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Definancialization, financial repression and policy continuity in East-Central Europe

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Abstract

The Great Financial Crisis ushered unorthodox financial policies that would have been unfathomable before 2008. Perhaps unexpectedly, some of the boldest measures on this unorthodox spectrum were adopted in semi-peripheral and therefore theoretically vulnerable countries such as some of the European Union's new member states from East-Central Europe. Why did policy makers in some of these countries (Hungary, Romania) embarked on rolling back financialization and resort to financial repression in ways that targeted foreign banks in contexts in which this seemed a very risky strategy? Why did such bold moves generally re-established state-finance relations in some countries (Hungary) while comparably milder ones left them generally unaltered in others (Romania)? Finally, why have some countries refrained altogether from such forms of financial unorthodoxy (Latvia)? The paper explains the varieties of policy responses in these countries, with three factors: the role of finance in the national growth model, the capacity of the state to protect itself against adverse bond market reactions and international constraints and opportunities.

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1. Introduction

The "finance and development" literature on the comparative political economy of financial systems has brought to the fore distinctive aspects of financialization outside the capitalist core. The question here is how subordinate financialization (i.e. financialization under condition of (semi) periphery) has generated sources of vulnerability for (semi)-peripheral economies in Europe and elsewhere (see Bortz and Kaltenbrunner 2018 for a recent overview). These countries appear to be in a bind. On the one hand, they rely on external sources to finance development and earn international credibility (Epstein 2017, Grittersova 2017). On the other hand, their very dependence on external sources makes them vulnerable to financial crises (Bonizzi 2013; Gabor 2013; Nelson 2020).

At the most general level, two issues appear salient in this tension: how semi-peripheral countries cope with this dilemma especially after major crises; and the conditions, means and constraints that shape state actions meant to roll back financialization and enroll financial institutions into domestic policy priorities via measures as broad as financial repression or domestic control over formerly foreign owned financial institutions.

Our paper seeks to address these issues by focusing on selected countries in East Central Europe (ECE) after the great financial crisis (GFC). Together, they constitute extreme cases of economic dependence in general as well as of dependent finance and subordinate financialization in particular. Not only that production and export sectors in ECE are dominated by transnational corporations, but the region also has among the highest share of foreign-owned banks globally (Epstein 2017). Certainly, while their presence in the region lent domestic financial sectors international credibility (Grittersova 2017), it also created sources of vulnerability via particular

aspects of financialization (Gabor 2010; Nelson 2020). Moreover, since the region assumes a low position in the international currency hierarchy (Gabor 2010), macroeconomic policies are heavily constrained and at risk of the "original sin" of not borrowing in their own currency. This exposes them to currency mismatches, volatile carry trade and limited abilities to pursue countercyclical monetary policies (Eichengreen and Hausman 2003).

Three ECE countries were particularly exposed to these vulnerabilities and had to turn to the IMF and EU for a bailout: Hungary, Latvia and Romania. While all three states therefore had strong incentives to decrease the vulnerabilities stemming from dependent finance and subordinate financialization after the GFC, only Hungary did so in a determined fashion. Here, a financial nationalist government ushered in a process of definancialization and financial repression. Romania partly followed Hungary's example, but was much less successful. Latvia, to the contrary, achieved partial definancialization by escaping to the Eurozone, but its dependency on external finance and foreign banks has remained high. What explains the different reactions to dependent finance, and what accounts for the relative Hungarian strength and Romanian weakness in attempts to definancialize?

These are the questions motivating our paper. In the broader architecture of the special issue, its role is to deal with the process of definancialization (or lack thereof) in semi-peripheral European economies. We do this by examining the state's attempts to shoehorn into their policy priorities the resources and options of the foreign banks that had ushered in financialization before the crisis.

Our answers focus on the interaction of three factors. The first is the makeup of state-bank relations under the local growth regime: Hungary and Romania had incentives to push back against financializing banks because these were not central to the countries' foreign direct investment (FDI)-led growth model, whereas bank-based finance is a central tenet of the Latvian entrepôt

economy. Second, we show that not all financial nationalists can achieve the bulk of their agenda. Instead, by underscoring the importance of market backlash against its own debt, we show that only those with solid state capacity (the capabilities and mandates of the revenue service) and a supportive the central bank can. Finally, we briefly scrutinize the constraints and opportunities stemming from the international and specifically the European crisis management. Building on Mabbett and Schelkle (2015), and Johnson and Barnes (2015), we argue that the IMF and the EU have paradoxically served as enablers of more controversial choices.

The paper is structured as follows. The next section briefly presents the state of the art and introduces our main concepts, research question and puzzles. Section 3 discusses our analytical approach. Section 4 shows how different growth models, and, concomitantly state-finance interactions, have shaped change and continuity in peripheral financialization after the crisis. Section 5 hones in on the role of institutional capacity in pushing back against subordinate finance(ialization), and the final section concludes.

2. Why study definancialization and financial repression in the (European) semi-periphery?

This paper focuses on an understudied subset of the observable implications of financialization as a regime of accumulation, namely the dynamics of dependent or subordinate financialization (see Bortz and Kaltenbrunner 2018 for overviews) after financial crises. From this literature we know that unlike financialization in the core economies, dependent financialization is characterized by shorter time horizons for international investors, higher interest rates, more exposure to short term speculative operations or excessive degree of external vulnerability. Here, changes in international liquidity preferences cause flight to the safety of "hard" currencies. Their lower position in the

international currency hierarchy forces such economies to offer higher interest rates and, when coupled with substantial exchange rate volatility, this makes their currencies and assets prime targets for highly speculative carry trade operations by international and domestic investors. For semi-peripheral countries exposed to highly speculative operations, hedging as a strategy for stabilizing carry trade operations is not always available (Bortz and Kaltenbrunner 2018, Gabor 2010).

Critically, the increased share of foreign investors in semi-peripheral assets (including via bank ownership) means that any change in funding conditions at their headquarters, or a tightening in risk perceptions, can negatively affect the prices of domestic assets, exchange rates and/or reserve stocks, with repercussions for non-financial firms and the financing conditions of the government itself. Furthermore, as Daniela Gabor (2013) showed, the structural power that comes with foreign banks' dominance enabled these financial institutions to navigate and shape uneven regulatory and institutional terrains in the direction of a shift from relational to market-based lending as well as "binge" lending in foreign currency and in some cases even speculative attacks on the local currency (Gabor 2013: 216-217).

