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Monetary Controversies

Results of the Central Bank's New Role Perception

Summary: External effects exerted on the focal points of the role undertaken by the central bank and the challenges posed by the current economic environment require effective responses that meet the needs of the era. Correctly prioritised economic policies in 2010 and the subsequent reinterpretation of the mission of the National Bank of Hungary, as well the abandonment of an overly passive monetary policy stance occurring in 2013, ushered in a new era of stabilisation for the national economy, with a central bank policy that achieved indisputable results through its support for the prevailing national economic policy. This study analyses the central bank's new role perception and the underlying factors and economic effects of this change.

Keywords: monetary policy, economic policy, role undertaken by the central bank, small and medium-sized enterprises, credit market, Funding for Growth Scheme
JEL codes: E52, G18, E58, E51, D53

The protracted transition to a market economy, the challenges of the accession to the European Union, the still ongoing convergence process and subsequently, the repercussions of the 2008–2009 financial and economic crisis put both the existing national economic policy and monetary policy to the test. A carefully chosen monetary policy stance and the applied monetary policy instruments are important drivers of balanced and sustainable economic development. By 2010, Hungary was faced with a financial consolidation pressure that was precipitated by the inadequate economic policy of the years following 2002 and by the consequences of the 2008 global financial crisis.

During the two decades following the fall of the Soviet regime, foreign currency lending and overconsumption were endemic throughout Hungarian society. Flawed decisions were made not only by economic and political decision-makers, but also by the population, households and corporations. These incorrect decisions can be primarily attributed to the lack of information, poor financial literacy, a lack of perspectival thinking and the resulting overstretched financial commitments and, in particular, the flawed structure of indebtedness.

The time we live in demands new solutions and this is especially true for public finance.[1] By 2010, it became clear that the failure of existing institutions to prevent chronic public overspending and the drastic rise in government debt call for a new approach, new institutions and new regulations. The role and operation of both the state and the central bank have changed. The crisis overrode the previous consensus of monetary policy.[2] Mainstream economic thinking shifted toward new focal

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points, leading to many new revelations. The main flaw of previous models was not their failure to predict the crisis, but the fact that they were founded on the presumption of an omnipotent and self-regulating market, and consequently failed to anticipate a crisis of this magnitude and duration.

Despite wide-ranging objections, government intervention[3] has become inevitable. In the context of government involvement, in reference to Adam Smith's economics, Stiglitz[4] refuted the existence of the efficient market. The established institutional system proved to be insufficient to cope with the 2007–2008 crisis, just as the market alone cannot tackle the global problems afflicting the societies of our times (inequalities, income gaps). Stiglitz holds that government intervention is necessary during the process of structural changes, and believes that economists should, first and foremost, serve the public good – an endeavour that clearly cannot be achieved through unregulated market mechanisms. Stiglitz identified a number of factors that may influence macroeconomic developments.[5] *Rajan*[6] argues that excessive government involvement and risk-taking carry systemic risks and warns that the state's guarantee gives rise to a skewed financial system. By contrast, similar to Stiglitz, *Posner's*[7] view of the state's role is entirely different. *Matolcsy* affirms the necessity of government involvement in relation to the operation of economic agents: *"it is the state's duty to arrange for the operational framework of the market economy and to remedy its flaws. Proper state regulation may help avoid episodes where too many market agents make the wrong decisions for too long".*[8] A substantial part of the market transition was accompanied by twin deficit and restrained state coordination which, coupled with the shock therapy of market economy transition, resulted in a deterioration of balance indicators comparable to that seen in the 1970s. This is aptly demonstrated by Hungary's failure to push the budget deficit below 3 per cent up until 2011 when, for the first time, it was capable of meeting the target as a result of the new policy objectives and consistent measures implemented from 2010.[9]

This paper examines the components of the value system constituting the new conceptual framework of monetary policy, analysing its macroeconomic justification based on the milestones of the transformation of the central bank's role. The author attempts to explore the focal points of monetary policy that can be identified as indispensable elements of the recovery from the crisis. The main focus of this study is the effect of non-conventional central bank instruments and the Funding for Growth Scheme on corporate lending.

RELATIONSHIP BETWEEN CENTRAL BANK INDEPENDENCE AND THE CHANGING ROLE OF THE CENTRAL BANK

The starting point of our analysis of the central bank's changing role – and the subject of this chapter – is the political transition and the subsequent evolution of the central bank, with special regard to the relationship between the central bank's independence and its changing role. Describing the role and legal status of the National Bank of Hungary (MNB) is an apt illustration of the evolution of Central and Eastern European central banks in the period between World War II and the political transition. Despite its status in the hierarchy of administrative organisations as an organisation vested with national competence, the operation of the central bank was far from being independent in this period. The National Bank of Hungary was the first central bank in Central and Eastern European countries to reinstate the two-tier banking system as of 1 January 1987. The implementation of central bank independence marked a new era in the history of central banking and the beginning of a multi-step banking reform. As a first step, various departments separated from the MNB to form individual commercial banks, which in turn enabled the MNB to become a central bank responsible for the conduct of monetary policy, although in the period of 1987–1991 the central bank was still subordinated to the government. The conditions for central bank operations in compliance with the requirements of the era were established by Act LX of 1991[10]. The primary objective of the legislation was to ensure the stability of the legal tender's purchasing power, the viability of the internal payment system, and the internal and external financial balance, sustainable development and international integration of the national economy. In this Act, the core task of the MNB was to protect the internal and external purchasing power of the legal tender. Under this legislative framework, *"the MNB shall support the implementation of the economic policy of the government using the monetary policy (and credit policy) instruments at its disposal".*[11] Under this legislation, the support to be given was not subject to any condition. Compared to the primary objective and core task stipulated by Act LX of 1991, Act LVIII of 2001 extended the scope and modified the content of both the primary objective and the core task to accommodate the requirements of a mature market economy. Consequently, the new, EU-conform Central Bank Act of 2001 specified the achievement and maintenance of price stability as the MNB's most important goal, and stipulated that the central bank will only support the government's economic policy to the extent possible without compromising this primary objective. The monetary policy instruments at the MNB's disposal were to be applied also for the purposes of maintaining the stability and enhancing the resilience of the system of financial intermediation and supporting economic growth. This Act is considered to be an important milestone in the implementation of central bank independence, as economic theories and practical considerations both confirmed that it was the only way to achieve and implement the central bank's objective efficiently.[12]

