BALANCE OF PAYMENTS REPORT

30 December 2016

Changing big picture: high, but lower than expected surplus, FDI picks up, external debt below 70% of GDP

- The C/A surplus in Q3 was much lower than the preliminary data, and also fell behind the figures from the previous quarters, so we revise our forecast to 5% of GDP for 2016 from 8%. In our previous reports we suggested that the big picture regarding the external position was changing. As domestic demand and commodity prices are on the rise, the surplus could peak in 2016 and could gradually contract on higher imports from 2017. While BoP data are volatile and usually subject to large revisions, the lower than expected surplus in Q3 may suggest that this process has already started and may be faster than we expected.
- Looking ahead, we maintain that the C/A surplus will decrease by at least 1.5 percentage points both in 2017 and 2018. As EU funds will keep the capital balance in a sizeable surplus, the external financing capacity will remain around 5% of GDP. However, as external indebtedness has been normalized, we expect deleveraging to slow down so the financing capacity will rather boost the accumulation of foreign assets.

Indicators of external imbalances: the surplus is still high, but lower than expected (Chart 1). The seasonally adjusted C/A surplus moderated to 3.9% of GDP (from 6% in Q2 2016; and 3% a year ago), which fell behind the preliminary data of roughly 8%. As the previous quarters have been revised downwards, the C/A surplus could be roughly 5% of GDP in 2016 as a whole, instead of the previously expected 8%. EU fund absorption picked up – previously frozen bills have been paid – therefore the **external financing capacity** (**EFC1**, the sum of the C/A and the capital balance) stagnated around 8% of GDP. The **EFC2**[1] (EFC1 plus net errors and omissions), the **first best indicator of external imbalances in our view, stagnated just below 6% of GDP.**

As we suggested in our previous reports, the surplus will peak in 2016 and decline starting from 2017 as tight fiscal policy will be loosened, the high savings in the private sector will melt down on accelerating consumption and investment revival in real estate and market service sectors. Furthermore higher commodity prices will also increase import bills. The Q3 data look to be in line with the pick up in domestic demand, suggesting that the process of decreasing surplus has already started (Chart 2).

Capital flows: FDI balance is improving, debt repayment remained strong (Charts 3 and 4). The four-quarter cumulated total and corporate FDI inflow started to rise, reaching 2% of GDP, a level last seen before the crisis. This could be a consequence of the rise in non-EU-fund-related investments. The continuation of trend would suggest that unorthodox policies may have decreased Hungary's attractiveness toward foreign capital to a lesser extent than we had expected. Strong debt repayment went on, stagnating around 7-8% of GDP in net terms.

Indebtedness: Gross external debt without SPVs and intercompany loans (which is more FDI-like than debt) **fell further,** to EUR 78 bn (EUR -1.5 bn in a quarter and EUR -6bn a year). This means that gross external debt to GDP fell below 70% for the first time since 2005 (from 72% a quarter ago, 77% a year ago, and 113 at the peak; Chart 5). Net external debt fell to EUR 23.6 bn (from 25 a quarter ago, 32 a year ago, and 55 at the peak). Short-term debt declined to EUR 18 bn (from 20 a quarter ago, 22 a year ago, and 38 at the peak). This means that every indicator of indebtedness has normalized from the high levels that made Hungary vulnerable in crisis years (CEE countries usually have external debt of 60% of GDP). From these levels we would expect deleveraging to slow down. Recently the private sector has accumulated foreign assets instead of repaying debt. The main driver of decrease in external debt in the past quarters has been the public sector, paying back foreign debt from FX reserves under the Self Financing Programme (Chart 6). But this may also slow down, as excess reserves have already been reduced (Charts 7 and 8).

[1] We always emphasise that we consider EFC2 the first best indicator of the external position, as it includes the transfer balance and the NEO, as it is not only consistent with the evolution of external liabilities, but is also less affected by the frequent revisions between the C/A balance and the NEO (net errors and omissions) lines.