The experience of ECE as a region in the GFC bears witness of the vulnerabilities stemming from subordinate financialization. EU accession involved fast liberalization of the capital account and eased the entry of foreign banks. Before the crisis, this was the region characterized by the highest level of foreign-owned banks in a global comparison (Epstein 2017). These developments introduced "new modes of profit generation reliant on impatient search for yield" (Gabor 2013: 26). Transnational banks have not contributed as expected to the financing of local non-financial firms in general and SMEs in particular (ECRI 2018); they have chosen instead to provide pro-cyclical consumer and mortgage lending (Bohle 2018). While low lending to SMEs in the region

should be understood in the light of its poorer supporting legal and regulatory infrastructure across post-communist Europe, table 2 shows that if we look across a few comparable cases from the region in 2010, Hungary stood out in terms of the high interest rate on SME loans as well as the share of SME in total business loans, making banks particularly vulnerable to financial nationalists. Indeed, the rapid domestic credit expansion that occurred before the GFC was driven by the household sector, rather than corporate borrowing (Mitra et al. 2010: 48-50, Király 2019). In some countries – notably the Baltic States, Hungary, Poland and Romania it was characterized by increasingly risky speculative carry trade, with banks lending in foreign currencies, without considering the foreign exchange risk of – largely unhedged – borrowers (ibid). [1] Rapid credit growth was typically accompanied by overvalued exchange rates and increasing current account imbalances. These developments accelerated at the onset of the GFC, when investors assumed that the region was decoupled from the troubles elsewhere (ibid).

However, shortly after the Lehman Brother's collapse, a number of countries in the region experienced sudden stops and reversal of capital flows (ibid, Gros and Alcidi 2013). Importantly, despite the fact that countries in the region had pursued different macroeconomic policies and varied widely in the imbalances accumulated before the crisis, and some of them were members of the Eurozone while others not, at the height of the 2008/2009 crisis, investors considered the region uniformly as high risk, and withdrew their funding. The European Central Bank (ECB) reinforced this perception by refusing formal foreign currency swap lines to ECE countries, and by not accepting the region's non-Eurozone members' government bonds as acceptable collateral

[1] With the exception of the Czech Republic, all ECE countries had significantly higher interest rates than the euro area during the 2000s. In Hungary, Poland and Romania, exchange rate volatility was high. It is this background that foreign banks engaged in risky foreign currency lending, either in euros – in those countries that had pegged their exchange rate to the euro, or in Swiss Franc in those countries with high exchange rate volatility.

(Király 2019). The ECE panic was further reinforced by misinterpretations of cross-border data of the Bank for International Settlement, which seemingly indicated a nearing collapse of both host and home countries of transnationally operating banks (ibid). Finally, when bailing out "their" banks, Western governments often demanded their stronger home country engagement. Against the background of this panic situation, governments in the region – no matter whether they ruled over a basically healthy financial system – as for instance Poland or the Czech Republic- or a heavily overstretched one – such as Hungary - had strong incentives to decrease the vulnerabilities stemming from subordinate financialization.

As Mérő and Piroska (2017) showed, although the ratio between non-performing loans to gross loans increased throughout the region (with Hungary and Slovenia sticking out), other metrics (such as loan growth in percentage year on year return on equity) deteriorated in Hungary, Bulgaria, Romania and Slovenia but not in Poland, Czech Republic, and Slovakia. However, even in Poland that had neither a recession nor a financial crisis, the threat of international disinvestment during the global financial crisis combined with the frustration of the local managers of TNCs about their lack of managerial autonomy and career advancement to motivate those managers to use their political connections to colonize the state apparatus and to use the state's financial and regulatory firepower with the objective to initiate definancialization and financial repression (Naczyk 2019).

Our paper is interested in how far the experience of vulnerability in the three countries most affected by financial vulnerabilities pushed governments to pursue policies of definancialization and financial repression, and how successful they are. More precisely, we ask three questions: Why do some countries repress finance while others do not? Why are some attempts at definancialization and financial repression more far-reaching and consistent than others? How

have international factors enabled or constrained attempts at definancialization and financial repression?

We define definancialization as an attempt to lengthen time horizons for investors, cut the interest rates originating in the subordinate currency positions, reduce forex lending and the excessive degree of external vulnerability for domestic bonds. Financial repression in contradistinction aims to subordinate finance to state priorities. While this has been the norm for advanced economies during the post-World War II period and in varying degrees up through the 1980s, financial repression is seen as a form of financial nationalism in the age of liberalized finance because it attempts to subordinate financial considerations to national development objectives.

According to Reinhart, Kirkegaard and Sbrancia (2011), like definancialization, financial repression includes forcing down interest rates, particularly (but not exclusively) those on government debt. At the same time, it goes further by entailing the creation and maintenance of a captive domestic audience that facilitates directed credit to the government; tax levies on banks; regulations that constrain financial institutions to direct credit to certain sectors and actors (Reinhart et al 2011). The social purpose of financial repression is a general attempt to enroll banking into specific governmental priorities such as the easing of the state's debt burden, increased budged revenues, more lending to domestic firms, or reduced debt burden on borrowing households. While both cooperation and coercion are likely to structure state-finance interactions in such settings, the fact that these interventions stand to hurt profits and business autonomy means that coercion is the more likely scenario.

To tease out whether, to which degree, and why (not) governments in the region have pursued policies of definancialization and financial repression, we focus on the cases that have been most exposed to the vulnerabilities of subordinate financialization, and had to turn to the IMF and EU

for a bailout: Hungary, Latvia and Romania. These countries had therefore a particularly strong incentives to decrease the vulnerabilities stemming from dependent finance and peripheral financialization. Yet, there is puzzling cross-national variation in the policies that governments have pursued to address the vulnerabilities.

