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Lisa Coiffard

INDEPENDENCE OF CENTRAL BANKS AFTER THE CRISIS - FOCUS ON HUNGARY

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Author:

Lisa Coiffard

Bachelor student at Paris Institute of Political Studies (Sciences Po Paris)

lisa.coiffard@sciencespo.fr

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Independence of central banks after the crisis - focus on Hungary

Lisa Coiffard[1]

Abstract[2]

The changes of the Hungarian financial regulation reflect the power of the Fidesz-government to challenge the European institutions. With the new structure of the Hungarian Central Bank (MNB) and unorthodox macroeconomic policy, Hungary uses the global trends in the financial sector to deviate from the European treaties. The complex European structure is not able to face the new challenges with its tools and is more than ever obliged to counter such behaviors to preserve the credibility and the values of the European project.

JEL Codes: E5, G2, H3, K4, N24, P2

Keywords: Financial regulation, MNB, ECB, Central Banks

Introduction

On the 8. April 2018, Fidesz, the party of the Hungarian prime minister Viktor Orbán has been reelected with 49,27%, which gave the party two-third majority in the parliament. The maintenance of his power permitted Orbán to continue the policy that already began in 2010, when his party was elected. Since then, numerous laws and structures of different institutions have been dismantled or changed. The process even

[1] Intern at the Institute of World Economics CERS HAS between February-May 2018. The author would like to thank Dóra Piroska, Gábor Oblath, István Kónya, Júlia Király, Miklós Sebők, Norbert Szijártó for the interviews – as well as Andrea Éltető for mentoring during her stay in Hungary.

[2] The paper was finished at the end of May 2018

affected the constitution that have been amended and the constitutional court that was replaced. One of the major changes that occurred recently affects the financial regulation, especially the structure of the Hungarian National Bank (MNB) and its tasks. Parallel to financial nationalism, the board of the new governor György Matolcsy took measures considered as the biggest overhaul of the MNB after the October 1991 Act on the MNB[3] that established the central bank's independence. We will see how the government used the global trend and previous reforms from other Member States to justify new legislations that tend to be against the European political consensus. The crisis played the major role that led to financial innovation, the consequences on the global level will be depicted in the first part of this paper.

In fact, the role of central banks worldwide slowly mutated to a more extended field of action. We will analyze in the second part, how Viktor Orbán took power over the MNB with the 'mission creep' justified by these new financial innovations. The reaction of the ECB has not gone further than criticizing the behavior in annual report, even though the unorthodox measures have been radical and infringed the principles of independence and other values represented by the treaties as we will see in the third part. How is it possible in a Union such as the EU, to be able to bypass the rule of law which is its proper foundation?

In the last part, we'll see that Europe is not appropriately armed to face such behaviors that contradict the European values. The ECB and in general Europe is not able to react accordingly because of several reasons that will be enumerated in this study. Some radical changes in the organization of the Union could be considered to prevent unorthodox and anti-democratically behaviors to sustain and other countries to behavior identically.

I. The new European landscape after the crisis: focus on Hungary

Academic and political consensus approved a large degree of independence of the central banks to be necessary for a stable financial environment. Central banks attached to governments increase inflation systematically to obtain common objectives such as

[3] https://www.mnb.hu/en/the-central-bank/organisation/history

high employment, financing the budget and stability. The literature first developed by Kydland and Prescott (1977) and then expanded by Gordon (1983) and Rogoff (1985) underline the fact that time inconsistency in political decisions occurs, when the government controls monetary policy. The cycle known as the political business cycle, in which higher inflation is targeted to decrease employment without any growth have been usually used before elections to fake prosperity (Nordhaus, 1975). Supported by this literature, the European Central Bank (ECB) was built up for being independent. Price stability has therefore a key role in independence for the maintenance of a stable economy. This newly acquired consensus was even branded in the Article 127.1 of the Treaty of the Functioning of the European Union (TFEU) that determines that the maintaining of the price stability is the primary objective of the ECB. In 2003, the Judgment of the European Court of Justice on OLAF Case[4], underlined again the independence of the ECB.[5]

I.1. "New kids in the block": the financial innovation that the crisis implied and the new EU framework for central banks

The ECB as a separate and independent entity is quick in taking decision, which is primordial in a sector such as the financial one. The Member States of the EU do not have the same effectiveness in decision taking regarding the speed needed in financial markets. Furthermore, the credibility becomes the first beneficial factor since the plans

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[4] « On 10 July 2003, the European Court of Justice (ECJ) delivered its judgement on Case C-11/00 Commission of the European Communities v. the European Central Bank, where the Commission challenged the validity of the ECB Decision 1999/726/EC of 7 October 1999 on fraud prevention (ECB/1999/5). The ECB attaches great importance to efforts to combat fraud. It was in this spirit that the ECB established, by means of its Decision of 7 October 1999, a comprehensive anti-fraud scheme under an independent committee aimed at the prevention and detection of fraud and other illegal activities detrimental to the financial interests of the ECB, which mirrored the regime established by the European Regulation concerning investigations conducted by the European Anti-Fraud Office (OLAF). The ECB acknowledges the ECJ's ruling that this European Regulation is applicable to the ECB and that therefore the protection of the ECB's financial interests against fraud and other illegal activities needs to be provided under that general European regime, and not separately as has so far been the case. In full respect of the ECJ's ruling in this case, the ECB will take the necessary steps to adapt its internal rules and procedures to the legal framework provided by the ECJ in its judgement, and will adopt the necessary measures to ensure close co-ordination with OLAF in the fight against fraud ».

[5] https://www.ecb.europa.eu/press/pr/date/2003/html/pr030731_1.en.html

of policymakers are no longer in accordance with the monetary policy. Especially in times of high uncertainty, the credibility of central banks is a key element (Demertzis and Viegi, 2010).

Legally, the influence of the governments has been tied, so that the ECB is prohibited from buying sovereign bonds in secondary markets (Maastricht Treaty, 2007). Therefore, the ECB cannot guarantee the liquidity backstop of the government and cannot be the lender of last resort. But the crisis of 2008 showed that this framework is not enough to guarantee the price stability. More than a bank, the role of the ECB slowly mutated towards an informal advisor to the government. Some critics might become vocal, since the ECB didn't transfer any power during the crisis but still strengthened its power through unconventional policy instruments.

During the sovereign debt crisis, several letters have been sent from ECB president Jean-Claude Trichet and central banks' governors to euro area governments.[6] The ECB completed thus an informal advisor role to governments. This is what Haas (1958) called political spillover, when political elites don't find solutions with domestic instruments any longer, and they have to search for a solution on the supranational level, which become more and more relevant during a time of globalization.

One of the example that illustrate, how the ECB gained power without any legal transfer is the fiscal policy. The ECB doesn't have any competences regarding the fiscal policy, but encouraged the government to straighten their fiscal policy by using tools such as LTROs[7], ELA[8] or sovereign bond purchase (Yiangou et al. 2013).

