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Funding Hungary: competing crisis management priorities of troika institutions

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ABSTRACT

This paper investigates the crisis management approaches of the troika institutions during the liquidity trap episode experienced by Hungary in October 2008. I demonstrate stark differences in the three institutions' interpretation of the crisis' origin that influenced the recommended policy responses: the IMF team was concerned with financial markets; the EU Commission emphasised the fiscal component of the crisis and recommended austerity measures, and, finally, the ECB focused primarily on the monetary stability of the Eurozone and overlooked the consequences of its decisions for EU member states outside the Eurozone. The paper argues that for Hungarian policy-makers the greatest challenge in crisis management was not the harshness of the austerity measures, but overcoming difficulties generated by the competing crisis management priorities of the troika institutions. The paper concludes with a note on policy coordination as a recurring obstacle to the troika's effective crisis management.

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Introduction

The Hungarian political economy has changed dramatically over the last few decades. In the post-transition period, the primary catalyst of change was the global financial crisis (GFC).¹ Consequently, the Hungarian financial crisis of 2008 attracted a considerable amount of attention from International Political Economy (IPE) scholars: Johnson and Barnes² explained in their influential piece the post-crisis emergence of financial nationalism and how this policy choice of the Orbán government was enabled by international actors. Bohle's³ analysis of housing finance shed light on the Orbán government's compensations to borrowers in foreign currencies, which were welfare legacies driven and socially sensitive, but legally controversial. Others, such as Györffy⁴ analysed different post-crisis fiscal consolidation measures in order to identify the policy measures most conducive to growth. However, up to now, most IPE research focused on the consequences of the crisis while less attention was paid to the management of the crisis itself. The scholars who studied the handling of the crisis either looked at the role of foreign banks (see Epstein⁵), or analysed pre-crisis

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economic policies and focused their narrative on the role of communist and post-communist government legacies (see Andor⁶ and Benczes⁷). Missing from these analyses is a thorough understanding of the involvement of the troika institutions in the management of the crisis. This seems to be a significant omission, as the IPE literature on the involvement of the International Monetary Fund (IMF), the European Commission, and the European Central Bank (ECB) in the management of the Eurozone crisis is abundant.

In this essay, I look at the Hungarian crisis in order to explicate differences in the approaches of the troika institutions in their crisis management. In doing so, the paper follows Lütz and Kranke's⁸ analysis, which contrasts the EU and IMF responses to the crisis in the Central and Eastern European (CEE) region. They demonstrate that in negotiations with Romania and Latvia in 2009 the IMF negotiating team proved to be far more flexible and embraced less orthodox fiscal policy recommendations, than representatives of the Commission and the ECB. I advance Lütz and Kranke's argument: looking at the Hungarian financial crisis, which preceded the Romanian and Latvian crises, I emphasize the three institutions' different takes on the Hungarian crisis. This methodological choice allows me to explicate differences in the three institutions' perspectives on the origin of the crisis, and to show that it had a defining impact on the actual crisis management steps. In turn, explicating competing crisis management priorities allows me to draw attention to the underestimated importance of policy coordination among the three institutions. Therefore, my findings complement Lütz and Kranke's analysis by pointing out that contradictions amongst crisis management decisions characterised the troika's operations. In the case of Hungary, as in many later cases of the troika's crisis management, it was not the harshness of austerity measures, but overcoming the contrasting crisis management priorities that proved to be the greatest challenge for national policy-makers.

In the final step, I take advantage of the 10 years that passed since the crisis to reflect on the management of the loans provided by the IMF and EU, as well as financial market and real economic developments. I review the actual use of the loan by the Hungarian Governments and detail the difficulties Hungarian policy-makers faced due to a number of policy coordination problems among the troika institutions. With regard to the banking sector developments, I point out the controversial results of the Orbán government's banking nationalism, and with regard to long-term growth, I show that the crisis seriously upset Hungary's growth trend, while its regional counterparts grew faster. With regard to the troika's disjointed response to the Hungarian crisis, I show that while it was not the main reason for the slow growth, it certainly played a key part in it, at least in the initial few years following the crisis episode detailed here.

During the course of this research, I conducted content analysis of the relevant policy documents and media discourses, 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 conducted semi-structured interviews with both Hungarian officials (high ranking and lower ranking) from the government and the central bank, and the troika's own representatives. (See the list of anonymous interviewees at the end of the text.)

The rest of the paper is structured as follows: in the next section, I put the Hungarian crisis into a theoretical and methodological context. Next follows a presentation of the pre-crisis banking sector, fiscal policy and currency market developments. The following three sections review the crisis management approaches of the troika. Then the paper evaluates the various approaches and describes economic developments post-crisis. The last section concludes.

Contextualising the Hungarian crisis

In this exploratory case study, the fact that lends importance to Hungary is that in October 2008 the country served as ground-zero for IMF–EU cooperation. The troika's relevance grew tremendously in the following few years. Therefore, the Hungarian crisis serves as a background against which to assess the evolution of their cooperation in later cases.⁹

In addition, analysing the Hungarian crisis also makes it possible to further insights offered by Lütz and Kranke on the changing policies of international organisations: namely, the Washington Consensus rescue by EU institutions and the relatively less orthodox policy stance of the IMF. Lütz and Kranke, who build on Barnett and Finnemore's¹⁰ moderate constructivist approach, draw a co-constitutive link between the institutional mandates of the organisations, their staff's latitude in interpreting these mandates, and the subsequent policy recommendations of the different organisations. They claim that the IMF staff had greater latitude in interpreting its mandate compared to the Commission's and the ECB's more rule abiding attitude. This is the reason why the IMF recommended laxer fiscal policies than the representatives of EU. In this study, while acknowledging the importance of both mandates and their staff interpretations, two additional considerations are proposed for understanding the different crisis management steps.

The first consideration is the difference in the perspectives of the three institutions. It seems that the IMF negotiating team had a market focus and stressed the European and regional dimensions of the Hungarian crisis. The Commission focused on the budgetary imbalances and treated the crisis primarily as a Hungarian crisis, but with the potential to contaminate the whole EU. Finally, the ECB exclusively focused on the Eurozone's stability. The next consideration, under-theorised by Lütz and Kranke, follows from the different perspectives: the three institutions were in stark contrast to each other in their interpretations of the origins of the crisis. The IMF team assumed the Hungarian crisis was prompted by the sudden drying up of liquidity in the international financial markets, while both the Commission and the ECB stressed the importance of the unbalanced budget. Both perspectives on the crisis, as well as the specific understandings of the origins of the crisis, significantly shaped the crisis managing options advanced by each institution. The IMF stressed the importance of increasing the stability of the banking sector and within that specifically the stability of domestically owned banks; the Commission recommended austerity measures to balance the budget, while the ECB used ring-fencing for the containment of contagion from an EU member state whose banking sector was dominated by Eurozone mother banks – it denied easily accessible liquidity to Hungary.

