Lessons from Europe for the study of international central bank cooperation

Spielberger, L.

Citation

Spielberger, L. (2023, March 22). *Lessons from Europe for the study of international central bank cooperation*. Retrieved from https://hdl.handle.net/1887/3576721

Version:	Publisher's Version
License:	Licence agreement concerning inclusion of doctoral thesis in the Institutional Repository of the University of Leiden
Downloaded from:	https://hdl.handle.net/1887/3576721

Note: To cite this publication please use the final published version (if applicable).

Chapter 4 – Central banks and Balance of Payments Assistance

Abstract

The objective of this chapter is to probe the relationship between central bank cooperation and Balance-of-Payments (BoP) programmes. It asks, first, to which degree central banks have been involved in the design and negotiations of BoP programmes in EU member states and, second, which role conditionality or domestic reforms played in the cooperation between central banks. It finds that central banks' engagement with individual BoP programmes varied because of the degree to which they felt responsible for the crisis and whether they had the requisite expertise. These findings imply not only that individually, central banks saw their roles in BoP programmes contextually, but also that the norms regarding their role in BoP assistance remained relatively stable throughout the crisis.

Introduction

Balance-of-Payments support programmes resemble central bank credit lines. Ultimately, both are forms of financial support that give the recipient access to additional foreign reserve assets (Murau et al., 2021). But while credit lines have the advantage of being set up quickly to offer short-term support, BoP programmes are usually intended for the medium term and linked to structural adjustment programmes and monitoring. For this reason, BoP programmes, and the associated reform programmes have often been controversial in public debate, while central banks' functionally very similar support is usually less salient.

By studying the relationship between central banks and BoP programmes, this chapter sheds light on a somewhat neglected form of central bank cooperation. Although central bank credit lines and BoP assistance programmes have been linked for a long time, central banks' input to the programme conditions has often not been considered explicitly. McDowell's (2017) account stops at the conclusion that the Fed's swap lines were provided precisely in moments when the IMF was unable to step in. However, central banks have contributed to BoP programmes more explicitly. Especially during crises in Emerging Markets joint loans from central banks, often brokered through the Bank for International Settlements (BIS), have often served as bridge credits (Cooper, 2006; Simmons, 2008). In the European context, the ECB has even tried to

weigh in on programme conditionality in its role in the 'troika' of creditors during the sovereign debt crisis (Fontan, 2018; Lütz & Hilgers, 2019; Lütz, Hilgers, & Schneider, 2019b; Lütz & Kranke, 2014). A systematic appraisal of how central banks relate to BoP programmes is necessary to capture an important way of how they cooperate.

The empirical findings in this chapter show central banks participated in BoP programmes to different degrees. Both the Hungarian and the Romanian programmes saw little involvement from foreign central banks, despite their strong financial linkages with West European banks. By contrast, both the ECB and the Sveriges Riksbank weighed in on central aspects of the Latvian programme. The Riksbank also linked the availability of swap lines to prior acceptance of IMF programme conditions. Lastly, central banks' involvement in the reform of both the European and global financial assistance architecture after 2008 further suggests that central banks preferred drawing on the IMF's expertise and credibility to committing to a role as major creditors themselves. Overall, the chapter finds that while central banks were reluctant to participate officially in BoP programmes, they sometimes linked their support to IMF support or tried to influence the loan conditions. To understand their involvement, it is necessary not merely to consider the material interests that were at stake for them, but also their perceptions of fairness, international norms, and the appropriate role of central banks in international financial assistance.

These findings contribute important insights to the overarching argument of this thesis. A first, relevant takeaway is that central bank cooperation on credit lines happened largely separate from formal negotiations for BoP support. Accordingly, it should be considered as following separate norms. Second, central banks' involvement often weighed considerations of appropriateness, including whether they had sufficient expertise and legitimacy to involve themselves directly in BoP programmes. Lastly, the reforms following the crisis left the

institutional ambiguity around access to central bank support and BoP assistance intact; even if the crisis in CEE led the ECB to improve its expertise for BoP programmes ahead of the Greek bailout. Central banks' role in BoP assistance reflected not a fixed institutional order, but contextual judgments, which were based on normative considerations and their confidence in their own technical capacities.

The chapter is structured as follows. The next section looks at the ECB's involvement in the BoP programmes in Hungary, Latvia, and Romania. Then the Nordic central bank's roles in the Icelandic and Latvian programmes will be considered, above all that of the Swedish central bank. The last substantive section turns to the evolving understanding of central banks' role in the international financial assistance architecture.

4.1 The ECB's involvement with BoP programmes

For the ECB, the financial crisis in Eastern Europe presented an unprecedented challenge. The ECB lacked experience with international financial rescues in general, and its specific role within the EU's BoP support architecture was not established. It pursued a contextual approach to the three BoP programmes in Eastern Europe, in two out of three cases it only joined the missions late, whereas in Latvia it was outspoken over the programme's conditions. These decisions can be understood against both the role that the ECB saw appropriate under EU norms and its limited expertise for BoP programmes at the onset of the GFC.

4.1.1 Central banks and the BoP programme in Hungary

The broadly shared assessment among interviewees of the ECB's and the European Commission's response to the outbreak of the financial crisis in Hungary was that both institutions were completely overwhelmed with responding to a BoP crisis in an EU member

state.[112] The Commission had a BoP instrument, called medium-term financial assistance facility (MFAF) of €12.5bn for member states outside the Euro Area, which had not been used since 1993 and had largely been forgotten about.[113] The ECB, as seen in chapter 3, had no plan in place either and took almost a week to decide on the terms of the credit line to Hungary.

During the first days after the Hungarian market collapse on October 9th 2008 several initiatives to assemble an assistance package were set in motion. Initially, the Hungarian central bank (MNB) had only reached out to the IMF for assistance, but the European Commission quickly intervened by stating that the Hungarian government should have requested support from the EU first (Blustein, 2015, p. 8). Yet, shortly after asserting its role, the Commission was forced to concede that it lacked the resources to run a BoP programme and that it would need to cooperate with the Fund (Király, 2020, p. 57). Coincidentally, many of the key players were at the IMF's Annual Meeting in Washington at the time. Negotiations between the Hungarian central bank, the IMF, and the Commission could already begin a day after the financial market collapse. It was quickly agreed that the IMF and the Commission would dispatch a joint mission to Budapest, but the ECB did not join in (Blustein, 2015).

