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Funding Hungary: Exposing Normal and Dysfunctional Crisis Management

Dóra Piroska[1]

This paper contrasts the approaches of the International Monetary Fund, the European Commission and the European Central Bank to the management of the Hungarian financial crisis of 2008. It exposes normal behaviour of the IMF and the EU Commission and dysfunction on the part of the ECB, during the first liquidity trap phase of the global financial crisis. The methodology applied contrasts the IOs' mandate with their framing of the Hungarian crisis as well as with their actual policy recommendations. It uncovers that the IMF negotiating team had a market focus, stressed the European and regional dimensions of the Hungarian crisis, and recommended large financial assistance. The Commission's Directorate-General for Economic and Financial Affairs representatives focused on the budgetary imbalances and treated the crisis primarily as a Hungarian crisis, which has the potential of contaminating the whole EU. They provided moderate financial assistance. Finally, the ECB thought to combat contagion to the Eurozone by ignoring the European dimension of the Hungarian case. It was reluctant to provide significant assistance to an EU member state, whose banking sector is dominated by Eurozone banks. It concludes with a note on the possible negative consequences of the ECB's action on the European Union's integration.

Keywords: Hungary; International Monetary Fund; European Union; European Central Bank; international organisation; global financial crisis; institutional dysfunction

JEL Classification: F34, F53, G01, H63, E58

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1. Introduction

In October 2008, two very different international organisations (IOs) teamed up to lessen the financial troubles of a European Union member state. The International Monetary Fund (IMF), an institution with relatively high autonomy[1], the EU Commission, an institution bound by rules and committed to pre-defined procedures,[2] have united their very different expertise. In the meantime, the European Central Bank (ECB) declared its intention to take care only of Eurozone countries. Hungary was the first EU member state who sought their assistance and thus became an experimental case for the three IOs to try out their skills in crisis management.

In this essay, I show the different approaches of the IMF and the EU Commission in handling the Hungarian crisis and expose the ignorance of the ECB. Drawing on constructivist and institutionalist approaches to the study of IOs, I explore the relationship between the IOs' policy recommendations and their institutional characteristics. The IMF negotiating team had a market focus and stressed the European and regional dimensions of the Hungarian crisis. The Commission's Directorate-General for Economic and Financial Affairs (DG ECFIN) representatives focused on the budgetary imbalances and treated the crisis primarily as a Hungarian crisis, which has the potential of contaminating the whole EU. Finally, the ECB thought to combat contagion to the Eurozone by ignoring the European dimension of the Hungarian case. It was reluctant to provide significant assistance to an EU member state, whose banking sector is largely dominated by Eurozone banks.

I argue that the IMF's and the Commission's handling of the crisis represent the normal behaviour of IOs, while the ECB's misconception and ignorance is a case of dysfunctional behaviour on the part of an IO. I build on Barnett and Finnemore[3] to argue that IOs are bureaucratic organisations which create and disseminate social knowledge of their environment. They ‘create actors, specify responsibilities and authority among them, and define the work these actors should do, giving it meaning and normative value.’[4] However, these processes may make IOs ‘unresponsive to their environments, obsessed with their own rules at the expense of primary missions, and ultimately lead to inefficient, self-defeating behaviour.’[5] Using Barnett and Finnemore’s insights, I contrast the three IOs’ policy recommendations – which I show to follow from their past experiences and institutional organisations – with their mandates in order to uncover normal and dysfunctional behaviours.

The ECB’s understanding of the member states’ crises as isolated incidents changed only very slowly in the course of the Eurozone crisis. For example, its concern with the whole Eurozone, and insistence that the Greek troubles are to be solved by Greece alone, made it blind to the fact that Greece’s troubles originated in the functioning of the Eurozone as a whole[6]. Similarly, the same misconception of the crisis prevented European authorities from promptly proposing adequate solutions to the crisis. As Véron[7] demonstrated, it was in the European Department of the IMF where the idea of the Banking Union was originally proposed with earnest. Even when change finally occurred, as Mochella[8] identified, it was only to save the status quo and the ECB’s preferences. In the end, the ECB’s attitude during the crisis contributed to the emergence of a situation opposite to the mandate of the ECB, which is to foster integration of the whole EU. This is why, following Barnett and Finnemore,[9] I call its operation during the Hungarian financial crisis an example of an institutional dysfunction.

During the course of this research, I consulted secondary documents, policy briefs, as well as the IMF’s and the EU Commission’s own assessments of their involvement in the Hungarian crisis. I also made semi-structured interviews with both Hungarian officials (high ranking and lower ranking) from the government, the central bank as well as the IOs’ own representatives. The interviewees preferred to stay anonymous.

The paper is structured as follows. First, I review the literature that analyses IOs' involvement in the European financial crisis. I show that most analyses of the ECB, almost exclusively consider its role within the Eurozone; the negative impact of its action on Central and Eastern European countries is rarely exposed. In the next step, I turn to the Hungarian case and present an assessment of pre-crisis risk factors. I proceed to first review the involvement of the IMF, followed by the Commission's DG ECFIN, and finally, the ECB. The last section concludes.

