At a half-way point: external indebtedness replaced by domestic funding

Improvement in the financing situation of the Hungarian economy

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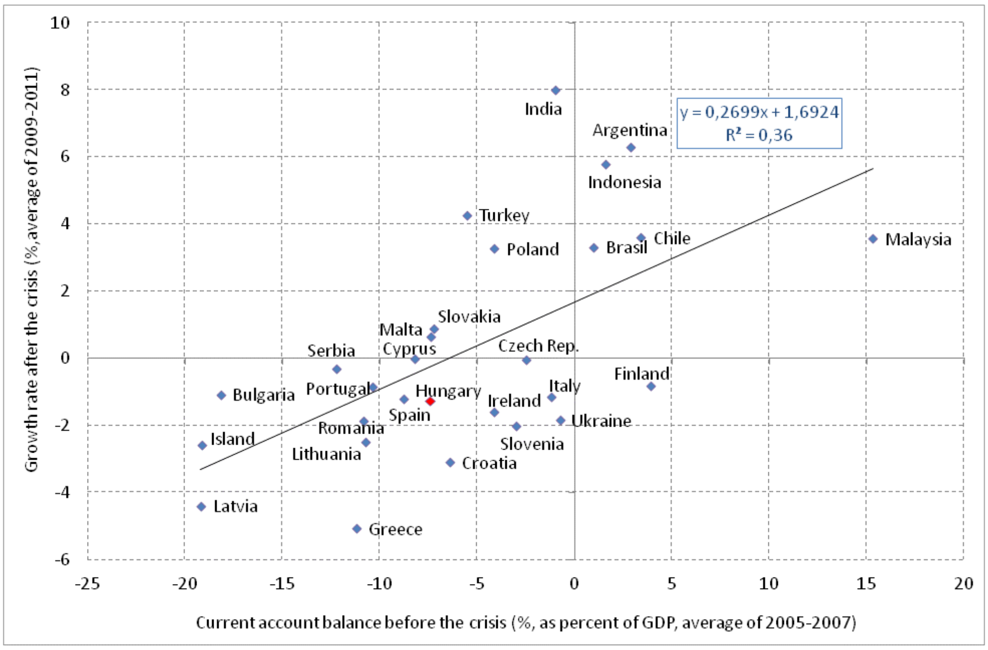
1. INTRODUCTION

The magnitude of external imbalances prior to the financial crisis had a profound influence on the performance of individual countries following the outbreak of the crisis in 2008. In the run-up to the crisis, financial markets had been characterised by abundant global liquidity driven by low interest rates and relatively strong appetite for risk. This led to the emergence of large external imbalances and substantial current account deficits in many countries.

At the onset of the financial crisis, individual countries experienced significant difficulties in accessing external financing as risk appetite declined, and therefore economies previously relying heavily on external sources of funding to step up their growth rates suffered massive output losses. **As the crisis unfolded, the larger the current account deficit proved to be,** the greater was the extent of the economic recession (Chart 1). Narrower access to sources of external financing prompted a sharp adjustment of consumption and investment demand. The decline in domestic absorption led to a simultaneous improvement in the trade balance crucially affecting a country's current account position and in private sector savings.

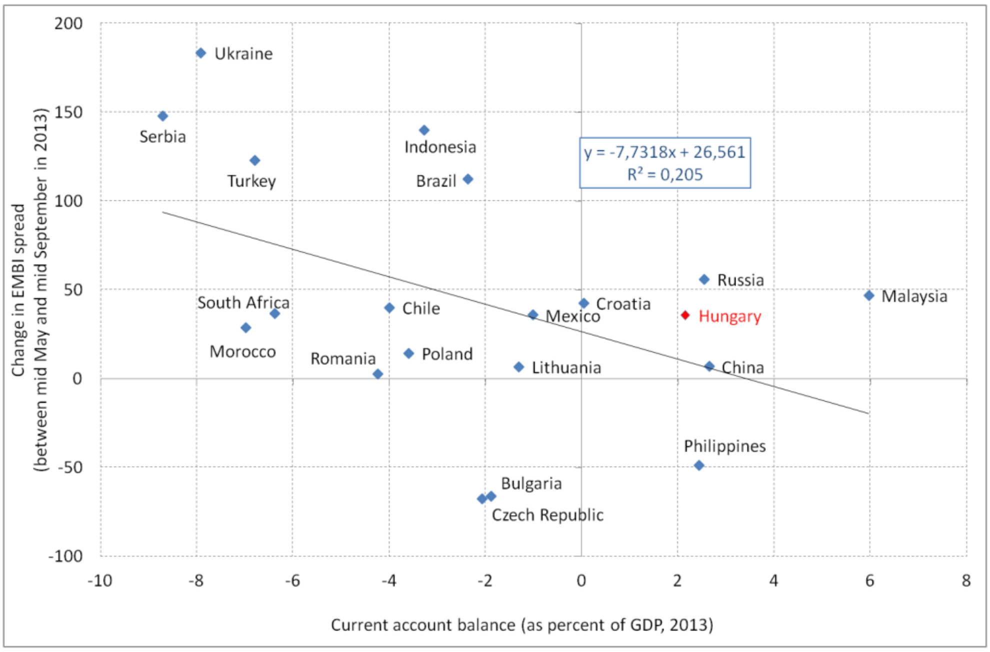
Chart 1: External balance of emerging and periphery countries prior to the crisis and their economic growth following the crisis