Despite the need for additional financial resources, no central bank made any contribution that was counted towards the Hungarian bailout. At the start of the negotiations, an IMF official contacted the deputy governor of the Austrian National Bank (OeNB) suggesting that the OeNB contribute to the bailout with about €1bn.[114] But that proposal fell on deaf ears – the OeNB never formally participated in the IMF's missions to Hungary, even though Austrian banks had

---

[112] Interviews IMF 1, IMF 2, IMF 3, Kiraly, Nagy, Wieser

[113] The facility had been kept in place after the euro's creation precisely because of the possibility of a BoP crisis in an accession state (EU Council, 2002)

[114] Interview IMF 2

strong linkages with the country. Besides, from the IMF's perspective, neither of the two credit lines, that the Hungarian central bank had received, helped resolve the BoP problem. The assessment of the IMF was that the ECB's repo 'was not counted toward filling the financing gap, because it was viewed as largely a domestic monetary operation' (Kincaid, 2016, p. 51). The swap line from their Swiss colleagues (a EUR/CHF swap line) did not feature as a capital inflow, because it only exchanged one foreign asset for another (International Monetary Fund, 2009b, p. 28). No IMF official interviewed recalls contacts with the Swiss National Bank.[115]

For over a year the ECB did not send its own representative on the joint Commission-IMF missions to Hungary, but it was involved in discussions through other channels. First, it took part in the discussion on the EU's MoU through the Economic and Financial Committee (EFC) where it argued for the of removal monetary policy issues (the monitoring of foreign reserves) from the text to avoid negative financial market reactions (Thissen et al., 2013, p. 19). Second, though the negotiations of the terms of the repo line between the ECB and the MNB took place separately from the MoU negotiations, an IMF official visited Frankfurt to meet with Klaus Masuch of the ECB's Economics Department[116] to discuss 'the workings of this repo line, including its collateral requirements' (Kincaid, 2016, p. 51). The IMF persuaded the ECB to accept a broader range of collateral a week after the original agreement with the MNB had been concluded.[117]

---

[115] Interviews IMF 1, IMF 2, IMF 3

[116] Interview IMF 3

[117] Under the original agreement, the MNB was only allowed to repo German, French, and Italian bonds. After the change, the ECB allowed public sector securities from all EU member states, as well as the European Investment Bank and the KfW (European Central Bank, 2008f).

Whereas the ECB was thus hardly involved in programme design, it nevertheless interfered with monetary policy conduct in Hungary. After the market for Hungarian government bonds had completely collapsed, the MNB a week later struck an agreement with the banks that usually bought government bonds (primary dealers). The primary dealers agreed again to participate in government bond auctions and the MNB would buy the same amount of bonds on the secondary market (Király, 2020, p. 62). Under this policy, the MNB intervened in the secondary markets seven times, until the return of confidence following the arrival of IMF funds (Magyar Nemzeti Bank, 2009, p. 22). Even though the measure thus proved successful in reviving the government bond market, it led the ECB to write an angry letter to the MNB in which it argued that such bond purchases violated the EU's monetary financing prohibition under Article 123, TFEU.[118] The MNB apologized, but ECB President Trichet refused to accept that the measure was necessary for this emergency (Király, 2020, p. 62). Even if the ECB insisted that it did not want to set programme conditions, it was unforgiving when it came to enforcing the EU Treaty provisions.[119]

Overall, the Hungarian BoP programme was the first attempt at establishing a task division between the three institutions that would become the troika during the Euro Area crisis. Yet, neither the ECB nor other central banks with exposure to Hungary participated in the programme negotiations or supported the MNB's efforts to stabilize financial markets. If the Hungarian crisis had established a precedent, one would expect that central banks would indeed

[118] In retrospect this point is highly ironic

[119] The ECB produced several similar opinions on central banks' crisis measures after October 2008 that show its lack of appreciation for the situation. In Denmark, for instance, the ECB at first argued that liquidity support to a nationalized bank would constitute monetary financing (European Central Bank, 2008b), Interview Berg (DNB). In Sweden, it made a similar point around the newly set-up financial stability fund (European Central Bank, 2008c)

play a subordinate role in BoP programmes. The experience of Latvia just a few weeks later, however, shows that in other circumstances, central banks were far more proactive.

4.1.2 The ECB and the Latvian programme

The negotiations for a BoP programme in Latvia started in late October 2008. This time, however, the ECB participated in the negotiations from the start when it sent Rasmus Rüffer, another German official from the Economics Department, as an observer to the missions (Blustein, 2015, pp. 10–11; Kincaid, 2016, p. 53). The ECB's representative played, however, only a limited role in the lead-up to the programme. One IMF official recalls him just attending the meetings and quietly reporting back.[120] Compared with the ECB's refusal to participate in the Hungarian missions, however, the fact that it sent somebody to Latvia at all is remarkable.

One of the most central issues during the negotiations of the Latvian BoP programme was the fixed exchange rate. The question of whether Latvia should devalue its currency created a deep divide between the IMF and all other parties involved in the bailout negotiations. The IMF initially drew largely on its previous experience with BoP programmes in emerging markets to justify its advocacy of devaluation (Blustein, 2015). Some staff members also found the degree of internal devaluation that Latvia would have to undergo to maintain the currency peg impossible.[121] But the IMF faced a broad opposition composed of the the European Commission, the ECB, and the Nordic governments (Åslund & Dombrovskis, 2011, p. 42). The Latvian government itself was adamant in ruling out devaluation in order to stay on course for Euro Area entry In the end, the European side prevailed, as the IMF acknowledged not just the technical merits of their case against devaluation, but also stressed the importance of 'country

[120] Interview IMF 1

[121] Interview IMF 1

ownership' of the programme conditions (Rosenberg, 2009). In return, however, the shares in the financing arrangement had to be adjusted to what was dubbed a 'reverse Hungary' (Blustein, 2015).[122] After the MFAF had been increased to a volume of €25bn, the EU had the necessary resources to cover €3.1bn out of the official programme financing of €5.3bn.