2. IOs' involvement in the European financial crisis

Almost ten years on, IOs' involvement into the global financial crisis has been studied from a number of perspectives. The IMF's role has been at the forefront of international political economy analyses. Researchers showed for example that contrary to popular perceptions the IMF is responsive to governments' electoral concerns[10]and that the IMF is able to change its policy recommendations. [11] Others looked at the challenges of global governance and examined the role of the IMF in it,[12] or argued that the IMF is still under the influence of the G5 countries.[13]

The role of the EU in the crisis has been studied mainly from a European integration perspective.[14] In most work, the EU institutions are lumped together and their joint performance is assessed. One exception to this trend is the assessment of the European Central Bank's performance. However, an important feature unites most of these assessments; namely, that they almost exclusively look at the impact of the ECB's activities within the Eurozone – the financial sector of aspirant countries or non-Eurozone countries are usually neglected.

For instance, from a neofunctionalist perspective Chang[15] argues that the ECB is the winner of the financial crisis as it was able to significantly enlarge its mandate by taking on new roles such as lender of last resort for banks and indirectly to sovereigns, the role of financial supervisor through the Single Supervisory Mechanism, and the role of government advisor. Saraceno, although critical of the ECB's and especially EU policy makers performance during the crisis, neglecting the Central and Eastern European (CEE) region, notes that the ECB's performance in the first 'liquidity trap' phase of the crisis was 'bold, coordinated, and overall successful.'[16] His overall criticism, that the crisis has highlighted a neglect of financial stability as an objective of monetary policy, has, however, implications beyond the Eurozone.

Jacoby [17] explicitly looks at the EU's performance in Central and Eastern Europe before and after the 2008 crisis. He observes that the Commission and the Council, although modestly, but still contributed to the lessening of the impact of the crisis in CEE through providing access to the Balance of Payments facility as well as through easing access to structural funds. Turning to liquidity provision, he is more critical of the ECB's performance: 'policies here appear tentative, improvised and late. There was also a divide between Eurozone states, who had access to ECB instruments, and non-Eurozone states, who received essentially no help from the ECB.'[18]

Lütz and Kranke[19]'s analysis is a significant piece of research that contrasts the EU's and IMF's responses to the crisis in the CEE region. They demonstrate that in negotiations with Romania and Latvia in 2009, the IMF negotiating team proved to be far more flexible, and embracing relatively less orthodox fiscal policy recommendations, than representatives of the Commission and the ECB. The authors argue that state-centric explanations of IOs' behaviour cannot explain the differences. This is because the US proved to be disinterested in informing the IMF's lending conditionalities and instead let European Union member states dominate the decisions of the IMF's Executive Board.[20] Under this condition, then, it is hard to understand either from a realist or a liberal state-centric perspective why the same European states would have preferred different policy recommendations. Instead, the authors argue, in order to understand the differences we have to look inside the two IOs to examine how they 'processed' the same preferences differently.[21] Drawing on a rich constructivist scholarship which treats IOs as bureaucracies ,[22] they argue that one must look at the organisations' mandate and the various ways in which staff within these organisations reinterprets these mandates. During the 2008 financial crisis, they found that the IMF staff reinterpreted their technical mandate broadly, while the EU representatives upheld many of the orthodoxies of the Washington Consensus.

In this paper, I build on the findings of Lütz and Kranke,[23] but also advance their argument. Looking at the Hungarian financial crisis, which preceded the Romanian and Latvian crises, I argue that to have a more comprehensive understanding of IOs' behaviour, it is not enough to explore how they interpret their mandate, but it is equally important to understand their interpretation of the crisis situation within which they found themselves. 'Seeing like an IO', Broome and Seadbrooke argue, 'provides insights into how they make their member states 'legible' and how greater legibility enables them to construct cognitive authority in specific policy areas.' [24] More importantly, investigating what an IO saw into a situation – how it framed the crisis – allows us to open up categories of crisis management that Lütz and Kranke[25] cautiously avoided. At the end of their analysis, they write that 'Our preceding empirical overview shall not be read as suggesting that either the IMF's or the EU's preferences were more economically sensible.'[26] However, if we look at IOs' reading of the crisis as well, and find that there were major differences in interpretations, then we will be in a position to distinguishing between normal and pathological crisis managements. In the case of the Hungarian crisis, the IMF's market focus and the Commission's fiscal imbalance focus, although represented very different understandings of the source of the crisis and the preferred ways to handle it, both took into consideration the European dimension of the Hungarian case. I argue that the ECB's framing of the Hungarian crisis as something to be ignored, and the subsequent denial of swap assistance to the Hungarian authorities as well as direct liquidity sources to the Hungarian subsidiaries of Eurozone mother banks represents a case of dysfunctional behaviour.