Source: Eurostat.

Recent experience has shown that for investors the balance of payments position of individual economies continues to be a closely watched macroeconomic indicator. In addition to the inevitable adjustment process taking place in the immediate wake of the crisis, major central banks introduced a variety of liquidity schemes on an increasing scale; however, the gradual phasing-out of these programmes drew attention to the macroeconomic imbalances present in certain economies. Increased concerns about the phasing-out by the Fed of its asset purchase programme led to wide swings in emerging-market asset prices. But while this process was disruptive in some countries, it had a relatively small impact in other countries, including Hungary. Although the differentiation across emerging countries and the different reactions of countries' money and capital markets were caused by a combination of several factors (e.g. the achievable real interest rate and changes in growth prospects), the current account deficit was one of the key indicators that attracted the attention of markets in the period. During the emerging-market sell-off, the countries with significant current account deficits suffered the most severe depreciation of their currencies (Chart 2).

Chart 2: Current account balances in emerging-countries and changes in EMBI spreads



Note: The change in the EMBI spread was calculated between the announcement of the tapering and the announcement on the delay in tapering. Sources: Eurostat, Bloomberg.

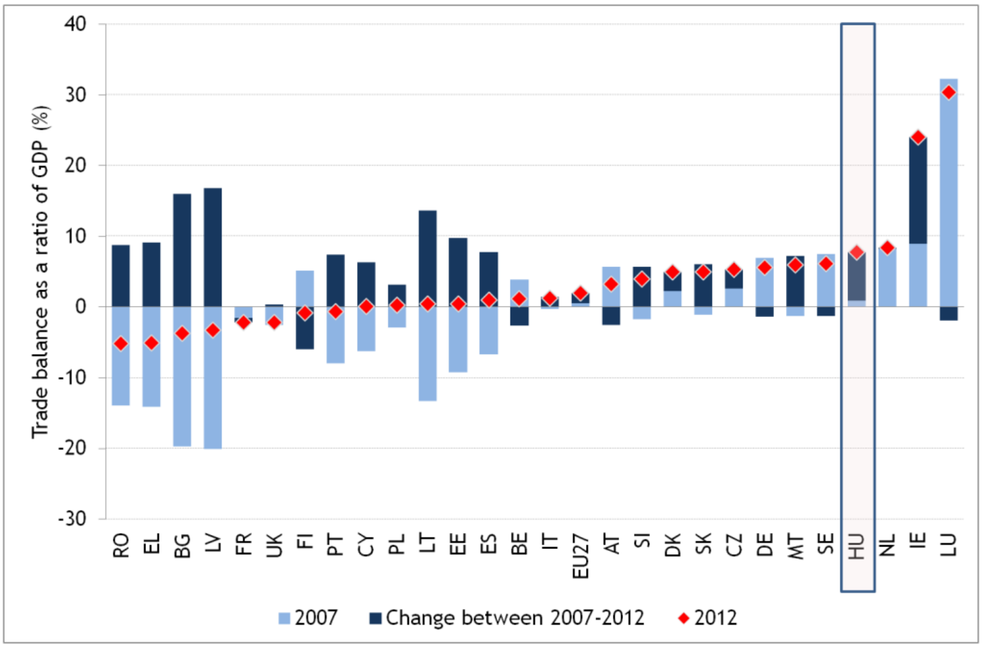
The above two recent examples also underline the significance of developments in the balance of payments position in judging the relative position of individual countries, particularly in a turbulent market environment. Fundamentally, a current account deficit may reflect two different things. Under the *absorption approach*, the deficit is the result of the fact that domestic absorption of the economy (i.e. consumption plus investment) is greater than total output, and so financing consumption and investment requires external borrowing. Under the *saving-investment balance approach*, the deficit is caused by the fact that net financial savings of domestic economic agents are negative, which typically results from the fact that the borrowing requirement of companies and general government is higher than financial savings of household. In other words, if a country runs a current account deficit, it is in a net borrowing position: the excess of domestic absorption over income must be financed by external borrowing.