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Fixed Income Desk

András Sovány
+36 1 288 7561
SovanyA@otpbank.hu

Benedek Károly Szűts
+36 1 288 7560
SzutsB@otpbank.hu

FX Desk

András Marton
+36 1 288 7523
MartonA@otpbank.hu

József Horváth
+36 1 288 7514
Horvath.Jozsef@otpbank.hu

FX Option Desk

Gábor Réthy
+36 1 288 7524
RethyG@otpbank.hu

Máté Kelemen
+36 1 288 7525
KelemenMat@otpbank.hu

Money Market Desk

Gábor Fazekas
+36 1 288 7536
FazekasGa@otpbank.hu

Gábor Heidrich
+36 1 288 7534
HeidrichG@otpbank.hu

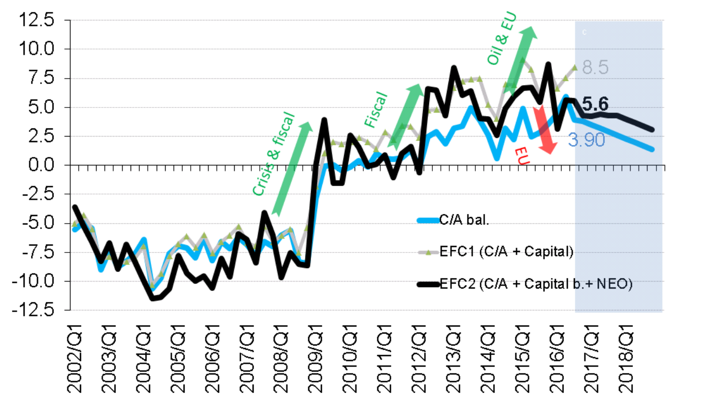
Judit Szombath
+36 1 288 7533
SzombathJ@otpbank.hu

Analyst

Gergely Tardos
+36 1 473 7273
TardosG@otpbank.hu

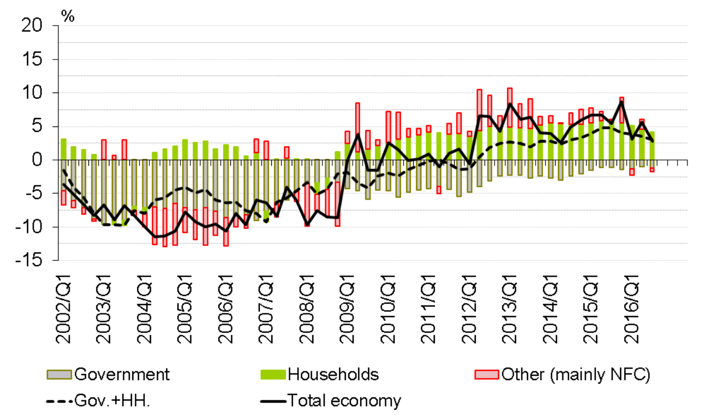
Looking ahead, we revise our forecast on C/A surplus to 5% of GDP for 2016. We maintain that it will decrease by at least 1.5 percentage points in both 2017 and 2018. As EU funds will bounce back to around 3-4% of GDP, keeping the capital balance in an equivalent surplus, the external financing capacity will exceed 5% of GDP. However as external indebtedness has been normalized, we expect the financing capacity to boost the accumulation of foreign assets, while the decrease in external debt is expected to slow down.

Chart 1: Main indicators of external balance
(as % of GDP, SA)



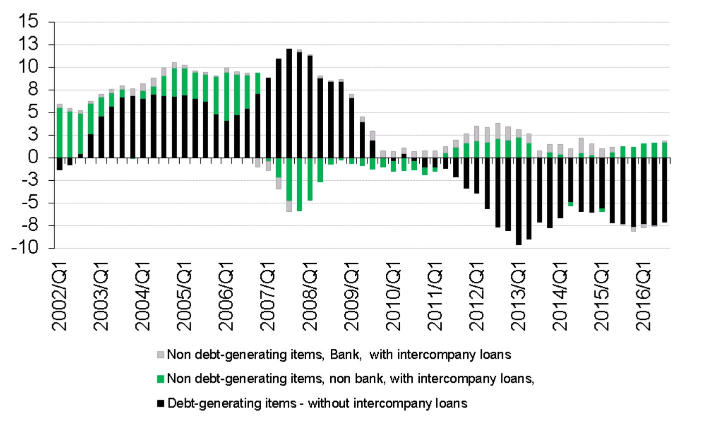
Sources: MNB, OTP Research

Chart 2: Net financing capacity of the main sectors and the whole economy (as % of GDP, SA)



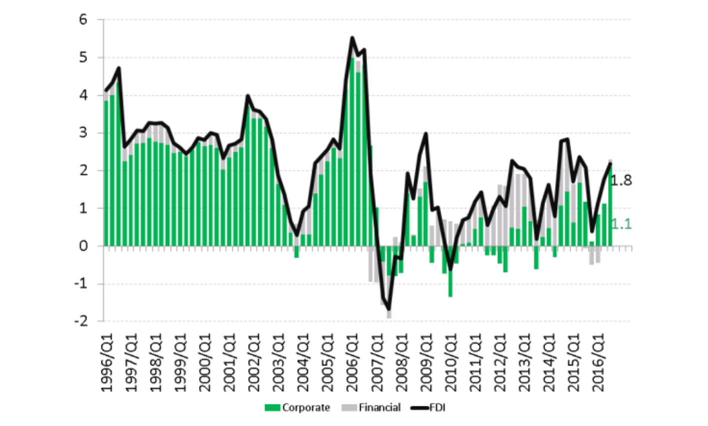
Sources: MNB, OTP Research

Chart 3: Structure of (net) capital flows
(as % of GDP, four-quarter average)



