

András Komáromi: The structure of external financing: Is there a reason to worry about financing through debt?

Hungary's external balance indicators improved a great deal in 2007. Simultaneously, however, the external debt ratio also rose which, in an international climate of uncertainty stemming from the sub-prime crisis, drew investors' attention to the structure of the country's external financing. This study argues that the recent increase in debt-creating external financing does not necessarily increase risks associated with sustainability. On the one hand, the record rise in debt-creating financing in 2007 is largely due to one-off items. On the other hand, the waning significance of non-debt-creating financing is not attributable to declining inflows but rather mostly to residents' stepped up capital exports, which is partly a result of the development in the institutional investor sector, and partly of the foreign expansion of a few large resident companies. The picture becomes even more intricate as according to recent research, the advantages generally associated with non-debt-creating financing are not always supported by findings, and empirical experience indicates that more developed countries are often characterised by a higher share of debt-type external liabilities. Naturally, and irrespectively of the structure of financing, Hungary's high level of net foreign liabilities in an international comparison continues to be a strong risk factor.

INTRODUCTION

Simultaneously with the decrease in the budget deficit, Hungary's external balance indicators also improved significantly in 2007. At the same time, the net non-debt-creating capital inflow reduced drastically compared to previous years, which – despite the moderating external imbalance – resulted in a marked rise in external indebtedness. In an economic environment of decreasing risk tolerance as a result of the sub-prime crisis, the spectacular rise in debt-creating financing has shifted the attention of analysts and investors to the structure of external financing.

Many saw a correlation between the fall in non-debt-creating financing and Hungary's poorer prospects for long-term growth and deteriorating competitiveness. Nevertheless, the processes deserve a more elaborate approach in many respects. Public thinking, for example, has a considerably unilateral view of the advantages of foreign direct investment, while we tend to interpret the rising role of debt-creating financing a sign of shattered investor confidence. Analyses only examining net capital flows also tend to oversimplify the question as they do not pay attention to the potentially different motivations behind the funds entering and leaving the country. Another important factor to be considered is that the structure of external financing can only

be evaluated in conjunction with the given level of external imbalance and the level of development of the economy and the country's institutions.

The first part of the study presents a brief overview of the conceptual framework within which external imbalance and the structure of external financing can be analysed. We look at the stylised facts in Hungary, and also examine the development of FDI flows in a regional comparison. This is followed by an attempt to put the structure of external financing into a wider framework with the help of theoretical and empirical findings in the relevant literature. Finally, an evaluation will be given of the recently accelerated restructuring of Hungary's external financing with some forward-looking conclusions as well.

EXTERNAL FINANCING REQUIREMENT AND THE STRUCTURE OF FINANCING¹

The financial savings of a country, i.e. the part of its gross national disposable income (GNDI),² which is not spent on consumption (C) or on capital formation (I), is known as the net external financing capacity (NFK). If we take into account that capital formation can be realised not only from disposable income, but also from net unilateral capital transfers in the *capital account* (KA) of the balance of payments, then we can demonstrate that the external

¹ A detailed elaboration on the contents of this chapter can be found in Antal (2006).

² Gross national disposable income (GNDI) is the sum of gross domestic product (GDP), the net foreign income (NFI) and the balance of current transfers (NFTC).

financing capacity equals the sum of the current account (CA) and the capital account balance:

$$\begin{aligned} NFK &= GNDI + KA - (C + I) = [GDP + NFI + NFTC] + KA - (C + I) = \\ &= [(C + I + X - M) + NFI + NFTC] + KA - (C + I) = \\ &= [(X - M) + NFI + NFTC] + KA = CA + KA \end{aligned}$$

When a country spends more than its income – as is the case in Hungary – then its net external financing capacity is negative, which is also called the external financing requirement.³ The financial transactions between foreigners and domestic agents, i.e. the financing of the country's external financing requirement, are shown in the *financial account* of the balance of payments. Here, we can monitor the asset-type breakdown in which domestic sectors attracted external resources.

Foreign resources can be classified according to whether they embody debt-type (*debt-creating*) or ownership-type (*non-debt-creating*) liabilities. Debt-creating funding generates principal or interest payment obligation to the foreign funder, whereas via non-debt-creating financing foreign actors acquire domestic property and are hence entitled to the income generated by the property.⁴ A further consideration for categorisation may be to see if the investment manifests itself in a financial instrument easily negotiable on the organised markets (so-called portfolio investment) or represents a less 'impersonal' and less easily transferable legal relationship (Table 1).

