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Lessons from Europe for the study of international central bank cooperation

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Chapter 2 – Central bank credit lines in Central Europe

Abstract

In the context of the financial crisis in Central Europe, the ECB and the SNB concluded credit lines both with each other and with the Hungarian and Polish central banks. These credit lines offer an intriguing starting point to learn about individual central banks' decision-making because both the ECB and the SNB demanded exceptionally strict credit terms. This chapter argues that the expected consequences account only partially for these decisions. The ECB chose to pursue a highly restrictive approach towards credit lines despite considerable financial linkages. The SNB, conversely, had few financial interests at stake but provided support out of solidarity. This chapter concludes that one needs to account for social norms and economic ideas to understand important facets of the decisions of both central banks.

Introduction

Credit lines are a powerful and well-established way in which central banks can assist each other during financial crises (Cooper, 2006; Fratianni & Pattison, 2001; Simmons, 2008). The recipient of such credit lines gains immediate access to additional liquidity in foreign currency and can use these resources to stabilise financial markets. So-called swap lines represent the most common loan instrument between central banks. Under swap lines, the borrowing central bank can provide its own currency as collateral for its drawings. All fourteen credit lines that the US Fed made available during the GFC took the form of such swaps.

The credit lines that the ECB and the SNB provided to central banks in Central Europe stood out in the context of the GFC (W. A. Allen, 2013, p. 150). Among themselves, the ECB and the SNB agreed on a swap arrangement under which the ECB obtained Swiss francs (CHF) against euros. However, while both set up credit lines with the central banks of Hungary (Magyar Nemzeti Bank, MNB) and Poland (Narodowy Bank Polski, NBP) they demanded these central banks provide collateral from their foreign exchange reserves instead of their own currencies. Especially the decision by the ECB to demand additional securities has since been criticised, because the stricter borrowing terms rendered the credit lines less useful for the recipients (Åslund, 2010; Tooze, 2018; Vallee, 2010).

This chapter aims to understand the ECB's and the SNB's credit lines in the context of the financial crisis in Central Europe. It applies the two perspectives of consequential and appropriate action to distinguish between important factors that bore on each decision. While the logic of consequences helps identify the roles of financial linkages and sovereign credit risk in shaping the terms of the loans, neither of these factors can fully account for them. Norm-based approaches have more traction, especially when it comes to the SNB's decisions, which were seen as expressions of solidarity. The ECB's reluctance becomes clearer against the backdrop of strong opposition from the Economics department and a set of principles for liquidity assistance developed early into the crisis. The chapter thus argues that, rather than responding to clear-cut financial imperatives, both the ECB's and the SNB's credit lines were affected by prior strategic choices and subjective understandings of appropriate action.

To substantiate this argument, the chapter proceeds as follows. The next section provides some background on the financial crisis in Central Europe to contextualise the central bank credit lines that were concluded. After that, the ECB's and the SNB's decision-making processes are analysed in turn. The empirical questions that these sections tackle concern the roles that material interests, such as bank exposure and credit risk, played, in juxtaposition with ideational and institutional dynamics. The final section summarises the findings and offers the first conclusion.

2.1 The financial crisis in Central Europe

The financial crisis in Central Europe initially took the form of a classic liquidity crisis. In October 2008, banks suddenly found themselves unable to access money markets and central banks were forced to step in as lenders of last resort. The ECB, the MNB, the NBP, and the SNB all played that role, supporting their banks with liquidity both in domestic and foreign currency. In this context, the credit arrangements varied in their usefulness, both for central

banks to intervene in markets and to restore banks' confidence in individual countries. Whereas the swap line between the ECB and the SNB was instrumental in restoring international stability, their credit lines with the MNB and the NBP were used to a much smaller extent and both Hungary and Poland secured additional support from the IMF.

2.1.1 Background

The financial crisis in Central Europe needs to be understood against the backdrop of rapidly growing foreign currency loans across the region. In Austria, Hungary, and Poland, firms and households tried to take advantage of low interest rates. On the eve of the GFC, foreign currency mortgages represented a significant share of banks' assets in these countries. The expansion of foreign currency mortgages started in Austria, in the 1990s when households started to borrow in Swiss francs, given that Swiss interest rates were traditionally lower than those for Austrian schilling and later euro loans. In 2007, 30% of all loans in Austria were denominated in foreign currencies (Beer, Ongena, & Peter, 2010). In Hungary and Poland, foreign currency loans only became popular after these countries joined the EU in 2004. But thereafter they rose steeply and in 2007 foreign loans made up more than half and about a quarter of all loans, in these countries respectively. The foreign currency loans in both countries were predominantly denominated in Swiss francs – 56% in Hungary and 69% in Poland – with the euro accounting for most of the remainder (Brown, Peter, & Wehrmüller, 2009). From the perspective of financial stability, these loans posed two different risks, namely credit risk and liquidity risk.

The first of these risks, credit risk – which materializes when the domestic currency depreciates against the currency in which the loan is denominated and leaves the borrower unable to repay – was, perhaps surprisingly, no major issue during the crisis.[4] Indeed, most of the households

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[4] Interview Martin Wohlmuth (Head of Strategy, Erste Bank)

that had taken out foreign currency mortgages were financially sound enough to bear the risks (Beer et al., 2010). In Poland, the financial regulator KNF in 2006 issued ‘Regulation S’ which restricted these loans to affluent households.[5] As a result, even though the euro, the Hungarian forint, and the Polish zloty all depreciated relative to the Swiss franc, the banks holding these loans faced only limited increases in non-performing loans (Pann, Seliger, & Übeleis, 2010).[6]

Liquidity risks, on the other hand, were more serious and highlight the importance of a second development before the crisis: foreign bank entry. Since the transition to market economies, foreign banks had expanded their operations into retail markets across Central Europe (R. A. Epstein, 2014), owning 76.5% of all financial assets in Poland and 84% in Hungary in 2008 (EBRD, 2009). While all banks, domestic and foreign, provided foreign currency loans (Banai, Király, & Nagy, 2010), only foreign banks’ subsidiaries could count on their parent bank for funding (R. de Haas & Naaborg, 2005). Domestically-owned banks, such as OTP (Országos Takarék Pénztár – 'National Savings Bank'), the largest bank in Hungary, relied on money markets, especially foreign exchange swap markets, to fund their foreign currency loans (Mák & Páles, 2009; Szpunar, 2009). Although Hungarian and Polish policymakers were aware that banks were left vulnerable to a potential breakdown in foreign exchange swap markets, they did not expect a crisis to materialise.[7]

[5] Interview Stanislaw Kluza (Head of the Polish Financial Supervision Authority, KNF)

[6] Later into the crisis, both Hungary and Poland would take aggressive measures to convert foreign currency loans into domestic currencies at favourable exchange rates. However, that was no immediate concern in 2008.