The new Central Bank Act adopted in 2013 with a view to preserving the guarantees of central bank independence (Act CXXXIX of 2013) laid down the MNB's primary objectives, basic tasks and the guarantees of institutional, organisational, personal and financial independence. Beyond classical central bank tasks, the Act introduced provisions on the MNB's operational and macroprudential tasks and responsibilities, on establishing the opportunities for effective macroprudential intervention and the possibilities for strengthening international macroprudential cooperation, and on elements related to the supervision of and control over the system of financial intermediation.[13]

The following two chapters examine, from an economic and monetary policy perspective, the decade-long period that preceded the monetary policy turnaround of 2013 and partially overlapped with the financial and economic crisis of 2008, and describes developments in the competitiveness of the national economy and the effects observed in the corporate sector. The consequences of the poor financial literacy of economic agents should be discussed before a detailed presentation of the monetary policy values implemented after the formulation of the new concept and objective hierarchy of monetary policy based on a broad range of new central bank instruments, as indeed, the enhancement of financial literacy was given an essential role among the central bank objectives.

THE PERIOD PRECEDING THE MONETARY POLICY TURNAROUND

In 2001, the monetary policy conducted by the National Bank of Hungary shifted to an inflation targeting system, and to an exchange rate band regime maintained until 2008. However, the central bank failed to stabilize inflation near the target rate. The demand for foreign currency loans was boosted by dramatically high forint interest rates. Between 2002 and 2010, debt swiftly accumulated both in the local government subsystem and at the level of households, and by 2008 the mounting debt level became unmanageable.[14] Escalating into a debt trap, over-lending caused severe economic damage, and it became clear that the lack of control over market players' activities were not conducive to achieving a lasting market equilibrium, instead resulting in the economic crisis.[15] Essentially, the 2008 crisis was a debt crisis that hit several economic regions simultaneously in a synchronised fashion.[16] The imbalances arising as a consequence of the financial and economic crisis, the economic recession and the grave liquidity problems of the corporate sector were combined with a lack of confidence, plummeting entrepreneurship and a deteriorating, pessimistic market sentiment. The lack of confidence in economic policymakers at the time encouraged the surviving and still competitive corporations to seek a quick way out. It became vital to provide swift and efficient state, government or even central bank assistance to Hungarian micro, small and medium-sized businesses. An interest rate policy[17] aimed at keeping the key policy rate above the neutral rate of interest would only have yielded results if the central bank had been also able to prevent all three economic participants from shifting to foreign currency loans from forint loans.[18] By 2010, the indebtedness of local governments (and hence, gridlocks) escalated to nearly unmanageable proportions, with grave consequences to the enterprises maintaining a business relationship with or affected by the investment and development activity of local governments, posing significant challenges to the competitiveness and survival of the enterprises concerned.

CONSEQUENCES OF THE INADEQUATE FINANCIAL LITERACY OF MICRO, SMALL AND MEDIUM-SIZED ENTERPRISES

Independent small and medium-sized enterprises in Hungarian ownership failed to use or take advantage of the market benefits offered by the accession to the EU, nor could they prepare for the challenges entailed by the accession. Instead of domestic business developments and projects, the Hungarian corporate sector was characterised by foreign direct investment inflows and the sector's share in exports remained at subdued levels. The negative impact of the process was exacerbated by the ostensibly rational vision of small and medium-sized enterprises, namely, that getting indebted in euro could not entail high-risks in view of Hungary's imminent accession to the euro area.[19] Market actors were exposed to foreign exchange risk affecting their expenditures during daily business operations without receiving regular euro-based income. Owing to poor financial literacy and financial culture,[20] Hungarian households and micro enterprises believed Swiss franc-denominated loans to be a safe solution to these issues. The absence of informative or cautionary messages from banks, combined with encouragement from political actors, and the resulting reckless household borrowing fuelled the proliferation of foreign currency loan contracts.

It has become clear that the active involvement of the state[21] is essential in improving financial literacy and developing financial culture. The main goal is to enhance the knowledge of the population about finances, public funds and the sharing of public dues and to facilitate the development of attitudes and forms of behaviour related to (public) finance.[22]

Moreover, with respect to the flawed structure of the indebtedness of micro and small enterprises, it should not be overlooked that the outstanding corporate debt of these companies has also manifested itself at the level of households: owing to the low level of financial culture, households used their private property as collateral behind their mortgage loans (for example, in the form or real estate collateral). Hungarian-owned companies implementing their projects and developments from foreign currency loans had more or less incorporated the potential risks of exchange rate movements into their business plans, but suffered severe losses nevertheless as a combined result of the 2008–2009 crisis and the ensuing economic recession. The recession of euro area countries deepened the crisis as previously built up risks materialised.

MONETARY POLICY – NEW CONCEPT AND NEW VALUES

Neither the monetary policy turnaround of 2013 nor its achievements can be comprehended without the economic policy turnaround of 2010. The series of steps taken consistently from 2013 were based on proactive and innovative central bank involvement aligned with a new set of monetary policy values. Before describing these steps and their results, however, it is important to emphasise that the monetary policy easing – which had been warranted by the inflation level in any event – was already overdue. In 2010, the central bank did not support the economic policy turnaround that culminated from 2010 with the monetary policy instruments at its disposal; instead of cutting the key policy rate, it raised the base rate to 7 per cent.