The net external financing requirement is covered by the domestic sectors' foreign borrowing, therefore it is expedient to examine the typical types of external resources which the domestic sectors rely on. The corporate sector may absorb both debt-creating and non-debt-creating foreign funds.

Non-debt-creating capital inflow may take the form of foreign direct investment⁵ or portfolio equity investment.⁶ The general government primarily relies on debt-creating resources from abroad, but the government's privatisation revenues are not-debt-creating funds. Generally households do not borrow directly from abroad, but this sector – similarly to enterprises – may still rely on debt-creating resources through credit institutions which merely act in such transactions as mediators.⁷

The mere fact that a country partly relies on external resources is not a problem itself. It is only natural that fast-growing, converging economies raise foreign capital to finance their abundant investment opportunities. However, a constantly high level of financing requirement is generally considered by investors as a risk factor which reduces a country's resistance to external shocks, and may also be indicative of the long-term unsustainability of economic processes. For this reason the development of the external financing requirement is monitored by economic policy makers, credit rating agencies, market analysts and investors, who use this information to formulate their opinions on the level of risk associated with the given country.

In respect of assessing sustainability, the level of external financing requirement is the primary factor; however in case of a significant external imbalance, the structure of financing may also come to the fore. Analysts generally tend to consider one set of resources more favourable from the recipient country's point of view, and find other forms of capital flows less healthy as they may increase the country's vulnerability. FDI is usually considered especially 'good' in this respect as it is thought to stimulate growth in the recipient country through various channels. On the other hand, many analysts consider portfolio investments more

Table 1

Groups of external resources

	Debt-creating	Non-debt-creating
Portfolio type	bonds, money market instruments	shares
Non-portfolio type	loans, bank deposits, currency	foreign direct investment (FDI)

³ This study primarily deals with processes in Hungary, and therefore the statements made herein are valid in an environment of negative external financing capacity (external financing requirement).

⁴ In contrast with the standard structure of the balance of payments, this analysis places no particular importance on international reserves, which is treated as an item reducing debt-type liabilities.

⁵ Consistent with the practice adopted in the Balance of Payments Statistics, parent company loans are also taken into account as part of FDI, because according to experience, the crossover between parent company loans and equity FDI is relatively easy and may take place without any fundamental reason and without any impact on market processes.

⁶ The separation of FDI and portfolio-type equity investment is very difficult empirically. Macrostatistics apply a very simple rule: any stake in foreign ownership exceeding 10 per cent is construed as FDI.

⁷ A good example is the increasing corporate and household FX lending of recent years, which greatly contributed to the rise in the absorption of foreign funds by the banking system.

volatile, and think that they may exaggerate swings in the business cycles, and may lead to or at least intensify financial crises.

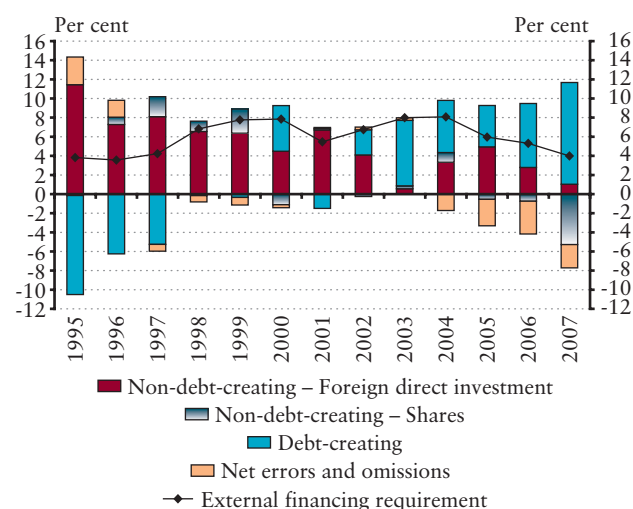
THE STRUCTURE OF EXTERNAL FINANCING IN HUNGARY: STYLISED FACTS

Hungary's external financing requirement compared to GDP increased remarkably towards the end of the 1990s and fluctuated quite a bit until 2006 in the extremely high band of 6 to 8 per cent. In addition to the steadily high level of external imbalance, there was also a marked shift in the structure of financing, i.e. the ratio between debt-creating and non-debt-creating resources changed (Chart 1).⁸

The period lasting to the early 2000s was characterised by high non-debt-creating capital inflow and broadly insignificant outflow: hence, the net volume of non-debt-creating financing always tended to exceed the external financing requirement. Early, quick privatisation played a direct role in the strong FDI and portfolio share inflow in the 1990s, and the general scarcity of capital and the economic policies that were designed to encourage investment by granting significant allowances made Hungary an attractive investment destination (Sass, 2003). Meanwhile, the direct

Chart 1

Structure of external financing in Hungary, 1995–2007 (as a percentage of GDP)



Source: MNB.

capital export of resident companies was insignificant, and the level of foreign equity investment was suppressed by the underdevelopment of the institutional investor sector (investment funds, pension funds, insurance companies).

