The MNB is launching the Funding for Growth Scheme (FGS)

In Hungary, outstanding corporate loans have been declining steadily since end-2008. This is an especially unfavourable phenomenon for small and medium-sized enterprises, as they are more prone to credit supply constraints, and it is more difficult for them to find alternative financing. In the current macroeconomic environment – in line the legal provisions – the MNB, in cooperation with credit institutions, is able to implement a targeted lending scheme to support sustainable economic growth without jeopardising price stability.

The primary objective of the Funding for Growth Scheme is to improve the financing conditions for small and medium-sized enterprises through preferential central bank financing, as their situation is of primary importance in terms of preserving and expanding production capacity and employment. The preferential interest rate reduces debt service costs of borrowing companies which has a positive effect both in terms of profitability and liquidity. Lower debt service burden also results in a decrease in the deterioration of the loan portfolios, and therefore may ultimately have a positive impact on banks' portfolio quality as well. In addition, the programme may also improve lending capacity through the balance sheet positions of banks.

Corporate loans outstanding (end-2012 data)

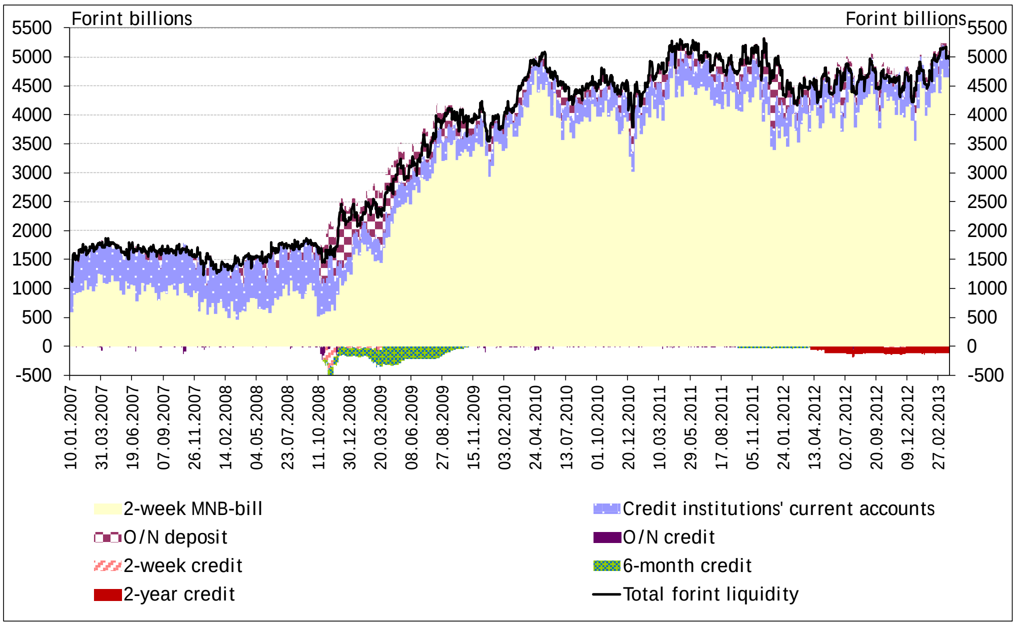
HUF billion	**Foreign currency**	**Forint**	**Total**
1. Micro and small enterprises	866.5	976.1	1842.6
2. Medium-sized enterprises	997.6	614.0	1611.6
(1+2) SMEs	1864.1	1590.1	3454.2
SMEs' currency distribution (%)	53.97	46.03	
3. Large companies	1990.9	702.1	2692.9
Large companies' currency distribution (%)	73.9	26.1	

Source: MNB.

As there are various government programmes available for tackling the problem of household lending and foreign currency mortgages, the Bank does not plan to develop any similar programme for households.

The Funding for Growth Scheme also comprises a reduction of the external vulnerability of the economy which, in turn, allows the reduction of interest expenditures. The provision of central bank refinancing at a preferential interest rate, which aims at the stimulation of lending to SMEs, increases the MNB's balance sheet as well as the two-week bills outstanding on the liabilities side, and thus the interest expenditures, currently amounting to close to 1% of GDP. The accumulation of two-week bills outstanding was mainly the result of the increase in foreign currency denominated debt within government debt and of the increase in foreign exchange reserves due to the financial vulnerability of the country, which was highlighted prior to and during the crisis. At present, two-week bills constitute the largest item on the liabilities side of the MNB's balance sheet. However, its cost – which would otherwise increase further with the cost of funds of the preferential central bank financing – can be reduced through the reduction in the country's vulnerability.

Distribution of interbank forint liquidity across forint liquidity management instruments



Source: MNB.

Preferential central bank refinancing for forint-based lending to SMEs

With the involvement of credit institutions, the MNB is initiating a Funding for Growth Scheme, under which it is going to provide a limited amount of refinancing loans with a preferential interest rate for commercial banks for a temporary period. The total amount of the programme is HUF 250 billion; the interest rate on the central bank loan is 0%.

Credit institutions wishing to participate in the programme will have to lend the central bank loan at a preferential interest rate with a fixed premium to the SMEs. According to our intentions, this premium will not be higher than 2 percentage points, so the interest rate on the corporate loan may be maximum 2%. To achieve this, recourse to guarantee programmes may become necessary. Regarding this and further details of the programme, the MNB is initiating negotiations with credit institutions.

