

When Does the Law Rule?  
The Politics of Banking Sector Legal Reform in the Post-Communist Region after 1989

Aneta B. Spendzharova  
University of North Carolina – Chapel Hill

[aneta@email.unc.edu](mailto:aneta@email.unc.edu)

Paper prepared for the tenth biennial conference of the European Union Studies Association (EUSA) in Montreal, Canada, 17-19 May 2007

This is an initial draft and comments are welcome!  
Please do not cite without permission.

*I thank Milada Anna Vachudova, Liesbet Hooghe, John Stephens, and Georg Vanberg for their abiding interest in my research project, invaluable feedback, and constructive suggestions. The research in this paper was generously supported by grants from the European Commission and the European Union Center of Excellence at UNC – Chapel Hill and the Graduate School at UNC – Chapel Hill.*

## 1. Introduction

As we learn more about the dynamics of political and economic adjustment in transitional countries, the rule of law is receiving increasing attention by scholars and policy makers. Democratization scholars have emphasized the overriding importance of legal reform for building liberal democracy (Linz and Stepan 1996; Diamond 1999; Carothers 1998; O'Donnell 2000). The rule of law is crucial because it reduces the arbitrary use of power and allows political, economic, and social actors to form reliable expectations about the behavior of the political elites.

Post-communist states have inherited similar policies and institutional arrangements from the previous regime. However, some sixteen years after the end of communist rule, we observe significant variation in the quality of democracy and economic performance across the region. Some states such as Estonia, Hungary, and Slovenia have built political systems in which the separation of powers is observed, legal accountability mechanisms have been put in place, and to a large extent both the decision-making elites and the citizens abide by the law. The strong legal foundations have contributed to the development of a liberal democracy and a functioning market economy. In other states such as Belarus, Turkmenistan, and Uzbekistan, authoritarian leaders have monopolized power and legal accountability is frequently breached. The authoritarian leaders and their entourage can easily circumvent the legal system and are practically beyond the reach of the law. The presence of a weak legal system is typical of the illiberal or pseudo-democratic regimes in the post-communist region.

Larry Diamond's (1999) work on conceptualizing democracy elucidates the contrast between liberal and illiberal democracy. According to Diamond, the minimal form of democracy, which he calls "electoral democracy," is a civilian constitutional system in which the legislative and executive offices are filled through regular, competitive, multiparty elections with universal suffrage (Diamond 1999: 10). "Liberal democracy" fulfils the criteria of "electoral democracy," but it supplements them with additional features. First, "liberal democracy" precludes the creation of reserved domains of power for the military or other actors that are not accountable to the electorate. Second, it prescribes horizontal accountability of the officeholders to one another. Third, it guarantees extensive freedom of individuals to organize and express their interests and values. Fourth, the rule of law is an integral component of "liberal democracy." Legal rules are applied fairly, consistently, and predictably across equivalent cases, irrespective of the class, status, or power of those who are subject to the rules (Diamond 1999: 11).

Scholars have noted the growing number of, at least nominally, democratic regimes in the world since the late 1970s, as part of the so-called "third wave" of democratization (Huntington 1991; Linz and Stepan 1996; Diamond 1999). However, many of the world's newly democratized regimes actually fall in the category of "hybrid regimes" that combine features of both democratic and authoritarian regimes. The concept of "illiberal democracy," or what Diamond calls "pseudodemocracy," has been developed to describe hybrid regimes that hold multiparty elections and may have some of the other constitutional features of liberal democracies, but fall short of meeting key criteria of being a liberal democracy. One feature of liberal democratic regimes that is often violated in illiberal regimes is access to an arena of contestation sufficiently fair that the ruling party can be voted out of power (Diamond 1999:15). Additional shortcomings of illiberal democracies are violations of the citizens' freedom of speech and association, silencing of critical media, and frequent use of coercion. At the same

time, illiberal democracies are significantly different from authoritarian regimes. Notably, illiberal democracies tolerate the existence of multiple parties that provide at least somewhat of an opposition to the ruling party. Also, illiberal democracies grant some organizational autonomy to individuals, even though that autonomy may be frequently breached (Diamond 1999: 16; Diamond 2002: 29). From a normative standpoint, the most problematic characteristic of hybrid regimes, including illiberal democracies, is that the pro-forma democratic features serve as the principal means of obtaining unchecked political authority and legitimizing the misuse of political power.

My dissertation contributes to two lively debates in comparative politics today: What factors have led to the divergent liberal and illiberal trajectories of reform in transitional countries, and how have international actors influenced legal reform in the region – for better or for worse? We still need to deepen our knowledge of the processes that promote the adoption and implementation of good quality laws across different issue areas. I ask: How do governments decide whether to reform the country’s legal framework and which course of legal change to pursue? Which mobilized actors, both domestic and international, influence legal change? To investigate these questions, I focus on legal reform of the banking sector in the post-communist region.

This chapter is organized in the following way: to begin with, I outline three important lines of interpretation of the rule of law and clarify where my research fits in the broader context of the rule of law literature. In the next section, I explain why the transformation of the banking sector legal framework is a worthwhile subject of inquiry and how it relates to broader questions raised during the transition process. After that, I present briefly the theoretical argument that I develop in my dissertation. Next, I clarify the dependent variable in my analysis: the quality of legal reform. The following section elaborates on the independent variables, which I have organized into two categories: the domestic determinants and the international determinants of legal reform. The section presenting the independent variables in my analysis also provides greater detail of the theoretical underpinnings of my project and how my research contributes to the different literatures that I use. Subsequently, I introduce two alternative hypotheses concerning the role of economic development and culture. At the end of this chapter, I describe the research methods employed in my dissertation and summarize the research hypotheses derived from my argument about the role of strategic political action in the course of legal reform.

## **2. The rule of law**

In the introductory part of this chapter I noted that the rule of law is an essential component of liberal democratic regimes. Commitment to adhere to the rule of law by the country’s elites and citizens alike distinguishes liberal democratic from the so-called pseudo-democratic regimes. In the next paragraphs, I outline three important strands of interpreting the rule of law in the literature.

Brian Tamanaha points out that one line of interpretation of the rule of law refers to having a government that is limited by the law (2004: 114). This interpretation emphasizes the constitutional separation of powers and the implementation of checks and balances in order to prevent abuse of power by a tyrannical ruler or government. Typically, authors in this line of inquiry investigate the domestic processes that help to build and sustain the rule of law. For example, in the dawn of the modern British and US governments, domestic groups mobilized

and pushed for the adoption of political mechanisms that would protect them from the reach of despotic rulers (North and Weingast 1989).

A second line of interpretation of the rule of law is concerned with the formal aspect of legality. According to Tamanaha, formal legality is defined as the presence of laws that are characterized by “generality, equality of application, and certainty” (2004: 119). Consistent with this line of thought, Hayek has observed that good laws make it possible “to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one’s individual affairs on the basis of this knowledge” (1944). Upholding formal legality is an important prerequisite for the development of a market economy, because it introduces transparency and predictability in the arena in which transactions take place. Research in economics has concluded that entrepreneurs are especially reluctant to commit resources in an uncertain legal environment (Dixit and Pindyck 1994; Brunetti et al. 1998).

Yet formal legality by itself has some significant pitfalls. It is compatible with democratic regimes, but also with authoritarian regimes that are extremely legalistic. Formal legality can satisfy the classical liberal demand for protecting the individual against a potentially tyrannical government. But formal legality can also serve as a tool to enforce political domination through extensive legal prescriptions. Guillermo O’Donnell concurs that an important facet of the rule of law is to ensure that all officials, including the highest ranking elites, “are subject to appropriate legally established controls” (O’Donnell 2004: 5). In addition, O’Donnell (2004) emphasizes that the existence of a civic culture in the population that supports the basic principles of the rule of law is essential in order to hold the administrative officials and the elites accountable in practice. He advocates that the rule of law should protect the civil and social rights of the citizens and should be more relevant to issues of distributive justice (O’Donnell 2004). In the post-communist context, it has been particularly important to adopt laws regarding the protection and social integration of ethnic minorities (Pogany 1995; Kelly 2004).

The third line of interpretation of the rule of law builds upon formal legality. If the principles of formal legality can be used to create a predictable environment for the citizens and other social, political, and economic actors, we need to ask: Who will be responsible for the practical application of formal legality? This question brings us to the role of the judiciary, which is comprised of legal experts who act as guardians of the law (Tamanaha 2004: 123). The rule of law is maintained by setting up an independent and fair judiciary that oversees and ensures the proper application of the country’s laws (Schedler, Diamond, and Plattner 1999). In a democratic system, the judiciary is supposed to safeguard and implement the principles of checks and balances and formal legality mentioned above. Although in the literature it has been shown that a judiciary with strong political ties can also act against its supposed ‘masters’ (Helmke 2002), the general recommendation of academics and practitioners is to set up an independent judiciary that has the capacity to rule even against the highest-ranking political elites if they transgress the boundaries of their power (O’Donnell 2000).

The corner-stone questions concerning constitutional design and the institutional set-up of checks and balances have already been investigated in the context of the post-communist transitions (Lijphart and Waisman 1994; Colomer 1995; Elster, Offe, Preuss 1998; Schwartz 2000; Gönenç 2002). My dissertation research contributes to the second and third lines of interpretation of the rule of law. I am primarily interested in how political factors shape the nature and quality of the adopted laws. I also investigate how the composition and the level of expertise of the judiciary affect law implementation. Overall, my dissertation project will help to glean important insights about how “the rules of the game” are established in a fluid social and

economic environment, and what kinds of groups can influence the content and the application of the laws.

### **3. Research question**

Following the collapse of the Soviet bloc in the early 1990s, policy-makers in post-communist countries could no longer rely on the economic practices used in the socialist planned economies and had to adapt to the rules of the game in a market economy framework. In order to be successful in the new economic environment, the production, investment, and management strategies of the government and the emerging private actors had to be very different from those used during the past five decades. One fundamental challenge was to reduce the involvement of the state in economic affairs and, consequently, amend and update the legal framework of post-communist countries in order to bring the regulations in line with the new economic environment. In the early 1990s, the newly elected parliaments across the region were engaged in a process of “legal updating” in policy areas as diverse as human rights, culture, and enterprise management.

Scholars of political economy and law have analyzed the new laws that defined property rights, settled issues of property restitution, and guided the privatization process in the post-communist region (Przeworski 1991; Rapaczynski 1996). Authors investigating the ongoing democratization and market reforms in the post-communist area have established that informal political processes are still very important in the region (Hellman 1998; Seleny 1999). In many countries, key institutions such as the judiciary, which are supposed to be impartial and competent in applying and overseeing the laws are in fact slow, inefficient, and easily swayed by political pressure (Carothers 1998; Magalhaes 1999; Hilmer 2002). Therefore, it is important to understand what political factors affect regulatory outcomes and investigate the dynamics of this relationship.

The banking sector is one pivotal piece of the puzzle of economic restructuring after the fall of communism, because it provides vital financial resources for the existing as well as the new economic actors. Across the region, the emerging small private businesses in sectors such as retail, food processing, and textiles, as well as the restructuring state-owned conglomerates in sectors such as the chemical industry, metallurgical industry, and electronics need access to financial resources in order to buy new equipment, renovate the infrastructure where the production processes take place, and invest in research and development. This is one important reason why a strong financial sector that can provide efficient and reliable banking services is a must in a market economy.

Several research projects have continuously followed the development of the financial sector in the post-communist region. Economists at the European Bank for Reconstruction and Development (EBRD), established in 1991 to boost economic development in the post-communist region, have analyzed in-depth different facets of banking reform such as bank privatization, bank supervision, and the relationship between banking sector restructuring and economic outcomes in the EBRD’s publications “Transition Report,” “Law in Transition,” and the journal “Economics of Transition.” Researchers at institutions such as the Austrian National Bank and the William Davidson Institute at the University of Michigan have investigated systematically the transforming banking sector in the region. In this broad frame of reference, my dissertation is one of the first projects to focus explicitly on the influence of political processes on banking sector legal reform.

Introducing market logic in the operation of the banking sector can be beneficial, especially when a country transitions from a regime with a heavy state involvement in financial decision-making, as was the case in the post-communist region. A weak banking sector cannot support the growth and improvement of the industrial and service sectors, which hampers the development of a functioning market economy. The advantage of a reformed banking sector with clear rules of the game is that economic actors can engage in meaningful long-term planning and assume availability of credit products and prompt servicing of financial accounts (Levine 2002; Barth, Caprio, and Levine 2006). Foreign investors prefer an environment where they can set up reliable operations; domestic investors prefer to have access to affordable domestic credit in order to develop their business activities (Marinov and Marinova 2003; Djarova 2004). Therefore, political actors have certain incentives to seek good quality banking legal reforms in order to promote economic development and growth.