Barnett and Finnemore[27] point to two features of IOs that are both the source of their power, but may also become the source of their dysfunction. The first is the notion that because bureaucracies are organised around rules, routines, and standard operating procedures, in certain cases these rules may become goals in themselves: ‘Rules and routines may come to obscure overall missions and larger social goals.’[28] The second source of dysfunction is that bureaucracies specialise, therefore they claim: ‘concentrated expertise and specialisation can (and perhaps must) limit bureaucrats' field of vision.’[29] Barnett and Finnemore do not provide a scale of assessment for the degree of pathologic behaviour. However, when they identify empirically pathologic behaviour of an IO, it is in the case of complete failure with devastating consequences. The ECB’s performance during the 2008 Hungarian crisis - although had negative consequences for the recovery of the Hungarian economy - should not be judged as devastating. Therefore, this research will only concentrate on evaluating the possibility of dysfunction in the case of the ECB.

In order to assess whether an IO’s team followed a normal behaviour or a dysfunctional one, according to Barnett and Finnemore[30] we must assess their efforts against their institutional mandate. I argue that the most efficient methodology for this purpose is to review their assessment of the situation, analyze their policy recommendation and contrast their efforts against the other IOs involved. By doing so, we will be in the position to understand the knowledge they gathered of the Hungarian crisis, their own role within it, and their actions in the form of policy recommendations. In the end, we will be able to judge the sensibility of their actions in terms of their mandate. Table 1 summarizes the argument.

Table 1. The argument

	IMF	EU Commission	ECB
Mandate	assist troubled member states	assist troubled member state	as a member of ESCB – assist troubled member states
Framing of the Hungarian crisis	Financial market perspective	Fiscal imbalance perspective	Non-member's crisis
Policy recommendations	Large financial assistance is needed	Financial assistance is needed	Best if ignored
IO's performance	**Normal**	**Normal**	**Dysfunctional**

3. Pre-crisis risk factors in Hungary

The banking sector in Hungary has been dominated by Western European mother banks since 1995. In 2008, the largest banks included Erste Bank, Raiffeisen Bank, UniCredit Bank, Intesa Sanpaolo, BLB, Volksbank, GE Capital, KBC Bank. There were only a few Hungarian controlled banks: OTP, FHB and the cooperative sector. In preparation for the 2004 EU accession capital flows were fully liberalized in 2001. Successive governments – although only moderately enthusiastically - have been preparing for Euro introduction ever since accession. [31] Crisis hit Hungary in the midst of a political turmoil, through the government bond markets and through the banking sector's Achilles heel: its loan structure. In the following, I present banking sector developments, macroeconomic conditions and political processes prior to the crisis.

Since 2000, retail credit expansion became the motor of banks' growth. As the growth of deposits was lagging behind, banks' external exposure (especially in the interbank markets) increased dramatically: the deposit to credit ratio achieved 170 per cent in 2008.[32] Even though credit to GDP ratio remained lower than in Western Europe, rapid credit growth became increasingly worrisome.[33] Starting from 2006, long term credit was increasingly financed through short term funds, especially foreign exchange (FX) positions. Thus, the process of credit expansion went hand in hand with a change in the banks' funding structure.

The Hungarian economy's current account remained relatively in balance due to the increased inflow of capital.[34] The early 2000's liquidity richness of the international capital markets also increased capital flow to Hungary. The massive inflow of credit was directed to the housing market, triggering a construction and housing boom.[35] The housing boom, however, never developed into a housing bubble according to the analysis of the central bank.[36] The housing loan expansion that developed in Hungary was in a number of aspects similar to the US sub-prime mortgage boom:[37] it was partly the result of a number of macroeconomic conditions, partly the result of competition in the banking sector, and partly the result of political factors.

Foreign currency inflow elevated the value of local currency to a higher level that could have been justified by the performance the real economy. Arguably, the central bank's interest rate policy was also not adequate to handle this situation. Second, inflation rate also accelerated and increased assets values. This development also put a pressure on the interest rate, increasing it to a level that made foreign currency denominated credit a lot more attractive than local currency ones. The government's plan to join the Euro also contributed to this process. Most of the loans were denominated in Swiss franc, which offered better rates than Euro denominated ones. Finally, the growth of foreign currency denominated loans further increased the value of forint, making it ever more difficult to recognize the risks built in the exchange rate. [38]

The credit expansion presented excellent profit making opportunity for all banks. Due to the lower level of competition and financial culture, high level of trust in the value of forint and the high local interest rates, mother banks could charge higher interest rate margins in CEE than in Western Europe. Mortgage loans became the preferred instruments of banks as well as equity loans. Importantly, the conditions of credit provisions gradually loosened: down payments diminished, maturities lengthened, and income check loosened.