In the years prior to the crisis, the Hungarian economy was facing severe external and internal imbalances. At the same time, economic growth was financed by the rapid and unsustainable build-up of debt. Hungary's key external balance indicators have improved significantly and persistently in the years since the onset of the crisis. This article provides a brief overview of the underlying developments in the current account predominantly influencing investors' perceptions in the years since the start of the crisis, first concentrating on the trade balance and then on financing.

2. TRADE BALANCE

In recent years, Hungary's trade balance has been in a substantial surplus even in international comparison. Net exports had made a negative contribution to growth in the years prior to the crisis, reflecting the strong increase in imports due to the internal absorption of the three sectors of the country's economy. The trade balance began to improve slowly from 2006, owing to the sharp growth of exports and fiscal adjustment measures. This process accelerated after the financial crisis began in 2008. Hungary's trade surplus has reached 6–8 per cent of GDP in recent quarters, which is high compared with other countries of the European Union (Chart 3).

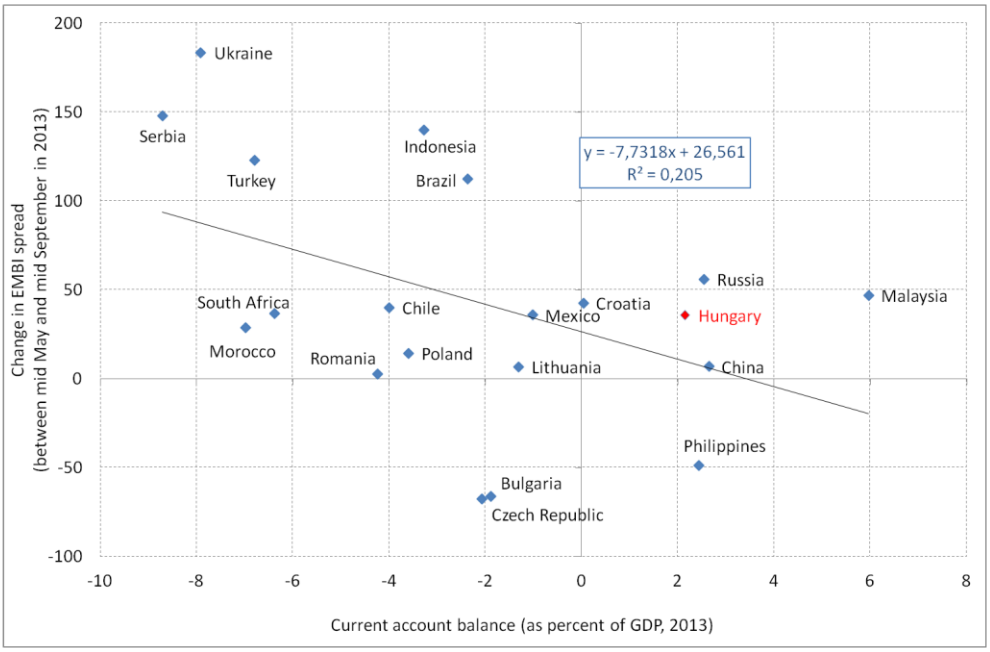
Chart 3: Trade balances in countries of the European Union prior to and after the crisis



Source: Eurostat.

The improvement in the trade balance was in large part due to the adjustment of imports, which mainly reflected the reduction in domestic demand. Prior to the crisis, each of the three institutional sectors (i.e. the government, household and corporate sectors) had accumulated large debts, thereby contributing to an increase in the economy's import demand. This has led to a necessary reduction in these debts during the crisis, which still continues. Economic agents are spending a large portion of their incomes on debt servicing, which in turn has led to sharp falls in spending on consumption and investment. The greater the degree of internal indebtedness proved to be prior to the crisis, the deeper was the decline in domestic demand during the crisis (Chart 4).