Table 2

Development of FDI flows in neighbouring countries (as a percentage of GDP)*

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
FDI inflow													
Czech Republic	4.6	2.3	2.3	6.0	10.6	8.8	9.1	11.4	2.3	4.5	9.3	4.2	5.3
Poland	n. a.	n. a.	n. a.	n. a.	n. a.	5.6	3.0	2.1	2.1	5.1	3.4	5.6	4.2
Romania	n. a.	n. a.	n. a.	4.7	2.9	2.8	2.9	2.5	3.1	8.5	6.6	9.3	6.0
Slovakia	1.2	1.7	0.8	2.5	1.6	10.1	7.0	16.1	1.8	2.7	4.4	7.4	3.9
Hungary	11.0	7.3	9.1	7.1	6.9	5.8	7.4	4.5	2.5	4.4	6.9	6.0	4.0**
FDI outflow													
Czech Republic	0.1	0.2	0.0	0.2	0.1	0.1	0.3	0.3	0.2	0.9	0.0	1.0	0.8
Poland	n. a.	n. a.	n. a.	n. a.	n. a.	0.0	0.0	0.1	0.1	0.3	1.1	2.6	0.8
Romania	n. a.	n. a.	n. a.	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.3	0.0
Slovakia	0.0	0.2	0.4	0.6	-1.9	0.1	0.1	0.0	0.0	-0.4	0.3	0.7	0.3
Hungary	0.1	0.0	1.0	0.6	0.5	1.3	0.7	0.4	2.0	1.1	2.0	3.3	3.0

Source: Eurostat, MNB.

* Including parent company loans.

** The one-off Budapest Airport transaction reduced the FDI-to-GDP ratio by 1 to 2 percentage points.

⁸ The balance of payments – similarly to all macroeconomic statistics – contains a certain degree of statistical uncertainty. This is demonstrated by the fact that the official net financing requirement (the sum of the current and the capital account) and the financial account that covers the former do not match numerically. The difference is shown on the line 'Net errors and omissions'. This difference in Hungary is extremely high, but the scope of this study does not allow us to dwell on the reasons.

In recent years, however, the rising non-debt-creating capital export of domestic agents has evolved as a new trend, which has gone hand in hand with an increase in the ratio of debt-creating financing. While there is no substantial decrease in the inflow of FDI (excluding privatisation revenues), the direct capital outflow generated by resident companies has significantly increased. There is a similar process concerning portfolio equity investments: Hungarian institutional investors are tending to buy foreign shares in increasing volumes, therefore the outflow of equity capital does in effect reduce net non-debt-creating financing.

Direct capital outflow from Hungary is also extremely high in comparison with neighbouring countries (Table 2). As far as the GDP-proportional FDI inflow is concerned, Hungary used to be number one in the region until the end of the 1990s, and then usually performed in a middle-rank position. This was largely due to the fact that privatisation in neighbouring countries was started much later.⁹ At the same time, direct capital outflow usually exceeded the level characterising the region, and this difference has further increased in recent years (for more details on capital outflow, see the box below).

The reasons behind and long-term impacts of non-debt-creating capital outflow

Concerns about Hungary's competitiveness together with the general macro-economic uncertainty may have contributed to the accelerated outflow of non-debt-creating capital in recent years; it seems, however, that so far other motivations account for the larger share of the capital export which has been seen.

The major part of FDI outflow we have so far witnessed is attributable to a few large resident companies that are performing well on the domestic markets (e.g. MOL, OTP, MKB).¹⁰ For these companies, the domestic market seems saturated, and therefore their capital export is motivated by regional expansion and acquisition opportunities which enable them to tap into new markets.

