WHEN DOES THE LAW RULE? THE POLITICS OF BANKING SECTOR LEGAL REFORM IN THE POST-COMMUNIST REGION AFTER 1989

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A dissertation submitted to the faculty of the University of North Carolina at Chapel Hill in partial fulfillment of the requirements for the degree of Doctor of Philosophy in the Department of Political Science.

Chapel Hill
2007

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ABSTRACT

Aneta Borislavova Spendzharova: When Does the Law Rule? The Politics of Banking Sector Legal Reform in the Post-Communist Region after 1989
(Under the direction of Milada Anna Vachudova)

I focus on legal reform of the banking sector in this thesis because it is a pivotal part of economic restructuring after the fall of communism. I ask: How do governments decide whether to reform the country's banking sector legal framework and which course of legal change to pursue? Which mobilized actors, both domestic and international, influence legal change in the banking sector? I argue that the interaction of three factors—the partisan coloration of the governing elites, the strength and character of the mobilized domestic stakeholders, and the influence of international actors—has shaped the quality of banking sector legal reform in the post-communist area. In particular, this project enhances our knowledge of the political configurations that promote the adoption and implementation of good quality laws. Chapter 1 of my dissertation presents the theoretical framework that I use to analyze how political processes shape the course of banking sector legal reform. Chapter 2 focuses on Hungary as an example of a front-runner of economic reform in the region. Chapter 3 focuses on Bulgaria as an example of a slow reformer in the region. Chapter 4 shows how Bulgaria eventually changed course and improved the quality of its banking sector legal framework. Chapter 5 presents a pooled cross-sectional time series statistical test of my explanation using data from twenty-five post-communist states.

For my parents
Borislav and Sevda Spendzharovi

ACKNOWLEDGEMENTS

I began writing my dissertation on Robert Duivenvoorden's coffee table in Durham, North Carolina some two years ago. Since then, this project has been a source of elation, obsession, and despair, as I hauled my books, papers, and numerous back-up CDs with dissertation materials and chapter drafts across lands and through seasons. This thesis brings together spring strolls along the banks of the Danube in Budapest, scorching Bulgarian summers, rainy Dutch autumns, and winter days in the Chapel Hill/Carrboro cafés … and University of North Carolina's Davis library.

I am grateful to many for encouraging and supporting me along the way, but above all I thank my extraordinary parents Borislav and Sevda Spendzharovi for their love and level-headed advice. My sister Svetlana's cheerfulness has helped me keep writing on many a gray day. Robert Duivenvoorden has listened patiently to my rants and helped me stay sane. I especially appreciate Robert's dedication to teaching me how to cook. This newly acquired skill saved me from starvation while I was revising and finishing my manuscript. Elena and Theo Duivenvoorden have welcomed me to their home in Voorschoten and showed me a more refreshing side of life in times of dissertation doldrums.

I have spent wonderful five years as a graduate student in the Political Science Department at UNC – Chapel Hill. Milada Anna Vachudova, my dissertation advisor here, has been an amazing mentor, friend, and source of inspiration. She has persisted with reading and commenting on my dissertation chapters as well as conference, grant, and job

applications and supplications. While I was finishing this manuscript, Lukas Vachuda Bryant has taught me Czech and the most impressive lion roar.

I am very much obliged to the members of my dissertation committee: Liesbet Hooghe, John Stephens, Georg Vanberg, Robert Jenkins, and Graeme Robertson for their abiding interest in this project, extensive feedback, and help to sort through the multitude of obscure, potentially interesting, sensible, and not-quite-clear ideas that I produced in the course of writing. Ruth Mitchell-Pitts and the friendly staff at the UNC Center for European Studies have made many research and conference trips possible, and the Graduate School at UNC has provided me with much needed financial support. Reading and discussing the cutting-edge research in Latin American and European politics of the fantastic comparative politics faculty and graduate students and UNC – Chapel Hill have made my stay in North Carolina a rich intellectual experience.

My dear friends at the American University in Bulgaria and the University of North Carolina – Chapel Hill have encouraged me to be myself, even in times when I was a recluse, and have always been kind to give me lifts home (as I somehow never learned to drive). A big thanks to my social safe heaven: Adam, Agustina, Albena, Altin, Anna, Anca, Bobby, Cameron, Chad, Christian, Cosmina, David, Dimo, Edi, Elena, Eli, Emil, Erica, Erik, Florin, Gina, Iliana, Inés, Ivo, James, Jan, Jason, Jenny, Jeremy, Juan, Katja, Lauren, Lisa, Maria, Marko, Mary, Milena, Nedyalko, Patrick, Peter, Petya, Ryan, Sarah, Sinziana, Stefan, and Stella. I have completed this thesis with support and encouragement from many. As for the work itself: Ut desint vires tamen est laudanda voluntas.

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CHAPTER ONE

1. Introduction

To understand better the dynamics of political and economic adjustment in transitional countries, scholars and policy analysts are paying increasing attention to the rule of law. Democratization scholars have emphasized the overriding importance of legal reform for building liberal democracy (Linz and Stepan 1996; Carothers 1998; Diamond 1999; O'Donnell 2000). Acceptance of the rule of law is crucial because it reduces the arbitrary use of power, and allows political and economic actors as well as citizens to form reliable expectations about the behavior of policy-makers, administrative officials, and social actors in general.

Post-communist states have inherited similar policies and institutional arrangements from the previous regime. However, some eighteen 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 with clear separation of powers and functioning mechanisms of legal accountability: To a large extent, both elites and citizens abide by the law. In turn, 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 eschewed meaningful legal accountability. The authoritarian leaders and their entourage can easily circumvent or manipulate the legal system and are practically beyond the reach of the law. The presence of a weak legal system

that is somewhat institutionalized and operational, but at the same time easily influenced by powerful political and economic interests is typical of the partially democratic regimes that exist in the “gray zone” between liberal democracy and authoritarianism, and that are the most common regime type in the post-communist region.

While establishing the rule of law posed one formidable challenge to post-communist states, reforming the economy posed another. Following the collapse of the Soviet bloc in the early 1990s, policy-makers 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 task was to reconsider the dominant role of the state in economic affairs and, consequently, amend and update the legal frameworks of post-communist countries. 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, local government, enterprise management, and banking.

Scholars of political economy and law have analyzed the new laws that define property rights, settle issues of property restitution, and guide the privatization process in the post-communist region (Przeworski 1991; Comisso 1991; Haggard and Kaufman 1992; Rapaczynski 1996). Authors investigating the ongoing democratization and market reforms have established that informal political processes have a strong impact on the emerging regulatory frameworks (Hellman 1998; Seleny 1999). Moreover, in many post-communist countries, key institutions such as the judiciary, which are supposed to be impartial and

competent in applying and overseeing the laws, are still slow, inefficient, and easily influenced by political pressure (Carothers 1998; Magalhaes 1999; Hilmer 2002). Therefore, it is important to understand how political processes have shaped the regulatory outcomes in post-communist states since the beginning of transition.

I focus on legal reform of the banking sector in this thesis because it is a pivotal part of economic restructuring after the fall of communism. The banking sector provides vital financial resources for existing as well as 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 chemicals, metallurgy and electronics, need access to capital to buy new equipment, renovate the production infrastructure 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 indispensable for an emerging market economy. Political economists have examined the difference between the so-called "bank-based" and "market-based" financial systems in advanced industrialized countries. In "bank-based" systems, banks serve as the main source of capital, while in "market-based" systems, firms raise capital predominantly via the stock and capital markets (Zysman 1984; Levine 2002). Companies from post-communist states have used the domestic and international stock markets to access funds, but banks remain the primary source of capital in the region (Filer *et al.* 2001).

The post-communist transition has generated incentives for governing elites to pursue good quality legal reforms of the banking sector, but also incentives to stall these reforms. 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 capital

allocation, 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 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 (Ditlbacher *et al.* 2002; 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.

Yet 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 in the post-communist region face incentives to implement partial banking reforms, which would give them greater discretionary power in the allocation of 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, and the state budget can be used to write off the bad loans in the portfolios of the state-owned banks. In the post-communist region, there have been numerous cases when public financial resources were misused for the private benefits of influential political and economic elites (Hellman 1998; Ganev 2001; Barnes 2003; Gould 2003; Hoff and Stiglitz 2004). In particular, Juliet Johnson (2000) has shown how heightened

political uncertainty, a half-hearted democratization process, and failure to uphold the rule of law facilitate the development and perpetuation of distorted incentives in the banking sphere.

There are legal remedies that help prevent the misuse of the banks such as laws that promote transparency in bank operations and information-sharing concerning large loans; laws that allow the central bank to operate independently of short-term political pressures to bail out the government; and institutional mechanisms to monitor the compliance of the banks with the legal rules. The puzzles that animate my dissertation are: How do governments decide whether to reform the country's banking sector legal framework and which course of legal change to pursue? Which mobilized actors, both domestic and international, influence legal change in the banking sector? To tackle these puzzles, we need to deepen our knowledge of the political processes that promote the adoption and implementation of good quality laws.

In the post-communist region after 1989, domestic and international factors have interacted to shape the quality of legal reform in the banking sector. Drawing on the insights of the comparative politics literature, I investigate the policy impact of government coloration and 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 domestic political arrangements – so it is these diverging domestic outcomes that I seek to understand more fully.

The dependent variable in my dissertation is the quality of banking sector legal reform. I analyze how three factors—the partisan coloration of the governing elites, the character and strength of the mobilized domestic stakeholders, and the influence of international actors—shape the quality of banking sector legal reform. I examine why some

configurations of the three factors produce good quality legal change, while others perpetuate poor quality reforms.

After regime change in the post-communist region, we observe two outcomes of legal reforms in the banking sector. Some post-communist states have pursued good quality legal reforms. They have streamlined the bankruptcy procedures, strengthened the monitoring and supervisory capacity of the state, and granted autonomy to the central bank to set monetary policy relatively independently from political pressure. Other post-communist states have implemented partial, and often inadequate, legal reforms. Those partial reforms have led to the development of a weak banking sector, where many banks hold a significant percentage of bad loans in their portfolios, political interference and clientelism are widespread, and many businesses cannot access capital.

In my dissertation, I argue that the actions of the governing elites and the domestic stakeholders are mutually reinforcing. So far, the literature on the post-communist transitions has focused primarily on the economic policy impact of government partisanship, but it has missed the extent to which governments of different partisan coloration respond to, and even cater to, the demands of salient domestic stakeholders such as organized economic interests. International pressure for economic liberalization, including the banking sector, is important to achieve good quality legal change, but it is not sufficient if the government and the domestic stakeholders are opposed to change. The case study on Hungary (Chapter 2) demonstrates that a configuration where all three factors—the partisan coloration of the governing elites, the character and strength of the mobilized domestic stakeholders, and the influence of international actors—are favorable to economic liberalization translates into an incremental improvement of the banking sector legal framework. In the first case study on

Bulgaria (Chapter 3), however, I show that the unreformed left governments that dominated policy-making in the country in the period 1989-1997 forged strong alliances with rent-seeking domestic stakeholders and engaged extensively in clientelism. Even though international actors such as the IMF advocated economic liberalization in their meetings with successive Bulgarian governments, international pressure alone was not sufficient to bring about good quality reform of the banking sector legal framework.

Yet change did eventually take place in some post-communist countries where the legal reforms immediately following regime change had undermined the rule of law and the development of a functioning market economy. Bulgaria is one representative example of how the quality of the banking sector legal framework can improve significantly over time. Why and how did the improvement take place in Bulgaria after 1997? In the second case study on Bulgaria (Chapter 4), I demonstrate that this significant policy shift resulted from the confluence of two factors: a change in the partisan coloration of the government alongside with a change in the agenda and relative strength of the mobilized domestic stakeholders. After a severe financial crisis in 1997, the Bulgarian political system experienced a shift from an unreformed communist party in power to a center-right party in power, accompanied by an increase in the importance of foreign direct investors and domestic business groups that favored transparency and trade with Western economies. International actors such as the IMF and the EU had provided blueprints for economic liberalization to the Bulgarian governments even before the watershed domestic changes of 1997, but only after 1997 did their message receive serious consideration from Bulgarian policy-makers.

In three main ways, the findings of this study contribute to our understanding of how the nexus of political and economic interests determines the quality of legal reform after regime change. First, my dissertation demonstrates that post-communist political parties, on the left and on the right alike, are heavily influenced by organized economic interests. However, the relationship with economic actors that unreformed communist successor parties build and sustain is very different from that of reformed communist successor parties and right parties. Unreformed communist successor parties in government use their political power to restrict the access of new actors to the economic arena. At the same time, they preserve the clientelistic linkages among state officials, enterprise managers, and bankers inherited from the old regime. In turn, political elites from the unreformed communist successor parties depend on the continued support of their economic "clients" in order to obtain revenues and maintain their grip on power.

By contrast, right and reformed left governments seek to create a more pluralistic economic environment that can accommodate a variety of economic actors. Right and reformed left governments pursue economic stability and growth by enabling emerging domestic economic actors to operate and grow, and by seeking to attract foreign capital. For that reason, big domestic enterprises, export-oriented domestic businesses, and foreign investors have significant power to pressure the right and reformed left governments for favorable legislation in the economic arena. We saw that post-communist governments can use legal reform to influence the number and kinds of actors that operate in the economy. An important implication of this finding in the region is that clientelistic economic relations are very likely to persist unless an electoral change of the governing elites brings a reformed left or a liberal/right political party in power. The results of my analysis confirm Steven Fish's

(1997) argument that replacing the old elites in government via elections has led to better economic reform and performance in the post-communist region.

Second, I find that reformed communist successor parties and right/liberal parties adopt very similar economic policies when in government: they undertake measures to liberalize the economy and seek to improve the regulatory capacity of the state. In this sense, the economic policy choices of the reformed left parties in the region are similar to the centrist policy behavior of "Third Way" left parties such as "New Labour" in the UK.

Third, my dissertation shows that post-communist countries that implemented good quality legal reforms in their banking sectors such as Hungary behave like modern regulatory states. Their governments have ceded some state control and allowed for a greater role of the market in economic affairs. At the same time, these governments have enhanced the regulatory capacity of the state in areas such as supervising the bank licensing regime, enforcing more transparency in bank transactions, and monitoring capital adequacy ratios. Thus, rather than giving up altogether state power in the financial sector, governments have accepted the increased importance of market forces, but they have also increased the regulatory capacity of the state.

This chapter is organized in the following way: Section 2 situates my argument in the literatures on liberal and illiberal democracy and the rule of law. It also defines and provides a theoretical background of the dependent variable in my analysis: the quality of banking sector legal reform. Section 3 presents the rationale for my case selection and describes the research methods employed in my dissertation. Section 4 unpacks the three independent variables in my analysis: the partisan coloration of the governing elites, the character and strength of the mobilized domestic stakeholders, and the influence of international actors. It

also provides greater detail of the theoretical underpinnings of my project and how my research contributes to the different literatures that I use. Section 5 discusses the implications of institutional capacity for law implementation. In Section 6, I introduce two alternative hypotheses for the quality of banking sector legal reform in the region that focus on the role of economic development and culture. In conclusion, Section 7 summarizes the research hypotheses derived from my argument about the role of strategic political action in the course of legal reform.

2. Understanding Political and Legal Change in the Post-Communist Region

2.1 Liberal and Illiberal Democracy

My dissertation investigates what factors account for the different quality of banking sector legal reform that we observe across the post-communist region. In doing so, it contributes to a lively debate in comparative politics today: What factors have led to the divergent liberal and illiberal trajectories of reform in post-communist countries? Here I shed light on the distinction between liberal and illiberal democracy. I also provide a more extensive theoretical background for the concept of the rule of law (an important component of liberal democracy) and for the dependent variable in my analysis: the quality of banking sector legal reform.

The recent transitions to democracy across the globe have given rise to the need for a better conceptualization of the quality of democratic regimes. One way to evaluate the different forms of democratic governance is to consider the distinction between liberal and illiberal democracy. According to Larry 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 (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; Karl 1995; Bunce 1995; Zakaria 1997). 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 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 some open 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. The distinction between liberal and illiberal democracy is important for my argument, because my two cases, Hungary and Bulgaria, illustrate the political processes of banking sector legal change in those two regime types, respectively. In Chapter 4, I show what factors moved Bulgaria from a path of illiberal reform until 1997 to a path of liberal reform after 1997.

2.2 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. By examining the process of legal reform in the banking sector, my dissertation offers 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 application of the laws.

Brian Tamanaha points out that one notion 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 research tradition 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 notion of the rule of law concerns 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). Formal legality allows individual citizens as well as firms and organized interests to foresee with reasonable certainty how the authorities will exercise their coercive power. 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 the transactions take place (Williamson 1987). Research in economics has established that entrepreneurs are very reluctant to commit resources in an uncertain legal environment (Dixit and Pindyck 1994; Brunetti et al. 1998). In the realm of finance, Rafael La Porta et al. find that cross-national differences in the legal protections of investors explain variation in the ownership structure and financing of firms (1998:1151).

Yet formal legality by itself has some dangerous 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. However, formal legality can also serve as a tool to enforce political domination through extensive legal prescriptions. Guillermo O'Donnell has stressed 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" (2004: 5). In addition, O'Donnell (2004) emphasizes that the existence of a civic culture in the population supporting 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 that ensure the protection and social integration of ethnic minorities (Pogany 1995; Kelly 2004).

The third notion 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. 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 described above (Tamanaha 2004: 123). Gretchen Helmke (2002) has shown that under certain conditions a judiciary which is vulnerable to political interference can rule against its supposed political principals. Yet the general recommendation of academics and practitioners is to set up an independent judiciary that has the capacity to rule against the highest-ranking political elites if they transgress the boundaries on their power (O'Donnell 2000).

The cornerstone questions concerning constitutional design and the institutional set-up of checks and balances have been investigated extensively in the context of the post-communist transitions (Lijphart and Waisman 1994; Colomer 1995; Elster, Offe, and Preuss 1998; Schwartz 2000; Gönenç 2002). My dissertation contributes to the second and third notions of the rule of law: establishing and applying formal legality. I am primarily interested

in how political factors shape the nature and quality of the adopted laws. I also investigate how the composition and expertise of the judiciary affect law implementation.

2.3 Dependent Variable: Quality of Legal Reform of the Banking Sector

How do we judge the quality of legal reform? It is indeed hard to define the components of "good" banking sector legal reform in absolute terms. Below, I present the analytical strategy that I use to define the quality of banking sector legal reform, and consider some important criticisms of my conceptualization.

My analytical strategy is to take into account the starting point of Eastern European transitions and the goals of transition. Then, I identify benchmark legal reforms necessary to achieve those goals. In Eastern Europe, the transitional regimes started out with a communist political system and a planned economy, and the broad goals of transition were to establish a liberal democracy and a market economy. The literature developed in the last decade has demonstrated that in the banking sphere it is desirable to: provide clear market entry and exit conditions (Kroszner 1998; Fries 2005); ensure the ability of banks to function without excessive 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; Johnson 2006); 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 legal reform in the banking sector developed by the European Bank for Reconstruction and Development (EBRD). Although the 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 International Monetary Fund (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 included some provisions about banking sector laws. Therefore, with respect to the dependent variable in my analysis, we need to consider whether international actors have pushed through an ideologically-driven agenda, or a collection of "best practices." 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.

The origin of the term "Washington Consensus" can be traced back to a conference assessing policy reforms in Latin America that was held in Washington, DC in 1990. John Williamson first used the term with reference to the package of policies promoted by Washington-based institutions, in particular the US Treasury Department, in the context of the debt reduction negotiations with Latin American countries (referenced in Williamson 2003). Developed for Latin American countries in the late 1980s, the "Washington Consensus" policy package was subsequently extended to other transitional economies, including the post-communist states. Williamson (1994) singles out ten broad policy objectives of the "Washington consensus": fiscal discipline; reorientation of public expenditure; tax reform (broadening the tax base and cutting marginal tax rates); financial

liberalization (lifting capital controls); unified and competitive exchange rates; trade liberalization (reducing tariffs and eliminating non-tariff 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 by Washington-based financial institutions" (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 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 sets of criticisms of the "Washington consensus." The first set of criticisms considers "Washington Consensus" policies to be altogether inadequate. It dismisses the value of "Washington consensus" recommendations as a one-size-fits-all neo-liberal solution to a variety of underlying domestic problems in the target countries (Fine 2000: 131-135). A second set of criticisms attributes the shortcomings of this policy package to faulty implementation and reluctant reformers. For example, Barbara Stallings and Wilson Peres argue that first-generation "Washington consensus" reforms were in fact "incomplete and need complementary policies to make them function properly" (2000: 204). The authors point out that in many emerging economies, the institutions responsible for implementing economic reform are weak and fragmented. The

third set of criticisms alleges that the original reform agenda was incomplete and excessively narrow in scope. Within this set of criticisms, Pedro-Pablo Kuczynski and John Williamson (2003) emphasize that reform should not to be pursued in a purely technocratic way and in isolation from social actors, for example by creating a central budget office and stopping there. Instead, the authors argue that because the advocated reforms affect deeply the structure of domestic interests and incentives, they should be embedded in the policy process and institutional context of the target country in order to be successful (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 to create more competition; streamlining bankruptcy procedures; and strengthening the central bank and bank supervision (Nord 2000; Stone 2002). 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 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 currently advocated by proponents of the so-called second-generation "Washington consensus" policies.

3. Case Selection and Research Methods

My dissertation combines in-depth case study analysis with statistical testing. I use insights from comparative politics and international relations to form expectations about the possible patterns that link the independent 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. 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.

How did I select the two central cases in my dissertation, Hungary and Bulgaria? 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, 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 Uzbekistan have been exposed to a different configuration of international influences). Yet, Hungary and Bulgaria offer important variation in the domestic political structures and actors that shaped their political and economic trajectories in the early 1990s, as well as in the timing and nature of banking sector legal reform.

There are two broad types of transition in the post-communist region, and Hungary and Bulgaria exemplify each type (Vachudova and Snyder 1997). The Hungarian case is analogous to other front-runners of economic reform such as the Czech Republic, Poland, and Estonia with respect to the emergence of a pro-market consensus early in transition (Commiso 1991; Schopflin 1991; Grosfeld 1991; Bartlett 1997). Even if the timing and method of reform in areas such as bank privatization differed somewhat across these cases, an in-depth investigation of the Hungarian path of banking sector legal reform reveals political decisions and laws which were significant for all front-runners. For its part, 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 the 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. Chapter 2 examines the path of banking sector legal reform in Hungary during the period 1989-2005. Chapter 3 investigates the reasons for the poor quality of banking sector legal reform in Bulgaria until 1997, and Chapter 4 examines why the quality of legal reform improved significantly in Bulgaria after 1997.

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 since the beginning of transition in 1989. At the same time, Hungary and Bulgaria offer important variation in the timing, nature, and actors involved in reforming the banking sector legal framework. 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; and collected and analyzed copies of laws and records of parliamentary debates.

In the three case studies presented in Chapters 2, 3, and 4, I use the method of difference to identify sources of variation in the quality of banking sector legal change. Then, I use comparative historical analysis (CHA) as a core research strategy (Mahoney and Rueschemeyer 2003). I analyze the historical sequences in my 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 5 I employ pooled cross-sectional time series statistical analysis to test the plausibility of my arguments on the set of twenty-seven post-communist cases. The specification of the time series model that I use and the operationalization of the variables will be discussed in detail in Chapter 5.

4. Unpacking the Determinants of Banking Sector Legal Reform

So far, we saw that by investigating the ongoing amendment and updating of the banking sector legal framework of post-communist countries, my dissertation aims to illuminate the complex process of building the rule of law, which is an essential component of liberal democratic regimes. This project analyzes how three factors – the partisan coloration of the governing elites, the nature and strength of the mobilized domestic stakeholders, and the influence of international actors – shape the quality of legal reform in the banking sector. I examine why and how some configurations of the three factors produce good quality legal change, while others perpetuate poor quality reforms.

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. I seek to understand whether the distinction between three types of partisan coloration—reformed communist successor parties, unreformed communist successor parties, and right-wing parties in government—affects the quality of legal reform in the banking sector. In addition, it is very important to understand whose preferences the political parties aggregate when they engage in policy-making. In light of recent evidence that political parties in Eastern Europe are estranged from voters (Kopecky 1995; Kitschelt 2000; Lewis 2001), I argue that post-communist political parties are heavily influenced by organized stakeholders such as domestic economic groups and foreign investors.

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 to build liberal democracy and market economy. I argue that 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.

In the post-communist region after 1989, domestic and international factors have interacted to shape the quality of legal reform in the banking sector. Below, Section 4.1 examines how the first factor in my theoretical framework, the partisan coloration of the governing elites, influences the quality of legal reform. I draw on the partisan politics literature to analyze the importance of government coloration. Section 4.2 unpacks the second factor in my theoretical framework: the mobilized domestic stakeholders. I use the literature on hybrid democracies and the comparative political economy literature on foreign

direct investment and trade to understand the role that the mobilized domestic stakeholders play in the process of legal reform. Section 4.3 discusses the impact of international actors on reforming the banking sector legal framework. To understand the influence of international actors, we need to look at three important mechanisms: 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 central banks; and the knowledge transfer that occurs between international financial experts and their counterparts from the post-communist region.

4.1 Partisan Coloration of the Governing Elites

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. Furthermore, Peter Mair (1997) has emphasized that apart from seeking office to maximize their own leverage in the policy-making process, political parties also interact and respond to the strategies and behavior of other parties in the political system.