INSERT TABLE 1 HERE

Table 1 presents a bird's eye view of the differences. It shows that Hungary is the country where the most radical change has taken place, with Latvia at the extreme of least change. Romania appears in the middle, albeit increasingly converging with Hungary. An additional difference between the three countries stems from whether business ("markets") or the state have the upper hand in initiating policies of definancialization and financial repression. In Hungary, changes in the sphere of financial institutions and the currency have been brought about by politics *against* markets. Following Johnson and Barnes (2015), we call the Hungarian strategy "financial nationalism." As such, financial nationalism is an economic strategy that seeks to increase the national room for manoeuvre in financial matters, and to selectively reward economic insiders. As Johnson and Barnes (2015) show, financial nationalism can motivate a broad variety of policies. In this paper, we look only at those policies that lead to definancialization and financial repression in ways that target foreign owned banks. In so doing, we do not imply that the reversal of foreign ownership necessarily means less financialization-linked vulnerabilities. As some scholars showed (Piroska and Podvrsic 2019, Epstein 2017) in Slovenia financialization took place in a financial system where domestic state-owned banks played a key role.

In Romania, a partisan nationalist turn has challenged dependent finance while facing strong political opposition from liberal political forces in a competitive political field. These measures

were less bold, more incremental and less institutionally supported than in Hungary. Finally, Latvia has implemented the fewest changes, and some of the changes were de facto a logical continuation of previous policies, such as the switchover to the euro. This step has eliminated the currency risks and reduced the problem of original sin. Paradoxically, however, it has also allowed the continuity of financialization. In Latvia, furthermore, business interests had the upper hand. We therefore label Latvia a financially captured state.

This variation presents us with puzzles that lend greater specificity to the research questions. First, why have policy makers in Hungary dared to impose financial nationalism targeting foreign banks in a context where this seemed a very risky strategy? This is puzzling because only a year before the Hungarian government started to implement excessive sectoral taxes on (mostly) foreign owned banks, force these banks to convert foreign currency loans, and tout the idea of the Magyarization of the Hungarian banking system, there was widespread fear that foreign banks would run and cut their losses. Epstein (2017) argues that this is because foreign banks in Eastern Europe are much less mobile than in other parts of the world, because they consider the region their second home markets and have invested for the long term. However, it is unlikely that this had been clear to policy makers already in 2010. Moreover, as an implicit comparison with manufacturing FDI reveals, policies towards foreign firms in manufacturing have displayed much higher continuity than those in the financial sector (Bohle and Greskovits 2019, Ban 2019). Are there reasons to assume that it is more feasible to overcome dependent finance than dependent production, and if so, why, and under which conditions?

A second puzzle arises from looking at the two extremes, Hungary and Latvia. Why is it that after the financial crisis had exposed the vulnerabilities stemming from subordinate financialization the policy responses have been so different? The contrasting answers are even more puzzling as

Latvia's crisis was much more severe than Hungary's. Why have governments in a country that has faced repeated banking crises not been able or willing to curb the excesses of financialization? To be sure, in none of the two countries the foreign banks acted as crisis triggers. Rather, in Hungary it was the sell-off of government bonds by non-residents, and in Latvia the run on its major domestic bank. Yet, the risky lending practices of foreign banks have contributed significantly to the countries' international exposure and put strong constraints on and difficult choices for crisis management. What made Latvian governments so much more accommodating with foreign banks?

Finally, why have financial nationalists in Budapest been more effective in repressing dependent finance than financial nationalists in Bucharest? Indeed, Hungary's financial nationalists confronted transnational finance under more difficult conditions and by taking greater risks than the Romanian counterparts did. The former began to drastically change the regulatory, fiscal and ownership environment of the financial sector even as they were still formally under the constraints posed by the IMF, had a public debt level twice as high as Romania's, a financial system twice as large as a percentage of GDP and the interest rates charged by the markets for its debt during the reform period (2011-2013) were much higher than Romania's in 2018-2019.

3. Analytical framework

Our analytical framework combines approaches emphasizing the strategic interaction of transnational business and political elites with approaches that show that the state and the social coalitions that underpin it can, under certain conditions, bend the priorities of transnational capital to domestic policy priorities. Further, we also look at the ways how the international order constrains or enables domestic policy choices.

Our first independent variable, as it were, hones in on the power relations between TNCs and domestic policy makers. This is because policy makers in East Central Europe can only achieve to definancialize the economy and repress finance if they can convince the foreign owned banks and other investors to change their lending priorities and practices. By treating business power as a variable contingent on the capacity of some sectors to develop relationships of interdependency with the state, the largest theoretical umbrella we fit under is the "business-state power" approach (Regan 2019).

For Eastern Europe, this research tradition has focused on industrial and enterprise policies in FDI-led growth models, and its main finding is that in these models, the basic bargains between TNCs and state elites tend to stick because TNCs in FDI-led growth models deliver continuous upgrading and export performance. Therefore, even the most nationalist government will not risk rolling back policies that support the very foundations of the national growth (Bohle and Reagan 2021). This finding confirms an earlier insight from development theory: initial bargains between TNCs and host governments are unlikely to obsolesce, as TNCs provide host countries with new specific advantages, such as investments, technologies and access to export markets which governments are unlikely to forego (e.g. Kobrin 1987). TNCs can also develop domestic and transnational alliances that reduces their risk of being taken hostage by hostile governments (Moran 1973).

Our contention is that banking capital can be different. While the relations between state and transnational manufacturing firms in the obsolescent bargaining model are in a form of mutual dependence, the same cannot necessarily be said about banks in dependent financial systems. If a country is not a global financial center or at least a regional one specializing in some bespoke form of finance (Latvia), but is a "boring" bank-based system (Hungary and Romania), financial innovation is not central (Gabor 2013) and therefore state-bank bargains can obsolesce if some

banks are seen as not contributing to local development priorities. In turn, this failure makes some banks vulnerable to political entrepreneurs determined to test the boundaries of what is economically feasible. We suggest that these political entrepreneurs' willingness to (at least partially) engage in definancialization and financial repression is dependent on how important the financial sector is for the growth model, how much domestic banks are able and willing to provide similar services as foreign owned banks, and how strong the anti-finance stance of the respective government is.