Matolcsy and *Palotai*[23] pointed out the negative economic consequences stemming from the lack of coordination between fiscal policy and monetary policy: the Hungarian economy sustained severe losses from the failure of fiscal policy and monetary policy to mutually support each other between the introduction of inflation targeting in 2001 and the monetary policy turnaround of 2013, i.e. for a period of 12 years. The period between 2010 and 2012 can be considered transitional in this regard: although fiscal policy had already been open for cooperation during these years, monetary policy did not take advantage of this opportunity at the time. It was the series of monetary policy reforms in 2013 that ultimately succeeded in establishing a system of mutual support aligned with the objectives of price stability, financial stability and sustainable fiscal policy, laying the foundations of sustainable economic growth. Analysing the criteria of fiscal and monetary policy coordination through the application of *Leeper's* model[24] and taking into consideration the experiences of economic history over the past one and a half decades, we can pin down the moment at which the possibility of achieving real harmony between the two policies opened up.

The individual branches of economic policy[25] – including monetary policy – contribute **to** improving social welfare by achieving their own objectives and by influencing economic processes. The primary objective of monetary policy is to maintain price stability,[26] as this is the most efficient way to contribute to economic growth and hence, to social welfare. At the same time – as shown above – cooperation between economic policy and monetary policy is indispensable for sustainable growth, and more developed countries have put this into practice either formally or informally. Beyond the primary central bank objectives enshrined in the Central Bank Act, the crisis brought a new sense of certainty. Accordingly, it is not enough for central banks to monitor low inflation; even low-inflation periods can witness the build-up of critical imbalances or credit market overruns that, after the bubble burst, may set back economic growth over the long run while rendering the achievement of the inflation target impossible. The situation of the euro area is a case in point.[27] It is important to perform parallel, in-depth analyses on ongoing processes in the markets of different assets. Macroprudential regulation (Act CXXXIX of 2013) appeared in central bank decision-making as a new element of the growth-oriented central bank toolset.

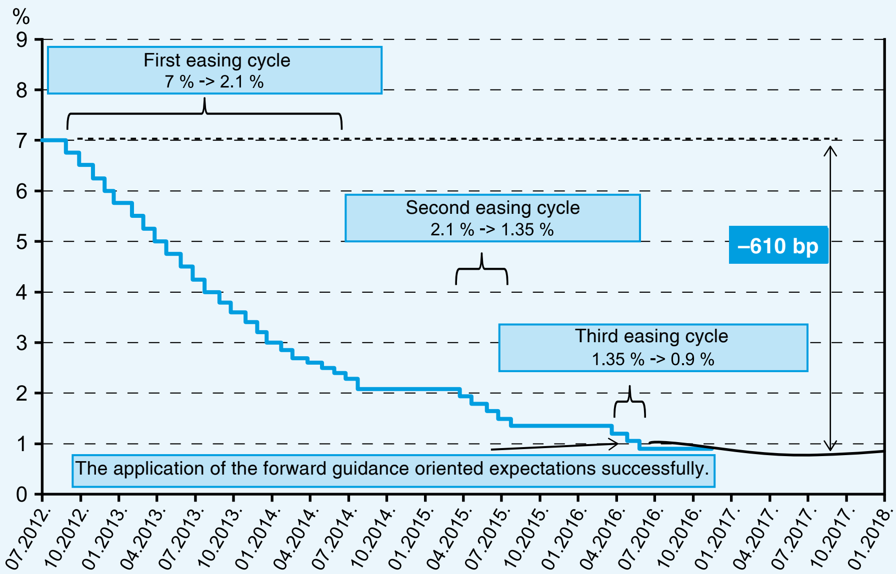
Instruments aimed at the adjustment of the key policy rate were supplemented with instruments directly influencing the activity of the financial system and risk assumption with a view to facilitating financial stability, economic growth and the monetary policy transmission.[28] As indicated by *Figure 1,* manoeuvring the key policy rate through the transmission mechanism is a signal for market participants and an important factor in shaping market expectations. With special regard to the forward-looking nature of monetary policy, the positive effects of a low interest environment (predictability, transparency, safer planning) are perceived by a broad spectrum of economic agents, and – beyond their contribution to price stability – private and business sector participants may improve the effectiveness of monetary policy through their decisions made in the present but aimed at the future. In addition to maintaining its primary objective of price stability, the central bank has set up a new framework of operational objectives, and assigned non-conventional instruments to them.[29] Accordingly, it is the central bank's objective to establish an interest environment that stimulates the real economy and, by maintaining a low policy interest rate over the long term, improves the credit supply of small and medium-sized enterprises and by encouraging investment, also increases the economy's long term growth potential. The targeted easement of credit constraints on SMEs (Funding for Growth Scheme), the Self-Financing Programme launched in spring 2014, and the renewed operation of the financial intermediation system all played a key role in the renewed monetary policy of the National Bank of Hungary (MNB).

While the purpose of the key policy instrument is to shape money market interest levels as deemed optimal by the MNB, the operative objective is to ensure that the main policy instrument has a direct effect on short-term interest rates. The flexibility of the central bank's set of objectives supported the addition of new central bank instruments to the key policy rate.

Launched with a view to reducing the vulnerability of Hungary, the Self-Financing Programme is a key element of the monetary policy toolset. In the wake of the financial and economic crisis of 2008–2009, two main priorities were defined: to mitigate the external vulnerability of Hungary and to reduce its strong dependence on external and foreign currency funding. The central bank announced its Self-Financing Programme in order to facilitate the financing of public debt from internal sources, and to reduce Hungary's reliance on external financing. The programme resulted in a simplified ("lean") central bank balance sheet and improving monetary policy transmission. It is possible to mitigate Hungary's external vulnerability by having the Government Debt Management Agency (ÁKK) use forints to refinance its maturing foreign currency debt, while also providing incentive for domestic participants to participate in the process. In this context, it is essential to have sufficient demand for the growing supply of