[7] Interviews Júlia Király (former Deputy Governor, MNB) and Kluza (KNF)

2.1.2 Central bank credit lines during the financial crisis

The funding problems materialized first slowly and then aggravated very quickly. Starting in 2007, turnover in unsecured Swiss franc money markets declined, as more and more lenders asked for collateral and increasingly shorter maturities (Auer, Kraenzlin, & Liebeg, 2012). Then, in October 2008, the financial market panic spread to Eastern Europe and money markets froze almost entirely. In the Swiss franc money markets, spreads between secured and unsecured increased rapidly leaving borrowers without suitable collateral unable to borrow Swiss francs short-term (Auer & Kraenzlin, 2011). On October 9 financial markets suddenly stopped completely in Hungary: a government bond auction failed, the currency came under depreciation pressure, OTP's stock price collapsed, and the foreign exchange swap market dried up, leaving banks to scramble for liquidity. In Poland, money market turnover also declined, albeit in a less dramatic fashion than in Hungary.

In this context, both these central banks turned to the ECB and requested swap lines to be able to manage the crisis. However, the ECB only agreed to a repo agreement, which meant that the borrowers would have to provide bonds of Euro Area governments that they already held in their foreign reserves as collateral. The repos would thus not increase their foreign exchange reserves, but allow the MNB and NBP to use their existing reserves faster. Given the dismal situation in Hungary, the MNB immediately drew on the ECB's repo to forward euros to the Hungarian banking sector, even though it was already running low on reserves. The MNB was disappointed that it received only a repo because it still needed to draw down its dwindling foreign exchange reserves.[8] However, market participants still took its announcement as a

[8] Interview Király (MNB)

positive signal (Société Générale, 2008). By contrast, the NBP never drew its credit line with the ECB.

The SNB agreed to swap Swiss francs against euros with all three central banks. For the ECB, this meant that it had a bilateral swap facility; the MNB and the NBP would only be able to obtain Swiss francs to the degree that they already had liquid euro reserves. All three recipients made use of the SNB's arrangement, though the ECB drew by far the largest amount.

In the spring of 2009, central banks' collective actions had succeeded in stabilizing foreign exchange swap markets and the crisis entered a new phase. However, a new problem materialized when Central European currencies depreciated heavily against the euro and the Swiss franc. The ECB, however, resisted calls for more support to the Central European central banks until the worst of the crisis had passed. Only in September 2009 did it agree informally to convert half the volume of the repo lines into swaps, but the credit lines were hardly used after that. The SNB resolved the problem of liquidity shortages single-handedly after March 2009 by taking the highly unconventional step of outright buying foreign currency to stem the appreciation of the franc (Moschella, 2015). Over the year, these purchases flooded international markets with Swiss franc liquidity and all four central banks agreed to discontinue Swiss franc swaps in early 2010.

2.1.3 Applying the ideal-typical logics of action

Before moving on to the empirical narratives, it is worth restating briefly how each logic of action would interpret the terms of credit lines in its ideal-typical form. The logic of consequences has outlined two different sorts of factors – considerations related to domestic monetary or financial stability and political interests – as reasons that could speak for providing a credit line. The central banking literature also proposes three considerations that could account for the ECB's and SNB's refusal to provide full-fledged swap lines (Bindseil, 2014, p. 285).

The credit lines could, first, result in an unwanted monetary expansion or, second, trigger moral hazard by allowing the borrower to delay necessary adjustments (Auer & Kraenzlin, 2011). Third, if the recipient defaulted on the loan, a swap would leave the lender with the useless local currency (W. A. Allen, 2013, pp. 99–100). Bindseil (2014, p. 285) explains further that '[t]his fear may be particularly justified if, overall, [the recipient country] is in a disastrous state and politically unstable.'[9] In short, a central bank purely concerned with its self-interest would likely see a reason to assist if its domestic policy targets were at stake, but if the potential borrower posed a clear financial risk, collateral might be required to protect the balance sheet.

Conversely, the logic of appropriateness would point to identities or behavioural norms to account for the unequal treatment of different central banks. Central banks of higher social status might thus receive concessionary terms, while those lower in the international hierarchy might be spurned. Similarly, indications of prior agreements to cooperate in case of a crisis would provide a norm-based reason to extend support. As the remainder of the chapter will argue, material concerns by no means provided unequivocal reasons to justify the ECB's and SNB's decisions. To understand the credit terms in Central Europe, it is crucial to understand the institutional and normative context.

2.2 The ECB's repos

The ECB's handling of the financial crisis and especially its controversial decision to provide repos to Hungary and Poland have widely been criticized, especially in comparison with the swap lines for Denmark and Sweden which will be the subject of the next chapter. So far, however, there has been more speculation than a systematic analysis of the reasons to decide to

[9] This textbook is written by an ECB staff member, who might be under some institutional pressure to provide an exculpatory rationale for the ECB's actions in 2008, given that collateralized central bank credit lines were formerly unprecedented.

do so. This section interprets the ECB's decisions through the lenses of both ideal types. Material factors provide little systematic guidance to the ECB's crisis handling; it appears if anything, even more puzzling. Yet the ECB also lacked a clear normative understanding of what it ought to be doing. Instead, the strength of a specific set of economic ideas during an initial period of uncertainty shaped the ECB's restrictive approach to the crisis in Central Europe.