On 25th March 2010, with the Greek bailout, the troika[9] showed that much more than a bank, the ECB institutionalized its role as a financial and political advisor hand in hand

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[6] https://www.irishtimes.com/business/trichet-letters/trichet-letters-show-that-some-are-more-equal-than-others-1.1994209

[7] **LTROs** - In recent years, the regular operations have been complemented by two liquidity-providing long-term refinancing operations in euro with a three-year maturity (maturing on 29 January 2015 and on 26 February 2015), as well as by US dollar liquidity-providing operations. (https://www.ecb.europa.eu/mopo/implement/omo/html/index.en.html)

[8] Euro area credit institutions can receive central bank credit not only through monetary policy operations but exceptionally also through emergency liquidity assistance (ELA). https://www.ecb.europa.eu/mopo/ela/html/index.en.html

[9] The troika is composed of the European Commission, International Monetary Fund and European Central Bank, who formed a group of international lenders that laid down stringent

with the European Commission and the International Monetary Fund (IMF). The role of the ECB was to offer liquidity to the countries introduced to the program. The troika and thus the participation of the ECB was created *"To overcome technical difficulties and to increase political credibility*" since "*the European Commission had very little experience in providing financial assistance, and the ECB had no experience whatsoever*" (Pisani-Ferry et al. 2013).

The participation of the ECB side by side with the IMF, raised a lot of critics (Sapir et al. 2014), since legally the role of those institutions is the surveillance and the implementation of financial assistance program, which do not include any competence regarding the fiscal policy.

However, the ECB was not the only central bank to gain power by "using monetary policy interventions in order to increase its power to shape national fiscal decisions" (Gabor 2014). It just followed the global trend of the central banks. By using unconventional policy instruments all central banks have gained in power over governments that let the central banks decide over the monetary policy, while concentration on the fiscal policy.

In fact, reason for that transfer is, that the political authorities abandoned active macro-economic management and let the central banks deal with it, while there were confronted with the task of cutting public expenditure during the time marked by austerity (Thompson, 2012). CBs have in possession a wide range of financial assets in order to fix the financial stability objectives, which led to an increase in domestic liabilities.

Even if the main goal of the central banks seems to be the target of low inflation, a new phenomenon appeared after 2007/2008. The Federal Reserve System (Fed), the ECB and the Bank of England (BoE) tried to increase their assets. If we look at the financial assets of the ECB, they tripled. Two peeks can be observed. The first one appears in 2008, when the ECB tried to counter the liquidity crisis by supporting its

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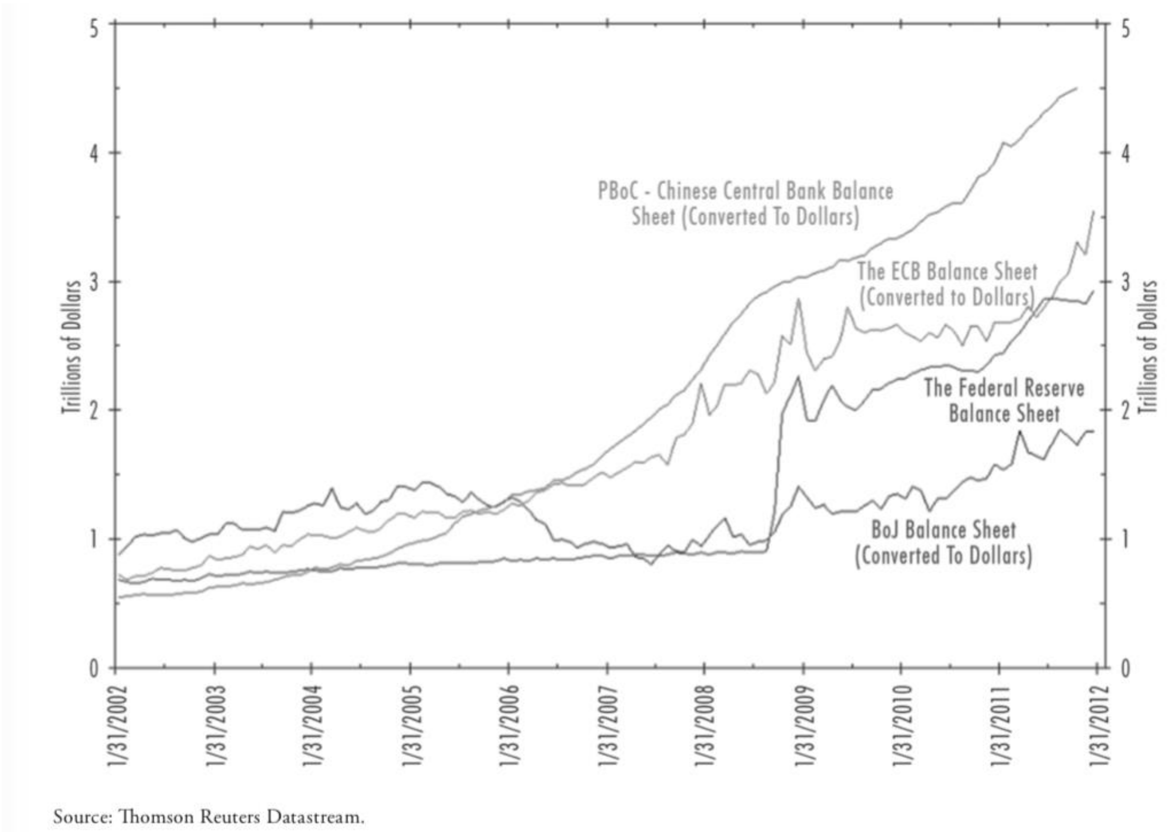
austerity measures when they bailouts, or promises of bailouts for indebted peripheral European states in the financial crisis. (http://lexicon.ft.com/Term?term=troika) bank. The second peek appeared in 2012, when the ECB managed the debt crisis especially for South-European countries. (Figure 1)

The increase of assets has been also marked during the crisis in the BoJ (Bank of Japan). In fact between 1997 and 2005, its assets increased from 12,5% of the GDP to 32% of the GDP, same for Denmark, that increased its assets by 165%. What differentiates the ECB from the other is, that the ECB is not a lender of last resort like in the US or UK, but a corporate entity with shareholders and capital stock. The capital stock is owned by all Member States and supervised by representatives of all the EU Member States, the Governing Council. The ECB is restraint to manage the foreign reserves, exchange rate, monetary policy which is similar to a Eurozone's bank but no explicit legal text is showing that the ECB is a lender of last resort.

Figure 1: Assets of the ECB, Fed, BoJ and the PBoC, 2002-2012 (trillions of US dollars)



Source: Thomson Reuters Datastream

Unconventional instruments changed the landscape of the main financial institutions that are represented by central banks. The objectives of the central banks were broader and have more effect on redistributive consequences than before, when they used only conventional instruments. Especially when quantitative easing (QE) had been introduced, the landscape of finance changed. It was considered the only possible innovation to face the crisis in 2007. The principle is simple, central banks want to encourage economic activity by buying from the private sector government bonds, which provide money supply is like the traditional "open market operations" (OMO). The main goal of the system is to help share prices so that the commercial banks can equilibrate their balance sheet, which can be simplified to "print money."

