

Toolkit for stimulating corporate lending

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Following the 2009 recession, a turnaround in corporate lending has not occurred in Hungary. Therefore, the risk of the phenomenon known in the literature as a creditless recovery has risen significantly. Based on empirical analyses, a creditless recovery leads to a slower and protracted economic recovery. Moreover, the escalating sovereign debt crisis in the peripheral euro area and banking regulatory responses in the EU may lead to more pronounced credit supply constraints by European banks, which could negatively affect the subsidiaries in the CEE region. The MNB staff has written numerous internal reports on the reasons behind the subdued lending and policy recommendations for reversing this trend. In this paper, we summarize the findings of this background research and review the state's possible intervention alternatives to boosting corporate lending on both the supply and demand side. We think that the most effective way of intervention is that the public sector assumes partial credit risk from the banking sector, since a contraction in corporate lending can be attributed to credit supply constraints stemming from strong risk aversion by banks, making interest rate cuts ineffective in stimulating demand for loans. At the same time, it is important to note that state interventions involve substantial fiscal costs; simple, cost-free solutions do not exist among the options. Partial credit risk assumption is not an exemption either, as it translates into government expenditures quickly due to loan losses.

Keywords: corporate lending, credit supply constraints, loan guarantee schemes, lending stimulation, state-owned development banks

1. Introduction

Following the deep recession in 2009, the Hungarian economy started to grow in 2010. This took place despite the marked year-on-year contraction of 5% and 3% in corporate and household loans outstanding, respectively, in 2010, which continued in 2011 as well. As a result, the risk of the phenomena known in the literature as a 'creditless recovery' has risen considerably in Hungary. Although the April 2011 forecast of the MNB had expected a turning point in corporate lending for the last quarter of 2011 (Chart 1), the turning point failed to come. Our earlier forecasts – which relied *inter alia* on forward-looking information received from banks – had always proven too optimistic in this respect. As a result of the latest macroeconomic developments, in the new autumn forecast the turning point was anticipated only in the second half of 2013.

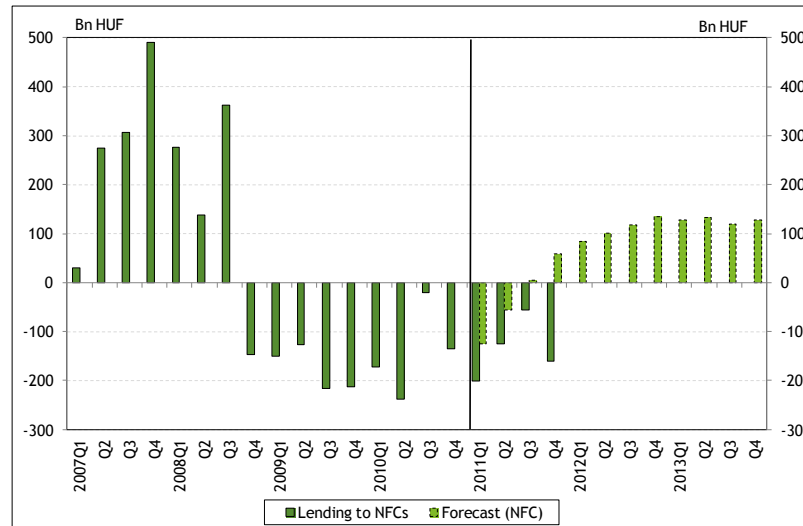
Although according to a recently published study of the IMF a creditless recovery is not unusual at all, it can be considered suboptimal compared with recoveries supported by lending (Abiad et al., 2011). The empirical data in the abovementioned study show that economic growth is slower in the case of creditless recoveries, and the convergence of GDP to the long-term potential growth rate lasts longer after the nadir of the crisis.¹

A creditless recovery is basically attributable to insufficient bank credit supply and to disruptions in the financial intermediary system. This paper is organised as follows: Chapter 2 of our analysis presents the facts pointing to credit supply constraints in the decline of corporate lending in Hungary.

¹ For more details on a creditless recovery see: MNB (2011).

Chapter 3 describes the theoretically possible government measures to stimulate lending. Finally, in the summary the argument is summarised that as supply constraints typically stem from low risk appetite, sharing the risks between banks and the state (partial assumption of risks by the state) may theoretically be the most efficient means of removing the constraints, even though it inevitably involves fiscal costs as well.

Chart 1: Net credit flow forecast of the MNB April 2011



Source: MNB data.

Note: The data includes domestic banks, foreign branches and financial enterprises. For Q4 2011 the data of financial enterprises are not yet available.

2. Supply constraints in corporate lending in Hungary

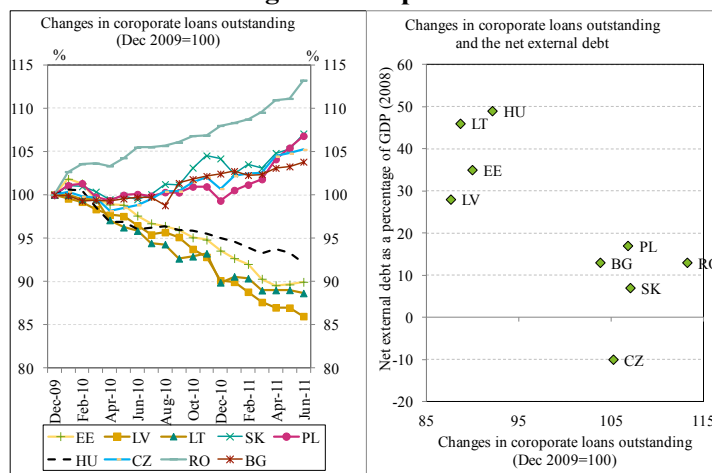
2.1. Corporate lending in a regional comparison²

The contraction in corporate lending in Hungary can be considered meaningful in a regional comparison as well. Considered both from the outbreak of the crisis (October 2008) or from the nadir of the recession (end-2009), the decline in corporate loans outstanding was only larger in the Baltic countries than in Hungary (Chart 2, left side). Although – except for Romania – corporate loan dynamics cannot be considered expressly strong in other countries either, loans outstanding have already increased since end-2009 in Poland, the Czech Republic, Bulgaria and Slovakia. Accordingly, the region can be divided into two well-separated units: where corporate lending already grew in 2010 and where it declined further sharply.

The most fundamental difference between the two groups of countries lies in the dependency on external financing (Chart 2, right side), although it is correlated to several other factors that determine banks' ability to lend (such as risk premium, loan-to-deposit ratio of banks etc.). In the Baltic countries and Hungary, deleveraging has been much greater, due to the intense narrowing of funding sources and the increase in funding costs following the onset of the crisis. All of this resulted in a shock to the willingness and ability to lend of the banking sectors, which also significantly relied on external funding due to excessive lending to households. This also points to the assumption that the regional differences observed in the dynamics of corporate lending might be related to the differences in loan supply and to differences in the willingness and ability to lend of the banking sectors concerned.

² This chapter is based on Fábíán et al. (2010).

Chart 2: Change in corporate loans outstanding (exchange-rate adjusted) and external debt in a regional comparison



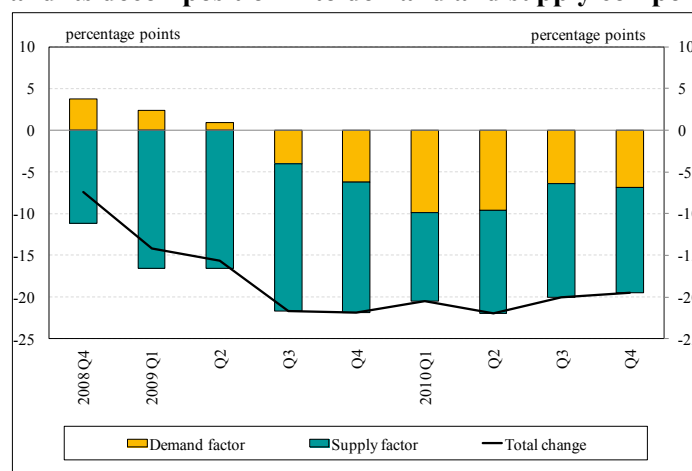
Sources: national central banks.