2.2.1 The ECB's repo's seen through the lens of the logic of consequences

Patterns of bank ownership presented a plausible reason for the ECB to support regional financial stability and provide swap lines to the Hungarian and Polish central banks. Almost all the foreign parents of banks in these countries were domiciled in the Euro Area. Austrian banks had by far the biggest exposure across the region, with regional exposure amounting to 70% of Austrian GDP in 2008 according to BIS data[10], but major banks from Belgium, France, Germany, Italy, and the Netherlands had all established a presence (Árvai, Driessen, & Ötker-Robe, 2009). In terms of the Euro Area's overall international exposure, even in comparison with the Eurodollar market alone,[11] the exposures to Central Europe remained relatively small and were diversified across Euro Area member states. Nonetheless, analyses by the IMF cautioned that regional financial contagion could turn a local problem in Central Europe into a problem for the parent banks (Árvai et al., 2009).

[10] The Austrian exposure was in practice likely even higher, closer to 100% of GDP, given that Hypo Alpe Adria and Bank Austria were both subsumed under their German and Italian parents' exposure in the BIS calculations, Interview Franz Nauschnigg (Head of Division, European Affairs and International Financial Organizations, OeNB).

[11] Interview Francesco Papadia (former Head of the Market Operations department, ECB)

The Euro Area banks that were active in the region had no intention of reducing their exposure when the financial crisis reached Eastern Europe in September 2008 (Stepic, 2019).[12] In fact, the largest foreign banking groups in the region pressured the ECB to alleviate liquidity problems in the region. In January 2009, nine major European banks active across Eastern Europe (including two Swedish banks) wrote a joint letter to the ECB and their home central banks in which they described both the nature of the financial risks to their operations. They urged the ECB to support euro liquidity conditions in Eastern Europe through central bank swap lines and other unconventional measures (the letter is reproduced in Würfel & Atroszczak, 2019, p. 238). This pressure from commercial banks amounted however to surprisingly little action from the ECB.

Not only did the exposed banks themselves push for swap lines to Hungary and Poland, but so too did their national central banks. The Austrian National Bank (Österreichische Nationalbank, OeNB) was, perhaps unsurprisingly, the biggest advocate of swap lines. One of its concerns in that regard was the exposure of the parent banks and the risk of a spillover of financial instability.[13] The OeNB's worries extended however beyond the financial risks to their banks: when financial market conditions deteriorated across Eastern Europe in early 2009, worries about Austrian banks' exposure led to speculative pressure against Austria's sovereign finances as well. Austria's Credit Default Swaps (the insurance against sovereign default) rose to the same level as Greece's – although Austria itself had no domestic banking crisis to speak of (Nauschnigg, 2011). New York Times columnist Paul Krugman drew the ire of the Austrian government when he wrote that Austria's East European exposure was 'off the charts'

[12] Interview Wohlmuth (Erste Bank)

[13] Interviews Nauschnigg, Ewald Nowotny (former Governor, OeNB)

(Krugman, 2009).[14] From Austria's perspective, restoring confidence in Eastern Europe was an unequivocal matter of self-interest.[15]

Other central banks in the Eurosystem advocated swap lines for Hungary and Poland for similar reasons. The Banque de France joined Austria's calls for a swap line with the Hungarian central bank (Vallee, 2010).[16] As regards Poland, Austria did not have major financial interests at stake, but Germany's Bundesbank advocated a swap line for their Polish colleagues – with an eye to German investments in Poland.[17] Considering the lobbying by major shareholders and the expected material consequences of inaction, the ECB's reluctance to open swap lines with the central banks in Eastern Europe becomes just more surprising.

Considering such compelling material reasons to provide swaps, the question is whether there were similarly strong concerns about credit risk that could justify demanding collateral. However, the ECB's approach to sovereign credit risk was too inconsistent to serve as a clear explanation. Before the crisis, the ECB had accepted a broad pool of euro-denominated collateral, rated at least A-, but in November 2008 it expanded its collateral pool to allow foreign currency bonds and securities rated as low as BBB- (European Central Bank, 2008f). Throughout the crisis, Poland maintained an A- rating. Hungary, by contrast, was initially rated BBB and only downgraded to BBB- in April 2009. Both these ratings would normally have qualified for ECB support. In other words, while the ECB considered Hungary and Poland too risky for swaps, it was ready to accept on its balance sheet commercial securities with a lower

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[14] Interview Nauschnigg (OeNB). Reflecting the impact of Krugman's blog entry, Epstein (2017, pp. 55, 86) found similar assessments in interviews with commercial bankers.

[15] Interview Nauschnigg (OeNB)

[16] Interview Nauschnigg (OeNB)

[17] Interviews Nauschnigg, Nowotny (OeNB)

credit rating. Thus, it is unlikely that the imminent risk of non-repayment was the sole motivation for the ECB to insist on repo lines.

Many other factors suggest that the ECB may have been excessively cautious in insisting on collateral from both central banks. Hungary was indeed running out of foreign reserves and needed a sovereign bailout, but Poland was seen as a 'beacon of resilience in Europe' (N. Epstein, Goretti, Llaudes, & Velculescu, 2012). Throughout the crisis, the Polish government was able to raise debt in euros, Swiss francs, and dollars. Moreover, once Hungary had the IMF Stand-By Arrangement (SBA) in place, the central bank felt assured that it would not default on a short-term swap.[18] Poland was one of the first countries to receive a Flexible Credit Line (FCL) from the IMF which had been created explicitly for countries with sound fundamentals and policies (N. Epstein et al., 2012, p. 158).[19] Both the MNB and the NBP were seen as responding competently to the crisis. For instance, a contemporary account in the British weekly *The Economist* concluded that the 'Hungarian Central Bank is impressively well-run' ("Who's Next?," 2008, p. 30). On balance, there were hence few indications that either country was on the brink of collapse.