However, the banking sector also provides fertile ground for political interference and corruption, because influential political figures can provide access to loans and preferential financing. Therefore, political actors face certain incentives to implement partial banking reforms, which would give them greater discretionary power in allocating financial resources. An unreformed legal framework of the banking sector may distort heavily the economic incentives in a country. When the state holds majority stakes in the most influential banks, the political agenda of the government can trump the market incentives of the banks. In the post-communist region, there have been numerous cases when public financial resources were misused for the private benefits of the influential elites (Hellman 1998; Ganev 2001; Barnes 2003; Hoff and Stiglitz 2004).

There are possible legal remedies to prevent the misuse of the banks such as laws that promote transparency in the banks' operations; laws that allow the Central Bank to operate independently of short-term political pressures to bail out the government in times of excessive budget deficit; and institutional mechanisms to monitor the compliance of banks with the legal rules. The puzzle inspiring my research is: Under what circumstances do governments put these laws and institutional mechanisms in place?

#### **4. Case selection and overview of the argument**

Chapter one of my dissertation presents the theoretical framework that I use to analyze how politics shapes the course of banking sector legal reform in transitional countries. Chapters two and three are focal cases studies. I use comparative historical analysis to formulate an explanation of strategic political action during banking legal reform. Chapter two focuses on Hungary as an example of a front-runner of economic reform in the region. Chapter three focuses on Bulgaria as an example of a slow reformer in the region, which eventually changed course and improved the quality of its banking sector legal framework. Chapter four presents a pooled cross-sectional time series statistical test of my explanation, using data from the post-communist region. Chapter five summarizes the main findings of my dissertation.

How did I select the two central cases in my dissertation? The Hungarian case is analogous to other front-runners of economic reform such as Estonia and Slovenia with respect to the emergence of a pro-market consensus early in the transition. Even if the particular choices of timing and methods of reforms such as bank privatization differed somewhat across these cases, an in-depth investigation of the Hungarian path of banking sector legal reform will reveal political decisions and laws which were significant for all front-runners. The Bulgarian case is

typical of a broader range of post-communist cases such as Romania and Albania that have experienced the pronounced resistance of key political actors to transparency in banking and the absence of a consistent vision for transforming the financial sector. A careful analysis of my two representative cases – Hungary and Bulgaria – yields findings about the political process of changing the banking sector legal framework which are generalizable to the post-communist region.

Influences from the international arena are an important component of my project, but my central argument is that the domestic political system is the major determinant of the timing and nature of legal change. Therefore, at this stage of my analysis, I chose the cases of Hungary and Bulgaria because the two countries have been exposed to similar international influences since 1989 (whereas post-Soviet cases such as Georgia or Azerbaijan have been exposed to a different configuration of international influences), yet Hungary and Bulgaria offer important variation in the domestic political structures examined in my dissertation, as well as the timing and nature of banking sector legal reform.

The dependent variable in my analysis is the quality of legal change. The independent variables are the governing elites, the mobilized domestic stakeholders, and the international actors. What factors have shaped domestic legal change of the banking sector in post-communist countries? I argue that on the domestic politics side, the political parties in power, responding to pressures from organized domestic stakeholders, have been instrumental in advancing, or limiting, banking legal reform. On the international politics side, international actors have promoted their vision of banking legal reform through conditionality, selective domestic empowerment, and elite socialization.

Within a few years of 1989, most post-communist states had adopted two basic features of democratic polities: a multi-party system and elections. Political parties are at the center of cabinet-formation and policy-making in the region, so they are instrumental in shaping the course of legal reform. Yet it is very important to understand whose preferences parties aggregate when they engage in policy-making. In light of recent evidence that political parties in Eastern Europe are estranged from the voters (Kopecky 1995; Kitschelt 2000; Lewis 2001), my dissertation contributes to the literature by investigating the nature and the policy consequences of the alliances formed between the political parties and the mobilized domestic stakeholders. An additional step in my analysis of the impact of domestic politics on banking sector legal reform involves evaluating the institutional capacity of the state to implement legal change, because good laws will bear no consequences if they are not used in practice.

Given the fluidity of the political, social, and economic situation in the post-communist region in the early 1990s, international actors had a chance to intervene and advocate the reforms that they deemed necessary in order to establish democracy and market economy. In the post-communist region, both the IMF and the EU resorted to the toolbox of conditionality policies. International actors also used selective empowerment of domestic organizations and institutions to reinforce the course of reforms set by conditionality. Lastly, elite socialization between the local elites and international proponents of banking legal reform helped to transfer knowledge about the banking laws operating in the Western market economies.

## **5. Quality of legal reform**

This section sheds light on the dependent variable in my analysis: the quality of banking sector legal reform. It is indeed hard to define the components of good legal reform in absolute

terms. One analytical strategy is to consider the starting point of Eastern European transitions and the goals of transition. Then we can identify benchmark legal reforms necessary to achieve those goals. In Eastern Europe, the transitioning regimes started out with a communist political system and a planned economy, and the goals of transition were to establish a liberal democracy and a market economy. In the banking sphere, good legal reforms would provide clear market entry and exit conditions (Kroszner 1998; Fries 2005); ensure the ability of banks to function according to market principles, without state intervention in their decision-making (Berglof and Bolton 2001; Fries 2005); guarantee central bank independence (Cukierman 1992; Eijffinger and De Haan 1996; Maxfield 1998; Maliszewski 2000); and establish independent banking oversight (Nord 2000; Holthausen and Ronde 2003). These are key policy standards, according to which I will judge the quality of a country's legal framework at any given time point. My analysis also relies on a quantitative measure of banking legal reform developed by the EBRD. Although the overall EBRD score that I use rates progress in banking reform in general, a large component of it is based on the adoption and implementation of benchmark banking laws.

Since transitioning in the early 1990s, many post-communist countries have found themselves in economic turmoil. Balance of payments and financial crises have been frequent. When post-communist governments approached the IMF for emergency financing and policy advice, or the World Bank for strategic loans to upgrade the public infrastructure, they had to take on the obligation to comply with the policy prescriptions of the so-called "Washington consensus," which contained some provisions regarding banking sector laws. Therefore, with respect to the dependent variable in my analysis, we need to consider whether international actors have pushed for an ideologically-driven agenda, or a collection of "best practices" used in developed market economies. In the following paragraphs, I outline the main tenets of the "Washington consensus"; summarize several significant criticisms of this policy; and explain why, in my view, in the post-communist region the banking sector policy advice of the IMF can be described as a collection of "good practices," rather than a purely ideologically-driven agenda in favor of neo-liberal economic reforms.

The origins of the term "Washington Consensus" can be traced back to a conference assessing the progress of policy reform in Latin America held in Washington, DC in 1990. John Williamson first used the term to refer to the package of policies promoted by Washington-based institutions, in particular the US Treasury Department, in the context of debt reduction negotiations with Latin American countries (Williamson 2003). Developed in the context of Latin American countries in the late 1980s, the "Washington Consensus" policy package was subsequently extended to other transitional countries, including the post-communist states. Williamson (1994) singles out ten policy objectives of the "Washington consensus": fiscal discipline; reorientation of public expenditure; tax reform (broadening the tax base and cutting marginal rates); financial liberalization (ending interest rate controls); unified and competitive exchange rates; trade liberalization (reducing tariffs and eliminating non-trade barriers); liberalization of foreign investment; privatization; deregulation; and securing property rights. In sum, we can say that the "Washington Consensus" comes down to "a list that, in its time, reflected the lowest denominator of policies recommended for Latin America" (Ortiz 2003: 15).

The "Washington consensus" policies have been endorsed by international organizations such as the IMF and the World Bank and have been a prominent feature of the IMF's conditionality. At the same time, the "Washington consensus" has generated much controversy with respect to the nature and scope of the promoted reforms after countries that have implemented the prescribed policies were hit by major economic crises such as the "tequila



crisis” in Mexico in 1994–1995, the “samba crisis” in Brazil in 1998–1999, and Argentina’s financial crisis in 2001.

Carlos Santiso (2004) has outlined three groups of criticisms of the “Washington consensus.” One set of criticisms considers “Washington Consensus” policies to be altogether inadequate. Another set of criticisms attributes the shortcomings of this policy package to faulty implementation and reluctant reformers. Yet another set of criticisms alleges that the original reform agenda was incomplete and excessively narrow in scope. The first group dismisses the value of “Washington consensus” policies altogether. As an example of the second group, Barbara Stallings and Wilson Peres argue that reforms undertaken in the first wave of “Washington consensus” reform were in fact “incomplete and need complementary policies to make them function properly” (2000: 204). The authors point out that in many reforming countries, the institutions responsible for implementing economic reform are weak and fragmented. To illustrate the third group of criticisms, Pedro-Pablo Kuczynski and John Williamson (2003) have emphasized that reforms should not be pursued in a technocratic way and in isolation from social actors, for instance by creating central budget offices or improving the legal framework for finance management and stopping there. Instead, the authors argue that because the reforms affect deeply the structure of interests and incentives in society, in order to be successful, they should be grounded in the policy process and the institutional context in which individuals operate (Kuczynski and Williamson 2003).

With respect to banking sector reform in the post-communist region, the IMF has been adamant about opening the sector to foreign banks and introducing more competition, streamlining bankruptcy procedures, strengthening the Central Bank and bank supervision (Nord 2000; Stone 2002; Pop 2006). Compared to other policy dimensions of the “Washington consensus” such as across-the-board deregulation and reduction of public spending, banking reform comes across as less ideologically-driven and more of a collection of “good practices” used in the advanced industrialized economies. Furthermore, for the post-communist countries that in the mid-1990s initiated negotiations to join the European Union, the obligatory pre-accession harmonization with EU law and governance practices has provided the comprehensive approach to legal and institutional reform that proponents of the second-generation “Washington consensus” policies are now advocating.

## **6. Explanatory variables, theoretical underpinnings, and contribution to the field**

Domestic and international factors interact to shape the quality of legal reform of the banking sector in transitional countries. Drawing on the insights of the comparative politics literature, I investigate the policy impact of government coloration and domestic policy networks. In my research, I find that influences from the international arena that are similar in nature, scope, and magnitude produce different policy outcomes when they are refracted through the prism of domestic political arrangements.

In the first part of this section, I examine three characteristics of the domestic political system that have a strong impact on banking sector legal reform: partisan politics, domestic alliances, and institutional capacity. I draw on the partisan politics literature to analyze the importance of government coloration. I use the literature on hybrid democracies and the comparative political economy literature on foreign direct investment and trade to understand the role of domestic alliances. I employ the public policy and law implementation literatures to investigate how institutional capacity influences banking sector legal reform.

In the second part of this section, I focus on three international mechanisms that influence banking sector legal reform: conditionality, selective domestic empowerment, and socialization. I draw on scholars' analyses of the use of conditionality by the International Monetary Fund (IMF) and the European Union (EU); the growing importance of independent domestic financial institutions such as the Central Bank; and the knowledge transfer that occurs between international financial experts and their counterparts from the post-communist region.

In the following section of this chapter, I elaborate on two alternative explanations of banking sector legal reform that are based on economic development and intrinsic cultural differences. At the end of this chapter, I summarize which of the hypotheses in my analysis of banking sector legal reform will be tested in chapter four using pooled cross-sectional time series analysis, and which hypotheses can only be tested in the qualitative case studies of Hungary and Bulgaria due to a lack of adequate cross-sectional time series data.

## ***6.1 Domestic determinants of quality of legal reform***

### ***6.1.1 Partisan politics***

According to traditional partisan politics accounts, the competition among political parties for office is an essential feature of the political process in democratic regimes (Duverger 1954; Blondel 1968; Sartori 1976). I use Giovanni Sartori's (1976) definition of political parties as organizations that seek to propel their candidates into parliament and government in order to pursue specific policy goals. Peter Mair (1997) has emphasized that apart from seeking office to maximize their leverage in the policy-making process, parties interact and respond to the strategies and behavior of other parties in the political system.