The ECB launched the expanded asset purchase program.[10] Article 123 of the TFEU forbids to buy government bonds in the primary market, this is why the ECB found a way to circumvent that condition by defining "blackout periods", in which the ECB does not buy in periods around the date of new issuance. In addition to that, some limits have been set to not "*block minority for collective action clauses if such clauses were ever triggered*."[11]

Finally, they added that unconventional measures are for the short-term, and are not designed for the long term.

Quantitative easing as a trend, have been intensively used in the US. The same phenomenon can be seen worldwide, especially in the United States, MBS (Mortgage-Backed Security)[12] played a big role in the expansion of the Fed. As their value failed after the US housing market collapses, the Fed used unconventional instruments to prevent the bankruptcy of the householders. (Thompson, 2012)

Before 2007, the role of the Fed was to assist financial institutions after 2007, when the Fed got involved in bond purchases and also supported the financial market. The estimation of expenses between 2007 and 2010 is more or less $1 trillion dollars (Keoun

[10] https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html
[11] https://www.ecb.europa.eu/press/key/date/2016/html/sp160623.en.html
[12] A mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages.https://www.investopedia.com/terms/m/mbs.asp#ixzz5BnxUmJYC

and Kuntz, 2011). Estimates for the global support should be around $7 and $8 trillion dollars.

With the introduction of the monetary policies, the mandate of the central banks became wider and fuzzier, which gives more “room for maneuver” to central banks within the legal framework. The consensus of central banks’ independence diminished with the crisis. Banks were accused to be technocratic institutions lead by career employees that have been elected by political authorities (Chang, 2017). Since they regulate price levels, they have power on one of the biggest concern of the public. In the case Gauwiler and others[13], German citizen claimed that the ECB has exceeded its mandate by using illegal tools such as OMT programs. But the accusation has been denied by the European Court of Justice.

It is therefore hard to find a good balance between the central bank discretion, (key of independence, that gives the ability to act within the legal framework) and too much independence that undermine the government (Goodhart and Lastra, 2017).

Accountability is therefore necessary to balance the freedom of central banks. They have to provide justifications to their actions and furthermore assume any damage to respect the system of the checks and balances.

Today the rules based constellation fiscal framework is more and more precise. The description of the rules is really broad, which gives a big maneuvering place to the Member States to exploit the rules in the way they desire. That broad framework undermines the power of the EU, who tried to attempt the right balance between lax rules and strict ones. On one side if it is to lax, the power of the ECB tends to be undermined while the strict regulations have the danger to be too complex and not useful for judgment. An example that perfectly illustrates this difficulty of finding the right path is the case of Hungary after 2013.

[13] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A62014CJ0062

I.2. Takeover of the Hungarian National Bank: "*mission creep*"

The Fidesz government elected in 2010 understood the previously explained phenomenon well and took advantages of the central banks' gaining of power worldwide to enhance some domestic policy changes dramatically. The new legislative framework after 2013 is against any pre-existing ideational background of the EU. When György Matolcsy, the new governor entered into the office in that year, the Hungarian National Bank (MNB) violated a major fundamental European value, on what we'll focus on below: the independence of the central bank (Johnson and Barnes 2014, Mérő and Piroska 2017). Within the framework of the new law (Act CCVIII of 2011 on the MNB) the Hungarian Financial Market Authority (HFMA)[14] have been merged with the MNB.

This concept of merging the banking supervision with the central bank was not new to experts, it has been discussed before amongst former governors and secretary deputies of the MNB to implement this innovation and follow the global trend.[15] But no previous board wanted the total merger, despite that there is a common European consensus on supporting the integration. Even the ECB took over banking supervision in 2014.[16] This innovation enhances the stability of the Union and enables to prevent a potential crisis by spotting problems early. The main tool of the banking supervision is to review and evaluate in a SREP (Supervisory Review and Evaluation Process) the risk profile thanks to several factors. What is primordial is that it doesn't interfere in any way the tasks of the ECB.

First, when the MNB proposed the merger to the ECB, the reaction was positive. The ECB welcomed the integration to "*safeguard financial stability and prevent or mitigate systematic risks.*"[17] The only concern of the ECB, was that the new tasks should not affect the MNB's functional and financial interdependence or similar tasks related to the ESCB. However, what happened after 1st January 2013 was different from the initial draft proposal that have been approved by the ECB. The Fiscal Council have been disclosed and replaced by the same name with three peoples in the committee, appointed by

[14] https://www.mnb.hu/letoltes/arh-jegybanktorv-en-20130102.pdf
[15] Interview with Júlia Király
[16] https://www.bankingsupervision.europa.eu/press/speeches/date/2017/html/se170118.en.html
[17] https://bbj.hu/business/ecb-thumbs-up-for-pszaf-mnb-merger_67439

Fidesz. In 2013, since they were no sense to maintain this so-called independence, the HFMA have been merged with the MNB (Miklós Sebők, 2018), which deviates from the values of the European Union.

Several measures followed, considered as being the biggest overhaul of all the history of the MNB since 1991 (when the MNB was created) under the name of "*mission creep*". (Miklós Sebők, 2018)

The government took the global dynamic of institutional innovations to create a company backed by the MNB for non-performing commercial real estate portfolios. After the financial nationalization led by Prime Minister Viktor Orbán with the famous statement that "*50% of Hungary's banking system should be in Hungarian hands*" the implications showed again, that the MNB picks up governmental objectives like the following example is showing:

The official role of the MNB in this case is the resolution authority, for "reorganizing the bank".[18] The MNB choose to create a "bad bank" status for the fifth biggest retail bank, MKB (Hungarian Commercial Bank). The acquisition of the MKB for the non-performing part of the retail bank and the recapitalization costed around EUR 270 million,[19] a sum that the MNB denied to publish. This operation was criticized heavily in Hungary and across the borders. In addition to that, in 2016 Ádám Balog, a right-hand of György Matolcsy and former deputy-governor of the MNB took the place of the new CEO of MKB. In 2017 Balog bought a 9.8 percent indirect stake in MKB[20] and at the same time Matolcsy's cousin bought 20.2 percent too[21]. Ferenc Karvalits, an ex-member of the board before the György Matolcsy era, assumed that the role of the central bank is not to conduct the resolution of troubled banks, requesting huge amounts of capital but the role of the central bank should only be concentrate on supervision and "*make the call whether a bank is liquid or not*"[22].