The ECB's actions over the further course of the crisis are, if anything, even less consistent. In the spring of 2009, when currencies in Eastern Europe came under renewed pressure, the Czech, Hungarian, and Polish central banks once more unsuccessfully appealed to the ECB to provide swap lines to restore confidence in their currencies (Verma & Thornton, 2009). The Czech Republic had not had any financial bubble and was good credit, with an A+ rating. The ECB's decision to informally convert half the repo line with the Hungarian central bank, €2.5bn, into

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[18] Interview Király (MNB)

[19] Interview IMF 2

a swap line in September 2009 (Király, 2020; Magyar Nemzeti Bank, 2010b, p. 5) supports the conclusion that it could have agreed to a swap from the start of the crisis.[20] All in all, the ECB's initial insistence on collateral, therefore, seems somewhat at odds with the repayment risks in Hungary and Poland.

The ECB's relative neglect of financial stability risks can be understood against the institutional backdrop of its mandate. In its initial conception, the ECB had no formal responsibility for financial supervision, which was instead a national responsibility. The ECB even lacked access to banks' balance sheets which it might have needed to assess risks in detail.[21] For these analyses, it relied instead on Member State authorities, including the National Central Banks. Spillovers from Central Europe would only be relevant to the ECB if they threatened financial stability in the entire Euro Area. ECB officials considered individual banks' exposures to Central Europe a problem for national authorities, but not for the ECB itself.[22]

2.2.2 The ECB's self-perception

The provisions in the ECB's mandate on their own do not provide a clear prescription for how the institution should respond to financial crises outside the Euro Area. Nevertheless, to understand the ECB's justification for its opposition to material interests, one needs to bear in mind how actors inside the ECB interpreted their obligations under the mandate considering

[20] In July 2010 the ECB reversed its lenience and again demanded euro-denominated collateral from the MNB (Magyar Nemzeti Bank, 2010a). This did, however, not stop the MNB from using the ECB repo to back up a forint/euro swap facility on which it drew sporadically until 2017 (including a €1.8bn drawing at the end of 2010). The author thanks Júlia Király and current MNB staff for providing this reference.

[21] Interview ECB 1

[22] Interview ECB 1

the financial crisis in Eastern Europe. In this regard, both its approach towards the international role of the euro and its general understanding of its financial stability mandate are relevant.

During the GFC, the ECB enjoyed full autonomy in setting its international policy conduct (Henning, 2007) – its mandate is purely domestic and the international dimension left underspecified (Verdun, 2009). However, shortly after its creation, the ECB decided to pursue a 'neutral stance' towards the international role of the euro. It argued that currency internationalisation should be the outcome of a 'market-driven process, not steered by central banks' (Duisenberg, 2000, p. 2). The ECB had thereby made clear that it would not feel bound to assume any international responsibility beyond its domestic mandate.

The ECB's handling of the international role of the euro becomes clearer against the backdrop of the intellectual influence of the Bundesbank which had served as an institutional blueprint for the ECB (Howarth & Loedel, 2005). The neutrality doctrine inherited core beliefs from the Bundesbank which had traditionally prioritized domestic policy targets over the international implications of its monetary policy (Marsh, 1992; Scharpf, 2018), not least when it triggered the ERM crisis in 1992 in pursuit of domestic price stability (James, 2012). Otmar Issing, the ECB's first Chief Economist, (and a previous Bundesbank Chief Economist), for instance, summarises his view of the appropriate role of the central bank as follows:

> 'Being ultimately responsible for the currency, the central bank also has a special responsibility as regards the role its currency plays internationally. It can best fulfil this by maintaining confidence in the stability of its currency' (Issing, 2010, p. 184).

The power of German ideas during the early years of the ECB was especially felt in the economics department. Both Issing and his successor as ECB Chief Economist, Jürgen Stark, played key roles in establishing German ordoliberal economic thinking as central to the ECB's policy approach (Dyson, 2009, p. 43; Dyson & Maes, 2018, Chapters 7–8; Warlouzet, 2019),

not least by bringing with them several former Bundesbank officials.[23] The Economics department ran not just the economic analyses for the Euro Area, but also all other EU member states. In these analyses, the ECB showed awareness of the build-up of foreign currency loans in Eastern Europe (European Central Bank, 2007a), but focused on supply-side factors and did not derive any potential implications for its policy.

Of course, within the ECB, there were different views on what the appropriate stance towards currency internationalisation should be. Tommaso Padoa-Schioppa, the first Executive Board member responsible for International Cooperation, was among those who argued that the euro occupied a new role and should be managed differently. '[T]here is no ground, for the Eurosystem, to inherit the traditional Bundesbank mistrust toward an international role of the currency, for fear that this could thwart a price stability-oriented monetary policy' (Padoa-Schioppa, 2008, p. 143). Overall however, the ECB struggled to formulate a continental approach to its currency. Its officials' attitudes were still coloured by their prior experiences working in smaller central banks, as well as the Bundesbank's neglect of the international role of the German mark.[24] The ECB's attempts to avoid direct responsibility for the international role of the euro can be seen as an institutional choice that reflected these inherited beliefs.

The ECB faced few legal constraints regarding support to central banks outside the Euro Area, especially in EU member states. Both the ECB and national central banks could 'acquire and sell spot and forward all types of foreign exchange assets' and 'conduct all types of banking transactions in relations with third countries […] including borrowing and lending operations' (European Central Bank, 2002 Art. 23). Concerning the ECB's responsiveness to financial

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[23] Interviews Jesper Berg (Head of Danish Financial Supervisory Authority, previously Market Operations department, ECB and Head of Market Operations, Danmarks Nationalbank), Nowotny (OeNB)

[24] Interview Papadia (ECB)

stability risks, it is important to note that it pursued a decidedly narrow interpretation of its mandate to justify its limited support for Eastern Europe. As a member of the European System of Central Banks, the ECB had to 'contribute to the stability of the financial system' (European Central Bank, 2002 Art. 3.3) – but it took that to refer only to the Euro Area as a whole, not the EU's financial system. In other words, the ECB decided that it would only respond to systemic threats to the Euro Area. If banks took financial risks in Eastern Europe, that was seen as an issue for financial supervision, which was still outside the ECB's mandate at the time. The ECB would provide liquidity to the parent banks, but not backstop capital risks from foreign operations.[25] This framing allowed it to evade acknowledging responsibility both for financial stability in EU member states outside the Euro Area and for responding to pressures from individual EU banks.

