Mihály Hoffmann, Balázs Kóczián and Péter Koroknai: Developments in the external balance of the Hungarian economy: indebtedness and adjustment*

Developments in Hungary's external assets and external liabilities are particularly important in assessing the external vulnerability of the economy. Focusing mainly on the financing processes, this study presents an overview of the structure of the foreign funds between 1998 and 2012, and points out correlations between capital flows and real economy developments in Hungary.

ABSTRACT

As typical for all emerging economies, post-transition Hungary was characterised by a significant external imbalance and a substantial current account deficit. The economic transformation and the undercapitalised economy ensured favourable returns on investment, funded by the investments of foreign investors. Accordingly, from 1998 to the beginning of the 2000s, Hungary saw a substantial inflow of direct investment, which – mainly by financing investment projects – generated relatively rapid economic growth without increasing the indicator capturing the vulnerability of a country, i.e. net external debt.

From the mid-2000s however, a very unfavourable trend began to emerge. The current account balance was still in deficit, but the deficit was no longer primarily financed by FDI-type funds, but rather by foreign loans. Indeed, state overspending and the surge in households' borrowing – initially denominated in forint and subsequently in foreign currency – was financed by external loans; both the state and the banks disbursing the loans relied heavily on foreign funds. Further exacerbating the situation, for the most part these loans were not spent on investments, which would have driven future economic growth, but served instead to increase domestic consumption; consequently, the spending of foreign loans did not ensure the subsequent ability to repay the loans disbursed. And while the adjustments by the state from 2006 decreased the public deficit spectacularly, households' consumption smoothing behaviour prompted the population to borrow even more (denominated in foreign currency), thus significantly reducing households' net financial savings. As a result, the crisis emerging at the end of 2008 hit the Hungarian economy at its weakest: due to the significant external imbalance, the economy relied heavily on external funds, and net external debt was very high with a remarkably large public debt. Meanwhile, the private sector had an enormous foreign currency loan portfolio, and the potential growth of the country fell so steeply that it also decelerated, to a large degree, the real convergence process relative to more developed countries.

Amidst the heightened uncertainty following the outbreak of the crisis, risk avoidance grew to such an extent that, owing to poor economic fundamentals, non-resident economic agents lost confidence in Hungarian investments. The consequences were felt severely in several areas. On the one hand, Hungarian government bonds could not be sold; on the other hand, the maturity of foreign financing was shortened considerably, ultimately forcing Hungary to borrow from the IMF and the EU. Thirdly, owing to the high risks associated with loans to the private sector, the banking system was not willing to disburse loans. Meanwhile, due to increased unemployment, deteriorating incomes and heightened uncertainty, households were not willing to take out loans. Consequently, Hungarian banks started to repay their foreign loans (or, in a different interpretation, parent banks began to withdraw their funds). In parallel with the shortfall in foreign funds, the real economy was also hit by the crisis. Household consumption fell due to decreased income, increased uncertainty and the freeze in lending. In the wake of dwindling external and internal demand and the limited availability of financing, corporate investment began to drop, which was also reflected in household consumption.

* The views expressed in this article are those of the author(s) and do not necessarily reflect the offical view ot the Magyar Nemzeti Bank.

At the same time – in addition to the significant impacts in other areas – the financing and real economy crisis improved the country's external balance to a large degree. The downturn in imports generated a substantial surplus on the foreign trade balance, which – combined with a significant increase in EU transfers in the new budget cycle – resulted in a current account surplus, after years of sizeable deficits. As regards the savings of sectors, a net savings position emerged in Hungary as a result of a surge in the financial savings of the private sector stemming from declining consumption and investments, while the public deficit remained low. On the financing side, the large external inflows observed previously were followed by the repayment of foreign loans after the outbreak of the crisis, which reduced the net external debt of the country.

Consequently, the external balance was restored in the flow indicators. Stock indicators, however, still lag behind in international comparisons, which may necessitate further adjustment in the future. With the weakening exchange rate, Hungary's external debt decreased only slowly, and the country's external debt ratio is still considerably higher than those of other countries in the region. At the same time, because of the country's significant open position in FX, a potential devaluation of the exchange rate would pose further risks to the economy. Reducing external debts would be also important from the perspective of economic growth: following the crisis, economies with relatively low external debt suffered a smaller downturn or succeeded in achieving more pronounced growth. Since another potential withdrawal of foreign funds by banks points to a continued slump in the credit market and hence, a more protracted recovery process from the economic crisis, an increase in foreign direct investment would be a welcome development, which may also pave the way to reducing high debt levels.

INTRODUCTION

In our analysis, we examine developments in the balance of payments between 1998 and 2012. In view of the complexity of the subject and the space limitations of this study, our analysis is not intended to be exhaustive, but it nevertheless takes account of the most important correlations.[1] Net external lending, which is a crucial factor from the standpoint of external balance, can be examined using three approaches: from the aspect of the real economy, based on financing structure (financial account) and according to the savings of individual sectors.

1. With the real economy approach, the current account balance consists of three main elements. The first item is the balance of goods and services, i.e. the net export balance of a country. The second part is the income balance, i.e. the sum of income outflows and inflows (profits, bond yields, dividend payments, remittances by those working abroad). The third main category is the balance of transfers to and from the country. These three items determine the current account balance. If a fourth element, the capital account, is added to these three main items – which is also called, together with current transfers, the transfer account and reflects current transfers supporting investment – we obtain the net lending[2] of the country in question (Chart 1).

2. The net lending of the country can be also split up between the sectors of the economy: the government, corporations and households. Ultimately, the portion of income generated by the sectors of the economy that is not spent on consumption or accumulation indicates the country's net lending. In other words, the sum of the net financial savings of individual sectors (households, corporations, state budget) equals the country's net lending.

3. The breakdown according to the financial account of the balance of payments divides the balance of payments based on the types of inflows into debt-type (typically a type of loan) and non-debt type items (direct investment or shares).

Theoretically, the three approaches yield the same result. Indeed, real economy processes are reflected in financing developments: for example, if the current account balance is positive, as has been typically the case in the Hungarian economy in recent years, the financial account will indicate an outflow of funds (negative balance) and vice versa. This means that the total balance of payments should theoretically be zero.[3]

[1] Our review is primarily focused on financing and savings processes, and touches upon the driving forces behind changes in the foreign trade balance only to the extent absolutely necessary.