Between 1945 and the 1989/1990, the countries in the region were ruled by the respective national communist party. 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, the end of communist rule brought about one dramatic domestic transformation: regime change opened the electoral arena to multi-party competition. Thus, newly formed political parties alongside with communist

successor parties and the parties that were revived after being disbanded in the 1940s suddenly competed with one another for the citizens' votes and a share of the seats in parliament. In parliamentary systems with a proportional representation electoral system, adopted by most post-communist countries after 1989, the government usually has the support of a parliamentary majority, and thus it can pass its most preferred policy agenda.[1] Therefore, after transition, political parties became pivotal in determining 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 successor parties 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). By reformed communist successor parties I mean political parties of the left that uphold liberal democratic standards, accept the market as organizing principle of the economy, and distance themselves from the human rights violations and economic mismanagement of the communist party which they have succeeded. 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 understand the association between partisanship and the quality of economic reform in the post-communist region: party ideology and political competition. Valerie Bunce (1999) demonstrates 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 a viable alternative to the economic policies under communism.

What mechanism accounts for the correlation between reformed communist/socialist governments in power and better economic reforms? Milada Vachudova (2001; 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 the 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; 2007) 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 impact of center-right and reformed communist successor parties in government on economic restructuring to be valid in the particular case of banking sector legal reform.

Hypothesis 1: We expect good quality banking sector legal reform if the domestic political process is characterized by center-right or reformed communist successor parties in power.

4.2 Domestic Stakeholders and Domestic Alliances

My research project acknowledges the importance of political parties in shaping 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 breaks new ground by investigating the alliances between political parties and the 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).

The relationship between the governing elites and the mobilized domestic stakeholders is an important and neglected domestic determinant of the quality of banking sector legal reform. 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 in post-communist countries is characterized by the formation of strategic alliances between the government and the domestic stakeholders in order to adopt and implement policy change. I argue that we can discern two distinct patterns of domestic alliances in the region. On the one hand, unreformed communist successor parties in government perpetuate and reinforce clientelistic alliances among state officials, economic managers, and finance professionals inherited from the old regime. On the other hand, center-right and reformed left governing elites reach out to foreign investors and export-oriented domestic businesses. Although this is the general pattern that we observe, research has shown that even reformed communist successor parties which have championed economic liberalization unequivocally such as the Hungarian Socialist Party (MSZP) have preserved some of the "old ties" from the communist economy (Stark and Bruszt 1998; Stark and Vedres 2006).

Before I examine in detail the two patterns of domestic alliances, let us consider some important insights from the literature about the nature of political processes in the region. 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. Do these assumptions hold in the post-communist region? 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 relatively stable party organizations, stable patterns of interaction among the political parties, and increasing voter familiarity with the policies endorsed by the different political parties (Bakke and Sitter 2005: 258).

However, the assumptions about a high degree of party cohesion and crystallization of programmatic parties become questionable 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 argues 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 and Poland have a propensity toward programmatic parties, but political parties have a fuzzier agenda than those in the "bureaucratic-authoritarian" communist regimes. According to Kitschelt's classification, "patrimonial" communist regimes such as Bulgaria and Romania face a bleak prospect of developing programmatic parties, because political competition in such regimes is highly personalized and revolves around charismatic leaders (Kitschelt 1995: 467).

An expert survey conducted in Eastern Europe to investigate the nature of the linkages between political parties and the citizens has established that the communist successor parties are the most entangled in clientelistic linkages. Stephen Whitefield and Robert 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 those parties (2006: 18). Yet, the authors do not distinguish between reformed and unreformed communist successor parties. The political parties on the right end of the spectrum in the region tend to be programmatic and non-charismatic. In contrast to the communist successor parties, political parties on the right are also significantly less clientelistic (Whitefield and Rohrschneider 2006: 18). According to the authors' statistical analysis, party-level factors such as party ideology and party organization are more important determinants of the nature of 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). Thus 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 the political parties' policy positions.

Why is domestic coalition-building essential to understanding the process of banking sector legal reform? In parliamentary proportional representation systems, which most post-communist countries adopted after 1989, [2] 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 at 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 has to convince social and economic actors to play by the new rules. 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 the banking sector 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 emerging 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 comprehensive 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.

Section 4.1 distinguished between governments headed by an unreformed communist successor party, on the one hand, and governments headed by a right-wing or a reformed communist successor party, on the other hand. I hypothesized that the latter two types of government are more likely to introduce good quality banking sector legal reforms. Here, I investigate the sources of the political elites' policy choices. I argue that unreformed and unchallenged communist successor parties in government face very different domestic incentive structures, compared to right-wing or reformed communist successor parties in government. 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 little 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 quiescent 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 shifting the costs to 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 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 and attract more votes in the elections. 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.

Domestic Alliances of Unreformed Communist Successor Parties: Clientelism in Hybrid Regimes

An important part of understanding the nature and timing of banking sector reforms in the post-communist region is to identify which domestic groups have mobilized against the introduction of comprehensive economic reforms and why. At the outset of the transition

process, Adam Przeworski (1991) and Stephan Haggard and Robert 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 Joel Hellman (1998) has collected ample evidence that the obstacles to economic reform in post-communist countries have come from a different source. Hellman 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. According to Hellman, the post-communist experience has shown 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 those actors can hardly be classified as short-term net losers of economic reform. On the contrary, they were the earliest and biggest winners.

Hellman clarifies 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 such as Bulgaria until 1997.

Hypothesis 2: We expect poor quality banking sector legal reform if the domestic political process is characterized by an alliance between unreformed communist 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 unreformed communist 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.[3] Appendix II contains information about the data sources. The first EBRD assessment conducted in 1994 used only three categories for the quality of banking sector reform, but the following assessments have used a finer measure that includes eleven categories. In Chapter 5, I develop a more comprehensive statistical model that employs pooled cross-sectional time series analysis.

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

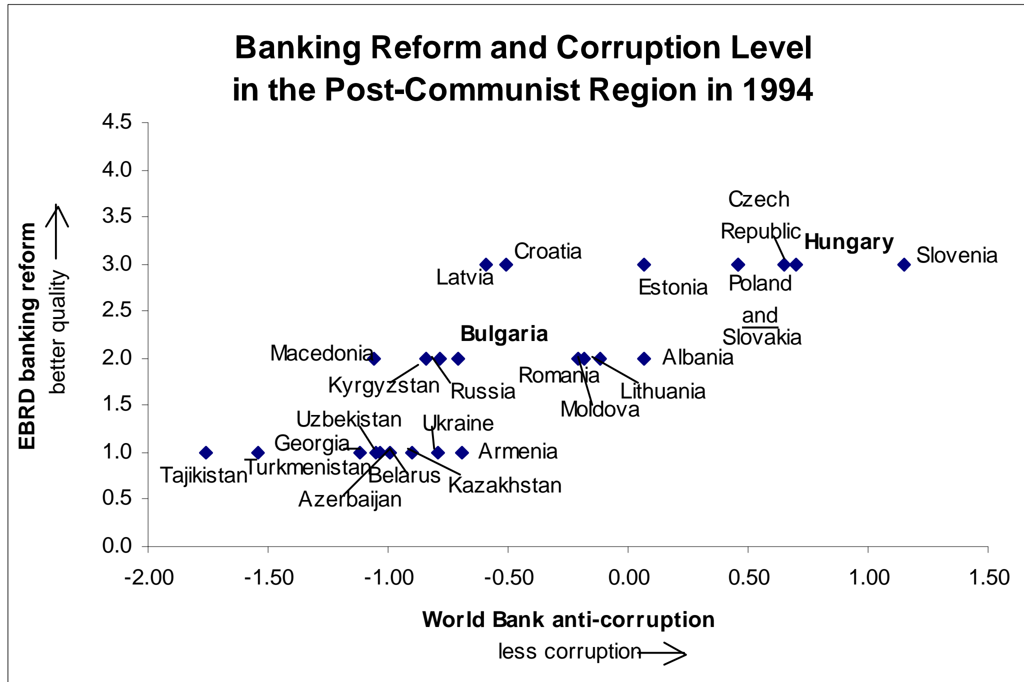
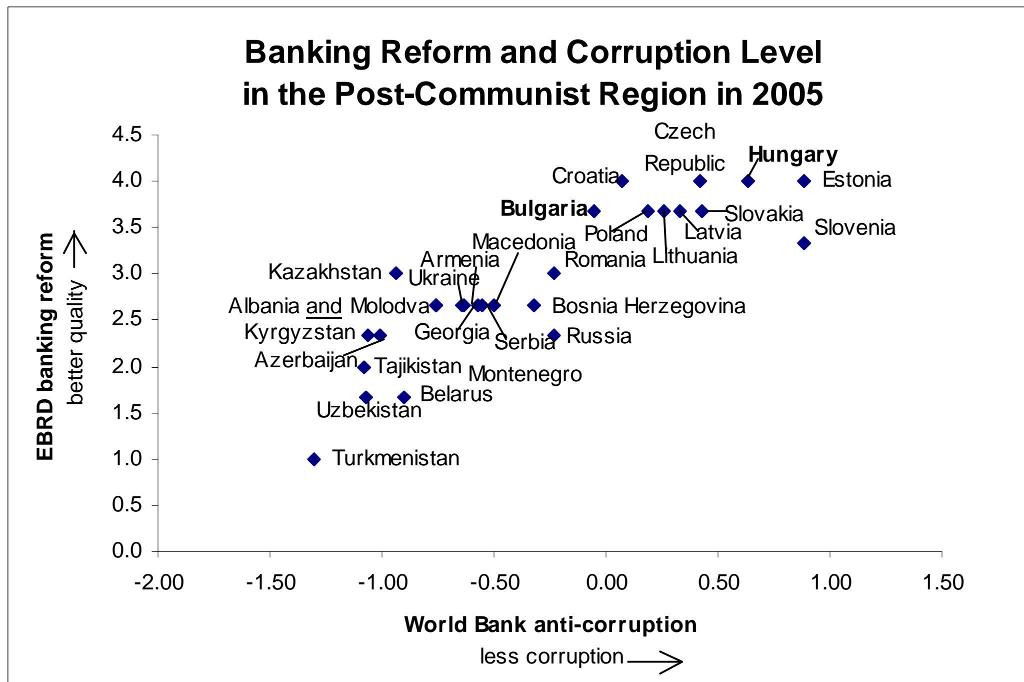


Figure 1.2: Quality of banking sector reform and corruption level in the post-communist region, 2005



Domestic Alliances of Reformed Communist Successor Parties and Right-Wing Parties: The Leverage of Foreign Investors and the Role of Trade with Advanced Industrialized States

Unreformed communist successor parties in the region tend to introduce only partial economic reform and perpetuate the clientelistic networks between state officials, economic managers, and finance professionals inherited from the previous regime (Hellman 1998). By contrast, 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 and attract more votes in the elections.

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 can be used to supplement low domestic resources to finance both ownership change and capital formation. Compared with other options for financing, FDI also facilitates the transfer of technology, know-how and skills, and helps local enterprises to reach foreign markets (Krkoska 2001; Ditlbacher *et al.* 2002).

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. Leslie Lipschitz, Tomothy Lane, and Alex 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 demonstrated that the EU Member States have been the most important source of FDI in Central and Eastern Europe (2002: 558). Furthermore, 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 frameworks in the post-communist countries where they set up operations (Bonin and Wachtel 1999).

Hypothesis 3: We expect good quality banking sector 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 the development of domestic institutions exists in the case of trade. Trade patterns are influenced primarily by considerations about economic efficiency, comparative advantage, and production costs. But is there a relationship between trade patterns and domestic political arrangements? 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) has found 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 the role of government intervention in the economy. However, one less contentious finding is that trade openness also generates pressures for more transparency and efficiency of the domestic financial sector (Beck et al. 2001).

Scholars of political economy have shown that since the 1970s, the world economy has become more integrated and the degree of trade liberalization has increased (Jordan and Majnoni 2002). Because the trade in goods is associated with the provision of financial services, the growth in the volume of international trade has also 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 ambiguous, some of them, including the EU, NAFTA, and ASEAN, have a positive effect on lowering trade barriers and reinforcing unilateral moves toward freer trade (1999: 106). Milner's analysis contains 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 foreign trading partners compliance with the legal benchmarks observed within that regional trade regime.

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.[4] The Europe Agreements obliged Central and Eastern European countries (CEECs) to open their markets to EU imports and eliminate trade barriers. Kaminski emphasizes that even before the formal completion of the eastward enlargement of the EU in 2004 and 2007, the Europe Agreements

promoted not only trade openness but also the adoption of Western-style company and competition laws, banking laws, laws on mergers and state aid, and intellectual property laws (2001: 5).

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

4.3 The Influence of International Actors

Against the backdrop of the growing social and economic interactions among the world's states and the increasing policy salience of international organizations such as the European Union, NATO, the IMF, and the World Bank, political scientists have produced a body of innovative research that explores 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 issue areas ranging from minority rights to monetary policy (Przeworski 1991; Aslund 2002; Jacoby 2004; Kelley 2004; Vachudova 2005; Grabbe 2006). My dissertation examines the policy tools that different international organizations use to influence banking sector 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 have the potential to

play an important role in the economic transformations, or lack thereof, in the post-communist region. Yet for policy transfers to occur, the relevant international actors have to be actively engaged in promoting a policy agenda—and the target country's government must be receptive to international advice.

Drawing on the insights of the international relations literature, I propose three salient mechanisms whereby international actors influence the course of domestic legal change: conditionality, selective domestic empowerment, and socialization. The three mechanisms have been discussed in the literature, but their overriding importance in the political process of changing banking sector laws in the post-communist region was corroborated by my field research interviews with policy-makers and scholars. Below, I elaborate on each mechanism in turn. Figure 1.3 presented at the end of the section shows these three mechanisms. What kinds of actors do the three mechanisms affect? Through conditionality, international actors influence the government of the target country. Selective domestic empowerment by international actors affects domestic institutions and domestic stakeholders. Socialization can transmit international influences both to the governing elites and domestic stakeholders.

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 that the post-communist candidate countries adopt the banking legal standards operating in the Union as part of the obligatory pre-accession transposition of the

acquis communautaire. As the case study chapters in my dissertation will show, conditionality has been an important determinant of the course of banking sector reform in the post-communist region, but in a more subtle way than described in the literature. Pressuring the government to accept the policy recommendations of international actors has caused some changes in the domestic legal framework, but conditionality alone does not lead to sustained domestic reform unless it is coupled with changes in the agendas and relative power of the relevant domestic stakeholders through the second mechanism presented below – domestic empowerment.

IMF conditionality was introduced in the 1950s as a way of ensuring that governments did not squander the financial support provided by the Fund. The IMF offers financial assistance only on condition that the target government agrees to pursue a range of economic stabilization and adjustment policies that are specified in a "letter of intent" document signed by the government and the Fund (Williamson 1983; Dreher and Vaubel 2003; Bird and Willet 2003). Over time, IMF conditionality has generated significant debate in the policy community. It has been reviewed by the Fund on a number of occasions and its nature has changed over time.

The IMF claims that its conditionality policies have a positive effect on the stability of the target country's financial system and attracting capital inflows. 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 pushed for 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). In my dissertation, the second case study on Bulgaria (Chapter 4) confirms that IMF conditionality helped curb inflation and stabilize the Bulgarian economy following the 1996/1997 financial crisis.

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 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 the formulation of any explicit demands for changes by the EU policy-makers. By contrast, "active leverage" denotes the deliberate use of conditionality by the EU in order to achieve domestic policy changes in the target states (2005: 63). Vachudova has analyzed the conditions under which the EU's leverage can influence illiberal regimes in the post-communist region (2006). One crucial prerequisite for the political elites in such regimes to consider the policy recommendations of international actors and embark on a liberal path of reforms, including in the economic sphere, 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 up the illiberal regime to international influences are slim.

In the economic sphere, Walter Mattli and Thomas Plümper (2004) have shown that EU conditionality provides a ceiling on the permissible market distortions and, consequently, constrains the opportunities to profit from clientelistic policies. In this context, governments in less democratic countries face a higher political price for compliance with EU conditionality, compared to more democratic regimes. According to Mattli and Plümper (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 prerequisites 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 costs of adopting and adhering to more liberal regulations (2004: 663).

According to Amichai Magen (2006), three factors influence the success of international conditionality. First, as outlined in the preceding paragraph, the success of conditionality policies depends on the ability of international actors to offer a desirable reward in exchange for the demanded domestic adjustments. Second, the success of

conditionality depends on how well the policy reflects the local circumstances and addresses local concerns. Third, the extent of compliance is affected by the degree of specificity of the demands and the rewards. Magen argues that all three factors were calibrated well in the case of the 2004/2007 enlargement of the EU (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 political costs of thorough regulatory reform. Therefore, it is worthwhile to probe whether in general international conditionality has affected banking sector legal reform in the post-communist region.

Hypothesis 5: We expect good quality banking sector legal reform if a country has been involved consistently in IMF and EU conditionality programs.

Domestic Empowerment by International Actors

The second salient mechanism of international influence in my theoretical framework—selective domestic empowerment[5] —means that some domestic groups such as human rights NGOs, particular state institutions, or 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 post-communist 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 independence of the central bank; strengthening

(and in some countries demanding the creation of) a state agency for financial oversight; and 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 presents examples of institutional domestic empowerment due to 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 rather inconspicuous. They were in charge of implementing regional PHARE projects. However, the role and the budget of the CDCs increased significantly over time due to the growing influence of the EU on Hungary’s domestic politics. Currently, the county development councils act as one of the key institutional pillars of implementing the EU’s Regional and Cohesion policy in the country (Jacoby 2004: 91).

In the realm of banking reform, Juliet Johnson (2006) demonstrates 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 the advanced industrialized states. The emerging financial sector in the post-communist countries has not necessarily welcomed independent central banks, because they often take 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" (2006: 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 (2006: 364).

Hypothesis 6: We expect good quality banking sector legal reform if international actors empower organizations such as independent agencies responsible for monitoring the financial sector and independent central banks.

Socialization

The two mechanisms outlined above, conditionality and domestic empowerment, represent a link between the demands of international actors and the response of domestic actors or institutions in terms of behavior and policy outputs, without referring to the inherent knowledge and preferences of the domestic players. By contrast, the third mechanism—socialization—entails policy change on the domestic level as a result of altering the cognitive beliefs and preferences of the relevant domestic players. The first two mechanisms are easier to detect and confirm empirically, whereas socialization requires direct evidence about the knowledge, 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' cognitive beliefs and 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.[6] 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.

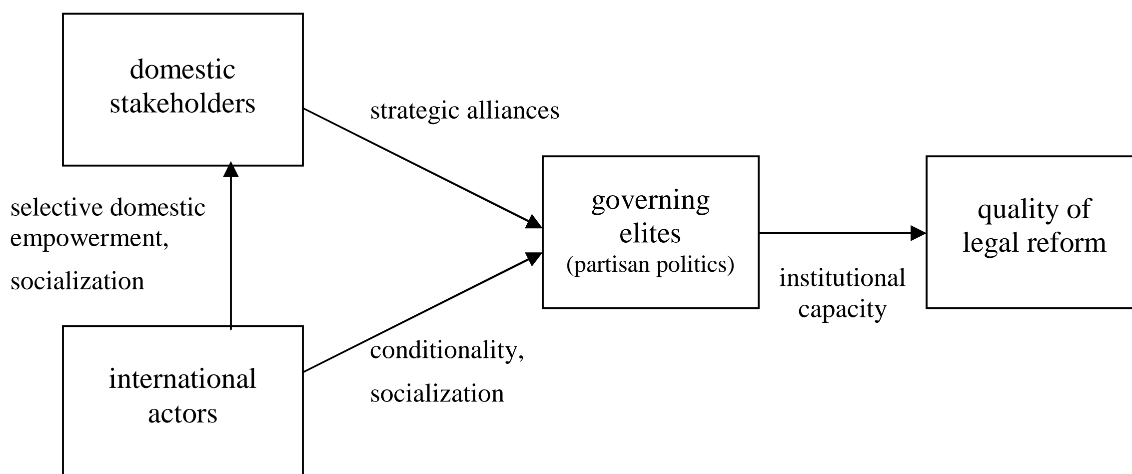
Rachel Epstein's work (2006) bridges the rationalist and constructivist approaches to analyzing policy change. According to Epstein, the rational calculations of domestic actors take place in a wider social context. Therefore, it is important to analyze the social interactions between domestic policy-makers and international advisors in order to understand the policy outcomes. In her investigation of the transformation of central banking policy in Eastern Europe, Epstein (2006) finds that international institutions can create support for particular ideas in a target society when the domestic policy-makers actively seek

foreign 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 specific recommendations for policy change. Epstein argues that policies such as central bank independence became institutionalized across the post-communist region because international institutions successfully cultivated a consensus in favor of central bank independence through persuasion, argumentation, and coalition building (2006: 1020).

Hypothesis 7: We expect good quality banking sector legal reform if elite socialization is taking place between the local elites and international proponents of banking reform.

Figure 1.3 illustrates the relationships between the three factors in my explanation of legal change in the banking sector of post-communist countries and shows the most important political mechanisms discussed in this section. At the end of the chapter, I summarize the set of testable hypotheses derived from the theoretical framework presented in this chapter.

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



Subsequently, in Section 5, I consider the implications of the state's institutional capacity for law implementation. Section 6 presents two alternative explanations of banking sector legal reform that are based on economic development and intrinsic cultural differences. In conclusion, Section 7 summarizes which of the hypotheses derived from my theoretical framework will be tested in Chapter 5 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.

5. Institutional Capacity

Whereas the partisan coloration of the governing elites, the nature and strength of the mobilized domestic stakeholders, and the influence of international actors make a significant impact during the early phases of legal change: the stages of law drafting, adoption, and amendment, the state's 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 the role of two key domestic institutions: the state administration and the judiciary. Chapter 2 demonstrates that Hungarian policy-makers adopted good quality banking sector laws, and the highly-skilled administration and relatively efficient judiciary have assisted governments during the law implementation stage. After 1997, the quality of Bulgaria's banking sector legal framework improved significantly, but the unsatisfactory performance of the state administration and the judiciary has influenced negatively law implementation. Chapter 4 shows how the EU accession process provided tools and incentives to tackle Bulgaria's problems with law implementation.

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 the state's 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, 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, for post-communist countries, the transformation of the administration into a professional and efficient organization has been a persistent challenge 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 states, "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 have found statistical evidence that the most significant determinant of quick and successful harmonization with EU laws between 1999 and 2003 in the thirteen EU candidate countries from the post-communist region is the strength and

competency of the state bureaucracy, rather than the peculiarities of the country's institutions, the number of relevant veto players, or political manipulation (2006: 547).

The judiciary is another key 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. The OSI country reports (2002) identify a bundle of recurring problems in the post-communist countries, including poor funding for the judges and lack of support staff; questionable judicial selection criteria and performance evaluation; poor working conditions; and limited capacity for electronic processing of the cases.

According to legal scholar Frank Emmert, 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 the perpetuation of common practices during communism such as "authoritarianism, nepotism, corruption, and indecision" (Emmert 2003: 296). In Emmert's view, 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). Next, we turn to two alternative explanations of banking sector legal reform.

6. Alternative Explanations

What are some plausible alternative explanations of why banking sector legal reform occurs, or fails to take place, in the post-communist region? I argue that the policy outcomes are driven by three factors: the partisan coloration of the governing elites, the nature and strength of the mobilized domestic stakeholders, and the influence of 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.

6.1 Economic Development

Adam Przeworski et al. (2000) examine systematically the relationship between regime type (democratic or authoritarian) and economic performance. As part of the analysis, the authors draw conclusions about the relationship between the nature of political and institutional arrangements and the level of economic development of different regime types. Although Przeworski et al.'s analysis is more sophisticated and nuanced than modernization theory accounts, it contends, in essence, that "poor countries cannot afford a strong state" (2000: 163). According to the authors' analysis of cross-sectional 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 those

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 whether the level of a country's economic development is the single most important factor that shapes its domestic institutions. Following the logic of the economic development argument, we should expect predominantly wealthy countries in the post-communist region to pursue good quality banking sector legal reforms.

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

6.2 Culture

Although it is difficult to capture the concept of culture in quantifiable terms, some scholars have attempted to study systematically the impact of culture on institutions and governance. Amir Licht et al. (2006) have analyzed the impact of culture on the rule of law, curbing corruption, and democratic accountability, which they regard as social norms. The authors identify seven broad types of world culture and examine the systematic influence of culture type on the social norms in their research project, including a norm called "respect for the law." The scholars find statistical evidence that "national cultural profiles predict governance outcomes some thirty years later" (2006: 29) and, therefore, they propose that the direction of causality flows from culture to social norms, including respect for the law. What is of particular relevance for my project is that Licht et al. (2006) claim that different cultural patterns are associated with systematically different levels of respect for the law. According to Licht et al.' s analysis, the wide acceptance of social norms such as law abidingness,

absence of corruption, and adherence to democratic principles is strongly related to the existence of "a broad cultural endorsement of individual autonomy" (2006:30).

Further back in time, Max Weber wrote in "The Protestant Ethic and the Spirit of Capitalism" that, historically, Protestantism encouraged the rational pursuit of economic gain and gave worldly activities such as developing one's own enterprise, engaging in trade, and accumulating wealth for investment a positive spiritual and moral meaning (1904/2003: 35-37). Writing in the early 1900s, Weber observed that the strong religious underpinnings of the protestant ethic in society were slowly disappearing. However, the emphasis on individualism, hard work, frugality, and profitable investment persisted. Such cultural values would be favorable for economic development. Of course, Weber stressed that while protestant cultural values had exerted a major influence on the course of economic development in Europe and United States, they were one important factor among many. According to Weber, equally significant factors for the development of capitalism were the pursuit of rationalism and scientific reasoning, the growing role of jurisprudence, and the development of large government and enterprise administrations to implement and monitor complex organizational planning (1904/2003: 25-27, 108, 136-147).

Alternative hypothesis 2: We expect good quality banking sector legal reform if there is an existing culture that supports the development of law-abidingness and market institutions.