Statements of EU Board Members at the time back up this account. ECB President Jean-Claude Trichet was 'determined to lead his institution exclusively under the treaties – in other words, avoiding any steps not exclusively outlined under the Maastricht and other treaties' (Bastasin, 2015, p. 87). Another senior ECB official stressed that the ECB was 'not assigned the responsibility to stabilise the East European states.'[26] Lorenzo Bini Smaghi clarified that 'the ECB did not want to get too much involved […] because it did not feel responsible.'[27] Luxembourgish central bank governor Yves Mersch provided perhaps the bluntest statement by stressing that the ECB had a 'eurozone mandate, not a mandate to be a United Nations Agency' and that it could not be 'a regional IMF' (Atkins, 2009). In short, many Governing

[25] Interview ECB 1, Nauschnigg (OeNB)

[26] Interview ECB 1

[27] Interviews Bini Smaghi, Papadia (ECB)

Council members were highly sceptical of involving the ECB in Central Europe (Atkins & Wagstyl, 2009).

Both the long-standing influence of German economic thinking inside the ECB, as well as the defensive framing of its responsibilities during the early phase of the crisis bore heavily on the ECB's refusal to agree to swaps.

2.2.3 Contingent dynamics of the ECB's decision making

It was initially unclear how the ECB would respond to the Hungarian and Polish requests.[28] The ECB staff simply had not thought about how it should respond if a liquidity crisis were to occur in an EU member state outside the Euro Area The Hungarian and the Polish National Bank reached out to the ECB on October 10th 2008 with their requests,[29] but it took the ECB several days to respond (Király, 2020). It was not until October 20th that the Governing Council approved a set of 'principles on liquidity assistance by the ECB to non-euro area EU countries' (European Central Bank, 2008h).

In the negotiations about the swap requests, the ECB Governing Council was divided. As mentioned earlier, several national central banks – the Banque de France, the Bundesbank, and the OeNB – supported swaps. Among the ECB staff, the International Relations and Market Operations Departments were likewise ready to provide swaps.[30] However, both ECB Executive Board and the Economics Department were sceptical about providing swaps.[31]

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[28] Interview Papadia (ECB)

[29] Documents released under public access regime - Market operations (europa.eu)

[30] Interview Papadia; from an operations perspective a central bank swap is also easier to organize than a repo, interview Nauschnigg (OeNB).

[31] Interview Papadia (ECB), Nowotny, Nauschnigg (OeNB)

Tellingly, protecting the balance sheet was seen as a 'very German argument' against providing swap lines.[32] Whether the credit lines would be useful for the recipients was less of a concern: 'the Economics department was mostly aloof towards Eastern and Central Europe.'[33] In the end, the decision to provide repos represented a compromise between the two camps, which would offer some sort of assistance, but assuage concerns about the ECB's balance sheet.

Though the 'principles' themselves are not public, the ECB's official justification is murky. It has stated that it considered 'a broad set of factors'[34] (European Central Bank, 2014, p. 75). Inside the ECB the decisions were considered as being taken on a case-by-case basis.[35] Nevertheless, the ECB's decision to provide a repo to the MNB would influence its approach over the further course of the crisis and limit its readiness to provide swap lines even to more economically stable countries like Poland. The official ECB response to the NBP, which was sent out on October 24th – a full two weeks after the NBP's request – bases itself on the newly written guidelines for liquidity assistance. The Executive Board proposed a repo for the NBP 'to be consistent with the precedent set by the recent repo agreement established between the ECB and [the Hungarian National Bank].'[36]

Recalling that Poland was in a very different economic situation than Hungary, this decision is hard to justify on technical grounds. The NBP had sufficient foreign reserves and the

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[32] Interview Nowotny (OeNB)

[33] Interview Papadia (ECB)

[34] '(i) the existence of exceptional circumstances […] (ii) the systemic relevance for the euro area of the country requesting a swap line […] (iii) the presence of sound economic fundamentals; (iv) the financial risk for the Eurosystem; and (v) the consistency with any parallel support provided by the IMF' (European Central Bank, 2014, p. 75).

[35] Interviews Bini Smaghi, Papadia (ECB)

[36] Request for a EUR repo agreement from National Bank of Poland (NBP): Executive Board proposal (europa.eu)

government enjoyed continued bond market access. And yet, before approving even the repo, the ECB first required the NBP to document the market dysfunctions that it was experiencing and to detail the measures that it had already taken.[37] The decision not to treat Poland better than Hungary, therefore, reflected the ECB's concerns of not stigmatising Hungary and a certain unwillingness to differentiate between these countries.[38]

In the further course of the crisis, the ECB missed further chances to help relieve market pressure against East European currencies and local government bonds. Yet it held its line without offering any public justification. In May 2009, the ECB said was only ready to provide swaps on a case-by-case basis but, in letters to the Czech, Hungarian, and Polish central banks, ECB President Jean-Claude Trichet re-emphasised that the ECB would only provide swaps in 'exceptional circumstances' (Verma & Thornton, 2009). By that time, it was however clear that these central banks asked for the swaps as a signal to markets and to rebuild confidence, rather than to use them. When the ECB finally agreed to informally convert half the repo with the Hungarian central bank into a swap line in September 2009, the crisis had abated.

Summing up, the ECB's approach towards credit lines in Central Europe can at best be partially understood based on material interests. Arguably if the ECB had granted swap lines to the MNB and the NBP, it could easily have justified these on the grounds of Euro Area banks' exposures and its overall collateral standards at the time. However, during an initial period of uncertainty, the ECB took many discretionary decisions that were influenced by perceptions of appropriate action. Both the ECB's restrictive interpretation of its mandate and its concern with balance

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[37] Request for a EUR repo agreement from National Bank of Poland (NBP): Executive Board proposal (europa.eu); Letter from the National Bank of Poland (NBP) to the European Central Bank, 30 October 2008 (europa.eu); No such requirements were imposed on the DNB.