Our second focus is on the international constraints on definancialization and financial repression that financial nationalists face. While financial repression was a common feature of Western finance between the 1940s and the 1980s, in the open financial system developed since the 1980s, such measures can attract the whole gamut of international forms of coercion, from credit downgrades and capital flight to sovereign debt refinancing problems. But do they have to? Altogether, financial repression has become less unorthodox since 2008. An IMF study showed that at the height of the financial crisis U.K. banks were required to hold a larger share of government debt in their portfolio, while Greek, Irish, and Portuguese banks have already liquidated a substantial fraction of their foreign assets proceeds to buy domestic public debt. Spain also reintroduced a de facto form of interest rate ceilings on bank deposits. [2] It can therefore be said that international conditions have increased the policy space also for economic nationalists to go beyond such comparably mild forms of repression and reach for tougher measures such as credit directed at specific firms (SMEs), tax levies or debt conversion. Furthermore, some recent literature points to the "international enablers of financial nationalism" represented by

[2] https://www.imf.org/external/pubs/ft/fandd/2011/06/reinhart.htm

international bond investors (Johnson and Barnes 2015), and the stabilizing role that the IMF and EU bailout measures have had in this regard (Mabbett and Schelkle (2015).

The third crucial element of our analytical framework is the capacity of the state to implement and defend financially nationalist policy changes against the expected financial market fallout. State capacity implies that the state is able to raise revenues and refinance itself, be autonomous enough from sectoral interests to impose its own priorities and be able to take policy choices into the implementation phase and defend them against challenges (e.g. Skocpol and Fingold 1982; Evans 2012).. Although state capacity is often in short supply in less developed countries (Reinsberg et al 2019), there is a great deal of variation among countries in terms of its levels (Kohli 2004). We will show that a state with sufficient capacity to reassure financial market investors via strong revenue generating measures can deflect market pressures (Kiser and Karceski 2017).

Yet boosting revenue capacity often takes time to produce results and financial markets are known to be impatient. In the short-term, financially nationalist governments can protect themselves against adverse market sentiment if the central bank monetizes or commits to monetize government debt (i.e. turns the central bank into a lender of last resort to the government) (Gabor and Ban 2016). Embracing debt monetization has generally been controversial among postcommunist central bankers (Johnson 2016). Financial nationalists may therefore be tempted to force the central bank to backstop sovereign debt, if needed by taking away central bank independence. The capacity to do so entails having a loyalist central bank management in stand-by and a political sphere that does not block adverse moves against the central bank in order to secure debt monetization.

In sum, our paper seeks to leverage the interaction of variation in business power, increased transnational freedom and state capacity for domestic policy choices in answering our research

questions. We answer our first question, why some states repress finance, while others do not through a paired comparison between Hungary and Latvia, and our answer lies with the different position of the financial sector in the economy, and the consequences for the state-business bargain. The second question why some attempts at repressing finance and definancialization overall more far-reaching and consistent than others will be answered through a paired comparison between Hungary and Romania. Here our answer points to the differences in state capacities. Regarding the international factors, we will show throughout the two sets of paired comparisons the relevance of the findings of the literature on the "international enablers" of controversial policy choices.

4. Obsolescing and viable bargains with foreign owned banks

The first comparison of our paper looks at why policy responses in Latvia and Hungary have been so different despite the fact that both countries experienced the fall-out from a weakly regulated, dominantly foreign owned banking sector that had engaged in large-scale carry trade to channel ample liquidity in unproductive (mortgage and housing) markets. We argue that the main difference is in these countries growth models, which assign different roles to bank-based finance

4.1 *Growth models and (non) obsolescent bargaining*

Figure 1 offers a bird's eyes view on Hungary's and Latvia's different growth models, and how these differences have impacted their post-crisis trajectories. It details the inflow of FDI in the FIRE (finance, insurance and real estate) and the manufacturing sector between 2001-2017/14 in Hungary and Latvia. These figures show that before the crisis, the FIRE sector attracted significantly more FDI than manufacturing in both countries, but this development was much more pronounced in Latvia than in Hungary. This trend continued in Latvia even after the crisis in contrast to Hungary, where FDI in manufacturing took the driving seat again.

INSERT FIGURES 1A AND 1B HERE

Hungary is a case of FDI-led growth, relying on foreign investment for export competitiveness. In 2008 foreign affiliates in Hungary accounted for about 80 percent of the exports (OECD TEC Statistics)[3] and that figure has not changed much since the crisis. Hungary's exports are concentrated in few sectors, with electronics, transport equipment and machinery taking the lead (Bohle and Greskovits 2012, Bohle and Regan 2021). FDI-led growth implies that Hungary's strategic sectors did not rely strongly on banks to finance their business, as they secured their financing needs through the reinvestment of profits and their parent companies (Nölke and Vliegenthart 2009).

Hungarian-owned companies were not in such a position. Yet, from the 2000s on, Hungary's banks – especially the foreign-owned ones turned away from financing the corporate segment to finance retail operations and households, where it could generate much higher profits (Bohle 2014, Király 2019). Moreover, the Hungarian government and central bank abetted this since they reasserted Hungary's intention to join the eurozone, which entailed a stable forint-euro exchange rate, the expectations of lenders and borrowers were that forex loans contained little currency risk (Johnson and Barnes 2015: 143). Thus, after the GFC had highlighted the costs of a business model that had exposed the country's population to exceedingly risky credits (particularly via a weakening forint), while paying insufficient attention to non-financial corporations in general and SMEs in particular, policy makers and large swaths of the population became convinced that these banks

[3] Trade by enterprise characteristics, http://www.oecd.org/sdd/its/trade-by-enterprise-characteristics.htm

did not deliver important services. What is more, there was limited upgrading and innovation in financial services, and domestic banks were easily able to move into the same market segments. This is the background against which Hungary's Fidesz government decided to take on the foreign owned banks, with the banks, the central bank and the Socialists cast as the culprits for the country's economic woes. The government effectively saw the original bargain with foreign banks as obsolescent and were not overly concerned with foreign banks deciding to leave. Indeed, the official objective was that foreign bank ownership fall from eighty to less than 50 percent (Johnson and Barnes 2015: 545).