Between 1945 and the early 1990s, the totalitarian regimes in the post-communist region were ruled by the respective national communist party, so the party politics logic developed to analyze the political process in advanced industrialized societies was not relevant in the context of the communist bloc. Even though periodic elections took place, the results of those elections were pre-determined and practically no party could challenge the dominant position of the communist party in power. However, when transition took place in the region in the early 1990s, one of the dramatic domestic political changes was the opening of the electoral arena to multi-party competition. Thus, the newly formed political parties, alongside with the communist successor party, and parties that were revived after being disbanded in the 1940s all competed to attract the citizens' votes and win a share of the seats in parliament. In parliamentary systems with a proportional representation electoral system, which most post-communist countries adopted after 1989, the government usually has the support of a parliamentary majority and thus it can pass its most preferred policy agenda.<sup>1</sup> Therefore, after transition, political parties became pivotal in determining the legal outcomes in post-communist countries.

A widely recognized finding in the comparative politics literature with respect to partisan politics in the post-communist area after 1989 is that center-right and reformed communist governments in power do better in the initiation and implementation of market-liberalizing economic reforms, compared to their unreformed communist counterparts (Haggard and Webb 1994; Ekiert 1996; Bunce 2000; Grzymala-Busse 2002; Vachudova 2005). Steven Fish (1997)

has demonstrated statistically that countries, where the opposition to communism won the first elections have performed best in undertaking and sustaining economic reforms after 1989.

Two mechanisms stand out when we try to account for the association between partisanship and economic reform: party ideology and political competition. Valerie Bunce (1999) suggests that the correlation between the right-wing opposition in power and better economic reform is grounded in the ideological foundations of the opposition parties in Eastern Europe. By virtue of denouncing the status-quo policies of communism, the opposition parties in most Eastern European countries have adopted a market-liberalizing economic agenda. It was only logical for the right-wing opposition parties in the region to endorse what they saw as the alternative to the economic policies under communism.

What mechanism accounts for the correlation between reformed communist in power and better economic reforms? Milada Vachudova (2005) and Anna Grzymała-Busse (2003; 2007) have analyzed the importance of alternation of the parties in power in order to develop meaningful party competition and improve the overall quality of policy outputs in the country. Vachudova argues that the availability of credible alternatives among the political parties exposes politicians to the close scrutiny of their political competitors, interest groups, and the media (2005: 14). In a noncompetitive political system, the government hinges on the support of a small fraction of society, in Vachudova's words "a small selectorate" (2005: 15). By contrast, in a competitive political system, the government must gain support from a wider subset of society, which forces political parties to consider a broader range of possible economic policies. Political competition also reduces the information asymmetries between the government and the citizens, and thus it makes voters more aware of the range of options and the likely practical consequences of the political elites' programs (Vachudova 2005: 17).

According to Grzymała-Busse, meaningful political competition increases the threat of replacement to governing incumbents and constrains the governing parties' ability to extract resources for their private benefit, because regardless of its partisan coloration, the opposition hopes to gain votes by monitoring and criticizing the government (2007: 92). Thus, political competition increases the range of policy and governance alternatives available in the political realm. Both Grzymała-Busse (2003) and Vachudova (2005) point out that in countries where the communist successor parties were defeated by the right-wing opposition in the first post-1989 elections, they were forced to become more transparent, revise significantly their policy agenda, and endorse at least some form of market-liberalizing reforms in order to "get back in the political game."

A good quality legal framework that regulates the operation of the banking sector is an integral part of the broad economic reforms intended to create more efficient economies in the post-communist region. Therefore, I expect the general proposition about the role of center-right and reformed communist governments in economic restructuring to be valid in the particular case of banking sector legal reform.

**Hypothesis 1:** We expect a good quality of banking sector legal reform if the domestic political process is characterized by right-wing governments or reformed communists in power.

#### *From political parties to domestic alliances*

The literature on party politics in advanced industrialized countries assumes low levels of electoral volatility, relatively high party cohesion, and crystallization of programmatic party

agendas. Is there empirical evidence that these assumptions are met in Eastern Europe? Elizabeth Bakke and Nick Sitter (2005) have found a strong degree of stabilization in the party systems of the four Visegrad states: the Czech Republic, Hungary, Poland, and Slovakia. Tracing the evolution of the party systems in their four cases over time, the authors conclude that the Visegrad states are characterized by stable party organizations, stable patterns of interaction among the political parties, and a decreasing percentage of wasted votes in the elections (Bakke and Sitter 2005: 258).

However, the assumptions about high party cohesion and crystallization of programmatic parties become questionable once when we move beyond the borders of the Central European front-runners of transition. As Herbert Kitschelt has pointed out, “the presumption that political conflict between parties is based on programmatic appeals is generally problematic for students of non-West-European politics” (1995: 448). Kitschelt distinguishes between three major types of communist regimes and proposes that these three types have been developing different structures of political competition after the fall of communism. “Bureaucratic-authoritarian” communist regimes such as the Czech Republic are developing political competition among programmatic political parties. “Negotiated transition” regimes such as Hungary have a propensity toward programmatic parties, but those have a fuzzier agenda than political parties in the “bureaucratic-authoritarian” communist regimes. “Patrimonial communist” regimes such as Bulgaria face a bleak prospect of developing programmatic parties. Political competition in “patrimonial communist” regimes is highly personalized and revolves around charismatic leaders (Kitschelt 1995: 467).

Stephen Whitefield and Robert Rohrschneider (2006) have conducted an expert survey in Eastern Europe to investigate the nature of the linkages between political parties and the citizens. Whitefield and Rohrschneider’s data indicates that the communist successor parties in Eastern Europe are by far the most programmatic, which the authors attribute to the Marxist origins of these parties (2006: 18). At the same time, many of the communist-successor parties in the region are also the most entangled in clientelistic linkages. Unlike communist successor parties, political parties on the right end of the spectrum in the region tend to be programmatic, non-charismatic, and also non-clientelistic (Whitefield and Rohrschneider 2006: 18). According to the authors’ statistical analysis, party-level factors such as party ideology and party organization are a more important influence on party-citizen linkages than structural factors such as the level of economic development (2006: 34).

Dwelling further on the nature of party-citizen linkages in the post-Soviet space, Petr Kopecky has demonstrated in his case study of the Czech Republic that despite the overall stabilization observed in the party system, Czech political parties are evolving as “formations with loose electoral constituencies, in which a relatively unimportant role is played by the party membership, and a dominant role is played by party leaders” (1995: 517). Even in political systems where programmatic parties are prevalent such as the Czech Republic, political parties are rather removed from their grass-root citizen supporters. Therefore, we need to investigate the input of other organized interests such as business associations and labor unions into parties’ policy positions. As a starting point, I take into consideration the political science and sociology literature that has underscored the role of economic policy networks in economic restructuring (Stark and Bruszt 1998); the impact of sociopolitical networks on institution building in post-communist countries (McDermott 2002); and the effect of foreign investors on the evolution of inter-enterprise networks (Stark and Vedres 2006).

My research project acknowledges the importance of political parties for banking sector legal reform, but it aims to improve our understanding of the linkages between political parties and their constituencies in times of rapid social and economic change. My dissertation will add to the current state of knowledge by investigating the alliances between political parties and organized interests in the region, in light of findings about the general decline in political party membership over the last two decades (Mair and van Biezen 2001) and the weak social grounding of Eastern European parties (Kopecky 1995; Kitschelt 2000; Lewis 2001).

### ***6.1.2 The missing link: Domestic stakeholders and domestic alliances***

An important domestic determinant of the quality of legal reform that has received less attention in the literature is the relationship between governing elites and mobilized domestic stakeholders. By domestic stakeholders I mean organized groups with a salient political or economic policy position such as business associations, labor unions, non-governmental organizations, and policy think-tanks. The domestic political process is characterized by the formation of strategic alliances in order to adopt and implement policy change. The nature and actual operation of these alliances vary across issue areas.

Why is domestic coalition-building so essential to understanding the process of banking legal reform? In parliamentary proportional representation systems, which most post-communist countries adopted after 1989, the government usually has the support of a parliamentary majority and thus it can pass the legal reforms that it deems necessary. Although the government, along with the parliament, is in the center of the law-making process, it depends heavily on the state bureaucracy and the courts for law implementation, as well as on private actors for adhering to the rules. Therefore, even if a democratic government is able to accomplish significant legal reforms, it cannot forcefully impose them on the state and society. The government rarely stands alone in introducing, or subverting, reforms. The elites in power tend to enter into strategic alliances with mobilized domestic stakeholders. Furthermore, because policy areas are interconnected, the fate of banking sector restructuring is tied to developments in the industrial and service sectors. The successful restructuring of the banking sector depends on the performance and management of the state-owned enterprises, as well as the large and small and medium-sized private enterprises.

What factors determine whether the domestic alliance will work toward cleaning up the banking system, or exploiting it for personal gains? I argue that the government decision-makers and the salient domestic stakeholders can converge on a reform agenda only if it will yield a better long-term payoff for these actors, compared to the potential payoffs from corruption and rent-seeking.

In the partisan politics section, I distinguished between governments headed by an unreformed communist successor party and governments headed by a right-wing or a reformed communist successor party. I hypothesized that the latter two types of government are more likely to introduce good quality banking sector legal reforms. In this section, I investigate the sources of political parties' economic policy choices. I argue that unreformed, and unchallenged, communist successor parties in government, on the one hand, and right-wing or reformed communist successor parties in government, on the other hand, face very different domestic incentive structures. Because of the different distribution of costs and benefits of economic policy reform, the two categories of political elites opt for different economic policy choices.

Unreformed, and unchallenged, communist successor parties in power face no pressure within the domestic political system to restructure the way in which they run the government. The fusion of party, state, and economy under communism left a dense network of relationships between state officials, economic managers, and finance professionals (Stark and Bruszt 1998; Wagener 1998). In the absence of a domestic push to restructure and seek new networks of economic policy-making during transition, the networks inherited from the previous regime are perpetuated. When citizens remain acquiescent and still vote the unreformed communist successor party into office, the governing elites obtain the greatest benefits from maximizing the short-term rents that they can extract for themselves, while imposing high costs on the rest of society. I explain how this process works in the section below that deals with clientelism in hybrid regimes.

Right-wing and reformed communist successor parties in government face significant competition for office. They need to reach out and build new economic policy networks that will be beneficial for economic restructuring and achieving economic growth in the short term, but also will be sustainable in the long term. Therefore, right-wing and reformed communist successor parties in government frequently reach out to strategic providers of capital and policy advice from abroad in order to boost the domestic economy. I elaborate on how this process works in the section below that deals with the leverage of foreign direct investors and the role of trade with advanced industrialized countries.

#### *Clientelism in hybrid regimes*

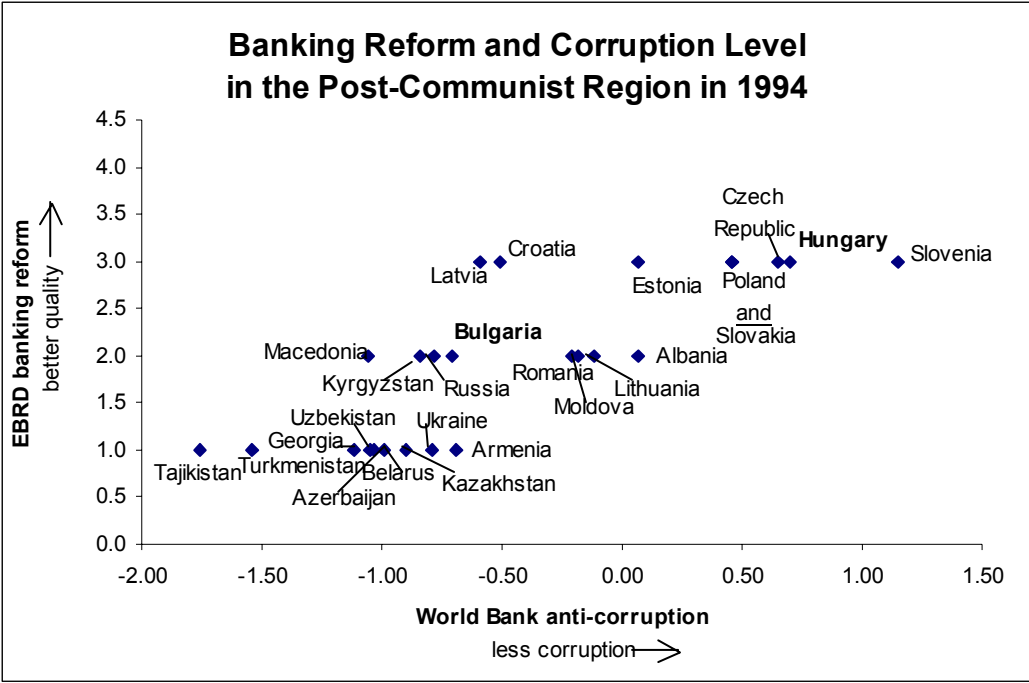
Joel Hellman (1998) has investigated the economic dynamics of hybrid regimes. He argues that the most significant threat to consolidating democracy and market economy does not come from the groups of structural reform ‘losers’ such as pensioners and heavy industry workers, but from the small group of partial reform ‘winners’ such as corrupt government officials and managers of state-owned enterprises (Hellman 1998). Branislav Slanchev (2006) has confirmed statistically this finding. Hellman’s analysis runs contrary to earlier studies of economic reform in the region. At the outset of the transition process, Przeworski (1991) and Haggard and Kaufman (1995) argued that the biggest threat to economic reform would come from reform losers, because the costs of reform are concentrated and the benefits are dispersed. This may be a fair assumption from the point of view of economic theory, but Hellman provides ample evidence that the obstacles to economic reform in post-communist countries have come from a different source. According to Hellman, the post-communist experience shows that reforms have been stalled by “enterprise insiders who have become new owners only to strip their firms’ assets; commercial bankers who have opposed macroeconomic stabilization to preserve their enormously profitable arbitrage opportunities in distorted financial markets; local officials who have prevented market entry into their regions to protect their share of local monopoly rents; and so-called mafiosi who have undermined the creation of a stable legal foundation for the market economy” (1998: 204). Hellman points out that these actors can hardly be classified as short-term net losers of economic reform. On the contrary, they were the earliest and biggest winners.