Incorporating the troika institutions' perspective and understanding of the origin of the crisis is an important component in explaining policy recommendations. As Hay¹¹ argued, crises are always in the eye of the beholder: it is how they are narrated that determines the kinds of policy changes they will elicit. Therefore, when we are to understand why the EU recommended harsher austerity measures than the IMF, it is important to delve into the analysis of the perspectives of these institutions as well. The Commission's delegation mainly focused on budgetary imbalances and sought the origin of the crisis in the country's past fiscal record. The IMF delegation looked for the origin of the crisis in international financial markets and hence recommended measures that can shield Hungary from the dry up of liquidity. The Commission thus was far more motivated than the IMF to bring about fiscal balance through austerity measures.

Furthermore, I point out that because none of the troika institutions recommended very harsh austerity measures, Hungary's difficulties stemmed mainly from policy coordination problems resulting from the conflicting priorities of the troika institutions. During the heyday of the crisis in October 2008, most immediate problems faced by national policy-makers stemmed from the lack of policy coordination between ECB on the one hand and the IMF-EU joint delegation, on the other.

In order to demonstrate the relevance of these points, I will first review the build up of the Hungarian crisis and show that it naturally lent itself to multiple interpretations. The features of a banking crisis, a fiscal crisis, and a currency crisis were all present in Hungary. Therefore, it mattered tremendously which feature was considered as the most pressing for immediate policy intervention. In the next step, I show in detail that the troika institutions' crisis management priorities were largely dependent on their views of the origin of the Hungarian crisis.

Multiple vulnerabilities: banking sector, fiscal balance, and currency market

The banking sector in Hungary had been dominated by western European parent banks since 1995 (Figure 1(C)). In 2008, the largest banks included Erste Bank, Raiffeisen Bank, UniCredit Bank, Intesa Sanpaolo, BLB, Volksbank, GE Capital, and KBC Bank. There were only a few Hungarian-controlled banks: OTP, FHB, and the cooperative sector. In preparation for

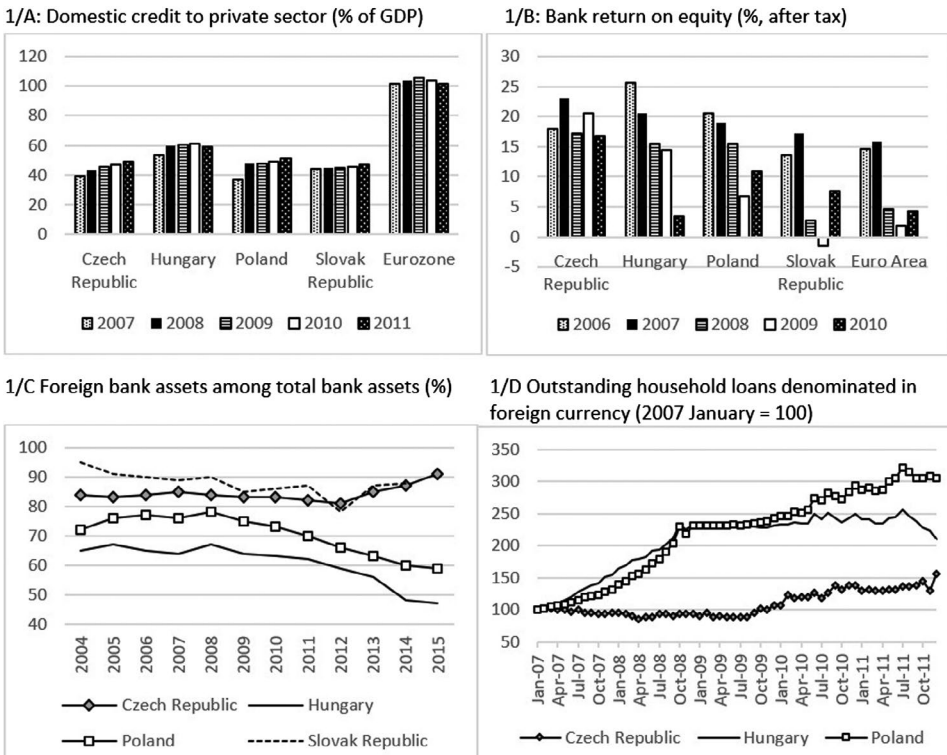


Figure 1. Selected characteristics of CEE banking sector. Sources: National Bank of Hungary, Bloomberg, WB GFDD, ECB.

the 2004 EU accession, capital flows were fully liberalised in 2001. Successive governments – although only with moderate enthusiasm – had been preparing for Euro introduction ever since accession. The crisis hit Hungary in the midst of a political turmoil, through the government bond markets and through the banking sector's Achilles heel: the composition of its loan portfolio.

Since privatisation, intermediation became increasingly deeper in both the retail and wholesale sectors of the banking sector. From 2000, retail credit expansion became the engine 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 reached 170% in 2008.¹² Even though the ratio of credit to GDP remained lower than in western Europe, rapid credit growth became increasingly worrisome (Figure 1(A)). 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 credit expansion presented itself for all banks as an outstanding profit-making opportunity. Due to the lower level of competition and financial culture, high level of trust in the value of the forint and high local interest rates, parent banks could charge higher interest rate margins in CEE than in western Europe (Figure 1(B)). Mortgage loans as well as equity loans became the prioritised products for banks (Figure 1(D)). Importantly, credit standards were gradually loosened: down payments reduced, maturities lengthened, and income checks were loosened.

The Hungarian economy's current account remained relatively in balance due to the increased inflow of capital.¹³ The early 2000's abundance of liquidity in international capital markets also increased capital flows to Hungary. The massive inflow of credit was directed to the housing market, triggering a construction and housing boom (Figure 2(D)). The housing boom, however, never developed into a housing bubble according to the analysis of the central bank.¹⁴ The housing loan expansion that developed in Hungary was in a number of aspects similar to the US subprime mortgage boom¹⁵: 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 inflows elevated the value of the local currency to a higher level that could have been justified by the performance of the real economy (Figure 2(A)). Arguably, the central bank's interest rate policy was not adequate to handle this situation (Figure 2(B)). The inflation rate also accelerated and increased asset values (Figure 2(C)). This development also put upward pressure on interest rates, increasing them 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 more favourable rates than euro-denominated ones. Finally, the growth of foreign currency-denominated loans further increased the value of the forint, making it ever more difficult to recognise the risks inherent in the exchange rate (Figure 2(D)).¹⁶

