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BALANCE OF PAYMENTS REPORT

24 June 2019

Headline C/A data returned to positive territory, but the large and widening NEO suggests further deterioration, in line with booming investment and FDI

- After the continuous deterioration in the past two years, Hungary's C/A balance improved in Q1 and returned to positive territory. However, errors and omissions widened to historic high levels, suggesting that something was mismeasured in the Balance of Payments statistics. Our experience suggests that the high NEO (net errors and omissions) results in revisions in the current account data more frequently than in the international investment position – this means that the underlying external position could be worse than the level suggested by the headline data. Macro trends – rapid pick-up in investment rate, faster-than-expected GDP growth, and weak external demand – would also support an ongoing deterioration in external balances, even if the end of the WLTP saga could lead to some short-lived improvement in Q1.
- Nevertheless, FDI and the capital balance are expected to offset the negative sum of the C/A balance and the NEO, so the external indebtedness to GDP ratio is expected to decrease further, in both gross and net terms.

Different indicators paint opposing pictures of external balance

- Hungary's C/A surplus reached EUR +330 million in Q1 (NSA), roughly half of the level seen a year earlier. It was marginally better than the preliminary figure of EUR +0.2 bn. In SA terms, the surplus was EUR +60 million (roughly 0.1% of GDP), modestly up from the deficit of the same size in the previous two quarters. The C/A balance came down from the peak of 6.2% of GDP in 2016 to just below zero by the second half of 2018.
- EFC1: after a long period of decline, Hungary's external financing capacity (the sum of the C/A and the capital balance) rose to 2.4% of GDP, up from 1.2% in Q4 and Q3, helped also by the improvement in the capital balance driven by higher EU fund absorption.
- **EFC2** (EFC1 plus net errors and omissions): After stagnating around 5% of GDP between 2012 and 2016, the indicator that we usually consider the first best indicator[1] of external balance **started to deteriorate in 2017 and fell into negative territory by 2018.** The current data show that **this deterioration went on as EFC2 reached -3.7% of GDP** in Q1**.** This was caused by the further widening NEO, which hit EUR 2 bn in Q1 and reached EUR 4 bn or 3% of GDP in the past few quarters (Chart 9).
- So the C/A data (with EFC1) has a totally different reading from the EFC2. **The current improvement in the C/A balance may suggest that the deterioration in the C/A balance of the past few years may have come to an end, around the level of zero.** However, **EFC2 has already reached a sizeable deficit and indicates ongoing deterioration.** Which story should we believe? The former one is supported by the effects of new car emission standards (WLTP) introduced last year, which resulted in lower sales and high inventories at car manufacturers, when Hungary's export growth slowed down, and corrected only in Q1 2019 once sales picked up again (inventories fell in Q1, GDP data showed). But the big picture would support the second scenario. The major process behind the deterioration of the external position in the past two years was the rise in domestic demand, especially in investment. And this trend went on in Q1. GDP growth was particularly strong, mainly because of faster-than-expected growth in investment (investment rate rose by 4 percentage points (see Chart 10)). Summing it up, the WLTP story may cause some noise in the data (deterioration in net exports in H2 2018 and some improvement in Q1 2019), but we think that this could be only short-lived. **As external demand has been weak, while domestic has been strong, we think that the underlying position deteriorated further, which could be reflected in the data that contain the NEO as well.**

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

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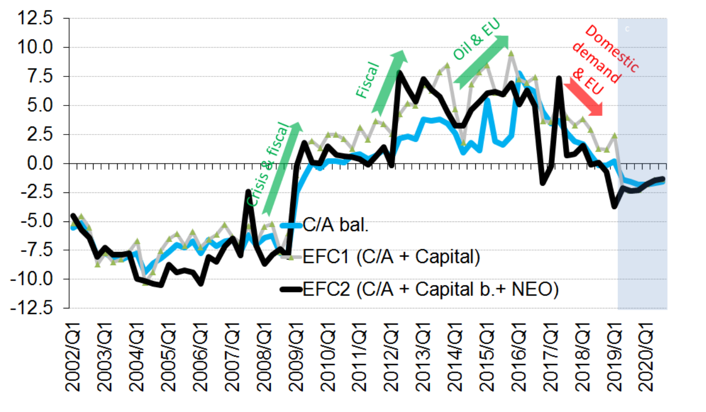
Capital flows: FDI inflow rose further, debt repayment stagnated (Charts 3 and 4). The four-quarter rolling average net FDI inflow rose to 5% of GDP, while non-financial corporate net FDI is around 4% of GDP as capacity bottlenecks in many industries and the tight labour market fuel private investment activity and FDI inflow. Net debt repayment has been stagnating around 2.5% of GDP for two years, but well below the 5-8% rates in 2015/16.