Note: on the left side of the chart, on the horizontal axis, the changes in corporate loans between end-2009 and June 2011 are depicted.

2.2. Decomposition of corporate lending into demand and supply factors using econometric methodology³

The econometric estimations carried out by the MNB also confirm that the fall in domestic corporate lending is mainly attributable to credit supply constraints (Sóvágó, 2011). According to the research, presented concisely in the April 2011 *Report on Financial Stability* of the MNB, 2/3 of the 20 percentage point contraction in corporate loans outstanding since the outbreak of the crisis can be explained by stricter credit supply, while 1/3 was due to the fall in demand for loans (Chart 3). The estimations suggest that the contribution of demand and supply to the contraction in lending changed over time: at the outbreak of the crisis the freezing of credit supply was the dominant factor, but as the recession unfolded, demand for loans also started to decline in 2009. Thereafter, from end-2009, simultaneously with the upturn, credit supply constraints became slightly looser, but started to strengthen again from mid-2010.

Chart 3: Changes in the annual growth rate of corporate loans outstanding compared to 2008 Q3 and its decomposition into demand and supply components



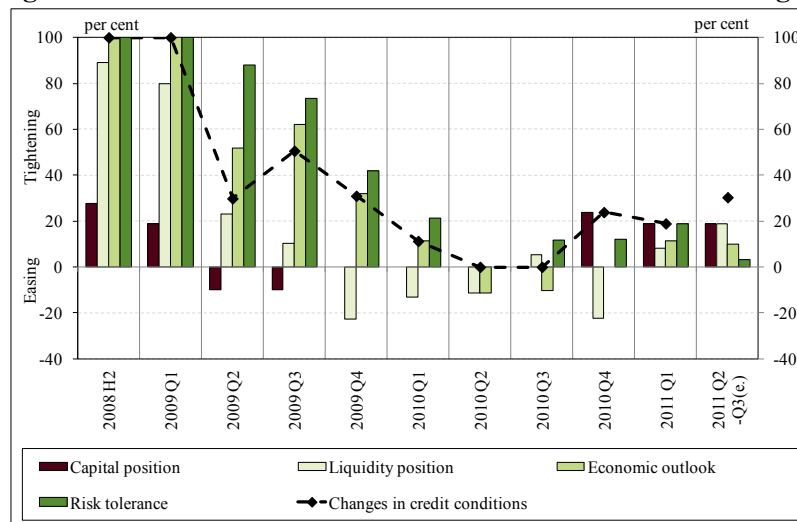
Source: MNB data.

³ This chapter is based on Sóvágó (2011).

2.3. Changes in corporate credit supply on the basis of the lending survey⁴

Essentially, the lending surveys of the MNB also showed that credit supply constraints were growing steadily in corporate lending in the previous years: since 2007, with minor interruptions, banks continuously indicated tightening in corporate credit conditions. As regards demand, starting from 2010, they perceived an increase in demand for loans (Chart 4), mainly for short-term loans.

Chart 4: Changes in banks' credit conditions and in the factors contributing to the changes



Source: MNB (2012).

In 2009, credit institutions cited liquidity, unfavourable economic prospects and low risk tolerance as the factors contributing to tightening (Chart 4). From end-2009 on, as a result of government and central bank measures as well as parent bank support, the liquidity problems had been resolved (therefore, at that time the liquidity situation would have justified easing in credit conditions). At the same time, the uncertain economic outlook and banks' low risk tolerance continued to contribute to a further tightening of credit supply. In late 2010 and early 2011, some banks reported that liquidity and capital constraints pointed to a tightening in credit conditions again, but it was more of a bank-specific problem rather than a systemic problem as in 2008 or 2009. Liquidity constraints are attributable to the tighter (or more expensive) availability of external funding, whereas the capital problems are related to the marked deterioration in the profitability, which impairs banks' internal capital accumulation and capital attraction abilities. Evaluating the period under review as a whole, it can be stated that since the outbreak of the crisis in October 2008 banks' low willingness to lend and to take risks contributed to the increase in credit supply constraints to a much greater extent than their ability to lend.

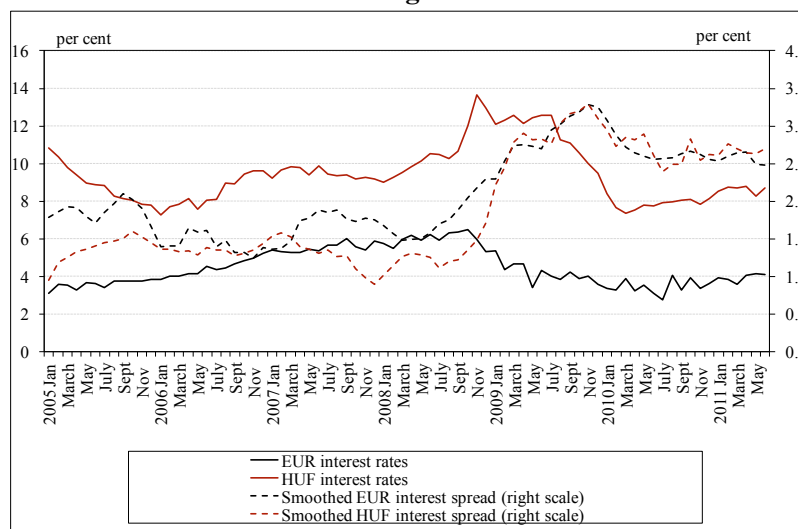
In addition to non-price credit conditions, developments in interest rates and interest rate premiums also point to the existence of credit supply constraints. Immediately after the outbreak of the crisis, due to mounting loan losses and rising external funding costs, banks added roughly 150 basis points to the interest rate spread over money market rates of the new forint and euro corporate loans (Chart 5). Starting from early 2010, premiums began to decline slightly, but they remain roughly 100 basis points above the pre-crisis levels.

In spite of the increase, the currently observed level of the interest rate premium may still be considered low, as it indicates that under the current credit conditions mainly those clients receive

⁴ This chapter is based on the lending surveys of the MNB:
http://english.mnb.hu/Kiadvanyok/hitelezesi_felmeres

loans whose creditworthiness is considered to be good, whereas the borrowing of small and medium-sized enterprises, which are considered to be riskier, is more limited. The survey of the MNB shows that banks expect an average (credit) risk premium of 100-200 basis points in the case of loans to large corporations and 400–800 basis points in the case of loans to SMEs. Of course, banks are afraid that the riskier SMEs are unable to afford such high premiums, so they adjust their non-price conditions in such a way that only more creditworthy companies have access to bank credit. Therefore, the average interest rate premium is closer to the premiums of the more creditworthy large-company clients, while riskier segments have rather limited access to credit.

Chart 5: Average lending rates and premiums on corporate loans disbursed by the domestic banking sector



Sources: MNB interest rate statistics, own calculations.

Note: The premiums were calculated with the 3-month moving average of the spreads between the current corporate loan interest rates and the 3-month interbank rate of the given foreign currency.