[38] Interview Nauschnigg, Nowotny (OeNB)

sheet protection were organisational choices that were internally contested. The ECB's overall approach to the crisis reflected the outcome of an internal bargaining process where these ideas won out against material interests. In the end, the decision to provide repos represented a compromise that would offer some sort of assistance, but assuage concerns about the ECB's balance sheet.[39]

2.3 The SNB's swap lines

Though the SNB's swap lines have received far less attention, they represent an intriguing case of central bank cooperation. In a way, the SNB offered the same terms to all its borrowers, since it swapped Swiss francs against euros in each case. But while consistency with its overall monetary policy framework was an important consideration, this course of action was enabled not just by more lenient political judgments, but also by a better degree of organizational preparedness than seen at the ECB.

2.3.1 The SNB's view of the international role of the franc

For the SNB, the international role of the Swiss franc was a central policy concern both before and during the GFC(Jordan, Ranaldo, & Söderlind, 2009). Switzerland occupied a unique position not just because it is a small open economy that issues an international currency, but also because this position is reflected in a central bank monetary policy framework that was more open towards currency internationalization than any other.

The SNB had long grappled with the international strength of its currency but pursued a different strategy for handling it. The Swiss franc had been under more or less constant appreciation pressure during the Bretton Woods period, culminating in the 'currency crisis' of

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[39] Interview Nowotny (OeNB)

1978, when the SNB had to take unprecedented measures to deflect and sterilize capital inflows (Roth, 2009). From the 1980s onwards, the SNB gradually gave up its resistance and opened towards internationalizing the Swiss franc. While its overriding objective remained price stability,[40] in 1999, it adopted an innovative operational framework tailored to the international role of the franc. Since then, the SNB targeted the 3-month LIBOR, an international market rate (Jordan, Peytrignet, & Rossi, 2010). It also gave foreign banks access to its facilities(Kraenzlin & Nellen, 2015), and expanded its collateral basket to accept securities denominated in seven different currencies (McCaughrin, Gray, & Chailloux, 2008). After having resisted the internationalization of the franc, the SNB now pursued an 'internationalized monetary strategy' (author's translation from German Roth, 2009, p. 16).

Despite the new framework, the SNB's main policy concern remained to limit currency appreciation to prevent deflation. To do so the SNB pursued a course of relatively lower interest rates than the ECB or the Fed. As a result, the Swiss franc became attractive as a carry-trade currency where investors would borrow in a low-interest rate currency and invest in a higher-yielding one.

That said, Swiss franc-denominated loans were a somewhat common instrument both in some Euro Area countries and Eastern Europe. In the late 1990s, Austrian households started taking out mortgage loans in Swiss francs to take advantage of the lower interest rates (Beer et al., 2010); after 2004, franc-denominated mortgages became popular in Hungary and Poland, too (Brown et al., 2009). The SNB was at first unaware of these mortgages – only in 2007 did the issue come to public attention[41] (for instance Fehr, 2007). In response, the SNB started

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[40] Price stability was only explicitly made part of its mandate when the SNB law was amended in 2004 (Jordan et al. 2010).

[41] Interview Martin Brown (Professor of Banking at the University of St.Gallen)

collecting data in the 'Swiss Franc Lending Monitor' and ran several analyses of the implications of these loans for its monetary policy (Beer et al., 2010; Brown et al., 2009; Yesin, 2012).

These analyses also found that some banks from the Euro Area depended on Swiss banks to finance their Swiss franc lending. Austrian, German, and Luxembourgish banks funded their loans 'on balance sheet' which meant that they issued bonds on Swiss capital markets (Brown et al., 2009). The Austrian banks were also active in the Swiss franc repo market before the crisis (Pann et al., 2010). By contrast 'the Swiss financial sector shows almost no direct involvement in refinancing of [Swiss franc] lending in Hungary and Poland' (Brown et al., 2009, p. 12). These banks relied primarily on their foreign parent banks or, if they had none, on 'off-balance' funding, such as foreign exchange swap markets to get funding in Swiss francs (Mák & Páles, 2009). As a result, Swiss cross-border claims on the entire region of Eastern Europe, including Russia and Ukraine, in late 2008 amounted to the equivalent of CHF 40bn or about 2% of Swiss international exposure – and only CHF 1.9bn of those claims were denominated in the Swiss currency (Roth, 2009, pp. 10–11).

The SNB concluded that there was 'no reason to react to the phenomenon of "carry trades." What the SNB can however react to within the context of its [monetary policy] concept are potential consequences for the exchange rate' (Hildebrand, 2007, p. 14, author's translation from German). Foreign borrowers were usually affluent enough to tolerate the currency risks (Brown & De Haas, 2012; Brown et al., 2009) and Swiss banks' exposure was not considered

systemically relevant. A reversal of fortunes might be problematic for borrowers in Hungary and Poland but would not require any response from the SNB.[42]

2.3.2 The SNB's swap lines and its operational framework

The SNB's institutional preparedness for international liquidity demand proved invaluable. About 80% of the Swiss franc emergency liquidity that the SNB provided throughout the crisis went to foreign banks (Auer & Kraenzlin, 2011). In contrast with the ECB, the SNB's credit lines are consistent with its overall operational framework.

The SNB's swap line with the ECB was set up in response to a concrete problem in international Swiss franc money markets. Whereas in normal times, the rates of secured and unsecured money markets are closely aligned, in October 2008, unsecured Swiss franc money markets broke down and prices rose to 300 basis points against the secured repo market (Auer & Kraenzlin, 2011, p. 411). However, the SNB could not on its own supply Swiss franc liquidity to foreign borrowers that relied on unsecured money markets. SNB staff noted that a breakdown of the Swiss franc money market could lead to the unravelling of outstanding Swiss franc carry trades, which could ultimately have negative consequences for the Swiss banks that owned their debt (Auer & Kraenzlin, 2011, pp. 411–412). Enabling the ECB to access Swiss franc liquidity sufficed for the SNB to overcome these market frictions and the spreads between secured and unsecured market rates duly normalized once the ECB started holding EUR/CHF swap tenders.