The ECB's motivation to get involved in the negotiations in Latvia seems above all to have been linked to Latvia's participation in the Exchange Rate Mechanism (ERM) II (Kincaid, 2016, p. 53). The Latvian lats was at risk of crashing out of the mechanism and under the operating procedures of the ERM II, the ECB was tasked with monitoring the sustainability of exchange rates of participating currencies (Lütz & Kranke, 2014). Since in these reports the had consistently emphasised the need for equal treatment (see e.g. European Central Bank, 2008a, p. 7),[123] it now saw that there 'was a risk that IMF surveillance might call into question aspects of the peer review conducted by EU institutions' (Kincaid, 2016, p. 53).

The ECB took a somewhat paradoxical position on the BoP programme in Latvia. Though it opposed a devaluation of the Latvian lats, the ECB was unwilling to contribute to the programme. The ECB had various reasons to oppose the devaluation. First, it assessed that 'the strategy of pegging and the de facto euroisation the Baltics have created a very difficult situation in which no ideal policy option exists' (European Central Bank, 2008h). Nevertheless, it argued that Latvia's economy would do better if the peg was maintained (European Central Bank, 2008h).[124] Second, it saw a risk of contagion if the currency was devalued. It was reasoned that

---

[122] This distribution reflected not just the Europeans' emphasis on maintaining the exchange rate but also the size of Latvia's financing gap (Interview Nauschnigg, OeNB). The IMF's share was about 1000% of Latvia's quote, similar to the share in the Hungarian programme; the overall programme size was almost a third of Latvia's GDP.

[123] I am grateful to one committee member for this suggestion

[124] Interview Bini Smaghi

currency speculators might target other fixed currency arrangements in CEE if the lats could not be defended anymore. Jürgen Stark, the ECB's Chief Economist, was among those who feared a potential domino effect that could hit not only the Baltic states.[125]

These worries brought both reputational and material interests to the fore. From a reputational standpoint, financial contagion which would have necessitated bailouts for more ERM II participants would have reflected negatively on the EU.[126] But if contagion spread to countries in Central Europe, it could also hurt the interests of banks from Euro Area states. At a meeting of the Belgo-Austrian IMF constituency, all states present agreed that Latvia should not devalue because contagion might spread to Croatia or Bulgaria, where other banks were more exposed. As one OeNB official recalls: 'The Balts were not so much our priority, but we wanted to protect them to protect ourselves.'[127]

Yet the ECB did not want to play any role itself in the defence of the Latvian currency peg and thus also not in the BoP programme. Curiously, the IMF's report on the programme request does not even mention the repo agreement that the Latvian central bank had received from the ECB (International Monetary Fund, 2008b). For the ECB it was clear that while devaluation should be avoided, the responsibility for that would lie with the Latvian government. An internal document in November 2008 restated that '[t]he ECB's policy line has always been that currency board or unilateral pegs by third countries are not backed in any way by policy

[125] Interview IMF 1

[126] Interview IMF 1

[127] Interview Nauschnigg (OeNB), translated from German

commitments from the ECB' (European Central Bank, 2008h). Additional resources to defend the currency peg would have to come from fiscal sources, not the central bank.[128]

With devaluation ruled out, the IMF floated another pragmatic, but unorthodox proposal. If the Latvian government did not want to adjust, it could simply adopt the euro as its official currency and thereby eliminate both the risk of devaluation and potentially gain access to the ECB's liquidity facilities (International Monetary Fund, 2008b, p. 27, 2009f). However, the ECB and the Commission were unforgiving about changing the exchange rate regime. In public, the ECB argued on economic grounds that

> '[…] entering the euro area prematurely – that is before reaching a sufficient degree of convergence and economic flexibility – would not be a panacea for the CEE countries to overcome the crisis impact. On the contrary, a premature entry into the euro area would deprive the countries from [*sic*] important adjustment tools and would therefore not be in the interest of the country joining' (Tumpel-Gugerell, 2009, pp. 4–5).

However, this technical argument has some glaring weaknesses. After all, if Latvia had committed itself to a narrow exchange rate peg, there were no adjustment tools left for it inside the ERM II framework. The IMF staff, having accepted that devaluation was no option, argued that adopting the euro was the 'technically more attractive' option than maintaining the peg (Kincaid, 2016, p. 53). But the ECB was immovable. The summary of the IMF Executive Board meeting on Latvia, for instance, records that while Directors from other constituencies contemplated the idea, 'in practice immediate euroisation has been ruled out by the EU authorities as inconsistent with the Maastricht Treaty' (International Monetary Fund, 2009f, p. 2). The ECB's economic case against euro adoption may have been unconvincing, but 'the Europeans insisted, and they were in a position to get their way, given their voting power on

---

[128] Interview Nauschnigg (OeNB)

the IMF board' (Blustein, 2015, p. 11). The real concern seems to have been to avoid setting a precedent for a looser application of the convergence criteria.

During the programme, another conflict between the EU and the IMF erupted on the issue of devaluation. Ahead of the first programme review in June 2009, the economic prospects worsened and the question of a potential devaluation returned (Åslund & Dombrovskis, 2011, pp. 75–81). At its core was a disagreement between the IMF and the EU side over the fiscal austerity package that the Latvian parliament had passed. The IMF considered the wide-ranging social spending cuts too harsh, but the EU side insisted that they were necessary to keep the country on track for euro adoption in 2014 (Lütz & Hilgers, 2018, p. 9). Though in this situation, again, the ECB still refused to offer material support, it weighed in on the debate when President Trichet (2009) expressed his 'full confidence that the Government of Latvia will take the decisions that are appropriate for the domestic context without a change in the currency.' In the end, the Europeans outmanoeuvred the IMF by releasing the next financing tranche without waiting for IMF Board approval, which replenished Latvian foreign reserves and brought the speculation against the exchange rate to an end (Åslund & Dombrovskis, 2011, pp. 75–81).