Government supported loan programmes also contributed to the credit expansion. From 2002 to 2006 public debt again started to rise from 56 per cent to 66 per cent of GDP, due to the Medgyessy led Socialist-Szdsz government's fiscal programme, which brought less popularity than expected but put very strong pressure on the budget. Fearing that the diminishing popularity of Medgyessy will eventually result in losing the next parliamentary elections, the Socialist party replaced him with Ferenc Gyurcsány as the Prime Minister in 2004.[39]

Gyurcsány's government, similarly to the American government, embraced credit expansion as a substitute to government sponsored welfare spending and thus effectively contributed to the conversion of public debt to private debt. [40] The Gyurcsány government profited from the unregulated credit expansion in two ways: through the economization of welfare spending as well as through the inflow of value added taxes that increased due to increased consumption spending. A corollary effect of this public policy is, however, that market actors both on the demand and supply side of FX denominated credit market became less risk averse.

In September 2006 an audio recording was leaked in which Gyurcsány admitted that the Socialists had been lying to the public about the economy for nearly two years.[41] A month of demonstrations and atrocities followed. From this point onward, Gyurcsány could never regain his former popularity. Between the period of the 2006 atrocities and 2008 October when the financial crisis hit Hungary, the Gyurcsány government cautiously led a retrenchment of the welfare state reform programme, cutting back public employment and tax hikes. Key elements of the programme were, however, ousted by a hugely successful referendum led by Fidesz in early 2008, which led to enough friction in the coalition that

Szdsz decided to leave the coalition in April 2008. From May 2008 the Socialist Gyurcsány led a minority government with minimal room for manoeuvring in its economic policy.

Prior to the crisis, the central bank was also slow to react to the mounting pressure and let its FX reserves deplete. The central bank only started increasing FX reserves in summer of 2008. Therefore, in October 2008 the central bank's foreign exchange reserves level did not reach the renewable part of the fiscal deficit and that of the FX denominated private debt, thus increasing the country's vulnerability.[42]

4. The IMF - Advocate of the financial markets

By October 2008, the IMF had already completed a major overhaul of its modus operandi initiated nearly a decade before. After the East Asian financial crisis in 1997 and the Russian financial crisis in 1998, it had been severely criticised for applying a standardised formula of economic orthodoxy that located the sources of the crisis in the domestic economy and prescribed solutions that demanded the restructuring of domestic economy which proved utterly inefficient. [43] As a response to criticism, the IMF underwent major internal changes, it learnt to appreciate local economic and political circumstances, put a special emphasis on local political ownership of the programmes that it accepted and was at the beginning of launching even more overarching changes. The IMF's mandate – however – has not changed: The Fund is a global credit union, whose purpose is to maintain stability of international finance by providing support to member states with adequate safeguards. [44]

The IMF staff had approached the Hungarian crisis situation from the vantage point of financial market actors. They 'flattened reality', i.e. excluded complexities, in a way to make the Hungarian case make sense for any imaginary financial market actor. The IMF team arrived at Hungary from the Marek Belka led European Department. They were all trained economists, experienced in other missions (although mainly Article IV reviews), and none of them spoke Hungarian.

During the first few days of their operation speculative attacks were launched not only against the forint, but also the largest and domestically owned Hungarian bank, OTP[45]. Trading on the stock exchange was suspended and the interbank market stopped functioning. The Hungarian government had short term maturity debt obligations of about EUR 3 billion, which if not fulfilled, was projected to force Hungary to default in December. However, domestic banks owed an even greater amount of short term obligations to foreign sources, which, due to the freeze of the interbank market, could not have been repaid on schedule. Foreign exchange reserves in the central bank stood at around EUR 17,4 billion, insufficient to cover all these obligations.[46]

In light of the 'market actor's perspective' framing of the Hungarian crisis, the IMF negotiating team as a first step convinced the Hungarian authorities that they are in need of a far greater amount of assistance than originally envisioned. The Hungarian authorities' assessment was that they face a budgetary problem and calculated that they are in need of EUR 3 billion to finance their foreign obligations. The IMF team made it rapidly clear, that in their understanding, Hungary is in a far worse situation; the biggest threat is not that they cannot renew their public debt, but that they cannot cover the outstanding obligations of the banking sector. Therefore, they recommended that Hungary contract for EUR 20 billion (interviewee)[47].

Second, the IMF team stressed the importance of safeguarding nationally controlled banks and demanded commitment from foreign owned banks.[48] The IMF team saw a major difference between the foreign owned and domestically controlled banks' access to foreign currency denominated funding. Therefore, they insisted that part of the credit they provide must be used to support systemically important domestic banks to buttress their credibility. They also demanded a letter of commitment to keep liquidity positions from each foreign owned bank. Commitments, however, were not binding.