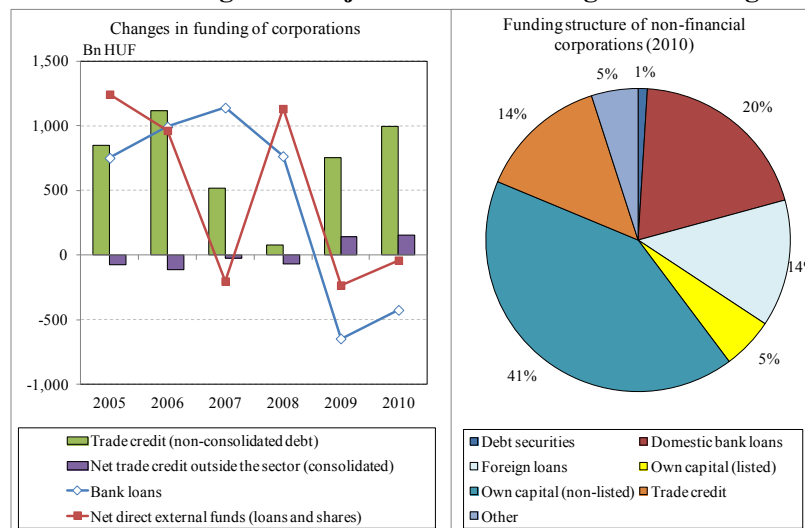
These interest rate spreads have another very important implication. If the risk premium of riskier companies is 400–800 basis points, it is easy to see that the size of the central bank policy rate has a relatively limited impact on their financing, because the risk premium itself constitutes a great portion of their borrowing rate. Accordingly, the reduction of the refinancing interest rate does not necessarily increase the scope of companies that banks might lend to (as the client interest rate still remains higher than what borrowers can afford with moderate-risk projects).

2.4. Decline in non-bank lending

The drying up of the sources of bank financing is a problem especially because for non-financial corporations it is not easy to access funds from other sources. Borrowing directly from abroad is only available for a narrower scope of large companies. The domestic corporate sector received such additional funds neither in 2009 nor in 2010: its net financing position vis-à-vis the rest of the world declined, although to a lesser extent than vis-à-vis the banking sector. However, the non-consolidated stock of trade credit increased significantly, although based on earlier years' experience this is also correlated to changes in economic activity (Chart 6). However, the increase in trade credit in 2009 during a deep recession was unusual: it could mean that by then the increase in trade receivables may have been an indicator of the scarcity of funds and not a concomitant of the expansion of economic activity, and may have indicated an increase in payment deadlines and gridlocks. In other words, companies tried to make up for the lost funding sources with their own suppliers, although this in itself

did not mitigate but may even have added to the liquidity tension. It did not bring any new funds into the system, while in the case of bankruptcies due to the increase in gridlocks, contagion risks also grow. In addition, the extension of payment deadlines and the increase in trade credit outstanding is a more difficult path to take for smaller firms which are in a weaker bargaining position; therefore, these funding sources are asymmetrical. According to the data available, among the liabilities of large corporations, the proportion of trade accounts payable is at least twice the value typical of SMEs.

Chart 6: Composition of the sources of financing of the non-financial corporate sector at end-2010 and the exchange rate-adjusted annual changes in funding sources⁵



Source: MNB, financial accounts.

3. Toolkit for stimulating corporate lending

This chapter contains a review of all theoretically reasonable means that could stimulate lending. Chart 7 provides an overview of their operating principles and mechanisms:⁶

Stimulating lending by government intervention is possible via the following mechanisms:

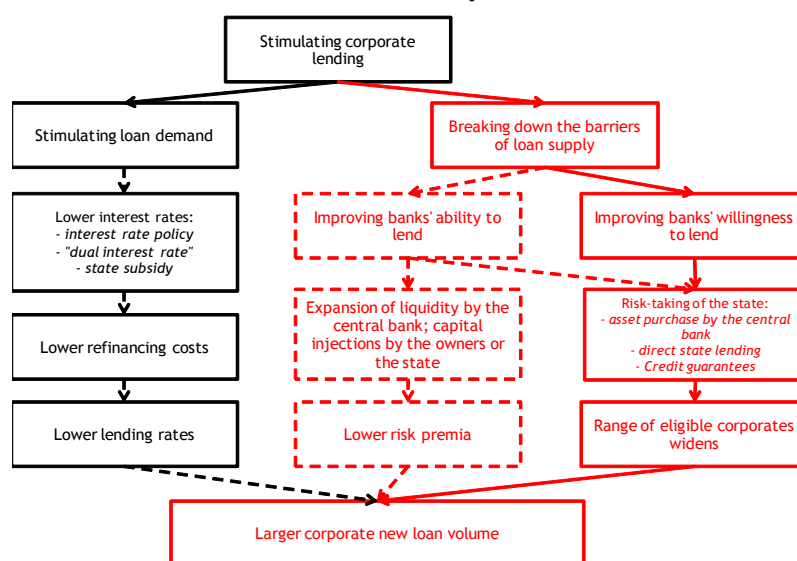
- *stimulation of demand*: recommended if demand factors dominate in the fall in lending; in this case a reduction in the refinancing interest rate and its pass-through into lending rates may help;
- *stimulation of supply*: here the primary objective is to ease credit supply constraints. Bank loan supply is determined by two factors:
 - *ability to lend*: one of the key elements of credit supply is whether the bank has sufficient liquidity and capital necessary for additional lending. If credit supply is constrained by low lending capacity, the central bank may provide liquidity (basically in domestic currency), whereas the state may provide long-term loans/capital to banks for lending (its most extreme form is bank consolidation, but the capital position is not the underlying

⁵ The change in trade credit also contains the change in trade credit vis-à-vis the rest of the world. However, in 2010 – according to the balance of payments statistics – the magnitude of its value was around HUF 130 billion, which is not meaningful compared to the increase of HUF 1,000 billion in the non-consolidated trade credit of non-financial corporations. Therefore, it can be stated that trade credit predominantly grew due to accumulated debts among domestic companies. The data regarding the stock of sources of financing are not consolidated.

⁶ This chapter relies on the paper of Balogh and Nagy (2009).

- reason for the downturn in lending and this is not addressed here). In addition, the state may take measures encouraging bank owners to increase capital;
- *willingness to lend (to take risks)*: the other important – and objectively less measurable – element of credit supply is willingness to lend, which is determined by how much risk banks are willing to take in new lending. Willingness to take risks is basically a subjective factor, which is related to the economic outlook and the deterioration in the quality of the existing portfolio. If banks' willingness to take risks is low, they will not extend loans even if their ability to lend and capacities would allow new lending (except for clientele considered to be the most creditworthy). In this case, a bank will not lend to riskier clients even with a higher interest rate, as its basic objective is exactly to avoid taking risks. If credit supply is limited by low willingness to take risks, the state can help by assuming some of the credit risks, i.e. the bank and the state share the risks.

Chart 7: Possibilities of intervention by the state to stimulate lending



Source: MNB data.

As presented in Chapter 2, the facts indicate that the downturn in corporate lending in Hungary primarily took place because of strong credit supply constraints, and within that mainly due to the low willingness to take risks (although to some extent due to deteriorating corporate creditworthiness as well). Nevertheless – for the sake of completeness – the possibilities of stimulating the demand for loans are also examined.

However, when evaluating the measures, two things must be kept in mind in all cases:

- *fiscal costs*: state interventions will have fiscal costs due to both the tools serving the artificial reduction of interest rates and the assumption of risk: immediately upon the assumption of the funding costs, and in a delayed manner when assuming the risks;
- *allocation problems*: both the means that serve the purpose of stimulating credit demand and supply entail the risk that companies that would use these funds ‘improperly’ (for example for arbitrage instead of investment) or inefficiently (not economically making losses) also receive loans. As the provider of the support (i.e. usually the state) does not have the monitoring and risk management capacities that could allow the prevention of these distortions in allocation (due to the information asymmetries between the debtor and the creditor even commercial

banks are unable to do this perfectly), these problems are inevitable. The more comprehensive and wide-ranging a given programme is, the greater the misallocation problems may be. The misallocation problem may be mitigated to some extent, although not terminated entirely, if commercial banks – with their own risk-taking – are given greater responsibility in the allocation of funds.

Bearing all of this in mind, five types of tools for stimulating corporate lending are presented below. The tools are classified according to state participants and the ways of their interventions.