Indebtedness and reserves: still decreasing external debt ratio (Charts 5-7). In Q1, Hungary's nominal gross external debt without SPVs and intercompany loans (which is more FDI-like than debt) rose by EUR 2 bn compared to Q4 and Q1 2018, driven by higher debt at non-financial companies and the banking sector. The debt-to-GDP ratio decreased to 56.6% from 56.9% a quarter earlier, and from 59% a year before. These data are in line with those of Hungary's regional peers (Chart 7 – note that World Bank's data are marginally higher than those of the MNB). Net external debt moderated further, to less than 8% of GDP, from 8.6% in Q4 and 11% a year ago (about 60% at the peak). Short-term external debt rose to EUR 20 bn or to 14% of GDP. As EU transfers started to flow in foreign currency, reserves rose to EUR 27 bn so their level exceeds the relevant adequacy rules (the IMF or the short-term debt rule).

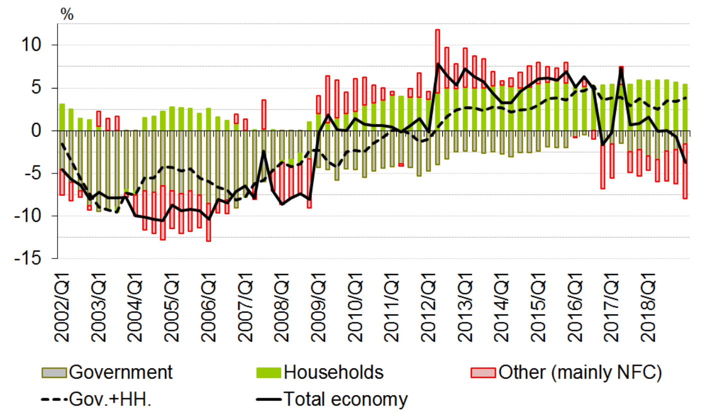
Looking ahead, we still forecast a current account deficit for 2019 (-0.5% of GDP) and 2020 (-1%) against the consensus of a modest surplus (+0.4%), which already reflects the better-than-expected data in Q1. But it should be emphasised that the high value of the NEO brings large uncertainity and the possibility of huge negative revisions in the C/A balance later. External debt is still on a decreasing trajectory, as the sum of the headline C/A balance and the NEO (we pencil in a level of -3% of GDP) is still offset by the capital balance (which should rise above +3% of GDP as more money will be transferred by the EU in the coming quarters) and net FDI, which could moderate to around 4% of GDP as the M&A (mergers and acquisitions) activity of Hungarian companies may rise. So we expect gross external debt to moderate to around 50% by the end of 2020.