Third, reflecting the latest research of the IMF's own research department, the team insisted on enclosing new bank regulations addressing macroprudential concerns into the agreement. A number of these regulations were proposed by the central bank authorities taking advantage of the golden opportunity. Others were much later implemented, not necessarily as macroprudential tools, but mainly as regulatory measures that increase the power of the government over the banks.[49] Fourth, in relation to the fiscal imbalance the IMF expertise was important in defining the macroeconomic models used to forecast future fiscal imbalances. However, the team was not interested in defining the exact steps through which the Hungarian policy makers were to achieve the set targets. In addition, the team welcomed the Hungarian officials' proposal of including into the programme the establishment of a Fiscal Council that would be able to supervise the long term sustainability of future budget proposals.

Finally, the IMF did not put emphasis on safeguarding the poor or including socially sensitive measures as the interviewees unanimously attested. The measures that may be conceptualized as socially sensitive were initiated by local politicians and included a promise to give priority to investment projects (co-financed by EU funds) designed to support small and medium-sized enterprises. In addition, a promise was put in place for a private debt resolution strategy that would alleviate the burden of households indebted with foreign currency loans[50]. The IMF team also reached out to opposition political parties, to ensure support of the programme.

In conclusion, I showed that the IMF team acted in accordance with its mandate providing financial assistance to one of its member states in balance of payment difficulty. As a bureaucratic organisation it framed the crisis in accordance with its institutional background and past experience and negotiated accordingly. First, the Hungarian crisis was understood as having the potential to harm not only Hungary but also Europe and major financial assistance was the key to prevent it. Contagion was to be prevented through a strengthening of financial sector balance sheets and improving financial market conditions, therefore these became the team's main objectives. According to the IMF's 2011 evaluating report 'A crisis in Hungary could have resulted in significant losses at foreign parent banks, with significant risks of contagion to the Euro area and in turn to the rest of the CESE region.'[51]

Second, Hungarian financial troubles were understood not to originate from the domestic economy itself, but from its high exposition to external factors. And these external factors, i.e. the dry up of liquidity on the international financial markets, were seen as the main reason for Hungary's problems. Therefore, the IMF team focused more on the banks and less on the fiscal imbalance. This becomes evident if we investigate the fiscal component of the programme. Although the fiscal consolidation efforts under the programme were sizable (originally projected at 5 percent of potential GDP for 2009–11), it did not demand any major structural changes - neither in the financial sector nor in the economy. The large redistribution mechanisms were left intact; it did not change the structure of public administration or local governance, or transform universal social entitlements to a need based one. In sum, the IMF followed its mandate to safeguard balance in the international financial markets and thus performed normal IO behaviour.

5. The Commission – Guardian of the fiscal balance

The Commission's involvement in the financial crisis management of an EU member state differed starkly from the everyday operation of this IO. Unlike the IMF, which is an organisation created to manage financial crisis and its staff experienced in it, the EU Commission was primarily created to manage the everyday operation of the EU and therefore very much unprepared for crisis management. The Commission mandate is defined by the Treaty on the European Union: 'the Commission shall promote the general interest of the Union' (Art. 17(1)) as laid down in Art. 17(1–2): by applying EU law in general and its treaties in particular…;administering the EU budget and representing the EU in its external relations (unless stipulated otherwise); and proposing legislative acts.'[52]

The negotiating staff assigned to Hungary came from a number of DGs, and although no formal mission head was named, the delegation was headed by the representative of the country group department where Hungary belongs of DG ECFIN. In 2008, the majority of analyses and background documents for the negotiating team were prepared by a team of economists, which included a few Hungarian nationals. According to their own assessment, in 2008 the Commission was unprepared to manage the financial crisis both in terms of its staff as well as its procedural preparedness (interviewee). This is why, most of the negotiations with Hungarian officials were led by the IMF mission team and the EU officials only seconded the agreements reached.

The mission staff's defining past experience with Hungary stems from their involvement in the excessive deficit procedure (EDP). The EDP was triggered in 2004 and was still in effect in 2008. In the framework of the EDP, commissioners are required to pay attention to budgetary developments of the member state and if necessary define recommendations for its government. The invocation of the Balance of Payments facility also enhanced the fiscal orientation of the team. Thus, the negotiating team's aim was 'to help the country to build a prudent, stability-oriented and sustainable economic policy by supporting the sustainability of Hungary's balance of payments.'[53] In 2008, a general understanding in the EU Commission held that Hungary could have avoided this crisis, if it had followed a more austere fiscal policy in the past, reached the Maastricht criteria and joined the European Monetary Union.

The Commission regarded the IMF as having superior experience in managing financial sector related policy issues, while themselves as having an advantage in their knowledge of the country's economy. They felt that their familiarity with Hungary's past fiscal policy, as well as actually being able to read the whole proposed budget, not only the English summary as the IMF, they could contribute to the joint programme by stressing its fiscal aspect. This became especially evident in the second and third reviews of the Hungarian programme in

February and May 2009, when it was the Commission that proposed stricter terms than the IMF (pension reform). Also, the Commission delegates' negotiation mandate required them to include a medium term deficit target into any agreement they signed with the Hungarian authorities. The IMF mission team had no such restrictions. During the 2009 negotiations the EU Commission team was mandated to agree upon fiscal targets (3 per cent deficit) for 2010 and also 2011, which obviously made negotiations tenser with the Hungarian authorities. This evidence supports Lütz and Kranke's findings that the EU representatives rescued many of the aspects of the Washington Consensus. In addition, I found that this was the case not only because of their strictly rule following behaviour, but also because of their past experience and superior expertise in fiscal policy.