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 domestic actors are mobilized to

carry out the necessary reforms. By contrast, structural accounts would predict little or no policy change if the underlying characteristics of the economic and social system remain largely the same.

7. Conclusion

In this chapter, I have argued that the interaction of three factors—the partisan coloration of the governing elites, the strength and character of the mobilized domestic stakeholders, and the influence of international actors—has shaped the quality of banking sector legal reform in the post-communist area. My research enhances our knowledge of the political configurations that promote the adoption and implementation of good quality laws. I break new ground by investigating the policy impact of alliances between political parties and organized interests in the region. Below, I summarize the arguments presented so far into a set of hypotheses that will be tested statistically in Chapter 5 of my dissertation, with the exception of Hypotheses 6 and 7 for which I do not have cross-sectional time series data. I will probe the plausibility of those two hypotheses using evidence from my case studies on Hungary and Bulgaria.

Hypothesis 1: We expect good quality banking sector legal reform if the domestic political process is characterized by center-right or reformed communist successor parties in power.

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

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

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

Hypothesis 5: We expect good quality banking sector legal reform if a country has been involved consistently in IMF and EU conditionality programs.

Hypothesis 6: We expect good quality banking sector legal reform if international actors empower organizations such as independent agencies responsible for monitoring the financial sector and independent central banks.

Hypothesis 7: We expect good quality banking sector legal reform if elite socialization is taking place between the local elites and international proponents of banking reform.

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

Alternative hypothesis 2: We expect good quality banking sector legal reform if there is an existing culture that supports the development of law-abidingness and market institutions.

This first chapter of my dissertation has presented the theoretical framework that I use to analyze how political processes shape the course of banking sector legal reform in post-communist countries. The following three chapters of my dissertation are focal case studies of banking sector legal reform in Hungary and Bulgaria. I conduct an initial probe of the explanatory power of the theoretical framework put forward in this chapter. Chapter 2 focuses on Hungary as an example of a front-runner of economic reform in the region. Chapter 3 focuses on Bulgaria as an example of a slow reformer in the region. Chapter 4 shows how Bulgaria eventually changed course and improved the quality of its banking

sector legal framework. The case studies also allow me to uncover the concrete mechanisms that explain how the domestic and international political constellations influence banking sector legal reform. Chapter 5 presents a pooled cross-sectional time series statistical test of my explanation using data from the post-communist region and discusses in greater detail the operationalization of the variables used in the test. In the Conclusion, I summarize the main findings of my dissertation.

Notes
Chapter 1:

[1] 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 East and Central European states 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. Central Asian post-communist states such as Kazakhstan and Tajikistan also have elected parliaments, but in those systems, the elected president of the country holds overriding power to appoint the cabinet and steer policy. In states such as Armenia and Georgia, the parliament has more policy-making powers than in the Central Asian states, but the elected president still has more power than his/her counterpart in the East Central European states.

[2] This argument applies best to the East and Central European states, in which the parliament is the center of law-making. In the presidential and semi-presidential systems in the region such as Kazakhstan and Georgia, the president exercises a great degree of influence over the adopted policies, even though the formal law-making activities still take place in the parliament.

[3] I use 1994 and 2005 as the earliest and the latest year for which data is available.

[4] 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.

[5] 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.

[6] 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 schools 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.

CHAPTER TWO

To summarize briefly my theoretical framework presented in Chapter 1, I argue that three factors—the partisan coloration of the governing elites, the nature and strength of the mobilized domestic stakeholders, and the influence of international actors—shape the quality of banking legal reform in the post-communist region. I examine why some configurations of the three factors produce good quality legal change, but others perpetuate poor quality reforms.

This chapter demonstrates that the driving force of the observed incremental improvement of banking sector laws in Hungary since 1989 has been the alternation of reformed communist and right-wing partisan elites in government, and their sustained alliance with domestic stakeholders in favor of economic liberalization. International actors have been active proponents of economic liberalization in Hungary. But I argue here that even without the involvement of international actors, the strong domestic coalition in favor of economic reform would have adopted good quality banking sector laws. Can we find sufficient evidence that corroborates my argument? In Chapter 2, I evaluate the set of hypotheses presented in Chapter 1 in a case study of the political and economic developments in Hungary after 1989.

The Hungarian case is analogous to other regional leaders of economic reform such as Poland, the Czech Republic, and Estonia with respect to the emergence of a consensus in favor of economic liberalization early in the transition process (Commiso 1991; Schopflin 1991; Grosfeld 1991; Bartlett 1997). Even if the particular choices of timing and methods of

reforms such as bank privatization differed across these cases, an in-depth investigation of the Hungarian path of reforming the legal framework in banking will reveal political decisions and laws that represent important steps toward creating a more efficient and reliable banking sector in transitional economies.

In Hungary, some market liberalization took place even during communist rule. The Hungarian communist party was overall moderate and prone to compromise. After the crush of the 1956 Hungarian uprising led by reform communist Prime Minister Imre Nagy, the new Hungarian leaders adopted a more moderate economic policy domestically. In 1968, communist planners initiated small-scale market and price liberalization, and in 1982 Hungary became member of the IMF, largely due to difficulties with servicing its significant foreign debt (Bartlett 1997). With this background in mind, it is not surprising that within four years after the collapse of communism, nearly half of the economy had been transferred to private hands, and by 1997 Hungary had attracted almost half of all foreign direct investment in the post-communist region (World Bank 2004).

In June 1989, the crushing defeat of the communist party in the first Polish multi-party elections came as a shock to its counterparts in the region. Inspired by the Polish roundtable talks that were held in February-April 1989, members of the Hungarian opposition and civil society met with the ruling communist elites in a series of roundtable talks that took place in the summer of 1989. The main purpose of those talks was to agree upon a framework for transition to a multi-party constitutional democracy (Elster *et al.* 1998: 66). The participants discussed a range of subjects such as choosing an electoral system to allocate the seats in parliament and deciding on the balance of power between the president and parliament. A key issue was to reach compromise: The communist elites wanted to

remain in the political system, while the opposition insisted on guarantees for fair competition and that authoritarian reversal would not occur (Elster *et al.* 1998). The Hungarian opposition lacked the tight and efficient organization of Poland's *Solidarność* movement, but the roundtable negotiations did pave the way for the first democratic multi-party elections in the country, and also resulted in revising the Constitution (Tőkés 1996: 357). The new Hungarian Constitution was enacted in October 1989, and the first freely contested multi-party elections took place in 1990 (Tőkés 1996: 361-388). Table 2.1 presents the constitutional set-up of the main political institutions in Hungary.

The rest of this chapter is organized as follows: Section 1 outlines the evolution of banking sector laws in the country after 1989. In Section 2, I assess the evidence from the Hungarian case with respect to the important domestic and international determinants of banking sector legal reform. Section 3 discusses additional domestic factors that influence law implementation, and Section 4 summarizes the main findings of the case study.

Table 2.1: Main political institutions in Hungary

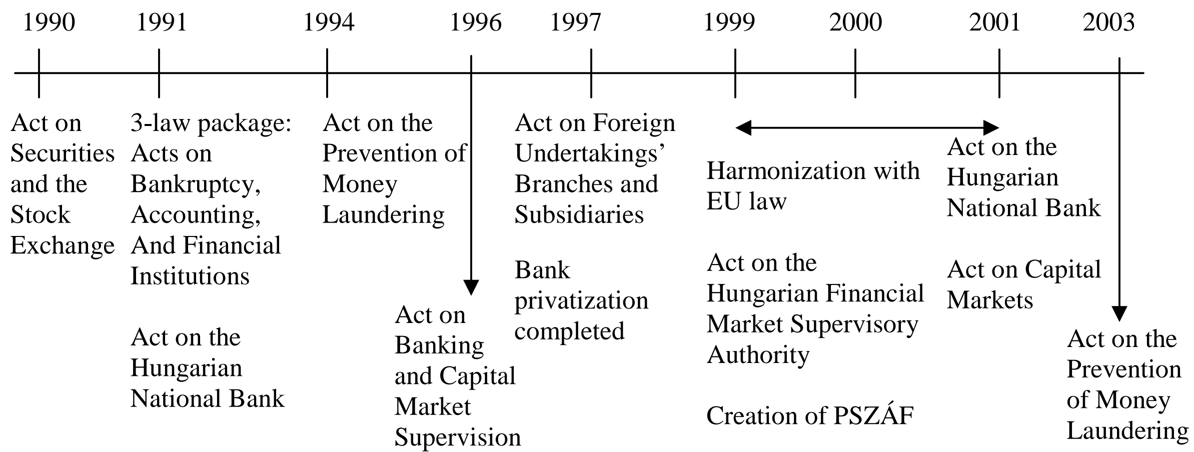
Political Institutions in Hungary	
Executive	Government elected by Parliament, headed by Prime Minister
Legislative	Unicameral Parliament 386 seats, 4-year term
- Electoral system	Mixed with three components: - closed list proportional representation; single-member district; proportionally allocated compensation seats
Judiciary - Courts	- 111 local and district courts act as courts of first instance; - 20 county courts act as courts of first instance and review appeals lodged against the decisions of the local courts; - 5 regional courts of appeal render judgment on legal remedy submitted against the decision of local or county courts; - 20 labor courts render judgment on labor disputes; - The Supreme Court ensures the uniform application of the law; adjudges appeals against the decisions of the county courts or the regional courts; and reviews petitions.
- Constitutional Court	The Constitutional court reviews the constitutionality of laws and ensures the protection of the fundamental rights granted by the Constitution. - Composition: 11 judges elected by Parliament; own budget.

1. Evolution of Banking Sector Laws in Hungary since 1989

In Chapter 1, I outlined several key policy standards that I use to judge the quality of a country's banking sector legal framework. According to these benchmarks, it is desirable to: (1) provide clear market entry and exit conditions; (2) introduce transparency in the banking system and ensure the ability of banks to function without excessive state intervention; (3) guarantee central bank independence; and (4) establish independent banking oversight. The purpose of the case studies in my dissertation is not to trace all changes in the legal framework of the banking sector, but to identify and analyze the political processes that have led to significant legal changes. In this part of the Hungarian case study, I identify a number of important laws that regulate the Hungarian banking sector and present briefly the goals and impact of those laws, in accordance with the four categories listed above.

To begin with, I examine the 1990 Act on Securities and the Stock Exchange and the so-called "three-law package" adopted in 1991 as examples of laws that ensure clear market entry and exit conditions and introduce transparency in the banking system. The section continues with an outline of the 1991 Act on the Hungarian Central Bank, the 1996 Act on Banking and Capital Market Supervision, and the creation of the Hungarian Financial Market Supervisory Authority (PSZÁF). These legal measures guarantee central bank independence and establish independent banking oversight. At the end of the section, I review the 1997 Act on Foreign Undertakings' Branches and Subsidiaries, which introduces easier market entry conditions for foreign banks, and I discuss the 1999-2001 period of harmonization with EU law. Figure 2.1 presents a timeline of the important banking sector laws discussed in this chapter.

Figure 2.1: Timeline of important banking laws in Hungary after 1989



One of the first financial sector laws adopted after the fall of communism by the newly-elected Hungarian Parliament was the 1990 Act on Securities and the Stock Exchange. This law established the rules for the issuing of and trade in securities, investment instruments, and commodity exchange instruments. It regulated the operation of asset management funds, investment funds, the stock exchange, and the clearing house. The law was passed with the clear goal to reopen the Budapest Stock Exchange (BSE) as early as 1990, develop the Hungarian stock market, and boost capital inflows (Act VI of 1990). Later on, this law also made possible the privatization of one of the biggest Hungarian state-owned banks, Országos Takarékpénztár És Kereskedelmi Bank (OTP), by listing it on the stock market.

In late 1991, the Hungarian Parliament passed a package of three very important laws: the Acts on Bankruptcy, Accounting, and Financial Institutions. According to the Bankruptcy Act, companies were obliged to shut down loss-making activities and, if necessary, declare insolvency before special bankruptcy courts. The Act on Financial Institutions forced banks to make heavier provisions against risky loans and introduced international standards for capital adequacy. The Accounting Act established Western

accounting principles to replace those used in the socialist planned economy (Denton 1992). The three-law package brought to daylight the large financial liabilities on the balance sheets of the Hungarian banks, still mostly state-owned, and highlighted the need to somehow deal with those liabilities (Mihályi 2006, personal interview). The Act on Financial Institutions limited any shareholder, including the state, to a twenty-five percent stake in the financial institution. This provision prevented enterprises from buying their own bank, possibly to use it for preferential financing. The new legislation set out capital adequacy requirements in accordance with Bank for International Settlements (BIS) norms.[1]

The 1991 Act on the Hungarian National Bank established the basic rules for the operation of the Hungarian National Bank in line with the independent central bank framework. The German Bundesbank was one institution that the Hungarian law-makers had in mind when drafting the law (Soós 2006, personal interview). The Act gave the National Bank the legal right to determine the course and choose the instruments for the implementation of monetary policy. The amendments to the 1991 Act adopted in 1994 and 1997 redefined the relationship between the state budget and the National Bank. Previously, the provisions for granting budgetary financing to the government were rather lax. After the 1994 and 1997 amendments, however, there remained only one exception to the explicit prohibition of budgetary financing by the National Bank. Under the new rules, loans could be extended to the central budget in order to bridge short-term liquidity difficulties. The rules were fairly strict: the maximum amount of such financing was limited to two percent of the planned budget revenues; the maturity had to be up to fifteen consecutive or separate days of a calendar month; and the loan had to be cleared by the end of the year (Act IV of 1994 in amendment of Act LX of 1991). Thus, there was little room left for any government to

misuse the Hungarian National Bank as a "cash cow." As part of the pre-accession legal harmonization with EU law, the Hungarian law-makers adopted in 2001 a new Act on the Hungarian National Bank that reinforced its growing autonomy and ruled out the possibility for budgetary financing altogether. The law defined the achievement and maintenance of price stability as the primary objectives of the Hungarian National Bank (Act LVIII of 2001).

The emerging legal framework of the banking sector did have some flaws, but the Hungarian policy-makers acted in a timely manner to correct them. For example, the Act on Bankruptcy did not guarantee adequate protection for creditors. The law allowed voluntary bankruptcy in the case of overdue debts and a three-month moratorium on debt servicing without requiring interim negotiations with the creditors (Act IL of 1991; Act LXXXI of 1993; Act XXVII of 1997). This legal arrangement opened the door for some companies to suspend payments to their creditors even though they were not insolvent (Várhegyi 2002). After several banks incurred significant losses, the law was amended to correct for these shortcomings.

As early as 1994, with the Act on the Prevention of Money Laundering, Hungarian law-makers took active measures to prevent money laundering activities in the country's financial system (Act XXIV of 1994). The measures were modeled after a 1991 EU Directive dealing with the same subject and required that financial institutions report any suspicious transactions and implement "know your customer" policies. However, some banking and government officials considered the implementation and enforcement of the anti-money laundering measures to be suboptimal. They attributed the implementation problems to a shortage of resources and a lack of experience in the detection and prevention of instances of money laundering. In 2003, a new streamlined version of the anti-money laundering law was

adopted by the Hungarian Parliament. The 2003 Act contains more rigid supervision instructions, including a detailed description of areas to be supervised that range from real estate to gambling (Act XV of 2003). Currently, the supervision responsibility to detect instances of money laundering is shared among the Hungarian National Bank, the Hungarian Financial Supervisory Authority, and the Hungarian Gambling Commission.

The 1996 Act on Hungarian Banking and Capital Market Supervision boosted the professionalism and independence of Hungarian bank and financial supervisors. Prior to 1996, separate supervisors were in charge of the different financial services. At the same time, many banks operated as holding companies and offered a wide range of financial services. This loophole opened the possibility for some banks to evade the mandatory capital adequacy provisions against risky loans. In order to close the loophole, banking and investment supervision were combined under the 1996 Act. In 2000, the Hungarian Financial Supervisory Authority, PSZÁF, was created to ensure a more comprehensive financial supervision, adding pension funds and insurance companies to the supervised entities (Act CXXIV of 1999).

The 1996 Act on Credit Institutions and Financial Businesses, and its subsequent amendments, introduced common EU standards in the banking sector such as universal banking. This law gave banks that possessed the appropriate licenses to operate in the domestic market the legal right to provide the standard range of commercial banking services plus the full range of security transactions, including trade in stocks and publicly-placed corporate bonds (Act CXII of 1996).

The 1997 Act on Foreign Undertakings' Branches and Subsidiaries removed the barriers to market entry for foreign banks that wanted to establish branches and subsidiaries

in Hungary (Act CXXXII of 1997). The Act abolished a prior requirement that all foreign financial institutions must obtain a formal permit from the Hungarian government to establish a bank subsidiary or buy more than a ten percent stake in an existing bank. Taken together with the government's pro-active privatization policies, these legal measures paved the way for the quick and successful privatization of Hungary's banks, which needed an infusion of capital to cover the bad debts in their portfolios and meet the more stringent capital adequacy requirements. After 1997, the subsidiaries of foreign-owned banks gained an increasing share of the Hungarian banking sector.

As part of the EU pre-accession process of legal harmonization with the *acquis communautaire*, in the period 1999-2001, Hungarian law-makers brought the legal framework of the banking sector in full compliance with EU regulations and Basel core principles. The Basel core principles set international standards for measuring capital adequacy. They are drafted by bank supervisors and central bankers from thirteen countries that make up the Basel Committee on Banking Supervision. Hungarian law-makers synchronized the domestic financial legislation with that of the EU fairly quickly, provisionally closing the Economic and Monetary Union, Free Movement of Capital, Freedom to Provide Services, Financial Control, and Finance and Budgetary Provisions accession negotiations chapters well on schedule.

The 2001 Act on Capital Markets regulates the activities of players on the capital market, which is overseen primarily by the Hungarian Financial Ministry and the PSZÁF (Act CXX of 2001). Banks that operate in Hungary account for most of the deals on the capital market, although some investment firms are active as well. The 2001 Act regulates the clearing and settlement of securities and derivatives as well as the operation of the

securities lending system. It specifies that the Ministry of Finance is responsible for overseeing the securities clearing and settlement systems, whereas the PSZÁF bears the responsibility for the supervision of the clearing houses.

In sum, this section showed an incremental improvement of the Hungarian banking sector legal framework since 1989 and an overall good quality of the laws that were put in place. Yet as one prominent financial sector analyst has pointed out, "implementation needs to become more effective" (Várhegyi 2002).

2. Domestic and International Determinants of Banking Sector Legal Reform in Hungary

In Chapter 1, I argued that three factors have shaped the quality of banking sector legal reform in the post-communist region. The first factor is the partisan coloration of the governing elites. The second factor is the nature of the mobilized domestic stakeholders and their alliances with the governing elites. The third factor is the influence of international actors. Here, I use process-tracing to determine whether those three factors have, in fact, influenced the course of banking sector legal reform in Hungary. I start by investigating the impact of the partisan coloration of the governing elites.

2.1 Partisan Coloration of the Government and Partisan Politics

Hypothesis 1: We expect good quality banking sector legal reform if the domestic political process is characterized by center-right or reformed communist successor parties in power.

Looking at the coloration of government alone, we would anticipate that both left-wing and right-wing governments would pursue good quality banking sector legal reforms in Hungary. As outlined in Chapter 1, two causal mechanisms are frequently used in the literature to account for the association between partisanship and economic reform: party

ideology and political competition. According to the party ideology mechanism, 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. According to the political competition mechanism, in a competitive political system, the government must gain support from a wider subset of society, which forces political parties to be less clientelistic and consider a broader range of possible economic policies.

Party ideology and robust electoral competition help to explain why Hungarian political elites have been committed to economic liberalization regardless of their partisan affiliation. In the realm of banking sector legal reform, significant advances were made both when left-wing and right-wing coalitions were in government. There is rich empirical evidence that the parties on the right in Central and Eastern Europe have endorsed a market-oriented economic agenda, including privatization and economic liberalization (Evans and Whitefield 1993; Ekiert 1996; Bunce 2000). This proposition applies to the biggest Hungarian political parties on the right end of the spectrum: the Hungarian Democratic Forum (MDF) and the Alliance of Young Democrats (FIDESZ).

Robert Jenkins (1992) has examined the origins and development of Hungarian opposition parties. Jenkins points out that the MDF was among the first organized opposition movements that formed in Hungary in the late 1980s. As early as 1988, the Hungarian writers and intellectuals speaking at MDF rallies called for electoral and constitutional reforms, greater civil rights, and economic reforms (Jenkins 1992: 25). Another important opposition movement in Hungary: FIDESZ also formed in 1988. Its founders were students affiliated with the István Bibó College of the Faculty of Law of Budapest's Eötvös Lórand University (Jenkins 1992: 30). Like the MDF, in the late 1980s, FIDESZ demanded economic

and political liberalization, more freedom of association and assembly, as well as lifting the administrative control and censorship of the mass media. Yet, Jenkins points out that before the fall of communism, the MDF emphasized cooperation and collaboration with the regime in order to promote change and adjustment, whereas the student movement FIDESZ openly antagonized the regime and, as a consequence, was frequently harassed by the authorities (Jenkins 1992: 66).

Table 2.2 summarizes the partisanship of the successive Hungarian governments and the respective Prime Ministers after the fall of communism in 1989. Table 2.3 presents the distribution of seats in Parliament for each election year in the period 1989-2006. In 1990, the Hungarian Democratic Forum (MDF) formed the first center-right government after the fall of communism in coalition with two smaller parties: the Independent Party of Smallholders (FKGP) and the Christian Democratic People's Party (KDNP). In the economic sphere, this cabinet defined property rights and initiated important market-liberalizing legislation. The Hungarian Socialists (MSZP) returned to power after the 1994 elections, in coalition with the Alliance of Free Democrats (SZDSZ). This government adopted two very important laws: the 1996 Act on Banking and Capital Market Supervision that boosted the monitoring and supervisory capacity of the state and the 1997 Act on Foreign Undertakings' Branches and Subsidiaries that facilitated the access of foreign banks to the Hungarian market.

Subsequently, the center-right won the 1998 elections. Yet this time, FIDESZ emerged as the biggest party on the right and practically occupied the position in the political spectrum previously held by the MDF. Agnes Batory (2002) explains that the rise of FIDESZ as the main political party on the right became possible only after the party that started out as

a small, liberal, anti-communist youth movement reinvented its organizational structure and message to the voters. Leading up to the 1998 elections, FIDESZ toned down its free market rhetoric and put much more emphasis on national unity and the national community (Batory 2002: 533). A survey of Hungarian MPs that spans the political spectrum (Batory 2002) and the 2002 Chapel Hill Expert Survey (data analysis in Vachudova and Hooghe 2005) confirm that the MDF and FIDESZ support market liberalization, but their positions are close to the center. On economic issues, the MSZP and, especially, the SZDSZ stand to the right of the MDF and FIDESZ (Batory 2002; Vachudova and Hooghe 2005).

Table 2.2: Prime Ministers and partisan coloration of the government in Hungary, 1989-2006

HUNGARY		
Prime Minister	**Government time in power**	**Ruling party/ government coalition**
Miklós Németh	23 Nov 1988 - 3 May 1990	L: MSZP
József Antall	3 May 1990 - 12 Dec 1993	R: MDF+ FKGP+ KDNP
Péter Boross	12 Dec 1993 - 15 Jul 1994	R: MDF+ FKGP+ KDNP
Gyula Horn	15 Jul 1994 - 6 Jul 1998	L: MSZP+ SZDSZ
Viktor Orbán	6 Jul 1998 - 27 May 2002	R: FIDESZ-MPP+ FKGP+ MDF
Péter Medgyessy	27 May 2002 - 29 Sep 2004	L: MSZP+ SZDSZ
Ferenc Gyurcsány	27 Aug 2004 -	L: MSZP+ SZDSZ

MSZP – Hungarian Socialist Party (Magyar Szocialista Párt)
MDF – Hungarian Democratic Forum (Magyar Demokrata Fórum)
FKGP – Independent Party of Smallholders, Agrarian Workers and Citizens (Független Kisgazda, Földmunkas és Polgári Párt)
KDNP – Christian-Democratic People's Party (Kereszténydemokrata Néppárt)
SZDSZ – Alliance of Free Democrats (Szabad Demokraták Szövetsége)
FIDESZ-MPP – Alliance of Young Democrats (Fiatal Demokraták Szövetsége)
Hungarian Civic Union (Magyar Polgári Párt)
later FIDESZ-MPSZ (Magyar Polgári Szövetség)
MIEP - Party of Hungarian Justice and Life (Magyar Igazság és Élet Pártja)

L stands for left, R – for right, and C – for centrist.

