Márton Nagy[1]: Why does the foreign currency debt of Hungarian companies pose no risk?

A need for detailed analysis instead of vagueness

Parallel with the increase in global risks, since April 2018 the risk appetite of investors has decreased significantly, which led to stronger differentiation than before in emerging countries. The resarches of investment banks and other market analyses (such as IIF) on external vulnerability are also used as a source in articles published in several international economic papers (including Wall Street Journal), however, these analyses are often too vague and thus they mistakenly compare basic indicators with different underlying fundamental processes. Suitable for deception, these analyses could be especially harmful in the current severe market situation, when a distorted view perceived by the investors could have major influence on the opinion about the stance of the economy in a country. Therefore, owing to the country-specific features, in the analysis special attention should be paid to a more thorough assessment of the gross external debt and foreign currency debt of Hungary.

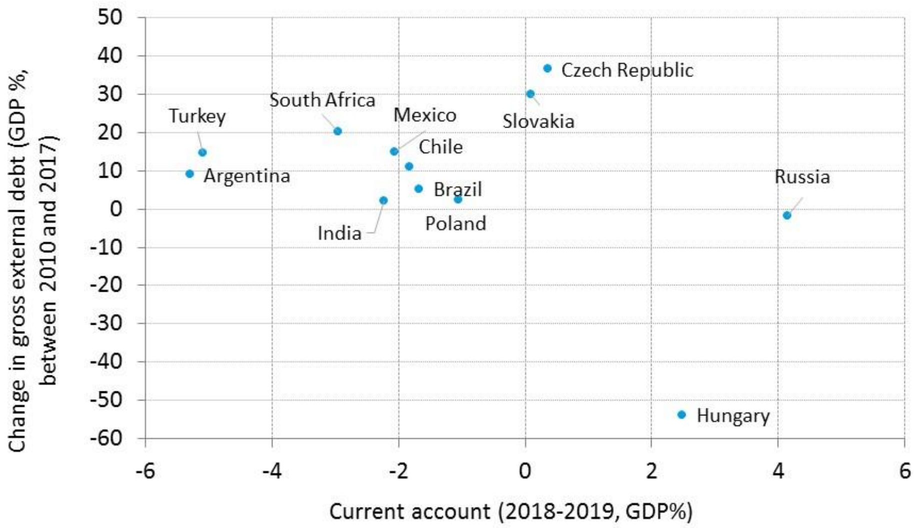
In the following article I would like to clarify the view formed about debts denominated in foreign currency. It is one of the most important statements that in contrast with the increase typically registered in emerging countries, the foreign currency debt of our country has decreased significantly since 2010 – as a result of a current account showing a significant surplus –, which mainly occurred in sectors sensitive to exchange rate risks. As a result of conversion into forint, the foreign currency debt of the households was terminated, while that of the government decreased constantly and to a large extent as a result of the self-financing programme, which played a substantial role in the improvement of the credit rating of our country. In addition, there is no exchange rate risk to speak up in the case of the corporate sector either: on the one hand, with an export revenue similar to the GDP Hungary is one of the most open countries of the world, which means a significant foreign currency revenue, and thus a natural hedge for the foreign currency debt of the sector, typically denominated in euro. On the other hand, as a result of the outstandingly high trade surplus registered over the recent years, in addition to the repayment of foreign loans, businesses have been building up an increasingly large foreign financial claim portfolio (providing a buffer in the case of a possible turbulence), i.e. the net foreign currency position shows a much more favourable picture – this latter is especially important because several credit rating agencies apply the indicator on net debts in their methodologies.

1. INTRODUCTION

By the turning of the current account into a surplus the external debt indicators of Hungary decreased substantially, which had favourable impact on foreign currency debt. The post-crisis adaptation of the Hungarian economy resulted in the current account turning into a substantial surplus from 2010, which caused the stable inflow of FDI and, owing to the actions of Hungarian economic policy (e.g. the self-financing programme) the significant decrease of net and gross external debt – while most of the emerging countries saw their external debt rising. Since the external debt is mainly related to debts denominated in foreign currency, therefore the improvement of the external debt had a beneficial impact on the foreign currency debt of the Hungarian economy as well, in which – as we will see – all the three sectors (households, non-financial corporations and the government) had a role to play. The gross external debt of the country amounted to half of the historical peak of 2009 in the first quarter of 2018, i.e. 60 per cent of the GDP, and the net external debt has decreased to a level close to 10 per cent of the GDP since then. Looking forward, the current account could remain permanently positive, which could ensure the continuing improvement of the external debt together with the impact of the EU transfers increasing the net lending.

[1] The author is the Deputy Governor of the Magyar Nemzeti Bank, responsible for Monetary Policy and Lending Incentives.