To conclude, this analysis found the EU Commission adhered to its mandate during the 2008 financial crisis: it supported the general interest of the Union by providing financial assistance of EUR 6.5 billion to a member state in trouble, and defined conditionalities that stemmed from its particularistic understanding of the crisis as having its origins in the member state's past fiscal performance. Nevertheless, as for the magnitude of the EU's financial assistance, Jacoby[54] shows for comparison that Eurozone member Ireland, whose population is 4.5 million compared to the roughly 10 million of Hungary, has received about EUR 45 billion in EU rescue packages.

6. European Central Bank –Defender of the realm

The European Central Bank's mandate is derived from the Protocol (no 4) on the statute of the European System of Central Banks and of the European Central Bank. According to the Protocol (no 4) ' the primary objective of the ESCB shall be to maintain price stability.' With regards to financial stability mandate the Article 127 of TFEU[55] (5) declares 'The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.' And specifically the ECB's role is: 'The ECB shall ensure that the tasks conferred upon the ESCB under Article 127(2), (3) and (5) of the Treaty on the Functioning of the European Union are implemented either by its own activities pursuant to this Statute or through the national central banks pursuant to Articles 12.1 and 14.'

There are two features of the ECB's mandate that are interesting from the point of view of the argument. First, the ECB's mandate of maintaining price stability is imprecise. The Treaty does not demand any specific level of inflation to be achieved; instead it gives relative freedom to the ECB staff to interpret its mandate. Second, the ECB is mandated – even if indirectly as a member of the ESCB – to contribute to the financial stability of the EU as a whole, not only to that of the Eurozone. Taken the two observations together, it becomes clear that in 2008 it was up to the ECB staff to decide and choose actions in relation to the Hungarian financial crisis.

The ECB's focus was on price stability of the Eurozone. As Trichet put it 'Our policy is geared towards preserving price stability …, in so doing, supporting the conditions for enduring financial and economic stability.'[56] It looked at the Hungarian cirri as an isolated incidence, which originated in the Hungarian domestic economy.

In October 2008 crisis management in Hungary could not be delayed post the EU-IMF agreement. Already in October the Hungarian central bank was required to advance actions to sustain the stability of banking in Hungary. As a first step, central bank authorities contacted the ECB and asked for a swap option in order to activate a 'swap lender of last resort' function, i.e. a last resort function for foreign currency denominated instruments. Within the framework of this agreement the ECB provided EUR 5 billion.[57]

There are a number of qualities, however, of this seemingly helpful arrangement. First, although the press communicated it as a swap deal, it was in fact a repo deal. The major difference between the two financial transactions is that for a swap option the drawing partner has to pledge domestic funds, whereas for a repo transaction the drawing partner has to pledge foreign reserves. This meant concretely, that Hungarian authorities had to back the EUR 5 billion with euro-denominated assets from the Hungarian central bank's reserve. Providing these assets further decreased Hungarian - reserves that were insufficient to begin with - this is precisely why the Hungarian authorities turned to the IMF, the EU and the ECB for financial assistance. The euro line provided by the ECB, in the end, could only be accessed with the help of the IMF-EU loan that Hungary contracted.

Second, the ECB did provide euro swap options to the USA[58], Switzerland[59], Sweden[60], and Denmark[61] at the same time it denied the Hungarian[62] authorities[63] (as it denied the Latvian[64] and Polish[65] central banks). Assessing their own actions, the ECB staff declared that the choice between swaps (to the USA, Switzerland, Sweden, and Denmark) and repo (to Hungary, Latvia and Poland) was made 'so as to minimise any impact on the ECB's provision of euro liquidity and the ECB's own monetary policy framework.'[66] Considering the magnitude of financial trouble in the receiving country was not part of their assessment.

Third, the ECB disregarded the negative consequences of its own actions for the Central and Eastern European government bond markets. As Neményi[67] argues it accelerated the selloff of Hungarian and Polish government bonds, thus aggravating these governments' public debt refinancing problems. Quite obviously, on liquidity dry government bond markets, who would invest in government bonds that not even the ECB accepts as collateral?