[18] https://budapestbeacon.com/mnb-recapitalization-of-mkb-may-violate-ec-regulations/

[19] https://www.verdict.co.uk/retail-banker-international/news/hungary-to-offload-mkb-bank-in-1345m-deal-010416-4853959/

[20] https://www.reuters.com/article/hungary-mkb-ownership/mkb-bank-has-two-new-major-shareholders-statement-idUSL8N1HY6IR

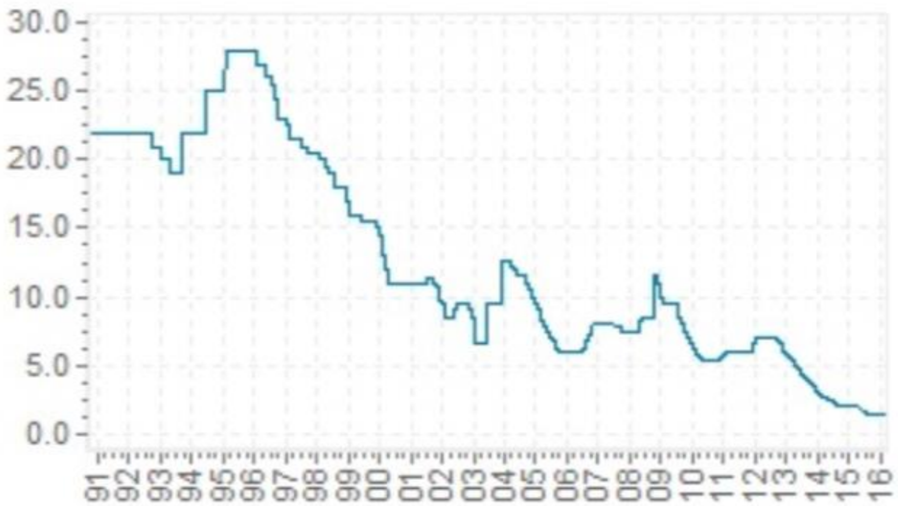
[21] https://budapestbeacon.com/gyorgy-matolcsys-cousin-lieutenant-buy-shares-on-credit-in-bank-recapitalized-at-taxpayer-expense/

[22] https://www.bankingsupervision.europa.eu/home/search/html/index.en.html?q=MNB

Even though unorthodox policies are maintained as a result of the well-targeted portfolio cleansing, the results of MKB are improving. The return on equity ratio decreased from 11,28% to 12,4%, while the NPLs dropped from 20% to 12%.[23] This increase led to the considerable enrichment of the ones having stakes at the MKB. György Matolcsy completes with this scheme a uniform institutional framework for banking supervision, financial regulation and also monetary policies, having a strong contrast to the mainstream approach.

Monetary policy is subordinated to the new governor. The central interest rate dropped and interest rate program have been introduced. The interest rate dropped 0,2 to 0,15 basic point even though the conventional one is up to 0,25 basis points (see the Figure 2 of the time series of the MNB Benchmarks). Since external events such as the fall of oil prices create a deflation environment, the consequences are not relevelled nowadays in the Hungarian economy but represents a hidden threat in future years since every deflationary environment comes to an end.[24] The Governor György Matolcsy used the macroprudential tools during the crisis to justify a certain amount of depreciation.

Figure 2: Time series of MNB's Benchmark interest rate



Source: global-rates.com

[23] https://bbj.hu/news/mkb-back-in-profit-after-six-years_130463

[24] Interview with Gábor Oblath

Squeezing the balance sheet led also to massive profits for the MNB. György Matolcsy introduced a “self-financing program”[25] in the spring of 2014 to “reduce the external vulnerability of the Hungarian economy“. After the foreign exchange (FX) loans crisis in 2008, it was clear that the first external risk for the MNB is the high external FX loans and government debt, considered as the main exposure to financial instability. The MNB used policy instruments. The two-week MNB bills influence the exchange rate and also indirectly influence yields of longer maturities such as the 3-month yield.[26] After having introduced a new interest rate swap, the interest rate corridor was modified in order to push the overnight interest near to negative. The depreciation of the Hungarian Forint against the EUR/USD led to major losses for the real economy but created on the paper an estimated surplus of HUF 400-600 billion for government bonds.

In sum, the “self-financing policy” have sold hundreds of billions of HUF from the balance sheet as government bonds. But the massive gain was not included to the budget of the Hungarian state. György Matolcsy instead, managed to negotiate the total gain of 260 billion forints[27] (contrary to the couple of billion forints mentioned in its annual reports) to be transferred in 6 private funds of foundations having reserves in Hungarian Bonds and inter alia goals in the domain of education. Major controversial critics pointed out that by this transfer, the MNB violated the monetary financing prohibition of the EU,[28] the MNB cannot be involved in fiscal policy, its job concerns only the execution of the monetary policy. Moreover, this step violated the EU legal requirement of independence of the central bank.

As mentioned before, the importance of accountability in the central banks that prone to be independent is fundamental for maintaining the checks and balances system. The actual MNB refused any transparent detailed reporting about the foundations. Transparency International Hungary tried to figure out where the funds are invested in, but György Matolcsy denied that any transparency is needed. Even though the balance

[25] https://www.mnb.hu/letoltes/mnb-the-first-two-years-of-the-self-financing-programme.pdf
[26] https://www.mnb.hu/letoltes/eszkoztar-reszletes-en.pdf
[27] https://www.ecoi.net/en/document/1397320.html
[28] Decision of the ECB of 20 February 2014 on the prohibition of monetary financing and the remuneration of government deposits by national central banks (ECB/2014/8), OJ L 159, 28.5.2014, p. 54.

between central banks and accountability is always different among the countries, none is apparently present at the MNB.

The only one able to apprehend the abuse of public funds, is the Constitutional Court. The Hungarian parliament is composed of two-third majority by Fidesz with the support of Jobbik party that makes it impossible to play the role of legal safeguard. After György Matolcsy claimed, that transparency isn't obligatory in the case of the foundations during a court hearing in 2015, the Court of Justice answered the opposite in April 2016.[29] The Constitutional Court published documents revealing the public funds fraud. A big share of their money was invested in real estate, which is not compatible within the legal framework of the MNB.[30] But no consequences followed after the claim of unconstitutionality for the individuals involved.

In fact, the system of the Hungarian Constitutional Court (HCC) is muzzled for a number of reasons. A new constitution was written after Fidesz came to power in 2010 and the HCC is no longer able to fulfil its duty as a protective and controlling function of the checks and balances system.

The first reason is the special aspect of the HCC: the nomination of the court happens every 9th year and is exceptionally renewable. This pressure forces judges to stay loyal on the long-term (Voigt, 2002-Gavison, 2002) and the Constitution serves everyday politics (Sólyom 2015 and Sonnewend, Jakab and Csink, 2015).

Secondly, the government voted the restriction of the ability of the country's Constitutional Court in the field of fiscal policy in 2010. The HCC isn't permitted to judge fiscal matters anymore, if basic rights such as freedom of thought or religion are threatened.[31] Since 2010, when Fidesz took over the power, the government reviewed the powers of the HCC by amending it 12 times without any ex ante public debate even though the amendments are changing the landscape of the democracy.[32] These quick developments were undertaken with the argument that the global financial and

[29] http://magyarnarancs.hu/belpol/matolcsy-masodik-alapitvanya-is-elbukott-a-birosagon-97291

[30] http://444.hu/2016/04/25/ahol-huszmilliard-gurul-ellenorzes-nelkul-ott-mindig-varakozik-nehany-barati-zseb

[31] https://www.ft.com/content/9ac8db2a-f1af-11df-bb5a-00144feab49a

[32] https://transparency.hu/wp-content/uploads/2017/01/In-Whose-Interest_Shadows-over-the-Hungarian-Residency-Bond-Program.pdf

economic crisis obliged them to react accordingly to cover up unappropriated and arbitrary actions.