3.1. Stimulating lending using monetary (central bank) tools

- *liquidity increasing (quantitative easing)*: central banks can expand the quantities and extend original maturities of central bank credit facilities, can reduce the reserve ratio, may expand the scope of securities or other instruments (corporate loans) serving as eligible collateral. These tools allow a discretionary extent of increasing the liquidity of banking sectors denominated in domestic currency. In addition, central banks may even provide liquidity for the banking sector in foreign currency to the debit of the foreign exchange reserves (for example, in the form of FX swaps or foreign exchange bank loans), although the available means are limited to the amount of the FX reserves in this regard;
- *non-traditional central bank financing of corporations with risk-taking (credit easing)*: in this case, central banks – circumventing commercial banks – directly assume the credit risk of companies and provide financing for them. This can mainly be implemented through securities purchases carried out at the money and capital markets (purchases of corporate bonds, short-term commercial paper, CPs and all other securitised corporate loans). Central banks do not finance corporations directly by lending, as this would lead back to the one-tier banking system (which, in line with EU legislation, is prohibited in Hungary by the MNB Act);
- *central bank refinancing of corporate loans at a preferential interest rate (without risk-taking)*: here central banks provide targeted refinancing with preferential interest rates for commercial banks, which use it for lending to a targeted scope of beneficiaries. In this solution, central banks do not take on corporations' credit risk directly, they only provide cheap financing for them. As a result, a 'dual interest rate level' is created, as for the scope of companies targeted in the programme (but only for them!); this step is equivalent to a reduction of the policy rate;
- *interest rate policy*: pursuing a traditional counter-cyclical interest rate policy, central banks can reduce the policy rate and in parallel with that the financing costs available in domestic currency. However, in the inflation targeting system, interest rate policy primarily serves the purpose of achieving price stability. Therefore, an interest rate policy aimed at stimulating corporate lending may conflict with this primary objective.

Following the outbreak of the crisis, it was mainly the *tools for increasing the liquidity* of the banking sector which were predominantly applied in practice in Hungary. Accordingly, in late 2008/early 2009 the MNB reduced the minimum reserve ratio, expanded the scope of eligible collateral in repo transactions (with local government bonds and the mortgage bonds of affiliated enterprises), and introduced 2-week and 6-month forint loan tenders as well as initially overnight, later 3- and 6-month FX-swap standing facilities. The latter measure was also completed with a lending incentive of administrative nature: the eligibility criterion in the 6-month swap tenders was that participating banks took on maintaining their corporate loans outstanding corresponding to the end-2008 level. Although the sanction for not meeting this condition was the exclusion from the tender, the number of participating commercial banks declined quarter by quarter. *Overall, these measures of the MNB were*

successful in strengthening the forint liquidity position of the domestic banking sector and in the prevention of foreign exchange liquidity problems, and restored the lending ability of the banking sector. The forint liquidity of domestic banks is very high at present. However, foreign exchange liquidity and the possibilities of obtaining long-term foreign-exchange funds are constrained for several banks, which was also reflected in the latest tightening of credit conditions (see also: Chart 4), the main underlying reason of which is the deepening of the debt crisis of the euro area. The MNB has very limited means to attenuate the resulting impacts, as the central bank cannot create liquidity in foreign currency (it can rely on assistance from foreign central banks at most), and the foreign exchange reserves allow the active use of these tools only in a limited manner and in very justified cases.

Theoretically, non-traditional central bank financing of corporations (through the *purchasing of corporate securities*) may have a positive effect on both credit supply (as in this case the central bank directly assumes the credit risk) and demand for loans, especially if the central bank buys corporate securities at a low yield (practically in a way corresponding to a preferential lending rate). In Hungary – similarly to countries where there is no developed capital or corporate securities market – no measure of this kind was taken during the crisis, because the size of the corporate bond market can be considered small. In Hungary, corporate bonds outstanding amounted to HUF 600 billion at the end of the third quarter of 2011, which is a mere 7.5% of all corporate loans outstanding; moreover, the scope of issuers is also limited to the largest and most creditworthy corporations. Taking into account the small company sizes, the development of the corporate bond market in Hungary is strongly limited, while another feasible way, the securitisation of SME loans is time-consuming and would entail significant additional costs. Moreover, the results of the recent mortgage bond purchasing programme of the MNB – which targeted a much higher-volume securities market – were also only limited in the field of market making.

Theoretically, the MNB could also *lend directly* to (non-financial) corporations. In line with EU legislation, however, this is not allowed by the MNB Act, and the central bank does not even have the necessary administrative staff; its setting up is costly, and therefore it would conflict with the low operating costs model of the central bank. Other state-owned banks, however, have already installed the necessary infrastructure, and the fiscal effect of lending performed by them is completely the same as if this task was performed by the MNB.

The effect of the *preferential central bank refinancing* of corporate loans – organised through commercial banks – is the same as that of the fiscal programmes described in Subchapter 3.2. Preferential lending can add to the liquidity in the banking system, but – after being circulated in the economy – the additional funds received by credit institutions are finally deposited in the form of MNB bills at the central bank. As the interest rate of MNB bills is higher than that of the preferential-interest credit scheme would be, this would result in a loss of the MNB and thus, with a delay of one year, in the central budget as well. Consequently, this solution means the same burden on the state budget as if the state itself extended loans to banks and corporations at a preferential interest rate. The only difference compared to direct interest rate subsidy provided by the state is that the interest rate spread appears in the budget only with a delay of one year. Moreover, due to the cheap credit, this tool mainly affects demand for loans, and may, at most, slightly improve banks' ability to lend, but would not help to increase willingness to take risks and to lend, which is the main problem (as in this case banks should continue to assume credit risks). In addition, it also should be emphasised that the more money is channelled into the economy at a lower interest rate by the central bank, the greater the decline in the actual, average central bank policy rate (which results from the average interest rate of preferential-interest and non-preferential-interest central bank instruments) is. To a certain extent, this

may lead to additional inflation. Therefore, (any form of) unlimited monetary financing conflicts with the price stability objective of the central bank, and is very harmful for the development of the economy over the long term.

Finally, *interest rate policy* itself may be a means of stimulating corporate lending. However, the same problem arises here as in the case of quantitative interventions: the primary objective of the interest rate policy is the achievement and maintenance of price stability; therefore, the suitability and applicability of this tool for achieving other targets are extremely limited. In addition, it is important to emphasise that an interest rate cut would only result in some increase in demand for loans, without having any material impact on supply constraints, which is the main reason for the decline in lending. In the SME sector, the reduction of the credit risk premiums may have a much greater effect than the cutting of refinancing interest rates.

Table 1: Summary of the advantages and disadvantages of the individual types of measures

	Advantages	Disadvantages
- General liquidity increasing ('quantitative easing')	practically, it has already been implemented, and further easing does not help, as the forint liquidity of the banking sector is high anyway; in the case of foreign exchange, it mitigates the lending constraints related to foreign exchange liquidity	it does not mitigate the constraints of risk-taking; in the case of foreign exchange it reduces the foreign exchange reserves, and increases the external vulnerability of the country
- Assumption of corporate credit risk by the central bank ('credit easing')	it mitigates the constraints of risk-taking; bypasses the banking sector	it works successfully only in a developed capital market and with developed securitisation; equivalent to fiscal risk-taking
- 'dual interest rate level': targeted and preferential central bank refinancing of corporate loans (without risk-taking)	its effect is similar to that of an interest rate cut, it reduces credit costs, and may add to credit demand	equivalent to state interest rate subsidy, but the technical settlement is more costly; lack of international examples, it does not mitigate the constraints of risk-taking; it conflicts with the primary, price-stability objective of the central bank
- policy rate reduction	it may reduce refinancing costs	it conflicts with the primary, price-stability objective of the central bank; unsuitable for solving the constraints of risk-taking

Source: authors' own construction.