[2] Since EU transfers can be shown both in the current account (in the row of current transfers) and in the capital account, in analysing the external position of the country, we assess changes in the current account and the capital account together, i.e. the net lending of the country. When the balance of the current account and the capital account shows a surplus, the country's net lending is established; when the balance is negative, the country has a net borrowing.

[3] Data derived from the different approaches should be identical; however, temporary differences are likely to arise due to non-integrated data sources, incomplete observation and the different handling of the exchange rate, which are then indicated in 'net errors and omissions'. Nonetheless, developments in the real economy and financing appear to be largely similar over the long run.

Chart 1
Net lending according to the real economy approach

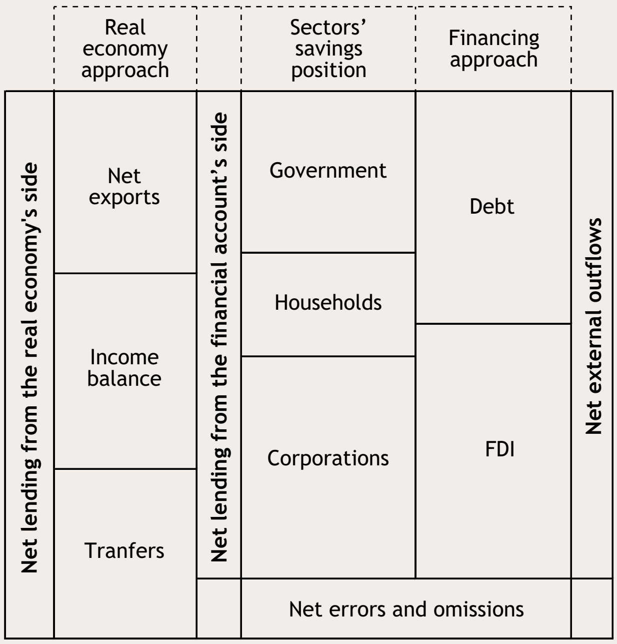
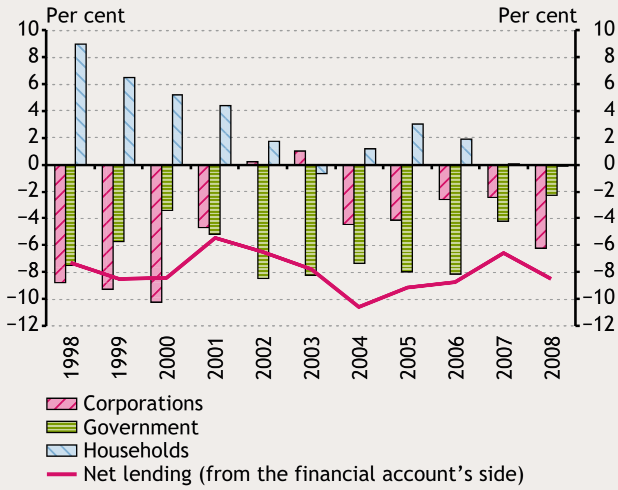


Chart 2
Division of Hungary's balance of payments into the savings positions of sectors between 1998 and 2008

(as a proportion of GDP)



Source: MNB.

In a small, open, emerging economy such as Hungary, the behaviour of the sectors shows that the corporate sector and the public sector typically produce a financing requirement which is partly covered by the savings of households. While companies need funds to cover their investment needs, public finances typically contribute to achieving economic and social goals by allowing expenditures to exceed revenues, i.e. by accepting a budget deficit. Accordingly, convergence is nearly always associated with external inflows, which is reflected in the deficit on the balance of payments. The crisis which occurred during the review period resulted in a significant increase of the net lending derived from the balance of payments of Hungary and also affected the inflow of foreign funds. Accordingly, our analysis divides the processes observed into two parts: from 1998 to the crisis and between 2008 and 2012.

PRE-CRISIS PERIOD

In the period preceding 2008, owing to the financing requirement of the state and the corporate sector, the economy relied on external funds, which household savings were increasingly unable to offset (Chart 2). The savings position of the Hungarian sectors suggests that at the end of the 1990s *households* had a substantial – but gradually decreasing – amount of savings, while the financing requirement of the corporate sector and the government was rather high. During this period, household savings were boosted by the fact that the financial intermediary system's lending to households was still subdued. At the same time, the steep increase in borrowings – attributed primarily to subsidised housing loans – eroded the sector's net lending, which remained consistently low between 2002 and 2008. The considerable financing requirement of the corporate sector – which can be observed over the entire time horizon – is a result of companies' investment/production activities. The financing requirement of the *government*, in turn, showed a declining trend at the end of the 1990s, before starting to rise again from 2000. During the period of significant budgetary imbalance between 2002 and 2006, the financing requirement of the state was close to 8 per cent of GDP on average. The adjustment that followed, however, tempered the state's financing requirement considerably. In view of the lax fiscal policy pursued between 2002 and 2006, based on the concept of Ricardian equivalence[4] we would expect households to have more substantial net savings which, however, did not materialise to a great degree. At the same time, the adjustment in 2006

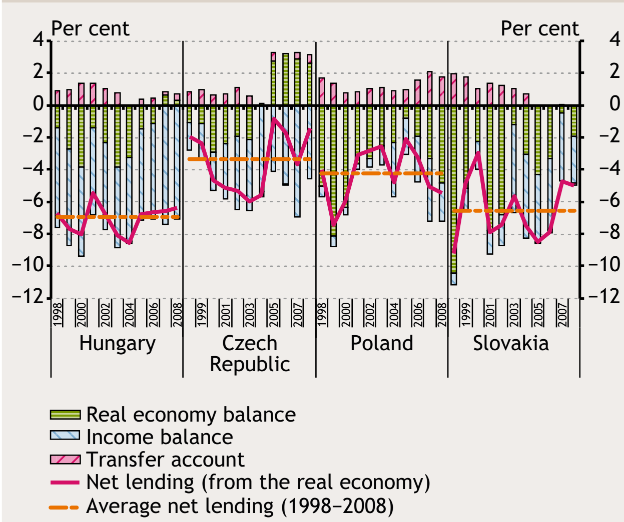
[4] According to the Ricardian equivalence, households and corporations respond to the temporary easing measures of the government by accumulating more funds in savings in proportion to their income, in consideration of an expected future increase in tax burdens. To put it more simply, over the long run, the private sector uses its financial savings to smooth out its consumption path that is influenced by the short-term imbalances of fiscal policy.

prompted a decline in savings, i.e. a mild consumption smoothing compared to the previous level; in other words, households also supported consumption by restraining their net savings. Overall, the behaviour of the sectors indicates a substantial external financing requirement in the period between 1998 and 2008.