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



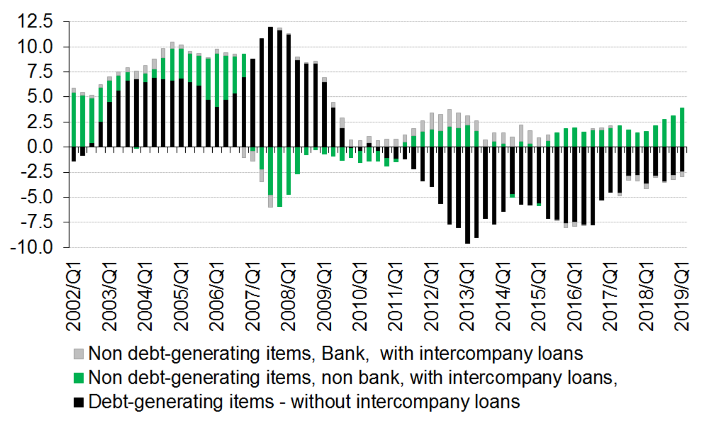
Sources: MNB, OTP Research

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



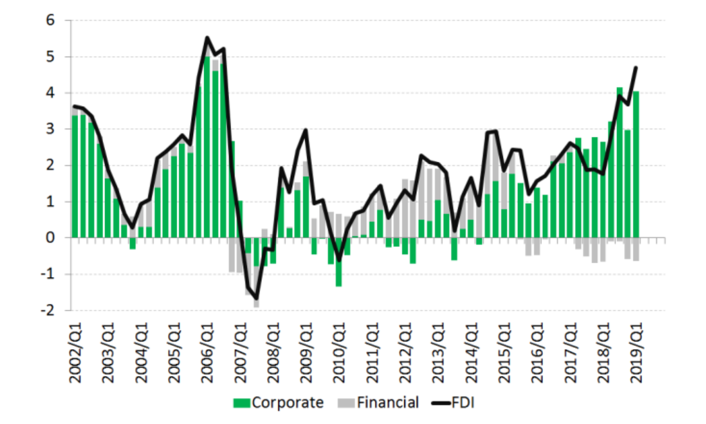
Sources: MNB, OTP Research

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



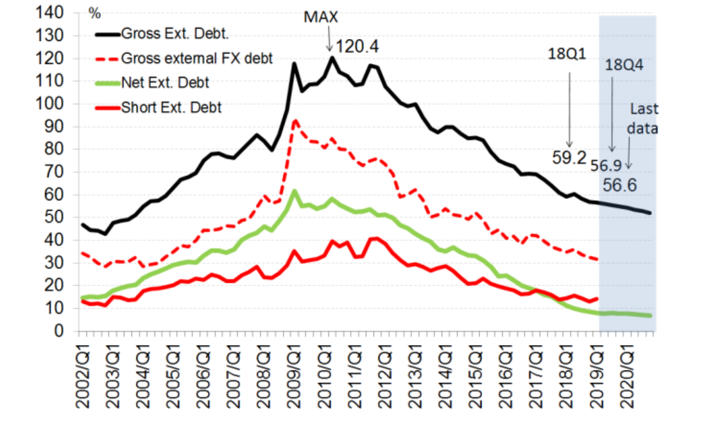
Sources: MNB, KSH (negative numbers represent outflow)

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



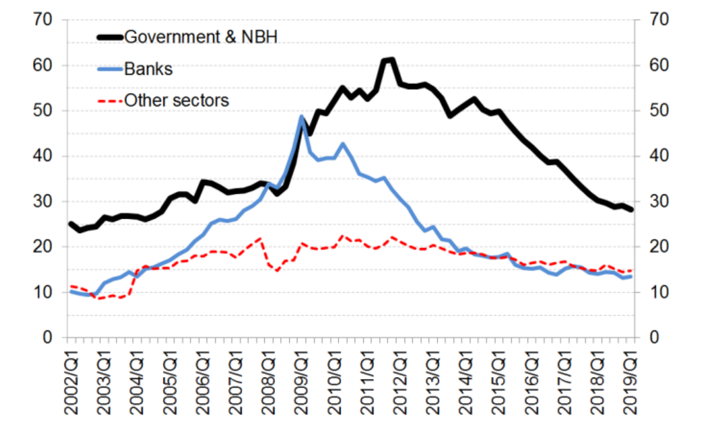
Sources: MNB, OTP Research (negative numbers represent outflow)

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



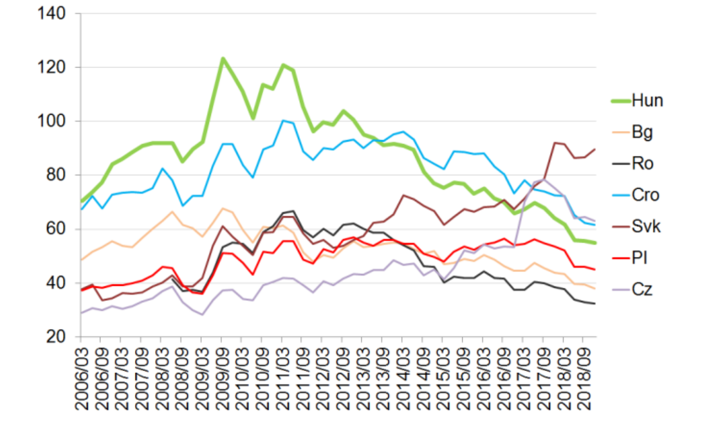
Sources: MNB, KSH (w/o intercompany debt)