In contrast, the state-finance bargain did not obsolesce in Latvia, which remained wedded to the original bargain with its transnational banks. Again, a look at the country's growth model provides an explanation. Latvia mostly serves as an entrepôt economy, offering offshore financial services and commercial activities for its Russian neighbour (Sommers 2009). Finance plays a major role in this. The country's financial sector exhibits two segments: next to the foreign – mostly Scandinavian – owned banks that dominate the local credit markets, domestically owned banks are mostly dependent on non-resident deposits and specialize in financial services to non-residents. The latter segment assigns Latvia an important role in global illicit wealth chains[4], as it serves as an entry point for semi and illegal money flows stemming from the wealth accumulated during the post-Soviet privatization and the commodity boom of the 2000s. This specialization of the domestic owned banking sector also explains why the initial bargain with Swedish banks never obsolesced: domestic banks were simply not interested in developing the more conventional

[4] We borrow the term global wealth chains from Seabrooke and Wigan 2014; 2017.

banking segments that foreign banks serviced, and the state had no incentives to foster lending to non-financial corporations, as these do not play such a crucial role for the Latvian growth model.

4.2 Definancialization and financial repression in Hungary…

When the Fidesz government came to power in 2010 it aimed at reversing the deal with foreign-owned banks as part of a general attempt to enroll banking into specific governmental priorities: increased budget revenues, more and cheaper lending to SMEs, more Hungarian ownership over banks (and therefore more leverage for the government over them), less of a debt burden on borrowing households and easier financing for the Hungarian state. In short, taking on the banks was about increased government control of finance, policy scope for economic priorities and development, and decreased vulnerability on financialization practices.

The government largely managed to meet these priorities. In 2010 it aimed to get out of policy conditionality and reduce external vulnerability by achieving budget surpluses. To do so it slammed a hard to evade levy on bank assets as well as a financial transaction levy, with other sectoral taxes on retail and telecom (and a controversial pension re-nationalization) added to the package. According to the IMF Article IV Report for 2014[5] (p. 11, footnote 4), revenues from sectoral taxes were 2.3 percent of GDP in 2013, of which 1.2 percent of GDP was collected from the banking system (via bank transaction taxes and the special bank levy). The government also sought to alleviate the burdens for households with foreign currency loans and to shift some of the costs onto the banks via preferential and advantageous exchange rates schemes for debtors, forced swaps of forex loans into local currency and compensation for unfair interest and exchange rates

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[5] https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=&ved=2ahUKEwjjq7iL6qTqAhWz5KYKHbRkCD8QFjAAegQIBxAB&url=https%3A%2F%2Fwww.imf.org%2Fexternal%2Fpubs%2Fft%2Fscr%2F2014%2Fcr14155.pdf&usg=AOvVaw0wHXLiPQ0eQecvORfuUGHj

(Bohle 2014). These measures were tied to a broader agenda of making the banking sector mostly domestically owned. Indeed, by 2015 the share of banking assets in domestic hands increased to 60 percent. [6] There is no denying that the renationalization[7] served political ends too: at least two of the three nationalized banks ended up under the control of close political friends of the Prime Minister (Oellerich 2019: 39-55).

A further concern of the Hungarian government was funding for domestic small and medium enterprises (SME). Not only are foreign banks less likely to extend credit to NFC, but firms in the region are also discouraged to apply for loans at these banks (Brown et al. 2011). The credit crunch after the global financial crisis led to a further sharp contraction of loans to SMEs (OECD 2016). In response, the newly repoliticized Hungarian central bank offered funds free of charge to commercial banks which granted low-interest loans to SME, a move that turned around the negative trend in lending to SMEs, contributed to new investment, and reduced regional inequalities in access to credit (Hungarian Central Bank 2017: pp. 22-23). As detailed in table 2 below, lending to SMEs became more abundant and conditions more favorable. The central bank effectively forced banks to become more patient and generous creditors to the government.

4.3 … vs a finance-captured state in Latvia

During the 2000s, Latvia underwent a spectacular finance-led growth spurt, which was nurtured from two sides. On the one hand, the commodity boom of the 2000s created vast fortunes for post-Soviet oligarchs, leading them to seek locations to launder and store their cash (Sommers 2009).

[6] https://financialobserver.eu/ce/hungary-is-unexpectedly-back-on-investors-agenda/

[7] Two of the Magyarized banks (BB and MKB) had been put for sale by their troubled American (GE Capital) and respectively German (Bayerische Landesbank) mother banks and this proved to be an enabling factor for the ease with which the government purchase was carried out. See Mérő and Piroska (2016).

On the other hand, as in other ECE countries, Latvia's EU entry made its underdeveloped domestic oriented banking sector an attractive destination for FDI (see figure 1). The continuing power of finance in Latvia's growth model manifested itself in the height of the crisis, when the Latvian government in its negotiations with the IMF and the EU decided to defend the Latvian currency peg, which had come under tremendous pressure. This was a highly controversial decision, as not only a number of internationally renowned economists, but also members of the IMF team suggested that Latvia abandon its peg to regain competitiveness. Against these forces, the European Commission and the Swedish Government however defended the peg (Hilmarsson 2018) But Latvia did not need to be pressured by the Swedish government or European commission. Bank of Latvia's governor, Ilmārs Rimšēvičs, was an adamant defender of the currency peg (Rimšēvičs 2010). The government followed suit, and there was very little public discussion about the issue, with the few dissenting voices quickly being silenced.

The power of finance also manifested itself in the management of the mortgage crisis. In contrast to Hungary, where foreign owned banks were heavily taxed, forced to convert foreign currency mortgages loans into Hungarian forints, and punished for unfair lending practices, banks in Latvia staged successful resistance against any initiative that would force them to shoulder any of the costs of reckless lending (e.g. Eglitis 2015).

As a result, while Hungary could engage in some form of financial repression, Latvia did not. Yet, some forms of definancialization have taken place in both cases: mortgage markets were made inherently less risky, and the forex exposure disappeared. In the Latvian case, this is the result of the country's exit to the eurozone, and more prudent lending behaviour of the foreign parent banks. From 2009 onwards, lending to households and corporations contracted, and it was only in 2016 that the annual change in loans to households turned positive again (Bank of Latvia, Financial

Stability Report 2017: 21).[8] Interestingly, however, while the foreign-owned banking segment definancialized, new risks built up in the domestically owned part of the banking sector, where attracting foreign deposits and money laundering became once again a major part of the business model (Meyer et al. 2019, Aslund 2017).