Figure 1

CHANGES IN THE KEY POLICY RATE AND MARKET EXPECTATIONS



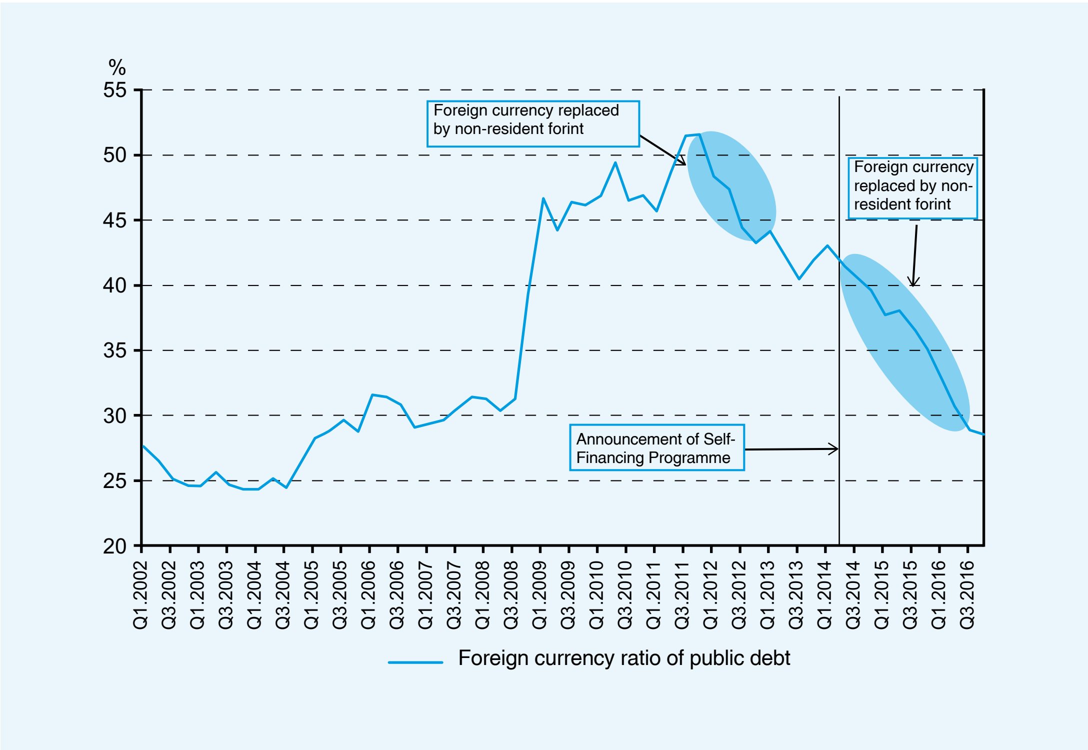
Source: MNB, 2016

forint-denominated government securities. The MNB has modified the form of the key policy instrument, switching from the former central bank bonds to central bank deposits in summer 2014. From August 2016, instead of the previous weekly frequency, the MNB accepts bank deposits via a monthly tender for the three-month key policy instrument, and from October 2016 it limits the amount of bank offers accepted on the tender. The yield reducing effect of the bank liquidity squeeze was felt in the relevant financial markets. *Figure 2* illustrates the positive change in the structure of foreign currency debt, also including the beneficial and stimulating effect of the Self-Financing Programme on the demand for government securities.

Besides the public sectors affected by the Self-Financing Programme, the reduction of foreign and foreign currency exposure also affected households. It was mainly facilitated by the phase-out of household mortgage loans and other foreign currency loans, in which the central bank played a pivotal part. The MNB provided banks with the foreign currency liquidity required for the conversion of these loans into forint loans – around EUR 10 billion – from the autumn of 2014 without impairing Hungary's reserve adequacy that plays a vital role in maintaining its stability. As a result of the conversion, unsecured foreign currency loans to households were removed from banks' balance sheets and Hungary stepped off the wrong path that led

Figure 2

DEVELOPMENT OF FOREIGN CURRENCY RATIO OF PUBLIC DEBT



Source: MNB based on ÁKK data, 2016

to the structural problems of the past one and a half decades.

After the equilibrium turnaround of 2010 and the transition to a consumption and performance oriented, turnover tax regime, in 2012 inflation stood at 5.7 per cent over the short run, followed by a moderate inflation environment as expected. From a price stability standpoint, it is important to note that a low and positive inflation level is desirable for the improvement of the economy's performance,[30] which is confirmed in practice by the effectiveness – or, as the case may be, the ineffectiveness – of monetary policy.[31] Accordingly, when inflation rises above a level compatible with price stability, economic agents suffer decreased competitiveness which, beyond a critical level, cannot be offset by an improvement in performance alone. This means that decreased competitiveness comes at a price, and will be costly for economic agents both in the short and medium term. Therefore, if price stability can be maintained, the steady state will contribute to eliminating inflation costs, which in turn improves the performance of the economy. Accordingly, enforcing the coordinating role of prices, maintaining a stable and predictable business environment, ensuring the stability of the legal tender's purchasing power and the ability to eliminate potential income redistributions have become key issues.

The next two chapters focus on the effect exerted on macroeconomic developments by the monetary policy turnaround that was intended to counteract the credit crunch and to improve banks' willingness to lend.

THE EFFECT OF THE MONETARY POLICY TURNAROUND IN THE CORPORATE SECTOR

It was the outbreak of the 2008 crisis and the possibility of the 2013 monetary policy turnaround (connected to the 2010 economic policy turnaround) that led to the recognition of monetary policy as a priority, and the instruments required for its implementation were ready to be mobilised in 2013.[32] While central banks across the EU and other international central banks did not hesitate to give an efficient response to the challenges posed by the 2008–2009 crisis, Hungary suffered a serious setback. It failed to commence the easing cycle up until August 2012, and it was not until the monetary policy turnaround in spring 2013 that the application of non-conventional central bank instruments began.