Government supported loan programmes also contributed to the credit expansion. The first programme was launched by the Orbán-led Fidesz government in 2001 and embraced by the following Socialist-Liberal government in 2004, but soon dropped due to the pressure it put on the budget. From 2002 to 2006 public debt started to rise again, from 56 to 66% of GDP (Figure 3(A)). This was also partly the result of the Medgyessy led Socialist-Liberal

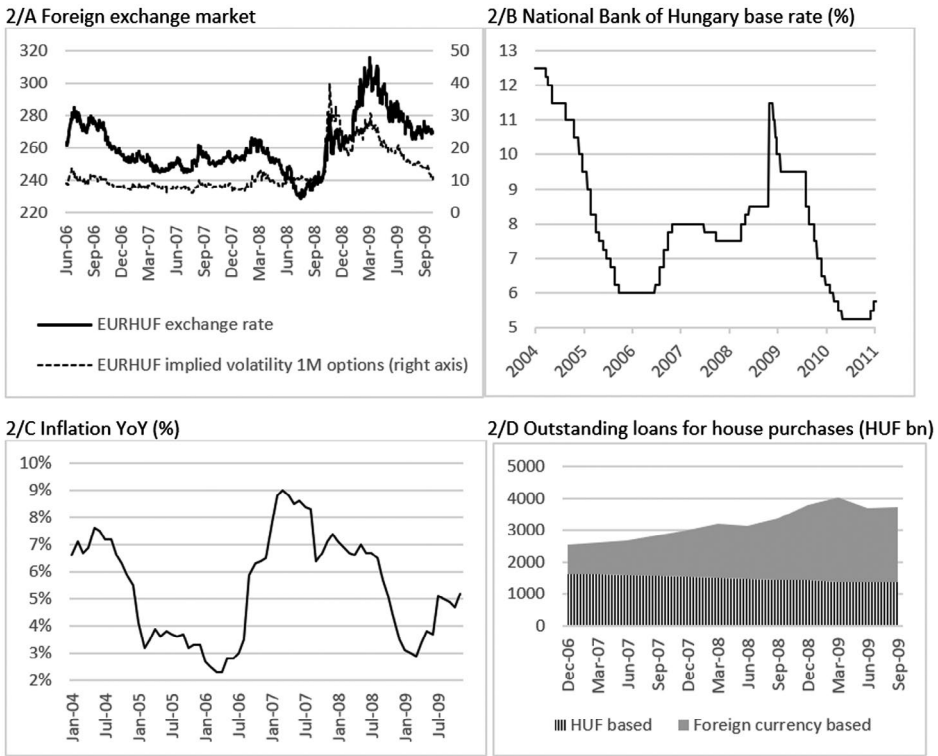


Figure 2. Currency pressure. Source: NBH, Bloomberg.

government’s fiscal programme, which brought less popularity than expected but put a very severe pressure on the budget (Figure 3(A) and (D)). Fearing that the diminishing popularity of Medgyessy will eventually result in losing the next parliamentary elections, the Socialist party replaced him with Gyurcsány as the prime minister in 2004.¹⁷ Until 2006, Gyurcsány’s government, similarly to the American Government, embraced credit expansion as a substitute to government sponsored welfare spending.

In September 2006 an audio recording, in which Gyurcsány admitted that the Socialists had been lying to the public about the economy for nearly two years, was leaked.¹⁸ A month of demonstrations and atrocities followed. From this point onward, Gyurcsány could never regain his former popularity. In the period between the 2006 riots and October 2008, 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. This led to enough friction in the coalition that the liberal junior partner decided to leave the coalition in April 2008. From May 2008, the Gyurcsány-led Socialist minority government only had minimal manoeuvring space in its economic policy.

Prior to the crisis, the central bank was slow to react to the mounting pressure and let its FX reserves deplete.¹⁹ Only in the summer of 2008 did the central bank start increasing its FX reserves. As a result, in October 2008 the central bank’s foreign exchange reserves level did not cover the refinancing need of the fiscal deficit and that of the FX-denominated private debt, and hence increasing the country’s vulnerability (Figure 3(B)).

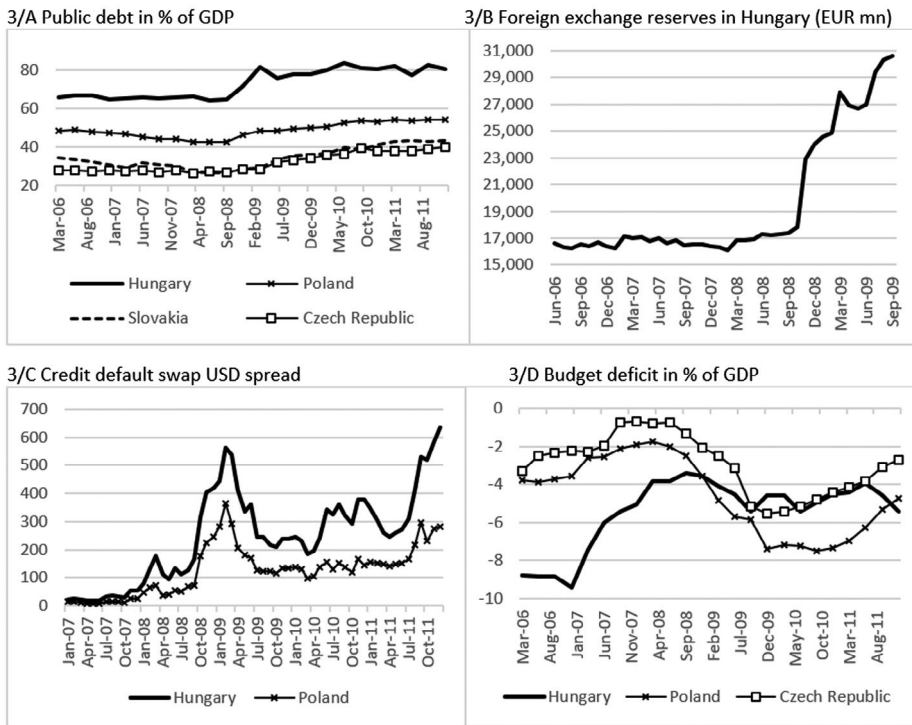


Figure 3. Selected fiscal data of CEE countries. Sources: Bloomberg, ECB.