4.4 International constraints and opportunities

As established by Johnson and Barnes 2015 and Mabbett and Schelkle 2015, the EU and market forces have by and large acted as international enablers of Hungary's economic nationalism. The former argued that with quantitative easing, countries in emerging markets remained a prominent investment location, even if they implemented controversial policy choices. In addition, with the EU's conditionality mostly focusing on fiscal restraint, a country can escape EU surveillance if it can reign its fiscal deficits and debt. Mabbett and Schelkle (2015) further show that in contrast to EMU countries, countries outside the eurozone benefited from an internationally coordinated stabilization effort which contributed to providing the region with more patient capital.

In contrast, Latvia's policy choices seem at a first glance much more externally imposed, with foreign banks having structural power, and the European Commission and the Swedish government pushing for internal devaluation. However, a closer analysis reveals a congruence of interests between Swedish banks, their home country government, the EU and the Latvian Central Bank (Eihmanis 2018, Aslund and Dombrovkis 2011). Moreover, the EU had been rather lenient it' s handling of the money laundering activities of Latvia's domestic banks (Merler 2018).

[8] https://www.bank.lv/images/stories/pielikumi/publikacijas/FSR_2017_EN.pdf

5. Why some financial nationalists get what they want while others don’t

While financial nationalism ruled in Budapest and spread to Warsaw, during the 2010s in Bucharest there had been a bipartisan consensus that was financially liberal rather than nationalist. The central bank remained independent and delivered protection for banks even against weak definancialization initiatives (Kudrna and Gabor 2012). It took a change in government in 2016 to see in Bucharest financially nationalist agenda grafted on select post-Keynesian priorities. However, Romanian financial nationalism came in weaker forms relative to Hungary: there were no plans to “Romanianize” the banks, force through extensive forex debt conversion, or subordinate the central bank. Furthermore, change was not a “big bang” of bold anti-bank measures. Instead, the government started in 2017 with timid moves such as capping real interest rates/penalties in some loan contracts and closing a large tax loophole for banks that made the sale of NPL fully exempt from taxation.

Then, in December 2018 the government took everyone by surprise with a 1.2 percent tax on bank assets if the bank used interest rates higher than a preset interbank lending rate, a measure that trampled the central bank’s monetary policy mandate. The tax was meant to capture more revenue from the banks’ large profits (they posted the highest returns on assets in Europe in 2017-2018, after years of accounting loses)[9] and, in what amounts to a form of indirect financial repression (Reinhart et al 2011), force interest rates for critical electorates and firms affected by fast increasing interest rates below thresholds decided by the fiscal authority by law. Other than the tax on bank assets, these steps were not as sweeping as the Hungarian measures and, as showed below, unlike in Hungary were soon diluted (cut to 0.4 for the biggest lenders and applied to 20 not 100

[9] Statement by BNR’s Florin Georgescu, February 2019.

percent of assets). Eventually the bank levy was eliminated as soon as the financial nationalists were out of office in late 2019 and were replaced by a liberal coalition. What explains the different fate of financial nationalism in both countries?

5.1 State capacity

The final outcome of financial nationalism in the two countries was decided less by the optimism of the will and more by the pessimism of institutional capacity. The Fidesz government in Hungary implemented a blueprint for how to refinance its debt even as its financial sector repression drew international criticism. To reassure bond investors, Budapest boosted EU funds inflows, centralized revenue collection, introduced online cash registers leading to improved VAT collection and paid higher salaries for tax agents. Together with the bank levy itself, the effect was a consistent growth in the share of EU funds and tax revenue in GDP. This reduced the share of government debt in GDP while pro-export measures coupled with low wage growth cranked out external surpluses.

In contrast, the Romanian financial nationalists encircled banks and pension funds while neglecting the fiscal state. The success at capturing EU funds remained modest, the capacity of the revenue authority declined (figure 2) and a flurry of tax cuts came together with large increases in public sector wages and pensions, leading to budget deficits amidst high growth rates and a modest cut in the public debt to GDP ratio (Ban and Rusu 2020). Moreover, a month before they announced the bank levy, the cabinet terminated an essential World Bank program designed to provide the revenue authority with an effective e-tax software system essential for better collection (Ban and Rusu 2020). When combined with increasing current account deficits, the increasing fiscal precariousness of the state made bond investors anxious, pushing up the bond spreads and,

thus, putting pressure on the government's definancialization and financial repression measures even as some of them promised higher revenues.

INSERT FIGURE 2 HERE

The contrast between the two countries endures when it comes to the role of the central bank in underpinning financial repression and definancialization. Even before Fidesz came to power in 2010, the MNB was supportive of the government's fiscal position. While the Romanian central bank insisted that IMF loan be disbursed into its reserves in 2009, MNB asked the IMF to lend the first two tranches directly to the Treasury. Similarly, in contrast to the BNR's contracting balance sheet, the MNB effectively engaged in quantitative easing through direct purchases of government papers from primary dealers or indirectly by exchanging the governments' foreign borrowing for forint liquidity, thus doubled its balance sheet from 2008 to 2009 (Gabor 2010: 211).

5.2 Central bank independence

While supportive, these interventions faced a major constraint: a third of the Hungarian government debt was denominated into foreign currency (which kept growing until 2011). This meant that debt monetization by the central bank under the conditions of financial nationalism were severely constrained. What was needed was a forced reduction in the forex-denominated public debt and a central bank management willing to back the government with as much debt monetization as it was allowed by the foreign-domestic currency balance in the structure of the debt. This required the subordination of the central bank to the cabinet's debt refinancing, a process completed between 2011 and 2013.