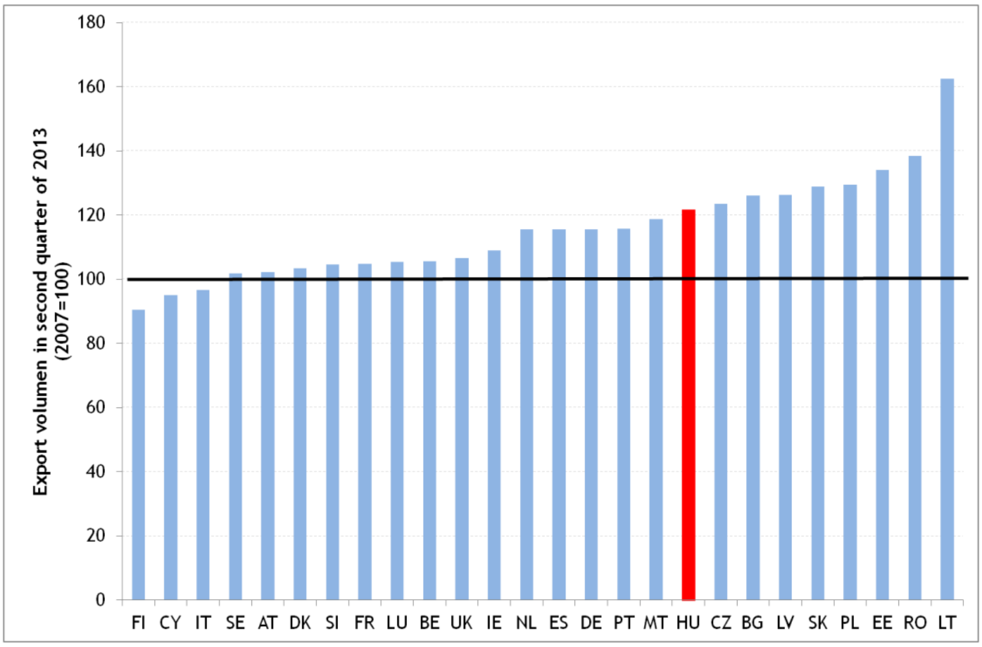
Chart 4: Net external debt prior to the crisis and changes in the components of demand during the crisis



Source: Eurostat.

In times of current account adjustment, the growth potential of the economy is basically determined by the expansion of exports. With debt at a high levels, domestic demand has made no or only limited contribution to the convergence process of the countries affected in the wake of the crisis. However, the financial crisis led to a decline in the performance of the global economy, thereby posing a limit to export-led growth; high debt levels led to the synchronised rise in demand problems in several key economic regions of the world. Despite the weak external demand environment, Hungary's exports have exceeded their pre-crisis levels by 20 per cent by 2013, which is better than the European Union average (Chart 5). For the time being, however, the majority of countries in the Central and Eastern European region have managed to record faster growth than Hungary, suggesting a more mixed picture. The restructuring of the Hungarian industry may have played a role in this. The sharp decline in the global market share of firms operating in the electronic sector has caused severe damage to the sector's productive capacity in recent years. The effects of this have been only partially offset by the increase in production using capacity built in the automobile industry. The transformation process may end this year, the effect of which is expected to be reflected in a further pick-up in exports.

