BALANCE OF PAYMENTS REPORT

23 June 2022

Hungary's current account deficit exceeded 6% of GDP in Q1, external debt rose faster than expected

Due to higher energy prices, strong domestic demand, and with the semiconductor shortage being a drag on exports, the current account and the net financing capacity of the Hungarian economy worsened fast, to around -6%/-6.5% of GDP. FX reserves just reach the level that could be considered adequate because external debt, especially short-term external debt, rose fast, partly due to hopefully one-off factors, like a rising-inventories-driven increase in trade credits, and weak net FDI inflow in Q1.

We maintain our current account and net financing capacity forecast of -7% for this year, which could moderate to around 4.5% next year as fiscal policy will be tightened, borrowing will fall on higher interest rates, and we also expect energy prices and product chain disruptions to ease. We expect external debt to follow a trajectory that rises this year and then turns into stagnation in 2023, in line with smaller deficit, but risks are on the upside.

Indicators of external balance have deteriorated to around 6-6.5% of GDP (Charts 1 and 2)

- In Q1, Hungary's C/A balance came in at EUR -2.3 bn, or a seasonally adjusted EUR -2.5 bn, which amounts to 6.4% of GDP. The SA deficit widened further compared to 5% in Q4 2021 and deteriorated sharply in comparison with Q1 2021, when the balance showed a modest surplus of EUR 0.3 bn NSA, and 0.2 bn SA (0.5% of GDP). Past data have been also revised, so last year's deficit reached 3.2% of GDP. The main factor behind the deteriorating trend is higher energy prices; net energy balance worsened by nearly EUR 3 bn over a year, mainly driven by higher prices. The lasting supply-side bottlenecks that increased inventories and dragged down exports also played a role, just like the huge fiscal-spending-related consumption boom. But these factors were dwarfed by the energy price effect. These factors have been partly counterbalanced by higher service revenues and improvement in the income balance.
- **EFC1** (the sum of the C/A and the capital balances): EU fund absorption stagnated at EUR 1.8 bn in quarterly and rose by EUR 1.2 bn in annual comparison, so the EFC1 deteriorated to -2.5% of GDP in Q1 (SA), and the balance of the past four quarters sank to -1.6%.
- **EFC2** (EFC1 plus net errors and omissions): the first best indicator of external imbalances (in our view) showed a huge surplus until 2017, a balanced position until 2020, then it started to worsen fast in 2021 to -5% of GDP in Q4 2021, and to -6% in Q1 2022. This deterioration went hand in hand with the current account, as higher EU fund absorption was counterbalanced by higher net errors and omissions – which usually means more hidden imports.

Capital flows: FDI inflow low, the deficit was mainly covered by debt (Charts 3 and 4)

- In Q1 FDI inflow fell to zero (these are preliminary data, final figures will be available much later, when corporate tax returns for 2022 will be incorporated into the balance of payment statistics), while FDI outflow got stronger, so the net inflow was negative (EUR -1.5 bn) in Q1. This drove down the four-quarter net FDI inflow to a mere EUR 1 bn, or to 0.6% of GDP (from 1.7% in Q4 2021). There was also outflow in portfolio equities (EUR 1.2 bn in Q1). As the net financing requirement rose, while non-debt generating inflows moderated, external financing became even more debt-based. The net incurrence of external debt reached EUR 5 bn in Q1, and EUR 9.5 bn in the past four quarters (without intercompany debt, which we consider as a non-debt generating item).