The government acted fast: the Fidesz-appointed MNB board members already formed a majority in the board within a year from the elections. Soon after the former Fidesz minister and economic

architect György Matolcsy became central bank governor in April 2013, the MNB assisted with targeted nationalizations and reprivatizations of commercial banks with the stated aim to lowering foreign ownership to 50 percent of the financial sector (including by taking shares in the resulting entities). Most importantly, the MNB rolled out a multiannual public debt monetization program ("Self-Financing Scheme") that squeezed foreign exchange denominated debt from the government balance sheets, lengthened the maturity of government debt and announced unlimited interventions to support government debt in case of bond market tensions. In effect, the MNB helped direct lending to the government by way of forcing banks to become more patient creditors to the government (a la Reinhart et al 2011: box 1). Specifically, of the gross financing sources for the government as a percentage of GDP, the bulk comes from long-term bonds and T bills, with external sources playing a minor role. A brief glance at IMF data shows the extent of definancialization: (1) the short term of international investors was rendered less constraining as domestic long-term bonds' share in the government's refinancing needs more than doubled (from 7.4 percent of GDP in 2011 to 17.2 percent in 2015), while that of external sources shrunk further from a low base of 4.4 percent of GDP in 2011 to 3.6 percent of GDP in 2015 (2) the interest rates came down for the government, albeit with some variation: the T-bill interest rate fell from 6.0 percent in 2011 to 1.1 percent in 2015 (IMF Article IV: 34) while the long-term (10 year) bonds' interest rate shrunk more modestly (although largely in sync with regional trends), from 3,95 percent in mid 2010 to 3.62 percent in late 2015 (3) foreign exchange volatility fell sharply, with Hungary's treasury operations targeting the reduction in the foreign exchange denominated debt, which fell from 52 percent in 2011 to 35 percent in 2015 and 27 percent in 2017.

Romania offers a stark contrast. At 46.5 percent of total government debt, the share of forex denominated government debt in Romania in 2018 was only slightly lower than in Hungary in

2010.[10] However, there was no equivalent of the Self-Financing Scheme, with the government left to fend for itself in its objective to reduce forex exposure. Critically, there had never been a plan in Bucharest[11] to take over a central bank keen to maintain credibility through orthodox policies. Although the Romanian central bank (BNR) had two members with heterodox views who had once served as ministers for the ruling Social Democrats (Ban 2016), they now supported the orthodox central bank governor's team and criticized the repression of the transnational financial institutions in general. Most importantly, the PSD-ALDE (Social Democratic Party - Alliance of Liberals and Democrats) did not have Fidesz's party loyalists well versed in central banking ready for deployment.

When bond market concerns mounted (the spread on Romanian bonds reached nearly 5 percent in 2019) as a result of the tax on assets, the BNR added its voice to that of transnational banks and warned about unsustainable increases in the bond yields. Left unprotected, the government watched as the spread went up in January 2019 and one debt issuance session went without buyers. The BNR hanged the government dry, forcing it to dip into the buffer. After pointing out that the tax on bank assets damaged the monetary policy channel, the central bank rallied the financial institutions on which the government relies for sovereign debt refinancing and dug in. This "resistance coalition" was soon joined by credit rating agencies threatening with downgrades while negotiating with the government to withhold the downgrade if the law would be changed. Given these multiple vulnerabilities, it took less than six weeks for the government to blink and agree to a central band designed and extremely watered-down version of the tax.

[10] Page 3 in the Ministry of Finance's *Public Debt Management Strategy*, http://discutii.mfinante.ro/static/10/Mfp/resurse/buletin_executii/strategia_2018_2020_engleza.pdf

[11] Interviews with PSD strategists (2018-2019).

But even if the Romanian government had a plan, it would have been hard to execute politically. Fidesz's political supermajorities and its increasingly authoritarian power grab, the weakness of the opposition of independent agencies able challenge the government's political dominance provided the supportive environment in which central bank subordination took place. Romania has more checks and balances than Hungary and chief amongst these is that fact that it is a semi-presidential system, where the President can (and occasionally exercises) damage cabinet initiatives.. To top it off, an independent anti-corruption prosecutorial body was busy targeting the financial nationalists, with their leader ending in jail in 2019 soon after the Social Democrats posted massive loses in the European Parliament elections. Once the Liberals came back to power in late 2019 on the back of the reelection of "their" President, the rollback of the already diluted financial repression and definancialization measures was at the top of their agenda.

5.3 International constraints

What about the institutional constraints posed by the EU? Being an EU member state means that there are strong EU-level legal protections for international investors. Certainly, strong foreign investor protections awarded by the EU led to many international investment arbitrages being lost by ECE states. Further, the EBRD-Fidesz government-Erste Bank agreement of 2015 whereby the government agreed to reduce the bank levy to the EU average by 2019 showed that transnational financial initiatives can put limits on financial nationalism. Also, the European Commission and the European Central Bank had issued harsh reactions to the takeover of the Hungarian Central Bank. However, over time the EU grew more passive and accommodated the financial nationalism observed in Hungary. However, the sectoral levies were later declared legal by the European Court

of Justice[12] and the 2015 "peace deal" with Erste and EBRD also highlighted the leverage of the nationalist government: Erste promised to launch a 550 billion euro lending program with preferential interest rates, a long time priority of the government.[13] Furthermore, the reduction of the bank levy also fit the Magyarization agenda, as by now the majority of the banking sector was locally-owned so the high tax was negatively affecting it.

All of this happened even when it was clear that they come in the same package with phenomena that should be inimical to the values the EU stands for. Indeed, the continuing democratic backsliding in Hungary was enabled by the tacit support given to Fidesz by European conservative party networks (Kelemen 2017).

As for the Romanian attempts to initiate Hungarian-style financial repression, the evidence suggests they had more modest results and for mostly domestic reasons. Indeed, there was little more than the diplomatic expression of concern in the European Semester and in letters from the Vice-President and the Commissioner of the Commission. However, after the initial admonishments, the ECB came to terms with the diluted form of tax on bank assets that had emerged from the confrontation between the state, the central bank and the banks in 2018-2019. What eventually terminated the Romanian experiment with financial nationalism was not the EU, but the arrivals of the Liberals in government in late 2019. In their first month of office, the Liberals

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[12] In the Judgments Vodafone Magyarország (C-75/18) and Tesco-Global Áruházak (C-323/18), delivered on 3 March 2020, the Grand Chamber of the ECJ held sectoral taxes to be compatible with EU law. The rulings did not apply to the bank levy but to telecom and retail yet the principle of the bank levy as a sectoral tax was upheld by the Court.