The Hungarian banking sector could have acquired foreign currency much cheaper if the ECB had treated the European banks on consolidated basis – as one entity - and thus the Hungarian subsidiaries of the European banks could have also accessed the facilities opened by the ECB for Eurozone countries. During this period, the ECB injected a large amount of liquidity into European financial markets.[68] For instance, the ECB opened unlimited liquidity provision at a fixed interest rate against adequate collateral; it lengthened the maturities of the longer-term refinancing operations (LTROs); opened supplementary refinancing operations; introduced a Covered Bonds Purchase Programme of EUR 60bn[69]. Eurozone mother banks could in principle channel part of this liquidity to Hungary, but it was up to the mother banks to do so; they could in principle decide not to bring liquidity. External observers lack of assurance of the liquidity providing willingness of Eurozone mother banks to off-Eurozone area led the EBRD and the IMF to propose the Vienna Initiative in 2009, in which Eurozone mother banks pledged to keep their position prior to the crisis.[70]

Hungarian controlled banks could not access ECB provided liquidity. This was the prime reason why the IMF insisted on a much larger loan as well as allocating part of the loan to Hungarian controlled banks. In other words, if the ECB had considered providing liquidity to Hungarian controlled banks, Hungary would have needed a smaller loan. This would have helped tremendously as part of the problem was that the Hungarian government's public debt was already too large to finance from the dried up financial markets. The IMF-EU loan evidently increased Hungary's outstanding debt obligation, and thus made its creditworthiness even worse.

In October 2008, the Hungarian central bank entered the secondary market for Hungarian government bonds as a substantial buyer[2]. This action was not in harmony with European regulation – as it represents government financing - however, it was essential to revitalize the Hungarian government bond market. Although in 2008 the ECB was very critical of these actions, it ended up taking similar measures not much later. In May 2010 the ECB launched the Securities Market Program (SMP) in which it purchased the sovereign debt of Eurozone countries such as Greece, Ireland, Spain, Portugal and Italy on secondary markets. This move caused considerable indignation among German central bankers as it could be construed as indirect government financing.[71] Thus, in 2008 the Hungarian central bank's actions were not

[2] Kiraly et al., "Contagion"

acceptable crisis measures in the ECB's assessment, but in 2010 it was acceptable to do just the same when Eurozone member governments experienced a crisis situation.

To conclude, during 2008 Hungarian financial crisis the ECB disregarded the interest and explicit request for swap assistance of the Hungarian authorities and Hungarian subsidiaries of Western European mother banks. Their interpretation of their mandate as guardian of the euro, made them insensitive to the magnitude of the Hungarian crisis and more importantly to the possible effects it may have on the financial stability of the Eurozone. The ECB staff prioritised its primary mandate regarding the Eurozone to the detriment of its financial stability mandate regarding the whole EU, not realizing the negative consequences for the integration of the European Union. Because the ECB acted against its explicit mandate, I define its actions as an institutional dysfunction.

7. Conclusions

Almost ten years on, there is growing evidence that the European Central Bank's performance during the European financial crisis was less effective than what Europe needed. Although macroeconomic analysis generally found a satisfactory performance of IOs including the ECB, an increasing body of international political economy (IPE) research points out sharp differences among them, and is generally critical of the ECB's performance. In this research, I pointed out very sharply the differences among these three IOs in their understanding of the crisis as well as in their management of the crisis situation. The IMF team, led by a financial market focus, advocated large financial assistance, which is capable of deterring speculative attacks and thus preventing the contagion of the Hungarian crisis to Europe. The EU commission, led by a fiscal balance focus, provided Balance of Payment facilities to the Hungarian authorities to regain their budgetary balance. At the same time, the ECB staff denied a swap option to the Hungarian central bank as well as access to liquidity by banks operating in Hungary.

Throughout this research, attention was paid on the IOs' framing of the crisis in order to explain the content of the programme agreed upon with Hungarian authorities. Clearly, the programme was the result of negotiations with Hungarian officials and their views are also reflected in the end result. In this research, although some of the concerns and suggestions of the Hungarian officials are spelled out, they are not accounted for systematically. In addition, there is only scarce attention paid to the interaction between the IOs. This is the result of the observation that the IMF absolutely dominated the first phase of the programme and negotiations. In the ECOFIN meetings the ECB's representatives never raised objections to the Commission's efforts to manage the Hungarian crisis, but also did not contribute to it (interviewee).

There are two implications of this research. First, the ECB, it seems, has a very narrow understanding of monetary stability in the European Monetary Union. It ignores labour market developments, industrial-relations, differences in productivities of member states, coordination efforts of governments, etc. As pointed out by a number of political economists, these factors matter for monetary stability.[72] In addition, as this research showed, it also disregards 'facts of its own creation' (for example the impact of not accepting as collateral Hungarian government bonds), and may undermine the stability of European financial markets in the process.

Second, the ECB seems to have a tendency to loosen the European East-West integration process, instead of tightening it. Prior to the crisis, it showed reluctance to pressure CEE governments into euro-adoption.[73] As this researched showed, its (in)actions during the 'liquidity phase' of the European financial crisis clearly did not serve the larger purpose of tighter integration of the European Union. Even after the crisis, in the early versions of the Banking Union, it denied non-Eurozone governments supervisory powers and only changed it as a result of excessive criticism of CEE governments. Again, it seems there is a counterintuitive side effect of the ECB's focus on price stability of the Eurozone: its harmful consequence for European integration.