In the pre-crisis period, in line with Hungary's peers in the region, the balance of payments showed a rather large deficit, owing to the income outflows in the context of the country's substantial amount of external debt. From the side of the real economy, from the end of the 1990s to 2008, Hungary's external financing requirement was around 7–8 per cent. One main reason for this was the negative *income balance,* arising from the fact that non-residents which had obtained significant ownership interests via their large capital investment during the privatisation period transferred their annual income to their home countries. Subsequently, the income balance was further deteriorated by the interest paid on the rising amount of debt. Meanwhile, owing to the high import content of household consumption and production for exports, Hungary's *real economy balance* was also negative for the most part during the pre-crisis period. Net exports turned positive from 2007, which – amongst other things – reflected booming exports and the decline in household consumption on the back of adjustments by the state. At the same time, Hungary's *transfer account* did not start to grow immediately after Hungary's accession to the EU, which can be probably attributed to the peculiarities of the EU's system of grants (Chart 3). The balance of payments (deficit) followed a similar course in other countries of the region, and its direction also reflects inflows. However, the balance observed in the region falls significantly behind that recorded in Hungary. Even the composition of the balances shows differences: while in Hungary and the Czech Republic the balance of payments was mainly determined by the income balance, in the case of Poland and Slovakia negative net exports were a decisive factor as well.

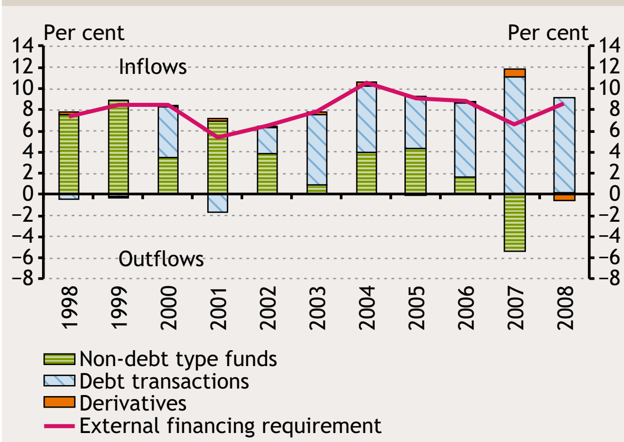
At the beginning of the period, in Hungary the majority of inflows represented non-debt funds (primarily direct investment); however, in the 2000s debt-type funds gained ground. Breaking down the balance of payments on the basis of the financial account, we find that the vast majority of foreign inflows were composed of direct investments up until 2002. In other words, funds arrived in Hungary through the acquisition of ownership interest in companies and greenfield investments. From 2003, however, this correlation changed markedly, with debt-type funds gaining ground over the increasingly subdued inflow of direct investments (Chart 4). That notwithstanding, this did not reduce the high level of inflows, which – as we pointed out in relation to the balance of payments – varied between 7 and 8 per cent in the pre-crisis period.

Chart 3
Changes in net lending in Hungary and its peers in the region
(as a proportion of GDP)



Source: MNB, Eurostat.

Chart 4
Structure of inflows to Hungary between 1998 and 2008
(as a proportion of GDP)



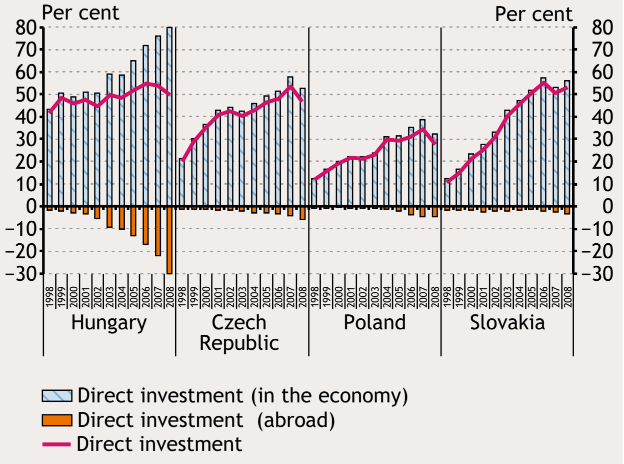
Source: MNB.

Initially, Hungary enjoyed a significant advantage over its regional competitors at the end of the 1990s in terms of foreign direct investment; however, its peers caught up gradually by 2008. As mentioned above, as a result of privatisation, non-residents acquired substantial ownership interests in the corporate sector. This was also reflected in the high level of foreign direct investment in Hungary at the beginning of the review period. Foreign direct investment, however, only increased very moderately between 1998 and 2008 in Hungary (Chart 5). This was partly caused by the fact that, while net foreign direct investment did not increase in Hungary, gross figures reflected a more pronounced shift. Indeed, large corporations in Hungary (accounting for nearly 30 per cent of domestic GDP by 2008) invested large amounts of capital abroad. Meanwhile, our regional competitors – especially Slovakia and the Czech Republic – recorded a consistent increase in the level of foreign direct investment until 2006. Nevertheless, even by the end of the review period they still did not reach the level observed in Hungary. The level of foreign direct investment outflows in other countries in the region was significantly lower than in Hungary.

Hungary's net external debt increased steeply until 2008 and approached the stock of foreign direct investment. By 2008, net external debt rose to above 50 per cent compared to 15 per cent at the end of the 1990s. This can be mainly attributed to a change in the type of inflows starting from 2002. While foreign funds had previously arrived in Hungary in the form of capital investment, starting from 2002 the inflow of debt-type funds gained ground, in line with banks' foreign currency lending as described below. By the end of the review period, the net level of debt-type funds approached the volume of FDI in Hungary (Chart 6). While net external debt was on the rise from 2003 in several other regional countries, its volume rose to excessively high levels in Hungary. And the fact that Hungary was subsequently hit by the crisis particularly hard was precisely because of the significant vulnerability caused by the high level of external debt. By contrast, the external debt of peers in the region was far lower: in Poland it was nearly 15 per cent of GDP before the crisis, in Slovakia it hovered around 0 per cent, while the assets of the Czech Republic in debt-type funds exceeded its liabilities.