Prelude to the analysis

In the first days of October 2008, speculative attacks were launched against the forint, as well as the largest and domestically owned Hungarian bank, OTP.²⁰ 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 bn, which if not repaid, were projected to force Hungary into default by December. However, domestic banks owed an even greater amount of short-term obligations to foreign sources, around EUR 20 billion, which, due to the freezing of the interbank market, could not have been repaid on schedule either. Foreign exchange reserves of the central bank stood at around EUR 17,4 bn, insufficient to cover all these obligations.²¹

On 9 October 2008, Hungarian public officials contacted both the EU Commission and the IMF for assistance in order to avoid a public debt crisis. Negotiations lasted until the end of October 2008. As a conclusion of the negotiations, Hungarian officials sent a Letter of Intent (LoI) to the IMF, in which the points of the negotiated policy package were detailed as conditions upon which the Hungarian Government would contract the loan from the IMF. The Letter of Intent (LoI)'s content was a result of the negotiations and therefore reflected both the IMF team's and the Hungarian official's positions. Similarly, Hungarian officials sent a Memorandum of Understanding (MoU) to the EU Commission and offered conditions upon which Hungary would contract from the EU's Balance of Payments facility. Just like in the case of the LoI, the MoU clearly reflects the agreement between Commission delegates and Hungarian officials.

It is important to point out that although there were overlaps between the Lol and the MoU, they also clearly differed with regard to the kind of policy conditions Hungarian officials agreed upon with the two troika institutions. While the Lol sent to the IMF contained measures aimed at both the financial sector and fiscal policy, the MoU sent to the Commission only contained fiscal measures. The fiscal measures were identical, but importantly the IMF's conditionality was more complex and contained financial market conditions as well as regulatory changes. Ultimately, the IMF agreed to loan EUR 12.5 bn in the form of a Stand-by-Agreement, the EU granted EUR 6.5 bn and the IBRD chipped in with a further EUR 1 bn. In total, Hungary received EUR 20 bn in financial assistance. In the meantime, central bank officials tried to secure a swap line with the ECB, as Hungary faced, in addition to a public debt crisis, an FX liquidity crisis and not merely a local currency liquidity crisis.

The IMF – the advocate of financial markets

The IMF negotiating team arrived in Hungary from the Marek Belka led European Department within a few days. They were all trained economists, experienced in other missions (although mainly Article IV reviews) – and none of them spoke Hungarian. As all interviewees attested, the IMF team soon took over the role of lead negotiator with Hungarian officials.

As a first step, the IMF negotiating team convinced Hungarian authorities that Hungary was in need of a far greater amount of assistance than originally envisioned. The Hungarian assessment was that they faced a public debt crisis as they were unable to refinance EUR 3 bn of obligations. They approached the IMF with a request covering exactly this amount. The IMF team made it clear swiftly that in their understanding, Hungary is in a far worse situation; the biggest threat is not that the Hungarian Government cannot renew public debt, but that it cannot cover the outstanding obligations of the entire banking sector. They stressed the dangers of the extensive drying up of liquidity on international financial markets. Due to these conditions, they recommended that Hungary contract for EUR 20 bn (Interviewee #1). The team's focus on the external origin of the crisis is evident from the Lol: 'In recent weeks, financial stress has increased sharply, mainly due to external factors. Investors' extreme risk aversion, which spilled over from difficulties in global financial markets, has negatively affected the foreign exchange, government securities, and equity markets in Hungary'.

Second, the IMF team stressed the importance of safeguarding nationally controlled banks. The IMF team saw a major discrepancy between foreign-owned and domestically controlled banks' ease of access to foreign currency-denominated funding. They therefore 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 from each foreign-owned bank to uphold liquidity levels. Commitments, however, were not binding (Interviewee #2). As for domestic banks the Lol stated the following: 'We have developed, in consultation with IMF staff, a comprehensive package of support measures available to all qualified domestic banks, to buttress their credibility and confirm our commitment to preserving their key role in the Hungarian economy'. As for foreign-owned banks the Lol stated: 'Most of the external funding comes from parent banks in the euro area, which now have access to liquidity through ECB facilities and which have pledged their continuous support for their subsidiaries in Hungary'.

Third, the team insisted on strengthening bank supervisory authorities and including new banking regulations addressing macroprudential concerns into the agreement. A number of these regulations were proposed by the central bank, taking advantage of the opportunity that it could get past the banks and the Ministry of Finance. Other regulations were implemented much later, not necessarily as macroprudential tools, but mainly as regulatory measures that increase government powers over banks.²² Fourth, the IMF expertise was important in defining the macroeconomic models used to forecast future fiscal imbalances. Nevertheless, 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 in the programme the establishment of a Fiscal Council.²³

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 conceptualised 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 (Interviewee #3). In addition, a commitment was made for a private debt resolution strategy that would alleviate the burden of households indebted with foreign currency loans.²⁴

In conclusion, I showed that the IMF staff had approached the Hungarian crisis situation from the vantage point of financial market actors. First, it was understood that the Hungarian banking crisis had the potential to harm not only Hungary but also Europe, through foreign-owned banks as the conduit, and major financial assistance was key in preventing this eventuality. Contagion was also to be prevented through the strengthening of financial sector balance sheets, improving financial market conditions as well as pledging support for the government. According to the IMF's 2011 evaluation 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.'²⁵

Second, the IMF's perception was that Hungarian financial troubles did not originate from the domestic economy itself, but from its high vulnerability to external factors. The drying up of liquidity on international financial markets was seen as the main source of Hungary's problems, which had the potential to infiltrate the entire banking sector. Therefore, the IMF team focused more on banks and less on fiscal imbalance. This becomes even more evident if we investigate the fiscal component of the programme. Although the fiscal consolidation efforts included in the programme were sizable (originally projected at 5% of potential GDP for 2009–2011), it did not demand any major structural changes – neither in the financial sector nor in the real 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.

The EU Commission – the guardian of fiscal balance

The Commission's involvement in the financial crisis management of an EU member state starkly differed from its everyday operation. Unlike the IMF, which is an organisation created to manage financial crises, the EU Commission was primarily created to manage the everyday operation of the EU, and therefore not immediately prepared for crisis management. The negotiating staff assigned to Hungary came from a number of Directorate Generals (DGs),

and although no formal mission head was named, in practice the delegation was headed by the representative of the country group department to which Hungary belongs within the DG Economic and Financial Affairs (ECFIN). In October 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.

The mission staff's defining past experience with Hungary stemmed from their involvement in the excessive deficit procedure (EDP). The EDP was triggered in 2004 against Hungary and was still in effect in 2008. Within the framework of the EDP, commissioners are required to oversee budgetary developments of the member state and, if necessary, form recommendations for its government. The invocation of the Balance of Payments facility, as the source of EU loans, also enhanced the fiscal orientation of the team. The negotiating team's focus on fiscal balance is clear from the MoU signed between the Hungarian Government and the Commission:

the assistance will help the country to continue and strengthen the fiscal consolidation efforts started in mid 2006 and to make progress with fiscal governance, financial sector regulation and supervision reforms and other measures to support a prudent, stability-oriented, and sustainable economic policy.

In October 2008, a general understanding in the EU Commission held that Hungary could have avoided the crisis if it had followed a more austere fiscal policy in the past, met the Maastricht criteria, and joined the European Monetary Union.