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



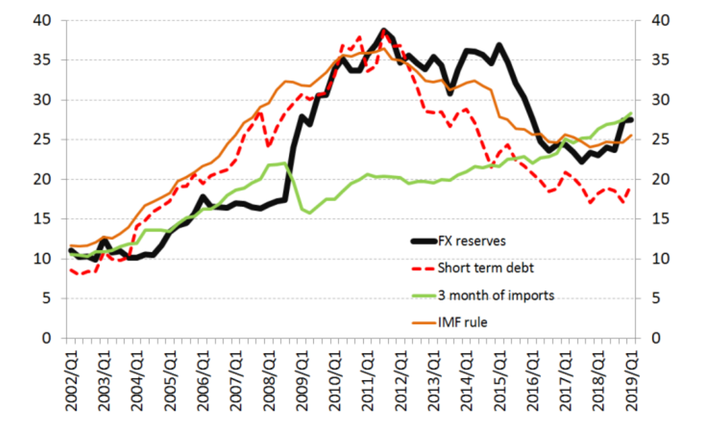
Sources: MNB, KSH (w/o intercompany debt)

Chart 7: Gross external debt (w/o intercompany debt, as % of GDP)



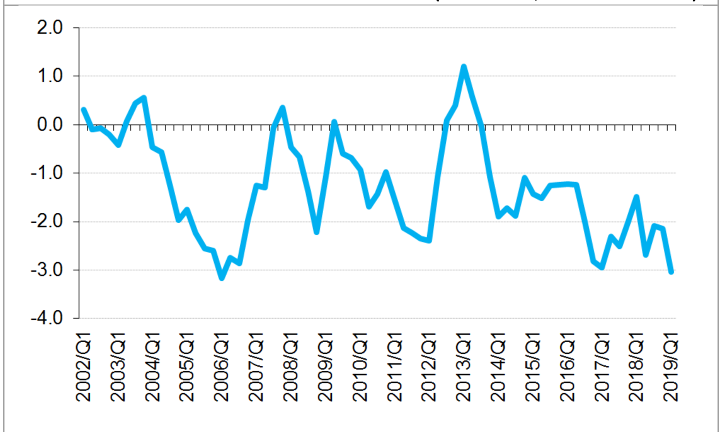
Sources: Datastream, OTP Research

Chart 8: Reserves and reserve adequacy rules (EUR bn)



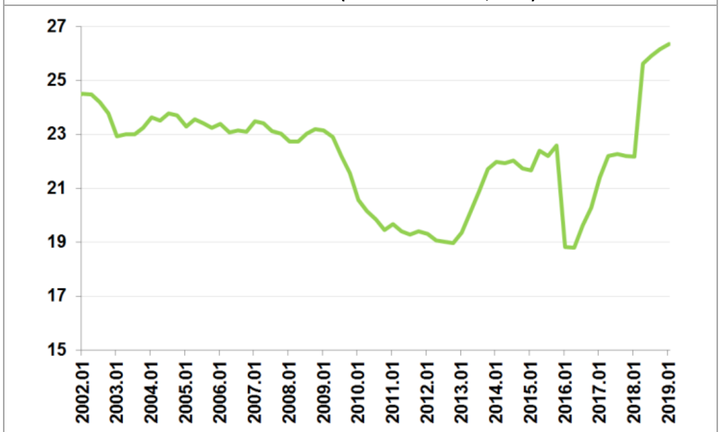
Source: MNB

Chart 9: Net errors and omissions (4Q AVG; as % of GDP)



Sources: Datastream, OTP Research

Chart 10: Investment rate (in % of GDP, SA)



Source: MNB

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This document was prepared on 24 June 2019.