A second concern for the SNB was the appreciation pressure on the franc. As the currency strengthened against the euro, the risk of domestic deflation increased. On March 12th 2009, the SNB single-handedly decided to cap the exchange rate and announced that it would buy foreign

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[42] Interview Brown (University of St.Gallen)

exchange in unlimited amounts to enforce that goal (Swiss National Bank, 2009, p. 9). The foreign exchange purposes represented an unprecedented monetary policy intervention (Moschella, 2015) that quickly resolved the international Swiss franc shortage and thereby staved off both the deflation risk and the financial stability risk from a disorderly wind-down of outstanding carry trades (Auer & Kraenzlin, 2011, p. 409). In short, the SNB pursued domestic interests by flooding international markets with its currency.

Whereas the SNB's swap to the ECB came in response to identifiable market dysfunctions, it is less clear to which extent the CHF/EUR swap lines to the MNB and NBP furthered these Swiss monetary interests. Both recipients could need the credit line to replace the foreign exchange swap markets that had dried up. As Swiss franc swap markets only slowly recovered, the SNB's swap lines were helpful because they helped the receiving central banks themselves when they were unable to convert their existing euro reserves into Swiss francs.[43] In the Euro Area, the Swiss franc shortages could disrupt the operational objectives of the SNB, but Hungary and Poland had problems in market segments that were less central to the SNB's operations.

There are further indications that the SNB would not have needed the swaps with the Hungarian and Polish central banks to meet its own monetary policy goals. The SNB's swap facilities for the NBP were set up in November 2008 and the Hungarian central bank began its Swiss franc auctions in February 2009. By that time, the spreads in international short-term money markets had already begun to stabilize. In addition, most of the banks there could already access Swiss franc liquidity through their parent banks. After all, the ECB covered Euro Area banks' Swiss franc needs and allowed them to forward these funds to their foreign subsidiaries. Moreover,

[43] Interview Király (MNB)

many parent banks could transact directly with the SNB.[44] Foreign-owned banks in Hungary and Poland therefore most likely already had access to Swiss franc liquidity.

On the issue of the collateral framework, the SNB's stance may have been strict, but at least it was consistent. Throughout the crisis, the SNB maintained a demanding minimum credit rating of AA- for securities that it would accept on its balance sheet (Jordan et al., 2009) – higher than any East European sovereign at the time. Its refusal to accept zloty and forint on its balance sheet may have been at odds with its overall openness towards foreign currency collateral, but the SNB was also a more financially prudent institution than the ECB, given its generally stricter collateral standards.

Finally, the size of each central bank's drawings supports the conclusion that the ECB swap was operationally far more important. The ECB had, at the peak of its drawings, CHF 40bn outstanding under the swap line with the SNB and supplied between CHF 15.5bn and CHF 36.5bn a month to its banks from October 2008 until August 2009 (W. A. Allen, 2013, p. 121). By contrast, both the MNB and the NBP made it expensive for banks to borrow Swiss francs from them to discourage the use of the facility (Király, 2020; Szpunar, 2009).[45] Neither of them ever auctioned off more than CHF 1bn in a single month (W. A. Allen, 2013, p. 121) –compared to the size of the SNB's balance sheet, the Swiss franc loan sector in Hungary and Poland was negligible.[46]

[44] Interviews Nauschnigg (OeNB), Wohlmuth (Erste Bank)

[45] Interview Kluza (KNF)

[46] Interview Brown (University of St.Gallen)

2.3.3 Deciding the SNB's credit lines

The SNB's approach to the GFC was consistent with its monetary policy framework and the financial market risks that it had identified before. Nevertheless, its cooperation was not merely aimed at the fulfilment of its policy mandate: these decisions also reflected international agreements and (limited) solidarity.

The SNB had ample experience with providing central bank swap lines before the GFC. Indeed, it had some standing agreements with West European central banks to establish a swap line during a crisis. Since the 1980s a swap agreement with the National Bank of Belgium has existed (which had been set up related to payment transactions).[47] Given the OeNB's potential need for Swiss franc liquidity, these two central banks had a precautionary bilateral agreement in place before the crisis.[48] Moreover, there was an agreement that the SNB would cooperate with the Eurosystem in case of an international crisis. A precautionary swap agreement that would allow the SNB to borrow euros from the ECB had been signed in 2003.[49]

According to the ECB's internal documentation,[50] the SNB took the initiative in proposing the swap facility in October 2008.[51] The conclusion of the agreement was facilitated by the previously established agreement. The swap agreement from October 2008 contains just an amendment to make the existing swap agreement reciprocal and allow the ECB to borrow

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[47] Swiss National Bank (SNB) - Questions and answers on foreign exchange swaps

[48] Interview Nowotny (OeNB)

[49] Amendment to the euro-Swiss franc swap agreement between the European Central Bank and the Banque Nationale Suisse-Schweizerische Nationalbank (europa.eu)

[50] Provision of 1-week Swiss franc liquidity to Eurosystem counterparties: Executive Board proposal, 14 October 2008 (europa.eu)

[51] Though inside the Eurosystem, the OeNB was already keen to secure access to Swiss franc liquidity, interview Nauschnigg (OeNB).

francs. Moreover, the SNB understood the international context and was aware that the announcement of the joint facility with the ECB might lead to further requests or assistance. But the SNB was initially reluctant to lend directly to the Central European central banks. At first, it proposed that those central banks should access Swiss franc liquidity via the ECB, rather than through separate bilateral swap agreements.[52]

Against this backdrop, it becomes clearer that the subsequent agreements between the SNB and the Polish and Hungarian central banks were not just motivated by credit risk. The fact that the SNB set up separate bilateral swap lines with both Central European central banks suggests that the ECB refused to act as an intermediary, as the SNB had initially asked. When the SNB negotiated the credit line with the NBP, = the ECB was informed about that. Concluding that the ECB's repo and the SNB's CHF/EUR swap were in any way related seems nevertheless implausible, considering that only the latter was drawn.[53] Cooperation with the NBP was facilitated because Poland belonged to the same IMF constituency and staff contacts were well-established.[54] Once the SNB had agreed to swap Swiss francs for euros for Poland, it could quickly extend the same offer to Hungary (though the MNB had asked for a swap against forint).[55] Both these credit lines were provided despite the SNB's prior conclusion that it had nothing at stake in those countries and its initial reluctance to lend to the central banks – they