The new constitution order “Fundamental Law” that took effect on January 1, 2012 affects the judiciary checks and balances unusually. The new judges are government-backed ones, thus the independence of the judiciary is definitely questionable. Also, the HCC is not able to have any decision anymore concerning the budget, which is now a domain exclusively handled by the government. Two-third majority of the parliament is needed to all fiscal policies, the economic governance is nearly arbitrary (Varju and Chronowsk, 2015), since it gives unrestrained direction in economic policy granted by the Parliament (Vincze and Varju, 2012). In 2014, the Cooperative Banking Restructuring decision confirmed that the HCC has to stand to the judgment of the government in power, when it comes to economic regulation (Decision 20/2014). It is furthermore very hard to review easily standing laws in the new Constitution. Even the process of individual control of the constitutionality has become nearly impossible, due to complex procedures.

The checks and balances system has been totally locked. The institutions that were basically designed to counter the power of the executive power are now have been replenished with governmental actors and deleted the autonomy of them. The MNB is now an instrument for the government[33] and the HCC as it was initially thought, has no longer the power to counterbalance the legislative and executive power, [34] which gives the government a “blank cheque” in economic policies.

II. The European Union isn’t prepared to face “unorthodox” behaviors

As a supranational power, the European Union is expected to react accordingly to the massive changes of the MNB in short order. Between 2013 and 2016, the cases of non-compliances were listed every year in Annual Reports. The ECB has especially been

[33] https://transparency.hu/wp-content/uploads/2017/01/In-Whose-Interest_Shadows-over-the-Hungarian-Residency-Bond-Program.pdf
[34] https://krugman.blogs.nytimes.com/2011/12/19/hungarys-constitutional-revolution/

active after the 2013 changes and published its concerns regularly. The 3th June 2013, the ECB criticized the new supervisory tasks of the MNB because they contain a "non-exhaustive list of matters, which fall within the ECB's field of competence" (*Article 2(1) of Decision 98/415/EC*).[35] In addition to this, the absence of a legal framework adapted to the principles of the bank independency is not in line with the attend of the ECB, that recommends further amendments to adjust the "Law on the MNB" to the TFEU. What comes in a recurrent way, is the absence of consultancy on the draft legislative provision, obligatory every time a National Bank wants to change a task concerning the domain of the ECB on an "appropriate stage in the legislative process." (*Article 2(1) of Decision 98/415/EC).*

II.1. Major set-backs: the cases of non-compliance that were multiplied after 2013 and the destiny of the EU-funds

In fact, the breach mentioned above about the merger of the HSFA and the MNB, proposed by the MNB and initially approved by the ECB have been regularly mentioned in the Annual Report of the ECB.[36] The new part of the draft legislation was written in a very unclear way, in which the distribution of the tasks between the government and the MNB is not clear (such as credit institutions and financial enterprises, capital markets, protection of consumers...).[37] And in spite of the claiming of the ECB in several opinions such as the one of 9th December 2013, to stick to the initial approved draft, the MNB did not followed the recommendations and breached the Statute of the European System of Central Banks of the European Central Bank.

Likewise, the MNB went further by not listing the ESC and the ECSB among corporation organizations and didn't fulfill the statistical reporting obligations towards the ECB, prescribed by Article 46.2 of the Statute of the ESCB.

[35] Opinion of the European Central Bank of 3 June 2013 on the new supervisory tasks of the Magyar Nemzeti Bank (CON/2013/40)

[36] Opinion of the European Central Bank of 9 December 2013 on the data reporting obligations supporting supervisory tasks of the Magyar Nemzeti Bank (CON/2013/88)

[37] Opinion of the European Central Bank of 7 October 2013 on the integrated Hungarian supervisory framework (CON/2013/71)

In line with the independency of the central banks, the monetary financing prohibition has also been infringed by the MNB.[38] This phenomenon was used in the past by governments to finance public expenditure with the help of central banks. Often, inflation followed such practices, and this is why its prohibition is written in the Article 123 of the Statutes to prevent central banks to print money.[39] If governments have access to central bank financing, it could undermine the price stability, which is the primary goal of the ECB following Article 282 of the TFEU.

Unfortunately, this was just the beginning of a number of ignored critics included in latter annual reports of the ECB. The launching of real estate investment programs that are not related to monetary policy, were main issues in the Annual Report of 2014[40], warning that the MNB took over state tasks. In the Annual Report of 2015, the ECB pointed out the illegal network of the 6 foundations as well as the program that allows the purchase of Hungarian artworks and cultural properties in addition to the purchase of the majority of the Budapest Stock exchange by the MNB. Again, concerns about monetary financing have been raised in accordance to the fact, that resources of the central bank are used for economic policy goals.

Those repeated cases showed that the new Hungarian legislation is not compatible with the Article 131 of the Treaty and the Statue of the ESCB.[41] These multiple non-compliance cases are reedited in the next annual reports, with the only conclusion that the ECB is monitoring the involvement of the MNB.

No measures have been taken since then and the unorthodox way of leading the MNB persisted in line with the loss of interest in being integrated in European monetary and/or banking unions. After 2013 the new board has expressed clearly its skepticism toward joining the Banking Union (BU), which is the first step to the full integration in the euro-zone. The Banking Union is supposed to create a single supervisory and crisis management and therefore deepen the financial integration (Darvas and Wolff, 2013). The two main arms of this are the Single Supervision Mechanisms (SRM) and the Single

[38] https://archive.intereconomics.eu/year/2015/4/monetary-financing-in-the-euro-area-a-free-lunch/

[39] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN

[40] http://www.ecb.europa.eu/pub/pdf/annrep/ar2014en.pdf

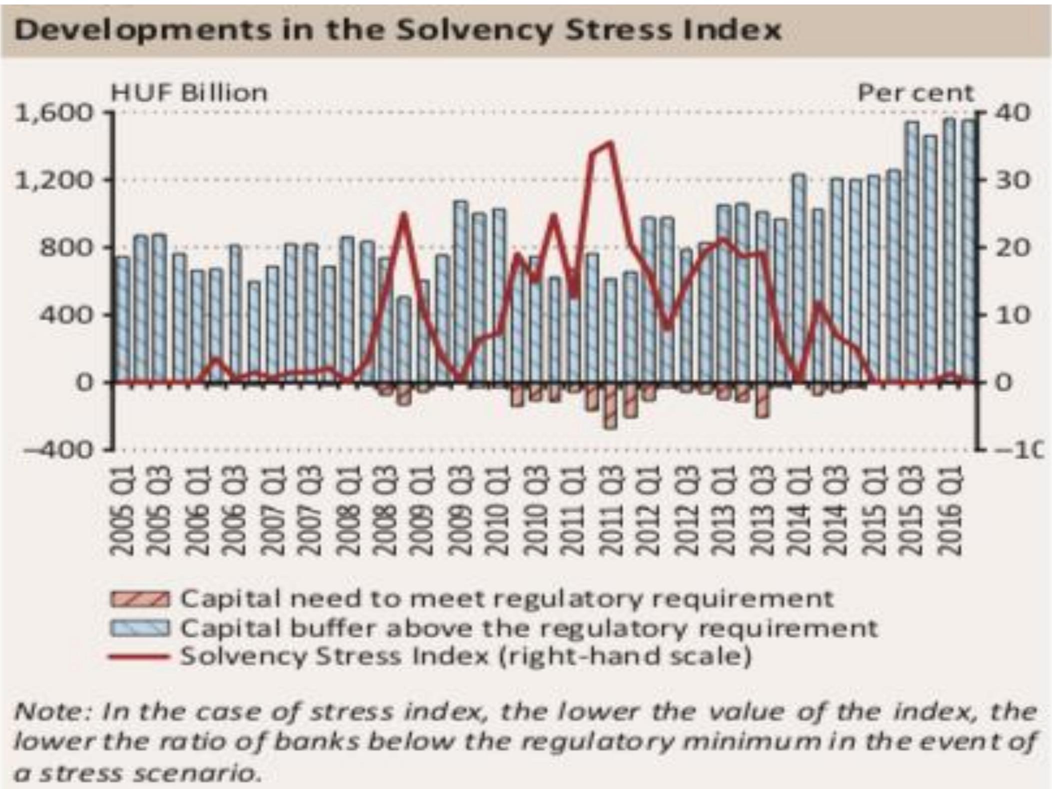
[41] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN

Resolution Mechanism (SRM). The first aim is to improve the credibility of the bank supervision. The second one is to unify the bank resolution among the sovereign states and provide a common funded backstop in addition to a common deposit insurance and a common fiscal backstop.[42] Romania and Bulgaria opted-in to be part of the Banking Union but the new Hungarian MNB governor board demonstrated in the paper "Banking union through Hungarian eyes – the MNB's assessment of a possible close cooperation" the wish to adopt a "wait-and-see approach". The lack of an actual community backstop is a big argument against the opt-in of Hungary in the BU. It is primordial to ensure the financial stability but this isn't available in the European framework, that doesn't eliminate the potential contagion effects between the national government and the banking sector.[43]

[42] https://www.bankingsupervision.europa.eu/about/bankingunion/html/index.en.html

[43] https://www.mnb.hu/letoltes/banking-union-mnb-op-115.pdf

Figure 3: Developments of the Solvency Stress Index



Note: In the case of stress index, the lower the value of the index, the lower the ratio of banks below the regulatory minimum in the event of a stress scenario.

Source: MNB Annual Report, 2016, p. 29.

In its Annual Report, the MNB states that the Hungarian banking sector's "shock-absorbing capacity is robust, both in terms of liquidity and capital shock". In fact Figure 3 shows that the development of the Solvency Stress Index is back to its pre-crisis situation, which means that nearly 0% of the ratio of banks are below the regulatory minimum in the event of a stress scenario. Furthermore, all capital buffers meet the regulatory requirements. The only shocks could be external ones from the European banking sector because of weak fundamentals of the European banking system that may contagion the Hungarian one. Despite poor results of the euro zone, the Hungarian economy is still growing and systemic risks seem to further decrease.

The mechanism of the EU is also criticized as being too time-consuming. The perceptible risk of a crisis can be smoothed by the MNB itself, by introducing an adequate macro prudential policy and new instruments, including the early intervention system.[44] This seems to be more adequate instead of contributing to a common fund that could go toward a bailing out of a foreign bank. This point of view is shared by the IMF (2015) that stated in 2015,[45] that the system is overcomplicated and that the same fiscal safety guard can be assumed by the non-Eurozone member state themselves for a cheaper sacrifice.

The main argument however is, that the new framework of the MNB enables the board to have a lot of maneuvering freedom. For the MKB case mentioned above, the MNB issued any type of licenses necessary to reshape the ownership of the MKB. Issuing licenses in the BU, would be the task of the ECB, what goes against the will and the freedom of the current board. The BU would increase the importance of an independent central bank and take over a lot of domain that are in favor of current politicians, since the BU was created precisely to loosen the ties between national banks and government.

The MNB do not intends to let the new structure under the control of the ECB supervision, therefore still debates the entry into the monetary union.

However, as a member of the European System of Financial Supervision, the MNB applies most of the EU directives and regulations in certain cases (such as the SEPA regulation, insurer supervisory based on EU authorization). In reforms such as the Bank's minimum reserve framework, the MNB is applying the rules of the ECB and requesting for ECB opinion when it comes to purely technical cases.[46]

The motivation of the MNB is reflected in the organization of conferences like the CESS 2016 (conference of European Statistics Stakeholders). In general, experts of the MNB are fulfilling their tasks by participating in the working groups of the ESCB committee. The experts of the national bank are writing joint positions and analyzing macro economies in Europe. In September 2016, the LEGSO (The Legal Committee of the European System of Central Banks) was invited by the MNB to held an external meeting in Budapest as well as the OMFIF (Official Monetary and Financial Institutions Forum) Economists Meeting in November 2016 about the European and global future of

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[44] https://www.mnb.hu/letoltes/felugyelet-en.pdf

[45] https://blogs.imf.org/2015/08/19/banking-union-before-euro-adoption-flak-jacket-or-straitjacket/

[46] https://www.mnb.hu/en/pressroom/press-releases/press-releases-2015/mnb-harmonises-its-reserve-requirement-system-with-the-ecb-s-practice

monetary policy. In addition to that, the European Bank of Reconstruction also works hand in hand with the MNB since 2014 to manage the non-performing loans efficiently and therefore increase competitiveness. It seems that the MNB is politicly neutral, and ready to cooperate in topics that are highly technical on the macro-economy and tends to follow the government when it comes to subjects that demands political decision making.

The pursue of unorthodox behavior and the weak credibility of the EU to react properly also made itself felt in other domains. Hungary have been the biggest recipient of EU development funds after joining the bloc in 2004. 34 billion EUR have been pumped [47]into Hungary in the last 10 years (not counting the agricultural support). Multiple scandals shed some light on where the EU funds are actually going.[48]

These cases show that the EU unintentionally extensively finances large-scale corruption in some of its member countries. The EU has weak controls of corruption and the system build up by the core Europe seems to be unprepared to such practices.

II.2. Why didn't the EU react accordingly?