In addition to achieving price stability and financial balance, the MNB launched the Funding for Growth Scheme, aimed at stimulating the sustainable contribution of the financial intermediary system to economic growth. In a low inflation environment, monetary policy placed increased focus on the support of the government's economic policy objectives. Indeed, these objectives played a key role not only in the recovery from the crisis but also in improving the competitiveness of the national economy. The goals of promoting sustainable economic growth and increasing employment were achieved as realistic and attainable objectives. The monetary policy turnaround is also historically significant with regards to Hungary's accession into the European Union, as it contributed to lifting the excessive deficit measures imposed on Hungary upon its accession, through the prevention of central bank loss compensation, and other contributions. The Funding for Growth Scheme had a positive impact on the turnaround in growth; employment increased, there was a turnaround in investment and consumption, the level of indebtedness declined, savings increased, and the country's exposure to foreign creditors and exchange rate movements declined.

After the acute segment of the 2007–2008 financial and economic crisis levelled out, many aspects of the shift in monetary policy would already have been possible, using the same central bank instruments later applied in 2013. The central bank's existing management at that time, however, did not exercise this option. As a result of resolute steps, a new approach and previously untried instruments, the switch in the direction of monetary policy in 2013 achieved success and results. It is hard to support any opposing views with rational economic arguments as indeed, the new type of public dues adopted under the new economic policy and the newly introduced tax levies on the financial sector did not jeopardise either financial stability or price stability, while the opposing views before 2013 violated numerous direct investor interests and caused significant damages.

The monetary policy turnaround was supported by the economic stabilisation and by the substantial 2013 surplus of the current account, which made Hungary more resilient to potential changes in market sentiment, protecting the financial system by the significant surplus accumulating in the trade balance.

With the abolition of the exchange rate band, a significant limitation of the inflation target system introduced in 2001 was lifted, thus, subsequent monetary policy was only indirectly affected by changes in the exchange rate, through their effects on inflation and the real economy. While the impact of the exchange rate on inflation decreased, and the weaker exchange rate opened up new export markets, Hungarian producers were also able to improve their market position and competitiveness, investing more heavily in exports. The increased demand required the implementation of new developments. The weaker exchange rate raised inflation to a lesser degree compared to the pre-crisis period; besides stimulating exports, it affected the economy through increased employment and more dynamic growth rates, boosting market agents' willingness to invest and stimulating internal consumption even without investment.

HUNGARY'S MACROECONOMIC DEVELOPMENTS IN INTERNATIONAL COMPARISON

As opposed to the Southern euro area, Slovenia and Bulgaria, essentially, it was not the business sector that played the leading role in the process of indebtedness in Hungary. Save for a short-lived spike, the debt-to-GDP ratio of Hungarian corporations moved within the range of 20–30 per cent in the first decade following the EU accession. In this period, the banking sector fuelled households' indebtedness by encouraging foreign currency lending, which in turn impaired the growth and development of corporations. During the years following the crisis, the outstanding borrowing of the Hungarian corporate sector did not grow significantly for two reasons: because of banks' restrained credit supply in consideration of the high loan-to-deposit ratio of the banking sector and because of scarce domestic demand. The real driver of the process was the contraction in parent banks' lending capacity, which forced Hungarian subsidiary banks to retrench their Hungarian lending activity. It posed an additional problem that lending conditions deteriorated relative to the region in any event, which was clearly reflected in Hungary's high lending rates[33] compared to its peers in the region. High even by international standards, Hungary's key policy rate and lending rate levels generated an adverse business climate and strong competitive disadvantage for Hungarian micro, small and medium-sized enterprises whose sales prospects were also significantly worsened by the increasing debt stock of the public and household sectors. In the wake of the fiscal adjustments implemented as part of the austerity policy measures between 2006-2010, the sharp fall in employment and domestic demand observed in pre-crisis years as well as in the first years of the crisis resulted in deteriorating investment conditions.

CONTRACTION IN BANK LENDING AMID INCREASING CORPORATE CREDIT DEMAND

Credit crunch in Hungary

As a result of the neoliberal economic policy direction, the debt-to-GDP ratio surged in Hungary, as shown above. It exacerbated the funding risk of lending that smaller companies indebted in foreign currency were unable to generate export revenues that could have served as a basis for predictability. Bank lending to economic participants shrank drastically and the credit crunch[34] phenomenon took hold. The Hungarian economy faced a long period of credit crunch between 2009 and the first half of 2013 and the competitiveness of Hungarian corporations suffered a serious setback compared to other corporations in the region. Based on the transactions underlying the trends in lending – the difference between disbursement and redemption – the outstanding borrowing of SMEs fell by 5–7 per cent per year.[35]

The conditions of efficiency, profitability and long-term competitiveness were severely lacking in the sector of small and medium-sized enterprises. Scarce liquidity, chronic underfunding and caution manifested themselves in several dimensions. As risk appetite declined and willingness to lend diminished, suppliers' credit dried up, prompting corporations to turn to banks, even though banks' risk aversion and unwillingness to lend were even greater than warranted.[36] Foreign-owned large banks, which represent a formidable share in the Hungarian banking sector, raised their capital to cover the expected losses and the outflow of their funds did not cause liquidity problems for their Hungarian subsidiaries. It is an important feature of the Hungarian credit crunch that banks' risk acceptance fell sharply despite their adequate lending capacity and sufficient capital adequacy. It became indisputable that state intervention was needed in order to counteract the severe macroeconomic effects of the adverse developments.

The duality of the economy was exacerbated further by the fact that banks only served clients with a safe background and ample capital stock and accordingly, they were more likely to lend to large corporations. While this strengthened the competitiveness of such firms, it deprived Hungarian small and medium-sized enterprises of the chance to gain market access up until 2013.

THE ROLE OF THE FUNDING FOR GROWTH SCHEME IN THE CREDIT MARKET

Among the central bank's non-conventional instruments designed to stimulate corporate lending and improve access to credit, this chapter focuses on the effects of the Funding for Growth Scheme.