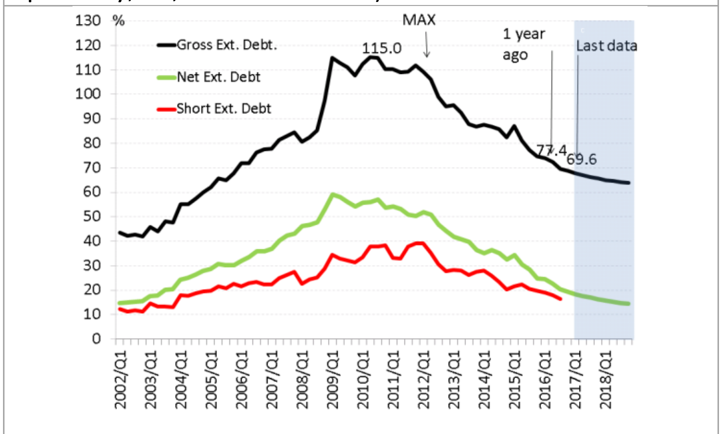
Sources: MNB, KSH (negative numbers represent outflow)

Chart 4: Net FDI inflow (as % of GDP, four-quarter average)



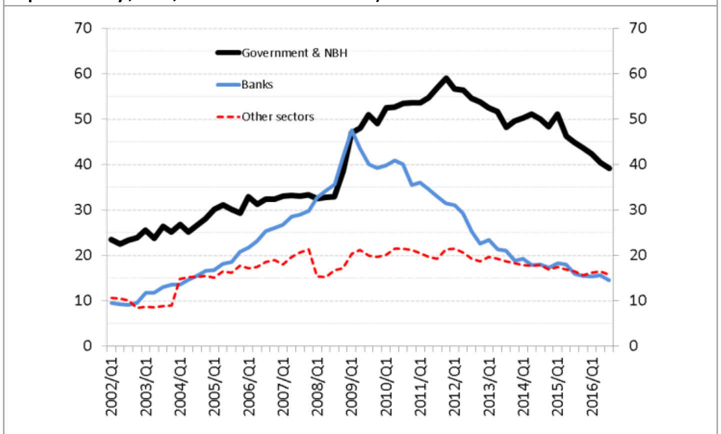
Sources: MNB, OTP Research (negative numbers represent outflow)

Chart 5: Indicators of external indebtedness (as % of quarterly, SA, annualised GDP)



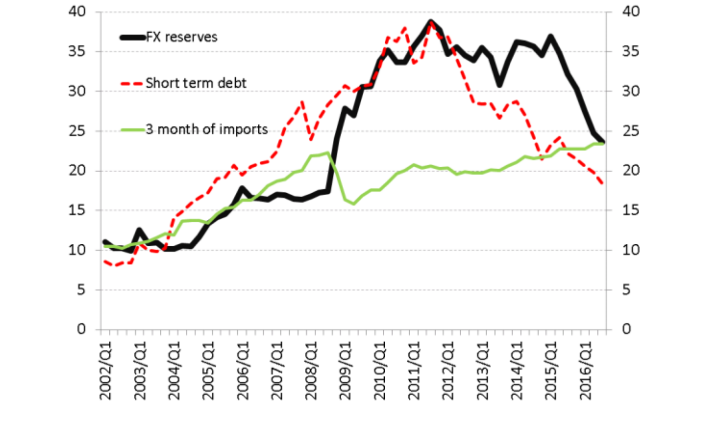
Sources: MNB, KSH (w/o intercompany debt)

Chart 6: Gross external debt by sectors (as % of quarterly, SA, annualised GDP)



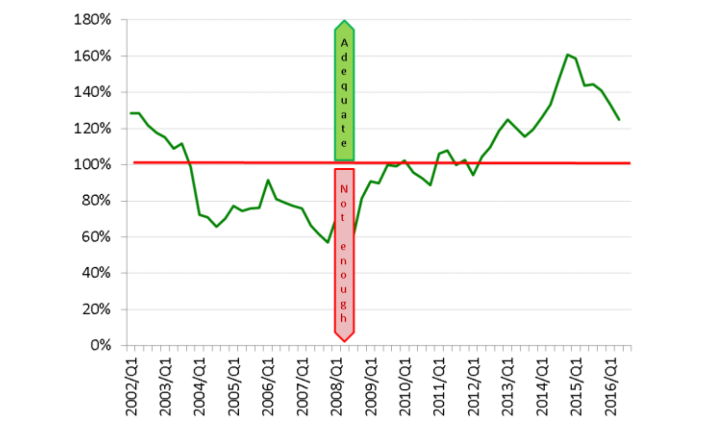
Sources: MNB, KSH (w/o intercompany debt)

Chart 7: Reserves and reserve adequacy rules (EUR bn)



Sources: MNB, OTP Research (w/o intercompany debt)

Chart 8: FX reserves / short-term debt (remaining maturity, %)



Source: MNB

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