The rise in capital outflow in the form of *portfolio equities* reflects the growing international activity of domestic institutional investors. Non-bank saving alternatives are increasingly popular among households,

and legislative changes have also supported the development of the sector.¹¹ On the one hand, a large volume of savings has been channelled into various funds, while on the other hand, complete foreign exchange liberalisation made the purchase of foreign shares possible without any constraints. The introduction of the 'elective portfolio system' for private pension funds has also contributed to a rise in capital export, since funds are forced to increase the ratio of shares in their portfolio in order to satisfy legal regulations.¹²

At the same time, non-debt-creating capital export may have positive effects over the long run. Through foreign direct investment, the domestic companies may expand further and institutional investors may diversify their portfolios by buying foreign shares. Non-debt-creating capital outflow may thus contribute to reducing the deficit in the balance of income and hence to the growth of disposable income in the whole economy.¹³

In 2007, the role of debt-creating financing accelerated to an outstanding level, which was fundamentally due to one-off factors. At the annual level, we saw more than EUR 3 billion in outflows of net non-debt-creating resources, which led to a 6.5 percentage point rise in net external debt. This capital outflow was greatly facilitated by the following two specific factors which have little to do with the macroeconomic environment:

- MOL attempted to protect itself against OMV's take-over efforts by purchasing its own shares in a value of over EUR 2 billion. The majority of the company's shares traded on

the stock exchange was in the hands of foreign shareholders, hence the transaction showed up as non-debt-creating capital withdrawal in the Balance of Payments.

- There was a change in the ownership of the foreign-owned Budapest Airport and parallel to that a change in its financing structure. The previous owner financed the acquisition of the company 100 per cent from FDI, while the new owner financed the larger part of the EUR 1.9 billion sale price from foreign bank loans, and not from FDI. As a result of the above transaction, there was a

⁹ The last larger wave of privatisation in Hungary (MOL, Budapest Airport) increased the volume of non-debt-creating financing for 2004–2005.

¹⁰ It is obvious even from public data that the banking sector plays an important role in FDI outflow. In the period 2003–2007, more than 30 per cent of FDI outflow was the result of commercial bank activities.

¹¹ In recent years, the structure of households' assets has been constantly changing in favour of investment units and insurance technical reserves (life insurance, pension fund savings).

¹² The equity exposure of funds (private and voluntary pension funds, health funds) rose from 14 per cent in the beginning of 2005 to 29 per cent by the end of 2007, while their managed wealth increased by more than 80 per cent. Simultaneously, the proportion of the previously dominant Hungarian shares in the portfolio steadily fell to account for a mere 36 per cent by end-2007.

¹³ Income revenue in connection with residents' non-debt-creating foreign investments was on a rising trend already in the last few years.

significant FDI outflow and an equal amount of debt-creating inflow recorded in the Balance of Payments Statistics.

The strong 2007 increase in Hungary's net external debt ratio is regarded as an unfavourable development by investors. Looking behind the aggregate indicators, it can be concluded that (i) the fall in the ratio of non-debt-creating financing is primarily a result of the increased outflow of such resources, while (ii) the inflow of FDI is around the average in regional comparison, furthermore (iii) in 2007 one-off factors resulted in a temporary acceleration in the spread of debt-creating financing.

NON-DEBT-CREATING FINANCING – QUESTIONABLE ADVANTAGES

The causes behind non-debt-creating capital outflow are likely to persist, and hence it is reasonable to expect a long-term shift towards debt-type resources in the structure of external financing even if we eliminate the one-off effects. This phenomenon may have a temporarily negative impact on investor sentiment, since investment banks and credit rating agencies tend to consider the ratio of external financing requirement covered by FDI or, more generally, by non-debt instruments a sort of vulnerability indicator.

However, the favourable properties associated with non-debt-creating foreign investment have been both theoretically and empirically challenged. In the following, we will examine the arguments most often cited in support of non-debt-creating resources with a critical eye. It is the aim of this section to demonstrate that most of these arguments are presented and embedded in public thought rather one-sidedly, even though, in the light of recent research, they are no longer held to be generally and widely valid.

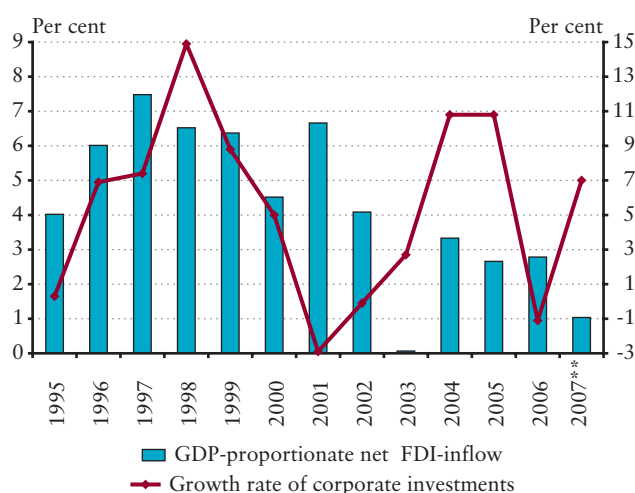
1. Non-debt-creating external resources are connected to the investment expenditures of the corporate sector, hence they contribute to future growth.