[52] Provision of 1-week Swiss franc liquidity to Eurosystem counterparties: Executive Board proposal, 14 October 2008 (europa.eu)

[53] Interview Kluza (KNF)

[54] Interview Brown (University of St.Gallen)

[55] Interview Király (MNB)

can therefore be understood as expressions of solidarity than as serving Swiss financial or policy interests.[56]

At the same time, the SNB paid close attention to ensuring the overall consistency of its international lending with its overall monetary policy stance. The swap lines with the NBP and the MNB were both integrated with the SNB's efforts to supply Swiss francs to foreign banks and both central banks 'joined' the foreign exchange swap operations of the SNB and the Eurosystem.[57] All these central banks coordinated their Swiss franc swap tenders at the same time as the SNB, which also determined the maximum allotment, though they could set the price themselves. The NBP offered to swap Swiss francs against zloty at a forbiddingly high price to push banks back to the market (Szpunar, 2009); the MNB relayed the SNB's credit line by asking domestic banks for euro collateral as well (Magyar Nemzeti Bank, 2010a).[58] By insisting on extraordinarily strict borrowing terms, the SNB ensured that the conditions were consistent with the SNB's policy framework. Under these circumstances adding the MNB and the NBP to the tenders had no operational downsides for the SNB.

After the SNB's swaps were allowed to expire in 2010, the SNB deepened its cooperation on credit lines. The ECB and SNB re-established a swap in 2011 when they joined the system of standing bilateral swap lines with the US Fed, the Bank of England, the Bank of Japan, and the Bank of Canada (European Central Bank, 2014, p. 66) and in 2012 the SNB also set up a new, precautionary swap line with the NBP, this time accepting zloty as collateral.[59] However, when

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[56] Interview Brown (University of St.Gallen)

[57] Narodowy Bank Polski - Internet Information Service (nbp.pl); Swiss National Bank and Magyar Nemzeti Bank cooperate to provide Swiss franc liquidity (mnb.hu)

[58] The MNB had originally asked the SNB to swap francs for forint, but was turned down. Interview Király.

[59] Swap agreement between the Swiss National Bank and the National Bank of Poland (snb.ch)

the MNB unofficially suggested an out-of-market swap deal in 2011, the SNB declined politely.[60]

The SNB's agreement with the ECB reveals a prior norm of cooperation in crisis times and that a set of prepared swap line agreements was in place with West European central banks. However, this solidarity was not extended to every central bank, as the credit lines to Hungary and Poland show. Though the SNB had been aware of the potential need for support in Central Europe, it was initially reluctant to provide support directly to these central banks. In the end, the credit lines were useful for the recipients in combatting specific local market failures, but they also served to protect the SNB against financial risks. The SNB acted consistently within its operational framework, but it does not appear that the credit lines to Hungary and Poland furthered any national interests. It rather seems that the SNB extended the support in response to the recipients' needs, provided that its own policy conduct would not be undermined.

Conclusion

This chapter has studied central bank credit lines in Central Europe and aimed to understand why both the ECB and the SNB took the unconventional step of asking for collateral from the Polish and Hungarian central banks while they concluded a swap line among themselves. While financial interests certainly played a role, normative considerations, the question of what is the 'right' course of action undeniably influenced the terms of these credit lines.

The SNB-ECB swap could relatively clearly be linked to the expected consequences for Swiss monetary policy. Failure to supply Swiss francs to Euro Area banks would have disrupted the SNB's key money market segment and led to unwanted currency appreciation. Yet, the ECB's

[60] Interview Király (MNB)

and SNB's credit lines with the MNB and NBP cannot be linked that clearly to material objectives, albeit for opposite reasons. The SNB had already in 2007 concluded that it had no interests at stake in Central Europe, but decided to provide support as long as it was consistent with its operational framework. The ECB pushed back against exposed banks and ended up refusing swap lines to central banks of states with solid credit ratings. If the SNB thus lacked any self-interested reason to extend support, the ECB was seemingly unconcerned with them.

Factors that are associated with the logic of appropriateness clarify both puzzling decisions towards the Central European central banks. The SNB seemed to be influenced by existing norms and agreements to cooperate during crises – even its swap with the ECB can easily be understood in those terms. The West European central banks had signalled their readiness to provide mutual support long before the crisis erupted. When it came to applying this norm in the context of the Hungarian and Polish crises the SNB faced a trade-off between showing solidarity and protecting its balance sheet. The SNB had already decided that it would only accept limited exposure to Central Europe before it received any requests. By adding them to its swap tenders with the ECB, the SNB found a way of allowing those central banks to access Swiss franc liquidity that would not jeopardise its balance sheet or its policy implementation. While the benefit for the recipients was clear, for the SNB this support had only a limited downside.

In the ECB's case, international solidarity was no decisive concern. On the contrary, the ECB sought to interpret its mandate in a way that excluded potential responsibilities for financial stability in Central Europe. One needs to understand the thinking inside the ECB to make sense of its reluctance to get involved: its neglect of the significance of the international role of the euro and the overly strict concern with credit risk were both linked to the strong intellectual influence of former Bundesbank economists. The evidence of internal disagreements and

bargaining about the right way of responding to the Hungarian swap request shows how contested these ideas were. The compromise to provide repos – to offer some form of assistance, but protect the balance sheet – reflected not just material considerations but also a distinct perception of what would be appropriate for the ECB to do. The repo to the MNB also set in motion a path-dependent process since the ECB's subsequent decisions of rejecting swaps to the Czech and Polish central banks were influenced by that precedent.

The credit lines in Central Europe were unconventional. As this chapter has shown, despite their similarities, they reflected starkly contrasting approaches to financial crisis management by the ECB and the SNB. Material concerns may align with or contradict perceptions of appropriateness. However, as the following chapter shows, in the Nordic/Baltic region, central banks found different ways of reconciling these two logics of action.