From 2001 households started to borrow extensively, which eroded their net lending. Studying the details of household sector developments, we find that loans to households started to grow from 1998 and then accelerated from 2001. In addition to the gradual development of the financial intermediary system, this can be attributed in the beginning to the state-subsidised housing loans and later to a surge in foreign currency lending, which led to the accumulation of a significant household loan portfolio by 2008. Although households' net savings consistently declined from 1998 due to borrowing, savings dipped to low points in both 2003 and 2007–2008 (Chart 7). Thus households, typically a net saver sector, could only slightly offset the high financing requirement of the rest of the sectors between 2003 and 2008.

Chart 5
Changes in the level of foreign direct investment in Hungary and other countries in the region between 1998 and 2008
(as a percentage of GDP)



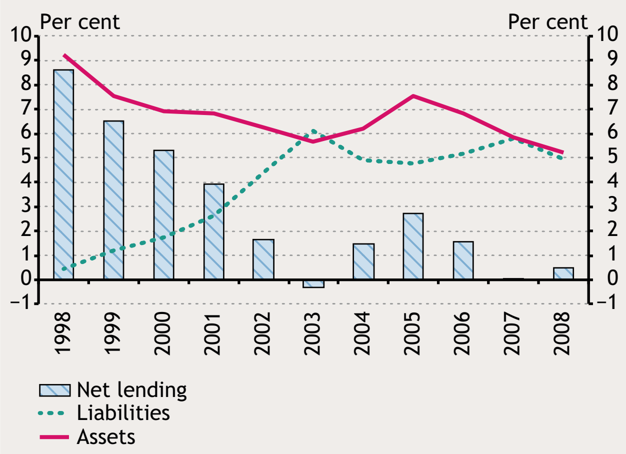
Note: Hungarian data of 2008 reflect the stock cleared from capital investment flowing through.
Source: MNB, CNB, NBP, NBS.

Chart 6
Changes in net external debt in Hungary and other countries in the region between 1998 and 2008
(as a percentage of GDP)

Source: MNB, CNB, NBP, NBS.

Chart 7
Breakdown of households' savings processes between 1998 and 2008

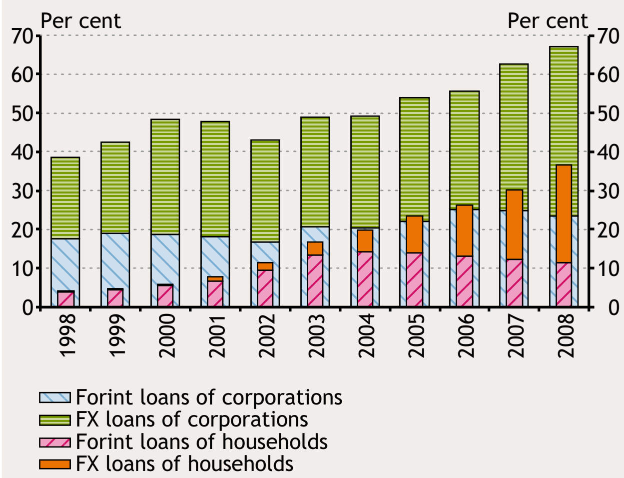
(as a percentage of GDP)



Source: MNB.

Chart 8
Loan holdings of households and corporations between 1998 and 2008 broken down by denomination

(as a proportion of GDP)



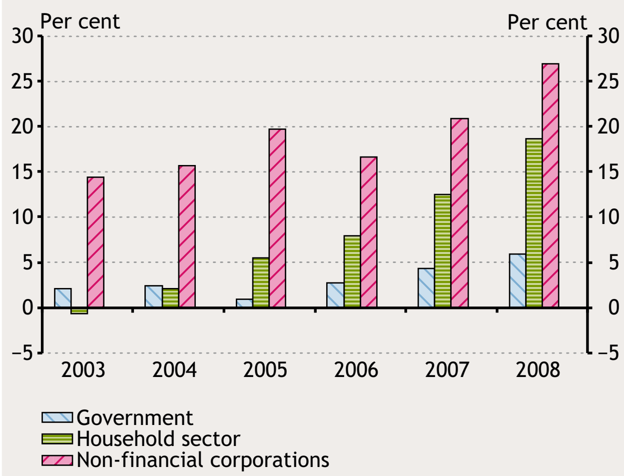
Source: MNB.

Instead of recourse to expensive forint financing, corporations and households became increasingly indebted in foreign currency. As understood so far, internal net savings of the economy were extremely low. Forint financing became increasingly expensive owing to the high nominal forint interest rates emerging in the context of the high inflation environment. In view of the relatively stable forint exchange rate and loose foreign monetary conditions, borrowers decided to take out foreign currency loans (Balás and Nagy, 2010).[5] Consequently, households and companies became indebted in foreign currency to a larger degree. From the start, FX-denominated loans contributed to the accelerated growth of the household loan portfolio observed from 2001, but this was mainly due to car loans at that time. Subsequently, owing to tightened subsidies from 2004, FX loans gained ground in housing loans. In 2008, the corporate loan portfolio exceeded the loans of households by nearly twofold, both in respect of forint and FX-denominated loans (Chart 8).

The external debt of Hungary – particularly in view of FX loans – is also reflected in the widening of the open FX position of households and corporations (Chart 9). Rising foreign currency debt implied wider open FX positions even from a sectoral perspective. The two largest sectors with an open position were the corporate sector and the household sector. Since many companies producing for exports have regular foreign currency income, the open position in their case implied a smaller risk than for households, whose income was nearly exclusively denominated in forints. The gap in the net foreign currency position can be also observed for the public sector; even at the end of 2008, however, its width was less pronounced than in the case of the corporate and household sectors, thanks to the foreign currency reserves of the MNB.

Chart 9
Open FX position of certain sectors between 2003 and 2008

(as a proportion of GDP)



Source: MNB.

[5] Balás T. and Nagy M. (2010), "Exchange of foreign currency denominated loans into forint", *MNB Bulletin*, October 2010.