The rise in external financing requirement is generally better received when it is associated primarily with an increase in investment rather than with a fall in domestic savings. If the stronger demand for external financing is closely related to increased corporate capital formation, it may improve future growth prospects and thus entail more moderate risks. If however, the rise in external financing requirement is a result of low household savings and fast consumption growth, or an increase in general government deficit, it is believed that external financing is less likely to contribute to future growth.

Non-debt-creating resources – particularly in the form of FDI – are often thought to be associated with corporate investment expenditure, although this is not necessarily the case. It is a fact that the general government and households (through the banking system) typically rely on debt-creating foreign financing, whereas corporations are capable of raising non-debt-creating resources by issuing shares or using FDI to satisfy their financial needs. However, there is no direct relationship between the form of financing and the purpose of the funds, hence non-debt-creating external financing does not necessarily go hand in hand with enhanced investment activities. This correlation seems rather weak in Hungary in particular (Chart 2).

Chart 2

FDI inflow and investments*



* Net inflow of FDI excluding privatisation revenues (MNB) and the investments of the economic entities operating as 'enterprises' (CSO).

** MNB estimate based on quarterly CSO reports.

2. Non-debt-creating resources – particularly FDI – are stable forms of financing and hence reduce the risk of a balance of payments crisis.

Foreign direct investment is traditionally regarded as a less liquid and therefore more stable form of financing than debt-type investments. According to common belief, it follows from this that these types of financing reduce the risk of a balance of payments crisis. Levchenko and Mauro (2006), for example, used simple descriptive statistics to demonstrate that under normal circumstances the volatility and persistence of the various forms of capital flows are not very different, but in 'sudden stop' periods, non-debt-creating resources – and particularly FDI – prove to be considerably stable. According to their conclusion, debt-type portfolio investments and, even more so, bank and commercial loans are held 'responsible' for the development of 'sudden stops'.

Many studies, however, challenge the view that there is a point in separately examining the various forms of financing in terms of the volatility and predictability of the total external capital inflow. Companies may, at their own discretion, reshuffle the structure of their liabilities, therefore in the event of a crisis, capital outflow does not necessarily mean an exodus of FDI. If, for example, a foreign company would like to remove capital from a given country in fear of a crisis, it has the option not only to remove its own equity, but also to use domestic loans to purchase foreign assets, or to pay back foreign loans. In this case, 'whatever comes in through the door, leaves through the window in a different form', therefore the volatility of FDI in itself provides little information about the volatility of the entire financial account (Fernandez-Arias and Hausmann, 2000).

3. *Non-debt-creating liabilities promote international risk sharing.*

One favourable characteristic of non-debt-creating financing is that it may play a potentially greater role in international risk sharing than debt-creating funds. This stems from the fact that returns realised on equity are generally pro-cyclical, i.e. foreign investors are entitled to lower income when the domestic economy is facing difficulties, and to higher income in times of boom. Similarly, when due to a negative shock the exchange rate is depreciating, the foreign currency denominated external debt service rises, while FDI and stock yields presumably fall. In this sense, non-debt-creating liabilities can contribute to smoothing the country's disposable income.

The advantages of this potential risk sharing are strongly weakened by the fact that foreign owners may react to slowing domestic economy by reducing the share of reinvested incomes.¹⁴ The total income generated by foreign-owned companies may in fact change according to the current general economic situation, but it is exclusively the owners' decision how much they choose to reinvest in the company and how much they take out from the country in the form of dividends, for example.

4. *Non-debt-creating liabilities do not involve maturity and currency mismatches.*

Theoretically, equity-type liabilities do not involve maturity or exchange rate risks since the owners' claim is the very cash flow – be it denominated in any currency – that is left over after paying out all the other eligible parties (creditors). Ideally, a company is capable of borrowing both short- or

long-term in any currency and hence can adjust its liabilities to the maturity structure of its assets and the denomination of its cash flows. When this is not possible however – i.e. the market is not complete – the company's balance sheet will contain maturity and currency mismatches. In such a situation, a greater role of non-debt-creating financing is justifiable in the optimal financing structure of the company.