During the negotiations the Bank will also count on the cooperation of business sector participants in formulating the adequate targets of preferential loans with the objective that the preferential loans exclusively reach those small and medium-sized debtors and in those sectors that have sound business models and that would like to grow. According to our estimates, the impact of the credit crunch varies across participants in the corporate sector. Small and medium-sized enterprises are particularly affected by credit supply constraints but, at the same time, there is no real alternative to bank financing for them. An analysis of the credit supply according to industrial sectors revealed that lending conditions had become considerably tighter even in sectors that may be of key importance in terms of potential growth. By contrast, in industrial sectors struggling with permanent sales problems, signs of forced lending are seen, i.e. companies with persistently low creditworthiness seem to be kept alive artificially. All this may justify a targeted use of the preferential loan according to sectors and company sizes.

The programme will result in an increase in the MNB's balance sheet. In the case of full utilisation, its total assets will increase by the HUF 250 billion refinancing loan, while its liabilities side will also expand with the same amount. The interest paid on the additional sterilisation holdings will constitute the MNB's direct contribution to the lending stimulus, as an interest-free loan appears on the assets side. However, this cost is offset by other part of the programme.

Commercial banks' would contribute to the programme in a way that instead of a premium corresponding to a risk level typical of an average SME, only the 2% premium – which is the starting point of the negotiations with the credit institutions – would be included in the lending rates. However, the income that is lost due to the lower premium may be offset by the improving solvency of debtors, which can be expected as a result of the interest burden far below the market level.

The MNB will not undertake any corporate credit risk with the loan programme. It will remain the banking sector's task to assess and manage this risk. Accordingly, apart from targeting smaller enterprises and perhaps including sectoral preferences as well, in the allocation of funds the programme will basically rely on commercial banks' lending decisions.

As a result of its target, size and one-off nature, the lending programme will not influence the conduct and efficiency of the interest rate policy, i.e. no 'dual interest rate' will be created. Interest rate policy will remain prudent and predictable. The targeted nature of the programme ensures that the preferential financing will stimulate business activity and will not influence the prices of financial assets. The maximum amount of the low-interest-rate refinancing that can be provided within the programme is limited: only 4% of domestic banks' total corporate loans and 7% of SME loans.

This form of stimulation of lending does not jeopardise price stability, maintenance of which is the primary objective of the MNB. In the present macroeconomic environment characterised by a sustained weak domestic demand, inflation may remain below the target over the longer term. The targeted stimulation of lending may contribute strengthening the growth potential by not allowing a reduction in production capacity. Considering that in the medium term the programme will affect potential output as well, the resulting medium-term inflationary pressure is negligible, thus in terms of the primary objective it does not have any material impact on interest rate policy.

Preferential central bank refinancing for converting SME foreign currency loans into forints

Also with the involvement of credit institutions, on a temporary basis, the MNB intends to provide a limited amount of preferential refinancing loans for the conversion of SME's outstanding foreign currency loans into forints. The total amount of the programme is HUF 250 billion; the interest rate on the central bank loan is 0%. The other conditions of the programme (size of the premium and the targeted manner) are also identical with those of the previous programme point. The maximum amount of the low-interest-rate refinancing that can be provided within the programme is limited in this case as well: it does not exceed 15% of domestic banks' total foreign currency loans to SMEs.

In addition to the difficult access to forint loans, another major problem of the SME sector is the high ratio of foreign currency loans outstanding. Nearly half of total SME loans is foreign currency denominated, amounting to HUF 1,860 billion (54% of total loans), related to 15,000 companies. Most of these loans are denominated in euro (86%), with the remaining portion being denominated in Swiss franc (14%). SMEs with Swiss franc-based loans (HUF 257 billion) presumably do not have natural or artificial hedge; therefore, these firms are exposed to a considerable exchange rate risk. The programme aiming at converting the SME foreign currency loans into forints improves the creditworthiness of the companies concerned, allowing predictable financing management for them.

In order to prevent the conversion of the foreign currency loans into forints from resulting in exchange rate volatility, the MNB is following the procedure that has already proven successful in the case of the early repayment scheme: for the currency conversion of the loans it provides foreign exchange for credit institutions from its foreign exchange reserves at market price on the condition that credit institutions undertake to use it for repaying their short-term external liabilities. As a result, the short-term foreign currency debt and foreign exchange reserves of the country decline to the same extent, i.e. Hungary’s reserve adequacy remains unchanged.

Suspension of the two-year liquidity providing loan tender

Taking account of the permanently favourable external money and capital market environment as well as banks’ persistently stable liquidity situation, the MNB is suspending the two-year secured loan tender for an indefinite period of time. In case of future money market turbulence, reactivation of this instrument will allow the effective management of liquidity shocks and ensure that a shortage of long-term liabilities would not impede corporate lending.

Reducing the vulnerability of the economy and the related interest expenditures

Together with the Government and banks, the MNB is developing a scheme, in which the reduction of the country’s short-term external debt by HUF 1,000 billion allows for bringing the foreign exchange reserves to a lower level, in line with the rules also applied before. In parallel with this, the total amount of two-week MNB bills will decline to HUF 3,600 billion, without jeopardizing the primary objective of the Bank and of financial stability. Reserve adequacy is ensured by the fact that the use of the foreign currency reserves of the MNB reduces the external debt expiring within one year to the same extent. Using nearly one-tenth of foreign exchange reserves to reduce the source of vulnerability due to which the reserves were accumulated is in full compliance with the fundamental principles of holding central bank reserves also respected by financial markets. At the same time, gross external debt of the country would also decline during the programme.