Table 2.3: Distribution of seats in Parliament for each election year, 1989-2006

Political parties	1990	% seats	1994	% seats	1998	% seats	2002	% seats	2006	% seats
MSZP	33	(8.55)	209	(54.15)	134	(34.72)	178	(46.11)	186 +4**	(49.22)
SZDSZ	92	(23.83)	69	(17.88)	24	(6.22)	19 +1**	(5.18)	18 +2**	(5.18)
FIDESZ-MPSz	21	(5.44)	20	(5.18)	113 +35*	(38.34)	188	(48.70)	164	(42.49)
MDF	164	(42.49)	38	(9.84)	17	(4.41)	(24)*		11	(2.85)
FKGP	44	(11.4)	26	(6.74)	48	(12.44)	0		0	
KDNP	21	(5.44)	22	(5.7)	0		0		(23)	***
MIEP					14	(3.63)	0		0	
Smaller parties, joint candidates, independents	11	(2.85)	2	(0.52)	1	(0.26)	0		1	(0.26)
Total seats	**386**		**386**		**386**		**386**		**386**	

Source: Author's calculations based on University of Essex data from the project "Political Transformation and the Electoral Process in Post-Communist Europe"

* joint list of FIDESZ and MDF (MDF seats in brackets are part of the total FIDESZ seats)
** joint list of MSZP and SZDSZ
*** joint list of FIDESZ and KDNP (KDNP seats in brackets are part of the total FIDESZ seats)

The economic policy record of the communist successor parties – usually the largest parties on the left – across Central and Eastern Europe has been more heterogeneous. Some communist successor parties have implemented thorough economic reforms while in power, but others have stalled economic reform and engaged in clientelism and corruption (Ishiyama and Bozóki 2002: 423-425). A distinct feature of the post-communist party system in Hungary is the pronounced pro-market agenda of the communist successor party: the Hungarian Socialist party (MSZP). Robust political competition and alternation between left and right parties in power is important for the quality of the adopted reforms. Milada Vachudova has argued that the presence of an organized and coherent opposition to communism "jump-start[s] the creation of a competitive political system" (2005: 25). When the ex-communist party confronts a credible challenger on the right end of the political

spectrum, it faces strong incentives to reform in order to “remain in the political game.” As Vachudova points out, “the Polish and Hungarian communists set the example: after losing the first democratic elections, they transformed themselves into social democratic parties and won the second elections” (2005: 34). In the case of the MSZP, the crystallization of a centrist economic program is especially clear in the period 1998-2002, while the MSZP was again in opposition. The party decided to adopt the “New Labor” model, which it used as a coherent ideological justification for the market-oriented policies that it had promoted since 1989 and its noticeable detachment from the labor unions (Agh 2000; Bozóki 2002: 111).

What additional factors account for the pro-market stance of the communist successor party in Hungary? The Hungarian communists had already begun to reform their party during the decade preceding the collapse of the communism. By 1990, they had renamed it the Hungarian Socialist Party (MSZP) and embraced a pro-market agenda (Grzymała-Busse 2002). András Bozóki has investigated the move of the former Hungarian communist party toward a center-left political ideology. According to Bozóki, for the MSZP, “being a reformer was not simply a political tactic … but slowly became an inseparable part of their identity” (Bozóki 2002: 96). The reformist orientation of the party is rooted in the Hungarian political and economic experience under communism. According to political scientist László Andor, “it is very important to understand that in Hungary the economic transformations started well before 1989” (2006, personal interview). Even during communism, the Hungarian leadership attempted to implement market principles in the planned socialist economy. In the late 1960s, the Hungarians experimented with a plan called the “New Economic Mechanism,” which introduced more decentralized decision-making in the economy as well as profit-oriented incentive schemes (Bartlett 1997). In the 1980s, a second

stage of reforms was launched, which also promoted market mechanisms in the economy (Csaba 2005).

Furthermore, László Andor (2000) attributes the post-1989 economic policy choices of the Hungarian Socialists to the recognition that the domestic system lacked capital in order to pursue economic development. Therefore, the party leadership contemplated foreign investors and privatization as possible sources of capital inflows. In the early 1990s, a consensus emerged among the Hungarian political elites on the left and the right that the privatization of a range of state-owned enterprises and assets had to begin immediately, but the political elites disagreed on exactly what measures to undertake (Körösényi 1999; Andor 2000).

Indeed, consistent with Hypothesis 1, when in power after 1989, both the left-wing and the right-wing government coalitions in Hungary actively sought to improve the performance of the financial sector, because integration in the Western markets was a paramount priority (Mihályi 2006, personal interview). What are some important policy contributions of the Hungarian governments discussed so far? To begin with, the 1990 center-right coalition government of the MDF, FKGP, and KDNP led by Prime Minister József Antall laid the foundations of successful legal reform in Hungary by introducing important market-oriented legislation such as the 1991 three-law package discussed earlier in this chapter. Later on, when the 1994 socialist-liberal government, a coalition between the MSZP and the SZDSZ, saw economic crisis looming, Prime Minister Gyula Horn tried to restore confidence in the country's economic management by nominating two reformers to key financial positions: Lajos Bokros as finance minister and György Surányi as president of

the Hungarian National Bank. Those two policy-makers stand out as the masterminds of the 1995 austerity package that brought the Hungarian banking system back on its feet.

Although political frictions existed between the Hungarian Socialists and their FIDESZ rivals on the right end of the spectrum, the alternation of political parties in power did not undermine the progress of legal reforms in the banking sector. For example, the 1998 FIDESZ government led by Victor Orban further improved the banking legal framework by adopting measures to tighten banking supervision and financial oversight. The Hungarian finance ministers of various governments followed a consistent policy of defining property rights, speeding up privatization, and maintaining financial stability in order to integrate Hungary as quickly as possible in the European economy (Csaba 2006, personal interview).

The laws regulating the operations of the Hungarian banking institutions were crafted predominantly by domestic experts who, at times, took into account the suggestions of foreign advisers. However, as one of my interviewees has pointed out, "the foreign experts were not the key figures running the show" (Csaba 2006, personal interview). Many of the experts who were instrumental in shaping the post-1989 Hungarian financial laws such as ex-finance ministers Mihály Kupa, László Antal, and Tibor Draskovic had undergone training at the Bank of England or the Bundesbank, and most of them had started their careers at the Hungarian National Bank (Csaba 2006, personal interview). According to Klára Csoór, an economist at the Hungarian Financial Supervisory Authority, owing to their advanced knowledge and international experience, the small group of domestic experts who designed the early banking laws and policies enjoyed a form of "enlightened absolutism" when it came to setting the parameters of banking sector reform (Csoór 2006, personal interview).

Yet the reformist stance of the Hungarian governing elites has been driven by the strategic considerations of the elites, rather than the demands of the political parties' loyal voters. Scholars of post-communist party politics have developed multiple accounts of the policy positions of political parties in the region. For example, Herbert Kitschelt, Zdenka Mansfeldova, Radoslaw Markowski, and Gabor Toka (1999) investigate the nature of the party systems in four post-communist states: Bulgaria, the Czech Republic, Hungary, and Poland. The authors use extensively interviews and surveys of politicians, scholars and experts, as well as voters. According to the authors' analysis, political parties in Central and Eastern Europe emphasize relative representation at the expense of absolute representation. Relative representation means that parties are generally responsive to voters and make an effort to relate their position to voters, but they *do not* reflect the preferences of their voter constituents (Kitschelt et al. 1999: 309). Kitschelt et al. use the term "trustee relationships" to describe the most common type of interaction between the voters and the political parties in the region. This arrangement gives legislators a green light to pursue almost any kind of policy that they deem necessary. In contrast to relative representation, absolute representation is characterized by "mandate relationships," which minimize the distance between the policy preferences of the politicians and the voters who have put them in office (Kitschelt et al. 1999: 81). Thus, absolute representation puts more constraints on the possible range of policies available to the legislators, compared to relative representation.

Based on the collected evidence, Kitschelt et al. conclude that Hungarian political parties do not have strong representational ties to the voters. The authors also argue that Hungarian political parties do not offer a menu of credible economic policy alternatives, which they attribute to the negotiated character of transition in Hungary and the prevailing

elite consensus on the desirability of market-liberalizing reforms (Kitschelt et al. 1999: 317). In general, Kitschelt et al. emphasize that the political elites in Hungary "push the economic reform agenda while their voters are more reticent to abandon the economic status quo" (Kitschelt et al. 1999: 327).

So far, we saw that both the Hungarian left and right have been committed to improving the quality of the banking sector legal framework since the end of communist rule in 1989. Now I ask: What has been the source of this stable commitment to reform that spans the partisan spectrum? As this section showed, we cannot trace the roots of the pro-market consensus that has characterized Hungarian politics since 1989 to the citizens' strong preferences in favor of market-oriented reforms. The puzzle remains what salient domestic constituents have influenced the Hungarian political parties during transition—and provided them with political support.

2.2 Domestic Stakeholders and Domestic Alliances

Scholars of political economy have established that organized interest groups are important players in the process of economic policy reform (Przeworski 1991; Haggard and Webb 1994; Haggard and Kaufman 1995; Schamis 1999). According to Stephan Haggard and Steven Webb (1994), salient interest groups such as labor unions and business associations possess a crucial capability to organize collective action outside of routine political channels. Examples of such collective action are labor strikes, capital flight, investment inflow, but also investment withdrawal (1994: 16). Therefore, as a number of political economists have pointed out, the implementation of adjustment measures in transitional economies can be regarded as a process of domestic coalition-building in order to carry out the desired reforms (Waterbury 1989; Haggard and Webb 1994). Thus, the success

of economic reform programs depends on the distributional consequences of the programs on the citizens, but also on the nature and strength of the affected domestic stakeholder groups.

Does the literature on the post-communist economic transition provide us with some insights about the salient domestic stakeholders in the region? Gerald McDermott (2002) has taken an "embedded politics approach" to analyzing the evolution and impact of industrial networks on economic restructuring in the Czech Republic after 1989. McDermott finds that industrial restructuring policy networks have a significant impact on broader political decisions about privatization, bank restructuring, debt restructuring, and investment. Therefore, we should consider the influence of industrial policy networks on issues of banking legal reform in Hungary.

David Stark and László Bruszt concur that policy networks have influenced economic reform in the Hungarian case as well. Stark and Bruszt emphasize that the centrally planned economies in the region created what the authors call strong "associative networks" among firms, political figures, and bureaucrats (Stark and Bruszt 1998). Some of these network ties dissipated during the transformation of the economic environment after 1989. However, other "associative networks" were reinforced while firms, individuals, banks, local governments, and other economic actors adopted joint strategies to survive in the new economic environment (Stark and Bruszt 1998).

One possible negative consequence of the presence of strong "associative networks" is reinforcing the pattern of clientelistic relationships, cronyism, and corruption that was present in the socialist planned economies (Rose-Ackerman 1999). According to Andor, it would be unreasonable to claim that Hungary accomplished a "pure" transition from communism, in which corrupt politicians were absolutely sidelined (2006, personal

interview). There have been instances of corruption, patronage, and questionable interference in the economy in Hungary after 1989. For example, Dóra Győrffy has shown how the Hungarian government employed "creative accounting" such as forming public-private partnership frameworks for investment in roads and education in order to couch the growing public debt as partly private debt (2006: 249). In the autumn of 2006, Prime Minister Ferenc Gyurcsány faced sustained protest rallies in the capital and demands that he step down after the surfacing of an audio recording from a closed-door party meeting, in which Gyurcsány admitted that the government lied to the citizens, was open to lobbying from private capital, and that he personally could not name any recent achievement that the government could be proud of (BBC 2006). Yet László Andor underscores that the big difference between Hungary and "partial-reform" regimes such as Bulgaria is that "in Bulgaria, the corrupt politicians among the elite could control whether reform would take place at all, whereas in Hungary, the corrupt politicians among the elite could slow down reform, but they could not subvert it" (Andor 2006, personal interview).

According to Hungarian political economist László Csaba, the limited extent of corruption in Hungary is largely an unintended consequence of the extensive privatization process (2006, personal interview). In Csaba's view, in the beginning of transition, the biggest concern with regards to the state of the Hungarian economy was inefficiency. The communist economic planners placed virtually no emphasis on efficiency and managerial skills. Thus, the aim of the initial economic reforms in Hungary was to correct the economic policy shortcomings of the previous regime (Csaba 2006, personal interview). Privatization was a convenient way to address the lack of domestic capital as well as the need to introduce Western managerial skills and boost economic development. Andor confirms that Hungarian

policy-makers were eager to attract foreign investors and involve them in the privatization process, because of the country's burdensome indebtedness and the fact that from the very beginning of transition, this policy was bringing in considerable amounts of international capital (2000: 82).

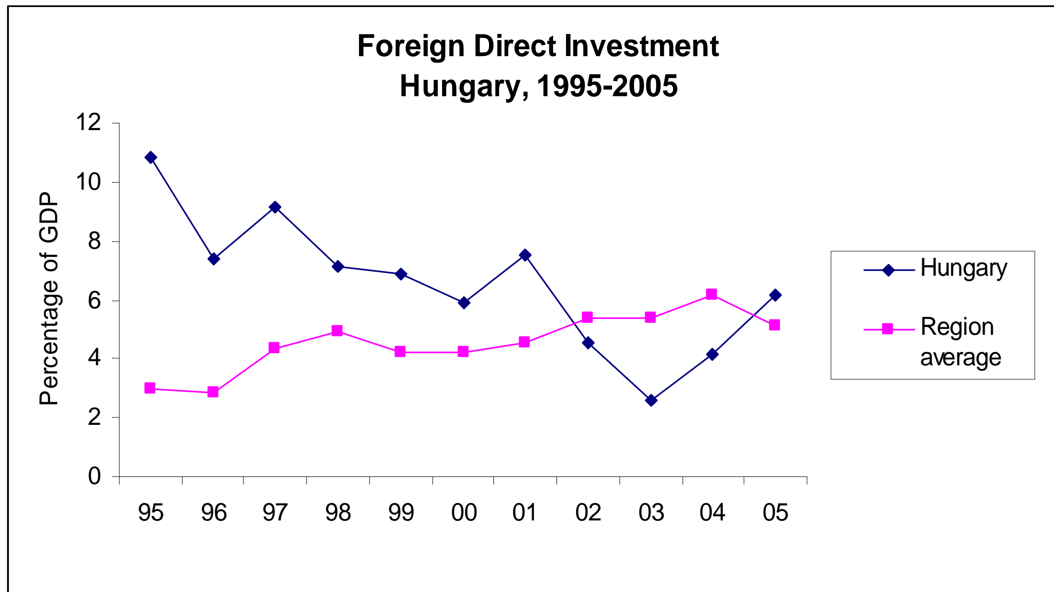
Susan Rose-Ackerman has argued that "privatization can reduce corruption by removing certain assets from state control and converting discretionary official actions into private market-driven choices" (1999:35). In confirmation of Rose-Ackerman's argument, the swift privatization process and the growing internationalization of Hungary's economy limited the possibilities to reinforce the old or develop new clientelistic relationships between local politicians and enterprise managers. In the realm of finance, the 1994 socialist-liberal cabinet led by Prime Minister Horn aimed to complete the privatization of the banking sector by the end of its four-year term. This attitude of Hungary's socialist-liberal government prompted one analyst to exclaim that it had almost "Thatcherite ambitions when it comes to privatization" (Marsh 1995b). Both the socialist-liberal government and the FIDESZ-led coalition that succeeded it in 1998 endorsed privatization and actively sought foreign investment (Andor 2000: 81).

The issue of privatization highlights the overriding importance of foreign investors for sustaining economic liberalization and promoting efficiency and growth. The pattern of domestic alliances in Hungary corresponds to the reformed communist successor party or right party in government type presented in Chapter 1. Thus Hypothesis 2, which refers to the domestic alliances of unreformed communist successor parties does not apply in the Hungarian case. Below, I evaluate Hypothesis 3 concerning the impact of foreign investors on the quality of banking sector legal reform in Hungary.

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

Greenfield foreign investors such as Audi, IBM, and Philips as well as big domestic exporters privatized through stock exchange IPOs[2] such as Richter (pharmaceuticals) and MOL (oil and gas) supported the development of an efficient banking system in Hungary (data from Mihályi 2000). From the point of view of the multinational corporations (MNCs), the possibility for market growth and low-cost production have been the main motivating factors to buy Hungarian firms, or establish new firm units. Some prominent representatives of the first type of investment are Henkel, Unilever, Parmalat, and GE. The second type of investment is represented by Elextorlux, Samsung, Audi, and Ford. Currently, foreign investors hold significant stakes in the following sectors: 62 percent in telecommunications, 51 percent in the manufacturing industry, and 44 percent in financial services (Andor 2000: 85). Figure 2.2 shows FDI as a percentage of GDP in Hungary compared to the average level of FDI in the post-communist region. Hungary was a regional leader in attracting FDI in the early 1990s, but FDI leveled off starting 2001, as other post-communist countries also stabilized their economies and improved their investment climate.

Figure 2.2: Foreign direct investment in Hungary, 1995-2005



Source: Author's calculations based on data from World Bank (2006).

Once attracting foreign capital had become a medium to long-term strategy for economic development, the Hungarian governments had to understand how to sustain the interest of potential investors and the inflow of capital. Thus, successive Hungarian governments created special incentives for foreign investors such as upgrading the roads and the communication networks as well as – important for my research question – streamlining the legal framework (Andor 2000: 82). As one of my interviewees has emphasized, "The foreign investors made a big push for the development of the banking sector in the early 1990s. They were fed up with the poor infrastructure of the banks and the slow service" (Csoór 2006, personal interview).

The nexus between enterprise restructuring and banking sector restructuring helps us to understand the path of banking sector reform in Hungary since 1989 and why the government chose privatization as a way of restructuring the sector. The new accounting

standards introduced in 1991 revealed the extent of losses and indebtedness of the state-owned Hungarian enterprises and banks. In 1993, the old debts amounted to 10 percent of the banks' portfolios. By 1994, some 90 percent new debts had accrued in the form of bad loans (Csaba 2006, personal interview). At that point, Hungarian decision-makers realized that the losses in the real economy and the financial sector were not due solely to some imaginary past. The growth of risky loans in the banks' portfolios was present and real. Hence, the policy-makers started thinking of possible ways to address this problem. One potential solution was to sell the state-owned banks in order to attract foreign capital and create a competitive environment in which the banks would be more efficient (Csaba 2006, personal interview). As Csaba pointed out, "Material considerations rather than the high moral standards of the Hungarian elites determined this behavior. Either the banks would be sold, or we would need to put again and again taxpayers' money into them" (Csaba 2006, personal interview).

The bank privatization process carried out by the 1994 socialist-liberal cabinet of Prime Minister Horn was swift. In 1997, the state, which had dominated the banking system in 1994, retained a majority stake only in two banks: the *Hungarian Development Bank* and *Eximbank*. Table 2.4 summarizes the main privatization deals in the Hungarian banking sector. The restructuring of bank ownership strengthened and stabilized the Hungarian banking system. It improved the quality of the loan portfolios: the number of non-performing loans as a percentage of total loans fell from 30 percent in 1993 to 3 percent in 2000 (Szapáry 2002: 114). Among the advantages of opening the banks to foreign ownership were: introduction of competitive, modern banking services; harmonization with EU standards; and reduction of the opportunities for corruption and misuse of the banks (Bonin and Wachtel

1999; Szapáry 2002). Bank privatization also increased the level of transparency in the sector (Soós 2006, personal interview). PSZÁF's Katalin Mérő concludes that the banking sector privatization in the period 1996-1997 completed the overall stabilization of the Hungarian financial system (Mérő 2006, personal interview). The biggest development in the banking sector after the end of bank privatization was the start of mergers and consolidation in 2000. Logically enough, with its 10-million population Hungary could hardly sustain more than 40 banks and financial institutions, half of them scrambling for the same market segment.

For some time, the Hungarian small and medium-sized enterprises (SMEs) had access to funds predominantly from government programs. The stabilization of the banking sector and the entry of foreign capital have been a positive development for the SMEs too. As two Hungarian banking experts have summarized, "most banks have stepped up their efforts to lend to creditworthy SMEs" (Király and Várhegyi 1998). In a competitive banking environment, lending to SMEs is a promising way for the banks to extend their loan operations.

Table 2.4: Key bank privatization deals in Hungary, 1994-2005

Name of bank	Year of privatization	Method of privatization/details
MKB Magyar Külkereskedelmi Bank *(Hungarian Foreign Trade Bank)*	1994 1996 2001	25% stake sold to Bayerische Landesbank (Germany) 16% stake sold to EBRD 8.2% stake sold to Deutsche Investitions und Entwicklungsgesellschaft (Germany) 25.8% stake sold to Bayerische Landesbank (Germany) consolidation: 99.68% stake owned by **Bayerische Landesbank** (Germany) and its subsidiary Bank für Arbeit und Wirtschaft AG (Austria)
OTP Országos Takarékpénztár És Kereskedelmi Bank *(National Savings and Commercial Bank)*	1995 1997	20% initial international stock exchange offering (Luxembourg) 13.4% stake for domestic offering 25% secondary stock exchange offering 3.6% stake sold to domestic retail investors 5% stake sold to management and employees
Budapest Bank	1995	27.4% stake and operational control given to **GE Capital** (US) 32.4% stake sold to EBRD
Dunabank	1996	Acquired by **ING** – Hungary (Netherlands)
Magyar Hitel Bank *(Hungarian Credit Bank)* later ABN AMRO Bank Hungary	1996 2005	89% stake sold to ABN AMRO merger with K&H Bank
K&H Kereskedelmi És Hitelbank *(Commercial and Credit Bank)*	1997 2000 2005	56% stake sold to consortium of Belgian-based Kredietbank – KBC and Irish Life Assurance merger with ABN AMRO Bank Hungary **KBC** bought 40.2% ABN AMRO stake, thus gaining full control of K&H
Mezőbank	1997	84% stake aquired by GiroCredit Bank (Austria), which merged with Erste Bank (Austria) in 1997
Postabank	2003	Sold to **Erste Bank** (Austria)

As outlined in the section above, foreign direct investment entails a long-term presence in the country and, therefore, foreign investors have a stake in the development of the domestic political and economic systems. The next hypothesis about the role of trade captures a weaker relationship between foreign capital and domestic economic developments.

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

With regards to post-communist countries, Bartolomej Kaminski (2001) has demonstrated that the more extensive the presence of foreign investors in the country, the more integrated the country is in the global markets. Kaminski attributes this finding to the trade pattern of foreign enterprises. The evidence suggests that foreign firms are more oriented toward foreign trade than domestic firms (Kaminski 2001: 33). Throughout transition, Hungary has attracted significant amounts of FDI (Mihályi 2005). It has become an integral part of the European production and trade networks in several areas: household electronics, telecommunications and office equipment, the automobile industry, and automatic data processing machines (Kaminski and Ng 2000). Because of its growing trade openness, Hungary has been exposed to pressures for more transparency and efficiency in the domestic financial sector, but Hungary's trade patterns alone do not explain the improvement in the legal framework of the banking sector over time. Trade is part of a bundle of economic transformations arising from Hungary's economic reorientation toward the European and Western markets. Overall, Hungary's gradual integration in the European economy and compliance with the rules and practices institutionalized in the EU are a more plausible influence on banking sector reform than trade alone.

2.3 International Actors

We saw so far that the alliance between reform communist and right-wing political elites in power and domestic economic actors strongly in favor of economic liberalization has been the driving force of the incremental improvement in Hungary's banking sector legal framework after 1989. At the same time, Hungary has experienced relatively high budget deficits, and there have been instances of political interference in economic projects such as public procurement tenders (Győrffy 2006). Such policies could drive away Western foreign investors in the long run. While international actors did not play a crucial role in Hungary, relations with the IMF and the EU still served as a signaling device that the country would not lapse into clientelism, and it would persevere with sound economic policies.

According to my theoretical framework presented in Chapter 1, international actors shape legal reform of the banking sector via three mechanisms: conditionality, selective domestic empowerment, and socialization. Here, I investigate whether we can find convincing evidence that those three mechanisms have influenced banking sector legal reform in Hungary. The first mechanism – conditionality – entails a package of rewards and punishments attached to demands for specific policy changes. In the course of designing the banking sector legal framework, Hungarian decision-makers have considered advice from international organizations such as the IMF and the World Bank, the Bank for International Settlements (BIS), the EU, and OECD, albeit selectively. I focus on the role of the most salient international actors in the post-communist region: the IMF, the World Bank, and the EU.

Hypothesis 5: We expect good quality banking sector legal reform if a country has been involved consistently in IMF and EU conditionality programs.

The IMF has used conditionality to influence Hungarian economic policy since the 1980s because of the country's indebtedness (Csaba 1995). During transition, the Fund was particularly influential in the period 1989-1995, because Hungary needed to obtain external financing for its balance of payments and maintain a good credit standing among foreign investors. In response to pressure from the IMF, the Hungarian National Bank stopped financing the budget deficit directly and started issuing bonds instead. The government also created a state aid agency in order to make government subsidies more transparent (Mérő 2006, personal interview). In 1992, the IMF suspended Hungary's three-year loan due to an excessive budget deficit. At that time, Hungary managed to cover its debt payments without help from the IMF by issuing bonds. However, continued cooperation with the IMF was tremendously important for the political elites because it signaled credibility and stability to the foreign investors (Denton 1993). In 1993, the Hungarian government cut the budget deficit and initiated some bank privatization measures. In return, the IMF disbursed $394 million over the following two years. This released an additional $100 million tranche from the World Bank for structural adjustment. The World Bank did not use its own conditionality policies in the post-communist region. Rather, it relied on and reinforced the terms of IMF conditionality. Thus, the loans for economic restructuring that the World Bank extended to Hungary, predominantly in the food and energy sectors, required compliance with IMF conditionality (Andor 2006, personal interview). Furthermore, the IMF and the World Bank had a joint advisory board to coordinate their actions.

As one of my interviewees, economist and former Hungarian MP Károly Attila Soós, pointed out "After 1989, we had to behave nicely, because we were watched by the international institutions" (2006, personal interview). With respect to the banking sector, in

1992, Hungary still depended significantly on the IMF for financing, so the banking community feared that losing the Fund's support would have serious repercussions for the emerging financial sector (Soós 2006, personal interview). According to Soós, when IMF financing was no longer of crucial importance for the Hungarian economy, the EU gradually took over the guidance and supervisory role that the IMF used to play in the country in the early 1990s (2006, personal interview).