The ECB thus got involved in the Latvian crisis from the start because the question of devaluation concerned one of its competencies as an EU institution. Both its uncompromising stance on the exchange rate and its reluctance to provide direct financial support were related to its interpretation of what was appropriate within the ERM II framework. Closing the financing gap, from this perspective, had to be done through fiscal means. Its more active role in Latvia was, however, an exception. During the next programme, in Romania, the ECB would once more stand by idly.

4.1.3 The ECB and the BoP programme in Romania

The Romanian BoP programme came somewhat later than the first two programmes and was agreed upon in May 2009. The financing shares between the Commission and the IMF were again reversed. The IMF covered €13bn out of €20bn; the Commission provided €5bn after the volume of the MFAF had now been raised to €50bn (Darvas, 2009). Most of the programme negotiations took place within the context of the Vienna Initiative, which the ECB attended as an observer (Franks & Tuladhar, 2012, p. 150). Especially the West European parent banks' commitment letters in March 2009 were seen as integral to the success of the programme (Kincaid, 2016, p. 57).

Unlike in Hungary and Latvia, the ECB has not provided a credit line to the National Bank of Romania (NBR). Again, it played a very limited role in programme design. The possibility of a credit line for the NBR is first mentioned as part of an IMF mission in mid-2010 (International Monetary Fund, 2010). Before that, the ECB had weighed in on the programme rather selectively. Several of the Romanian programme conditions concerned monetary policy issues, such as the exchange rate and stress testing. These issues were however only covered in the Memoranda of Understanding (MoU) with the IMF and not those with the European Commission[129] (Kincaid, 2016, pp. 57–58). The EU's reluctance to interfere with monetary policy resembles the decision on the programme in Hungary, where the ECB had argued against including monetary policy in the programme conditions.

In one regard, however, the ECB quickly came to the aid of the NBR: in early 2010, the government pushed through a sweeping round of fiscal austerity measures and cut all public

[129] The IMF memorandum included several quantitative performance criteria for foreign assets and inflation (International Monetary Fund, 2009e, pp. 12–14). These conditions are missing in the EU's MoU (*Memorandum of Understanding Between The European Community And Romania*, 2009).

employees' salaries by 25% (Åslund, 2010, p. 39). After a protest from the ECB that this measure not just infringed on the financial independence of the central bank, but also constituted monetary financing of the state if the savings were added to the fiscal budget (European Central Bank, 2010b), the government quickly moved to withdraw the measure again (International Monetary Fund, 2010). In Hungary, the newly-instated Orbán government took a similar measure around the same time, capping the central bank Governor's salary (Király, 2020, p. 100) which led to a similar response from the ECB (European Central Bank, 2010a).

4.1.4 Taking stock of the early 'troika'

The BoP programmes in Hungary, Latvia, and Romania were the first instances in which the ECB had to define its role in providing external financial assistance, not just vis-à-vis the IMF as another creditor, but also the European Commission. As shown in this section, the ECB succeeded in bracketing out monetary policy from the EU's MoUs in Hungary and Romania. Its input to crisis measures seems, however, limited to safeguarding the integrity of the EU principles by taking a strict line on the monetary financing prohibition and central bank independence, even if these decisions at times interfered with financial crisis management or rolled back austerity measures.

In Latvia, a similarly principled stance led the ECB to veto plans to adjust the exchange rate or accelerate euro accession. Its proactive involvement both in the IMF missions and the design of the programme conditions seems largely driven by the ECB's institutional role in the euro adoption procedure. However, as in the other two cases, the ECB insisted it avoid a role in programme financing, which was left to the Commission and the IMF.

Considered against the backdrop of material interests, the ECB's course of action is somewhat puzzling. In the two countries that saw a strong involvement of Euro Area banks, the ECB initially refrained from interfering with programme design. But in Latvia, it was strongly

involved from the beginning, despite the virtual absence of financial linkages with the Euro Area. Even in Latvia, the ECB's actions ran counter to its desired consequences; the ECB aimed to avoid currency devaluation. However, unlike the Nordic central banks, the ECB did not make a financial contribution to tide the Bank of Latvia over.

The ECB's particular interpretation of its policy mandate and the EU's principles for central banking provides more clarity. There was a consensus inside the ECB that it had no role in BoP crises outside the Euro Area.

> 'While the ECB was very much involved in Greece, with the IMF, was very close with the IMF on Ireland, on Portugal, Spain […] in the non-Eurozone countries, frankly, I don't think we had a possible role. […] Because the […] responsibility for monetary policy was in the national central bank, fiscal policy was in the country. So, it would have been interference on the ECB's role.'[130]

A similar stance was taken by Luxembourgish central bank governor Yves Mersch who emphasized that the ECB's Governing Council's agreed stance was to focus on price stability in the Euro Area and that the ECB could not be 'a regional IMF' (Atkins, 2009).

Moreover, whenever EU laws and agreements provided clear prescriptions, the ECB was ready to enforce them. Both the ECB's dogged insistence on Latvia's original euro accession schedule and the refusal to support the exchange rate were firmly rooted in its narrow reading of the ERM II principles. In Hungary and Romania, the ECB interfered with crisis management when it feared the transgression of the monetary financing prohibition or central bank independence. Strikingly all these measures appeared largely unrelated to the practical requirements of crisis management.

---

[130] Interview Bini Smaghi

Besides the ECB's role perception, another concern seems to have been the ECB's limited expertise in BoP crises at the time. Lorenzo Bini Smaghi argued that 'the ECB didn't want to get too much involved […] not only because of the availability of staff and knowledge but also because it was not responsible.'[131] Another former ECB Board Member mused that the ECB could, if it all, be involved when it came to monetary policy (which, as seen, was largely left out of the EU's MoUs), but not be part of the programmes.[132] In other words, the ECB deferred to the IMF on questions of conditionality not just because it avoided responsibility for financial crises outside the Euro Area, but also because it could not design a programme itself. It is worth adding though that several interviewees have indicated that the ECB after the Hungarian crisis improved its capacities for structural adjustment programmes, as will be discussed at the end of the chapter. However, one can only speculate whether it would have responded differently to the East European crises if it had had better staff capacities.