3.2. Stimulating lending by fiscal subsidy (without assuming bank credit risks)

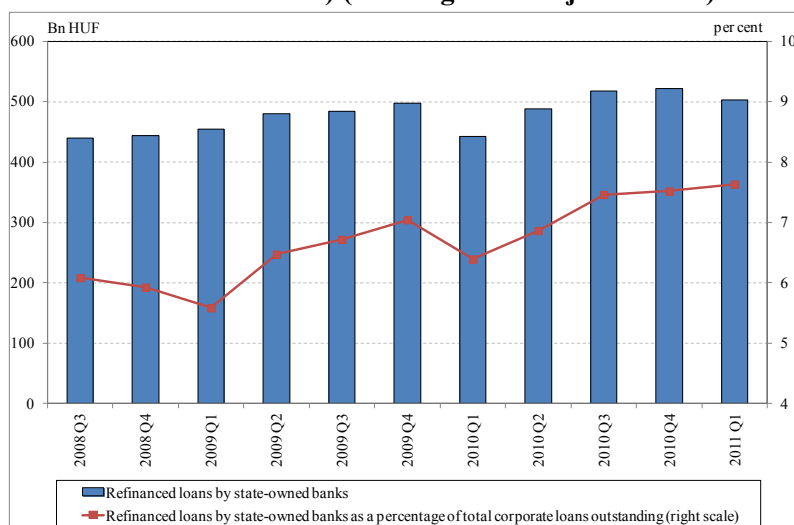
The objective of state subsidies provided for corporate lending is to reduce lending rates and thus enable companies to access cheaper credit than in the market, eventually allowing a decline in their credit costs as well as an increase in their demand for investment and through that in their additional borrowing. With some exceptions, these tools basically attempt to boost credit demand, and they are

less efficient in mitigating credit supply constraints. State subsidy that reduces credit costs and stimulates lending is feasible in the following ways:

- *direct interest rate subsidy*: in this case the bank extends the loan, and – if certain conditions are met – the state provides an interest rate subsidy for it; as a result, the bank can reduce the client’s interest rate to the extent of the subsidy (for example, Széchenyi Card);
- *interest rate subsidy with refinancing*: in this case even the financing for extending the loan is provided for the bank by the state or another state participant, at a preferential price and with various conditions (for example, New Hungary credit programmes). In this case, either the state itself or the state-owned bank has to raise the funding necessary for the programme. This may also take place by using external, for example, EU, EIB or EBRD funds; in this case the cost of the preferential interest rate is borne by the external financier;
- *other measures that reduce banks’ fiscal burdens depending on lending*: other measures can be for example, when the state waives a certain portion of the burdens and taxes of banks if they increase their lending to corporations.

Both in the case of the *interest rate subsidy with refinancing* and the *direct interest rate subsidy*, the difference between the preferential and market interest rates burdens the budget, thus the fiscal effect of these two forms is identical. In the case of direct state financing, refinancing may add to gross government debt, but if the funds are borrowed by an organisation outside the central budget (for example a state-owned bank), it is somewhat more expensive. Both tools raise the problem of efficient allocation: if the scope of beneficiary companies is tailored too narrowly or cautiously, the programme does not channel a significant amount of additional funds to the economy, but in the opposite case less viable projects may also have access to funds. The allocation problem is well illustrated by the fact that the losses on corporate loans directly extended by state-owned banks are significantly higher than the average of commercial banks. However, the greatest weakness of these tools is that they are unable to mitigate credit supply constraints, as the risks of lending continue to be borne by the commercial bank.

Chart 8: Interbank loans of state-owned banks (mostly refinancing loans provided to commercial banks) (exchange rate-adjusted data)



Source: MNB data.

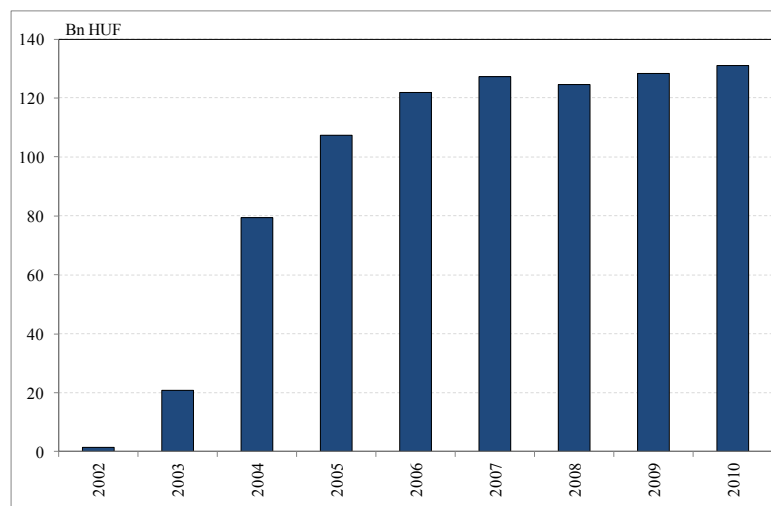
Nevertheless, it cannot be stated that subsidised credit programmes were not successful at all in recent years in Hungary. Refinancing by state-owned banks has increased since the end of 2008 (Chart 8); for

example, to date the MFB's refinanced corporate loans outstanding increased by some HUF 100 billion (more than 30%), while other interest rate subsidy programmes, mainly the Széchenyi Card stagnated, as opposed to commercial banks' considerably falling corporate loans outstanding (at the same time, in the case of the Széchenyi Card risk-taking also takes place; see the box below). All in all, the relative success of the preferential refinanced loans and other programmes is overwhelmed by the fall in commercial banks' loans outstanding.

Box 1: The Széchenyi Card Programme

The Széchenyi Card Programme is the most popular state-subsidised credit scheme. Its element, operating for the longest period of time (since 2002), is the Széchenyi Card Overdraft Facility with its upper limit of HUF 25 million, allowing small and medium-sized enterprises to obtain a credit line that can be used for a discretionary purposes (the overwhelming majority of credit applicants are micro enterprises). Since 2008, the total volume of the credit line of the Széchenyi Cards issued has stagnated at annual amount of some HUF 120–130 billion; the drawing ratio of the credit lines is also stable at 70%. The credit is made available by commercial banks from their own funding, while the state provides interest rate subsidy. The Széchenyi Card is a 'hybrid' programme in the sense that in addition to the interest rate subsidy it is also backed by guarantee institution: the Card may be applied for only with an 80% guarantee of Garantiqa Credit Guarantee Co. Ltd.; for the related fee the state provides guarantee fee subsidy for the clients. The guarantee reduces the risks of commercial banks. Last autumn, the Government completed the Széchenyi Card Programme with the Széchenyi Business Credit and the Széchenyi Investment Loan Programmes, which already target larger companies as well within the SME segment. In their case as well, the interest rate subsidy is coupled with the guarantee of Garantiqa Credit Guarantee Co. Ltd. and the relevant guarantee fee subsidy. The amount of loans extended within the framework of these programmes did not yet reach HUF 1 billion in 2010. In the summer of 2011, the Government launched the Agricultural Széchenyi Card Scheme as well, which provides an overdraft credit facility (similar to the Széchenyi Card) for agricultural enterprises, backed by the guarantee of the Rural Credit Guarantee Foundation.

Chart I: Credit lines within the framework of the Széchenyi Card Programme



Note: as the Széchenyi Cards have to be renewed annually, and the extensions are also included in the opening of new lines, the above data provide a good approximation of the outstanding credit lines as well.

Source: KA-VOSZ Co. Ltd.

The *stimulation of corporate lending by tax allowances* was discussed recently in Hungary as well. For example, there was a proposal according to which banks would have been allowed to somehow reduce the bank levy to be paid by them on the basis of the new loans extended to SMEs. Theoretically, a tool like this may have a positive impact on credit supply, as it increases the willingness to lend and may, to some extent, boost credit demand if banks pass on a portion of the allowance to the companies (in the form of cheaper lending rates). However, this positive impact can only be felt if the tax thus remitted is of adequate magnitude, and, of course, there are fiscal effects as well. In addition, this kind of tax allowance is also inefficient because it is not targeted: even those banks can use it that would lend otherwise as well.