The relationship between the European Union and its Central and Eastern European neighbors was not very well defined in the early 1990s. Yet it is clear that Poland, Hungary, and Czechoslovakia were the first to receive attention from the Union (Andor 2000: 117; Vachudova 2005: 82). The credible prospect for EU membership helped to sustain a domestic incentive structure, where reform was a beneficial long-term strategy, because it would bring about political stability, an influx of foreign investment, good credit standing on the international financial markets, and popularity with the domestic pro-reform groups. In the period 1994-1998, Hungarian policy-makers took determined steps to join the EU. Economic minister Attila Chikan pointed out that Hungary was "no longer coming out of the communist system, it [was] converging with the requirements of the European Union" (quoted in Done and Eddy 1998). As the formal accession negotiations with Hungary proceeded, the EU also used the tools of pre-accession conditionality. However, the Union's demands with respect to banking law harmonization were not controversial and the Hungarian government was able to comply quickly. Between 1999 and 2001, Hungarian legislators synchronized the domestic financial sector legislation with that of the EU, provisionally closing the Economic and Monetary Union, Financial Control, Free Movement

of Capital, Freedom to Provide Services, and Finance and Budgetary Provisions accession negotiations chapters well on schedule.

We now turn to selective domestic empowerment by international actors, which means that some domestic groups such as human rights NGOs, citizen associations, and moderate and reformist wings within political parties increase their influence on the domestic political process, because they get rhetorical and financial support from international actors that endorse a similar policy position. In Hungary, the IMF consistently pushed for regulations that are friendly to capital such as low corporate taxes, a tight monetary policy, and fast bankruptcy procedures (Csaba 1995). In that sense, the IMF has empowered Hungary's central bank, but to the extent that it would pursue price stability and control of inflation.

Hypothesis 6: We expect good quality banking sector legal reform if international actors empower organizations such as independent agencies responsible for monitoring the financial sector and independent central banks.

The other very influential international actor in the post-communist region, the European Union, has emphasized institution-building. In particular, the EU accession process has empowered significantly the Hungarian National Bank, HNB, and the Financial Supervisory Authority, PSZÁF. A 1997 report outlined the two main objectives of EU policy with regards to financial sector reform in Central and Eastern Europe. The first objective was to develop the central banks into institutions that could formulate and conduct monetary policy independently (Mörner 1997). The second objective was to maintain a high degree of confidence in the banking system by creating an independent supervisory agency that would

oversee and seek to eliminate the sources of weaknesses and volatility in the banking system (Mörner 1997).

The Hungarian National Bank gained significant independence with the first Act on the National Bank passed in 1991. Therefore, in Hungary, the basic framework for independent central bank decision-making already existed in the beginning of transition. The contribution of the harmonization with EU law was to reinforce the position of the Central Bank with respect to both policy independence and financial independence. However, we have to note that, as elsewhere in Eastern Europe, political control and influence over key appointments in the central bank have been highly contentious issues in Hungary. The 1991 National Bank Act made it almost impossible to sack the governor of the HNB. At the time, the HNB was headed by György Surányi, who was popular in the Western circles with his tight monetary policy. However, Surányi was *not* closely associated with Prime Minister Antall's party. In the end of November 1991, shortly before the new law entered into force, Surányi was substituted for Péter Ákos Bod, who was expected to be more amenable to government influence (Denton and Robinson 1991). In 2003, the FIDESZ-appointed central bank leadership was also under fire, this time from the new socialist-liberal government, for allegedly keeping interest rates too high. The socialist-liberal government proposed a controversial legal amendment changing the composition of the Hungarian monetary council, which could allow the government to override the decision of the HNB governor on interest rates. Internationally, this measure was perceived as a threat to the independence of the central bank (Condon 2004). After the European Central Bank carried out an investigation and released an opinion criticizing the heavy-handed approach of the Hungarian government,

the government announced that it would respect HNB's independence on the issue of interest rates.

Furthermore, the EU has bolstered banking supervision in Hungary. Thomas Reininger et al. (2001) observe a notable improvement in prudential regulation and supervision in Hungary over the years, especially after granting more independence to the merged supervisory authority, PSZÁF. While the Hungarian National Bank monitors whether the banks fulfill the stipulated macro-economic parameters, the financial supervisors at PSZÁF monitor, and have leverage over, the behavior of the bankers on the micro-level (Csoór 2006, personal interview). The Hungarian Financial Supervisory Authority, PSZÁF, has been instrumental in the successful implementation of international financial sector regulations (Csaba 2006, personal interview). György Szapáry points out that the PSZÁF staff has undergone extensive training and the quality and professionalism of the supervisors is excellent (2002: 115). For example, as part of the EU accession process, the supervisors at Hungary's PSZÁF were trained to use the EU-wide system of criteria to evaluate the domestic banks, which induces more transparency in the banking system. The significant presence of subsidiaries of EU banks in Hungary created an additional demand for the adoption and implementation of the common banking standards used in the Union (Mérő 2006, personal interview). The following hypothesis and discussion focus in greater detail on the effects of socialization by international actors.

Hypothesis 7: We expect good quality banking sector legal reform if elite socialization is taking place between the local elites and international proponents of banking reform.

Even during communism, the Hungarian economic elites had the opportunity to travel and interact with their counterparts in Western Europe. During transition too, as one of my interviewees has pointed out, "the regular interactions with Western experts and policy learning were crucial in shaping the elites' approach to transforming the economy" (Mihályi 2006, personal interview). Therefore, the constructivist mechanisms of socialization and persuasion through communication and social interaction (Checkel 2001) are a plausible additional explanation of why the Hungarian political elites have been able to implement liberalizing banking reforms relatively quickly and efficiently.

Since 1982, Hungary has been a member of the IMF because of the country's heavy debt burden and the need for balance of payments financing from the Fund (Csaba 1995). In this way, some Hungarian economists were dispatched to work in the IMF and the World Bank, which was rather exceptional for a country in the Soviet Union sphere of influence. Before 1989, the Hungarian National Bank also regularly sent personnel to work in its branches abroad. As one of my interviewees has emphasized, the know-how that those Hungarian experts accumulated abroad was very important: "When the financial experts returned home, they knew the capitalist game and they could formulate strategies how to integrate Hungary in the changed global economic environment" (Soós 2006, personal interview). Furthermore, the university-level instruction in economics in Hungary was advanced and fairly technical, rather than ideological, even in the 1970s and 1980s. This paved the way for a more technocratic approach to economic reform in general, and banking sector reform in particular.

The socialization literature places much importance on what James March and Johan Olsen call the "logic of appropriateness" (1989: 160). According to this logic, actors choose

to abide by certain rules if they are persuaded that the rules are legitimate and appropriate. My research suggests that the "logic of appropriateness" helps us to understand the overall prudent and responsible behavior of Hungarian bankers since 1989. From the very beginning of transition, the Hungarian banking community abided by "a culture of responsible behavior" (Mérő 2006, personal interview). Bank managers avoided making losses and misusing the assets that they controlled, because that would threaten their position and reputation in the sector and jeopardize their future career development (Mérő 2006, personal interview).

Overall, in Hungary, international actors did not play an essential role in the process of banking sector legal reform. But political interference and partisan appointments in important institutions have occurred in Hungary as well. Thus, I showed in this section that the EU has served as an external guarantee for the independence of two domestic financial institutions: the Hungarian National Bank and the Financial Supervisory Authority. We have examined the process of law adoption and amendment. Now we turn to issues of law implementation.

3. Implementation

Good laws will be inconsequential if their implementation fails. Taking into account the insights of the legal compliance literature, I will examine the impact of two overriding institutional factors: the state administration and the judiciary system. First, scholars of European integration have investigated the broad issues of compliance and implementation in the context of EU law (Börzel 2001; Tallberg 2002; Sedelmeier 2006). Tanja Börzel (2001) has emphasized the importance of administrative capacity to achieve efficient implementation. When the state administrative capacity is low, even if there is sufficient

political will to pass legal reforms, the relevant state institutions struggle with the implementation of the adopted policies. This problem has not surfaced in Hungary. Hungary has been a front-runner of civil service reform in the post-communist region. It was the first country in the area to embark on a fast-track building of an independent civil service, immediately after its first democratically elected government came to power in 1990 (Verheijen 1999). The professionalism of Hungarian civil servants has helped successive Hungarian governments. In the banking sector too, the cooperative attitude of the state bureaucracy has boosted the legal reform process (Csoór 2006, personal interview).

Hungary's strong administrative capacity can be traced back to the active measures to create and sustain a technocratic state administration adopted in the late 1960s and the 1980s as part of the broad economic reforms. For example the National School of Public Administration (NSPA) was founded in 1977 to prepare a more professional civil service. The origins of the 1992 Civil Service Act go back to the mid-1980s when Hungarian policy-makers contemplated the introduction of a meritocratic career system in the civil service (Meyer-Sahling 2001: 965). Kitschelt et al. have classified Hungary before 1989 as a national-accommodative communist regime where "formal rational bureaucratic governance structures were wide-spread and distinguished between party rule and a technical state administration" (1999: 24). Notwithstanding the advanced and professional state of the Hungarian civil service, we have to point out that successive Hungarian governments have exercised their powers to make some political appointments in the ministries, especially regarding senior positions (Vass 2000, 2001).

Second, in a number of post-communist countries, the judiciary system, which is supposed to be impartial and competent in applying and overseeing the laws, is in fact slow,

inefficient, and easily swayed by political pressure (Magalhaes 1999; Hilmer 2002; Gerring and Thacker 2005). Although the Hungarian courts are somewhat slower and less efficient than their counterparts in the EU Member States, the overall performance of the Hungarian legal system has been relatively satisfactory for the business community. Table 2.5 presents selected assessments from a World Bank firm-level survey of the investment climate across the globe. While I only present data on two front-runners and two slow reformers in the post-communist region, it is clear that Hungary's legal system enjoys a solid 66.94 percent approval on the part of business leaders, compared to a 47.33 percent approval of another regional front-runner: the Czech Republic (World Bank 2002).

Table 2.5: Selected legal system assessments from World Bank Investment Survey, 2002

Legal system as business constraint	Albania	Bulgaria	Czech Republic	Hungary
No obstacle	9.76%	34.17%	47.33%	66.94%
Minor obstacle	28.05%	26.67%	25.51%	19.83%
Moderate obstacle	29.27%	21.25%	16.05%	8.68%
Major obstacle	32.93%	17.92%	11.11%	4.55%
Number of firm surveys	164	240	243	242

Question wording: Please tell us if the legal system/conflict resolution system is a problem for the operation and growth of your business. Please judge its severity as an obstacle on a four-point scale where: 0 = No obstacle; 1 = Minor obstacle; 2 = Moderate obstacle; 3 = Major obstacle; 4 = Very Severe Obstacle.

4. Conclusion

The Hungarian case study shows that when the decision-makers recognize that comprehensive reforms can bring about considerable political and economic rewards, they are likely to engage in restructuring and improving the legal framework in the country. Over time, the supportive stance of the mobilized domestic stakeholders who also benefit from reform creates a positive feedback loop that reinforces the elites' commitment to improving the legal framework. In the post-communist region, international organizations such as the

IMF and the EU have also assisted banking sector legal reform through policy advice, financial assistance, and continued interaction with the domestic elites.

I examined how three factors—the partisan coloration of the governing elites, the nature and strength of the mobilized domestic stakeholders, and the influence of international actors—have shaped the quality of banking sector legal reform in Hungary after 1989. It is difficult, and somewhat problematic, to determine accurately the independent causal weight of each factor. Yet the Hungarian case offered some evidence to gauge the relative importance of those three factors for the observed incremental improvement of the banking sector legal framework. In my view, the driving force of the good quality legal reforms in Hungary was the combination of a favorable stance to market liberalization of the main political parties and the keen interest of foreign investors and domestic exporters in a more efficient banking sector. It is beyond the scope of my analysis to examine the causes of good administrative and judicial capacity, but my research showed that the efficiency of those two institutions in Hungary has ensured satisfactory implementation of the adopted laws.

International actors have provided paradigms for economic liberalization and influenced the understanding and reform plans of Hungarian policy-makers. Nevertheless, based on the evidence presented in this case study, I would argue that absent the international actors, the domestic political process in Hungary would still have produced the good quality reforms of the banking sector legal framework that we observe today. At the same time, political interference and partisan appointments in important institutions have occurred in Hungary as well. This chapter showed that the EU has served as an important external guarantee for the independence of two important domestic financial institutions: the Hungarian National Bank and the Financial Supervisory Authority.

Notes
Chapter 2:

[1] The Bank for International Settlements (BIS) is a Basle-based grouping of central banks.

[2] IPO stands for Initial Public Offering. This is a procedure to take a company public, allowing investors to buy the company's stock.

CHAPTER THREE

Following World War II, Bulgaria became part of the Soviet Union sphere of influence in Europe. The Bulgarian communist regime was one of the USSR's staunchest allies in the Eastern Bloc. Organized domestic opposition in the country was weak: Bulgaria never experienced resistance to Soviet rule on the scale and intensity seen in Hungary in 1956 and Czechoslovakia in 1968 (Dimitrov 2001). As the communist regimes began to crumble across the Eastern Bloc, the Bulgarian communist leader, Todor Zhivkov, was also removed from power in November 1989. An interim government led by Prime Minister Andrey Lukanov from the communist successor party ruled the country until the first regular multi-party parliamentary elections in 1991 (Dimitrov 2001: 35).

As happened in Poland and Hungary in 1989, the leaders of the BCP (Bulgarian Communist Party) held roundtable talks with members of the opposition and representatives of civil society in 1990 (Dimitrov 2001). I discussed in Chapter 2 that the main purpose of the roundtable talks in the region was to agree upon a framework for transition to a multi-party constitutional democracy (Elster *et al.* 1998: 66). In Bulgaria, the participants in the talks decided that a Grand National Assembly[1] should be convened to create a new Constitution. The elections for the Grand National Assembly took place in June 1990, and it adopted the new Bulgarian Constitution in July 1991, after that it was dissolved (Dimitrov 2001). Table 3.1 at the end of this section presents the main political institutions in Bulgaria enshrined in the new Constitution.

We can discern two distinct periods in the Bulgarian transition to democracy and market economy. During the first period, 1989-1997, the unreformed communist successor party BSP (Bulgarian Socialist Party) dominated the political and economic arenas. The governing elites undertook some economic liberalization and established relations with international actors such as the IMF, but they stalled economic restructuring and engaged in corruption and clientelism (Ganev 2001; Hristova and Angelov 2004; Vachudova 2005). In the summer of 1990, the Grand National Assembly elected Zheliu Zhelev, one of the leaders of the opposition umbrella party SDS (Union of Democratic Forces), the first President in Bulgaria's post-communist period. However, like the Hungarian opposition, SDS lacked the organizational strength and popular appeal of Poland's *Solidarność*. Furthermore, SDS suffered from significant internal fragmentation and disagreement among the party leaders (Dimitrov 2001). Overall, in the period 1989-1997, the pronounced resistance of key political and economic actors in Bulgaria to introducing transparency in the banking sector and the absence of a consistent vision for transforming the financial sector are typical of a broader range of post-communist cases such as Romania and Albania. This chapter shows how in the beginning of Bulgaria's transition, the governing elites implemented limited and selective banking reforms that gave them great discretionary power in allocating the available financial resources.

A severe economic crisis in 1996/1997 paved the way for a change of the governing elites. The early parliamentary elections in 1997 brought to power the right-wing opposition party SDS (Union of Democratic Forces). Chapter 3 examines the configuration of governing elites, domestic stakeholders, and international actors that shaped the legal framework of the Bulgarian banking sector in the period 1989-1997. This configuration changed significantly

after the 1996/1997 economic crisis and the subsequent change of governing elites. During the second period that I consider in my dissertation, 1997-2005, the Bulgarian governing elites supported the development of a more competitive political system, undertook comprehensive economic reforms, and were more receptive to the recommendations of international organizations (Vachudova 2005: 203). This period culminated with the acceptance of Bulgaria as a full member of the European Union in January 2007. Chapter 4 investigates how the post-1997 configuration of governing elites, domestic stakeholders, and international actors, whose influence grew significantly after 1997, has affected the evolution of the banking sector legal framework in Bulgaria.

In this chapter, I start by presenting an overview of the evolution of banking sector laws in Bulgaria during the period 1989-1997 in Section 1. Section 2 investigates whether the empirical evidence confirms my theoretical expectations about the role of three factors—the partisanship of the governing elites, the nature and strength of the mobilized domestic stakeholders, and the influence of international actors—in shaping the quality of legal reform in the Bulgarian banking sector. In Section 3, I summarize the main findings of this chapter.

Table 3.1: Main political institutions in Bulgaria

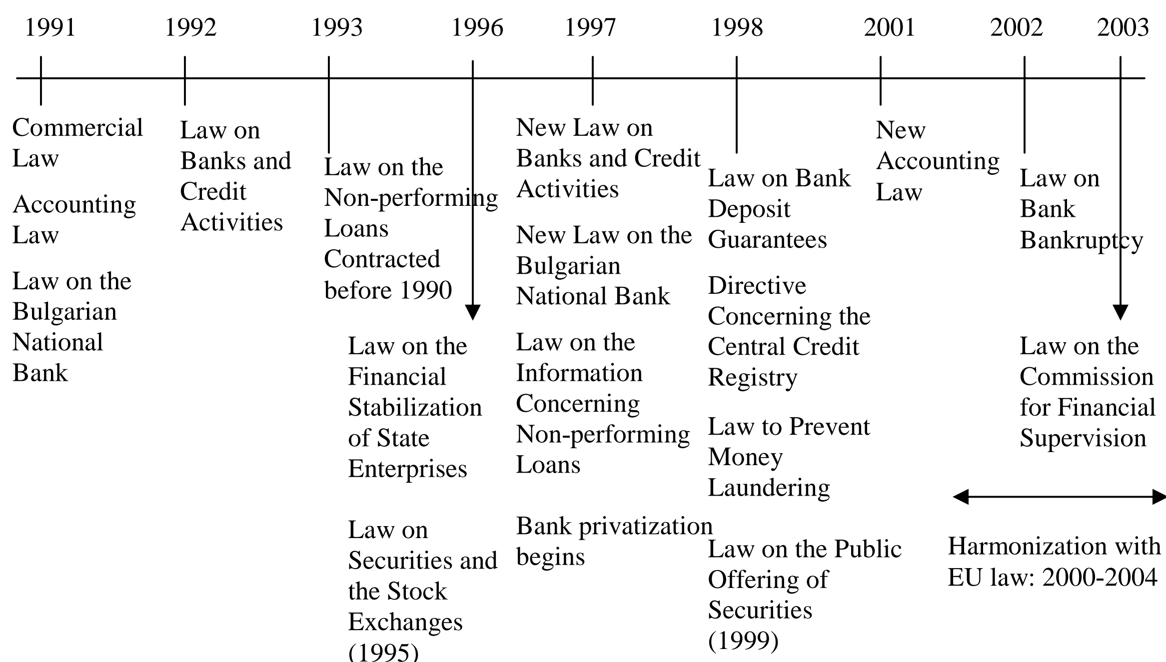
Political Institutions in Bulgaria	
Executive	Government elected by Parliament, headed by Prime Minister
Legislative	Unicameral Parliament 240 seats, 4-year term
- Electoral system	Proportional representation, closed list
Judiciary - Courts	- 100 regional courts act as courts of first instance; - 28 district courts act as courts of first instance for complicated civil cases, all commercial cases, and grave criminal cases and review appeals lodged against the decisions of the regional courts; - 6 courts of appeal review appeals lodged against decisions of the district courts; - The Supreme Court of Cassation reviews appeals against decisions of the district courts and the courts of appeal; - A separate Supreme Administrative Court reviews cases challenging administrative acts.
- Constitutional Court	The Constitutional court reviews the constitutionality of laws and ensures the protection of the fundamental rights granted by the Constitution. The President, the Council of Ministers, the Chief Prosecutor, or one-fifth of the members of the Parliament may bring before the Court general constitutional questions. - Composition: 12 judges appointed or elected for 9-year terms. The Parliament elects 1/3; the President appoints 1/3; the annual joint session of the Supreme Court of Cassation and the Supreme administrative courts elects the remaining 1/3.

1. Evolution of Banking Sector Laws in Bulgaria, 1989-1997

In Chapter 1, I outlined several key policy standards that I use to judge the quality of a country's banking sector legal framework at any given time point. According to these benchmarks, it is desirable to: (1) provide clear market entry and exit conditions; (2) introduce transparency in the banking system and ensure the ability of banks to function without excessive state intervention; (3) guarantee central bank independence; and (4) establish independent banking oversight. Here I present major developments in the evolution of Bulgarian banking laws in the period 1989-1997. This section demonstrates that the emerging legal framework failed to meet the criteria for good quality.

The purpose of the case studies in my dissertation is to identify and analyze the political processes that have led to important legal changes. Therefore, I emphasize what I think are some very important laws regulating the operation of the Bulgarian banking sector, and I present briefly the goals and the impact of those laws. I begin with the 1991 Commercial Law, the 1991 Accounting Law, and the 1991 Law on the Bulgarian National Bank. Then I discuss the 1992 Law on Banks and Credit Activities, which regulated the operation of the first commercial banks in Bulgaria after 1989. I also analyze the 1993 Law on the Non-performing Loans Contracted Before 1990, and the 1996 Law on the Financial Stabilization of State Enterprises, which allowed for the accumulation of significant "bad loans" in the banks' portfolios. Finally, I discuss the 1995 Law on Securities and the Stock Exchanges. In Chapter 4, I outline and analyze the important laws that were introduced after the 1996/1997 economic crisis. Figure 3.1 presents a comprehensive timeline of the important banking and financial sector laws adopted in Bulgaria after 1989.

Figure 3.1: Timeline of important banking and financial sector laws in Bulgaria after 1989



In Bulgaria, the 1991 Commercial law was the first comprehensive legal act intended to regulate the more liberalized market after the fall of communism. The law established the principles for conducting commercial transactions and the licensing regime for commercial entities. It introduced a typology of private and state-owned enterprises, and contained guidelines for transforming the legal status of commercial entities, which is an important legal prerequisite for the privatization of the state-owned enterprises. This law also regulated bankruptcy procedures, including bank bankruptcies, because the Bulgarian legal framework at the time regarded banks as a special sub-type of commercial entities (*Targovski zakon*). Yet because the Commercial law regulated a wide range of substantive issues—from ownership structure to bank bankruptcy—the treatment of some issue areas such as bank bankruptcy was inevitably shallow. The 1991 Accounting Law updated the accounting standards used in the planned economy, but it did not include provisions to make the

companies' balance sheets available for public review. Nor did the Accounting Law stipulate transparent auditing requirements for the big state-owned enterprises and banks.

The first Law on the Bulgarian National Bank (BNB) after the fall of communism was adopted in 1991. According to this legal act, the main goal of the BNB was to maintain the domestic and international stability of the national currency: the lev (*Zakon za BNB*, Article 2). The law also gave the BNB the legal responsibility to monitor the activities of the commercial banks, collect information, and oversee the stability of the banking system as a whole (*Zakon za BNB*, Article 44). Although the law stipulated that the BNB was independent of political interference, it also contained a special clause allowing the government to request funds from the central bank in case of a severe necessity.

There were frequent changes in the legal framework of the Bulgarian banking sector in the early 1990s, indicating that the policy-makers used a trial-and-error approach to legal reform, rather than a strategic and comprehensive approach. For example, the Law on Banks and Credit Activities was adopted in 1992 under the reformist right-wing government led by Philip Dimitrov. Between 1992 and 1997, this law was changed nine times, and it was finally repealed in 1997 after the financial crisis in the country. Additional shortcomings of the early banking sector legal framework were the overly liberal licensing regime and the relatively small amount of initial capital required to open a bank. Thus, many small private Bulgarian banks were created by borrowing initial capital from the already existing state banks (Hristova and Angelov 2004: 74). The 1992 Law on Banking and Credit Activities allowed banks to exchange shares, which in practice enabled banks to operate legitimately by using one single pool of money. The banks that took advantage of this legal loophole such as *Chastna Zemedelska i Investiocionna Banka*, *TB Slavjani*, *Dobrudzhanska Banka*, and

Biznesbank were often involved in giving bad loans to their shareholders, or relatives of the management team (Hristova and Angelov 2004; Stanchev 2005, personal interview). At the same time, the 1990s legal framework deterred foreign banks from entering the domestic market. By 1994, only the Greek *Xios Bank* and the Dutch *ING Bank* had set up branches in Bulgaria.

In the early 1990s, the Bulgarian banks operated under what economists have called "soft budget constraints" (Kornai 1986; Andronova-Vincelette 2003). Pressured by politicians, the bankers extended sizeable credit to the loss-making state enterprises. As a consequence, in 1995, 75 percent of all bank loans in Bulgaria were classified as non-performing (Walko 2004). Responding to the government's requests, the Bulgarian National Bank (BNB) kept providing liquidity to the market to prevent banks from failing. But its intervention did not alleviate the ongoing decapitalization of the banks. At the end of 1995, only 4 of the 47 banks operating in Bulgaria at the time reported end-of-the-year profits (Hristova and Angelov 2004: 77). The remaining 43 banks were all running losses. According to economists Assenka Hristova and Georgi Angelov (2004), the recapitalization of the Bulgarian banks was the most costly bank bailout in the post-communist region and amounted to 41.6 percent of GDP for the period 1991-1998. Overall, Bulgarian taxpayers paid $4 billion for the bank recapitalizations (Todorova and Raeva 1997). In 1995, given the lack of adequate bankruptcy legislation, the BNB attempted to take a pro-active position by revoking the licenses of two troubled banks. Yet, when the banks appealed against the measure before the Bulgarian Supreme Court, the Court reversed the BNB decision (Kapital 1997).