The negotiating team regarded the IMF as having superior experience in managing financial sector-related policy issues, while regarding itself as having an advantage when it comes to a detailed knowledge of the country's economy and the history of its economic policy. They felt that because of their familiarity with Hungary's past fiscal policy, as well as actually being able to read the proposed budget and not only the English summary as the IMF team did, they could contribute to the joint programme by stressing its fiscal aspect (Interviewee #4). This is evident from the MoU, which only contains fiscal targets as major conditions for transferring the first instalment of EUR 2 bn. These fiscal targets included 'a deficit of 2.6% of GDP ... (i) a nominal wage freeze in the public sector in 2009; (ii) eliminating the 13th month salary for all public servants; and (iii) capping the 13th month pension payments at HUF 80,000'.²⁶

The Commission's focus on fiscal imbalance became increasingly evident in the second and third reviews of the Hungarian programme in February and May 2009, when it was the Commission that proposed stricter and more specific terms than the IMF (pension reform). The Commission delegates' negotiation mandate also required the inclusion of a medium-term deficit target into any agreement signed with the Hungarian authorities. The IMF mission team had no such restrictions. During the 2009 negotiations, the EU Commission team was mandated to set fiscal targets (3% deficit) for 2010 and also 2011, which obviously made negotiations tenuous with the Hungarian authorities. This evidence supports Lütz and Kranke's findings that the EU representatives prioritised the inclusion of strict austerity measures. In addition, I found that this was the case not only due to their strict rule following behaviour, but also because of their past experience and expertise in Hungarian fiscal policy (EDP).

To conclude, this analysis finds that the EU Commission's understanding of the crisis as having its origins in the member state's past fiscal performance led it to draw up fiscal consolidation measures with an emphasis on fiscal austerity. Thus, the Commission's delegation

did not compete with but complemented the IMF's financial market focus. However, the result of their joint conditionalities compounded crisis management targets for Hungarian officials.

European Central Bank – defender of the realm

On 8 October and 15 October ECB's Governing Council made a number of decisions that had far reaching consequences for the management of liquidity crises across the European Union. In making these decisions, the Council's explicit focus was on the Eurozone. Evaluating the impact of these measures outside the Eurozone, but inside the EU did not figure among ECB's immediate priorities. In addition, when designing instruments to deal with risks coming from outside the Eurozone the ECB stated: 'In order to reduce these risks to acceptable levels, the Eurosystem maintains high credit standards for assets accepted as collateral, evaluates collateral on a daily basis and applies appropriate risk control measures.'²⁷ As such, risk management in EU member states outside the Eurozone was reduced to the idea of ring-fencing the Eurozone.

On 9 October, dealing with the crisis in Hungary could no longer be delayed until the negotiators reached an agreement with the EU and IMF delegates. By then the Hungarian central bank was required to take actions to sustain the stability of the banking system in Hungary. As a first step, central bank authorities contacted the ECB and asked for a swap facility 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 bn.²⁸

There are several qualities of this arrangement that are worth highlighting in order to understand the ECB's perspective on the Hungarian crisis. First, although the press communicated it as a swap facility, it was in fact a repo facility. The major difference between the two financial transactions was that in a swap transaction the drawing partner has to pledge as collateral domestic currency, whereas in the repo transaction the drawing partner has to pledge as collateral foreign assets as collateral. This meant specifically, that Hungarian authorities had to back the EUR 5 bn with euro-denominated assets from the Hungarian central bank's reserves. Providing these assets further decreased Hungarian reserves, which were insufficient to begin with. The low level of reserves was 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 facilities for the USA,²⁹ Switzerland,³⁰ Sweden,³¹ and Denmark³² at the same time it denied it to the Hungarian³³ authorities (as it denied it to the Latvian³⁴ and Polish³⁵ central banks). In the ECB's own assessment, the reason for providing liquidity was 'containing global contagion and reducing systemic risk and spill over effects on euro area markets.'³⁶ However, the ECB's choice between swaps (to the USA, Switzerland, Sweden, and Denmark) and repos (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.'³⁷ Consequences of the repo decision for the crisis management efforts of the Hungarian, Latvian, and Polish policy-makers is missing from the ECB's analysis.

Third, the ECB disregarded the negative consequences of its own actions for the Hungarian and Polish Government bond markets. As Neményi³⁸ argues, its choice of repo financing accelerated the selloff of Hungarian and Polish Government bonds, thus aggravating the public debt refinancing problems faced by these governments (see Figure 3(C) on the CDS spread jump from October 2008 to April 2009 for Hungary and Poland). With government bond markets dry of liquidity, who would invest in government bonds that not even the ECB accepted as collateral?

During October 2008, the ECB injected a large amount of liquidity into European financial markets.³⁹ These facilities were only open to Eurozone banks; subsidiaries based in the EU but operating outside the Eurozone were not eligible. Eurozone parent banks could in principle channel part of this liquidity to Hungary, but it was up to the parent banks to decide if they wanted to do so. The lack of assurance that Eurozone parent banks would be willing to provide liquidity outside the Eurozone area led the foreign-owned banks to urge IMF and EBRD to propose the Vienna Initiative in 2009.⁴⁰ In this agreement, Eurozone parent banks pledged to keep their subsidiaries' liquidity similar to the pre-crisis levels.

Furthermore, as per ECB rules, domestically controlled banks in Hungary 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 domestically controlled banks, a smaller loan would have been sufficient for Hungary. This would have been tremendously helpful for the country, as part of the problem was that the Hungarian Government's public debt was already too large to be financed from the barely functioning financial markets (see Figure 3(A) for the hike in public debt after the IMF agreement in January 2009). The IMF-EU loan evidently increased Hungary's outstanding debt obligation, and thus made its creditworthiness even worse.

Finally, in October 2008, the Hungarian central bank entered the secondary market for Hungarian Government bonds as a substantial buyer.⁴¹ This action was not in harmony with European regulations, but it was essential to revitalise the Hungarian Government bond market. Although in 2008 the ECB was very critical of these actions (Interviewee #2), it ended up taking similar measures itself not much later. In May 2010, ECB launched the Securities Market Program (SMP) in which it purchased the sovereign debt of troubled Eurozone countries on secondary markets. This move caused considerable indignation among German central bankers as it could be construed as indirect monetary financing.⁴²

To conclude, during the October 2008 Hungarian crisis ECB's focus was on price stability of the Eurozone. For as Trichet put it, 'Our policy is geared towards preserving price stability ... in so doing, supporting the conditions for enduring financial and economic stability'.⁴³ The ECB disregarded the explicit request for swap assistance by Hungarian authorities, and failed to open liquidity instruments for Hungarian subsidiaries of western European parent banks or for Hungarian-controlled banks. It therefore contributed to the immediate deepening of the Hungarian crisis situation and alienated Hungarian central bankers. This finding is also important as it shows how the ECB's crisis management approach of the Hungarian case foreshadowed later cases (notably Greece and Ireland). As Gabor⁴⁴ explains: 'The ECB's reluctance to resume extraordinary crisis measures continued even as increasingly apocalyptic scenarios accompanied the Portuguese bailout in April 2011, the second Greek bailout and the Italian and Spanish sovereign bond market pressures in June 2011'. In the meantime, in October 2008, ECB did assist Eurozone banks with significant amounts of liquidity, and

unlike national governments, who implicitly prohibited assisted banks from transferring funding outside their home country,⁴⁵ ECB did not impose any implicit or explicit restrictions on the intra-bank transfer of funds outside the Eurozone.