Chart 1: Best changes of gross external debt and the expected development of the current account



Source: IMF

2. FOREIGN CURRENCY DEBT HAS DECREASED SIGNIFICANTLY IN HUNGARY

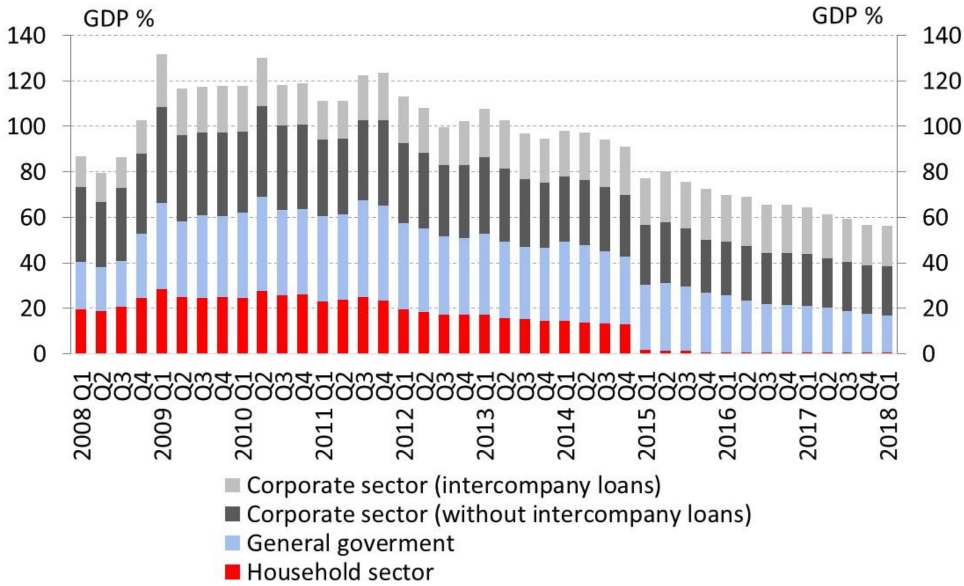
The gross foreign currency debt of the Hungarian economy measured as the ratio of GDP has halved over the recent decade, from the earlier historical peak, at the end of March 2018 it amounted to 56 per cent, in which the decrease of debt all the three sectors played a role. In the years prior to the crisis, the foreign currency indebtedness of the private sector, after the outbreak of the crisis the loan borrowed from international organizations, the depreciation of the forint and the decrease of GDP all contributed to the rise of the gross foreign currency debt of the Hungarian economy (inclusive of intercompany loans) to a high level, in the first quarter of 2009 it was above 130 per cent of the GDP, reaching a historical high. Since 2010, parallel with the increase of the net lending of the economy, the process of decrease of foreign currency debt started, which was supported by actions of the government in addition to the deleveraging of the private sector. In 2015, owing to the conversion into forint, the foreign currency exposure of households was practically terminated, while the funding of the government from internal resources – also supported by the self-financing programme – enabled the gradual elimination of the foreign currency debt, and the reduction of the foreign currency debt of non-financial corporations[2] was supported, in addition to deleveraging, by the involvement of funds through Funding for Growth Scheme (FGS). At the end of March 2018, the gross FX debt-to-GDP ratio of the Hungarian economy was 56 per cent, while it was 39 per cent excluding intercompany loans.

It is important to highlight that when the debt rates typical in corporations are assessed, in the analyses one should consider the data free of capital in transit and intercompany loans, which constitute almost half of the total foreign currency debt of the sector. The reason is that, on the one hand, in Hungary the activity of the so-called special purpose vehicles (SPVs) – typically operated for the purpose of tax optimization – does not affect the processes of the real economy, at the same time, funds from abroad and then leaving the country (the so-called capital in transit) are included in the debt indicators. On the other hand, intercompany loans provide debt type financing within direct investments, while in an economic sense they can be rather considered a non-debt type form of financing, since financing by the parent companies in the form of participations and intercompany loans are flexibly interchangeable to a large extent (over the recent years these two forms have often moved in opposite directions, and their consolidated timeline has moved much more steadily), in addition, the risks associated with the loans – such as the rollover risk, interest risk – are much lower in the case of intercompany loans, compared to bank loans. Without SPVs nearly half of the foreign currency debts of enterprises are constituted by these intercompany loans, cleared of the

[2]The foreign currency debt of financial corporations can be considered secured, therefore we refrain from quantifying the foreign currency debt of this sector.

impact of these the corporate foreign currency indebtedness in the 1st quarter of 2018 was only about 20 per cent of the GDP.