The evidence presented so far suggests that Bulgarian law-makers followed a different approach to reforming the legal framework of the banking sector than their Hungarian counterparts. Chapter 2 showed that the Hungarian policy-makers aimed for generality and consistency in the laws. By contrast, the Bulgarian legislators adopted laws to address the arising problems and issues on an ad hoc basis. For example, the Bulgarian policy-makers passed several laws to settle the bad debts of the state-owned enterprises to the banks such as the 1993 Law for Settling the Non-performing Loans Contracted before 31 December 1990 and the 1996 Law for the Financial Stabilization of the State Enterprises. Yet, as the following sections of this chapter will show, these laws did not provide efficient solutions to the targeted problems. Furthermore, because of the shortcomings in the 1991 Accounting Law, many of the liabilities on the balance sheets of the state-owned banks and enterprises were not even recognized until the mid-1990s.

In Chapter 2, we saw that the stabilization and development of the banking sector are closely linked to the transformation of the real sector of the economy. Thus, the restructuring, or lack thereof, of the state-owned enterprises is bound to have an impact on banks' lending portfolios and bank performance. The failure of the Bulgarian governments to restructure the real sector in the early 1990s contributed to the growth of bad loans in the banking sector, where the state-owned banks were still the main players.

Which laws made possible the rapid growth of bad loans in the Bulgarian economy in the early 1990s? In accordance with Article 4 of the 1993 Law for Settling the Non-performing Loans Contracted before 31 December 1990, the Bulgarian Financial Ministry issued long-term government bonds in October 1993 that were denominated both in leva, the national currency, and in dollars. These government bonds, also known as ZUNK bonds,

provided a legal way for the government to assume responsibility for the loans contracted by the state-owned enterprises before 1990. When this law entered into force, the bad debts that the state enterprises owed to the banks were transformed into government ZUNK bonds (Hristova and Angelov 2004: 75-76). Thus, the participating enterprises became mostly debt-free. But instead of using this opportunity to restructure and seek ways to be profitable, the state-owned enterprises negotiated new loans with the banks to cover their loss-making operations (Hristova and Angelov 2004: 77).

According to Bulgarian scholar Todor Yalamov, the government, which still owned much of the real sector in the early 1990s, did not create incentives for the enterprises to be efficient and profitable (2007, personal interview). If anything, the weak oversight of the state enterprises and lack of legal mechanisms to sanction the loss-making state firms allowed corruption to flourish. For example, a wide-spread practice that was not addressed by the laws at the time was to use subcontractor firms which sold to the state-owned enterprise raw materials at above-market prices, only to buy the output goods at below-market prices. The subcontractor firms were connected, or paid bribes, to the management of the state-owned enterprise (Yalamov 2007, personal interview).

In an isolated attempt to contain the growth of bad loans in the economy, Bulgarian law-makers passed the Law for the Financial Stabilization of State Enterprises in 1996. As stipulated in Article 1, the main goal of this law was to restructure, and if possible reduce, the loans of a number of state-owned enterprises selected by the government (*Zakon za finansovoto ozdravjavane*). The law allowed the eligible enterprises to suspend the payments on their loans, but they were not permitted any additional borrowing. The participating enterprises were obliged to comply with a year-long stabilization plan prepared by the

Financial Ministry. In case of good performance, the Minister of Finance would recommend to the Bulgarian President to write off the enterprise's debts. In case of poor performance, or non-compliance with the stabilization plan, the Minister of Finance had the legal power to shut down the enterprise. The 1996 Law for the Financial Stabilization of State Enterprises signaled some political will to put an end to the uncontrolled borrowing of the state-owned enterprises, but in practice it was abandoned when the 1997 right-wing Kostov government came to power and initiated its own program for privatization and shutting down of the most inefficient industrial enterprises. As of 1999, this law was no longer in force.

We saw in Chapter 2 that Hungarian policy-makers were keen to pass the Act on Securities and the Stock Exchange as early as 1990 in order to reopen the Budapest Stock Exchange. The *First Bulgarian Stock Exchange* opened in 1991 (Bulgarian Stock Exchange 2007). Between 1992 and 1994, 20 more regional exchanges were opened for business. Yet, in contrast to Hungary, the emerging Bulgarian capital market functioned in the absence of legal rules. Bulgarian legislators passed the Law on Securities and the Stock Exchanges as late as 1995. The law mandated the creation of a Commission on Securities and the Stock Exchanges that would have the power to oversee and regulate the capital market. By the end of 1995, all small regional exchanges merged with the *First Bulgarian Stock Exchange*, which became the only operating exchange in the country. In 1996, the Commission on Securities and the Stock Exchanges introduced a requirement that all companies develop a prospectus in order to list their stocks on the Exchange. Because none of the traded companies met this requirement in due course, the Bulgarian Stock Exchange was forced to suspend trade in securities for a year (Center for the Study of Democracy 1997). Trade resumed in 1997 after the partisan change of government and the beginning of the

privatization process increased the number of companies that wanted to list their stocks on the Bulgarian Stock Exchange.

Let us return to the four policy standards that I use judge the quality of a country's banking sector legal framework presented in the beginning of this section. My analysis of the evolution of Bulgarian banking sector laws during the period 1989-1997 showed that the 1991 Commercial Law and the 1992 Law on Banks and Credit Activities did not provide clear market entry and exit conditions. Furthermore, the Laws on Non-performing Loans and the Financial Stabilization of the State Enterprises demonstrated the deficiencies of the Bulgarian banking sector legal framework in terms of ensuring transparent bank operations without excessive state intervention. Finally, the Law on the Bulgarian National Bank did not provide sufficient guarantees for the central bank's independence from political pressure.

2. Domestic and International Determinants of Banking Sector Legal Reform in Bulgaria, 1989-1997

In Chapter 1, I argued that three factors have shaped the quality of banking sector legal reform in the post-communist region. The first factor is the partisan coloration of the governing elites. The second factor refers to the mobilized domestic stakeholders and the nature of the resulting domestic alliances. The third factor is the influence of international actors. Here, I assess the evidence to determine whether those three factors have, in fact, influenced the course of banking sector legal reform in Bulgaria in the period 1989-1997. I start by investigating the impact of the partisan coloration of the governing elites.

2.1 Partisan Coloration of the Government and Partisan Politics

Based on the partisan coloration of the Bulgarian governments in the early 1990s, we do not expect to observe decisive moves toward economic liberalization and a significant

improvement of the quality of the Bulgarian banking sector legal framework. Apart from the term of the reformist right-wing SDS government that lasted 14 months in 1991-1992, Bulgaria was ruled by nominally non-partisan governments and the unreformed communist successor party, BSP. The short-lived 1990 government headed by Dimitar Popov and 1991 government headed by Lyuben Berov were nominally non-partisan expert cabinets, but in fact they rested on the parliamentary support of the BSP. Thus, the non-partisan governments did not undertake any economic liberalization measures that the BSP would refuse to support in the legislature. Table 3.2 summarizes the partisan coloration of Bulgarian governments in the period 1989-1997. Table 3.3 presents the distribution of seats in Parliament for each election year during that period.

Table 3.2: Prime Ministers and partisan coloration of the government in Bulgaria, 1989-1997

BULGARIA		
Prime Minister	**Government time in power**	**Ruling party/ government coalition**
Andrey Karlov Lukanov	3 Feb 1990 - 7 Dec 1990	L: BSP
Dimitar Popov	7 Dec 1990 - 8 Nov 1991	non-partisan
Philip Dimitrov Dimitrov	8 Nov 1991 - 30 Dec 1992	R: SDS
Lyuben Borisov Berov	30 Dec 1992 - 17 Oct 1994	non-partisan
Reneta Ivanova Indzhova	17 Oct 1994 - 25 Jan 1995	interim
Zhan Vasilev Videnov	25 Jan 1995 - 13 Feb 1997	L: BSP
Stefan Antonov Sofiyanski	13 Feb 1997 - 21 May 1997	interim

BSP – Bulgarian Socialist Party (Balgarska Socialisticheska Partija)
SDS – Union of Democratic Forces (Sajuz na Demokratichnite Sili);
later ODS – United Democratic Forces (Obedineni Demokratichni Sili)
DPS – Movement for Rights and Freedoms (Dvizhenie za Prava I Svobodi)
Evrolevitsa – Euroleft
BZNS – Bulgarian Agrarian National Union (Balgarski Zemedelski Naroden Sajuz)
BBB – Bulgarian Business Bloc (Balgarski Biznes Blok)

L stands for left, R – for right, and C – for centrist.

Table 3.3: Distribution of seats in Parliament for each election year, 1989-1997

Political parties	1991	% seats	1994	% seats	1997	% seats
BSP	106	(44.2)	125	(52.08)	58	(25.03)
Evrolevitsa					14	(4.4)
DPS	24	(10)	15	(6.25)	19*	(9)
BZNS	0		18	(7.5)	0	
SDS/ODS	110	(45.8)	69	(28.5)	137	(57.55)
BBB			13	(5.42)	12	(4.02)
Total seats	**240**		**240**		**240**	

Source: Author's calculations based on University of Essex data from the project "Political Transformation and the Electoral Process in Post-Communist Europe"

* DPS ran in alliance with a few smaller political parties.

In Chapter 1, I presented two causal mechanisms used in the literature to account for the association between partisanship and economic reform: party ideology and political competition. According to the party ideology mechanism, 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. According to the political competition mechanism, in a competitive political system, the government must gain support from a wider subset of society and withstand a credible opposition, which forces political parties to consider a broader range of possible economic policies. How do these two mechanisms help explain the path of banking sector legal reforms in Bulgaria?

Hypothesis 1: We expect good quality banking sector legal reform if the domestic political process is characterized by center-right or reformed communist successor parties in power.

The right-wing opposition in Bulgaria endorsed market-liberalizing reforms, but it did not spend sufficient time in government to be able to implement them. There was little

organized and coherent elite opposition in Bulgaria before 1989. When the opposition party Union of Democratic Forces (SDS) formed in late 1989, it lacked sufficient popular backing to defeat decisively the Bulgarian Socialist Party (BSP) in the first democratic elections. In 1991, the SDS formed a minority government, relying on the support of the centrist Movement for Rights and Freedoms (DPS) that represented the Turkish minority in Bulgaria. However, the two parties did not have a formal coalition agreement. The first right-wing government in Bulgaria after 1989 did initiate a range of economic reforms: it passed the Commercial Law and the Law on Banks and Credit Activities, and it also contemplated starting the privatization of a number of state-owned enterprises. Yet, it did not survive long enough to implement its program for economic reform. The SDS government fell in late 1992, after the DPS failed to support it in a parliamentary vote of confidence (Dimitrov 2001).

What were the ideological underpinnings of the economic policies endorsed by the other big player in Bulgarian politics in the early 1990s: the Bulgarian Socialist Party (BSP)? Scholars of post-communist party politics have developed multiple accounts of the policy positions of the parties in the region. For example, Daniel Ziblatt and Nick Biziouras (2002) attempt to explain the ideological stance of communist successor parties as a function of the source of party funding. They argue that communist successor parties that have largely retained their resources after 1989-1990, or rely on the state for party funding, are more likely to show ideological adaptability and accept market liberalization (Ziblatt and Biziouras 2002: 288). According to the logic of this argument, communist successor parties that are funded primarily through membership contributions remain "captured" by the anti-reform

ideological preferences of their voters and remain unreformed (Ziblatt and Biziouras 2002: 288).

Ziblatt and Biziouras assume that after transition, party politics in the post-communist region has functioned according to the same organizational and fund-raising principles as in advanced industrialized democracies. However, scholars studying the post-communist region have demonstrated that party membership has been declining steadily in the region, political parties are weakly rooted in society, and no parties fund their activities primarily through their members' contributions (Kopecky 1995; Kitschelt 2000; Lewis 2001). These findings apply to the BSP as well. Therefore, it is not warranted to attribute the lack of ideological adaptation in the Bulgarian Socialist Party to the intransigent ideological preferences of the party's voters.

The BSP controlled the government in 1990, immediately following the fall of the communist regime, and it returned to power again after the early elections in 1994. According to former Socialist MP Cezar Karafeizov, the policies that the BSP put in place were shaped by the interests and ambitions of groups within the party, rather than by its ideological commitments to the voters (2005, personal interview). Indeed, Herbert Kitschelt et al. have found in their analysis of post-communist party systems that unlike the Hungarian Socialists, the Bulgarian Socialists "thwarted a radical break with the past inside the party" (1999: 200). The authors point out that the BSP's organizational and ideological structure contained deeply divided and antagonizing groups. In the beginning of transition, the most influential group within the BSP represented the stalwarts of the previous regime who were part of extensive patronage networks (Kitschelt *et al.* 1999: 200). In addition, the BSP contained small groups of Westernizing quasi-Social Democrats and middle-of-the-road

technocrats. As Kitschelt et al. have found, the stalwarts of the previous regime were opposed to undertaking comprehensive economic reforms. Instead, they maintained the party's organizational coherence and grip on power through clientelist networks, especially in sectors such as state-run enterprises and collectivized agriculture (Kitschelt *et al.* 1999: 201).

Political scientist Todor Yalamov has emphasized that while the BSP was in power, the changing party leadership pursued slightly different policy goals (2007, personal interview). In particular, the 1990 government led by Prime Minister Andrey Lukanov differed significantly from the 1994 government led by Zhan Videnov, which ultimately was responsible for the economic crisis in 1996/1997. According to Yalamov, the Lukanov government represented the "old elite" in the Bulgarian Socialist Party. By contrast, the Videnov government represented younger members of the party who, according to Yalamov, had not yet obtained "their share from the spoils" of transition and pursued asset-stripping schemes and clientelism even more aggressively than the members of the "old elite" (Yalamov 2007, personal interview).

We saw so far a clear distinction between the transition strategy of the Hungarian Socialists and that of their Bulgarian counterparts. In Hungary, the MSZP understood very early on that endorsing the free market could bring tremendous benefits in the new international environment after the end of the Cold War. The MSZP also anticipated that support for market liberalization would make its program more appealing to voters (Andor 2006, personal interview). By contrast, the Bulgarian Socialists showed little vision and responsibility for the long-term fate of the country and the economy. While they controlled the state's financial resources, the BSP elites maximized asset-stripping and personal benefits

from clientelism. According to Todor Yalamov, in the early 1990s, the BSP elites were primarily focused on securing private gains from the transition process, if need be at the expense of the state's stability and long-term institutional viability (2007, personal interview).

Bulgarian journalist Georgi Stoev (2003) has traced the roots of the self-interested attitude and lack of vision of the Bulgarian Socialist elites to the communist elites' management of the Bulgarian economy in the 1980s. Stoev's research shows that in the early 1980s, the Bulgarian current account started to register persistent deficits. Driven by its commitments as part of the Soviet Bloc, the Bulgarian communist regime exported goods and services to Middle Eastern and African countries such as Iraq and Libya, even though the importer countries frequently failed to pay (Stoev 2003). At the same time, in the mid-1980s, the USSR stopped its generous subsidies to Bulgaria. To stabilize the economy, the ruling elites borrowed extensively on the international capital markets, as a result of which Bulgaria's foreign debt tripled in the period 1985-1989 (Stoev 2003). Yet, Bulgaria's Socialist planners did not invest the borrowed money to upgrade the production infrastructure and pursue higher productivity. Instead, they kept borrowing on the international markets to cover the budget deficits and pay the workers in the state-owned enterprises in order to prevent social unrest (Stoev 2003). The same attitude persisted after 1989, as more or less the same elites remained in power. Only after 1989, the theoretical possibility to be voted out of government meant that the new strategy of the BSP nomenklatura became "take as much as you can before you have to quit power" (Stoev 2003).

In Chapter 1, I outlined how 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. In contrast to the Hungarian Socialist Party (MSZP) which pursued genuine reform, in 1989, the Bulgarian Socialist Party only changed its name from communist to socialist, but it failed to adjust its goals and methods to the standards of liberal democracy (Vachudova and Snyder 1997). The lack of reform within the BSP was partly due to the absence of strong domestic political competitors in the early 1990s. As Milada Vachudova has pointed out, the absence of a credible challenge from the opposition allowed the BSP to maintain its grip on power. As a consequence, the BSP political and economic elites were able to stall economic reform and reinforce wide-spread corruption and clientelism (Vachudova 2005: 51).

How much intentionality can we attribute to the actions of the early BSP governments that ultimately caused the 1996-1997 economic crisis? In a recently published monograph, one of the prominent BSP politicians throughout the 1990s, Alexandar Lilov, admits that the party leaders made many poor choices when they appointed to key management positions in the state-owned enterprises people who did not have any understanding of free market economics (Lilov 2004: 545). Ministers in the early Socialist governments kept changing the enterprise managers, often employing people who lacked the necessary qualifications and had little prior experience (Lilov 2004: 546). In the end, Lilov acknowledges that the BSP failed to produce a viable left strategy for a "social transition" that could have minimized the negative impact of economic restructuring on the citizens (2004: 526). Yet, he attributes this failure to the lack of knowledge of the market economy framework and wide-spread management incompetence in the beginning of transition.

Bulgarian economist Nikolay Nenovsky points out that both lack of knowledge and deliberate misuse of the banks undermined the stability of the banking sector in the early

1990s (2007, personal interview). First, the BSP policy-makers did lack an advanced understanding of the state of the banking system, and they never formulated a strategy for its development. The educational and experience requirements for top bank management were low (Yalamov 2007, personal interview). Furthermore, many members of the bank management team possessed discretionary power to grant sizeable loans, while the banks did not circulate among each other loan-related information (Stanchev 2005, personal interview). This point is related to the weak monitoring capacity of the central bank, which in the 1990s did not have legal instruments to exercise oversight of the amount and nature of the loans given away by the banks (Yalamov 2007, personal interview). Second, given the general lack of systematic information about the state of the Bulgarian banking system, Nenovsky emphasizes that some political and economic figures were in a position to misuse the sector for personal benefits (2007, personal interview). Nenovsky stresses that we cannot pinpoint a single mastermind of the downfall of the Bulgarian banking system. Rather, we can discern networks of political and economic elites who took advantage of the murky regulatory environment. In particular, influential members of the Bulgarian political elite at the time were keen to transform their temporary access to political power and regulatory politics into long-term economic gains and economic influence (Nenovsky 2007, personal interview). We now turn to an investigation of the domestic alliances and domestic stakeholders who influenced the economic policies passed by the Bulgarian Socialists in the early 1990s.

2.2 Domestic Stakeholders and Domestic Alliances

As I outlined in Chapter 1, what Joel Hellman (1998) has called "partial reform" alliances gained a strong foothold in Bulgaria in the early 1990s, while the unreformed communist successor party, BSP, was in power. Taking advantage of the loopholes in the

country's banking laws, corrupt officials in key political and economic positions extracted financial gains for themselves and their rent-seeking clients. Yet two puzzles remain: Who were the organized constituents of the BSP? What factors allowed them to exercise such a powerful influence on the policy-making process? Here I analyze my hypothesis about the nature of the domestic stakeholders and the partial reform alliances in Bulgaria in the period 1989-1997.

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

Drawing on Hellman's (1998) analysis of the politics of partial reform in the post-communist region, in Chapter 1 I proposed that the persistence of financial and industrial manager networks from the previous regime would be associated with a worse quality of banking sector laws. David Stark and László Bruszt (1998) have emphasized that the centrally planned economies in the region generated what they call "associative networks" among firms, political figures, and bureaucrats. Some of these networks dissipated during the transformation of the economic environment. However, other "associative networks" were reinforced as firms, individuals, banks, local governments, and other economic agents sought ways to survive in the new economic environment (Stark and Bruszt 1998). This scenario applies well to Bulgaria until 1997. Still other "associative networks" were reinvented as the same actors searched for new customers and suppliers, new sources of credits and revenues, and new strategic allies (Stark and Bruszt 1998). As we saw in Chapter 2, this pattern applies to the alliances that the Hungarian Socialist Party (MSZP) has built after 1989.

One possible negative consequence of the presence of strong “associative networks” is reinforcing the pattern of clientelistic relationships, cronyism, and corruption that was present in the socialist planned economies (Rose-Ackerman 1999). The misuse of the Bulgarian banking system in the early 1990s shows how this possibility worked in practice. In 1989, the Bulgarian banking system was transformed from a one-tier to a two-tier one comprised of the Bulgarian National Bank, the central bank, and the new commercial banks. Yet, the distorted incentives in the system severely hindered the development of Bulgarian banks. Of the 10 relatively large banks in Bulgaria at the end of 1995, 9 were state-owned (Barisitz 2001). Kenneth Koford and Adrian Tschoegl (1997) have studied the bank performance and crediting practices in Bulgaria before the 1996/1997 crisis. They found evidence of wide-spread inside crediting, a vague legal environment, and rampant corruption (Koford and Tschoegl 1997). In the period 1990-1994 alone, the Socialist governments issued $480 million worth of government bonds to cover the bad loans of the state-owned banks (Todorova and Raeva 1997). Acting upon government recommendations, the BNB refinanced the state-owned banks multiple times to save them from bankruptcy (Hristova and Angelov 2004).

In one instance, it appeared that the Bulgarian government was cleaning up its act and taking the path of reforms. In 1991, the right-wing minority government led by Prime Minister Philip Dimitrov was determined to catch up with the Central European front-runners (Dimitrov 2005, personal interview). The cabinet sought policy recommendations from PHARE (EU assistance program for Eastern Europe) officials, the World Bank, and the IMF. In addition, experts from Poland, Czechoslovakia, and Hungary contributed insights about their experience with economic reform (Dempsey 1992). However, before this government

could implement its ambitious program for economic restructuring, it lost a parliamentary vote of confidence in late 1992 and resigned.

Prime Minister Dimitrov's economic team shared one important concern with the Hungarian Socialists: the lack of capital necessary to boost economic development. As Dimitrov recalls, several large Bulgarian banks such as *Vanshnotargovska banka* (later called *Bulbank*) were restructured in the early 1990s, but there was no influx of new capital into those banks (Dimitrov 2005, personal interview). Because all large banks were still state-owned in the early 1990s, the bank management was pressured by government ministers to give loans to large state-owned conglomerates, so that the enterprises would continue to function and pay their employees. Absent new capital in the banking system, this operation was bound to be financed by the central bank (Dimitrov 2005, personal interview). We saw in Chapter 2 that the Hungarian Socialists responded to the continuous pressure to refinance the banks by privatizing the banking system. By contrast, in Bulgaria, after the Dimitrov government resigned in 1992, the continuing practice to decapitalize the state-owned banks through bad loans, and then use the central bank to refinance the banks ultimately led to the collapse of the banking system in 1996-1997.

The case of Bulgaria until 1997 shows that during the ambiguous period of state-led creation of property rights and ownership restructuring, the governing elites can facilitate the misuse of state assets for personal gains by deliberately weakening the state's monitoring and regulatory capacity. Political scientist Venelin Ganev has demonstrated how the early Socialist governments in Bulgaria de-institutionalized the state agencies that stored information and monitored the economic conditions in the country (2001b: 391). This paved

the way for what Ganev calls "selective privatization" to insiders with personal links to the ministers who controlled the state assets of interest.

When the 1994 Socialist government of Prime Minister Zhan Videnov took office, clientelism flourished. The Socialists claimed that they won a mandate for a "socially-oriented" transition (Lilov 2004). Policy-wise, this translated into subsidizing the state enterprises and pressuring the banks to extend more bad loans. Venelin Ganev (2001a) has examined one of the prime examples of partial reform alliances in Bulgaria: the financial-industrial conglomerate Multigroup. In the early 1990s, Multigroup gained control through privatization of more than 120 Bulgarian companies in sectors such as metallurgy and mining, engineering, petrochemicals, transport of natural gas and gas distribution systems, and tourism (Ganev 2001a: 5-8). Ganev points out that the majority of the company's twenty general directors previously held positions as directors of state-owned enterprises, ministers, and deputy-ministers in the governments before 1989 or in the first post-1989 BSP cabinets. In his investigation of Multigroup's rise to become one of the most powerful private economic actors in the post-1989 Bulgarian economy, Ganev concludes that "the profits of the private conglomerate are invariably accompanied by losses of its state-owned partners" (2001a: 8).

The relationship between the Videnov government and Multigroup discussed above exemplifies the kinds of domestic stakeholders favored by the BSP governments in the early 1990s. Let us consider some further examples of partial reform alliances in Bulgaria, and the factors that facilitated their formation. According to journalist Milena Dalakchieva (1998), the lack of a central credit registry and the subordinated position of the central bank were the main institutional factors that made possible the unprecedented growth of bad loans in the

economy. In 1996, when the country had already plunged in economic crisis, the Ministry of Internal Affairs prepared a report on the bad loans in the economy. The Bulgarian media gained access to the report in 1998. The data shows that a few large economic groups owed the largest amounts. Multigroup headed the list with bad loans for 91 billion leva. Seven firms that were part of the Multigroup structure owed 34 large loans to *Balkanbank*, which declared bankruptcy in 1997, and 1 large loan to *Biohim* bank (data and analysis from Mihalev 2001).

Another leader in the list of the largest bad loans is *Agrobiznesbank*. By 1997, this smaller bank had managed to borrow 52.4 billion leva from large state-owned banks such as *DSK (Darzhavna Spestovna Kasa).* In fact, the owners of *Agrobiznesbank*, Hristo Alexandrov and Hristo Danov, had borrowed from their own bank 15 loans amounting to a total of 17.2 billion leva that they never repaid (Dalakchieva 1998). Asset-stripping one's own bank was a common practice in Bulgaria in the early 1990s. Ivan Evlogiev, owner of *MBIR (ezhdunarodna Banka za Investicii I Razvitie)*, had borrowed from his bank 21 loans amounting to a total of 54.6 billion leva (Mihalev 2001). Both *Agrobiznesbank and MBIR* were among the institutions that went bankrupt during the 1996-1997 collapse of the banking sector, but they had managed to survive until then because the Bulgarian National Bank periodically refinanced all troubled banks throughout the early 1990s.