Hellman underscores that in most post-communist countries, the reform winners described above did not oppose the initiation of the economic reform process, nor did they seek a full-scale reversal of reform. Rather, the reform winners sought to “stall the economy in a *partial reform equilibrium* that generates concentrated rents for themselves, while imposing high costs

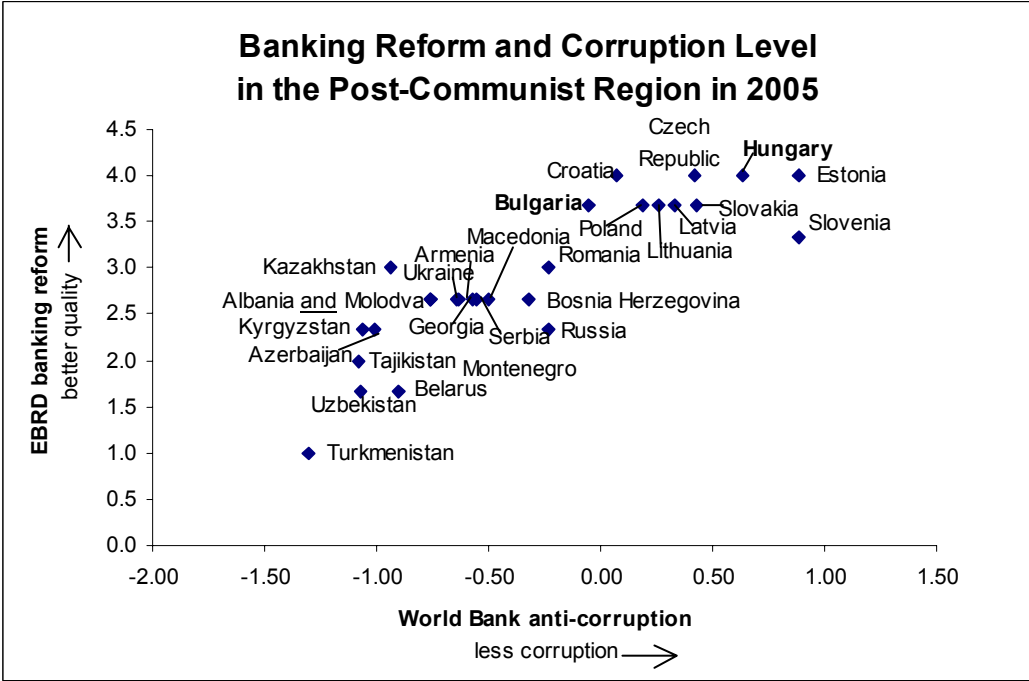
on the rest of society” (Hellman 1998: 204). Yet the underlying causal mechanisms that have made partial reform a possible, and in some cases lasting, equilibrium in the post-communist region need further investigation. My dissertation contributes to this literature by examining how partial reform equilibria are sustained over time, and under what conditions liberalizing economic reforms can become a winning strategy even in “partial reform” regimes.

**Hypothesis 2:** We expect a poor quality of banking legal reform if the domestic political process is characterized by an alliance between corrupt elites in power and rent-seeking domestic stakeholders.

If my reasoning about the primary importance of the alliances established between the governing elites and the mobilized domestic stakeholders is correct, I expect the presence of an alliance between corrupt government elites in power and rent-seeking domestic stakeholders to perpetuate inferior quality banking laws. Conversely, an alliance between reformers in government and domestic stakeholders mobilized in favor of market-friendly banking laws will be associated with good quality legal reform. As figures 1.1 and 1.2 show, both in 1994 and 2005, the more corruption is present in a political system, the lower the quality of its banking legal framework.<sup>2</sup> Appendix I contains information about the data sources. To check the robustness of my proposition, I will assess the relationship between the level of corruption and the quality of banking laws with the addition of other variables. In chapter four, I develop a more comprehensive statistical model that employs pooled cross-sectional time series analysis.



**Figure 1.1:** Quality of banking reform and corruption level in the post-communist region, 1994.



**Figure 1.2:** Quality of banking reform and corruption level in the post-communist region, 2005.



*The leverage of foreign investors and the role of trade with advanced industrialized countries*

Scholars of political economy have established that foreign direct investment (FDI) has affected positively the economic performance of transitional economies in the post-communist region (Dunning and Narula 1996; Schröder 2001; Marinov and Marinova 2003). From a macro-economic perspective, FDI helps to cover current account and fiscal deficits. Moreover, FDI supplements the low domestic resources to finance both ownership change and capital formation. Compared with other financing options, FDI also facilitates the transfer of technology, know-how and skills, and helps local enterprises to reach foreign markets (Krkoska 2001).

What is the mechanism through which foreign direct investors influence banking sector legal reform? Foreign direct investment differs from other types of international capital flows with respect to the purpose and duration of the commitment that it involves. The purpose of FDI is to establish lasting commercial relations and to exert a noticeable managerial influence in the foreign country (Barrell and Holland 2000: 478). Therefore, it is long-term oriented, compared to shorter-term opportunities such as portfolio investment. Lipschitz, Lane, Mourmouras note that FDI is the type of foreign investment that is least likely to be withdrawn in response to short-term market volatility (Lipschitz et al. 2002: 4). The long-term commitment of FDI investors motivates them to take an active part in the enterprise decision-making process and press the country's government for a more transparent and efficient business environment, including better banking laws.

According to economic analyses, improvements in the domestic investment climate that are undertaken to attract FDI eventually translate into higher gross fixed capital formation, which in turn leads to sustainable economic growth (Lankes and Venables 1996; Baldwin *et al.* 1997; Mattli 1999; European Roundtable of Industrialists 1999). Hence, attracting foreign direct investment can be beneficial for governments which want to boost the development of the economy. The development of a viable domestic financial sector may also allow domestic enterprises, as opposed to foreign-owned enterprises, to increase their gross fixed capital formation and expand. This could prevent the creation of a two-tier economy where foreign-owned enterprises flourish whereas domestically-owned firms, and particularly small and medium-sized enterprises (SMEs), cannot finance their growth (Krkoska 2001).

Walter Mattli and Thomas Plümper have shown that the EU Member States have been the most important source of FDI in Central and Eastern Europe (2002: 558). Kimberly Clausing and Cosmina Dorobantu have found statistical evidence that prospective EU membership has a beneficial effect on the inflow of foreign investment, because it signals an improved risk environment and promises a barrier-free access to the European common market (2005: 96). For the subset of post-communist countries that established themselves as credible future members of the European Union in the mid-1990s, foreign investors have been instrumental in promoting banking sector reform. International banking groups such as Italy's Unicredito and Austria's Erste Bank and HVB Bank have played a major role in the bank privatization process and have supported the improvement of the banking sector legal framework (Bonin and Wachtel 1999).

**Hypothesis 3:** We expect a good quality of banking legal reform if foreign direct investors have a strong presence in the country.

As outlined above, foreign direct investment entails a long-term presence in the target country. Therefore, we expect investors to have a stake in the development of the domestic political and economic system. A weaker relationship between foreign capital and domestic economic developments concerns the role of trade. Trade patterns are influenced by considerations about economic efficiency, comparative advantage, and production costs, so they are not necessarily related to the country's legal framework. Scholars of political economy have analyzed the impact of trade on domestic politics. Axel Haldenius (1992) has argued that exposure to international trade brings higher rates of economic growth, which in turn fosters political liberalization and a more democratic and accountable domestic political system. Dani Rodrik (1997) provides evidence that greater trade openness constrains governments to relinquish the use of various fiscal policy instruments in order to maintain competitiveness. Whether such constraints are interpreted positively or negatively depends on the value that one places on government intervention in the economy. However, one less contentious finding is that trade openness also generates pressures for more transparency and efficiency in the domestic financial sector (Beck et al. 2001).

Cally Jordan and Giovanni Majnoni (2002) have argued that since the 1970s, the world economy has become more integrated and the degree of trade liberalization has increased. Because the trade in goods is associated with the provision of financial services, the growth in the volume of international trade has led to increased financial integration and harmonization of important financial laws (Aliber 1984; Jordan and Majnoni 2002). Furthermore, Helen Milner has pointed out that although the overall economic impact of regional trade regimes is still ambiguous, some of them, including the EU, NAFTA, and ASEAN, seem to have a positive effect on lowering trade barriers and reinforcing unilateral moves toward freer trade (1999: 106). Milner's argument suggests a possible mechanism through which trade can influence the domestic legal framework. Regional trade regimes that operate based on institutionalized rules and have the capacity to enforce those rules can demand from their trading partners compliance with desired legal benchmarks.

The European Union is the most significant rule-based trade regime geographically proximate to post-communist countries. Could the EU use its trade leverage to exert pressure on its post-communist neighbors for better financial laws? Bartolomej Kaminski has argued that until the mid-1990s, the EU did not have a significant impact on the course of economic reforms in Central and Eastern Europe, because the Union's policy lacked credible incentives and punishment mechanisms (2001: 4). However, the EU became a much more influential factor in the region after the so-called Europe Agreements were put in place.<sup>3</sup> The Europe Agreements obliged Central and Eastern European countries (CEECs) to open their markets to EU imports and eliminate trade barriers among their economies. Kaminski emphasizes that even before the formal start of the eastward Enlargement of the EU, the Europe Agreements promoted not only trade openness, but also Western-style company and competition laws, banking laws, laws on mergers and state aid, and intellectual property laws (2001: 5).

**Hypothesis 4:** We expect a good quality of banking legal reform if a country has strong trade relations with advanced industrialized economies.

### ***6.1.3 Institutional capacity***

The remaining important domestic facet of the banking legal reform process in my explanation is the country's institutional capacity. Whereas the coloration of the government and the nature of the domestic alliances make a significant impact during law amendment and law adoption, institutional capacity influences law implementation. Therefore, to form a comprehensive understanding of legal change, we should also evaluate the state's institutional capacity to apply the adopted legal changes. I focus on two institutions: the state administration and the judiciary.

Taking into account the findings of the law implementation literature (Frye and Shleifer 1997; Nunberg 1999; Verheijen 2000; Goetz 2001; Dimitrova 2002; Grabbe 2006), I first consider state administrative capacity as a factor that affects the very capability of the government to implement the legal changes adopted by the law-makers. Antoaneta Dimitrova (2002) has observed that at the outset of transition in post-communist countries, the state bureaucracy was a discredited institution because it used to serve as a tool of repression in the hands of the old regime. Therefore, it has been a persistent challenge to transform the administration into a professional and efficient organization after the separation of party and state in the early 1990s (Dimitrova 2002: 180). In the realm of economic policy, post-communist governments are still grappling with a deficit in administrative capacity to develop and implement policy coherently (Brunetti et al. 1997; Crawford 1995; EBRD 1997; Thedick and Bertucci 1997; Goetz and Margetts 1999). In 1997, the World Bank Development Report underlined that the inefficient state administrations in the region are a critical impediment to the success of political, social, and economic reforms (World Bank 1997).