In this case, however, it would be a mistake to interpret the high share of non-debt-creating financing as a sign of economic stability, because this is probably a mere reflection of the investors' optimal reaction to the mismatches evident in the country's balance sheet. Empirical studies have, for example, indicated that countries suffering from 'original sin' – those that are unable to borrow in their own currencies – rely much more on FDI to satisfy their external financing needs (Hausmann and Fernandez-Arias, 2000).

5. *Non-debt-generating financing – particularly FDI – contributes to economic growth through positive externalities.*

Arguments in support of foreign direct investment very often state that FDI can accelerate growth and economic convergence in the host country. According to the traditionally accepted explanation, it is the associated positive externalities that make FDI different from investments carried out by domestic companies. Foreign-owned companies may bring with them new technology, know-how, managerial skills, and access to new markets which, when passing through into the recipient country may expand the production-possibility frontier.

It is important to recognise, that the above mentioned advantages attributed to FDI are, in fact, linked to the companies themselves rather than the manner of financing. When a foreign-owned company provides the host country with new technology, better management systems, or access to new export markets, then this is solely due to the company's activities and has nothing to do with direct capital. Direct capital is only one of the possible ways to finance a company – a macro-accounting concept – and has no external impact itself. The positive impact that foreign investments have on domestic economic growth – if it exists at all – cannot be restricted only to external financing in the form of FDI.

A large part of the empirical literature either finds no detectable relationship between FDI and growth in the host country, or the relationship seems to be evident only in countries with low levels of economic development

¹⁴ When calculating gross national domestic income (GNDI), the reinvested incomes of foreign companies are also deducted as they are not linked to resident property. Still, it is considered more advantageous if foreigners reinvest a larger share of their profits realised in Hungary into their enterprises, as this amount reduces the country's need for 'new' or 'additional' external resources.

(Mileva, 2008; Herzer, Klasen and Nowak-Lehmann, 2008). These findings are consistent with the observation that in countries with relatively underdeveloped financial markets and weak institutions, foreign-owned companies tend to rely on FDI. For this very reason, in order to draw any far-reaching conclusions regarding the structure of external financing, it must be understood what factors foreign investors consider when choosing the form of financing. Economic theory may provide us with a starting point for this endeavour.

THEORIES AND HYPOTHESES RELATING TO THE STRUCTURE OF EXTERNAL FINANCING

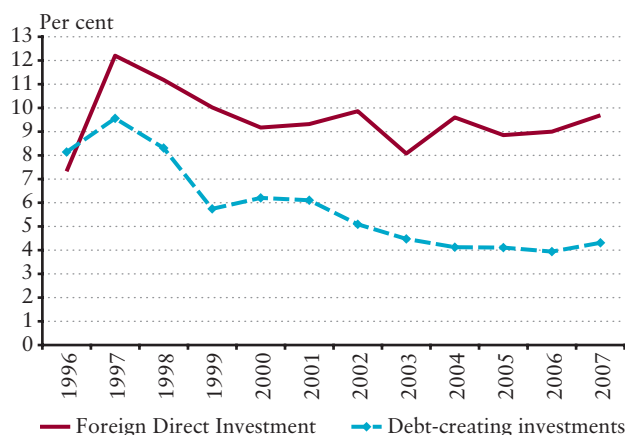
Although there is no widely accepted theory for explaining the external capital structure of firms, the vast majority of the literature sets out from the microeconomic models of corporate finance. The classic study by Modigliani and Miller (1958) demonstrated that in an environment of perfect information, and in the absence of bankruptcy costs and distorting taxes, the value of a firm is unaffected by how it is financed. The majority of subsequent analyses attributed the empirical failure of the ‘irrelevance theorem’ to the asymmetric information of actors. If, for example, external investors are less informed concerning the internal operations of a company, the market will underprice newly issued shares, and therefore raising funds through equity is more expensive for the firm than using internal funds. This train of thought takes us to a certain kind of hierarchy of the different types of financing, in other words, firms rank financial instruments in accordance with the extent of information asymmetry and the related mispricing.

The fundamental principles laid down in the literature of corporate finance are very useful in examining the external financing of countries, although other types of imperfections may also become decisive from a macroeconomic perspective. It follows from the analysis of the impacts of information asymmetry presented above, that share-buying investors require a higher return for accepting higher uncertainty (risks) than creditors do. This micro-level correlation stands true for the investments of foreigners as well (Chart 3).