Competing crisis management priorities – a policy coordination problem for Hungarian officials

The different crisis management approaches taken by the troika institutions had conflicting implications for the Bajnai-led care-taker government (in power from April 2009 to May 2010). The IMF team's insistence on a large loan to back domestic-owned banks had both positive and negative implications. Clearly, the Fund's readiness to back the Hungarian Government had the consequences of calming financial markets. (This was a much-needed development due to the upset of market expectations caused by a miscalculation of Hungary's position by BIS officials (interview #4)). The agreement reached sent the message that the Hungarian Government and therefore Hungarian banks will be able to meet their obligations. This argument is also cited by the IMF as a reason for the success of overcoming the liquidity trap phase of the crisis.⁴⁶ Its negative impact, however, is much less emphasised: namely that it led to a substantial increase of Hungarian public debt, which was already higher than that of other CEE countries (Figure 3(A)). The importance of the DG ECFIN staff was increasing over time. During the heyday of the liquidity trap phase in late 2008, they played the role of an observer rather than active crisis managers. However, with the new assessment rounds of 2009 and the worsening economic conditions, the ECFIN team's approach regarding public debt and deficit became ever more important and their influence on the 2009 budget cuts is noticeable. They consistently pressed for austerity measures, especially in the public sector. Finally, as mentioned above, the ECB's denial of swap assistance had a clear negative effect in the short run on the CDS spread of Hungarian Government bonds (see Figure 3(C)). In addition, the denial of liquidity to Hungarian banks increased the size of the loan that Hungary eventually had to contract from the IMF and the EU Commission. However, the liquidity the ECB provided for parent banks was instrumental in keeping the Hungarian financial market liquid and thus stable.

These findings point to the consequences of the competing crisis management priorities of the troika institutions: (1) the IMF's insistence on enhancing Hungarian financial market stability was a corollary to the denial of liquidity assistance by ECB to the Hungarian central bank, Eurozone banks' subsidiaries, and domestically controlled banks. (2) Budget cuts demanded by the Commission, aimed at increasing the creditworthiness of the Hungarian Government, were in contradiction with the ECB's decision to not accept Hungarian Government bonds as collateral, thus resulting in extreme CDS spreads and a deteriorating credit worthiness of Hungarian Government bonds. Finally, (3) the IMF's insistence on a large loan to regain international investors' trust in the soundness of Hungarian financial markets elevated the Hungarian budget to a level that made the rollover of Hungarian bonds increasingly difficult.

In light of these observations, it is worth reviewing what the joint IMF–EU loan was eventually used for. First, the EUR 1 bn offered by IBRD was never contracted. Out of the total loan of EUR 19 bn Hungary only drew EUR 14,3 bn, approximately 75% of the total. Most of this amount was drawn before 2010. Since the Orbán government set as a priority the repayment of the IMF loan, it was gradually refinanced starting in 2011 with the last tranche (EUR

2,1 bn) refinanced in August 2013. The EU loan was fully repaid in 2016. The loan was used partly for refinancing public debt and deficit between 2008 and 2010 (41% of the total EUR 20 bn), partly for non-crisis related purchases (13% went to repurchasing shares of MOL, Hungary’s Oil Company), and partly for increasing reserves.⁴⁷ Only as little as 7.6% was spent, as part of the bank rescue package, to buttress credibility of two domestically controlled banks. This amount was repaid by the banks the following year. The Hungarian Government did not spend any additional amount on bank rescue – no bank had to be bailed out or backed up in any other way.

Ten years after

As a final step of the analysis, it is worth reviewing the evolution of fiscal policy, banking policy and real economic developments since the crisis. By 2011, fiscal policy developments resulted in a reduced government deficit level, while public debt levels remained relatively high (Figure 4). In banking, the domestic credit to private sector ratio remained unchanged during the crisis years of 2008 and 2009, but started to decline after the Orbán government came into power in 2010 (Figure 5(A)). Non-performing loans, especially the ones denominated in foreign currency increased dramatically (Figure 5(B)) prompting the Orbán government to take action. However, these actions, as accounted for by Mérő and Piroška⁴⁸ were driven by banking nationalism and thus led to counter-intuitive results. Since 2010, the

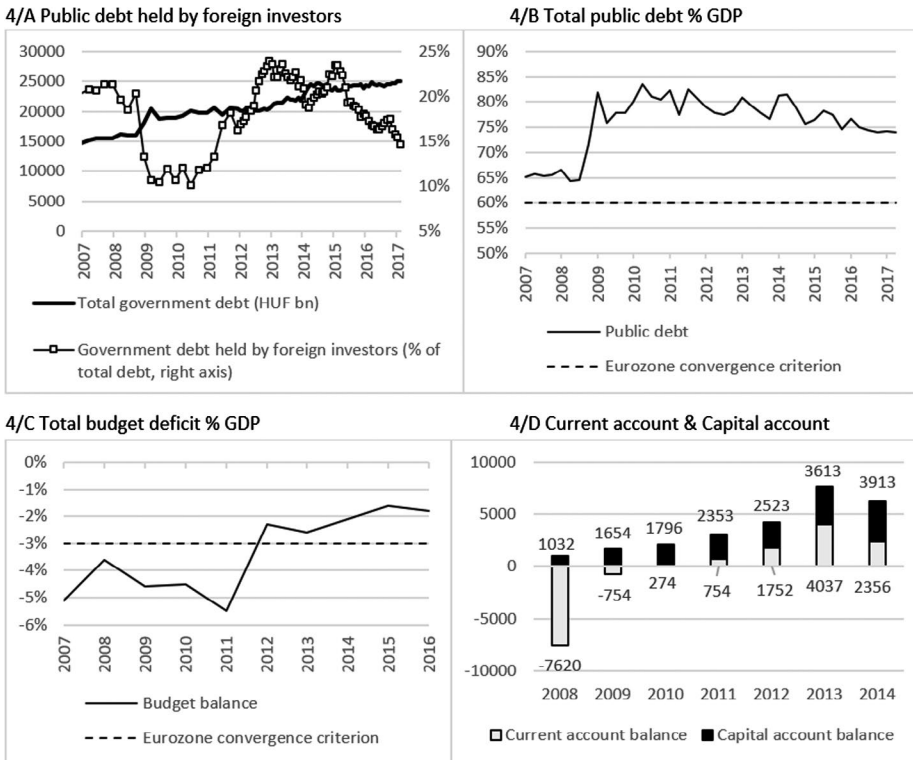


Figure 4. Fiscal developments after GFC. Source: Hungarian Government Debt Management Agency, HCSA.