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[1] Barnett and Finnemore, *Rules for the World*
[2] Lütz and Kranke, "The European rescue of"
[3] Barnett and Finnemore, "The politics, power and pathologies"
[4] Ibid, 700
[5] Ibid, 700
[6] Epstein and Rhodes, "The political dynamics"; Hanké, *Unions, Central Banks, and EMU*
[7] Véron, "The International Monetary Fund's"
[8] Moschella, "Negotiating Greece."
[9] Barnett and Finnemore, "The politics, power and pathologies"
[10] Rickard and Caraway, "International negotiations"
[11] Ban and Gallagher, "Recalibrating policy orthodoxy"
[12] Higgott and Hodder, "The IMF"
[13] Copelovitch, "Master or servant?"
[14] Schimmelfennig, "European integration in the euro crisis",
[15] Chang, "The European Central Bank"
[16] Saraceno, "The ECB", section 4
[17] Jacoby, "The EU Factor"
[18] Jacoby, "The EU Factor", 62
[19] Lütz and Kranke, "The European rescue"
[20] Lütz and Kranke, "The European rescue", 314
[21] Ibid, 315
[22] Barnett and Coleman, "Designing police"; Orenstein, et al., "Transnational actors"
[23] Lütz and Kranke, "The European rescue"
[24] Broome and Seabrooke, "Seeing like", 1
[25] Lütz and Kranke, "The European rescue"
[26] Lütz and Kranke, "The European rescue", 321
[27] Barnett and Finnemore, "The politics, power and pathologies"
[28] Ibid, 718
[29] Ibid, 719
[30] Ibid.
[31] Johnson, "The remains of conditionality"
[32] Király, "Likviditás válságban"
[33] Johnson and Barnes, "Financial nationalism"
[34] Váhegyi, "Sebezhetőség"
[35] Bohle, "Post-socialist housing"
[36] Király, et al., "Contagion"
[37] Király, "Az amerikai"
[38] Várhegyi, "Sebezhetőség"
[39] Tóka and Popa, "Hungary"
[40] Streeck, "The crises of democratic capitalism"
[41] Johnson and Barnes, "Financial nationalism"
[42] Váhegyi, "Sebezhetőség"
[43] Krugman, "Balance sheets"
[44] Lütz and Kranke, "The European rescue of", 322; Articles of Agreement

[45] According to Nemény it became clear only later that the attack was launched by Soros Fund Management LLC against OTP, by HSBC and by Deutsche Bank AG London.
[46] Ecorys, "Ex-Post Evaluation", 35
[47] Hungary contracted EUR 6.5 billion from the total of EUR 12 billion in the EU's Balance of Payments fund. The IMF agreed to EUR 12.5 billion in the form of a Stand-by-Agreement, and IBRD chipped in EUR 1 billion. Together Hungary received EUR 20 billion in financial assistance.
[48] IMF, "Hungary"
[49] Mérő and Piroska, "Central and Eastern European countries' twist"
[50] Letter of Intent
[51] IMF, "Hungary", 6
[52] Lütz and Kranke, "The European rescue of", 325; Treaty on European Union
[53] Ecorys, "Ex-post evaluation", 5
[54] Jacoby, "The EU Factor"
[55] Lisbon Treaty
[56] Trichet, "The financial crisis"
[57] ECB, "Monthly Bulletin"
[58] 12 December 2007 ECB establishes swap agreement with Federal Reserve USD 20, the first, followed by many
[59] 15 October 2008 ECB establishes swap agreement with Swiss National Bank CHF 25 per tender
[60] 20 December 2007 ECB establishes swap agreement with Sveriges Riksbank EUR 10
[61] 26 October 2008 ECB establishes swap agreement with Danmarks Nationalbank EUR 12
[62] 16 October 2008 ECB establishes agreement to provide euro to Magyar Nemzeti Bank EUR 5
[63] ECB, "Monthly Bulletin"
[64] 11 November 2008 ECB establishes agreement to provide euro to Latvijas Banka EUR 1
[65] 21 November 2008 ECB establishes agreement to provide euro to Narodowy Bank Polski EUR 10
[66] ECB, "Monthly Bulletin", 75
[67] Neményi, "A monetáris politikai"
[68] ECB Policy Responses between 2007 and 2014: A Chronological Analysis and an Assessment of Their Effects Carlos Rodriguez • Carlos A. Carrasco
[69] Rodríguez and Carrasco, "ECB policy", 9
[70] Epstein, "When do foreign banks 'cut and run'?"
[71] Howarth, "Defending the Euro"
[72] Hancké, *Unions, Central Banks, and EMU*
[73] Johnson, "The Remains of Conditionality"

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