Chart 2: Foreign currency debt of the non-financial sectors in Hungary



2.1. HOUSEHOLDS

By the conversion of household loans into forint, the foreign currency ratio of the sector was practically reduced to zero, while a recurring increase is prevented by macroprudential rules. The residential foreign currency loan portfolio that built up prior to the crisis posed a significant risk concerning the external vulnerability of the economy. After the crisis, the depreciation of the exchange rate and the increase of HUF returns burdened the incomes of households, which restricted the latitude of monetary policy and also put the profitability of the banking system under pressure. By the early repayment of 2011 and then the conversion into forint completed in 2014, the risks related to the foreign currency debt were successfully eliminated, thus the FX rate of the Swiss Franc that appreciated later on no longer had an adverse impact on households. The implementation of macroprudential rules – such as the payment-to-income ratio and the LTV ratio regardless of the currency of the disbursed loan – prevent a recurring surge of foreign currency loans, and therefore minimize the risks related to foreign currency lending. Under the decree, only such persons are allowed to borrow loans in foreign currency who also have an income in foreign currency, therefore unsecured foreign currency positions cannot exist in the residential sector. Therefore, after the conversion into forint, if the macroprudential rules are enforced, the foreign currency positions of households can be maintained at around zero, which can be considered optimal for external vulnerability.

2.2 PUBLIC FINANCES

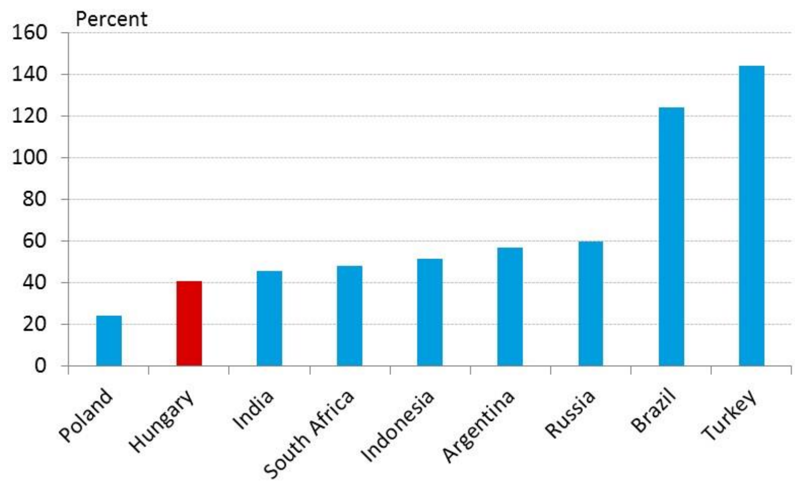
Over the recent years the foreign currency debt of government finances has been reduced substantially, which played a meaningful role in the reduction of external vulnerability. After 2011, one of the key objectives of the government's debt management strategy was to strengthen domestic financing, in forint, which was also supported by the central bank's self-financing programme. In 2016 the last instalment of the EU-IMF loan was repaid, and in recent years the maturing foreign currency bonds were also refinanced from forint. As a result, the foreign currency debt of the general government household as the ratio of GDP dropped significantly, from almost 40 per cent at the end of 2010 under 20 per cent by the end of 2017.While the value as of the end of 2010 represented an outstandingly high value compared to the countries of the region, at present the foreign currency debt of general government finances as the ratio of GDP is the same as the regional average in terms of magnitude. The aims of debt strategy remain unchanged, the deleveraging of the foreign currency debt will be supported by bond issues and the expansion of the portfolio of residential papers in the following years as well. The trend of decrease in foreign currency debt makes a major contribution to the continuous reduction in external vulnerability and to the upgrade of Hungary's credit rating. In order to accomplish the reduction of the ratio of foreign currency debt in public debt, as a major aim of economic strategy, it is still not necessary to issue foreign currency bonds.

2.3 CORPORATES

According to the database of OECD, Hungary is one of the most open economies, therefore exporter companies will not run any risks by foreign currency debt, since its ratio is markedly low compared to export activity, which provides natural hedging. The optimal ratio of the foreign currency sources of companies is significantly influenced by the foreign currency structure of the revenues of the business sector, since the foreign currency revenue of exporting companies provides natural hedging against foreign currency debt. What is more, borrowing loans in foreign currency alleviates the risks for companies whose revenues are mainly realized in foreign currency, since this is how they create harmony between the currency structure of the revenues and expenses of the company. Domestic large corporations export in significant value even by international standards, which is reflected in the value of export as a ratio of GDP. In this indicator Hungary is the fourth most open country of those included in the database of the OECD, which occurred in 2017 with a high trade surplus, exceeding 7.5 per cent of the GDP. If we assess the relatively high corporate foreign currency debt as the ratio of GDP by these criteria, then the value of the foreign currency debt of Hungary compared to the export revenues of the sector – i.e. compared to the export revenues of the corporate sector – is markedly low. This duality characteristic of the Hungarian economy is also reflected in the lower export activities of SMEs. Having realized that, the Funding for Growth Scheme (FGS) launched by the MNB also supported the opportunity provided for the sector with less foreign currency revenues to change its former foreign currency loans for loans denominated in domestic currency at low costs.