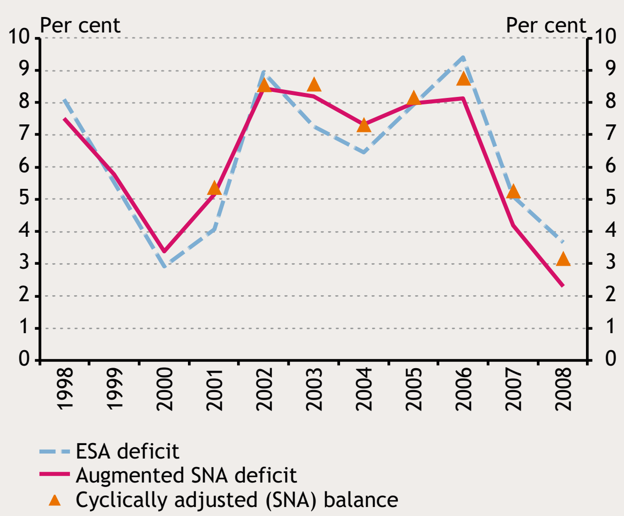
Meanwhile, as the crisis approached, non-resident agents were increasingly reluctant to undertake a forint exchange rate position, i.e. they were less willing to finance Hungarian economic agents in forint. Hungary's net external debt rose steadily in the period 2003 to 2008, and by the end of 2008 it exceeded 50 per cent of GDP.

The public deficit was still declining in the late 1990s, but after the millennium it started to climb and remained at high levels between 2002 and 2006 until the fiscal adjustment package lowered it in 2006 (Chart 10). The public deficit fell between 1998 and 2000 and reached its low point in 2000. Subsequently, however, it shifted upwards and between 2002 and 2006 a consistently high level of deficit – hovering around 8 per cent – was observed. The government's easing reached its peak at this point, followed by an adjustment in 2006. As a result, the deficit was reduced, and the net financing requirement of the public sector was lowered significantly. However, since this decline was accompanied by the diminishing net lending of households due to their consumption smoothing behaviour, it did not considerably reduce Hungary's external financing requirement.

CRISIS AND ADJUSTMENT

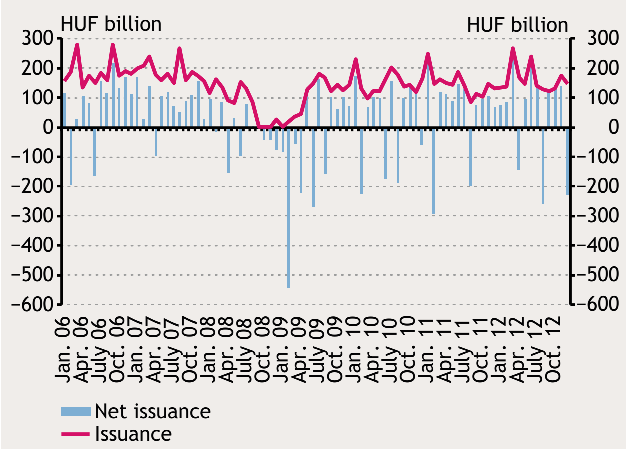
After the bankruptcy of Lehman Brothers, investors' risk tolerance declined. Consequently, the ability to finance the central government from the market was called into question, which was finally resolved by the loan from the IMF/EU. Although the public deficit was relatively low thanks to the adjustments from previous years, high accumulated debt with a large share of foreign currency debt combined with the risk aversion of investors prompted a substantial sale of government papers by non-residents in the autumn of 2008. In addition to selling Hungarian instruments, non-residents also participated less and less in Hungarian government paper auctions, which ultimately led to the suspension of government bond issuance for six months (Chart 11). In this situation, the Hungarian government turned to international organisations to be able to finance the deficit and maturing bonds. Thanks to the foreign currency loans extended by the IMF/EU, temporary financing difficulties were resolved, but the ratio of foreign currency in public deficit rose to close to 50 per cent from 30 per cent; in other words, the exposure of public accounts to foreign currency increased significantly. It should also be noted that the maturity of Hungary's external funds shortened considerably during the crisis and the resulting heightened uncertainty, which significantly increased the country's foreign currency requirement. In other words, the foreign currency denominated loan borrowed by the state – which increased the foreign currency reserves of the central bank as well – was warranted even by reasons beyond the financeability of the government. It is also important to mention that because of the crisis and the heightened risk aversion, the maturities of the country's external funds decreased, significantly increasing the country's FX reserve requirements. Therefore, the loans extended by the international institutions were also justified beyond the financing needs of the government. Moreover, since parallel to the FX loans taken up by the state the

Chart 10
Indicators of public deficit between 1998 and 2008
(as a proportion of GDP)



Source: MNB.

Chart 11
Issuance of forint-denominated government bonds with a maturity of over one year
(monthly figures)



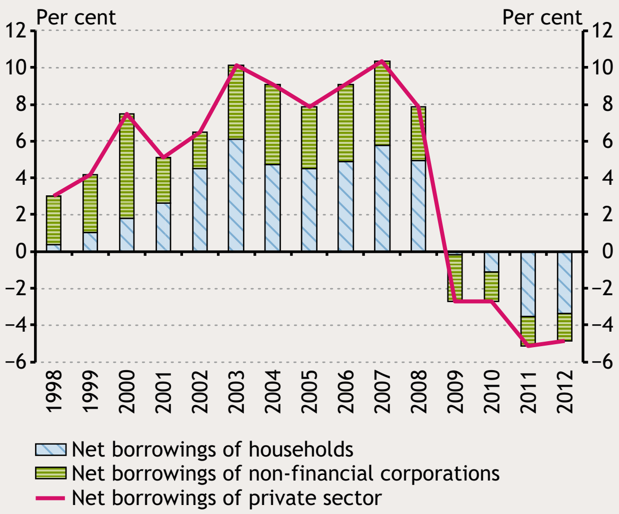
Source: MNB, ÁKK.

central bank's foreign currency reserve increased as well, at the level of public finances consolidated with the MNB, foreign currency exposure grew far less significantly than mentioned above.

Risk avoidance gave rise to a significant change in banks' behaviour as well: in contrast to the previous ample supply of loans, lending to the private sector dropped drastically. While banks extended loans to the private sector in a volume corresponding to 8–10 per cent of GDP, after the outbreak of the crisis lending decreased to such a degree that both the household and the corporate sectors became net loan repayers (Chart 12). Besides the credit supply of banks, the private sector's plunging credit demand also contributed to the decline in lending: rising unemployment, falling incomes, the spread of precautionary savings and the recognition of risks associated with foreign currency lending all may have played a role in the downturn in households' credit demand (Sóvágó, 2011).[6] In parallel with this, the decline in external and internal demand and the increased uncertainties surrounding future economic growth also undermined corporate credit demand.