The last explanation that several interviewees from outside the ECB mentioned is that the ECB generally had little trust in the EU's new member states. Hungarian central banker Julia Király, for instance, recalled that for '[ECB President] Trichet, [CEE] was dangerous, unreliable, unpredictable […] For him, Romania, Bulgaria, Hungary, Czech, is all the same.'[133] While EU officials still considered the stigma of an IMF programme off limits for a member of the Euro Area, 'its loans were fine for poor ex-Communist nations' (Walker, Forelle, & Blackstone, 2010).

---

[131] Interview Bini Smaghi, Nauschnigg (OeNB)

[132] Interview ECB 1

[133] Interview Király (MNB)

The ECB thus justified its aloof stance on adjustment programmes in CEE on two principles. Acting as a central bank, it insisted on a very narrow interpretation of its mandate, but in its role as an EU institution, it aimed to uphold treaty principles. All in all, these conclusions suggest that its attitude followed considerations of appropriate action with relative disregard for the expected consequences.

4.2 Nordic cooperation on BoP programmes

The Nordic central banks contributed, to differing degrees, to the two BoP assistance programmes in the Nordic/Baltic IMF constituency. This section will discuss how both swap lines were conditional acceptance of IMF criteria and how the Riksbank played a leading role in defining the principled quid pro quo approach towards financial assistance in the region. Though central banks' measures were closely coordinated with the IMF, their cooperation was separate from the negotiations between finance ministries.

4.2.1 Contributions to negotiations and programme financing

The Riksbank took a leading role in shaping the Nordic central banks' approaches to financial assistance in 2008. In the early days of both the Icelandic and the Latvian crises, the Riksbank conducted its own analyses of the situation and coordinated with the IMF. In the case of the Icelandic crisis, it is noteworthy that the Riksbank was the only major central bank that sent officials to Reykjavik to assess the situation, while the Fed and the ECB relied instead on an assessment of the IMF (Gissurarson, 2018, pp. 41–42).

Though the IMF only officially sent a mission to Iceland in October 2008, it nevertheless played an important role in influencing the terms of the swap. The previous chapter has discussed the

stringent conditionality that the Nordic central banks – especially the Riksbank[134] – demanded in return for the Icelandic swap. As it turns out, these conditions had been negotiated during the IMF spring meeting in April 2008 (Ingves, 2018, p. 10). One official remembers asking the IMF's country desk for Iceland for which policies to demand.[135] The Riksbank took a hard-handed approach: at one point in the negotiations, CBI Governor Oddson handed over his phone so that Ingves could speak directly to the Icelandic prime minister (Gissurarson, 2018, p. 43). In the end, three Icelandic ministers had to sign up to the conditions for the swap line.

Though the Riksbank initially refused the CBI access to the swap line, as discussed in the previous chapter, the Nordic swap lines were maintained once the Icelandic government had signed its IMF agreement (Sveriges Riksbank, 2009c). By that point, all the Nordic governments, plus the Polish one, had all committed additional financing to the programme (Ibison, 2008). The swap lines remained in place until June 2009.

The Riksbank's approach to the crisis in the Baltic states was a bit more conciliatory but no less proactive. When the Latvian government requested IMF assistance, Ingves immediately signalled his readiness to provide a swap but on the condition that the Latvian government agreed to an IMF programme. According to the summary of one Riksbank official Ingves told the Latvian side 'We know that the IMF will take some time. But as soon as we are certain that the IMF will recommend to its board a set of programs […] on that very day, we will have a swap line with you.'[136] In this case, the Riksbank explicitly linked its support to the conclusion of an IMF programme.

---

[134] Interview Riksbank officials, Berg (DNB)

[135] Interview Riksbank officials

[136] Interview Riksbank officials

The Riksbank also assisted in the resolution of the Latvian crisis directly. Already in October 2008, Ingves sent his advisor Göran Lind to report on the progress of the bailout negotiations. Lind recalled travelling to Riga and back about ten times during that period.[137] In November 2008, he participated in the negotiations on the takeover of the bank Parex, one of the most crucial issues of the programme (Åslund & Dombrovskis, 2011), alongside IMF and European Commission representatives (FCMC, 2009, pp. 6–7). But Lind's role in the bank resolution went beyond that: subsequently, he co-drafted the piece of emergency legislation that would pass the Latvian parliament to enable the takeover.[138] Though the Riksbank was no creditor institution itself, it had directly influenced some terms of the Latvian programme.

When it came to the question of whether Latvia should devalue, the Riksbank's opposition to the IMF was above all motivated by the effect on financial markets. Though Swedish banks appeared sufficiently well capitalized to withstand the expected loan losses if the Latvian lats was devalued, it was expected that Swedish banks might lose critical access to market funding.[139] During the Riksbank's Executive Board meeting in December 2008, Deputy Governor Lars Nyberg pointed out that

> '[…] the Baltic states […] are experiencing considerable problems and the situation in Latvia is particularly worrisome. We cannot rule out the possibility of a deterioration in the Baltic countries leading to problems for the Swedish banks, too, and for Sweden as a nation in obtaining funding in the international financial markets' (Sveriges Riksbank, 2008).

Other members of the Nordic IMF constituency took similar views. Andres Sutt of the Bank of Estonia recalled the feeling that 'if Latvia go [*sic*] under we have also an issue.'[140] But besides

---

[137] Interview Riksbank officials, IMF 2

[138] Interview Riksbank officials

[139] Interview Riksbank officials

[140] Interview Sutt (Bank of Estonia)

that, there was also a consensus that devaluation would not be the appropriate course of action from a Latvian perspective. According to Per Callesen, then of the Danish Finance Ministry,

> '[…] [t]he Nordic view was if [Latvia had devalued], then they would have had an unprecedented inflationary spiral. Latvia didn't have a particularly strong export sector. It could have boosted inflation; they would have been compensating wage demands. So, they would have entered the vicious circle where they had to devalue once again and again. So better stop that from the outset.'[141]

Arguably, their IMF constituency offered the Nordic/Baltic states another channel through which they could influence the terms of the Latvian programme. The Nordic/Baltic Monetary Financial Committee (NBMFC), which was composed of one finance ministry and one central bank representative per state, was 'central' to the work done by the Nordic/Baltic IMF constituency.[142] Jens Henriksson, the IMF constituency's Executive Director, was in that respect an important player.[143] The Nordic and Baltic states also formed a working group together with the European Commission to discuss the programme terms.[144] Officials from the constituency have emphasised that avoiding devaluation required not just having the necessary votes, but also making a technically convincing case that internal devaluation could work.[145] Indeed Callesen argues that 'we won the argument [about devaluation] in practice, and intellectually.' The joint IMF constituency was thus not just a source of voting power, but also a way for the Nordic and Baltic states to influence the terms of the discussion inside the IMF.