Chief Economist

Gergely Tardos
TardosG@otpbank.hu

Institutional Sales Desk

Attila Preisz
Head of Department
+36 1 288 7526
Attila.Preisz@otpbank.hu

Zoltán Ballai
+36 1 288 7545
Zoltan.Ballai@otpbank.hu

Kitti Palásthy
+36 1 288 7574
Kitti.Palasthy@otpbank.hu

Péter Nagy
+36 1 288 7551
Peter.Nagy.4@otpbank.hu

Judit Kornis
+36 1 288 7548
Judit.Kornis@otpbank.hu

Corporate Sales Desk

János Imrei
Head of Department
+36 1 288 7544
Janos.Imrei@otpbank.hu

Nóra Ilona Gordos
+36 1 288 7549
Nora.Ilona.Gordos@otpbank.hu

Borbála André
+36 1 288 7541
Borbala.Sarolta.Andre@otpbank.hu

Edit Kovács Gyimóti
+36 1 288 7542
KovacsGyE@otpbank.hu

István Fodor
+36 1 288 7555
Istvan.Fodor.1@otpbank.hu

Rudolf Flórián Andorka
+36 1 288 7558
Rudolf.Florian.Andorka.1@otpbank.hu

Péter Huck
OTP Trader
+36 1 288 7543
Peter.Huck.2@otpbank

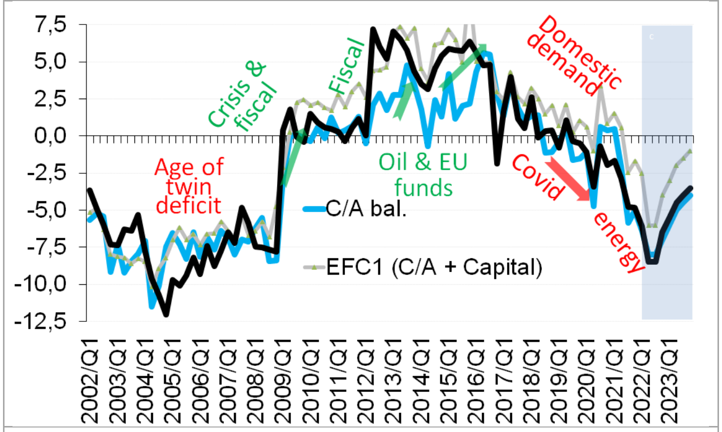
Indebtedness and FX reserves: gross external debt rose further (Charts 5-7), the level of FX reserves could be seen as just adequate

- In Q1 gross external debt[1] reached EUR 97 bn, which is consistent with an increase of EUR 5bn in a quarter and EUR 16 bn over a year, so the gross-external-debt-to-GDP ratio reached 64% of GDP. The level could be seen as average in regional comparison.
- Net external debt rose by EUR 2.5 bn in Q1, and by EUR 7 bn over the past 12 months, to EUR 19 bn or 11.5% of GDP, which is still modest.
- More worrying is that short-term external debt rose by EUR 6bn in three months, and by EUR 10 bn in 12 months, reaching EUR 33 bn, or 22% of GDP. This could be party explained by higher inventories and soaring energy prices, which cause companies to borrow more in the form of short-term trade credits (their stock rose by EUR 2 bn).
- By the end of March, Hungary's FX reserves reached EUR 37 bn, from which EUR 1 bn was related to HUF liquidity boosting FX swaps. Since then FX reserves have moderated to EUR 34 bn by May, while the volume related to swaps fell to EUR 0.3 bn. These figures mean that the level of FX reserves could be considered just adequate, as the short-term debt rule and the IMF rule (which combines external debt, monetary base, and import-related rules, and also takes into account the exchange rate regime) would suggest at least EUR 33 bn. The import rule (which considers the reserve level adequate if it covers three months of imports) would suggest EUR 37 bn, but we do not think that this rule could be used for Hungary, where most of the imports are reexported in a few months.

- In our previous BoP report in March, we argued that the temporary factors deteriorating Hungary's external position (higher energy prices and supply chain disruptions) were likely to last longer, as we expect energy (particularly natural gas and electricity) prices to remain at elevated levels, and to moderate only very gradually over the coming years. Although the fiscal adjustment programme has been announced and monetary tightening is going on, and we also expect higher tourism revenues and some improvement in product chain disruptions, these factors are unlikely to be able to fully offset the energy bill effect. **We maintain our current account balance forecast of -7% of GDP for 2022, and -4.5% for 2023, which are well above the market consensus in the Focus Economics poll (up to -4.2% for 2022 and -2.5% for 2023, from -1.9% for 2022, and -1% for 2023 in March).** We maintain that the net financing requirement could be equal to the current account deficit, as the NEO might offset EU fund absorption. Regarding financing, we would expect some improvement in net FDI inflow due to weaker M&A activity of Hungarian companies, and more inflow due to manufacturing investments like the BMW plant or battery factories. The main risks have not changed since the previous quarter: EU funds and energy prices means huge negative risks. We assume a deal with the EU this autumn, which is far from a done deal, and the lack of EU fund inflows could result in higher net financing capacity. Regarding energy prices, we assumed gas prices of EUR 100, oil at USD 110, with a 30% Brent–Urals gap. According to our calculation, under these conditions Hungary's external debt would exceed 70% of GDP by the end of 2022. However, external debt and especially short-term debt rose faster in Q1 than we had expected, which partly could be explained by temporary factors, like weak FDI inflow, and a rise in trade credit financing inventories, so debt processes should be monitored closely.