Europe isn't prepared to face countries that are evading European principles because the EU wasn't legally build-up to sanction behaviors that were not predicted. None of the core European countries, which includes Luxembourg, Germany, France, Italy could think of a governmental skepticism arising in certain countries. The result is that no

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[47] https://bbj.hu/economy/hungarys-economy-heavily-depends-on-eu-funds-study-finds_130880

[48] The most famous story is the one of Tiborcz, the son in law of Viktor Orban. In 2008, he decided to start a small business hand in hand with a friend that had approximatively a profit of 8 million forints. 2 years later the annual profit increased to 2,5 billion forints,[48] which arises questions. Közgép's division purchased the majority of shares in Tiborcz's business and renamed it as E-Os Innovatív Zrt. Customers were FIDESZ majors that contracted with him projects funded by EU cohesion funds to finance the installation of street lighting.[48] The worth of the transaction is about 2,9 billion forints.[48] Grants would be distributed if they reduce the energy costs and indeed received large sums of money for the work done. The European Anti-Fraud Office (OLAF) investigated and condemned the Tiborcz's company of "Budgetary fraud (article 396),[48] Falsification of document and forgery (Article 345). The possible qualification of organized crime (Article 321) should also be considered" https://budapestbeacon.com/olaf-says-hungary-should-repay-51-million-in-eu-funds-paid-to-prime-minister-son-in-laws-company/

legal instruments are able to stop the European backsliding of Hungary.[49] The only tool they can apply against the Fidesz government is Article 7, which suspends certain rights of member states according to the EU Treaty.[50] This Article is the only possible procedure to counter eventual backsliding on European values not fully accomplished. The proposal has to be voted by unanimity. But, as for Poland and Hungary are in "the same boat", they will use the veto to hinder the expulsion of the neighbor.[51]

Therefore, the EU has been unable to fight against the erosion of the rule of law in Hungary, Viktor Orbán and the MNB have always gone as far as possible under the EU law. All of the World Bank's Worldwide Governance Indicators have declined for Hungary between. Before the Fidesz government, in 2006, the country was in the 83rd worldwide for "rule and law" and 79th percentile in "voice and accountability". In 2016, the first indicator dropped to 70th percentile and the second to 57th percentile.[52] This is possible since the EU is not able to infer with the inner system of the Member States and can only try to make the rules up-holed.

Another factor, which is often neglected is the fact that Viktor Orban's Fidesz party is part of the conservative party called European People's Party (EPP), which has a dominant place inside the European parliament. The EPP never opposed the reelection of Viktor Orbán officially, they will also vote against any law that would endanger Viktor Orbán's party.

This is where the conditionality of pre-accession of the countries shows its limit in the context of EU-Enlargement. An elaborate system have been build-up to select the right candidates and ensure the EU doesn't suffer from eventual setbacks. Rule of law are one of the famous and often enounced "*acquis communautaire*"[53] and had a major role in the

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[49] https://www.nouvelobs.com/monde/20180409.OBS4855/hongrie-que-peut-faire-bruxelles-contre-les-derives-de-viktor-orban.html
[50] http://www.dw.com/en/eu-wants-to-hit-hungarys-viktor-orban-where-it-hurts-the-wallet/a-43289207
[51] http://www.dw.com/en/what-is-article-7-of-the-eu-treaty/a-41876855
[52] http://info.worldbank.org/governance/wgi/#home
[53] The *Acquis Communautaire* is the accumulated body of European Union (EU) law and obligations from 1958 to the present day. It comprises all the EU's treaties and laws (directives, regulations, decisions), declarations and resolutions, international agreements and the judgments of the Court of Justice. It also includes action that EU governments take together in the Area of Freedom, Security and Justice and under the Common Foreign and Security Policy. New EU Member States must accept all the existing *acquis* - some elements of it during a

Copenhagen criteria's. But, even though it is a commonly shared European value, the rule of law is too vague and blurred with different definitions (Kochenov, 2008). The rule of law, as it is written in European Treaties, cannot be measured and lets every single Member State to interpret this condition in its proper way that fits its interests.

The following citation of Goddhart[54], clearly states the problem of this "*acquis communautaire*"*:*

"*The confusion which may arise from our failures to make proper analysis of the various ideas which are under discussion has sometimes proved of value to those who are seeking to the whole issue*." There is also a problem in the consistency of the applications of different values.

Article 237 (1) of the Treaty establishing the European Community[55] especially brings geographically and democratically shared values together and permits the accession of a state if it is an European state in which the constitution is guaranteed by the existence of a democracy and by the protection of human rights. This article have been underlined with the Case 93/1978 *Lothar Mattheus v Doego Fruchtimport und Tiefkühlkost eG*,[56] (dealing with the accession of Greece, Spain and Portugal) where the commission had the opportunity to clarify this article but let too much room-maneuver to interpret them instead of detailing how they have to be applied.

The Article 6(1) of the European Treaty defines: any European state is '*respecting the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the Rule of Law(…) which are common to the Member States*' but doesn't define any operational conditions and there isn't a straight continuation of these values.

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transitional period - and put in place mechanisms to adopt future elements of the *acquis*. (researchbriefings.files.parliament.uk/documents/SN05944/SN05944.pdf)

[54] Goodhart, (1958): The Rule of Law and Absolute Sovereignty, University of Pennsylvania Law Review, Vol. 106, p. 944.

[55] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A12002E237

[56] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A61978CJ0093: *The Amtsgericht Essen referred to the Court of Justice for a preliminary ruling in pursuance of Article 177 of the treaty three questions on the interpretation of Article 237 of the treaty which are designed to find out whether the accession of Spain, Portugal and Greece to the European Communities for reasons based on community law is not possible in the foreseeable future.*

Same counts for the Copenhagen criteria, that refer to entering the EU at a certain point of time but nothing is put in place to consistently track and control if these values are still operating the way they should. The theory, depicted in the treaties and how it is regulated in practice can be quite different, especially for Member States that should adapt their legislatures to the European Union standards and also at the same time rebuild their system on the ruins of a communist past (Kochenov, 2008).

Laws should be seen as they operate and not as abstract normative instruments that are easy to surround. Furthermore, a supervision has to be legally implemented, but the EU directives do not contain any references of such. The EU is built up on the belief that every Member State will take up moral obligation and that supervision is redundant (Green and Petrick, 2002). Instead of a formal incorporation of high supervision and protective standard, the lawbook is mainly a result of a compromise between European institutions and national institutions that are not clear rules.

One of the trait that persist in Hungary is the presence of corruption (Torsello, 2010) that is getting worse after the change of the government. In the scale from 0 (highly corrupt) to 100 (very clean), we can observe that the Hungarian corruption index dropped significantly after 2012 from 55 to 45 in 2017 (see figure 4).[57]

Figure 4: Corruption index, Hungary

Source: Transparency International

57 https://tradingeconomics.com/hungary/corruption-index

The number of corruption cases in politics and public administration has not decreased over the year. One possible reason of this phenomenon is that many of the CEOs had been raised under socialism, where corruption was usual and this remained in their mindset. During socialism only one leader had the power over others and nobody could question the action taken by the top. After the democratization of the country, the established government bodies that were in power before the change are currently fighting to preserve their legitimacy.[58] That is also reflected in the rigidity of the public administration's hierarchy. Certain power levels cannot be controlled, which implies that morality is imperfect.