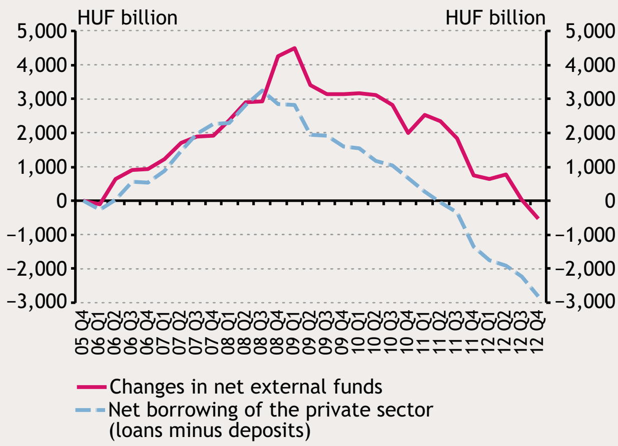
In parallel with the steep fall in lending, non-resident owners withdrew substantial amounts of funds from Hungarian banks. Up until 2008, banks financed loan disbursements in excess of deposits growth by borrowing

Chart 12
Net borrowings of the private sector
(as a proportion of GDP)



Source: MNB.

Chart 13
Changes in banks' external liabilities
(cumulated transactions)



Source: MNB.

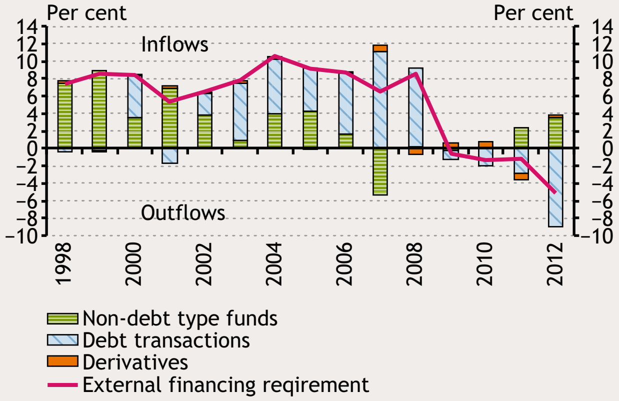
external funds (Chart 13). The outbreak of the crisis changed banks' balance sheets fundamentally. Net loan disbursement (difference between disbursements and placements of deposits), which previously required financing resources, began to decline abruptly due to the increased net savings of the private sector. In addition to the downturn in loans due to demand and supply reasons (particularly in the corporate sector), this increase in net savings can be traced back to the growing deposit portfolio. Along with these factors, banks used their extra funds mainly for the repayment of foreign liabilities.[7]

Overall, non-resident economic agents (investors, parent banks, banks) significantly reduced their financing directed to Hungary. As a consequence, the balance of payments on the financing side turned around after the outbreak of the crisis: in the net sense, no external funds reached the Hungarian economy, which also meant that the existing indebtedness was followed by a slow decline in external debt (see below).

Financing developments were also reflected in the changes in certain sectors' financial savings: due to the steep decline in lending, the net lending of the corporate and household sectors increased sharply, despite the lack of any material fiscal easing. Shrinking external and internal borrowing options led to a surge in the net financial savings (i.e. savings reduced by borrowings) of the private sector. At the same time, from the side of the real economy,

[6] Sóvágó S. (2011), "Demand and supply factors in corporate lending", *MNB Occasional Papers*, No. 94.
[7] The break in the previously observed, close covariance between changes in net loan disbursement and net external funds can be attributed to the increased MNB bill portfolio of the banking sector. This means that Chart 13 can be interpreted in such a way that, without the increase in the portfolio of the MNB bill, parent banks may have withdrawn even more funds from the Hungarian banking system.

Chart 14
Financing of the external financing requirement as a proportion of GDP



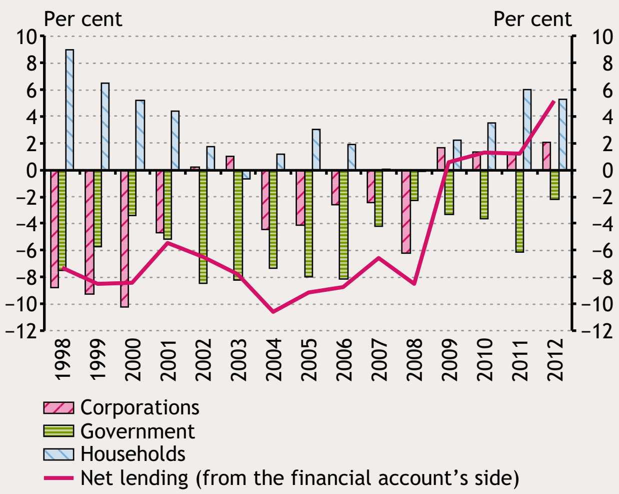
Source: MNB.

the expansion was driven by the decreased consumption and investment ratios; i.e. in reality it was the economic downturn that led to the steep increase in the private sector's financial savings. Meanwhile, except for 2011[8] which was a year largely influenced by one-off transactions, the financing requirement of the government remained moderate even after the crisis, which points to further adjustments in the context of decreased tax revenues during the recession.

Rising EU transfers also played an important role in the increase in net lending. In the new EU budget period (2007–2013) far more EU grants were allocated to Hungary than in the previous period: in 2012, the amount of EU transfers rose to 4 per cent of GDP compared to 1 per cent in 2007 (Chart 16). Therefore, the steep rise in EU transfers following the crisis can be linked to the EU budget cycles. Another important fact to note is that the growth in the net lending of the private sector can be also partly linked to the increase in EU transfers: households and non-financial corporations received substantial amounts of funds in the form of direct aid.

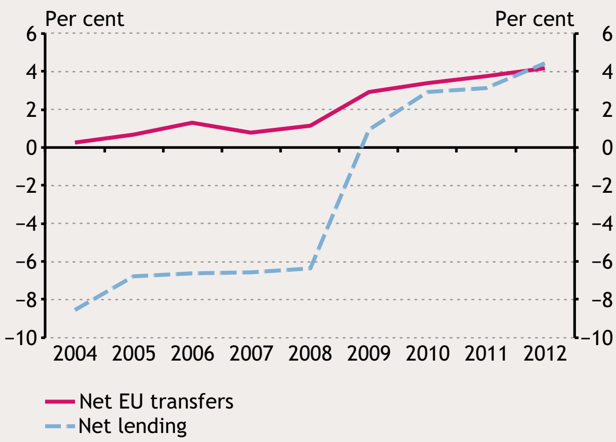
The impacts of the decline in external financing, the suspension of lending and the underlying reasons were all felt in the real economy as well: consumption and investment fell drastically and, in parallel to the financing crisis, the real economy was hit by a crisis as well (Chart 17). In the wake of the adjustments carried out since 2006, annual growth in households' consumption expenditures began to decline, but their consumption then fell sharply in the context of scarce lending due to the financing crisis, and the increased unemployment and general uncertainty triggered by the crisis. As a result of the global financial crisis, in addition to plunging external demand, internal demand dropped as well which, combined with increased uncertainty, led to a marked decline in the investment spending of corporations. The downturn in the main domestic absorption items could not be offset by the increase in the foreign trade balance resulting from the fall in imports in the context of weakening consumption and investment, and as a consequence, the Hungarian economy fell into recession.