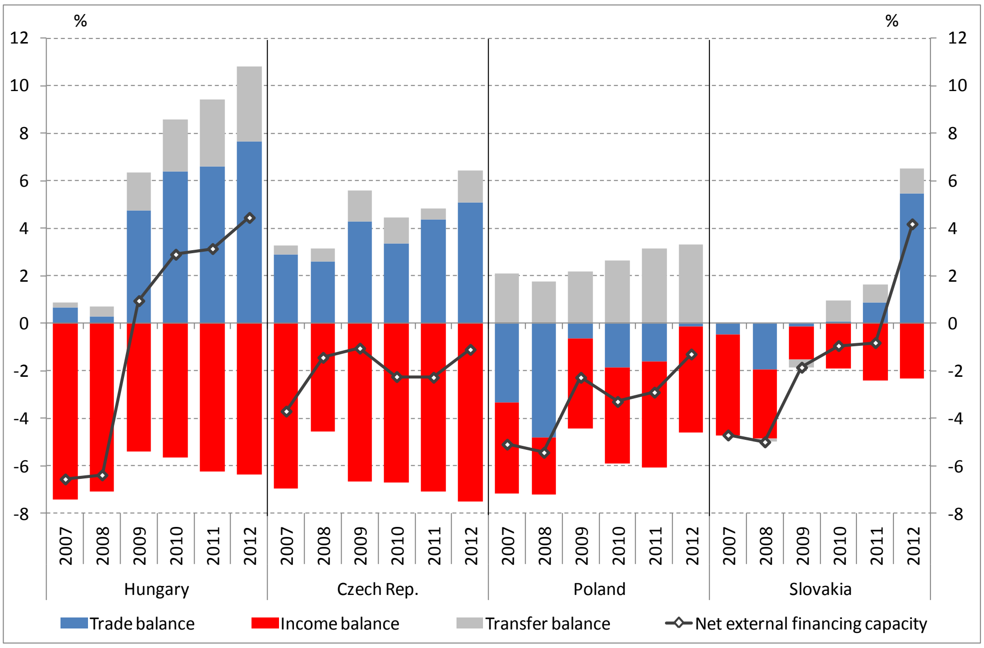
Chart 5: Export volumes in the second quarter of 2013
(2007=100; exports as a percentage of GDP)



Source: Eurostat.

The decline in the deficit of income balance and the increase in EU transfers also contributed to the improvement in the country's external financing capacity, in addition to the improvement in the trade balance. The crisis led to a decline in the profitability of foreign-owned companies operating in Hungary, which was further exacerbated by the special levies introduced in order to stabilise the fiscal position. The reduction in the deficit of income balance caused by falling income on equity was greater than the increase in interest burden on debt accumulated in prior years. Reflecting these factors, in 2012 the income account deficit as a percentage of GDP was about 1 per cent below its level prior to start of the crisis. In addition, the inflow of EU transfers picked up from 1 per cent to 4 per cent of GDP between 2007 and 2012. Consequently, these factors, in addition to the substantial increase in the trade surplus, also contributed to the improvement in the external financing capacity of the Hungarian economy, which was much stronger than in any other of the Visegrád countries. As a result, Hungary's saving position as a percentage of GDP was also the highest in 2012 (Chart 6).

Chart 6: External financing capacity of the Visegrád countries as a percentage of GDP



Source: Eurostat.

3. FINANCING FLOWS

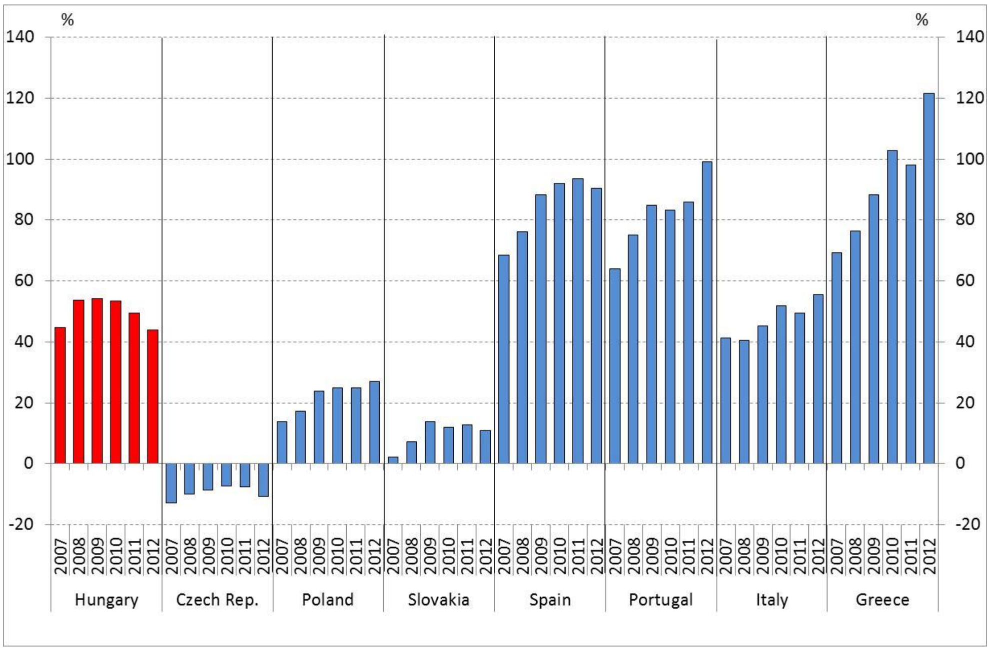
Rising financial savings of each of the three sectors of the economy contributed to the improvement in Hungary's external financing capacity following the crisis. The factors playing a role in the improvement in the trade balance were also reflected in private sector savings: the declines in consumption and investment, respectively, were accompanied by a significant increase in the financing capacity of households and companies. The related developments on the financing side, which were taking place in parallel with those in the real economy, were determined by a sharp contraction in bank lending: with the tightening in access to credit, strong growth in net borrowing was followed by repayments of loans. Consequently, the deleveraging process prompted by the crisis led to an increase in the sectors' financial savings. It is also important to note, however, that, as a result of the successful fiscal consolidation, the borrowing requirement of general government remained persistently low, in contrast to the trends characterising Europe.