[13] https://www.ebrd.com/news/2015/hungary-ebrd-and-erste-group-join-forces-to-strengthen-financial-sector-and-bolster-economic-growth.html

pulled the plug even on the diluted form of financial repression that emerged from negotiations with the central bank.

5.4 the performance of financial nationalism in comparative perspective

Can any of the economic advantages associated with the Hungarianization of banks and repression be obtained under more liberal policy regimes? To address this important question, in Table 2 we looked at three comparable cases: Slovakia, Slovenia and the Czech Republic, none of which has engaged in financial nationalism. OECD data shows that both the share of SME loans in total loans increased by several orders of magnitude more in Hungary between 2010 and 2018, albeit starting from a lower level than the other countries. Similarly, the interest rate for SME fell by 72 percent in Hungary, 48 percent in Slovakia, 24 percent in the Czech Republic and only 6.2 percent in Slovakia. By 2018 Hungarian SMEs had the lowest interest rate environment amongst the ECE members of OECD.

Regarding government debt, the effects of definancialization show a slightly more mixed picture. The interest rate on long term debt (10-year bonds) between September 2010 and December 2018 fell more in Hungary (-58 percent) than in the Czech Republic (-46 percent) but not as much as in the euro zone member states Slovakia (-75 percent) and Slovenia (-74.5 percent). It is important to point out, however, that Hungarian sovereign debt did not benefit from the support of the ECB's unorthodox monetary policy after 2012 that that Slovenia (euro member since 2007) and Slovakia (euro member since 2009) benefited from.

INSERT TABLE 2 HERE

Importantly, while financial repression reduced foreign investment in the banking sector, they did not damage Hungary's reputation as a destination for FDI in general and manufacturing in particular, which is precisely what the government aimed for. Between 2011 and 2013 Hungary remained one of the top recipients of FDI in the region, it experienced the largest increase between 2011 and 2012 (the apex of the confrontation with the banks) and the decline in FDI experienced in 2013 was comparable to that of the Czech Republic and much smaller than that of Poland (Hunya and Schwarzhappel 2014: 22; Bohle and Greskovits 2018).

6. Conclusions

Why has the Great Financial Crisis and its exposure of the vulnerabilities of dependent financialization led to very different policy responses, with some countries attempting definancialization and financial repression (Hungary and Romania) while others defending it (Latvia)? Why was financial nationalism successful in some settings (Hungary) but not in others (Romania)? By answering these questions, we made several contributions to the comparative political economy literature on dependent finance in general and apply insights of the "business-state power" literature to finance.

First, we apply to finance the obsolete bargaining model, originally developed to explain the wave of renationalization of natural resource sectors in the developing world in the 1970s. This is counterintuitive because finance's mobility and sophistication should give it the upper hand in bargains with host countries. We attribute the fact that bargains in finance can obsolesce due to the fading promise of dependent and financialized banking systems that they can be sources of quantitatively adequate and stable levels of lending. Failure to deliver on this promise have

convinced political entrepreneurs keen to articulate financial nationalism that the bank's business model was up for revisions.

As our case studies show, the willingness to (at least partially) engage in definancialization and financial repression is dependent on how important the financial sector is for the growth model, how much domestic banks are able and willing to provide similar services as foreign owned banks, and how strong the anti-finance stance of the respective government is. Further, willingness is not enough, as states need to have the institutional capacity to do so. Policy makers in Hungary were both willing and able to definancialize and repress, and they could do so because the major source of finance for their growth model stemmed from FDI in manufacturing, rather than finance. While the latter holds true for Romania as well, this country lacked the capacity to implement major changes in the bargains with banks. Finally, in Latvia, banks as a sector enjoyed structural power, as the sector is crucial to the country's growth model. Domestically owned banks were not interested in taking services provided by foreign owned banks, as they had their own lucrative market niche. As such, the paper clarifies the conditions under which measures aimed at reducing emerging markets' financial vulnerability (Antoniades 2016) travelled or failed to travel beyond the confines of large emerging powers such as the BRICS.

Second, where the "second home market model" literature (Epstein 2017) stressed the strengths of having transnational banks with long time horizons, attention to households and resilience to volatility, we found that model was rendered vulnerable to financial nationalists by the combination between fixed investments, low upgrading capacity and, critically, poor performance at financing domestic non-financial firms. When economic nationalism came into office, making these vulnerabilities part of an economic paradigm, dependent banking experienced state-led attempts at drastic transformation.

Third, we advance the literature on the limits of economic nationalism when bargains between state and finance obsolesce and the obsolescence is called out by nationalists. Where the extant literature focuses on industrial policy institutions as hallmarks of state leverage, we bring to the fore the centrality of central banks and revenue authorities. Specifically, the comparison between Hungary and Romania shows that in the short term, financial nationalists cannot "do battle" on finance without having a central bank committed to defend the state in the sovereign bond markets via debt monetization and without having capable agencies able to rake in tax and non-tax revenue to reduce debt rollover risks.

Finally, our findings corroborate some more counterintuitive findings of the recent literature on international constraints and opportunities offered by international actors and markets for domestic policy choices (Mabett and Schelkle 2015, Johnson and Barnes 2015). In short, we argue that the EU and international bond markets have served as enablers of some of the more controversial choices that we have analyzed in this article as long as the fiscal state and central banks provided the required protections.

Our conclusions should be carefully circumscribed to the conditions of relative international financial calm and international financial investors' rush to periphery bonds that the financial nationalists enjoyed. A rich literature (see Grittersová 2017 for a compelling overview and upgrade) showed that in political economies with repressed finance and currencies plagued by low credibility and subordinate status, the lender of last resort interventions deployed to stave off a banking crisis might come with inflation and exchange rate risk and may not stop capital flight absent drastic interventions such as capital controls. Although well-governed financial systems such as postwar Western Europe were able to keep crony lending under control (Reinhart et al 2011), others were not (e.g. Argentina) and tended to accumulate non-performing assets. As such,

it is banking crises that may be the real test of financial nationalism in such economies. Furthermore, financial repression (let alone bank nationalizations) may in the long run damage the FDI flows into productive industries that FDI-led growth models rely on, a systemic risk as far as our analysis goes. Indeed, Orban-style financial nationalism may survive business-as-usual times, but it may melt down fast in rainier days.

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