In particular, Klaus Goetz and Helen Margetts (1999) have studied the operation of what they call "centers of government" (COGs) in the post-communist region. Examples of COGs are ministries, agencies, councils, committees, and local administrations. The authors conclude that in most post-communist countries, "COGs are ill-positioned to respond effectively to the demand to serve as policy coordinators" (Goetz and Margetts 1999: 427). Furthermore, Peter Hille and Christoph Knill find statistical evidence that the quick and successful harmonization with EU law between 1999 and 2003 in the thirteen EU candidate countries from the region has been shaped mostly by the strength and competency of the bureaucracy, rather than by the peculiarities of the country's institutions, the number of relevant veto players, or political manipulation (2006: 547).

**Hypothesis 5:** We expect worse quality of banking legal reform if a country has low administrative capacity.

The judiciary is another institution that affects the implementation of the country's legal framework. The judiciary is supposed to be impartial and competent in applying and overseeing the laws, but in fact in many post-communist countries this institution is slow, inefficient, and easily swayed by political pressure (Magalhaes 1999; Hilmer 2002; Gerring and Thacker 2005). The Open Society Institute (OSI) in Budapest has been monitoring the development of judicial capacity in the region as part of the EU accession reforms. The OSI country reports (2002) identify a bundle of recurring problems in the region, including poor funding for the judges and lack of support staff; questionable judicial selection criteria and performance evaluation; poor working conditions; and little electronic processing of case information.

Frank Emmert shows that some law implementation problems in the post-communist region are rooted in ambiguities and lacunae in the new laws themselves. Such problems tend to be addressed and corrected over time. However, the most challenging obstacles to judicial efficiency stem from common practices during communism such as “authoritarianism, nepotism, corruption, and indecision” (2003: 296). According to Emmert, post-communist countries that have moved faster toward “reforming the people” in the judiciary system have consistently performed better in the implementation of legal reforms (2003: 312).

**Hypothesis 6:** We expect worse quality of banking legal reform if a country has low judiciary capacity.

## ***6.2 International determinants of quality of legal reform***

My research also contributes to the innovative literature on the interaction between domestic and international politics. Over the past three decades, we have learned much about the international sources of domestic policy choices both in advanced industrialized and developing states (Gourevitch 1978; Putnam 1988; Haggard and Webb 1994; Keohane and Milner 1996; Pridham *et al.* 1997; Schmitter 2001; Whitehead 2001). Specifically, the literature on the influence of international organizations in the post-communist region has demonstrated the strong policy impact of the EU and the IMF in a variety of issue areas, ranging from monetary policy to minority rights (Przeworski 1991; Aslund 2002; Jacoby 2004; Kelley 2004; Vachudova 2005). My dissertation examines the policy tools that different international organizations use to influence banking legal change and explores the implications for the sustainability of the promoted reforms.

It is unlikely that a detached international community will have an impact on domestic legal change. However, an engaged international community will not automatically produce change either. International actors such as the IMF and the EU and salient neighboring states such as Russia have the potential to play an important role in the economic transformations, or lack thereof, in the post-communist region. Yet for policy transfer to occur, the relevant international actors have to be actively engaged in promoting a policy agenda, but also the government must be receptive toward international advice. Drawing on the international relations literature, I propose three salient mechanisms whereby international actors may influence the course of domestic legal change: conditionality, selective domestic empowerment, and socialization. I elaborate on each mechanism in turn. Figure 1.3 presented at the end of this section shows the three mechanisms.

### ***6.2.1 Conditionality***

The use of conditionality by international actors has received significant attention by scholars and policy-makers (Mayhew 1998; Schmitter 2001; Schimmelfennig and Sedelmeier 2004). In general, conditionality entails a package of rewards and punishments, attached to demands for specific policy changes. With regards to the banking sector, the IMF has requested that certain legal standards be met as a prerequisite for releasing funding. The EU has also demanded the adoption of the banking legal standards observed in the Union as part of the obligatory pre-accession transposition of the *acquis communautaire*.

IMF conditionality was introduced in the 1950s as a way of ensuring that governments do not squander the financial support provided by the Fund. The IMF offers financial assistance only on the condition that the respective government agrees to pursue a range of economic stabilization and adjustment policies that are spelt out in a “letter of intent” document signed by the government and the Fund (Williamson 1983; Dreher and Vaubel 2003; Bird and Willet 2003). IMF conditionality has been a subject of significant debate. It has been reviewed by the Fund on a number of occasions and its nature has changed over time. Most recently, the influential Meltzer Commission (IFIAC 2000) charged that conditionality is ineffective and suggested that it should be abandoned.

The IMF claims that its conditionality policies have a positive effect on attracting private capital flows and improving the stability of the target country’s financial system. The Fund defends conditionality as a signaling or commitment device that increases the markets’ confidence in the country and encourages private market actors to become involved, whereas without conditionality they would have been reluctant to do so (IMF 2001; Bird and Willet 2003; Edwards 2003). With respect to banking sector legal reform in the post-communist region, the IMF has demanded legal provisions that guarantee the independence of the Central Bank from political pressure; opening the banking sector to foreign investors and competition; strengthening banking supervision; and improving the bankruptcy legal framework (Bonin and Wachtel 1999; Berglof and Bolton 2001).

I now move to discuss European Union conditionality, which is broader in nature and scope than IMF conditionality. With respect to credible future members of the Union, the specific policy demands of EU conditionality in the banking sphere are part of the comprehensive and compulsory pre-accession harmonization with EU law, organized into thirty-one accession chapters. Legal provisions concerning the banking sector regulatory environment feature in the following accession negotiations chapters: Economic and Monetary Union, Free Movement of Capital, Freedom to Provide Services, Financial Control, and Finance and Budgetary Provisions.

Milada Vachudova (2001; 2005) has demonstrated the impact of the “passive” and the “active leverage” of the European Union on the acceding states from Central and Eastern Europe. In Vachudova’s argument, “passive leverage” denotes domestic changes resulting from the attractiveness of EU membership for credible candidate states without any explicit demands for change by EU policy-makers. By contrast, “active leverage” denotes the deliberate use of conditionality by the EU in order to achieve domestic political change in credible future members (2005: 63). Vachudova has analyzed the conditions under which the EU’s leverage has influenced the domestic politics of illiberal regimes in Central and Southeastern Europe (2006). One crucial prerequisite in order to embark on a liberal path of reforms is the occurrence of what Vachudova calls “watershed elections,” in which the elites who had previously monopolized power are voted out of office and are peacefully succeeded by their domestic political competitors (2006: 3). Unless this crucial political alternation takes place, the chances of opening the illiberal regime to international influences are slim.

Walter Mattli and Thomas Plümpert (2004) have shown that EU conditionality provides a ceiling on the permissible market distortions and, consequently, constrains the opportunities to profit from clientelistic policies. Under this condition, it follows that governments in less democratic transitional countries face a higher political price for compliance, compared to more democratic regimes. According to Mattli and Plümpert (2004), accepting conditionality is a viable political solution only if the political gains to governments from compliance outweigh the costs that the implementation of the EU’s *acquis* inevitably entails. Frank Schimmelfennig has also investigated the conditions for the success of EU conditionality. In his view, “credible membership incentives and low domestic political costs of meeting international conditions have been individually necessary and jointly sufficient” to guarantee effective promotion of

international actors' conditionality policies in Central and Eastern Europe (2007: 131). In a different analysis, Frank Schimmelfennig and Ulrich Sedelmeier observe that authoritarian governments are more prone to turn down the potential rewards from compliance with international conditionality, rather than accept the political power costs of adopting liberal democratic rules (2004: 663).

According to Amichai Magen (2006), the extension of the relatively successful EU conditionality policy to the Union's neighbors to the East and the South such as Ukraine, Belarus, and Morocco is problematic for several reasons. First, the success of conditionality policies depends on the ability of the international actor to offer a desirable reward in exchange for the demanded domestic changes. Second, the success of conditionality depends on how well the policy reflects the local circumstances and addresses local concerns. Third, the extent of compliance with conditionality is affected by the degree of specificity of the demands and the rewards. Magen (2006) argues that these three conditions were calibrated well in the case of the 2004/2007 Eastern Enlargement of the EU. However, with respect to the EU's European Neighborhood Policy towards the Union's neighbors to the East and the South, Magen concludes that the EU has reached the boundaries of applicability of its conditionality toolbox, because it is confronted with a neighborhood of largely poor, illiberal regimes that are less likely to respond to the model used in Central and Eastern Europe (2006: 427).

Overall, the literature offers convincing evidence that international conditionality can achieve its goals when it is well-calibrated. However, for some regimes, the potential rewards from compliance with international conditionality may not be sufficient to offset the costs of reform. Therefore, it is worthwhile to test whether in general conditionality has affected banking sector legal reform in the post-communist space.

**Hypothesis 7:** We expect a good quality of banking legal reform if a country has been involved consistently in IMF, World Bank, and EU conditionality programs.

### ***6.2.2 Domestic empowerment***

The second salient mechanism of international influence used in my dissertation – selective domestic empowerment<sup>4</sup> – means that some groups such as human rights NGOs, citizen associations, as well as the moderate and reformist wings within political parties raise their profile and influence on the domestic political process, because they get rhetorical and financial support from international actors that endorse a similar policy position. Recently, scholars have paid closer attention to the changing domestic political game in transitional countries as a result of the influence of international factors (Kelley 2004; Vachudova 2005). Specifically in the banking sector, selective domestic empowerment has occurred in the following ways: boosting the role of moderates and reformers in the political process; strengthening (and in some countries demanding the creation of) a state agency for financial oversight; as well as endorsing and reinforcing the position of domestic banks that “play by the rules.”

Wade Jacoby's work (2004) provides a general example of how international organizations can empower domestic economic actors. Jacoby finds that consumer protection NGOs in the Czech Republic have been active advocates of consumer interests, but in general “they can only survive with outside support” (2004: 75). In order to research and bring to court cases of consumer rights violations, these NGOs depend heavily on grants from European Union

programs or individual EU Member States. Jacoby (2004) also provides examples of institutional domestic empowerment, resulting from the EU accession process such as the county development councils in Hungary (CDCs). In the beginning of the EU accession process, these local institutions were relatively inconspicuous and implemented regional PHARE projects. Their role increased significantly over time due to the growing ties with the EU, and, currently, they act as one of the key institutional pillars of implementing the EU's Regional and Cohesion policy in Hungary (Jacoby 2004: 91).

In the realm of banking reform, Juliet Johnson (2006b) shows that the Central Banks of East European states have gained increasing independence since 1989 as a result of the on-going integration in the Western financial system and international pressure to emulate the central banking model of advanced industrialized states. The emerging financial sector in the post-communist countries did not necessarily welcome independent central banks, because they have taken an active role in placing constraints and pressures on the domestic commercial banks. In Johnson's words, "These newly independent central banks began the post-communist period with shallow domestic support, and maintained this support primarily because of EU accession requirements" (2006b: 368). For the post-communist states involved in the EU accession process, the policy harmonization demands of the Union empowered the Central Banks, which otherwise may not have acquired so much control over financial policy-making. Johnson further argues that East and Central European central bankers are pushing for the quick adoption of the common EU currency, the euro, because this would force their increasingly reluctant governments to cut their fiscal deficits enough to meet the Maastricht criteria and then cede control over monetary policy to the European Central Bank (2006b: 364).

**Hypothesis 8:** We expect a good quality of banking legal reform if international actors empower organizations such as independent agencies responsible for monitoring the financial sector and independent Central Banks.

### ***6.2.3 Socialization***

The two mechanisms outlined above: conditionality and domestic empowerment represent a link between the demands of the international actors and the domestic response of actors or institutions without making assumptions about the inherent preferences of the domestic players. By contrast, the third mechanism – socialization – entails policy change on the domestic level as a result of altering the preferences of the relevant domestic players. The first two mechanisms are easier to detect and confirm empirically, whereas socialization requires direct evidence about the preferences and strategies of the domestic players. My empirical approach with respect to socialization is to use elite interviews, records of parliamentary debates, and newspaper articles in search of evidence of changes in the political actors' preferences over time.