At the macro level, however, the relevant question is how much of the country’s external financing needs the foreign investors are willing to finance through debt, and how much through direct ownership. This decision is, however, very much influenced by factors that relate back to the fundamental differences between a firm and a country. On the one hand, the information asymmetry between residents

Chart 3

Implicit yield paid on Hungary’s external resources*



Source: MNB calculation.

* The implicit yield is calculated as the quotient of expenditure in the income balance and the gross average stocks.

and foreigners may be significant for obvious reasons (geographical distance, language, knowledge of the institutional system, etc.), while on the other hand, after the realisation of the foreign investment a sovereign state cannot always be forced by legal means to ensure the original conditions agreed on.

According to the first approach, foreign investors will favour financing forms that will help remedy their information disadvantages compared to residents, and also the mitigation of information frictions associated with a particular type of asset may increase its role in external financing. Neumann (2003), for example, presumes that equity-type claims (FDI, shares) also transmit a certain degree of control rights and thus convey some information about an investment. If ownership does indeed help reduce the costs of monitoring necessary due to information asymmetry, then non-debt-creating financing is a more favourable way of financing than debt, which transmits less information. Using the same logic, it follows that the more transparent and developed a country’s capital market is – i.e. the smaller the information asymmetry between residents and foreigners, which may only be bridged by direct ownership – the greater the role played by debt in external financing.

The second approach focuses on the possibility of expropriation and the problem of imperfect enforceability of international contracts. A major difference between a country and a company is that governments may at any time expropriate the assets of the private sector, or refuse to repay their sovereign debts. When such measures are pursued, the claims of foreigners and residents are usually treated

differently – normally to the detriment of foreigners.¹⁵ For this reason, foreign investors will prefer financing forms that are more difficult to expropriate either directly or indirectly. According to Albuquerque (2003), the vast share of FDI is intangible (technology, brand names), and is thus more difficult to expropriate. It follows from this, again, that countries with less developed legal and institutional structures – where the possibility of yields being expropriated is higher – can only finance themselves through direct investment, whereas in countries with developed capital markets, the ratio of debt-type financing – which in theory may be easier to expropriate – may be higher.

The above models suggest that the significant role played by non-debt-creating foreign investments (and particularly FDI) is not necessarily a sign of investors' confidence in the host country, but – quite on the contrary – may be a reflection of high risk and uncertainty associated with the legal system, or the weakness of the institutional system. Of course, such 'soft' hypotheses are difficult to test based on aggregate macro-economic data, but there is some evidence that the above relationships are, by and large, valid. Using various development and risk indicators, and institutional quality indices, many studies have succeeded in demonstrating that a more predictable economic environment and a higher level of development usually go hand in hand with a higher share of debt-type foreign investment (Albuquerque, 2003; Faria and Mauro, 2004; Faria, Lane, Mauro and Milesi-Ferretti, 2007; Daude and Fratzscher, 2006).

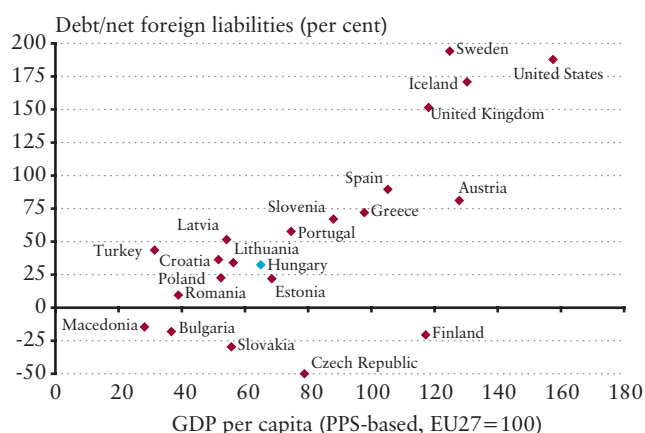
Looking at a wide range of European countries relying on external financing, it is striking that in many relatively developed countries debt-creating liabilities account for a large share of total net external liabilities (Chart 4).¹⁶ Every country's international investment position is naturally affected by a number of other factors – often rooted in the country's history¹⁷ – but the data are still broadly consistent with the conclusions of the theory. Taking into consideration the significant scattering of the values, we can certainly conclude that the share of Hungary's external debt in total foreign liabilities is not far off from countries with a similar level of development.