The *Plama Oil Refinery*, a Bulgarian industrial conglomerate, owed the banks a staggering 204 billion leva worth of bad loans. From the beginning of transition, Bulgarian governments pressured the state-owned banks to give loans to the *Plama* refinery. Politicians guaranteed that the state would never allow *Plama* to go bankrupt, because of its strategic importance for the economy (Dalakchieva 1998). However, when a team from *Kapital*

newspaper investigated how the loans were used, it found out that a small portion of the loans paid the workers' salaries and maintenance procedures, but the management had not undertaken any costly investment or upgrading of *Plama*'s infrastructure. Thus, at the end of the day, most of the funds that the *Plama* management had borrowed from the Bulgarian banks were not accounted for (Dalakchieva 1998). So far, we saw how strong the rent-seeking domestic stakeholders were in Bulgaria in the early 1990s. Were there any foreign investors or domestic actors in favor of economic liberalization who could challenge and weaken the clientelistic alliances that dominated the Bulgarian economy?

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

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

Bulgarian scholar Todor Yalamov has researched the sources of capital formation in the Bulgarian economy during the early years of transition. In his view, whereas the political and economic elites in Hungary made a strategic decision to seek Western capital in order to boost the economy, their Bulgarian counterparts lacked such a strategic vision (2007, personal interview). According to Yalamov, until 1997, the Bulgarian economy relied on four main sources of capital formation: money deposited abroad by the communist elites before 1989; profits from traffic in drugs, weapons, and people; asset-stripping of the state-owned enterprises; and taking loans from the growing number of commercial banks with no intention to repay (2007, personal interview).

The business environment in Bulgaria in the early 1990s was not attractive to Western investors. A survey of the few foreign investors present in the country in 1997

revealed that 46 percent had come to Bulgaria to take advantage of the consumer potential in the country. For 36 percent of the foreign investors, the skilled labor force and low cost of labor were an important factor to come to Bulgaria. Only a meager 6 percent of the investors considered Bulgaria's Foreign Investment Law and tax conditions to be favorable for their business (all data from Kapital 1998, *Veski edin it trima*). Foreign investors were particularly disappointed with the frequent changes in Bulgaria's legal framework and the myriad of bureaucratic impediments to business (Kapital 1998, *Veski edin it trima*).

In Chapter 2, we saw that in the early 1990s, Hungarian policy-makers actively sought to attract foreign investors and were prepared to offer laws that would facilitate the investors' business operations. By contrast, the Socialist governments of the early 1990s in Bulgaria cared little about attracting foreign capital. According to Todor Yalamov, the clientelistic business environment in Bulgaria in the early 1990s attracted investors from the ex-Soviet Union bloc, especially Russia, who were used to corrupt business practices in their own economies. Thus, the early foreign investors in Bulgaria in fact tolerated and reinforced the existing clientelistic business practices in the domestic economy (Yalamov 2007, personal interview).

A similar argument applies to the impact of international trade on Bulgaria's legal framework in the early 1990s. Early on during transition, Hungary reoriented its trade toward the European Union. As a result, Hungarian export businesses had a higher exposure to the business practices in the EU that discouraged corruption. By contrast, Bulgaria did not reorient its international trade toward the EU until after 1997. Prior to 1997, Bulgaria's main trading partners were still countries from the ex-Soviet bloc, notably Russia (Dobrinsky *et al.* 1995).

Chapter 2 showed that the Hungarian governing elites deliberately chose to limit the links between industrial enterprises and banks in order to reduce the possibilities for corruption during transition. Yet, the general model of economic development, where industrial enterprises maintain close links with so-called "house banks" has been very successful in coordinated market economies such as Germany. The literature has demonstrated that the close relationship between industries and banks has been beneficial for economic growth in states such as Germany and Sweden (Zysman 1983; Siebert 2004). Banks were able to provide industries with "patient capital" at relatively low interest rates and over an extended period of repayment. In turn, the availability of "patient capital" stimulated investment in cutting-edge technology and made the industries that benefited from this opportunity more profitable and competitive in the long-run. Yet a crucial assumption of the "patient capital" model is that industrial enterprises and banks will pursue long-term gains, productivity, and efficiency. Unfortunately, the endemic clientelism, cronyism, and corruption characteristic of post-communist economic relations compromised the applicability of this model in the region. As this chapter has showed, in systems where the state-owned banks were closely associated with the state-owned industries such as Bulgaria until 1997, the capital borrowed from the banks was channeled predominantly into the private accounts of the bank and enterprise managers.

What additional factors compromised the applicability of this model in post-communist transitional countries such as Bulgaria? According to Bulgarian political scientist Todor Yalamov, the managerial ethos created and sustained during the decades of planned socialist economy violated a crucial assumption of market economies: that enterprises would pursue profits through efficiency and expanding their operations (2007, personal interview).

Following the collapse of the Soviet bloc, many managers of the Bulgarian state-owned enterprises were entangled in a network of private and state-owned firms whose main business involved stripping the assets of the state-owned conglomerates. For example, the enterprise managers procured raw materials necessary for the production process from subcontractor firms at above-market prices. After the production process took place, the enterprise managers arranged the sale of the manufactured goods to subcontractor firms at below-market prices. Thus, the profit from the production process was not collected by the state-owned enterprises, but by the subcontractor firms. In exchange, those firms offered lucrative kickbacks to the managers of the debt-accumulating state conglomerates (Kitschelt *et al.* 1999: 201; Yalamov 2007, personal interview).

2.3 International Actors

My theory suggests three mechanisms whereby international actors influence banking sector legal reform: conditionality, selective domestic empowerment, and socialization. Here I investigate whether we can find evidence that the three mechanisms have influenced the path of banking legal reform in Bulgaria in the period 1989-1997.

Hypothesis 5: We expect good quality banking sector legal reform if a country has been involved consistently in IMF and EU conditionality programs.

Like in Hungary, the international community was engaged and willing to support Western-style market reforms in Bulgaria. Here I focus on the role of the most salient international actors in the post-communist region: the IMF, the World Bank, and the EU. However, unlike the Hungarian Socialist governments, the Socialist governments in Bulgaria in the early 1990s were hostile toward what they interpreted as the interference of international actors in Bulgarian domestic politics. The conditionality mechanism did not

work in Bulgaria at all in the early and mid-1990s. I attribute the weakness of this mechanism not to a lack of engagement on the part of the international community, but to a lack receptivity[2] on part of the Bulgarian government at the time. For example, ex-Prime Minister Andrey Lukanov stated before the arrival of IMF representative Anne McGuirk in December 1995, "We should not accept the dictate of the international financial institutions with respect to the loans to state-owned enterprises" (quoted in Kapital 1998, *Trite godini*). The 1994 Videnov government brought this enmity to a new level: the IMF requested the removal of Deputy Prime Minister Roumen Gechev from the Bulgarian negotiation team, because "he was prone to lying about the economic situation in the country" (Kapital 1998, *Trite godini*). But as we will see in Chapter 4, the IMF became a very important factor in Bulgarian financial policy after the 1996/1997 crisis and the early elections that brought to power Ivan Kostov's right-wing government.

According to a Bulgarian banking sector professional, the political elites in the early 1990s were aware that Bulgaria did not have sufficient foreign currency reserves to manage successfully its foreign debt. In 1993, the monitoring mission of the IMF in Bulgaria had alerted the government that the debt payments negotiated with the London club of creditors were too burdensome and unfeasible, given the state of the Bulgarian economy at the time (anonymous personal interview, 2007). Yet, the governing elites refused to acknowledge that they did not have a sustainable plan for managing the state budget and the growing foreign debt. Deputy Prime Minister Roumen Gechev also said: "So what, we don't have to sign an agreement with the IMF. We have figured out the budget without the IMF. We can always borrow money from somewhere else – not from the IMF or the World Bank – as long as we can provide state guarantees we can borrow from the private markets" (quoted in Kapital

1998, *Trite godini*). A few months after Gechev made this statement, the Bulgarian financial system practically collapsed during the 1996/1997 economic crisis that I describe at the end of the chapter. This section has demonstrated that the BSP governments of the early 1990s were not responsive to the policy advice of international actors. Below, I show that international actors also lacked leverage to empower an independent central bank, and influence Bulgarian decision-makers through socialization.

Hypothesis 6: We expect good quality banking sector legal reform if international actors empower organizations such as independent agencies responsible for monitoring the financial sector and independent central banks.

The Law on the Bulgarian National Bank put the central bank in a vulnerable position with respect to political pressure from the government. Although the law stipulated that the BNB was independent of political interference, it also contained a special clause allowing the government to request funds from the BNB in case of a severe necessity. The BSP governments used this clause multiple times to force the central bank to refinance the banks that had lost capital due to the high percentage of bad loans. As Lena Roussenova, Chief Economist at the BNB in 1996-1997, pointed out, the central bank itself did not adopt an active position on what the most desirable policies were. Rather, the Bulgarian central bankers in that period took a more passive role and responded to developments in the financial system and pressure from the government (Roussenova 2007, personal interview).

Hypothesis 7: We expect good quality banking sector legal reform if elite socialization is taking place between the local elites and international proponents of banking reform.

Bulgarian policy-makers in the early 1990s were somewhat interested in how the market economy framework worked. However, they lacked the training and expertise that some Hungarian economic experts had. Bulgarian economist and central banker Nikolay Nenovsky provides an anecdotal example of how well Bulgarian policy-makers approached financial sector reform in the early 1990s. According to Nenovsky, Bulgarian financial experts obtained a copy of US Finance Professor Frederic Mishkin's textbook "The Economics of Money, Banking and Financial Markets." After reading the textbook, they introduced the entire range of financial instruments discussed in the Mishkin textbook in the Bulgarian legal framework, notwithstanding the nascent stage of development of the Bulgarian capital market and the absence of a Law on Securities and the Stock Exchange (Nenovsky 2007, personal interview). Thus, the great discretionary power in the hands of the governing elites coupled with the wide range of financial instruments that they introduced in the economy created further opportunities for fraud and embezzlement of financial assets owned by the state (Nenovsky 2007, personal interview).

During communism, the Bulgarian elites were closely allied with the Soviet Union leadership and had little exposure to Western economic thought. As more or less the same elites constituted the early BSP governments in Bulgaria, they had strained relations with international promoters of free market policies. Thus, the constructivist mechanisms of socialization and persuasion through communication and social interaction (see Checkel, 2001) were confronted with very hostile domestic conditions in Bulgaria until 1997 and could not alter domestic policy. Cezar Karafeizov, former Socialist MP in the Great National Assembly that adopted the post-1989 Bulgarian Constitution, highlights the so-called "Rahn-Utt Plan" as an example of the limited impact of international advisers (2005, personal

interview). The Rahn-Utt Plan is named after two US economists, Richard Rahn and Ronald Utt, who were commissioned to prepare a report outlining strategies for Bulgaria's transition to market economy by Prime Minister Andrey Lukanov in 1990. Overall, the research team working on this project consisted of 34 US advisers and 29 Bulgarian economists (Karafeizov 2005, personal interview). Rahn and Utt visited Bulgaria as early as August 1990 and in October 1990, the project team published a report with its recommendations for reforms called "Bulgarian Economic Growth and Transition Project." The report contained 23 chapters and extensive regulatory and policy recommendations such as reforming monetary policy, creating free trade zones, and revamping the healthcare and education systems (Lilov 2004: 524).

The Rahn-Utt report provides evidence that in the early 1990s, the Bulgarian political elites had access to international advice about the transformations that were needed to make the Bulgarian economy more competitive and efficient. Why were those ideas neglected by the governing elites? Were the policy recommendations of the report too drastic? In general, the Rahn-Utt report did suggest rapid market-oriented reforms in three interrelated areas: creation of property rights; privatization of the state enterprises; and reform of the taxation, banking, and financial systems. But these market-oriented reforms would be complemented by revamping important social policies such as education and healthcare (Rahn and Utt 1990, *Chapter 1*). According the Alexandar Lilov, a prominent BSP politician throughout the 1990s, the Rahn-Utt report was simply not palatable to the high-ranked BSP party officials (2004: 524). Furthermore, in Lilov's view, the Bulgarian Socialist Party faced sharp internal struggles over who should control the policy-making process (2004: 525). In the end, the

BSP politicians who opposed thorough market-oriented reforms prevailed and the party simply shelved proposals for reform such as the Rahn-Utt project.

Let us examine the policy recommendations of the Rahn-Utt report with respect to restructuring the Bulgarian financial sector. In Chapter 5 of the report, Richard Rahn outlined several options for reforming Bulgarian monetary policy such as a currency board, using the currency of a foreign country, a quasi-gold standard, or using a standard basket of goods as a benchmark. Rahn discussed the pros and cons of each approach, summarized which countries had already used the different approaches, and the economic conditions under which each approach performed best and worst. While a detailed analysis of each option is beyond the scope of this chapter, it is important to point out that Rahn's overall recommendation to Bulgarian governments with respect to monetary policy was to stabilize the national currency (the lev) by liberalizing prices, cutting the loans to poorly performing state enterprises, and reducing the budget deficit (Rahn and Utt 1990, *Chapter 5*).

Chapter 6 of the Ran-Utt report, written by Mary Bush and William Middendorf, clearly outlined the moral hazard in the Bulgarian banking system at the time. The authors observed that due to the centralized state-owned nature of the banking system, the government alone controlled credit allocation in the country. The institutional set-up allowed the government to pursue its own investment program, or worse, allocate credit according to the interests of the most influential politicians (Rahn and Utt 1990, *Chapter 6*). Given the lack of domestic capital that could support economic development, Bush and Middendorf recommended selling the banks to strategic foreign investors (Rahn and Utt 1990, *Chapter 6*). This move would attract international capital and introduce better management practices

and banking services (Ran-Utt 1990, Chapter 6). As I have shown, however, the BSP governments of the early 1990s completely ignored the advice of the Rahn-Utt report.

In Section 2, I investigated how three factors—the partisan coloration of the governing elites, the nature and strength of the mobilized domestic stakeholders, and the influence of international actors—have shaped the quality of banking sector legal reform in Bulgaria in the period 1989-1997. The evidence presented in this chapter helps understand which of the three factors led to the observed ad hoc development of the banking sector legal framework and the overall poor quality of the adopted reforms. The Rahn-Utt report demonstrated that the international actors were present in Bulgaria in the early 1990s, and promoted their suggestions for comprehensive economic liberalization. However, at the end of the day, the alliance between the unreformed communist successor party elites in power and the rent-seeking domestic stakeholders blocked off the international actors from achieving any impact on domestic policy reform. The banking sector legal framework developed in Bulgaria in the early 1990s reflected exclusively the preferences of the domestic elites and mobilized stakeholders. In Chapter 4, I examine the effect of Bulgaria's administrative and judicial capacity on law implementation.

3. Conclusion

Recent work in comparative politics has enhanced our knowledge of "hybrid regimes" that combine characteristics of democratic and authoritarian governance (Karl 1995; Diamond 2002; Levitsky and Way 2002) as well as "partial reform" regimes where influential political and economic elites have stalled economic reform to extract personal benefits (Hellman 1998; Ganev 2001; Barnes 2003; Gould 2003). This chapter has improved our understanding of one such regime in the post-communist region: Bulgaria until 1997. We

saw how a small elite undertook limited ownership change of the state assets, undermined the economy, and neglected the long-term consequences for the citizens. Influential members of the Bulgarian Socialist Party were able to transform their temporary access to political power into long-term economic gains and economic influence (Nenovsky 2007, personal interview).

The main legacy of the Videnov BSP government was widespread economic mismanagement that gave rise to shortages and culminated with a severe financial crisis in the winter of 1996/1997. The two most visible dimensions of this financial turmoil were a currency crisis and a bank crisis. Because of the significant loss of value of the national currency, the lev, that began in 1995 and skyrocketing inflation, firms and citizens alike rushed to convert all their leva assets to foreign currency, which needless to say was in short supply. In addition, due to the absence of a wide range of investment opportunities, most of the population's savings were channeled into the banking system (Dobrinsky 2000: 590). As the public's confidence in financial institutions started to erode in late 1995, citizens sought to withdraw their savings from the troubled banks, only to find that the banks did not have sufficient liquidity to meet the depositors' demands (Dobrinsky 2000: 591). In the winter of 1996/1997, the country witnessed unprecedented social mobilization against the disastrous economic policy of the BSP government. Citizens held protest rallies in the capital and across the country calling for the Prime Minister's resignation. In January 1997, more than 10 000 protesters blockaded the Bulgarian parliament building, demanding that the BSP government step down immediately. Riot police violently broke up the blockade, but in the following days the demonstrations did not subside. Eventually, the BSP government announced on 4 February 1997 that it would resign, thus paving the way for early elections. Following the government's resignation, President Petar Stoyanov appointed a caretaker

cabinet that would be in power for several months before the early elections took place in April 1997.

Once the BSP was ousted from power, the clientelistic networks became difficult to maintain or extend without access to the financial resources provided by the state (Kitschelt at al. 1999: 201). Chapter 4 turns to the next period in Bulgaria's transition, 1997-2005. Following the economic crisis in 1996/1997, the early elections brought to power the right-wing government of Prime Minister Ivan Kostov. This was the first non-Socialist government in Bulgaria to carry out its entire four-year mandate and, consequently, implement its program for economic reform.

Notes
Chapter 3:

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[1] The Grand National Assembly in Bulgaria is different from the regular National Assembly. A Grand National Assembly is convened in order to change the Constitution, during war-time or other instances of social upheaval. While the regular National Assembly has 240 seat allocated through a proportional representation electoral system, the Grand National Assembly has 400 seats. Of those, 200 seats are allocated through proportional representation and the remaining 200 seats are allocated through a single member district electoral system (Elster *et al.* 1998: 66).

[2] By receptivity I mean not just being in touch with the international actors, but actually considering, analyzing, and using some of their advice when drafting legislation.

CHAPTER FOUR

In Chapter 3, I argued that we can discern two distinct periods in the Bulgarian transition to democracy and a market economy. During the first period, 1989-1997, the unreformed communist successor party BSP (Bulgarian Socialist Party) dominated the political and economic arenas. As we saw in the previous chapter, although international actors promoted their vision of comprehensive economic liberalization in Bulgaria in the early 1990s, ultimately the alliance between unreformed communist successor party elites in power and rent-seeking domestic stakeholders blocked off international influences. Thus, the banking sector legal framework developed in the early 1990s reflected exclusively the preferences of the domestic elites and stakeholders. The laws had significant shortcomings that made possible the uncontrolled accumulation of bad loans.

In this chapter, we turn to the second period in Bulgaria's transition. A severe economic crisis in 1996/1997 paved the way for a change of the governing elites. This crisis discredited the BSP decisively, and forced early elections in 1997 that brought to power the right-wing opposition party ODS (Union of Democratic Forces). During the period 1997-2005, successive right-wing and centrist governments supported the development of a more competitive political system, undertook comprehensive economic reforms, and were more receptive to the recommendations of international actors (Vachudova 2005: 203). This period culminated in the acceptance of Bulgaria as a full member of the European Union in January 2007. I examine how the post-1997 configuration of the governing elites, domestic

stakeholders, and international actors (whose influence grew significantly after 1997) produced a significant improvement of the banking sector legal framework.

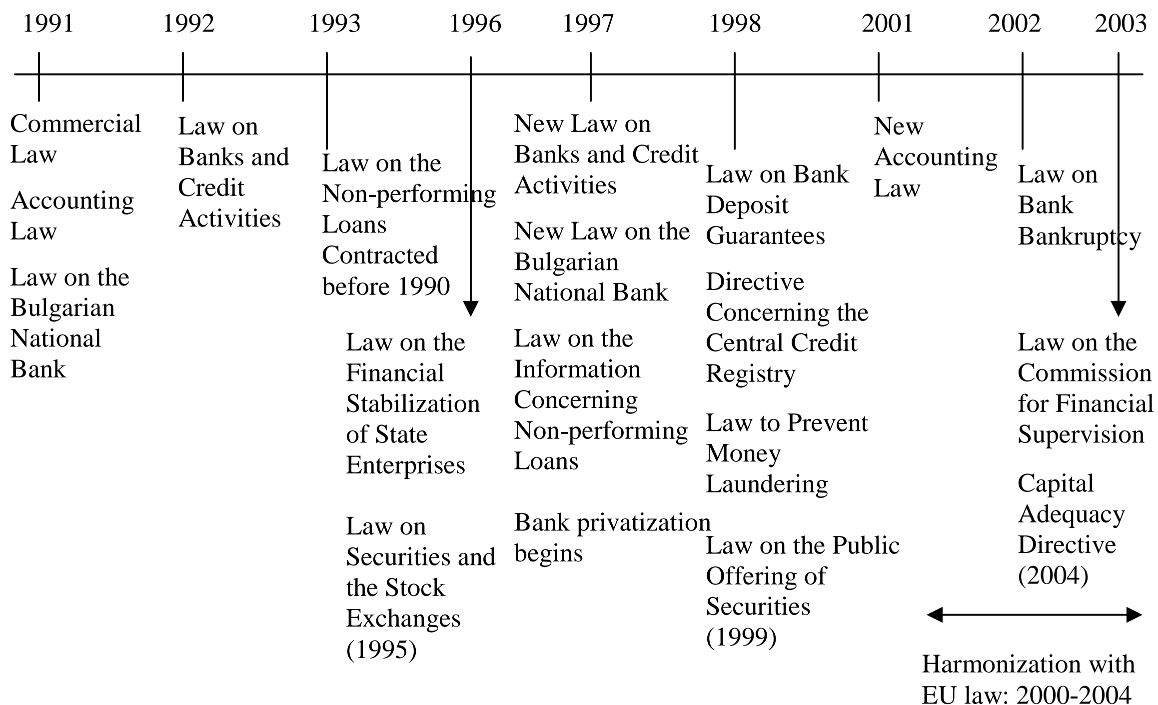
What factors contributed to breaking away from the "partial reform equilibrium" and clientelism of the early 1990s and undertaking comprehensive economic liberalization? The 1996/1997 economic crisis exposed the flaws of the economic policy that the BSP had promoted since 1989, and served as a catalyst for the subsequent electoral change of government. I argue that the turning point in Bulgaria's banking sector legal reform was the partisan change of the governing elites in 1997, and the resulting sustained alliance between reformers in government and international proponents of economic liberalization such as the IMF and the EU. The ODS cabinet led by Prime Minister Kostov was the first Bulgarian government since 1989 to serve an entire four-year term. It promoted a stronger role of market mechanisms in the economy, and its full term in office allowed sufficient time to reach out to domestic stakeholders who benefited from the improved economic environment, "lock in" the institutional changes, and create positive feedback loops reinforcing economic liberalization.

In Section 1 below, I present an overview of the evolution of banking sector laws in Bulgaria during the period 1997-2005. Section 2 investigates whether the empirical evidence confirms my theoretical expectations about the role of three factors—the partisanship of the governing elites, the nature and strength of the mobilized domestic stakeholders, and the influence of international actors—in shaping the quality of banking sector legal reform. In Section 3, I consider additional domestic factors that influence law implementation. Section 4 summarizes the main findings of this chapter.

1. Evolution of Banking Sector Laws in Bulgaria, 1997-2005

In Chapter 1, I outlined several key policy standards that I use to judge the quality of a country's banking sector legal framework. According to these benchmarks, it is desirable to: (1) provide clear market entry and exit conditions; (2) introduce transparency in the banking system and ensure the ability of banks to function without excessive state intervention; (3) guarantee central bank independence; and (4) establish independent banking oversight. Here I present major developments in the evolution of Bulgarian banking sector laws during the period 1997-2005, corresponding to the four categories listed above. I show that the new Bulgarian governing elites improved significantly the quality of the banking sector legal framework, and that their policy choices have been influenced strongly by two important international organizations—the International Monetary Fund (IMF) and the European Union (EU). Section 2.3 examines in greater detail the IMF's legal recommendations in the aftermath of the 1996/1997 economic crisis and the legal impact of the EU after 2000 as part of the pre-accession legal harmonization with the *acquis communautaire*. Figure 4.1 presents a comprehensive timeline of the important banking and financial sector laws adopted during the period 1989-2005.

Figure 4.1: Timeline of important banking and financial sector laws in Bulgaria after 1989



Here I outline important features of new Law on Banks and Credit Activities, the Directive Concerning the Central Credit Registry, the Law to Prevent Money Laundering, the Law on Bank Deposit Guarantees, and the Law on Bank Bankruptcy. These laws have corrected many of the shortcomings of the pre-1997 legal framework of the banking sector with respect to setting clear market entry and exit conditions and introducing transparency in the banking system. The 1997 Law on Banks and Credit Activities establishes stricter criteria for the required education and experience of bank managers (*Zakon za bankite,* Article 9). This law also introduces a more rigorous licensing regime that increases the power of the central bank (the BNB) to grant and revoke bank licenses (*Zakon za bankite,* Article 12-17; Miller and Petranov 2001: 54). In particular, Article 21(2) obliges the central bank to revoke a bank's license if it fails to fulfill a legally binding commitment within seven days, or the

total liabilities of the bank exceed the total assets. The 1997 Law on Banks and Credit Activities was also designed in order to make possible the start of bank privatization.

In Chapter 3, we saw that the accumulation of bad loans was facilitated by the lack of information exchange among the banks concerning the nature and amount of loans in the system. In 1998, the Directive Concerning the Central Credit Registry corrected this problem by creating a Central Credit Registry. Starting 20 January 1999, the commercial banks have to report to this registry all clients who borrowed more than 10 million leva (roughly equal to $6.5 million) and the amount of the loan. The Bulgarian National Bank (BNB) then disseminates monthly the collected information about the nature of the large loans and the banks' total outstanding loans. BNB reports also contain information about outstanding inter-bank loans. All measures outlined above increase the level of transparency in the banking system. Furthermore, the 1998 Law to Prevent Money Laundering introduced anti-money laundering measures in accordance with the recommendations of the 1993 International Convention on the Measure against Money Laundering (Kapital 1998, *Bankite shte poluchat*).