Due to the continued inflow of FDI capital, the increase in the country's external financing capacity was accompanied by an outflow of debt liabilities and a sharp reduction in external debt. As in other countries of the region, the size of foreign direct investment inflow fell relative to earlier periods, but it continued even after the onset of the crisis. Consequently, the country's external financing capacity materialised mainly in conjunction with an outflow of debt liabilities: due to deleveraging in each of the sectors, economic agents sought to repay their external debts. This process was most marked in the banking sector: banks spent funds available from net loan repayments by the private sector and deposits to reduce their foreign liabilities. As a result, for example, banks' foreign liabilities fell by more than EUR 20 billion in the period from 2009 to 2012. The net external debt-to-GDP ratio, contributing significantly to the vulnerability of the Hungarian economy prior to the crisis, declined sharply, from 54 per cent at the end of 2008 to below 40 per cent by June 2013, reflecting the effect of repayments of foreign loans. However, it is also important to note that, due to the large share accounted for by foreign currency in the country's external debt, the lower level of the exchange rate relative to its level prior to the crisis offsets the decline in the external debt ratio expected on the basis of the outflow of debt liabilities.

The level of short-term external debt, particularly important in terms of the economy's external vulnerability, also fell. As a consequence of the decline in appetite for risk, economic agents were able to roll over their maturing debt only by making use of shorter-term funding. As an effect, Hungary's short-term external debt even rose slightly, despite the repayments of loans. However, from mid-2011 the economy's short-term external debt also began to fall sharply, and by now the stock of liabilities with no longer than one-year original maturity is much lower than its level prior to the crisis.

Although the external debt ratio of the Hungarian economy is lower than in the periphery countries, it is still higher than of the neighbouring countries. Consequently, further adjustment may be needed despite the country's significant external financing capacity. Developments in the current account balance have been the focus of investors' analyses of sustainability. However, although significantly lower than in the periphery countries as a whole, Hungary's external debt ratio continues to be higher than in other countries of the region, despite its downward trend. Reducing the external debt ratio is particularly important because the economic growth of countries accumulating a higher external debt prior to the crisis has been slower during the crisis than that of less indebted countries, as can be seen by international comparisons.

Chart 7: Net external debt as a percentage of GDP in the Visegrád countries and the euro-area periphery



Source: Eurostat, regional central banks.

In summary, the growth model of the Hungarian economy in the years prior to the crisis, relying on significant inflows of external financing, has proved to be unsustainable. Reduced global appetite for risk during and following the financial crisis made economies facing high external imbalances particularly vulnerable, in contrast to economies relying on domestic sources of financing, which proved to be more resilient. In recent years, the Hungarian economy has experienced an adjustment of its unsustainable balance of payments position, associated with significant real economic costs. It has a significant external surplus by international standards, which is forecast to be a factor in the coming years, contributing to a gradual reduction in the country's vulnerability caused by its high external debt.

In the medium term, access to external financing may improve as global appetite for risk stabilises. However, local and international experiences of the crisis of 2008 suggest that positioning the economy on a sustainable growth path will require an adjustment of the growth model pursued in the 2000s, which relied on a fast build-up of debt.

On the financing side, the most important factors of this new growth model could be: (i) maintaining a disciplined fiscal policy committed to keeping the deficit at low levels; (ii) a competing financial intermediary system allocating domestic savings efficiently; (iii) in terms of external financing, a development policy relying – instead of consumption – on the expansion of productive capacity, improving the longer-term growth potential of the economy; and (iv) regulatory policy adequately monitoring and managing macro-level risks.