The Swedish side played a central role during the formal negotiations of the Latvian programme, but there was a clear division in responsibilities between the political level and

---

[141] Interview Callesen (Danish MoF)

[142] Interview Callesen (Danish MoF), Ross (Bank of Estonia)

[143] Interviews IMF 1, Kivine (Estonian MoF), Riksbank officials

[144] Interviews Callesen (Danish MoF), Kivine (Estonian MoF)

[145] Interview Kivine (Estonian MoF)

central banks. When it came to negotiating the programme, Sweden's finance minister Anders Borg was the leading figure.[146] It was he who summoned the finance ministers from across the region to Arlanda airport shortly before the agreement of the IMF programme (Åslund & Dombrovskis, 2011, p. 46). At the meeting, the governments of the four Nordic countries, plus the Czech Republic, Poland, and Estonia committed a total of €2.2bn in bilateral loans to close the financing gap for the Latvian programme. In these political negotiations, the central bank did not play a visible role,[147] though the IMF report acknowledges the input of both the Swedish finance ministry and the Riksbank (International Monetary Fund, 2008b).

The Riksbank also made clear that it would provide similar loans to the other two Baltic states. Its precautionary swap with the Bank of Estonia, as seen, was not related to an IMF programme. And even the Lithuanian prime minister at one point visited the Riksbank to discuss a potential swap agreement, though, in the end, his country managed without a loan and an IMF programme.[148]

Despite the formal separation between fiscal and monetary support during the negotiations, the central bank swap was counted towards the programme financing for Latvia (International Monetary Fund, 2008b, pp. 13, 20). The loan fulfilled its purpose of tiding over the Bank of Latvia between the conclusion of the BoP programme negotiations and the IMF board approval three weeks later. The swap line also provided additional resources during a government crisis in Latvia in February 2009, but the Bank of Latvia did not draw it anymore during the height of the June crisis.

---

[146] Interview IMF 1, Kivine (Estonian MoF)

[147] Interview IMF 1

[148] Interview Riksbank officials

4.2.2 Understanding the Riksbank's role in the BoP programmes

Whereas it may be tempting to link the Riksbank's involvement in the Baltic region to the large exposure of Swedish banks, its leading role with the Icelandic swap lines illustrates that its relationship with the IMF was more multifaceted. The IMF served the Riksbank both as a commitment device and by helping the Riksbank ensure the Icelandic loan conditions were equivalent to an IMF programme. To appreciate this strategy fully, once more, the specific role understanding of what is appropriate to do for central banks during a crisis played an important role, as well as the agents inside the Riksbank that were ready to assume this form of leadership.

The Riksbank stands out for its confidence in responding to financial crises. Stefan Ingves himself had strong credentials. He had led the Swedish bank resolution authority after the Nordic banking crisis and published on the Swedish approach to banking resolution (Ingves, 1998; Ingves & Lind, 2008). Until he became Riksbank governor in 2006 he headed the IMF's Financial Stability Department, where he had been involved with the Indonesian BoP programme.[149] Several IMF officials stressed Ingves' linkages to the Fund as a factor that facilitated the cooperation.[150] Göran Lind, the Riksbank's representative to the Latvian missions, was a financial stability specialist who had been a long-time member of the Basel Committee on Banking Supervision. Early into the crisis, Ingves and Lind even co-authored an article in which they advocated other countries follow the Swedish approach to banking crises (Ingves & Lind, 2008). In short, the Riksbank could draw on considerable experience when the crisis erupted (cf. Mayes, 2009).

---

[149] Interview Riksbank officials

[150] Interviews IMF 1, IMF 2

These prior experiences also informed how the Riksbank defined its contribution to BoP programmes. There had been a longstanding awareness that central bank credit lines could serve as a bridge or a supplement to IMF programmes.[151] After all, since the financial crisis in Mexico in 1982, leading central banks had provided syndicated loans to distressed emerging markets, usually through the BIS (Cooper, 2006). Lind recalls even an informal quota scheme for such occasions at the BIS, where the Riksbank's share amounted to about 2%.[152] In this sense, the Riksbank had a template for its role in international financial rescues and Ingves knew from personal experience that some time could elapse between the agreement and approval of an IMF programme.[153]

The Riksbank's proactive involvement in both Iceland and Latvia before the conclusion of their programmes suggests that the Riksbank was confident in its expertise in financial stability issues. But the Riksbank made a clear distinction between central bank cooperation and BoP assistance and acknowledged the IMF's expertise by linking the swap to programme approval. Slightly understating his handling of the Icelandic government Ingves (2010, p. 3) argued that 'the Riksbank neither can nor should become involved in assessing whether or not the country is making the necessary economic adjustments.' Another issue was the Riksbank's weak mandate for financial stability even in Sweden, not to mention internationally (C. Goodhart & Rochet, 2011; Riksrevisionen, 2011).[154] For such considerations of institutional legitimacy, the

[151] Interview Riksbank officials

[152] Interview Riksbank officials

[153] Interview Riksbank officials

[154] Interview Riksbank officials

matter of ensuring that the programme came together was officially left to the political actors (Ingves, 2018, p. 13).

Many facets of the Nordic central banks' involvement with BoP support strengthen the conclusion that central banks chose to play a rather narrow and specific role by providing credit lines. Callesen's explanation of the relationship between the two suggests that this relationship between the two is rooted in a broader understanding of the significance of central bank loans compared to IMF programmes.