With regard to sustainability, therefore, it is not the structure of financing that is primarily decisive but the level of foreign liabilities. On the basis of the above, when evaluating different countries' dependency on external financing, it does not take us very far if we only focus on some selected types

Chart 4

Ratio of debt-creating liabilities in net external liabilities

(31 December 2006)



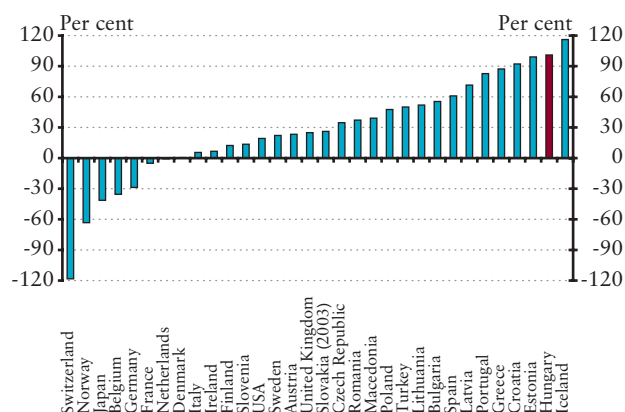
Source: Eurostat, *International Financial Statistics* (IMF). The sample includes those countries of the EU27 and countries presently negotiating accession whose net external liabilities are positive, together with the USA and Iceland. Ireland and Italy are not shown in the chart for practical representation reasons.

of foreign liabilities, as the country's total international investment position and its dynamics ought to be examined. While owing to the decreasing external financing requirement, Hungary's net external liabilities to GDP stabilised in 2007, the ratio is still extremely high by international standards (Chart 5). In the event of a renewed rise in external imbalance, the high starting base could have

Chart 5

Net external liabilities in international comparison

(2006, as a percentage of GDP)



Sources: *International Financial Statistics* (IMF), MNB.

¹⁵ Schnitzer (2002) points out that the host country's sovereign government may exercise negative impacts on the yields of foreign investments by means other than nationalisation as well. These may include changes in the tax system or the introduction of special import or export customs ('creeping expropriation').

¹⁶ A similar conclusion may be drawn on the basis of the external debt-to-GDP data.

¹⁷ It is a widely shared opinion that Ireland's impressive inflow of FDI was also due to the fact that there was a live relationship between Ireland and the management of US multinationals through the ex-patriate Irish community.

an exceptionally negative impact on the country's risk assessment.

CONCLUSIONS: DOES INCREASING DEBT-CREATING FINANCING PRESENT A PROBLEM FOR HUNGARY?

In 2007, Hungary's external debt-to-GDP ratio increased significantly, which in a period of fading global risk appetite drew attention to the gradually increasing role of debt-creating external financing.

In evaluating *recent* processes one must take into account the role of one-off factors and the fact that FDI inflow cannot be considered low compared to other countries in the region. In 2007, two one-off transactions related to MOL and Budapest Airport dramatically decreased the net non-debt-creating inflow of capital (by about 4 per cent of GDP). Meanwhile, FDI inflow which is considered a very important index by many analysts did not increase in any of the countries of the region, and there was a slight decline in most of them.

Over the long run it is worth taking into account natural reshuffling in the financing structure and the potential advantages of capital export. The rise in the capital export of domestic companies and institutional investors' increasing foreign share purchases indicates that the structure of external financing is likely to shift towards debt-creating resources in the long run. Although this may be temporarily disadvantageous with regard to investor sentiment, it does not necessarily represent a problem in terms of long-term sustainability and, furthermore, in some respects, it may be considered a natural part of the convergence process.

With the termination of privatisation and progress in economic transition, the drop in FDI inflow is partly a natural phenomenon. It is an empirically demonstrable trend that with the deepening of financial intermediation, economic development and the improvement of the institutional system, the structure of external financing of a country shifts towards debt-creating liabilities over the long term. Development of the domestic financial markets and the institutional system require foreign investors less and less to invest their capital in the country through direct ownership.

Increasing non-debt-creating capital outflow may, over the long run, contribute to the improvement of the balance of income and thus increase the gross national disposable income (GNDI) in the entire economy. Parallel to falling non-debt-creating capital inflow, as has seen recently, Hungary may become a jump-off point for FDI towards less developed countries (e.g. Ukraine, Romania, Bulgaria), and

institutional investors may diversify their portfolios by buying foreign shares. Equity-type investments can generate a greater income over the long run than debt liabilities, and hence we can expect a greater inflow in the balance of income than seen currently.

Accordingly, in the event of a permanent decrease in the budget deficit and concurrently in the external financing requirement, the rise in the share of debt-creating financing itself should not be considered detrimental. It is, however, important to point out that, independently from the structure of financing, the level of Hungary's net external liabilities is extremely high, which continues to present a serious risk to sustainability.

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