After interviews of 15 public administrators in Budapest (Torsello, 2010), it came out that even today, people who opposed the system were reallocated or even fired. In addition to that, a lot of businessmen with close link to the Fidesz party got their wealth increased since the party took over the power in 2010. It is an "oligarchic system" that emerged since Viktor Orbán is head of the government, where business success is correlated with the links to political power. A lot of business development have been achieved through state contracts and about 60% of them are funded but the EU funds.[59] Indeed, licenses that have been issued by the government to the new party-linked business elite after the law in 2013 permitted the state bank to finance domestic companies. The Corruption Research Center Budapest, a non-governmental organization analyzed all public procurement contracts between 2010 and 2016 and found out, that the business elite linked to Fidesz won 5% of contracts by value, which represents a total of EUR 1,88bn. In return the companies are funding the party's political campaigns.[60]

This way of doing business is also present in the government internally. György Maltolcsy is surrounded from a group of advocate to bypass any laws, that could contradict his actions. To defend the creation of a real estate portfolio, he answered the

[58] Potuček,Not Only the Market: The Role of the Market, Government, and the Civic Sector in the Development of Postcommunist Societies, Central European University Press 1999
[59] https://www.ft.com/content/ecf6fb4e-d900-11e7-a039-c64b1c09b482
[60] http://foreignpolicy.com/2018/02/05/hungary-and-poland-arent-democratic-theyre-authoritarian/

critics that this serves the public interest by creating public wealth, even though no governor before used that activity before as a core mission of the central bank (Miklos Sebők, 2018). The Lending program for Small and Medium sized Enterprises, which clearly fostered the companies of relatives and friends have been defended by being based on the model of Funding for Lending in the UK. Viktor Orbán and György Maltolcsy are using the topic of the ECB's independence in the sense that it serves as a central bank for an area that is not a political union. This means that the ECB cannot interfere in domains that are strictly under the state's hand. Indeed, the European Union was constructed to regulate markets but not to regulate politics. The European Union often struggles to find the right balance between flexibility and rigor, which is very different from country to country. This makes it complicated to build-up a rule-based framework in unexpected political and economic contingences.

György Matolcsy and Viktor Orbán have also good arguments, which discredit the opinion of the ECB. Owing to the efforts to consolidate its public finances Hungary was released from the excessive deficit procedure in 2013, the first time since its accession. The situation of Hungary is, despite of unorthodox policies very good compared to other countries such as Greece or Spain, that followed every single recommended step. In the investment sector, Hungary was strongly preferred over euro zone countries facing the worst of the sovereign debt crisis. Regarding that the international financial system had a surplus in liquidity, emerging markets such as Hungary became much more attractive for international financial actors because of slightly higher yields than the European average.

In this way, by building up Europe, the different cultures and expectations were underestimated. Especially in finance: exercising monetary policies in a multi-lingual, multi-cultural creates struggles in anticipating and understanding policy made by the ECB. (Berger et al., 2006). Assignment of a EMU (European monetary Union) is so complex and includes different histories of inflation, policy strategies and economic environment, delegation of tasks that these can be observed very differently through the MS.

In fact, the ability to forecast monetary policy decisions from the ECB depends on the geographic proximity to the ECB and reflects the phenomenon of different approaches of monetary policies. In addition to the geography, history seems also to be problematic. Common legal origins, institutions regrouped into socio-cultural attitudes are key elements when information spillovers are taking place (Thrift 1994, Grote 2004). Analysts working in a headquarters in Frankfurt tend to have less error on forecast than experts of countries elsewhere. This might be because in the financial center it is easier to observe actions of ECB up-close. One other important fact is the history of the independence of the central bank. Countries with a long-standing tradition of independent central banking, and therefore having a similar institutional history forecast better ECB actions and understand them even better than other countries. The MNB's independence is far from the ideal aspiration of the ECB.

Expectations and understanding are crucial in the transmission of monetary policy. The ECB should be open to a heterogeneous environment to tackle the problems better and decrease uncertainty and financial market volatility that such a phenomenon implies. It would be certainly better for the success of the ECB with unorthodox actors such as the MNB to adopt a common expectations-formation process and therefor overcome such national and regional biases.

The proposition was made to use forgotten committees such as the "Agence des droits fondamentaux de l'UE" or the "Copenhague Commission" that could ring the emergency bell if constitutional criteria are not fulfilled. The idea is to give those independent institutions more power, to stay away from political interest and argumentation to justify procedures against countries that goes against European values. Binding the budget and the EU funds to conditions could also be a pertinent proposition. On 2. May 2018 the European Commission proposed a draft that suggest to make the EU budget dependent from rule of law criteria: "The new proposed tools would allow the Union to suspend, reduce or restrict access to EU funding in a manner proportionate to the nature, gravity and scope of the rule of law deficiencies. Such a decision would be proposed by the Commission and adopted by the Council through reverse qualified majority voting »[61]

[61] http://europa.eu/rapid/press-release_IP-18-3570_en.html

However, by reducing the EU funds, the propaganda against the EU could be stronger in Hungary with the argument that Brussel dictates. The EU needs more than ever, have the definition, treaties and tasks distribution to be clearer and stronger.

Conclusion

Protectionism is very costly, not only for Hungary but also for the European Union, that sees its values threated and its credibility weakened. The debates on the functioning of the European Union as well as the ECB should all the time be renewed to redefine new priorities and adapt to new challenges. Especially in a recent and young institutional union, trying to create something that never happened before, the debate has to be permanent and the errors quickly repaired.

The example of Hungary shows how vulnerable and volatile political economics of the European Union can be and how the rules have to be renewed to apply on different situations. After the transition, Hungary experienced two radical different bank system regulations. The rise of internationalization and the lack of regulation led to a credit expansion. The 2006 collapse damaged Hungary's economy dramatically and gave the opposition parties (like Fidesz at that time) the chance to win the legislative elections. Fidesz entered easily the parliament after the crisis and managed to unable the central bank to act. In fact, after the global financial crisis, the role of the central banks around the world, the ECB included, has been extended. New legislation frameworks gave much more power to central banks to catalyze the recent crisis problems. The governments handed over the macroprudential economics, in order to focus on the sovereign debt crisis and austerity politics. The Fidesz government took the example of the neighbours to extend the power of the central bank but in another way that has been expected. Multiple unorthodox measures have been implemented after György Matolcsy became the head of the governor board. In political topics, the MNB is not independent anymore as we proved in this paper: MNB and Fidesz are working hand-in-hand.

The strategy of the government goes beyond financial regulation. Fidesz uses previously applied reforms from other member states to justify the changes of MNB's role. The HFMA ended up being under the authority of the MNB, the MKB have been bought by the central bank, which lead to the enrichment of the high governmental relatives and numerous macroprudential actions such as the deflation enhance massive gains. The governor board put them into 6 foundations, infringing the primary article of the independence of the central banks going against the monetary financing prohibition.

Even though the European values and treaties have been encountered, the European Union doesn't seem to be adequately armed to face such behaviors. That is why it is highly important to tie the constitutional values to the pre-accession conditions of the countries on the long term and not only in a certain period of time. Since Poland and other countries are following the trend of introducing unorthodox measures, it is now more than ever time to fight the new protectionism wave that threatens European values.

The Venice Committee is responsible to monitor countries implementing the European Convention on Human Rights, designed to protect democracy and rule of law[62]. Such institutions should gain in importance and power over the Member States to abstain countries such as Hungary or Poland to ignore the rule of law. Opinions emitted by the ECB are definitely not enough, because they do not have any power that can constraint these behaviors. Therefore the treaties should have the ability to sanction if needed. The best way to oblige countries to apply the rule of law may be to tie the conditions to EU-funds. These conditions should last only for a certain time and could be renewed to be updated to new situations, which can change dramatically from one government to another.

[62] https://www.coe.int/en/web/about-us/who-we-are

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