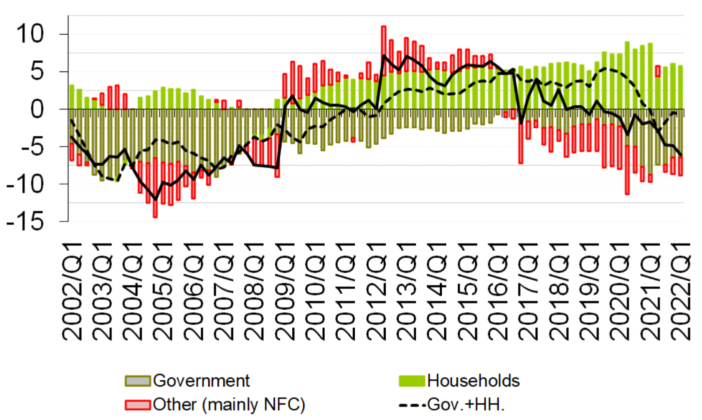
[1] We use the BoP and external debt figures without SPVs. In our view, the figures that contain special-purpose vehicles are heavily distorted by entities that do not have too much to do with the Hungarian economy. We found that data cleaned from SPVs are more consistent with the Hungarian macro trajectory, and provide more reliable information on indebtedness and vulnerability. We also filtered out intercompany loans, which we consider to be more FDI-like than debt.

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



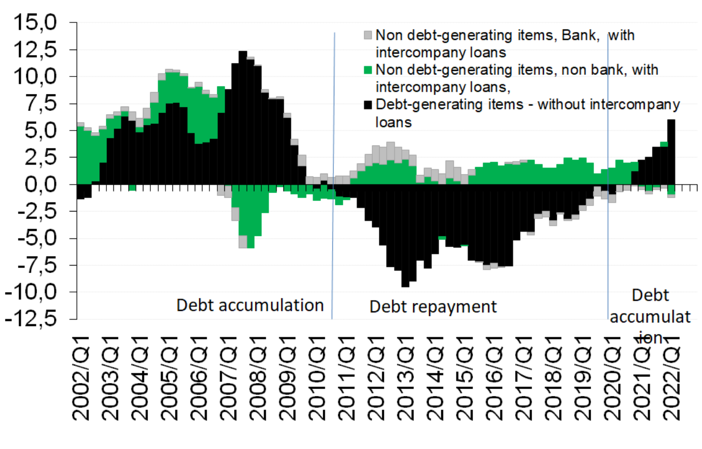
Sources: MNB, OTP Research

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



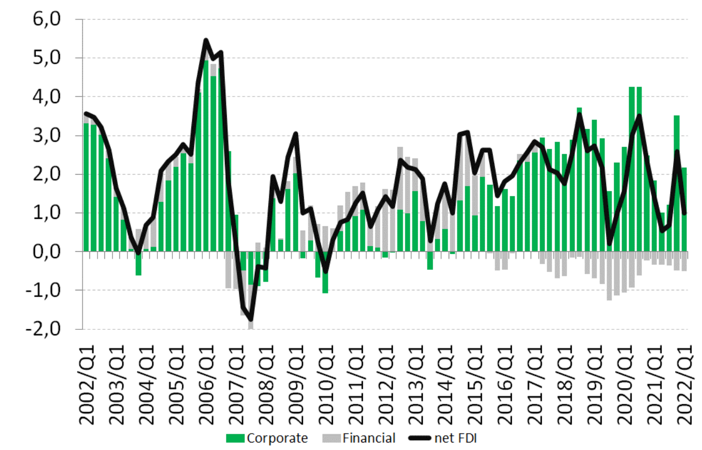
Sources: MNB, OTP Research

Chart 4: Structure of (net) capital flows
(as % of GDP, four-quarter average)



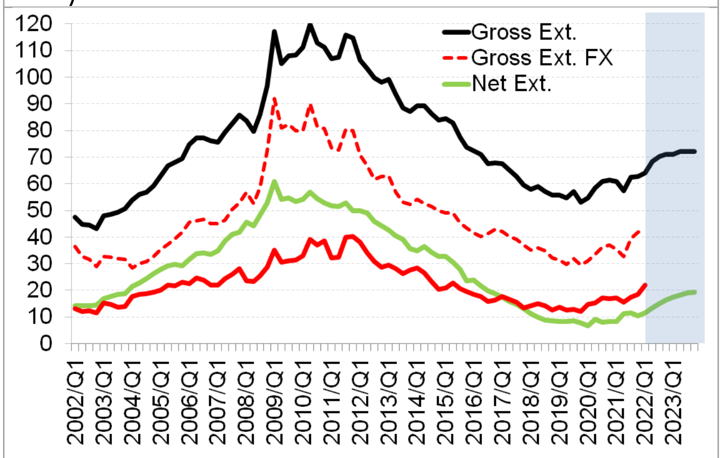
Sources: MNB, KSH (negative numbers represent outflow)