In the first phase of the Funding for Growth Scheme, the main reason for borrowing was loan redemption. However, there was also a significant volume of new loans. Smaller enterprises are capable of repaying larger loans if their monthly payments are reduced. The credit structure of companies accessing loans under the Funding for Growth Scheme became healthier not only because of the elimination of the exchange rate risk, but also because of the fixed interest rate and the long maturity. The fixed, maximum 2.5 per cent lending rate offered a sense of security with predictable monthly payments over the medium and long term horizon, which made a lasting contribution to the improvement of financial conditions. The total amount available for allocation in the first phase of the FGS (June-August 2013) was HUF 750 billion. Credit institutions concluded contracts for 93.5 per cent of this amount (HUF 701 billion) in relation to roughly 10 thousand contracts.[37] According to calculations, the first phase generated an almost 0.5 per cent increase in Hungarian GDP and besides the creation of new jobs, it also helped retain existing jobs.[38] While the FGS significantly reduced the interest burdens of SMEs, it also encouraged competition among banking sector participants, especially because of the freedom of bank switching (for around 20 per cent of all contracts, enterprises took advantage of this opportunity).

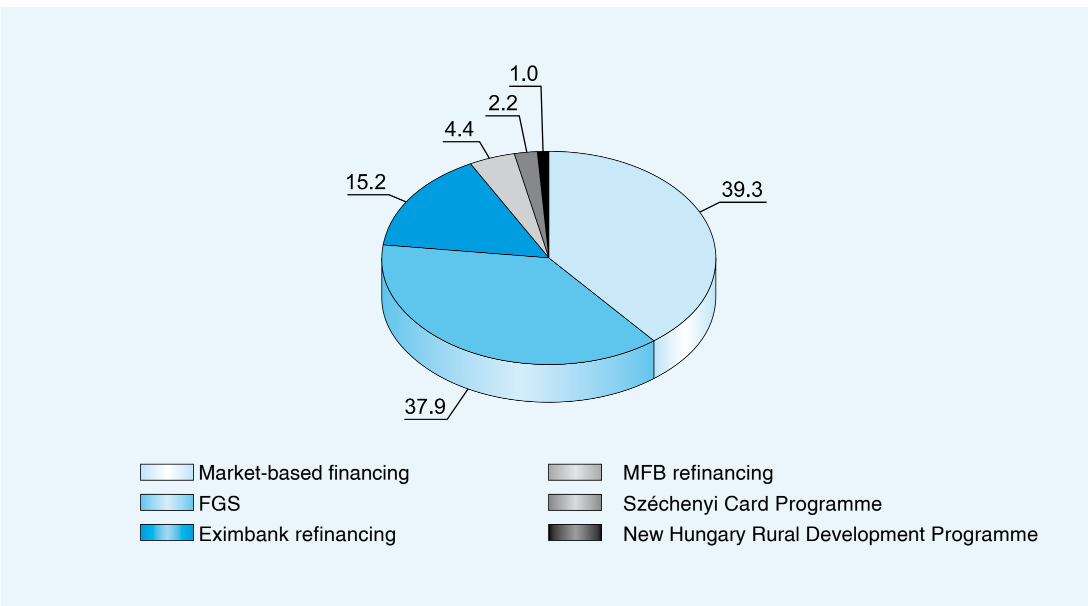
In the second phase of the FGS (between October 2013 and 31 December 2015), a total of HUF 1,402.1 billion in loans was granted to small and medium-sized enterprises, involving transactions with 26,745 enterprises. New disbursements accounted for the majority of the contracts concluded in the second phase, where 97 per cent of the contracts involved new loans, and 61 per cent investment loans. The longer contracting period and more vigorous competition resulted in the more intense participation of micro-enterprises, and half of the loans granted at this stage were below HUF 10 million.[39] In order to facilitate lending to medium-risk businesses (in parallel with the second phase), the FGS+ scheme was launched, which involved the MNB assuming partial (50 per cent) credit risk from credit institutions, while also providing refinancing.[40]

As the purpose of the FGS was to act as a temporary instrument, part of its gradual phasing-out process was introduced in the third stage of the FGS, which was initiated in 2016 (as part of the Growth Support Programme), and allowed for an increased volume of targeted funding. The exit phase concluded in March 2017, by which time the allocated HUF 700 billion was almost fully utilized. In the three phases of the FGS and within the framework of the FGS+ scheme, the banks concluded a total of about HUF 2,800 billion in credit agreements, with nearly 40 thousand enterprises benefiting from favourable financing.[41] Between 2013-2016, in addition to stimulating the economy through interest rate cuts, MNB estimates show that the FGS contributed approximately 2% to GDP growth. *Figure 3* illustrates the evolution of SME loans.

As a result of the FGS, the long-term slowdown in SME lending, experienced over several years, has not only stopped, but has in fact caused a positive trend in lending dynamics. By 2016, lending had increased to a level capable of supporting economic growth. The FGS was required to halt the long-term decreasing trend in corporate lending stock.[42] The expansion of the SME loan portfolio and the MNB's questionnaire surveys conducted in 2014[43] suggest that in the absence of the programme, a significant segment of the FGS-borrowed loans would not have been utilized by the SMEs. We can conclude that these favourable loans were not a substitute

Figure 3

DISTRIBUTION OF LOANS TO SMES (%)



Note: For the refinancing of Eximbank and MFB, the exact SME ratio is not known. As such, the given values are considered to be a theoretical maximum.

Source: own editing based on MNB data, 2016 for, but rather a supplement to market loans (mainly in the first two years of the programme; subsequently, this additionality presumably experienced a gradual decrease, as a result of the lowered interest rates on market loans). Real economic/credit market opportunities reconfirm that it is essential to stimulate market-based lending outside the FGS. To this end, the MNB launched the Market-Based Lending Scheme in early 2016, using a number of instruments to assist banks with the switch to market lending. In return, the banks were obligated to undertake to increase their SME lending. In 2016, the banks overall overperformed their lending commitments of almost nearly HUF 200 billion in total, and remained close to maintaining that total in 2017 as well.

Especially from 2010, changes in the volume of corporate loan applications pointed to micro, small and medium-sized enterprises' positive expectations, growing appetite to borrow and rising credit demand, which also provided justification for the launch of the Funding for Growth Scheme.

It should be stressed that the attitude of some company managers to borrowing was dampened by the series of economic shocks, the deepening recession and the global phenomenon of over-lending, which gave rise to extreme – even excessive – cautiousness in some cases.