> '[A] swap line is something very narrow, specific, it's related to liquidity back and forth, you shouldn't interpret that as a lending arrangement. […] What it took to manage the financial crisis was much more than that […] When you accept an IMF programme […] it comes with heavy strings attached.'[155]

The IMF constituencies offered another setting where central banks and finance ministries could coordinate and affect programme design. Nevertheless, there existed a clear segmentation between what would be discussed at the political level and what would be done by central banks.

4.3 Reforming the financial assistance architecture during the crisis

This section turns to the question of whether central banks changed their approach to BoP crises based on their experiences during the GFC. The ECB's involvement on the EU level suggests that it reformed after its weak response to the crisis in CEE; the reforms at the IMF level highlight both the surprising role of CEE in reforming the IMF, but also central banks' general willingness to channel financial support through the IMF, rather than bilaterally.

[155] Interview Callesen (Danish MoF)

4.3.1 The EU's bailout system

Almost as soon as the Hungarian crisis exposed the EU's limited capacity for handling BoP crises in member states, work started on the issue of being better prepared next time. One relatively straightforward way of increasing the EU's crisis-handling capacity consisted in ramping up the volume of the MFAF. From initially €12.5bn, the EU Council increased the facility in November 2008 and March 2009 to €50bn.[156] This increase took place largely in response to the escalating crises, as especially Hungary and Romania required considerable EU funding (Kincaid, 2016). In the context of the second Romanian programme in 2011, the MFAF was also broadened to include also precautionary financing arrangements (which allowed the EU to continue demanding reforms without disbursing funds).

Growing the MFAF was however only the bare minimum that the EU could do, as the facility could only be used by member states outside the Euro Area. The Hungarian crisis also served as a wake-up call for the Commission and the ECB that something similar could befall a member of the Euro Area and that the EU had no instruments to cope with that. As soon as November 2008, a secret task force was formed to discuss the options for such a scenario, composed of high-level representatives from the Commission, the ECB, the Eurogroup, and the French and German governments (Walker et al., 2010). Soon thereafter, reports about potential Euro Area bailout scenarios became public, though the ECB, at least in public, was at first opposed to the idea (Bastasin, 2015, pp. 86–88; Reiermann, 2009).

[156] The ECB opposed the idea of giving the Commission the power to raise the ceiling of the facility unilaterally. Some voices from the OeNB had even demanded an increase to €100bn (Nauschnigg, 2009).

The ECB also had to concede that it lacked the internal capacities to run adjustment programmes.[157] An evaluation report of the ECB's Research Department, for instance, criticised that the ECB had focused its activities too much on monetary policy and econometric modelling, at the expense of financial stability. 'DG Research will have to expand its research capabilities in the areas of financial-real linkages, financial stability [and] global and intra-European imbalances' (Freedman, Lane, Repullo, & Schmidt-Hebbel, 2011, pp. 10, 13). But several interviewees noted that, while the ECB may initially have been hapless, the institution quickly learned, not least thanks to its cooperation with the Fund.[158] Klaus Masuch, the ECB person assigned to the Hungarian programme, would in 2009 head a new ECB team working on special tasks 'related to vulnerable countries and the sovereign debt crisis in the euro area.'[159] He would later head the ECB's troika delegation to Greece and Ireland in 2010. Mr. Rüffer, the ECB representative on the Latvian mission, was similarly relocated to work on the sovereign debt crisis and headed the ECB's team for Portugal in 2011 (Henning, 2017, p. 104). The crisis in Eastern Europe proved a valuable learning experience for the ECB to develop its capacities for structural adjustment programmes.

4.3.2 Central banks in the IMF reform

The reforms of the global financial safety net after 2008 provide further evidence for the clear task division between central banks and IMF loans. The funding of the IMF holds important lessons in that regard. At the G20 summit in London in April 2009, the IMF's resources were

---

[157] Interview Bini Smaghi

[158] Interview ECB 1, IMF 1

[159] Interview ECB 1. Klaus Masuch | Bruegel Masuch had previously worked as Issing's assistant professor at Würzburg University and was among the German officials that Issing had brought with him to the ECB's Economics Department, Interview Berg (DNB, ex-ECB).

increased from $250bn to $750bn (Blustein, 2015, p. 9). Though some authors dispute the necessity of the measure at the time (Helleiner, 2014, pp. 35–38), the increased IMF lending capacity became necessary to finance the Fund's share in the Euro Area bailouts and was raised once more in late 2010 after the onset of the Greek crisis (Henning, 2017, pp. 158–159).

The financial crisis in Europe had a catalysing effect on the IMF quota increase because most IMF lending in late 2008 and early 2009 went to European countries. The programmes for Iceland, Hungary, and Ukraine were being negotiated during the G20 Washington summit, where the increase of IMF resources was agreed to in principle (Helleiner, 2014, p. 34); programmes for Latvia, Serbia, Belarus, Romania, and Bosnia and Herzegovina followed soon (Bakker & Klingen, 2012). Most new IMF lending by volume around that time, accordingly, went to European countries. This fact was not lost on US officials who took the view that 'Eastern Europe, it's a European problem, and the Europeans should pay for it.'[160]

Until the Obama Administration took office, European efforts to increase the IMF's firepower ran into resistance from the US that opposed changes to the IMF quotas to maintain its veto on the Fund's Executive Board. But the European constituencies and Japan moved ahead by offering bilateral credits to the IMF, which would later be converted into New Arrangements to Borrow (NAB) (Henning, 2009). The decision on the EU level was taken during the European Council in March 2009 which agreed that '[f]or specific crisis support, EU Member States are ready to provide on a voluntary basis a fast temporary support of IMF lending capacity in the form of a loan to a total amount of EUR 75 billion' (Council of the European

---

[160] Interview Nauschnigg (OeNB)

Union, 2009, p. 15). This contribution at once exceeded the top-up of the MFAF to €50bn agreed upon at the same meeting.

Several central bankers interviewed for this research have emphasized that the IMF is funded from central bank resources (Murau et al., 2021) and that, consequently, the bilateral credits came straight from central banks.[161] Lending to the IMF is even explicitly exempted from the EU's monetary financing prohibition of public bodies.[162] In other words, by increasing the IMF resources, the EU's central banks could ensure that the necessary funds were available without getting directly involved, but this mechanism was not 'entirely transparent' – the OeNB could sell it as a measure to strengthen the IMF to gain parliamentary approval.[163] In fact, central banks' commitments to the IMF were far larger than the bilateral credit lines that they concluded.[164] Going via the IMF was attractive for central banks since the Fund would not just set the lending conditions, but also bear the credit risk and the political responsibility for the programmes.