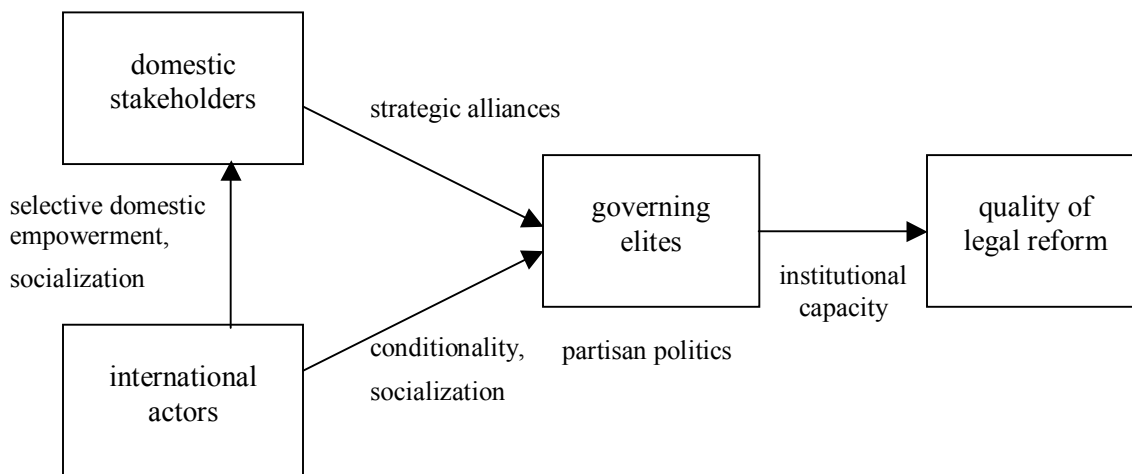
Jeffrey Checkel (2001) has examined how socialization induces policy change through communication and social interaction in the case of minority policy in Eastern Europe. The socialization mechanism presumes that actors follow what James March and Johan Olsen call the "logic of appropriateness" (1989: 160). According to this logic, rule-transfer will occur if the domestic actors are persuaded that the rules advocated by the international actors are legitimate and appropriate. For the rationalist school, consequentialism and cost-benefit calculations

underlie the process of taking important decisions.<sup>5</sup> By contrast, for the constructivist school, other causal mechanisms grounded in social interaction lead to policy change. For example, constructivist scholars argue that preference change – and therefore policy change – will occur if the international and domestic actors are involved in an on-going process of deliberation, persuasion, and learning (Checkel 2001: 581). Often scope conditions apply. For example, persuasion is more likely to take place if the domestic actors do not have strong cognitive priors and are open to considering different arguments.

Rachel Epstein’s work (2006a; 2006b) bridges the rationalist and the constructivist approaches to analyzing policy change. According to Epstein, the rational calculations of domestic actors take place in a wider social context. Therefore, it is important to analyze the social interactions between domestic policy-makers and international advisors in order to understand the policy outcomes. In her investigation of the transformation of central banking policy in Eastern Europe, Epstein (2006b) finds that international institutions can create support for particular ideas in a target society when the domestic policy-makers actively seek their technical assistance and expertise. The influence of international actors is enhanced in situations of preceding policy failure and when the external actors promote consistent and fairly specific recommendations for policy change. Epstein argues that policies such as central bank independence became institutionalized in diverse post-communist states because international institutions cultivated a social consensus in favor of central bank independence through persuasion, argumentation, and coalition building (2006a: 1020).

**Hypothesis 9:** We expect a good quality of banking legal reform if elite socialization is taking place between the local elites and international proponents of banking legal reform.

Figure 1.3 illustrates the relationships between the main variables in my explanation of legal change in the banking sector of transitional countries and labels what I expect to be the most important political mechanisms that shape banking legal reform. At the end of this chapter, I also summarize the set of testable hypotheses resulting from my theoretical framework discussed so far.



**Figure 1.3:** Political processes during banking sector legal reform in the post-communist region.



## 7. Alternative hypotheses

What are some plausible alternative explanations of why banking sector legal reform occurs, or fails to take place, in the post-communist region? According to my analysis of banking legal reform, the policy outcomes result from the interplay of domestic and international actors. This is an agent-driven account, assuming that foremost strategic considerations motivate the actors involved in the process of legal change. The most compelling alternative conceptualizations are structural ones. According to structural accounts, the policy outcomes are driven by the initial conditions in which countries find themselves such as their level of economic development, or fundamental cultural characteristics. I now look at each of these alternative explanations in turn.

### *Economic development*

Adam Przeworski et al.'s (2000) project examines systematically the relationship between regime type (democratic or authoritarian) and economic performance. As part of their analysis, the authors draw conclusions about the relationship between the nature of political and institutional arrangements and the level of economic development of different countries. Although Przeworski et al.'s analysis is more sophisticated and nuanced than modernization theory accounts, in essence, it contends that "poor countries cannot afford a strong state" (2000: 163). According to the authors' analysis of data since the 1950s, countries with an annual per capita income below \$1,000 have very grim prospects of ever developing economically, and consequently, institutionally (2000: 162). The scholars detect a more heterogeneous pattern of economic and institutional development for states with annual per capita incomes between \$1,000 - \$2,000 and upper per capita income categories. In these income groups, some countries such as Singapore, Portugal, and Greece grew economically over time, whereas other countries remained in the same income category, or descended below the \$1,000 boundary (2000: 162). Even if we accept the argument that very poor states cannot sustain complex political institutions, the question remains of what factors other than the level of economic development have shaped the path of institutional change in countries from the heterogeneous income categories. If we follow the logic of the economic development argument, we should expect predominantly wealthy countries to have advanced banking laws.

**Alternative hypothesis 1:** We expect a good quality of banking legal reform if a country has a high level of economic development.

### *Culture*

Although the concept of culture is not easy to capture in quantifiable terms, some scholars have attempted to study systematically the impact of culture on institutions and governance. Amir Licht et al. (2006) analyze the rule of law, curbing corruption, and democratic accountability as part of a general bundle of social norms. The authors identify seven broad types of world culture and examine the systematic influence of culture type on the bundle of social norms, including a norm called "respect for the law." What is of particular relevance for my study is that Licht et al. (2006) claim that different cultural patterns are associated with systematically different levels of respect for the law. The authors find statistical evidence that

“national cultural profiles predict governance outcomes some thirty years later” (2006: 29) and therefore propose that the direction of causality flows from culture to social norms, including the rule of law.

The volume “Culture Matters” edited by Lawrence Harrison and Samuel Huntington (2000) shares a similar vision of the role of culture in society. As Stace Lindsey emphasizes in his contribution to the Harrison and Huntington project, “individuals will often accept intellectual arguments, understand the need to change, and express commitment to changing, *but then resort to what is familiar*” (2000: 283). In other words, cultural values matter because they form the principles around which economic activity is organized. Hence, if we follow the logic of this project, altering the institutional and legal environment in a country presupposes a change in the underlying attitudes, beliefs, and assumptions.

**Alternative hypothesis 2:** We expect a good quality of banking legal reform if there is an existing culture of respect for the law, rather than evasion.

Overall, the theoretical framework presented in this chapter and the structural accounts yield different predictions about the likelihood of legal change over time. According to my argument, even in cases with adverse initial conditions, good quality legal change is possible if there is sufficient political will and mobilized actors ready to carry out the necessary reforms. By contrast, structural accounts would predict little or no change if the underlying characteristics of the economic and social system stay the same. At the end of this chapter, I will summarize the research hypotheses in my dissertation and I will outline how I plan to test them.

## 8. Research methods

My dissertation combines in-depth case study analysis with statistical testing. I use the insights of the comparative politics and international relations literatures to form expectations about the possible patterns that link the explanatory variables in my analysis: the governing elites, the mobilized domestic stakeholders, and international actors with the dependent variable: the quality of banking sector legal change. Then, I systematize these regularities into a theoretical framework that can be used to analyze how political processes influence legal change in the banking sector of post-communist countries.

Comparative politics scholars frequently use case studies to generate new theories, or probe the explanatory power of existing theories. One of the significant advantages of case studies is that they bring about a high level of precision and confidence in the findings (Yin 1993; Van Evera 1997). In this tradition, I make an initial probe of the explanatory power of my theoretical framework in the cases of Hungary and Bulgaria. I use the most similar systems design in selecting the two central cases in my dissertation. I cannot control experimentally for the multitude of factors that may affect domestic legal change, but my case selection maximizes the common contextual influences: Hungary and Bulgaria have been exposed to very similar broad influences since the beginning of transition in 1989. At the same time, Hungary and Bulgaria offer important variation on the timing, nature, and approach toward reforming the banking sector legal framework since 1989. Over the course of nine months, I conducted field research in Bulgaria and Hungary to probe empirically my theoretical argument. I interviewed politicians, practitioners, and academics; read media accounts of the legal reform processes; collected and analyzed copies of laws and records of parliamentary debates.

In the two case studies, chapters two and three of my dissertation, I use the method of difference to identify sources of variation in the quality of banking sector legal change in the two focal cases. Then, I use comparative historical analysis (CHA) as a core research strategy to examine systematically banking sector legal change (Mahoney and Rueschemeyer 2003). I analyze the historical sequences in my two cases to demonstrate the causal mechanisms at work. Overall, this research methodology helps me to achieve a higher level of conceptual and measurement validity compared to large-n statistical analyses. Yet this methodology also makes it difficult to put forward conclusions that hold true for a large number of cases. Thus, in chapter four of my dissertation, I employ pooled cross-sectional time series statistical analysis to test the plausibility of my arguments on the universe of post-communist cases. The specification of the time series model that I use and the operationalization of the variables will be discussed in chapter four.

## **9. Research hypotheses**

Now I move on to summarizing the arguments presented so far into a set of hypotheses that will be tested statistically in chapter four of my dissertation, with the exception of hypotheses eight and nine, for which I do not have adequate cross-sectional time series data. I will probe the plausibility of hypotheses eight and nine using evidence from my case studies of Hungary and Bulgaria. My argument is agent-based. According to the theoretical framework presented in this chapter, the strategic actions of the government, the mobilized domestic stakeholders, and international actors shape legal reform of the banking sector in transitional countries. I expect that even in cases with adverse initial conditions, good quality legal change is possible if there is sufficient political will and mobilized actors ready to carry out the necessary reforms.

**Hypothesis 1:** We expect a good quality of banking sector legal reform if the domestic political process is characterized by right-wing governments or reformed communists in power.

**Hypothesis 2:** We expect a poor quality of banking legal reform if the domestic political process is characterized by an alliance between corrupt elites in power and rent-seeking domestic stakeholders.

**Hypothesis 3:** We expect a good quality of banking legal reform if foreign direct investors have a strong presence in the country.

**Hypothesis 4:** We expect a good quality of banking legal reform if a country has strong trade relations with advanced industrialized economies.

**Hypothesis 5:** We expect worse quality of banking legal reform if a country has low administrative capacity.

**Hypothesis 6:** We expect worse quality of banking legal reform if a country has low judiciary capacity.

**Hypothesis 7:** We expect a good quality of banking legal reform if a country has been involved consistently in IMF, World Bank, and EU conditionality programs.

**Hypothesis 8:** We expect a good quality of banking legal reform if international actors empower organizations such as independent agencies responsible for monitoring the financial sector and independent Central Banks.

**Hypothesis 9:** We expect a good quality of banking legal reform if elite socialization is taking place between the local elites and international proponents of banking legal reform.

**Alternative hypothesis 1:** We expect a good quality of banking legal reform if a country has a high level of economic development.

**Alternative hypothesis 2:** We expect a good quality of banking legal reform if there is an existing culture of respect for the law, rather than evasion.

The following two chapters of my dissertation are focal case studies of banking legal reform in Hungary and Bulgaria, respectively. I conduct an initial probe of the explanatory power of the theoretical framework presented earlier in this chapter. The case studies also allow me to uncover the concrete mechanisms that explain how the domestic and international political constellations influence banking legal reform. Chapter four presents a large-n statistical test of the hypotheses derived from my theoretical framework and discusses in greater detail the operationalization of the variables used in the test.

## Appendix I: Data sources for figures 1.1 and 1.2

### **EBRD quality of banking reform**

The quality of banking reform variable measures progress in adopting banking regulations such as bankruptcy laws and guarantees for Central Bank independence.

The scale runs from the lowest score (=1) to the highest score (=4.3)

The following qualitative description of the scores is taken from the EBRD methodology report:

1= Little progress beyond establishment of a two-tier banking system.

2= Significant liberalization of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.

3= Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalization with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.

4= Significant movement of banking laws and regulations towards BIS (Bank for International Settlements) standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.

Source: European Bank for Reconstruction and Development. 2005. "EBRD Transition indicators by country." In *Transition Report 2005: Business in Transition*.

Available at: <<http://www.ebrd.com/pubs/econo/6520.htm>>.

### **World Bank control of corruption**

This variable is a composite score based on expert surveys obtained from different organizations. It taps into public trust in the honesty of politicians; frequency of making extra payments in order to 'get things done'; percentage of government officials, judges, and elected leaders involved in corruption.

The scale runs from the lowest score (= -2.5) to the highest score (=2.5)

Source: Danial Kaufmann, Aart Kraay and Massimo Mastruzzi's project *Governance Matters V*.

## Bibliography

- Achen, C. H. 2000. "Why Lagged Dependent Variables Can Suppress the Explanatory Power of Other Independent Variables." *Political Methodology Working Paper*. Available at <<http://polmeth.wustl.edu/papers/00/achen00.pdf>>
- Alexander, G. 2002. "Institutionalized Uncertainty, the Rule of Law, and the Sources of Democratic Stability." *Comparative Political Studies* 35 (10): 1145-1170.
- Bakke, E. and Sitter, N. 2005. "Patterns of Stability: Party Competition and Strategy in Central Europe since 1989." *Party Politics* 11(2): 243-263.
- Baltagi, B. H. 2001. *Econometric Analysis of Panel Data*, 2<sup>nd</sup> edn. New York: Wiley.
- Barnes, A. 2003. "Comparative Theft: Context and Choice in the Hungarian, Czech, and Russian Transformations, 1989-2000." *East European Politics and Societies* 17(3): 533-565.
- Barrell, R. and Holland, D. 2000. "Foreign Direct Investment and Enterprise Restructuring in Central Europe." *Economic of Transition* 8(2): 477-504.
- Barth J.R., Caprio, G. and Levine, R. 2006. *Rethinking Bank Regulations: Till Angels Govern*. Cambridge: Cambridge University Press.
- Beck, N. and Katz, J. 1995. "What to do (and what not to do) with time series cross-section data." *American Political Science Review* 4: 634-647.
- Beck, T., Demirgiu-Kunt, A. Levine, R. 2001. "Law, Politics, and Finance." *World Bank Policy Research Working Paper*, Number 2585.
- Berglöf, E. and Bolton, P. 1998. "Soft budget constraints and banking in transition economies." *Journal of Comparative Economics* 26(1): 18 – 40.
- Berglöf, E. and Bolton, P. 2002. "The great divide and beyond: Financial architecture in transition." *Journal of Economic Perspectives* 16(1): 77 – 100.
- Bird, G. and Willett, T. 2003. "IMF Conditionality, Implementation and the Political Economy of Ownership." Manuscript.
- Bonin, J. and Wachtel, P. 1999. "Lessons from Bank Privatization in Central Europe." *World Bank and Federal Reserve Bank of Dallas Conference*, 19-20 November, 1998.
- Bradley, D. 2001. *The Political Economy of Employment Performance: Testing the Deregulation Thesis*. Unpublished Doctoral Dissertation. University of North Carolina – Chapel Hill.
- Bradley, D. H. and Stephens, J. D. Forthcoming. "Employment Performance in OECD Countries." *Comparative Political Studies*.
- Brunetti, A., Kisunko, G. and Weder, B. 1998. "Credibility of Rules and Economic Growth: Evidence from a Worldwide Survey of the Private Sector." *The World Bank Economic Review* 12(3): 353-84
- Bruszt, L. and Stark, D. 1998. *Postsocialist Pathways. Transforming Politics and Property in East Central Europe*. Cambridge: Cambridge University Press.
- Bunce, V. 1999. *Subversive Institutions. The Design and the Destruction of Socialism and the State*. Cambridge: Cambridge University Press.
- Bunce, V. 2000. "Comparative Democratization. Big and Bounded Generalizations." *Comparative Political Studies* 33(6-7): 703-734.
- Carothers, Thomas. 1998. "The Rule of Law Revival." *Foreign Affairs* 77(2). <<http://www.ceip.org/people/carrule.html>>.
- Checkel, J. 2001. "Why Comply? Social Learning and European Identity Change." *International Organization* 55(3): 553-588.

- Cochrane, D. and Orcutt G. H. 1949. "Application of Least Squares Regression to Relationships Containing Auto-Correlated Error Terms." *Journal of the American Statistical Association* 44 (245): 32-61.
- Colomer, J. 1995. "Strategies and Outcomes in Eastern Europe." *Journal of Democracy* 6(2): 74-85.
- Cukierman, A. 1992. *Central Bank Strategy, Credibility, and Independence*. Cambridge: MIT Press.
- Dawisha, K. (ed.) 1997. *The International Dimension of Post-Communist Transitions in Russia and the New States of Eurasia*. M.E. Sharpe.
- De Boef, S. 2004. *Pooled Time Series and Cross-Sectional Analysis*. Class notes for Spring 2004.
- Diamond, L. 1999. *Developing Democracy. Toward Consolidation*. Baltimore: Johns Hopkins University Press.
- Diamond, L. 2002. "Thinking About Hybrid Regimes." *Journal of Democracy* 13(2): 21-35.
- Dimitrova, A. and Dragneva, R. 2001. "Bulgaria's Road to the European Union: Progress, Problems and Perspectives." *Perspectives on European Politics and Society* 2(1): 79-104.
- Dimitrova, A. 2002. "Enlargement, Institution-Building and the EU's Administrative Capacity Requirement." *West European Politics* 25(4): 171-190.
- Dixit, A. and Pindyck, R. 1994. *Investment under Uncertainty*. Princeton, N.J.: Princeton University Press.
- Dreher, A. and Vaubel, R. 2003. "The Causes and Consequences of IMF Conditionality" *mimeo*.
- Edwards, M. 2003. "Domestic Institutions and Economic Performance Under IMF Programs, 1979-1995." Manuscript.
- Eijffinger, S. C.W. and De Haan, J. 1996. "The Political Economy of Central Bank Independence." *Princeton Special Papers in International Economics*, Number 19.
- Ekiert, G. 1996. *The State Against Society*. Princeton, NJ: Princeton University Press.
- Elster, J., Offe, C. and Preuss, U.K. 1998. *Institutional Design in Post-Communist Societies. Rebuilding the Ship at Sea*. Cambridge: Cambridge University Press.
- Emmert, Frank. 2003, "Administrative and Court Reform in Central and Eastern Europe." *European Law Journal* 9 (3): 288-315.
- Epstein, R.A. 2006a. "Cultivating Consensus and Creating Conflict. International Institutions and the (De)Politicization of Economic Policy in Postcommunist Europe." *Comparative Political Studies* 39(8): 1019-1042.
- Epstein, R.A. 2006b. "Cultivating Consensus: International Institutions and a Liberal Worldview." Paper presented at the annual meeting of the American Political Science Association, 31 August-2 September 2006, Philadelphia, PA.
- European Bank for Reconstruction and Development. 2005. "EBRD Transition indicators by country" in *Transition Report 2005: Business in Transition*. <<http://www.ebrd.com/pubs/econo/6520.htm>>.
- Finnemore, M. Sikkink, K. 2001. "Taking Stock: The Constructivist Research Program in International Relations and Comparative Politics." *Annual Reviews of Political Science* 4: 391-416.
- Fish, S. M. 1997. "The Determinants of Economic Reform in the Post-Communist World." *East European Politics and Societies* 12(1): 31-78.
- Fries, S. 2005. "Politics of Banking Reform and Development in the Post-Communist Transition." *EBRD Paper*.

- Frye, T. and Shleifer, A. 1997. "The invisible hand and the grabbing hand." *American Economic Review: Papers and Proceedings* 87(2): 354 – 358.
- Ganev, V. 2001. "The Dorian Gray Effect: Winners and State Breakers in Post-communism." *Communist and Post-Communist Studies* 34: 1-25.
- Goetz, K. 2001. "Making Sense of Post-communist Central Administration: Modernization, Europeanization, or Latinization?" *Journal of European Public Policy* 8(6): 1032-1051.
- Gould, J.A. 2003. "Out of the Blue? Democracy and Privatization in Postcommunist Europe." *Comparative European Politics* 1: 277-311.
- Gourevitch, P. 1978. "The Second Image Reversed: The International Sources of Domestic Politics." *International Organization*, 32(4): 881-912.
- Gönenç, L. 2002. *Prospects for Constitutionalism in Post-Communist Countries*. Martinus Nijhoff.
- Grabbe, H. 2006. *The EU's Transformative Power*. New York: Palgrave.
- Grzymała-Busse, A. 2002. *Redeeming the Communist Past*. Cambridge: Cambridge University Press.
- Haggard, S. and Kaufmann, R. (eds.) 1992. *The Politics of Economic Adjustment*. Princeton: Princeton University Press.
- Haggard, S. and Webb, S. (eds.) 1994. *Voting for Reform. Democracy, Political Liberalization, and Economic Adjustment*. Oxford: Oxford University Press.
- Haggard, S. and Kaufmann, R. 1995. *The Political Economy of Democratic Transitions*. Princeton NJ: Princeton University Press.
- Haldenius, A. 1992. *Democracy and Development*. New York: Cambridge University Press.
- Hayek, F.A. 1944. *The Road to Serfdom*. Chicago: Chicago University Press.
- Hellman, J. 1998. "Winners take all: The politics of partial reform in postcommunist transitions." *World Politics* 50(2): 203-234.
- Hicks, A. 1994. "Introduction to Pooling" In A. Hicks and T. Janoski (eds.) *The Comparative Political Economy of the Welfare State*. New York: Cambridge University Press.
- Hoff, K. and Stiglitz, J. E. 2004. "After the Big Bang? Obstacles to the Emergence of the Rule of Law in Post-Communist Societies." *The American Economic Review* 94(3).
- Holthausen, C. and Ronde, T. 2003. "Cooperation in International Banking Supervision: A Political Economy Approach." Unpublished manuscript.
- International Monetary Fund. 2001. "Conditionality in Fund-Supported Programs: Overview." *Mimeo*.
- Jacoby, W. 2004 *The Enlargement of the European Union and NATO: Ordering from the Menu in Central Europe*. Cambridge: Cambridge University Press.
- Johnson, J. 2006a. "Postcommunist Central Banks: A Democratic Deficit." *Journal of Democracy* 17(1): 90-103.
- Johnson, J. 2006b. "Two-track diffusion and central bank embeddedness: the politics of Euro adoption in Hungary and the Czech Republic." *Review of International Political Economy* 13(3): 361-386.
- Jordan, C. and Majnoni G. 2002. "Financial Regulatory Harmonization and the Globalization of Finance." *World Bank Policy Research Working Paper*, Number 2919.
- Judge, G.C., Griffiths, W. E., Hill, R. C., Lutkepohl, H., and Lee, T. (1985) *On the Theory and Practice of Econometrics*, 2<sup>nd</sup> edn. New York: Wiley.
- Jupille, J., Caporaso, J. and Checkel, J. 2003. "Integrating Institutions. Rationalism, Constructivism, and the Study of the European Union." *Comparative Political Studies* 36 (1/2): 7-40.