Table 2: Summary of the advantages and disadvantages of the individual types of measures

	Advantages	Disadvantages
- provision of state interest rate subsidy or cheap bank refinancing in order to encourage corporate lending	reduces lending rates, increases credit demand	does not mitigate the constraints of risk-taking; a burden for the budget; allocation problems
- provision of interest rate subsidy from EU and foreign funds	reduces lending rates, increases credit demand; is not a burden on the budget	does not mitigate the constraints of risk-taking; stricter framework of conditions; allocation problems
- tax allowance, fiscal transfer to banks that lend to corporations	somewhat increases banks' willingness to lend; may reduce lending rates, increases credit demand	mitigates the constraints of risk-taking only slightly; a burden for the budget; not targeted

Source: authors' own construction.

3.3. Stimulating lending by partial or complete fiscal risk assumption

The credit supply constraints that are attributable to the low willingness to take risks may best be reduced if a state participant partially assumes the risk itself from the bank. There are two possible forms of this:

- *direct lending*: in this case, a state participant partially or completely takes over the lending role of banks. Under such circumstances, both loan losses and the solving of financing burden the state participant. This type of lending is performed by state-owned banks (MFB, Eximbank) in Hungary.
- *undertaking a guarantee*: in this case, the loans are still extended by commercial banks, but a state(-related) participant undertakes a guarantee for a part of the loans extended, thus reducing the risk of the bank. In Hungary, several state-related firms perform tasks like this with state counter-guarantee; based on the guarantees undertaken so far, Garantiqa Credit Guarantee Co. Ltd. and the Rural Credit Guarantee Foundation (AVHGA) are of considerable size.⁷ In the case of state counter-guarantee, it is again the state that eventually bears the loan

⁷ Other, smaller-sized organisations: Venture Finance Hungary Private Limited Company, Start Equity Guarantee Pte Ltd. and UNIO Guarantee Cooperative, but their total market share is a mere 1–2%. However, Venture Finance Hungary Private Limited Company (MV Zrt.) recently became the organiser of the New

losses (although it partially shares them with the commercial banks), but the fiscal costs appear in a protracted manner and with a delay.⁸

The main advantages of financing provided by state-owned banks to corporations are that it treats the root of the problem, i.e. the low willingness to take risks and that the necessary apparatus is already available. At the same time, the losses stemming from this kind of lending (or the preferential interest rate level in a given case) appear in the budget with a delay of one year. In addition, the state-owned banks themselves have to obtain the funding for such loans: although it will not be a part of the debt of the central budget, it adds to the gross government debt in a wider sense (consolidated with the debt of state-owned firms). Moreover, state-owned banks at present can obtain (foreign exchange) funds at a higher price than the Hungarian State. In addition, in the case of these programmes the aforementioned allocation problems also arise automatically (see page 7).

The state guarantee that can be applied for the SME loans is practically distributed by two major organisations: Garantiqa Credit Guarantee Co. Ltd. and the Rural Credit Guarantee Foundation (AVHGA); the latter mainly provides guarantees for companies involved in rural development. The business model is the same in the case of both organisations: the organisations undertake joint and several guarantee up to 80% of corporate loan receivables, 70% of which was counter-guaranteed by the state until June 2011. Pursuant to a recent amendment of the law,⁹ however, now already 85% is counter-guaranteed by the state on the basis of the Budget Act. The extent of the guarantee is important because of the distribution of risk between the bank and the guarantee organisation, whereas the extent of the state counter-guarantee is important because of the capital position of the guarantee organisations and their ability to provide guarantees. This latter ability is also increased by the fact that in May the No. 70/2011 Government Decree reduced the risk weight of own funds (i.e. of the portion not counter-guaranteed by the state) of the guarantees undertaken by Garantiqa Credit Guarantee Co. Ltd. and the AVHGA from 100% to 50%.¹⁰ The banks or the debtor pay a guarantee fee for the guarantee to the guarantee providing organisation. In this scheme, the state undertakes off-balance-sheet obligations (i.e. the direct debt indicators are not made worse *immediately*), but, eventually, loan losses burden the budget in this case as well. Allocation problems are somewhat smaller in this solution, as the distribution of risk between the banking sector and the state encourages banks to carry out thorough corporate credit rating and risk analysis.

Hungary Credit Guarantee Programme and the New Széchenyi Counter-guarantee Programme of the Government, which allows MV Zrt. to undertake guarantees in a total value of HUF 58 billion, with a 100% state counter-guarantee.

⁸ However, this impairs the transparency of the budget to some extent, and easily produces the false illusion that state interventions actually do not entail any costs. For more details see: Kiss (2011).

⁹ Act LXIV of 2011 on the Amendment of Act XCVII of 1995 on Personal Income Tax and of Act LXV of 2006 on the Amendment of Act XXXVIII of 1992 on Public Finances and other Related Acts (effective: 18 June 2011).

¹⁰ Directive 2006/48/EC of the European Parliament and of the Council theoretically allows the regulatory authority to determine an even lower risk weight for Garantiqa's and the AVHGA's own guarantee undertakings, provided that the Commission is notified of it.

Box 2: The European practices of guarantee institutions

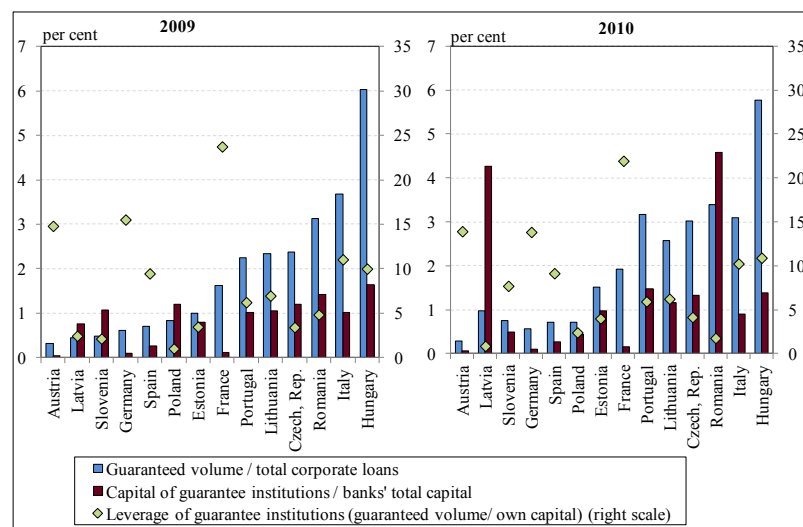
European comparison shows that in Hungary the role of guarantee organisations (and of state counter-guarantee) in corporate lending is considerable compared to other countries of the continent.

There are three main types of guarantee institutions in Europe: the state scheme that exists in Hungary as well, mutual guarantee institutions originating from the alliance of SMEs and mixed mutual guarantee institutions in which the state also participates. Firstly, mutual guarantee institutions facilitate companies' access to credit by providing guarantees, which are considered to be excellent and timely enforceable collateral. Secondly, the continuous and detailed peer monitoring of mutual guarantee institutions reduces information asymmetry, thus the membership of a given company carries a positive message for the bank, adding to its willingness to lend.

During the crisis, the role of guarantee organisations appreciated considerably: according to the data of the AECM (European Association of Mutual Guarantee Societies), new guarantee undertakings increased by 60% on a quantitative basis in 2009, compared to the earlier average growth of 8%. In addition, guarantee institutions eased their conditions, so guarantee fees declined, the portion of loans covered by guarantee increased, and they also strived to accelerate the rating procedure. A further important counter-cyclical step was the introduction of new products, such as the guarantees of leasing schemes and working-capital loans. The latter proved to be especially successful, as two thirds – nearly EUR 12 billion – of the special guarantee programmes developed for crisis management were spent on guaranteeing working-capital loans in 2009, helping nearly one hundred thousand small and medium-sized enterprises (AECM 2010). Analyses of individual data show that the credit constraint mitigating effect of mutual guarantee institutions sustained during the financial crisis as well, thus the probability of financial tensions was lower at the members (Bartoli et al., 2010).