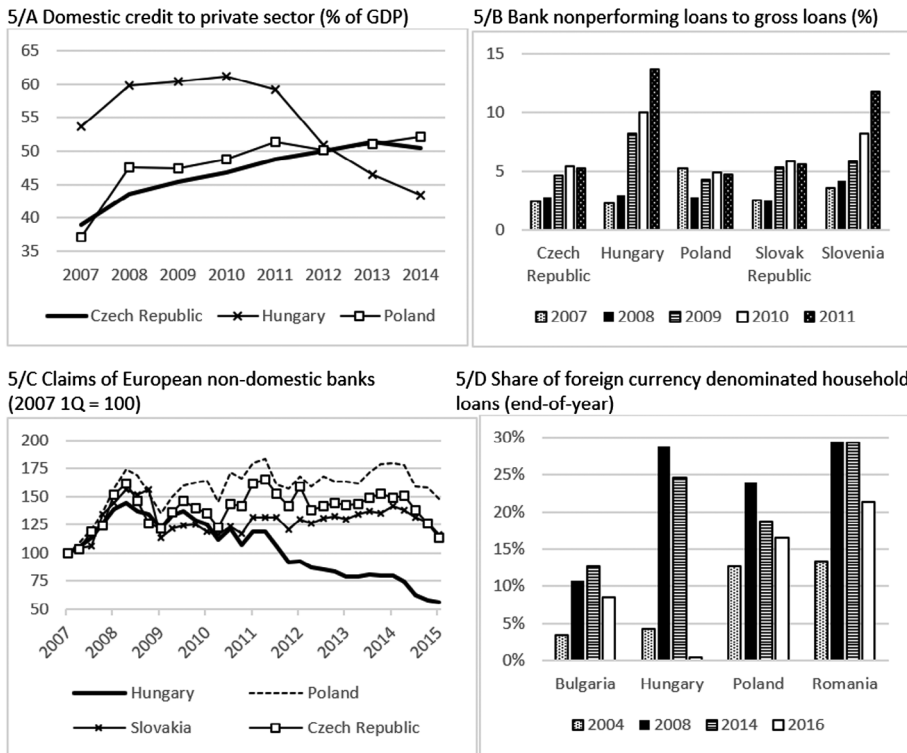


Figure 5. Banking sector developments after GFC. Source: NBH, ECB, Bloomberg.

Orbán government's banking policy aims at decreasing the role of foreign banks and foreign currency dominance in banks' portfolios. The results can be seen above in Figure 1(C) which shows the decline of foreign bank assets in total assets as well as Figure 4(C) that depicts a decline of Eurozone banks' claims in regional comparison. The central bank's support of the Orbán government's effort in reducing foreign currency liabilities can be seen in Figure 4(D). In regional comparison, by 2016 Hungary largely cleared out its banks' portfolio of FX-denominated loans.

As shown in Figure 6, the Hungarian economy contracted in 2009 and again in 2011 to return to slower than pre-crisis growth rates. Real income declined in four consecutive years. Of the three sources of growth (consumption, investment and trade) Figure 6(B) shows that household consumption had significantly declined, especially relative to GDP. Similarly, investment dramatically declined to 88% of its pre-crisis level in 2012 and has not reached its 2007 level yet (Figure 6(C)). For a small open economy like Hungary, trade is the most important source of growth. As Figure 6(D) shows, Hungary's export growth rate decreased in 2009 by almost 6%. However, while trade, investment and consumption clearly had a contracting impact on the Hungarian economy, they cannot be the only reason for the contraction and stagnation. Looking at the post-crisis developments of Hungary's regional partners, we see that the Hungarian growth trend deviated downwards compared to other Central and Eastern European countries. As Figure 7 shows, Slovakia, the Czech Republic, and Poland converged to EU averages while Hungary stagnated. Clearly, the trioka

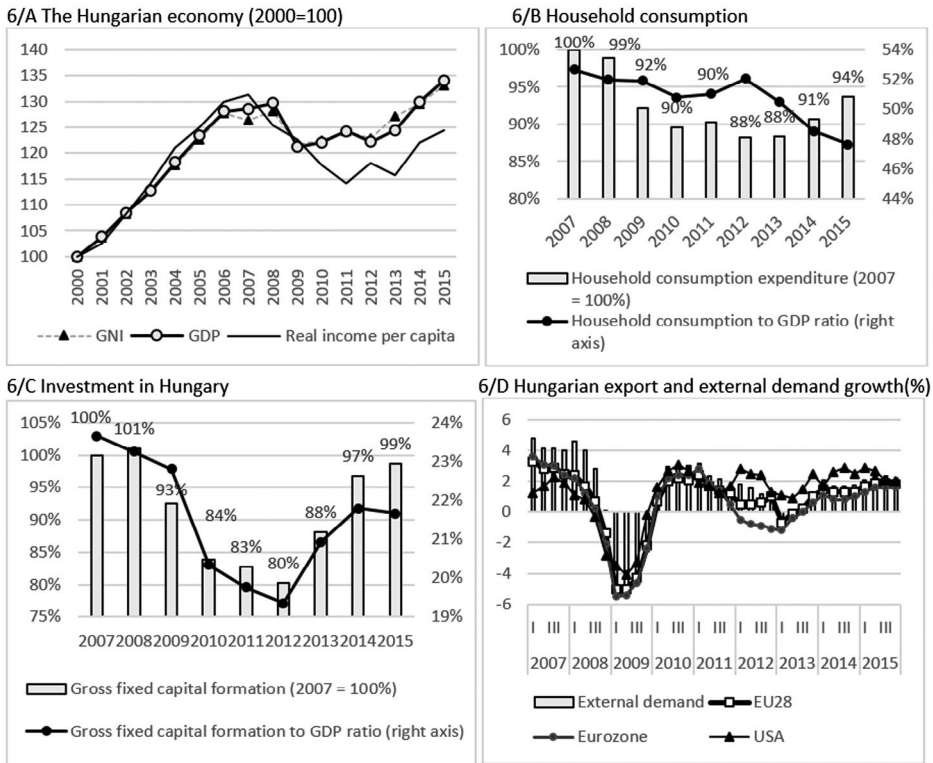


Figure 6. Hungarian economy after the crisis. Source: BCE – GTEKK, HCSA.

