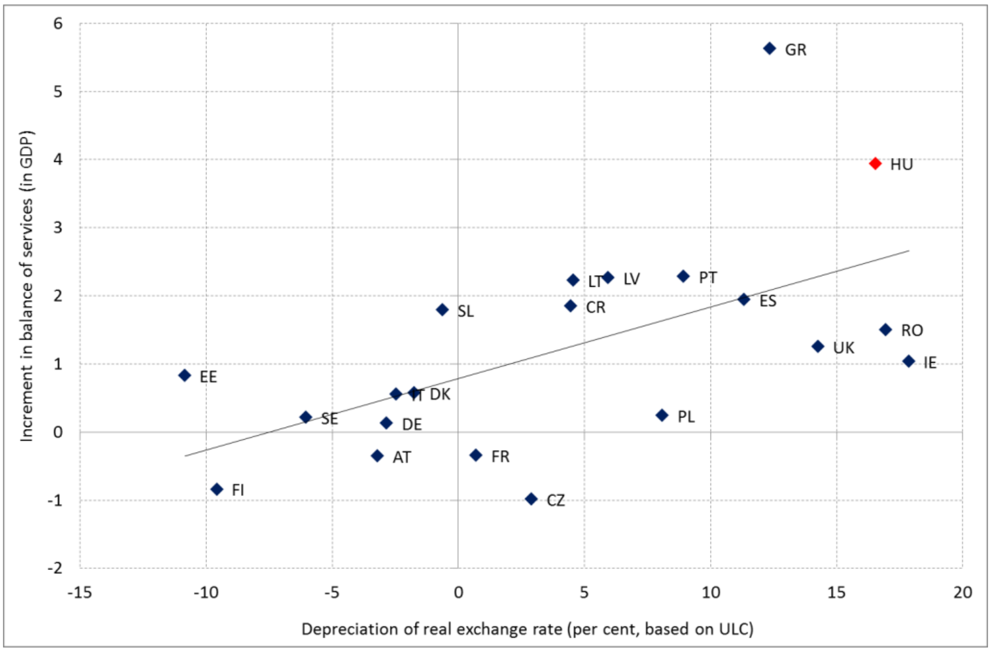
Chart 36: Balance of tourism in EU member states and developments in GDP per capita (2013)



Source: Eurostat.

Developments in the balance of services may also be linked to the weakening real exchange rate since the crisis. In the years that followed the financial crisis, Hungary saw its balance of services surplus increase significantly. This rise in the balance of services was also pronounced compared to other countries within the European Union. The depreciation in the real exchange rate since 2007 may have contributed to this. In general, the depreciation of the labour cost based real exchange rate goes hand-in-hand with a rising balance of services surplus through improving competitiveness. It should be noted that among Mediterranean countries, Spain and Portugal saw a significant depreciation in their real exchange rates, which may have been driven for the most part by a relative decline in labour costs.

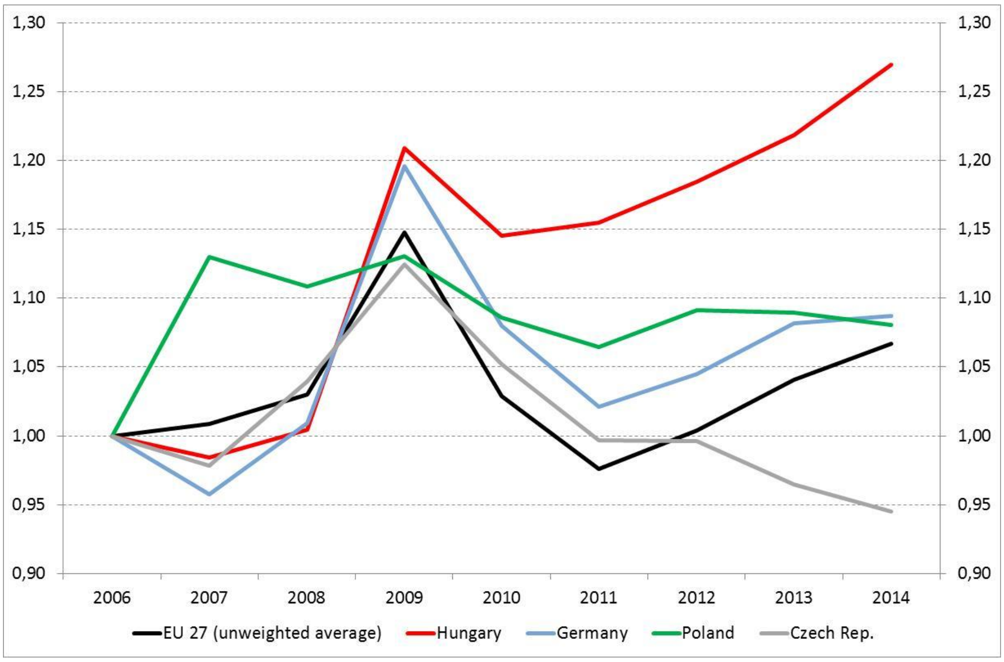
Chart 37: Changes in the balance of services (as a percentage of GDP) and depreciation of the labour cost based real exchange rate between 2007 and 2014



Source: Eurostat.

Exports of services declined far less during the crisis than exports of goods, suggesting that the former are less vulnerable to fluctuations in demand. Similarly to Hungary, several other European countries saw their exports of services remain much more resilient in the face of the crisis compared to exports of goods – the data reflect that the proportion of services exports to goods exports spiked during the onset of the crisis and only gradually returned to pre-crisis levels (Chart 38). It should be noted that the decline proved temporary in Hungary, and the rate of services exports exhibited a further increase, in contrast to other countries. This phenomenon, i.e. a slighter decline, may be explained by several factors.[14] For one, many services may form an integral part of production, and are thus necessary even if production is restrained, and their absorption is independent of production volumes (such as accounting services). Also, contrary to goods, services cannot be stored and services created earlier cannot be used to satisfy current demand. Thirdly, services are presumably less vulnerable to the negative impact of tighter financing: besides lower capital requirements, in the case of services, delivery and payment are more closely linked, so service firms are thus prone to late payments and the related financing gaps.

Chart 38: Exports of services relative to exports of goods (2006=1)



Source: Eurostat.

[14] For more detail, see Andrea Ariu: Crisis-Proof Services – Why Trade in Services Did Not Suffer During the 2008-2009 Collapse (Working Paper Series No 1691 / July 2014).

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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H-8200 Veszprém, Tartu u. 6.

H-1054 BUDAPEST, SZABADSÁG TÉR 9.
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