In international comparison, the guarantee undertaking activity was remarkable in Hungary. In 2009, 6% of all non-financial corporate loans outstanding were guaranteed, while the European average was around 1.5%.¹¹ Moreover, the equity of guarantee institutions compared to the equity of the banking sector was also the highest in Hungary in 2009; however Hungary lost its leading position in 2010 as a result of capital injections to the guarantee institutions in other countries, namely Romania, Latvia, Portugal and the Czech Republic. The average leverage (guaranteed loans outstanding/equity) of guarantee institutions was tenfold in Hungary (although with high asymmetry between institutions), which roughly corresponds to the European average, but is below the leverage in Germany or Austria. Overall, it is evident that due to credit supply constraints there was substantial need for credit guarantees in Hungary; the downturn in corporate lending would be much stronger without them. Considering the utilisation of the guarantees, this tool can be considered successful in reducing the risk aversion of banks.

¹¹ However, the Hungarian data also contain the guarantees undertaken for loans to local governments and large corporations, whereas no information on this is available in the case of the data of foreign organisations. Nevertheless, if only the total guarantees undertaken for SME loans are compared to total corporate loans, the proportion of guaranteed loans would still be nearly 5%, which can still be considered remarkable.

Chart I: Total capital of guarantee institutions and guaranteed corporate loans at end-2009

Sources: ECB data and AECM (2010).

Since the outbreak of the crisis the importance of both the direct lending by the state and state-guaranteed loans has increased in the banking system. The weight of corporate loans directly extended by state-owned banks within total corporate loans outstanding grew from 2.7% in September 2008 to 4.8% (HUF 341 billion) by the end of 2011. The ratio of loans extended with state counter-guarantee exceeded even the above figure: at end-2010, the total volume of guarantees undertaken by the largest guarantee organisations amounted to 6.5% (HUF 432 billion) of corporate loans. At the same time, neither direct lending by the state, nor the increasing undertaking of guarantees was able to offset the substantial fall – more than HUF 1400 billion between October 2008 and end-2011 – in lending to corporations by commercial banks.

However, the growing role of state-owned banks and guarantee organisations was reflected in the increase in budgetary expenditures as well. In 2010, the state was burdened by around HUF 21 billion resulting from the state counter-guarantee of the risk-takings by guarantee organisations; moreover, actual expenditures exceeded the planned amount. The activity of state-owned banks also added to the general government deficit, as at the end of last year a HUF 20 billion capital injection had to be carried out.

Overall, in their present form of operation, of the two types of tools – also taking account of the fiscal costs of intervention – guarantee organisations seem to be more efficient in stimulating corporate lending:

- with the same amount of equity, guarantee organisations are able to attain much higher risk-taking and leverage (as their commitments are partly state-guaranteed and partly lower-risk off-balance-sheet items). It may be emphasised here that not all guarantee organisations use the available resources to an adequate extent: the capital adequacy of some organisations would allow the granting of much more guarantees than the present situation. Accordingly, the institutional system has significant reserves here;
- the guarantee organisations burden the budget with immediate, specific expenditures to a lesser extent – especially compared to the magnitude of risk-taking. The corporate clientele of guarantee organisations reflects a clearly better portfolio quality than that of state-owned banks: the ratio of non-performing corporate loans in the case of the latter is twice the similar

data of guarantee organisations. Presumably, one of the underlying reasons is that the risk-taking of guarantee organisations is not 100%, i.e. commercial banks also bear some part of the losses of non-performing transactions, and they are also involved in the credit rating process. This is likely to in itself reduce the allocation problems (the risk of lending to ‘bad’ companies). Of course, at the same time it may also mitigate the efficiency of the tool, as some extent of risk-taking by the bank is also necessary for the transactions of the guarantee organisations to be concluded. On the other hand, more and more state guarantees reduce the transparency of the budget as well, and it is also important to emphasise that the losses originating from the guarantees eventually add to the budgetary expenditures the same way.

However, it is important to underline that any possible intervention inevitably entails an increase in budgetary expenditures.

Table 3: Summary of the advantages and disadvantages of the individual types of measures

	Advantages	Disadvantages
- direct lending by the state through state-owned banks	mitigates banks’ credit supply constraints by assuming the risk	a burden on the budget; implicit government debt is produced; allocation problems
- undertaking of guarantee by the state for corporate loans	mitigates banks’ credit supply constraints by assuming the risk; does not (immediately) result in government debt; the distribution of risk reduces moral hazard	a burden on the budget; results in a pending commitment of the state

Source: authors’ own construction.

3.4. Stimulating lending using prudential means

Prudential regulation applies to the size of the minimum expected regulatory capital of banks and to the profit-reducing loan loss provisioning, and as such it significantly influences both banks’ ability to lend (because of the capital constraints) and the pricing of loans (because of the cost of capital of the regulatory capital). Therefore, in the event that the expected level of regulatory capital required with regard to corporate loans decreases,

- *the capital constraint of the bank declines*: if, for example, the capital requirement of SME loans decreases to one half, the bank (or guarantee organisation) can lend twice as much with the same regulatory capital;
- *the cost of capital included in the price of bank loans declines, and thus the lending rate may also decline*: however, its impact is in fact very limited. As the risk weight of loans to (large) corporations is 100%, i.e. the capital requirement is 8% of the exposure, the cost of capital of 100 units of a loan to a (large) corporation is 1.6 units, assuming a 20% expected ROE (return on equity). Accordingly, even the (most radical) reduction of the capital requirement of the corporate loan with the highest risk weight to zero may reduce the lending rate by barely 160 basis points at most.

However, the primary objective of prudential regulation is to make the bank (or guarantee organisation) keep capital for individual loans that is proportionate to their credit risk, and to set aside

loan loss provisioning for its outstanding loans on the basis of their expected losses. Consequently, this by itself already contradicts the objective of stimulating lending. In addition, the framework of prudential regulation is determined by the European Capital Requirements Directives, and the Hungarian regulation may only be stricter than them. However, this is not typical at present: during the implementation of the European Capital Requirements Directives in Hungary, the domestic regulation also applied the highest possible allowance for the corporate capital requirement. Thus, for example, the risk weight of SME loans according to the standard method is 75%, as opposed to the 100% risk weight of loans to large corporations (although according to anecdotal information not all commercial banks are utilising this at present). The domestic regulation of the developed method (IRB) also grants the same capital allowances for smaller companies as the European Capital Requirements Directives. As regards guarantee institutions, a more preferential classification of the public organisations that guarantee the SME holdings cannot result in a significant decline in the capital requirement.

It was mentioned above that in May the Government reduced the risk weight of own funds (of the portion not counter-guaranteed by the state) of the guarantees undertaken by guarantee organisations from 100% to 50%. As a result of this amendment, the capital adequacy of guarantee organisations may even double compared to the current values. At the same time, the objective of this step was not to attain a decline in the cost of capital of banks, but to enable guarantee organisations to provide more guarantees.

Another possibility would be if the state counter-guarantee behind the debt guaranteed by the guarantee organisations was further increased from the current level of 85% reached following the recent modification (see also Subchapter 3.3). Thus the capital requirement of banks that use this type of guarantee for their loans could decline. However, the capital reduction potential attainable in this manner is very low: from a banking aspect, the total capital requirement of the loans guaranteed by the guarantee organisations is barely 2.2%¹² (and their cost of capital is roughly 40 basis points). Moreover, extension of the state guarantee would entail the direct burdening of the budget.

In addition, theoretically, an easing of the loan loss provisioning rules is also conceivable: then banks would have to set aside lower loan loss provisions for their impaired loans, which would improve their profit and thus their capital position. However, at present as well, the relevant No. 250/2000 Government Decree provides very wide room for manoeuvre for banks, which practically must set aside loan loss provisioning on the basis of their expected losses. Further easing of this is not possible without violating accounting principles and prudential aspects.