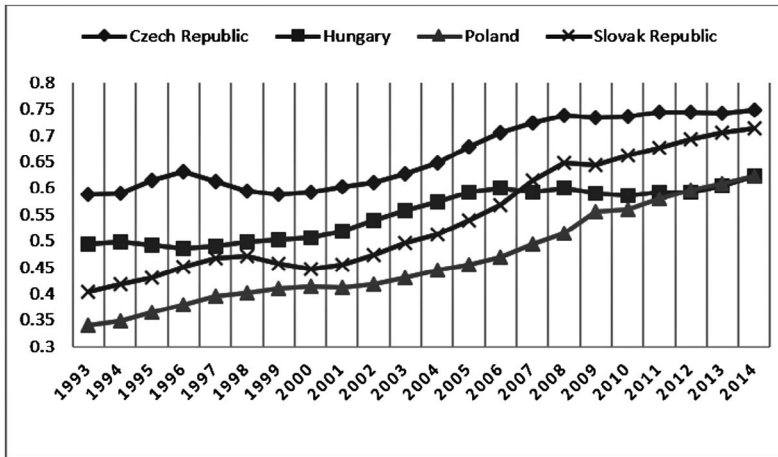


Figure 7. The convergence of Visegrad countries. Source: BCE – GTEKK, OECD.

institutions' disjoint effort only explains difficulties in economic policy management in the first liquidity trap phase of the crisis. The impact of the loan agreement could only be felt until 2010, since only part of the loan was contracted and most of the contracted amount spent until 2010. Since 2010, when the Orbán government came to power, the troika's impact

on Hungary's economic development has been negligible; stagnation until 2015 is to be explained rather by the radical political changes and the emergence of a new economic elite.⁴⁹

Conclusion

This paper set out to investigate the different approaches of the troika institutions to crisis management during the liquidity trap phase of the global financial crisis in Hungary. With regard to the troika's role in managing the Hungarian crisis, key findings include: First, policy recommendations and crisis management steps were not only defined by the rules and delegations' interpretation of them as explained by Lütz and Kranke, but also by the delegations' perspective on the crisis and subsequent understandings of the origin of the crisis. It seems clear that each delegation was driven by its own perspectives, the IMF team by its financial market priorities; the Commission team was unprepared to see the broader picture and – trapped in institutional inertia – continued to focus on the budget, while the ECB was preoccupied with ring-fencing and stabilising the Eurozone. Second, there was only limited policy coordination among the IMF and Commission on one side and the ECB on the other. The kind of layering and institutional learning that Moschella⁵⁰ identified in relation to negotiations with Greece took place only to a limited extent. Third, lack of policy coordination exacerbated the difficulties of crisis management for Hungarian policy-makers during the liquidity phase of the global financial crisis of 2008.

Contradictions that reflect deeper differences in policy options were to characterise the troika's operations in later years. It seems that it was not the harshness of austerity measures emphasised by a number of studies, but overcoming these differences in crisis management priorities which proved to be the greatest challenge for all nations who had to seek the troika's assistance.

List of interviewees

Interviewee #1 High ranking Hungarian central bank official

Interviewee #2 High ranking Hungarian central bank official

Interviewee #3 High ranking finance ministry official

Interviewee #4 High ranking DG ECFIN official

Interviewee #5 Lower ranking central bank official

The interviews and five additional not referred to in the text were conducted between December 2016 and February 2017.

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Notes

1. Kornai, "Hungary's U-Turn."
2. Johnson and Barnes, "Financial Nationalism."
3. Bohle, "Post-Socialist Housing."
4. Györfy, "Austerity and Growth."
5. Epstein, "When Do Foreign Banks 'Cut and Run'?"
6. Andor, "Hungary in the Financial Crisis."
7. Benczes, "From Goulash Communism."
8. Lütz and Kranke, "The European Rescue of."
9. This study is an important source for contextualizing Henning's argument in 'Tangled Governance' about the reasons for the IMF involvement in the Eurozone crisis.
10. Barnett and Finnemore, "The Politics, Power, and Pathologies."
11. Hay, "Narrating Crisis."
12. Király, "Likviditás válságban."
13. Várhelyi, "Sebezhetőség."
14. Király et al., "Contagion."
15. Király, "Az amerikai."
16. Várhelyi, "Sebezhetőség."
17. Tóka and Popa, "Hungary."
18. Tóka and Popa, "Hungary."
19. Várhelyi, "Sebezhetőség."
20. The attack against OTP was launched by Soros Fund Management LLC, by HSBC and by Deutsche Bank AG London (Hungarian Financial Supervisory Authority 26 March 2009).
21. Ecorys, "Ex-Post Evaluation," 35.
22. Mérió and Piroška, "Policy Diffusion, Policy Learning."
23. IMF, "Hungary."
24. Letter of Intent.
25. IMF, "Hungary," 6.
26. These targets are also included in the Lol, in addition to a number of other fiscal, financial market and monetary targets.
27. ECB, "Annual Report," 109.
28. ECB, "Monthly Bulletin."
29. 12 December 2007 ECB establishes swap agreement with Federal Reserve USD 20 bn, the first, followed by many.
30. 15 October 2008 ECB establishes swap agreement with Swiss National Bank CHF 25 bn per tender.
31. 20 December 2007 ECB establishes swap agreement with Sveriges Riksbank EUR 10 bn.
32. 26 October 2008 ECB establishes swap agreement with Danmarks Nationalbank EUR 12 bn.
33. 16 October 2008 ECB establishes repo agreement to provide euro to Magyar Nemzeti Bank EUR 5 bn.

34. 11 November 2008 ECB establishes repo agreement to provide euro to Latvijas Banka EUR 1 bn.
35. 21 November 2008 ECB establishes repo agreement to provide euro to Narodowy Bank Polski EUR 10 bn.
36. ECB, "Monthly Bulletin."
37. ECB, "Monthly Bulletin," 75.
38. Neményi, "A monetáris politikai."
39. ECB, "Annual Report," 99–104.
40. Epstein, "When Do Foreign Banks 'Cut and Run?'"
41. Kiraly et al., "Contagion."
42. Howarth, "Defending the Euro."
43. Trichet, "The Financial Crisis."
44. Gabor, "The Power of Collateral," 27.
45. Epstein, "When Do Foreign Banks 'Cut and Run?'"
46. IMF, "Hungary."
47. http://www.portfolio.hu/users/elofizetes_info.php?t=cikk&i=229691.
48. Méréő and Piroška, "Banking Union and Banking Nationalism."
49. Johnson and Barnes, "Financial Nationalism."
50. Moschella, "Negotiating Greece."

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