Chart 15
Net lending of specific sectors
(as a proportion of GDP)



Source: MNB.

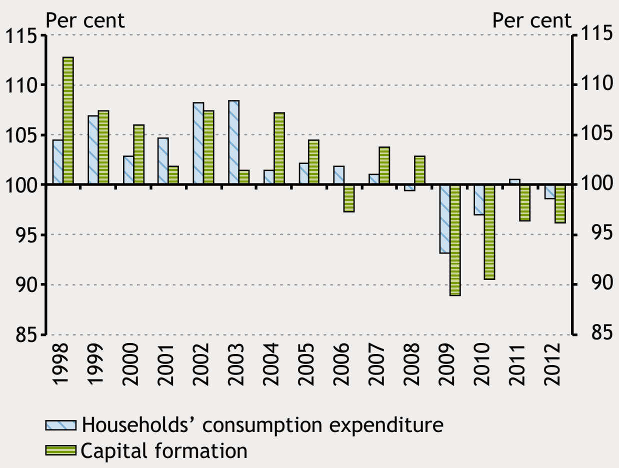
Chart 16
EU transfers and net lending
(as a proportion of GDP)



Source: MNB.

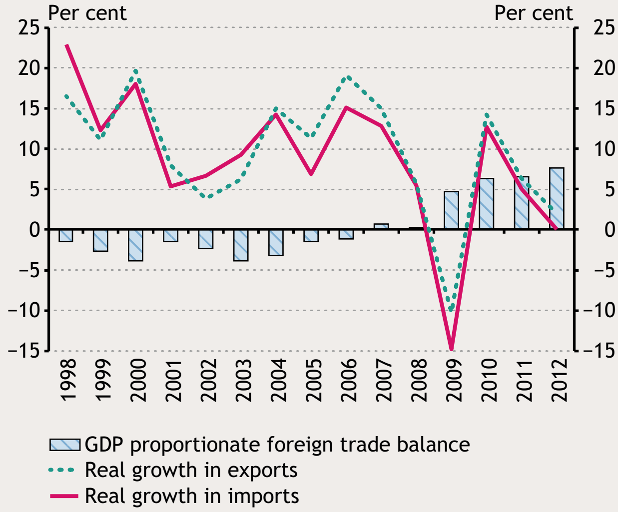
[8] The spike in the government's financing requirement in 2011 was fundamentally associated with one-off items (payment of pension fund real yields; corporate VAT refund).

Chart 17
Real growth of the main items of domestic absorption
(previous year = 100)



Source: HCSO (Hungarian Central Statistical Office).

Chart 18
Developments in foreign trade



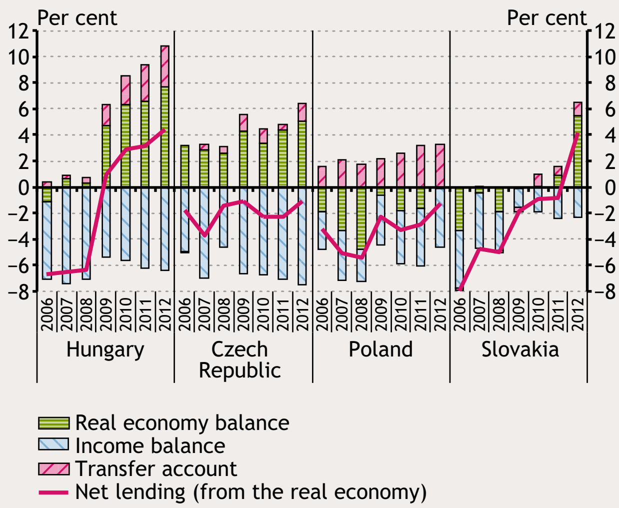
Source: HCSO.

In parallel with the developments on the financing side, there was a turnaround in Hungary's foreign trade balance and accordingly, the current account balance, as well. In conjunction with the significant decline in the main items of domestic absorption, imports decreased as well, and thus the foreign trade balance produced a significant surplus despite falling exports in the context of reduced external demand. Since 2005, real growth in exports has consistently exceeded growth in imports, but due to the significant difference between their levels, the foreign trade balance did not turn positive until 2009. The foreign trade surplus continued to grow thereafter, and by 2012 it had reached 7-8 per cent of GDP. It should be noted, however, that the expansion of trade has gradually declined in recent years and dropped to a very low level lately, which – in the context of declining external demand caused by the slowdown in global economic growth – may suggest that the Hungarian economy faces competitiveness problems as well.

Other countries in the region experienced similar trends as Hungary, but to a much lesser extent. The crisis resulted in an improvement in the foreign trade balance of the rest of the Visegrád countries as well and, in line with the new EU budget period, the EU transfers received by these countries increased, giving a boost to their net lending (Chart 19). It is an important difference, however, that – except for Slovakia's data, which suggest moderate net savings in 2011 – it was only in Hungary where external financing turned into a significant surplus after the outbreak of the crisis, while in the rest of the countries the improvement was only sufficient to moderate the previously accumulated, high deficit. It is also worth noting that the EU transfers received by Hungary, which were significantly higher than those going to the Czech Republic and Slovakia, also contributed to this result.