- Kaminski, B. 2001. "How Accession to the European Union Has Affected External Trade and Foreign Direct Investment in Central European Economies." *World Bank Working Paper*.
- Karl, T. (1995) "The Hybrid Regimes of Central America." *Journal of Democracy* 6(3): 72-87.
- Kelley, J.G. 2004. *Ethnic Politics in Europe. The Power of Norms and Incentives*. Princeton NJ: Princeton University Press.
- Keohane, R.O. and Milner H.V. (eds.) 1996. *Internationalization and Domestic Politics*. Cambridge: Cambridge University Press.
- Kitschelt, H., Mansfeldova Z., Markowski R. and Toka G. (1999) *Post-communist party systems: competition, representation, and inter-party cooperation*. New York: Cambridge University Press.
- Kitschelt, H. 2000. "Linkages Between Citizens and Politicians in Democratic Polities." *Comparative Political Studies* 33(6/7): 845-879.
- Kittel, B. and Obinger, H. 2002. "Political Parties, Institutions and Welfare State Dynamics in Times of Austerity." *Discussion Paper 1/2002*. Cologne: Max-Planck Institut für Gesellschaftsforschung.
- Kopecky, P. 1995. "Developing Party Organization in East-Central Europe: What Type of Party is Likely to Emerge?" *Party Politics* 1(4): 525-534.
- Krkoska, L. 2001. "Foreign Direct Investment Financing of Capital Formation in Central and Eastern Europe." *European Bank for Reconstruction and Development Working Paper*, Number 67.
- Kroszner, R. S. 1998. "The political economy of banking and financial regulatory reform in emerging markets." *Research in Financial Services* 10: 33 – 51.
- Krueger, A.O. (ed.) 2000. *Economic Policy Reform: The Second Stage*. Chicago: The University of Chicago Press.
- Kuczynski, P.P. and Williamson, J. (eds.) 2003. *After the Washington Consensus: Restarting Growth and Reform in Latin America*. Washington, D.C.: Institute for International Economics.
- La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. 1998. "Law and Finance." *The Journal of Political Economy* 106(6): 1113-1155.
- Lankes, H.P. and Venables, A.J. 1996. "Foreign direct investment in economic transition: The changing pattern of investments." *The Economics of Transition* 4(2): 331-47.
- Levine, R. 2002. "Bank-based or Market-based Financial Systems: Which is Better?" *William Davidson Working Paper*, Number 442.
- Levitsky, S. and Way, L. 2002. "The Rise of Competitive Authoritarianism." *Journal of Democracy* 13(2): 51-65.
- Levitsky S. and Way, L. 2006 "Linkage versus Leverage: Rethinking the International Dimension of Regime Change." *Comparative Politics* 38(4).
- Lewis, P.G. 2001. "The 'Third Wave' of Democracy in Eastern Europe. Comparative Perspectives on Party Roles and Political Development." *Party Politics* 7(5): 543-565.
- Lijphart, A. and Waisman, C.H. (eds.) 1994. *Institutional Design in New Democracies: Eastern Europe and Latin America*. Boulder, CO: Westview Press.
- Linz, J. and Stepan, A. 1996. *Problems of Democratic Transition and Consolidation*. Baltimore: Johns Hopkins University Press.
- Lipschitz, L., Lane, T. and Mourmouras, A. 2002. "Capital Flows to Transition Economies: Master or Servant?" *IMF Working Paper*, Number 02/11.
- Magen, A. 2006. "The Shadow of Enlargement: Can the European Neighbourhood Policy Achieve Compliance?" *CDDRL Working Paper No.68*, August 2006.

- Mahoney, J. and Rueschemeyer D. (eds) 2003. *Comparative Historical Analysis in the Social Sciences*. Cambridge: Cambridge University Press.
- Mair, P. and van Biezen, I. 2001. "Party Membership in Twenty European Democracies, 1980-2000." *Party Politics* 7(1): 5-21.
- Maliszewski, W. 2000. "Central Bank Independence in Transition Economies." *Economics of Transition* 8(3): 749-789.
- Marinov, M. and Marinova, S. (eds.) 2003. *Foreign Direct Investment in Central and Eastern Europe*. Aldershot: Ashgate.
- Mattli, W. and Plümper, T. 2004. "The Internal Value of External Options." *European Union Politics* 5(3): 307-330.
- Maxfield, S. 1998. *Gatekeepers of Growth: The International Political Economy of Central Banking in Developing Countries*. Princeton: Princeton University Press.
- Mayhew, A. 1998. *Recreating Europe. The European Union's Policy towards Central and Eastern Europe*, Cambridge: Cambridge University Press.
- McDermott, G.A. 2002. *Embedded Politics. Industrial Networks and Institutional Change in Postcommunism*. Ann Arbor: The University of Michigan Press.
- McDermott, G.A. 2004. "The Politics of Institutional Learning and Creation: Bank Crises and Supervision in East Central Europe" *William Davidson Institute Working Paper*, Number 726, November 2004.
- McFaul, M. 1995. "State Power, Institutional Change, and the Politics of Privatization in Russia." *World Politics* 47(2): 210-243.
- McFaul, M. 2002. "The Fourth Wave of Democracy and Dictatorship. Noncooperative Transitions in the Postcommunist World." *World Politics* 54(2): 212-244.
- Meyer-Sahling, J.H. 2001. "Getting on Track: Civil Service Reform in Post-communist Hungary." *Journal of European Public Policy* 8(6): 960-979.
- Milner, H. 1999. "The Political Economy of International Trade." *Annual Reviews of Political Science* 2: 91-114.
- Neale C.W and Bozsik, S. 2001. "How the Hungarian State-Owned Banks were Privatized." *Post-communist Economies* 13(2): 148-169.
- Nickell, S. 1981. "Biases in Dynamic Models with Fixed Effects." *Econometrica* 49: 1417-1426.
- Nord, R. 2000. "Central and Eastern Europe and the New Financial Architecture." *Finance and Development* 37(3).
- Nunberg, B. 1999. *The State after Communism: Administrative Transitions in Central and Eastern Europe*. Washington, D.C.: The World Bank.
- O'Donnell, Guillermo. "Polyarchies and the (Un)Rule of Law in Latin America."  
<<http://www.uoregon.edu/~caguirre/odonnell1pr.html>>.
- Open Society Institute EU Accession Monitoring Program. 2002. *Monitoring the EU Accession Process: Judicial Capacity*. Budapest: Open Society Institute.
- Ortiz, G. 2003 "Latin America: Overcoming Reform Fatigue." *Finance and Development* 40(3): 14-7.
- Ostrom, C. 1978. *Time Series Analysis. Regression Techniques*. London: Sage Publications.
- Pastor, M. and Wise, C. 1999. "The Politics of Second-Generation Reform." *Journal of Democracy* 10(3): 34-48.
- Pevehouse, Jon C. 2002. "Democracy from the Outside-In? International Organizations and Democratization." *International Organization* 56(3).
- Plümper, T., Troeger, V. and Manow, P. 2005. "Panel Data Analysis in Comparative Politics: Linking Method to Theory." *European Journal of Political Research* 44: 327-354.

- Pogany, I. (ed.) 1995. *Human Rights in Eastern Europe*. London: Edward Elgar.
- Pop-Eleches, G. 2006. "From Crisis to Reform: Partisan Responses to Economic Crises in Latin America and Eastern Europe" *Annual Meeting of APSA*, 31 August-3 September, Philadelphia, PA.
- Pridham, G. and Lewis, P.G. (eds.) 1996. *Stabilising Fragile Democracies: Comparing new party systems in southern and eastern Europe*. Routledge.
- Pridham, G., Herring, E. and Sanford, G. (eds.) 1997. *Building Democracy? The International Dimension of Democratization in Eastern Europe*. London: Leicester University Press.
- Przeworski, A. 1991. *Democracy and the Market. Political and Economic Reform in Eastern Europe and Latin America*. Cambridge: Cambridge University Press.
- Putnam, R.D. (1988) "Diplomacy and Domestic Politics: The Logic of Two-Level Games." *International Organization* 42(3): 427-460.
- Rapaczynski, A. 1996. "The Role of the State and the Market in Establishing Property Rights." *Journal of Economic Perspectives* 10(2): 87-103.
- Rodrik, D. 1997. *Has Globalization Gone Too Far?* Washington, DC: Institute for International Economics.
- Rogowski R. 1987. "Trade and the variety of democratic institutions." *International Organization* 41: 203-224.
- Santiso, C. 2004. "The Contentions Washington Consensus: Reforming the Reforms in Emerging Markets." *Review of International Political Economy* 11(4): 828-844.
- Sayrs, L. 1989. *Pooled Time Series Analysis*. London: Sage Publications.
- Schedler, A., Diamond, L. and Plattner, M.F. 1999. *The Self-Restraining State. Power and Accountability in New Democracies*. Boulder: Lynne Rienner Publishers.
- Schimmelfennig, F. and Sedelmeier, U. 2004. "Governance by Conditionality: EU Rule Transfer to the Candidate Countries of Central and Eastern Europe." *Journal of European Public Policy* 11(4): 661-679.
- Schmitter, P. 2001. "The Influence of International Context Upon the Choice of National Institutions and Policies in Neo-Democracies" in Whitehead, L. (ed.) *The International Dimensions of Democratization: Europe and the Americas*. Oxford: Oxford University Press.
- Schwartz, H. 2000. *The Struggle for Constitutional Justice in Post-Communist Europe*. Chicago: University of Chicago Press.
- Slantchev, B. 2005. "The Political Economy of Simultaneous Transitions: An Empirical Test of Two Models." *Political Research Quarterly* 58 (2): 279-294.
- Stark, D. 1996. "Recombinant Property in East European Capitalism." *The American Journal of Sociology* 101(4).
- Stark, D. and Vedres, B. 2006. "Social Times of Network Spaces: Network Sequences and Foreign Investment in Hungary." *American Journal of Sociology* 111(5).
- Stone, R.W. 2002. *Lending Credibility: The International Monetary Fund and the Postcommunist Transition*. Princeton, N.J.: Princeton University Press.
- Tamanaha, B.Z. 2004. *On the Rule of Law*. Cambridge: Cambridge University Press.
- Tucker, J. 2006. *Comparative Economic Voting: Economic Conditions and Election Results in Russia, Poland, Hungary, Slovakia and Russia from 1990-99*. Cambridge: Cambridge University Press.
- Vachudova, M.A. 2001. "The Leverage of International Institutions on Democratizing States: Eastern Europe and the European Union." *EUI-RSCAS Working Paper*, Number 33.

- Vachudova, M.A. 2005. *Europe Undivided: Democracy, Leverage, and Integration After Communism*. Oxford: Oxford University Press.
- Verheijen, A.J.G. 1999. *Civil Service Systems in Central and Eastern Europe*. Cheltenham: Edward Elgar.
- Verheijen, A.J.G. 2000. "Administrative Capacity Development: A Race Against Time?" *WRR Working Document no.107*. The Hague: Scientific Council for Government Policy.
- Vreeland, J. 2003. *The IMF and economic development*. Cambridge: Cambridge University Press.
- Whitefield, S. and Rohrschneider, R. 2006. "Explaining Party-Citizen Linkages: Programmatism, Charisma and Clientelism in Post-Communist Party Systems." Manuscript.
- Whitehead, L. (ed.) 2001. *The International Dimensions of Democratization: Europe and the Americas*. Oxford: Oxford University Press.
- Williamson, John (ed.) 1983. *IMF Conditionality*. Washington DC: Institute for International Economics.
- Williamson, J. (ed.) 1994. *The Political Economy of Policy Reform*. Washington: Institute for International Economics.
- Williamson, J. 2003. "From Reform Agenda to Damaged Brand Name." *Finance and Development* 40(3): 10–3.
- Zakaria, F. 1997. "The Rise of Illiberal Democracy." *Foreign Affairs* 76(6): 22-43.
- Zielonka, J. and Pravda, A. (eds). 2001. *Democratic Consolidation in Eastern Europe*. Oxford: Oxford University Press.

## Notes

### Chapter 1:

---

<sup>1</sup> Some post-communist countries such as Hungary use complex electoral systems that mix proportional representation and single-member district electoral principles, but the overall logic even in those cases is to observe the proportionality of the vote for the different parties. Most post-communist countries have a unicameral parliament. In the case of bicameral parliaments, in order to form a government, again a parliamentary majority is necessary. Often, no party has a clear majority in parliament, in which case several parties come together to form a coalition government that can rely on the support of a parliamentary majority.

<sup>2</sup> I use 1994 and 2005 as the earliest and the latest year for which the data is available.

<sup>3</sup> The so-called “Europe Agreements” are association agreements between the European Union and the Central and Eastern European countries that subsequently became EU candidate countries. The Europe Agreements were signed in the mid-1990s (before the formal start of the accession negotiations) and contain provisions about setting up political dialogue with the EU; establishing business relations with the EU, particularly within a free-trade area; developing economic, cultural, social and financial cooperation with the EU; and aligning national legislation with EU laws.

<sup>4</sup> My argument draws on Milada Vachudova’s (2005) thorough analysis of domestic empowerment in the general case of democratizing reforms in Central and Eastern Europe after 1989.

<sup>5</sup> It is beyond the scope of my argument to summarize the origin and intricacies of the debate between the rationalist and the constructivist school. However, two excellent articles that provide an overview of what is at stake in this debate and whether we can find a common ground between the two research traditions despite their different ontological foundations are Finnemore and Sikkink’s (2001) article on constructivism in international relations and comparative politics and Jupille, Caporaso, and Checkel’s (2003) survey article on integrating rationalism and constructivism in the study of the European Union.