Chart 5: Net FDI inflow (4Q sum; EUR bn)



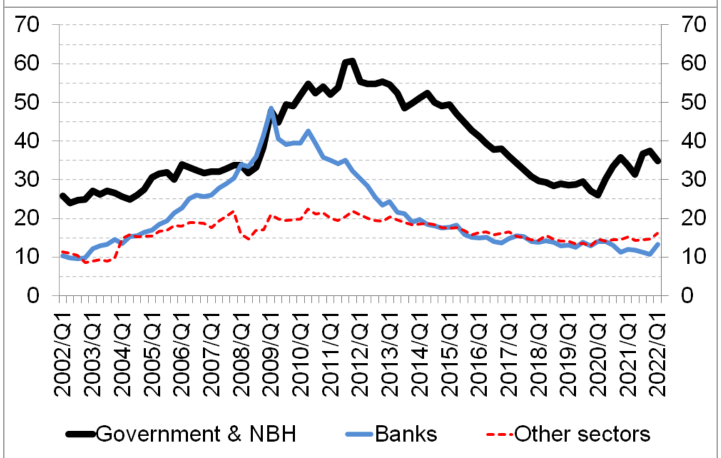
Sources: MNB, OTP Research (negative numbers represent outflow)

Chart 6: Indicators of external indebtedness (as % of GDP)



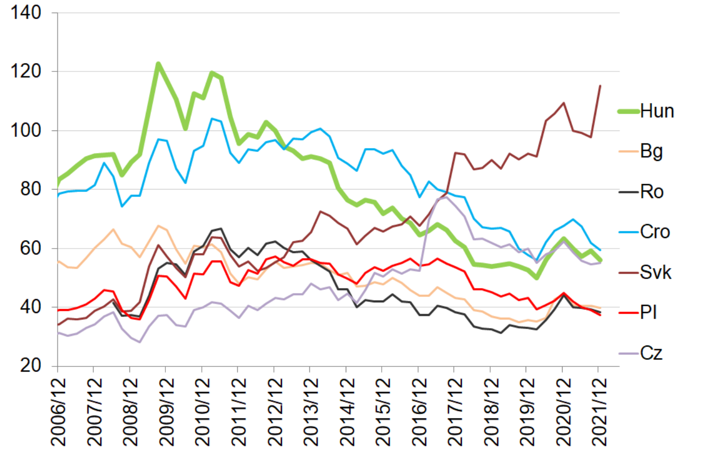
Sources: Datastream, OTP Research

Chart 6: Gross external debt by sectors (as % of GDP)



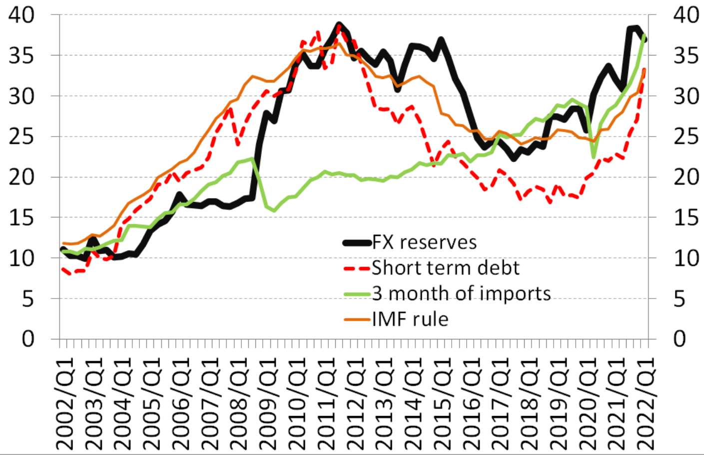
Source: MNB

Chart 8: Gross external debt (w/o intercompany debt, as % of GDP, data available till Q4 2021)



Sources: Datastream, OTP Research

Chart 9: Reserves and reserve adequacy rules (EUR bn)



Source: MNB

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