As uncertainties about the Hungarian economy increased, the exchange rate weakened markedly, which had a mixed impact on the external balance. On the one hand, changes in the exchange rate reinforced the adjustment process which had commenced in the current account balance and the financial account. Indeed, the weakening

Chart 19
Factors determining net lending in the region
(as a proportion of GDP)



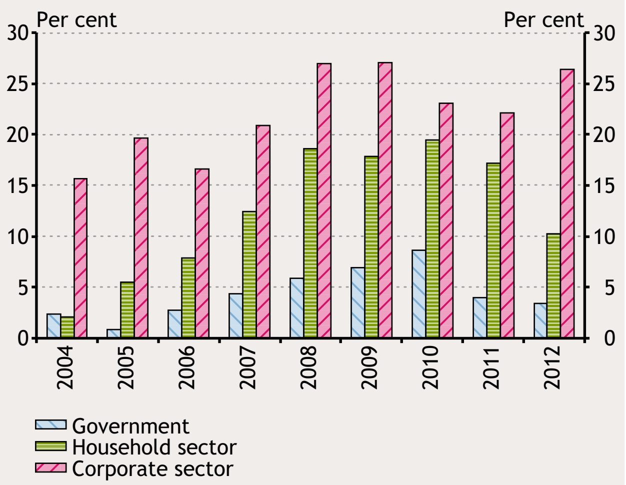
Source: MNB, Eurostat.

of the exchange rate increased the risk of the Hungarian banking system, which in turn reduced the amount of inflows and may have contributed to the growth of net exports through the improvement of export competitiveness and the continued deceleration of imports in the context of the elevated level of instalments.[9] On the other hand, the weakening of the exchange rate has negative effects due to the open FX position of specific sectors, which remains wide despite continuous loan payments. Because of households' large FX-denominated loan portfolio, the weakening of the forint exchange rate increases the interest burden and loans outstanding of households, prompting the sector to further reduce expenditures which, in turn, impairs the recovery from the crisis.

Despite the considerable net lending of the Hungarian economy, owing to the weaker exchange rate, the net external debt ratio – a key indicator of the country's vulnerability, which played an important role in the crisis which hit Hungary very severely – did not drop below pre-crisis levels until the end of 2012. Despite the financing and real economy crisis, in recent years the developments in the current account of Hungary appear to be sustainable as opposed to the deficit, which was extremely high even before the crisis and was thus deemed as being unsustainable over the long run. This notwithstanding, developments in the external balance shows that further adjustment is needed. Along with transaction data (i.e. flow indicators), investors tend to attach great significance to stock indicators, which are influenced not only by the surplus of the current account, but also by changes in the forint exchange rate. The weaker forint exchange rate restrains the decline in stocks, thereby decelerating the adjustment process commenced in the external debt ratio. And, owing to the extremely poor start, the level of Hungary's net external debt is far higher than those reported by regional countries, even despite the fact that the Hungarian data has been declining steadily for years, whereas the external debt ratio of its peers has been on the rise.

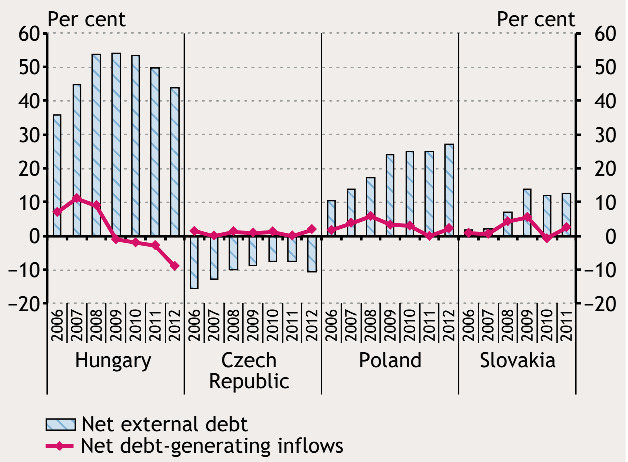
Hungary's external debt ratio is still high in international comparison which, combined with the vulnerability of the Hungarian economy, may restrain future economic growth. Although rising debts were once considered an inevitable consequence of the capital accumulation process in emerging countries prior to the crisis, after the onset of the crisis debt proved to be the greatest impediment for the economies of indebted countries. A high debt ratio implied a competitive disadvantage in and of itself. The higher the debt ratio a country had at the onset of the crisis, the more it was to have limited growth in subsequent years, and this disadvantage is likely to persist in the coming period as well (Chart 22).

Chart 20
Open FX position of certain sectors
(as a proportion of GDP)



Source: MNB.

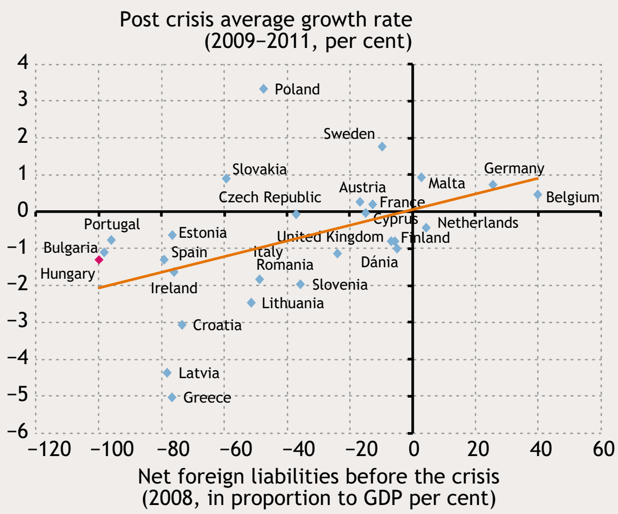
Chart 21
Net external debt of regional countries
(as a proportion of GDP)



Source: MNB, CNB, NBP, NBS.

[9] It is important to note that we only mentioned the most important effects exerted on the external balance; in reality, the balance-improving effects further impeded the recovery of the Hungarian economy from the crisis.

Chart 22
Pre-crisis net foreign position of certain countries and their post-crisis economic growth



Note: In addition to debt, net foreign claims include the balance of direct investments as well.
Source: Eurostat.

SUMMARY

Before the outbreak of the crisis, the Hungarian economy struggled with severe external imbalances: the easing of liquidity constraints gave rise to a surge in borrowing, which reduced the savings of households. This, together with the significant financing requirement of the corporate sector, kept the current account deficit at high levels. The situation was exacerbated by the fact that, partly owing to the surge in foreign currency lending, the deficit was financed predominantly from external borrowing. Due to a reliance on external funds and accelerating external debt, the crisis which started at the end of 2008 caught the Hungarian economy in a particularly vulnerable position. The credit crunch forced economic participants to carry out severe adjustments. In the context of subdued lending and increased risks, consumption and investment slumped, while savings rose. These developments –combined with higher EU transfers – generated a surplus in the current account balance; Hungary became a net saver and started to repay its external debts. Despite the favourable developments, the external indebtedness of Hungary remains extremely high, which may necessitate further adjustments in the future.