Another topic of international financial reform was to clarify the relationship between central bank swap lines and IMF lending. The South Korean government at the G20 summit in Seoul in 2010 pushed for a structured system for central bank swap lines instead of the ad hoc approach in 2008 (Helleiner, 2014, p. 45). Several proposals were circulated for establishing conditions for countries to be eligible for swap lines in coordination with the IMF's

---

[161] Interviews Callesen (DNB), Nowotny, Naunschigg (both OeNB)

[162] Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b (1) of the Treaty - Publications Office of the EU (europa.eu), Art 7. This did, however, not stop Bundesbank President Axel Weber (2009) from decrying it as monetary financing and encouraging moral hazard.

[163] Interview Nowotny (OeNB), author's translation from German

[164] Interviews Callesen (DNB), Nauschnigg, Nowotny (both OeNB)

precautionary credit line (e.g. Henning, 2015; Truman, 2011). However, the institutionalization of central bank swap lines was uneven. On the one hand, the world's leading central banks – the Fed, the ECB, the Bank of England, the Bank of Canada, the Bank of Japan, and the Swiss National Bank – set up a standing network of swap lines in 2013. But on the other hand, both the Fed (Kim & Chey, 2012) and the ECB (Dorucci & McKay, 2011, pp. 37–38) insisted on maintaining 'constructive ambiguity' as to the question of lending to other central banks, ostensibly to prevent moral hazard. After the Cannes G20 Summit concluded that 'central banks play a major role in addressing liquidity shocks at a global and regional level,' (G7, quoted in Kim & Chey, 2012) the issue ran aground.

If the reforms at the EU level have thus spurred the ECB to prepare for a more active role in future BoP crises, the reforms at the global level support the conclusion that central banks have aimed to avoid a too visible role in financial rescues or commitments to provide support. The finding that central banks saw the bilateral credits to the IMF as a substitute for additional credit lines to central banks can be interpreted as reflecting both material and normative concerns. On the one hand, lending to the IMF reduced the credit risk for central banks and ensured the enforcement of policy conditionality. On the other hand, central banks seemed generally reluctant to get officially involved in political questions of policy conditionality.

Conclusion

In financial terms, central bank credit lines and BoP assistance programmes are similar because they work by increasing the recipient's access to foreign exchange reserves. However, this chapter has found that this similarity was seldom reflected in the way that central banks related to official BoP programmes. Central banks tried to ensure that BoP programmes would be the principal way of providing financial support to distressed countries in CEE. The ECB initially abstained from participating in two out of three BoP programmes; the Riksbank made its swap

line to Latvia conditional on programme approval; and the OeNB preferred to channel funds to CEE through credits to the IMF, rather than bilaterally. Curiously, central banks often bypassed or paralleled IMF credit lines, offering credit lines that served rather narrowly defined purposes. They argued that the IMF should provide medium-term financial assistance to peripheral countries in Europe.

The argument advanced here is that this course of action was often the result of strategic choices that were often informed by norms, rather than interests. Perhaps the clearest case in this regard is the OeNB's refusal to contribute to the BoP programme in Hungary when asked to do so, despite Austrian banks' financial stakes in the country. The ECB's choice to participate only in the Latvian programme missions, but did so because of the euro adoption process, rather than any immediate threat to Euro Area stability. Lastly, the Riksbank pursued a consequent approach of asking for policy commitments in return for financial support. The resulting arrangement for Iceland was an 'IMF loan without the IMF' (Ingves, 2018, p. 10); the Latvian government had to agree to its BoP programme to receive the swap.

Conflicting institutional mandates weighed on the ECB which initially struggled to define a clear role for itself. On the one hand, it insisted on a restrictive interpretation of its primary mandate for price stability in the Euro Area, rather than taking a more expansive definition that included financial stability in the entire EU. It did not feel responsible for events outside the Euro Area. On the other hand, its role as an EU institution led it to interfere with other central banks' crisis measures and even programme design in the case of Latvia. Its stance to avoid both devaluation and euroization was at least in part motivated by its insistence on the rules of the EU's euro adoption schedule.

The Riksbank pursued a proactive approach towards financial stability in the Nordic/Baltic region. Crucial components were not just strong financial linkages, but also a consistent

strategic approach informed by Ingves' personal experience at the IMF and a role understanding of the Riksbank from its previous participation in financial rescues.[165] Both the linkage between credit lines and acceptance of conditionality and the Riksbank's efforts to co-opt their Danish and Norwegian colleagues for the Latvian loan were deliberate choices, not financial necessities.

Financial risks and the IMF's stronger expertise in BoP programmes both provided reasons for central banks to defer to the IMF instead of acting more proactively. The ECB clearly lacked expertise and the IMF was seen as adding credibility and expertise to the programmes that the central banks lacked themselves. This theme would repeat itself during the Euro Area crisis (Henning, 2017). The decision to make far more resources available to the IMF than through bilateral loans seems to have been motivated by the 'elegant'[166] idea of avoiding financial liability.

Yet, as the last section of this chapter has shown, while the crisis in CEE started new efforts at reforming the global and the European financial stability architecture, they failed to lead to a more profound change in the institutional relationship between central banks and BoP programmes. The ECB would soon involve itself far more proactively in the design of BoP programmes for Euro Area countries (Henning, 2017), but a standing network of central bank swap lines would only be set up between the leading Western central banks and remain separate from the IMF. Compared with the governance arrangements that were set up in Europe to coordinate central banks' crisis measures, central banks' involvement in IMF programmes was

[165] One could add here the Riksbank choice to send a financial stability expert to the missions, whereas the ECB dispatched economists.

[166] Interview Nauschnigg (OeNB)

however limited. The following chapter will begin the study of central banks' collective actions by studying how they coordinated the provision of liquidity to cross-national banking groups.