The only material bank capital easing would be attainable through the reduction of the individual additional bank capital requirements discretionally imposed pursuant to Pillar 2 (SREP) by the HFSA, the Hungarian regulatory authority. However, theoretically, the additional capital thus required was determined on the basis of prudential considerations; therefore, its waiver with the objective of stimulating lending would have a negative effect in terms of the shock-absorbing capacity of banks.

¹² The calculation of the capital requirement of the loans guaranteed by Garantika and the AVHGA is as follows: the guarantee organisations undertake guarantees of up to 80% for the loans, and there is state collateral security behind 85% of it. Accordingly, from a risk aspect a loan can be divided into three parts: a part protected by state collateral security ($80\% \times 85\% = 68\%$), a part protected by the capital of the guarantee organisation ($80\% \times 15\% = 12\%$) and the risk falling upon the bank (20%). The risk weight of the state collateral security: 0%, of the portion protected by the guarantee organisations: 100%, although in the case of SME loans the risk weight of the debtor is only 75%, so the lower value has to be taken into account for SMEs. The risk weight of the part falling upon the bank: 75%. Accordingly, the risk weight of the total loan is not more than: $68\% \times 0\% + 12\% \times 100\% + 20\% \times 75\% = 27\%$. 8% of it is the capital requirement, i.e. 2.16 units for 100 units of loan.

Table 4: Summary of the advantages and disadvantages of the individual types of measures

	Advantages	Disadvantages
- reduction of the capital requirement based on guarantee organisations' own guarantee undertakings	capital constraints of guarantee organisations (continue to) ease	not efficient, at present, there is no capital constraint at these organisations;
- increasing the ratio of state collateral security at the guarantee organisations	further reduces the bank capital requirement of guaranteed loans; also reduces the capital requirement of guarantee organisations	not efficient, the capital advantage gained is insignificant; additional burden on the budget; moral hazard at the guarantee organisations
- easing of prudential requirements (SREP or loan loss provisioning rules)	an intervention that does not have fiscal effects (over the short run)	violates accounting principles and prudential aspects, impairs financial stability over the long term

Source: authors' own construction.

3.5. Stimulating lending using administrative means

The easing of credit supply constraints is also feasible in such a manner that

- *the regulatory authority makes lending a precondition of other support provided for banks:* this already occurred when the MNB linked participation in the 6-month swap tender to the maintenance of corporate loan holdings (see also Subchapter 3.1). The state formulated similar expectations in connection with the capital injections at FHB as well as the disbursement of preferential foreign exchange loans to MFB, FHB and OTP in early 2009. However, these means are inefficient: if they are not accompanied by sanctions, the conditions are not complied with by the beneficiaries, and if there are strict sanctions, they may conflict with the objective of the original assistance and support;
- *the state strengthens the rights of creditors with administrative tools:* theoretically, it reduces the risks of creditors, i.e. eases the constraints of risk-taking; on the other hand, however, creditors' rights may essentially be increased only at the expense of borrowers, which may reduce demand for loans. International comparisons show that in Hungary creditors' rights and legal procedures are mostly near the average (Table 2); therefore, it is possible to improve efficiency in several respects, which may have a positive impact on banks' willingness to take risks. However, as these issues cannot be considered as being within central bank competence, they are not discussed here in more detail.

Table 5: Summary of the advantages and disadvantages of the individual types of measures

	Advantages	Disadvantages
- Stimulating with administrative measures	no fiscal burden	may have other, undesirable externalities; efficiency problems

Source: authors' own construction.

Table 6: Administrative burdens from the aspect of the enforcement of creditors' rights on the basis of the World Bank Doing Business Database (2010)

Country	Creditors' rights (1 - 10)*	The average number of procedures to enforce a contract	The average time of procedures to enforce a contract (days)	Time for creditors to recover their credit** (years)
Hungary	7	35	395	2.0
Austria	7	25	397	1.1
Bulgaria	8	39	564	3.3
Czech, Rep.	6	27	611	3.2
Denmark	9	35	410	1.1
Estonia	7	36	425	3.0
Finland	7	32	375	0.9
France	7	29	331	1.9
Germany	7	30	394	1.2
Greece	3	39	819	2.0
Ireland	8	20	515	0.4
Italy	3	41	1,210	1.8
Latvia	9	27	309	3.0
Lithuania	5	30	275	1.5
Netherlands	6	26	514	1.1
Norway	7	33	280	0.9
Poland	9	38	830	3.0
Portugal	3	31	547	2.0
Romania	8	31	512	3.3
Slovakia	9	31	565	4.0
Slovenia	5	32	1,290	2.0
Spain	6	39	515	1.0
Sweden	5	30	508	2.0
Switzerland	8	31	417	3.0
UK	9	28	399	1.0
USA	8	32	300	1.5

Note: *How strong the rights of the creditor are upon the enforcement of collateral and liquidation (1: the weakest, 10: the strongest).

**The number of years during the liquidation proceeding from turning to the court until settling the last asset.

Source: World Bank, Doing Business Database 2010.

4. Summary

After the 2009 recession, the economy started to grow again in Hungary, but this turning point has not yet been followed by a rebound in corporate lending. Therefore, the risk of the phenomenon known in the literature as a creditless recovery has risen significantly. Although economic growth is possible without a rebound in corporate lending, according to relevant researches the growth is usually lower than in the case of growth supported by lending.

Since the outbreak of the crisis the MNB staff has dealt with the reasons for the contraction in corporate lending and with the possible means of promoting lending. Some of these analyses have been published; some of them – especially in connection with the means of stimulating lending – have not, and so this study has also served as a summarising work.

Earlier research showed that it was mainly the credit supply constraints of banks which played the major role in the downturn of domestic corporate lending. Credit supply is determined by two factors: banks' ability to lend (whether they can lend) and willingness to lend (whether they are willing to take

risks). Banks' ability to lend was more or less restored in Hungary following the shocks in 2008. However, there was no turnaround in willingness to lend: banks' low willingness to take risks, due to the deteriorating portfolio quality and the increasingly difficult assessment of corporate creditworthiness, tightened credit supply steadily in the last two years.

Our analysis reviewed all the theoretically applicable means – suitable for boosting either demand or supply – that allow for the stimulation of corporate lending. We examined the possibilities of the central bank, fiscal interest rate subsidy and fiscal risk-assumption as well as prudential and administrative means. Of them, at present it is basically the fiscal risk-assumption, i.e. the partial assumption of banks' credit risks by the state seems to be the most efficient method, as the underlying reason behind the fall in lending is the low willingness to take risks. The state is practically able to assume credit risk of corporations in two ways: direct lending (or lending through state-owned banks) or granting a guarantee.

Since the outbreak of the crisis both means have been used; as a result, the weights of both direct lending by state-owned banks and of corporate loans outstanding backed by guarantee organisations have increased in Hungary. However, this was not – and could not even have been – able to offset the substantial fall in commercial bank lending. In addition, the risk-takings of state-owned banks and guarantee organisations also resulted in significant losses for the budget.

Nevertheless, the financial situation of both the state-owned banks and guarantee organisations could allow them to further expand their activities. Therefore, these organisations would be able to assume corporate credit risks even in a magnitude of an additional several hundred billion forints. However, the costs of these programmes through loan losses may very soon appear in the budget. In this respect, guarantee organisations seem to be the more efficient means of stimulating corporate lending: stemming from their business model, they are able to utilise their equity with a higher leverage, and – at least based on experiences to date – as a proportion of total loans outstanding they create less costs for the state (because in their case commercial banks participate in the credit rating and risk-taking as well).

Altogether it has to be kept in mind that if economic policy intends to stimulate corporate lending in a more active manner, it inevitably results in higher fiscal costs as well.

Finally, it is also necessary to take into account that the assumption of credit risks to a greater extent by the state can only be a temporary and partial solution, as the state cannot take over the role of financial intermediaries (and this is not the task of the state either). Accordingly, a permanent recovery of lending is inconceivable without stable, predictable economic growth.

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