SUMMARY ON THE EFFECTIVENESS OF MONETARY POLICY

Even in the absence of a monetary policy turnaround, the economic policy turnaround of 2010 played a pivotal role in the stabilisation of the economy, although its achievements and positive effects on the real economy culminated only from 2013, with the monetary policy turnaround.

25 years after the regime change, the central bank took it upon itself to take steps in the interest of Hungarian economic development and during the process, it took recourse to such unorthodox instruments that had not even been contemplated in previous debates and controversies.

The current central bank management represents successful economic policy priorities – and from 2013, a monetary philosophy and value system – that were valid even in previous decades and that have been confirmed and verified by macroeconomic developments and actual figures. The change in the instruments and the background that could be mobilised for the implementation strongly restricted the room for policy manoeuvre in previous years.

Following the easing cycle, the phase-out of foreign currency loans and the establishment of a predictable environment, the Funding for Growth Scheme and the Self-Financing Programme contributed significantly to moderating the cost of finance and Hungary's external vulnerability. The necessity of the Funding for Growth Scheme was specifically underscored by enterprises' increasingly positive expectations and confidence in the future; moreover, it was instrumental in avoiding a catastrophic credit crunch**.** The Funding for Growth Scheme succeeded in preventing the further deterioration of the adverse credit market conditions associated with banks' restrained willingness to lend and improved lending terms significantly.

After the Funding for Growth Scheme – as a programme of historical economic significance – had fulfilled its objective, the focus shifted to stimulating and restoring market-based lending, both in parallel to the programme's phase-out as well as in subsequent periods. This process was supported by the MNB's Market-Based Lending Scheme. An active banking system that allocates savings efficiently is indispensable for sustainable economic convergence and growth.

A stable, predictable and transparent monetary policy and the step-by-step implementation of the easing cycle supported the downward shift in Hungarian risk spreads and the upswing in corporate lending.

Thanks to the structural reforms, between 2010 and 2012 Hungary succeeded in catching up to its regional competitors with respect to the balance of public finance, public debt, employment and unemployment. By 2013, Hungary achieved considerable successes in economic stability, attained price stability and improved financial stability significantly. As a result, in 2016 and 2017 improving the competitiveness of the national economy may gain greater priority.

Competitiveness and effectiveness are closely related concepts that, in the context of national economic competitiveness, also mean that all economic agents – especially less informed companies, households and families – have an understanding of monetary policy objectives. Enhancing the financial literacy of these segments is the vested and mutual interest of all market participants.

Reinforcing the results and successes achieved so far is of crucial importance.

Notes

1 Domokos (2013): Központi kontroll és az államháztartási ellenőrzési rendszer megújítása Magyarországon (Public finance controls and the renewal of the supervisory system of public finance in Hungary). In: Csaba Lentner: Közpénzügyek és államháztartás (Public finance and the study of state finances), p. 17. NKTK, Budapest.

2 Kolozsi drew attention to a seemingly operative but strategic shift: while central banks focused their attention solely on managing short-term interest rates before the crisis, by now it has become a generally accepted view that other monetary policy factors may also have a bearing on macroeconomic developments, with special regard to the credit crunch and the credit rationing phenomena. Kolozsi, P. P. (2015): Útkeresés és megújulás a közgazdasági gondolkodásban (New Ways in Economic Thinking: Reflection and Renewal). Polgári Szemle, Vol. 11, Issue 1–3.

3 Németh and Kolozsi (2015): In regard to state involvement, it is essential to reinterpret the concept of efficient and effective fiscal management, which should be measured against a combination of quantitative and qualitative criteria. The golden triad of public spending is regularity, expediency and effectiveness. Taxation, Finance and Public Finance Management, pp. 153–179. NKTK, 2015.

4 Joseph Stiglitz American economist, Nobel Prize recipient and a professor at Columbia University, President of the International Economic Association.

5 This includes such positive effects on the economy as central bank models building on the combined and complementary application of microprudential and macroprudential instruments – which gained special significance in the post-crisis period – and factors restraining economic growth, such as rising income inequalities that have become an acute problem in America.

6 According to Raghuram Rajan, professor of finance at the University of Chicago, former Governor of the Reserve Bank of India, if banks were more adequately supplied with capital there would be fewer bank defaults, although prudence is a welcome result of bankers' bankruptcy avoidance. In the author's opinion, in defining the debt-to-equity ratio, striking a balance in-between may ensure the optimum efficiency of the system.

[7] In Posner's opinion, mounting debt has put an upward pressure on prices. The Fed's policy to keep interest rates close to zero drove savings toward riskier assets, and the heightened risk appetite may have fuelled the housing bubble.

[8] Matolcsy (2015a): Equilibrium and Growth, p. 41. Kairosz Kiadó.

[9] Later, the methodology of deficit calculation changed (ESA2010 instead of ESA95), with a retrospective increase in the 2011 deficit, according to the new methodology. According to ESA2010, 2012 was the first year in which the deficit fell below 3%.

[10] Repealed by Article 75 of Act LVIII of 2001.

[11] Article 3 of Act LX of 1991.

[12] Members of the MNB's bodies must be independent in carrying out their statutory duties and meeting their obligations, and may neither seek nor take instructions from the government or from any other organisation. The government may not attempt to influence the MNB in the course of the performance of its statutory duties. (Article I of Chapter I and Article 38 of Chapter III of Act LVIII of 2001).

[13] Effective from 7 July 2015, Act CXXXIX of 2013 on the Magyar Nemzeti Bank was formulated pursuant to Articles 41 and 42 of the Fundamental Law.

[14] Lentner (2015a): The Comprehensive Handbook of Foreign Currency Lending, p. 37. Nemzeti Közszolgálati és Tankönyv Kiadó, Budapest.

[15] Lentner (2015): The new Hungarian public finance system in a historical, institutional and scientific context, p. 458, Public Finance Quarterly 2015/4.