A significant part of the foreign currency debt of Hungarian corporations is denominated in euro, in accordance with the export revenues. It is important for the business sector to have the debts and revenues of the sector denominated in the same currency. Approximately 60 per cent of the exports of Hungary goes to the euro zone. In accordance with that, a significant part of the foreign currency debt of companies is denominated in euro, which confirms that the foreign currency debt of the business sector can also be used to hedge risks the arising from foreign currency revenues.

Chart 3: Corporate FX debt as a percentage of exports (2017)

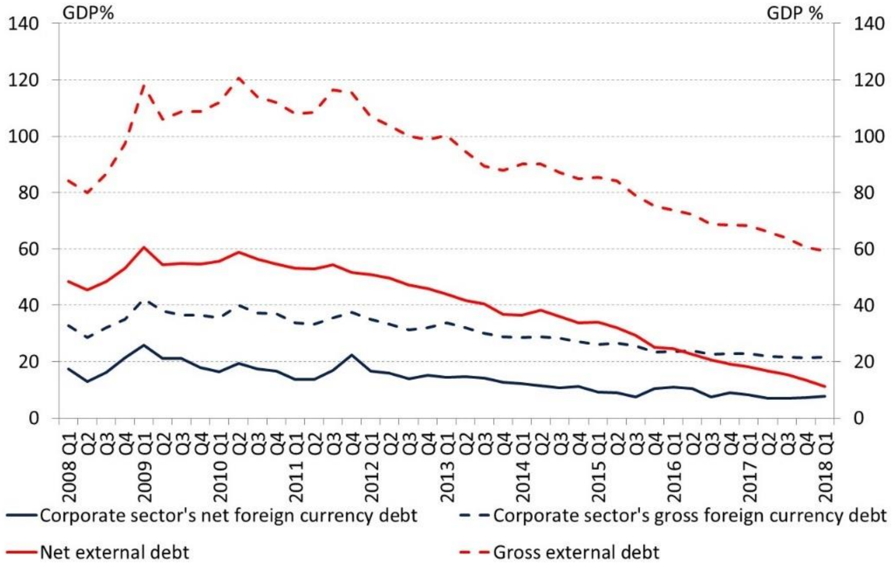


Source: Nomura (IIF), OECD

3. THE NET INDICATOR ALSO NUANCES THE PROCESSES SIGNIFICANTLY

The net foreign currency debt captures the actual open foreign currency position of certain sectors of the economy better, since it also takes into account the foreign currency assets that reduce the exchange rate risk. Although presumably with regard to the availability of the data, the international comparative analyses are usually limited to the assessment of the gross debt, at the same time, when the actual vulnerability of the economic sectors are assessed, it is recommended to apply the net indicator. This is also supported by the fact that the credit-rating methodology applied by Fitch also uses the net external debt for the quantification of external exposure. (Similarly to foreign currency debt, the net external debt of the economy has decreased significantly over the recent years, which substantially contributed to the reduction of the vulnerability of the Hungarian economy). In addition to external debt, the net indicator should be also used when foreign currency exposure is assessed, since on the one hand, the foreign currency assets of the sectors could provide funding even if the foreign currency sources are scarcely available, on the other hand, they partly hedge the open FX position, thus they offset the revaluation effects arising from possible exchange rate movements, thereby reducing the risks of the economic operators. The net foreign currency debt of non-financial corporations is also substantially lower than the gross debt. Over the recent years, the corporate net foreign currency debt including foreign currency assets has been gradually decreasing from its peak level exceeding 25 per cent of the GDP, thus since 2016 it has been under 10 per cent of the GDP, in which the increase of the foreign currency assets of corporations also played a role in addition to debt deleveraging.

Chart 4: The external debt of Hungary and the foreign currency debt of corporates (without intercompany loans)



4. CONCLUSION

Therefore, in total it can be stated that the size of the foreign currency debt of the country as of a particular date provides a misleading view on the vulnerability of the country, and that it should be presented together with several nuanced details. Of these the following are the most important:

- past and anticipated trends: in Hungary a drop took place and further decrease can be expected;
- differentiation according to the individual sectors: in the government and household sectors that are the most exposed to FX risks, there was a significant drop and further decrease can be anticipated;
- in the case of businesses, composition of the debt of the sector: the capital in transit and the intercompany loan carry much lower risks;
- the foreign currency exposure reducing effect of export revenues: Hungary is one of the most open countries;
- composition of foreign currency debt: the foreign currency debts of domestic companies are mainly denominated in euro, i.e. the currency in which the revenues are realized;
- in addition to gross debt, considering the net indicator: the position is much better owing to the accumulation of foreign assets.