[16] Matolcsy and Palotai (2015): Growth without imbalances. The economy has embarked on a sustainable growth path. Polgári Szemle, Vol. 11, Issue 4–6.

[17] With long-run equilibrium or neutral interest rate levels, the central bank's interest rate conditions neither alleviate nor exacerbate inflationary pressure, even though in the short term, the level of interest rates that may steer the economy toward the equilibrium may persistently deviate from them. Importantly, under the equilibrium state of the economy, the interest rate will reach a neutral, equilibrium level when, on the one hand, the economy develops in line with the demand and supply capacities (the output gap is closed) and, on the other hand, inflationary pressure cannot be expected and the risk spreads correspond to their medium-term values. In such cases, monetary policy does not need to adjust the key policy rates as the central bank's inflation mandate remains on the monetary policy horizon.

[18] Matolcsy (2015b): While this could not have been prevented in the case of the state, the central bank could have significantly restricted – or put an end to – the foreign currency borrowing of the other two market participants. Equilibrium and Growth, p. 441–442. Kairosz Kiadó.

[19] The changeover to euro was partly accomplished in the economic-business community even without the replacement of the legal tender with euro. Settlements between market participants and businesses were based on the euro; amounts were expressed in euro, and certain business payments had to be aligned with the EUR exchange rate (e.g. real estate leases, cooperation with foreign business partners in Hungary). This opened the door to the possibility of gaining extra profits for a group of non-resident partners and domestic enterprises.

[20] Botos et al. (2012) (Financial literacy and risk-taking of households in the Hungarian Central Great Plain) found that households of the region lack the financial knowledge for proper risk assessment despite being conservative with respect to their finances and striving to minimise risks as much as possible. Public Finance Quarterly, 2012/3, pp. 291–309.

[21] National Bank Of Hungary (MNB), State Audit Office of Hungary (SAO), Ministry of Human Capacities (EMMI), Ministry for National Economy (NGM)

[22] Németh et al. (2106): Pénzügyi kultúra fejlesztési programok felmérése (An assessment of financial literacy development programmes), Research Report, p. 8. SAO.

[23] Matolcsy and Palotai (2016b): The interaction between fiscal and monetary policy in Hungary over the past decade and a half, pp. 5–32, Financial and Economic Review, Vol. 15, Issue 2, 5 June 2016. In their research, Matolcsy and Palotai relied on Eric Leeper's model.

[24] Leeper and Leith (2016): Understanding Inflation as a Joint Monetary-Fiscal Phenomenon. The article was prepared for the Handbook of Macroeconomics, Volume 2 (Eds: John B. Taylor and Harald Uhlig), Elsevier Press. Leeper and Leith are economists at the Indiana University and at the University of Glasgow, respectively.

[25] Branches of economic policy include, for example, monetary policy, fiscal policy, tax policy, employment policy, etc.

[26] It means the combination of persistently low inflation and anchored expectations.

[27] Interview with Barnabás Virág, Executive Director of MNB [Szajlai, Csaba: A kezdeményező szerepből a nemzeti bank nem engedhet. (The national bank should not relinquish its initiative role.) http://magyarhirlap.hu/cikk/36301/A_kezdemenyezo_szerepbol_a_nemzeti_bank_nem_engedhet (Magyar Hírlap, 26 September 2015)]

[28] During the multi-step process of monetary policy transmission, by shaping the decisions of market participants the central bank's monetary policy measures affect output and inflation developments via 5 channels: interest rate channel, exchange rate channel, asset price channel, credit channel and expectations channel.

[29] Standard forint market instruments include the key policy instrument, the minimum reserve system and instruments supporting the undisturbed operation of the interest rate corridor. These instruments were supplemented with the application of high-priority non-conventional tools.

[30] It is a central bank objective to attain – through a real economic stimulus that can be achieved in an optimal interest environment – the 3 per cent inflation level deemed desirable over the horizon of 1.5–2 years.

[31] Krugman, Paul R. (2012): End This Depression Now! pp. 208–222. W. W. Norton & Company, New York, London. Krugman stresses the importance of pursuing a non-conventional monetary policy in the Fed's case, as it may stimulate the economy in a near zero interest rate environment, supporting the 3–4 per cent inflation level from 2012 over a horizon of around 5 years or, as a second possibility, it would target a dollar-denominated GDP value with the assumption of a similar inflation rate.

[32] The possibility of mobilising the monetary policy instruments can be clearly linked to the modification of the control over the instruments in March 2013.

[33] Based on the data released by the ECB, during the years following the crisis the lending rates offered to Hungarian corporations on loans above EUR 1 million ranged between 6 per cent and 14 per cent compared to 4–8 per cent for its competitors in the region (V4 peers). As regards loans under EUR 1 million, the lending rates of Hungarian corporations amounted to 7–14 per cent compared to 4–8 per cent for the rest of the V4 countries.

[34] Also known as a credit squeeze.

[35] Fábián (2014): Az NHP megfordította a hitelszűke negatív spirálját (The FGS reversed the downward spiral of the credit crunch). MNB.

[36] For more detail about the negative consequences of the increasing prominence of neoliberal ideas, see Parragh (2014): A rendszerváltás befejezése – A siker kapujában 25 év után (Completion of the Political System's Transformation – Gateway to Success After 25 Years), Polgári Szemle, Vol. 10, Issue 3–6, p. 83.

[37] MNB (2015): Analysis of the first phase of the Funding for Growth Scheme

[38] MNB calculations

[39] Percentages based on the MNB's data disclosures (credit institution reports, data supplied by the operators of subsidised programmes), 2015.

[40] MNB (2015): The rationale behind the launch of FGS+.

[41] MNB (2017): Press release on the conclusion of the Funding for Growth Scheme (FGS) (5 April 2017)

[42] Nagy (2015): A Növekedési Hitelprogram szerepe a hitelbefagyás elkerülésében és a gazdasági növekedés élénkítésében (The role of the Funding for Growth Scheme in avoiding a credit freeze and in stimulating economic growth). Polgári Szemle, Vol. 11, Issue 1–3, p. 27.

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