The 1998 Law on Bank Deposit Guarantees ensures that banks will return depositors' assets in case of bankruptcy and closure. According to Article 15, each bank is obliged to contribute to an independent government agency called *Fund for Bank Deposit Guarantees* a sum equal to 1 percent of its initial capital (but not less than 100 000 leva) plus 0.5 percent of all deposits for the preceding year (*Zakon za garanciite)*. This law mandates that commercial banks refund fully deposits of individuals and non-financial entities up to 6900 leva (Miller and Petranov 2001: 14). The law also features more stringent education and experience requirements for members of the governing board of the *Fund for Bank Deposit Guarantees*,

and requires the board to publish the agency's budget in the State Gazette (*Zakon za garanciite)*. The law gives legal power to the BNB Supervision Department to demand information from the commercial banks in order to evaluate the soundness of their operations.

In 1999, the BNB formed a working group to draft and present to Parliament a new Bankruptcy Law (Mihalev 2002). At the time, bank bankruptcy procedures took place according to the general Article 38 "Insolvency" of the Commercial Law. Banking experts found this legal arrangement to be inefficient in dealing with bank bankruptcies (Dimitrova 1999). In 2002, the Parliament finally adopted the new Bank Bankruptcy Law. The controversy that delayed the introduction of this law centered on the proposed role of the *Fund for Bank Deposit Guarantees.* The initial version of the bill empowered the *Fund for Bank Deposit Guarantees* to tackle bankruptcy proceedings outside the judiciary system, because of the slowness and inefficiency of Bulgarian courts. However, the judiciary lobby in Parliament opposed vehemently this arrangement on grounds that it would undermine the power of the judiciary (Mihalev 2000). In 2002, the government pushed trough the Bank Bankruptcy law, including provisions for faster bankruptcy proceedings overseen by the *Fund for Bank Deposit Guarantees*. By that time, of the eleven banks that suspended operations in the aftermath of the 1996/1997 financial crisis, five banks had already been bought by other banks, or their assets had been repossessed by the state. The six remaining banks were in pending status (Mihalev 2002).

As the 1991 Law on the Bulgarian National Bank was repealed during the 1996-1997 crisis, in 1997 Bulgarian legislators passed a new Law on the Bulgarian National Bank that increased significantly its independence. The law altered the structure of the BNB to make it

compatible with the currency board arrangement adopted in 1997 in accordance with IMF recommendations. In general, the currency board implemented in Bulgaria introduced strict controls over money supply to curb inflation and maintain exchange rate stability. I will return to this issue in Section 2.1. According to Article 2 of the 1997 Law on the Bulgarian National Bank, the main task of the central bank is to maintain the stability of the national currency through monetary and credit policy, and contribute to the establishment and maintenance of efficient payment mechanisms (*Zakon za BNB* 1997). The law gives the BNB the exclusive right to issue banknotes and protects it from political interference. Finally, the law also stipulates that the BNB is responsible for regulating and supervising all other banks in the system (Miller and Petranov 2001: 52).

In Bulgaria, legal harmonization with the EU *acquis communautaire* took place during the period 2000-2004 and required more time than in Hungary. In the realm of finance, Bulgaria closed the Free Movement of Capital negotiation chapter in 2001 and the Economic and Monetary Union and Financial Control chapters in 2002. But two chapters—Finance and Budgetary Provisions and Competition Policy—posed tough challenges for the government such as the provision of state aid. Bulgaria closed those two chapters in 2004 (EU Commission Representation 2007).

As part of the legal harmonization process, Bulgaria also adopted a new Accounting Law in 2001, a new Law on the Commission for Financial Supervision in 2003, and a new Capital Adequacy Directive in 2004. In 2002, Bulgarian banks began to use international accounting standards to meet the requirements of the 2001 Accounting Law that introduced common EU standards and practices. The 2003 Law on the Commission for Financial Supervision established the foundations of integrated financial supervision in Bulgaria,

including securities, insurance, pension and investment funds. The law set up an independent Commission for Financial Supervision that monitors the securities market, pension and investment funds, and insurance companies. According to Article 1, the goal of the commission is to maintain stability and transparency in financial markets as well as to protect the interests of investors and account holders (*Zakon za finansovia nadzor)*. Articles 18 and 19 give the commission power to grant and revoke licenses, monitor the activities of financial market participants, and initiate sanctions (*Zakon za finansovia nadzor)*. Lastly, in 2004, the BNB prepared a new directive concerning capital adequacy. The long-term goal of the central bank is to harmonize the risk-management measures and capital adequacy requirements in Bulgaria with the Basel II capital adequacy standards that are widely used in the European Union (Sabeva 2004).

Let us return to the four policy standards that I use to judge the quality of a country's banking sector legal framework. So far, we saw that after 1997 the Law on Banks and Credit Activities, the Directive Concerning the Central Credit Registry, the Law to Prevent Money Laundering, the Law on Bank Deposit Guarantees, and the Law on Bank Bankruptcy improved significantly the market entry and exit conditions in the Bulgarian banking sector. Furthermore, the 1998 Directive Concerning the Central Credit Registry introduced more transparency in the banking system by mandating the creation of a Central Credit Registry. The new Law on the Bulgarian National Bank passed in 1997 guaranteed central bank independence and established better rules for the oversight of commercial banks. In addition, in 2003, the Law on the Commission for Financial Supervision set up an independent agency responsible for the integrated supervision of financial markets.

2. Domestic and International Determinants of Banking Sector Legal Reform in Bulgaria, 1997-2005

In Chapter 1, I argued that three factors have shaped the quality of banking sector legal reform in the post-communist region. The first factor is the partisan coloration of the governing elites. The second factor is the nature of the mobilized domestic stakeholders and their alliances with the governing elites. The third factor is the influence of international actors. Here, I assess the evidence to determine whether those three factors have, in fact, influenced the course of banking sector legal reform in Bulgaria in the period 1989-1997.

Overall, I argue that the improvement of the banking sector legal framework in Bulgaria after 1997 resulted from the partisan change of the governing elites following the early elections and the receptivity of the new government to the policy recommendations of international actors. Once the BSP was ousted from power, the clientelistic networks between political elites and rent-seeking domestic stakeholders that we saw in Chapter 3 started to break down without access to the financial resources provided by the state. The right-wing Kostov government began to alter the legal environment and seek allies who would support its economic reform program such as foreign investors and domestic businesses. The pattern of domestic alliances built by the Kostov government and the centrist cabinet that succeeded it resembles the domestic alliances observed in the case study on Hungary (Chapter 2). The following sections examine the impact of changing the partisan coloration of the governing elites, and the process of forming alliances with domestic stakeholders in favor of more economic liberalization.

2.1 Partisan Coloration of the Government and Partisan Politics

Based on the partisan coloration of Bulgarian governments after 1997, we expect pronounced moves toward economic liberalization and a significant improvement of the

quality of the Bulgarian banking sector legal framework. In 2001, the right-wing ODS government of Prime Minister Kostov was succeeded by a centrist coalition government between NDSV and DPS led by Prime Minister Simeon Sakskoburggotski. The BSP returned to power in 2005 in a coalition government with NDSV and DPS, but during the eight years that it had spent in opposition, the BSP had transformed itself into a reformed communist successor party and, more or less, endorsed liberal democratic values. Table 4.1 summarizes the partisan coloration of Bulgarian governments in the period 1989-2005. Table 4.2 presents the distribution of seats in Parliament for each election year in that period.

Table 4.1: Prime Ministers and government coloration in Bulgaria, 1989-2005

BULGARIA		
Prime Minister	**Government time in power**	**Ruling party/ government coalition**
Andrey Karlov Lukanov	3 Feb 1990 - 7 Dec 1990	L: BSP
Dimitar Popov	7 Dec 1990 - 8 Nov 1991	no party/indep.
Philip Dimitrov Dimitrov	8 Nov 1991 - 30 Dec 1992	R: SDS
Lyuben Borisov Berov	30 Dec 1992 - 17 Oct 1994	no party/indep.
Reneta Ivanova Indzhova	17 Oct 1994 - 25 Jan 1995	interim
Zhan Vasilev Videnov	25 Jan 1995 - 13 Feb 1997	L: BSP
Stefan Antonov Sofiyanski	13 Feb 1997 - 21 May 1997	interim
Ivan Yordanov Kostov	21 May 1997 - 24 Jul 2001	R: ODS
Simeon Borisov Sakskoburggotski	24 Jul 2001 – 16 Aug 2005	R/C: NDSV+ DPS
Sergey Dimitrievich Stanishev	16 Aug 2005 -	L/C: BSP+ NDSV+ DPS

BSP – Bulgarian Socialist Party (Balgarska Socialisticheska Partija)
SDS – Union of Democratic Forces (Sajuz na Demokratichnite Sili);
later ODS – United Democratic Forces (Obedineni Demokratichni Sili)
DPS – Movement for Rights and Freedoms (Dvizhenie za Prava I Svobodi)
Evrolevitsa – Euroleft
BZNS – Bulgarian Agrarian National Union (Balgarski Zemedelski Naroden Sajuz)
BBB – Bulgarian Business Bloc (Balgarski Biznes Blok)
NDSV – National Movement Simeon II (Nacionalno Dvizhenie Simeon Vtori)
DSB – Democrats for Strong Bulgaria (Democrati za Silna Balgaria)
Ataka – Attack (Nacionlano Obedinenie Ataka)

L stands for left, R – for right, and C – for centrist.

Table 4.2: Distribution of seats in Parliament for each election year, 1989-2005

Political parties	1991	% seats	1994 early	% seats	1997 early	% seats	2001	% seats	2005	% seats
BSP	106	(44.2)	125	(52.08)	58	(25.03)	48	(20)	82	(34.17)
Evrolevitsa					14	(4.4)	0		0	
DPS	24	(10)	15	(6.25)	19*	(9)	21*	(8.75)	34*	(14.17)
BZNS	0		18	(7.5)	0		0		13**	(5.42)
SDS/ODS	110	(45.8)	69	(28.5)	137	(57.55)	51	(21.25)	20	(8.33)
DSB									17	(7.08)
BBB	0		13	(5.42)	12	(4.02)	0		0	
NDSV							120	(50)	53	(22.08)
Ataka									21	(8.75)
Total seats	**240**		**240**		**240**		**240**		**240**	

Source: Author's calculations based on University of Essex data from the project "Political Transformation and the Electoral Process in Post-Communist Europe"

* DPS ran in alliance with a few smaller political parties
** BZNS ran in alliance with a few smaller political parties

In Chapter 3, I argued that the clientelistic linkages between unreformed communist governing elites and rent-seeking domestic stakeholders hindered economic liberalization in Bulgaria until 1997, and led to the adoption of poor quality banking sector laws. After the partisan change of government, BSP politicians no longer had access to the state's resources and the clientelisitic linkages started to break down. Section 2.1 shows how introducing a currency board and initiating privatization further loosened those linkages, prevented reversal of the economic reforms, and led to a better quality of the adopted banking sector laws. Section 2.2 demonstrates that Bulgarian governments after 1997 actively sought foreign investors and created incentives for the growth of domestic private businesses. These actors are important pro-reform constituents that create a positive feedback loop to sustain economic liberalization and "lock in" the concomitant institutional and policy changes.

Hypothesis 1: We expect good quality banking sector legal reform if the domestic political process is characterized by center-right or reformed communist successor parties in power.

As we already saw in Chapter 3, the main legacy of the Videnov BSP government was a widespread economic mismanagement that gave rise to shortages and a financial crisis in the winter of 1996/1997. Social protests in the capital and across the country called for the Prime Minister's resignation. In January 1997, following citizen protests and a blockade of the Parliament building, the BSP government was forced to resign, and the President appointed a caretaker cabinet that would be in power for several months before the early elections scheduled for April 1997. The United Democratic Forces (ODS), a right-wing umbrella party of opposition groups pursuing a reformist agenda, won those elections and appointed Ivan Kostov as the new Prime Minister.

In the banking sector, the imprudent economic policies of the Videnov government had a very high cost. The vicious circle of pumping money into loss-making banks and state enterprises undermined the domestic currency and led to a high budget deficit. For the most part, the huge budget gap was covered by an emergency credit from the Bulgarian National Bank to the Ministry of Finance. As the BNB kept printing money to bail out the government, in 1996 alone inflation grew almost tenfold, to 311 percent (Miller and Petranov 2001). At the same time, the Videnov government faced increasing difficulties to service Bulgaria's foreign debt. It depleted the foreign exchange reserves and witnessed the near collapse of the foreign currency exchange market, as citizens rushed to convert their savings into foreign currency denominations in response to the skyrocketing inflation.

The political economy literature has shown that severe economic crises can trigger policy reform (Haggard and Kaufmann 1992; Hall 1993; Huber and Stephens 1998; McDermott 2004). However, only recently have scholars distinguished between the objective impact of crises and the subjective interpretations of decision-makers (Pop-Eleches 2006). An investigation of the effect of economic crisis on policy reform is beyond the scope of this chapter, but it is worthwhile to point out that in Bulgaria, the pace and quality of banking legal reform clearly improved after the economic crisis and political turnaround in 1997.

I argue that the turning point in Bulgaria's banking sector legal reform was the partisan change of the governing elites in 1997 and the sustained alliance between reformers in government and international proponents of economic liberalization such as the IMF and the EU. The Kostov cabinet was the first Bulgarian government since 1989 to serve an entire four-year term. It promoted a stronger role of market mechanisms in the economy, and its full term in office allowed sufficient time to "lock in" the institutional changes and create positive feedback loops reinforcing economic liberalization (Thelen 1999: 358).

As the Kostov government took power in 1997, the IMF approved a credit line of $582 million to support Bulgaria's balance of payments in accordance with the country's Stand-by agreement. The Fund pushed for the implementation of an austerity package that included putting in place a currency board and amending significantly the banking sector legal framework (Financial Times 1997; Miller and Petranov 2001). The currency board, introduced in July 1997 with IMF support, pegged the Bulgarian currency, lev, to the Deutschemark (DEM) with an exchange rate of 1 DEM = 1000 leva. After the 1999 redomination measure, the exchange rate became 1 DEM = 1 lev. Subsequently, with the launch of the common EU currency, the euro (€), the exchange rate of the Bulgarian lev

became 1 € = 1.9558 leva. In order to support the exchange rate, the BNB must maintain sufficient foreign currency reserves.

The currency board prohibits the BNB from extending loans to the government and the commercial banks, and from holding government securities (Miller and Petranov 2001: 56). This arrangement has helped Bulgarian governments maintain financial and banking discipline, pursue a prudent fiscal policy, and increase the currency reserves (Dimitrova and Dragneva 2001). The currency board contributed significantly to Bulgaria's macroeconomic stabilization after the 1996/1997 economic crisis. By 1999, inflation fell to single-digit levels (EBRD 2006). The economy began to recover and the private sector share of GDP grew steadily from 55 percent in 1996 to 75 percent in 2005 (EBRD 2006). Private sector share of employment also increased noticeably from 47 percent in 1996 to 71 percent in 2005 (EBRD 2006). According to Bulgarian economist Nikolay Nenovsky, Prime Minister Kostov initially opposed the idea of a currency board, because it imposes high sovereignty costs (2007, personal interview). However, international actors, in particular the IMF, pressured the Kostov government into adopting a currency board (Nenovsky 2007, personal interview).

In departure from general currency board prescriptions, the Bulgarian variant allows the operation of a special Banking Department in the Bulgarian National Bank that can act as a "lender of last resort" in case of a severe financial crisis. In the aftermath of the 1996/1997 crisis, IMF loans ensured that the BNB had sufficient foreign currency to meet this function. At the same time, BNB's Regulation 6 stipulates very strict conditions under which lending to commercial banks can occur. Only solvent banks experiencing liquidity shortages are eligible for a loan, and the ceiling is set to the amount of funds that the Banking Department has on deposit at the BNB's Issue Department (Miller and Petranov 2001: 57). Thus, in

contrast to the lax legal environment in the early 1990s that allowed political interference in the BNB's decision-making, the new legal conditions make it significantly harder for governments to use the central bank as a cash cow.

After the 2001 parliamentary elections, a centrist coalition between the National Movement Simeon II (NDSV) and the Movement for Rights and Freedoms (DPS) took power. In the economic sphere, the new government built on the reforms initiated by the Kostov government. Key figures in the cabinet such as Finance Minister Milen Velchev and Minister of the Economy Nikolay Vassilev entered politics with a strong background and professional experience in Western financial markets. Although the coalition partners faced frequent policy disagreements over the closure of state-enterprises, state subsidies, and the search for strategic investors, the economy continued to grow at annual rates of about 4 percent (Kapital 2001, *Posokata*; EBRD 2006). The NDSV-DPS government persisted with the privatization process. During the period 1997-2000, the Kostov government had sold 67 percent of all state assets eligible for privatization, compared to 11 percent privatized by all pre-1997 governments (Kapital 2001).

After spending eight years in opposition, the Bulgarian Socialist Party (BSP) returned to power in 2005 in coalition with NDSV and DPS. While in opposition, the BSP had transformed its ideology to be more in line with Social Democratic ideas (Spirova 2005). A younger and more pragmatic party leadership prevailed over the stalwarts from the old regime and endorsed market principles of organizing the economy. Furthermore, the BSP became a full member of the Social Democratic international organization Socialist International in 2003. Overall, scholars of Bulgarian politics did not expect a reversal of economic liberalization after the BSP returned to power. According to economist Georgy

Ganev, the country had overcome the fundamental problems that led to the 1996/1997 economic crisis. By 2005, the banking system had become more stable and transparent. The majority of investment projects in Bulgaria were initiated and run by private actors or foreign companies that pursued profits, rather than state asset stripping (quoted in Kapital 2004, *Opasana li e BSP*).

2.2 Domestic Stakeholders and Domestic Alliances

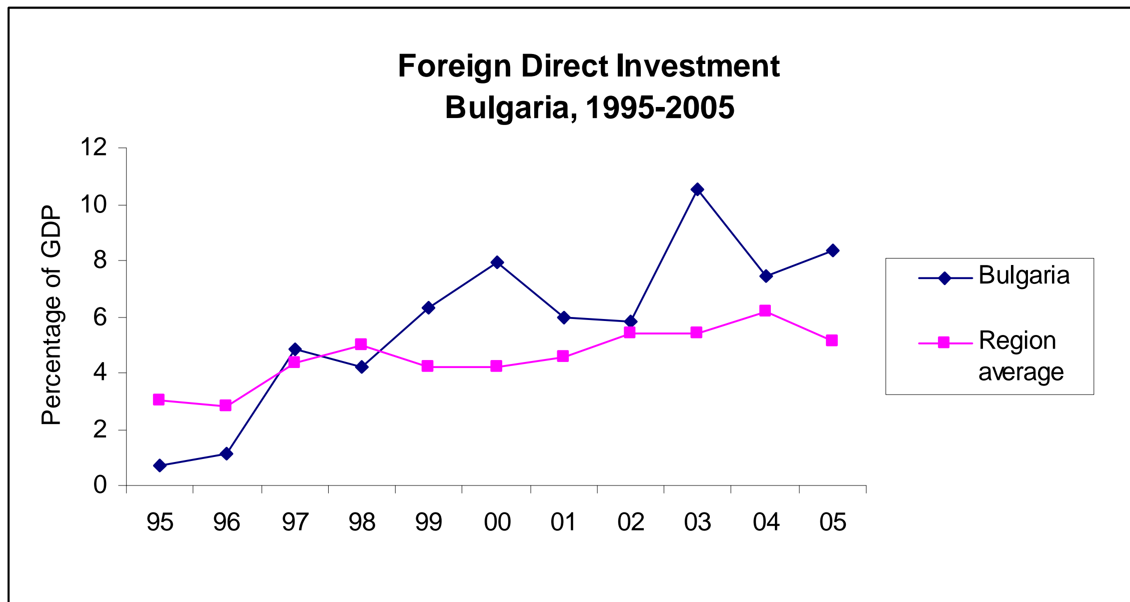
What factors have weakened the clientelistic alliances after 1997 and boosted the role of domestic stakeholders that favor economic liberalization? According to Bulgarian political scientist Todor Yalamov, three important developments have improved significantly the business environment in Bulgaria. First, since its introduction in 1997, the currency board has guaranteed macroeconomic stability. Second, the election of the right-wing Kostov government marked the beginning of a period of political stability and continuity in the implementation of economic reforms endorsed by international actors. Third, the post-1997 governments amended Bulgaria's legal framework to correct the governance failures of the early 1990s (Yalamov 2007, personal interview). Overall, the partisan change of governing elites cut off the access of rent-seeking domestic stakeholders to state assets. In addition, the privatization programs of post-1997 governments, developed in consultation with the IMF, have made it nearly impossible to re-establish the clientelistic nexus between politicians and managers of state-owned enterprises and state-owned banks (Kapital 1998 *Poslednijat kompromis*). Below, I examine two hypotheses that focus on the role of foreign investors and trade. I investigate whether the positive impact of these two factors that we observed in Hungary also holds in the case of Bulgaria after 1997.

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

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

Indeed, as we saw in the case study on Hungary (Chapter 2), large foreign investors such as Marvex - Spain, Solvay – Belgium, and Interbrew – Belgium had significant leverage in pressuring the reformist Bulgarian governments for a better regulatory environment, including in the banking sector. Some of these foreign investors had entered Bulgaria in 1994 and 1995 as part of their strategy to expand operations in Eastern Europe, regardless of the imperfections in Bulgaria's legal framework. Still, the majority of foreign investors came to Bulgaria after 1997 when the privatization process accelerated. After the political turnaround in 1997, the amount of foreign direct investment (FDI) in Bulgaria grew steadily from 1 percent of GDP in 1996 to 8 percent of GDP in 2005 (World Bank 2006). Figure 4.2 shows the growth of FDI as a percentage of GDP in Bulgaria, compared to the average FDI growth in the post-communist region. Foreign investors preferred to operate in transparent and corruption-free business conditions, and therefore, demanded harmonization with international standards (Jordanova 1999). The small and medium-size domestic enterprises (SMEs) did not have the financial clout of big foreign investors and were not organized enough to influence governments considerably. Yet better banking laws and the more competitive banking environment were beneficial for the SMEs as well, because they could borrow at a lower cost and were less vulnerable to liquidity crowding-out, as was the case during the "partial reform" period in the early 1990s (Budina *et al*. 2000).

Figure 4.2: Foreign direct investment in Bulgaria, 1995-2005



Source: Author's calculations based on data from World Bank (2006).

According to Todor Yalamov, the substantial influx of foreign capital in Bulgaria did not start until the introduction of the currency board in 1997 (2007, personal interview). Economist Nikolay Nenovsky confirms that the currency board served as a signal to foreign investors that the macroeconomic conditions would be sound in the medium to long-term. In addition, the restrictive monetary policy of the BNB and governments' commitment to service Bulgaria's foreign debt reinforced the international credibility of the country (Nenovsky 2007, personal interview).

We turn to the next step in breaking up the clientelistic nexus between politicians, state-owned enterprises, state-owned banks, and rent-seeking economic actors—the privatization process. Was privatization of the state-owned enterprises and banks an unavoidable measure? Was it possible to carry out economic restructuring, introduce more efficiency in the system, and preserve extensive state ownership at the same time? Let us return to Joel Hellman's (1998) insightful argument about the so-called "partial reform"

equilibrium and the actors which undermined economic liberalization in the region. According to Hellman, those actors were "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). Indeed, the analysis of Bulgaria's stalled economic reform until 1997 presented in Chapter 3 confirmed Hellman's argument. Hence, as long as those economic actors have access to power and the state's resources, we do not expect to see thorough economic liberalization. As in Hungary, privatizing the state-owned conglomerates and banks in Bulgaria provided a feasible solution, given the strong incentives for corruption in the post-communist economic environment.

The privatization of the Bulgarian banks is regarded as one of the country's transition success stories (Barisitz 2001; Yalamov 2007, personal interview). Until 1997, the state-run Bank Consolidation Company (BCC) that was founded in 1992 to improve the functioning of the banking system had not completed a single privatization deal. At the end of 1997, 28 commercial banks were active, most of which were still owned by the state. The Kostov and the subsequent Sakskoburggotski governments completed the bank privatization process. By 2003, the share of private ownership in the banking sector had reached 97.6 percent of bank assets. Only two banks remained state-owned: the Ministry of the Economy owned *Nasurchitelna Banka* and Sofia municipality owned *Obshtinska Banka* (Anglelov and

Chobanov 2004). Table 4.3 summarizes the key bank privatization deals in Bulgaria during the period 1997-2005.

Table 4.3: Key bank privatization deals in Bulgaria

Name of bank	Year of privatization	Method of privatization/details
OBB Obedinena Bulgarska Banka *(United Bulgarian Bank)*	1997 2000	EBRD, foreign strategic investors Openhaimer and Co., and Bulbank 90% share sold to **National Bank of Greece**
First Investment Bank	1997	European Privatization Investment Company (Austria) and the EBRD
Postbank	1998	US-Greek consortium (US Insurance company ALICO and the Greek European Financial Bank Group (EFG).
Expressbank	1999	**Societe Generale**
Hebrosbank	1999 2004	Regent Pacific Group (UK) Bank Austria Creditanstalt - HVB Bank Biohim
Biohim Later - HVB Bank Biohim	2002	**Bank Austria Creditanstalt** (Austria)
Bulbank *(former Foreign Trade Bank)*	2000	**UniCredito** Italiano and **Allianz** Holding (Germany)
DSK Darzhavna Spestovna Kasa *(State Savings Bank)*	2003	**OTP** (Hungary)

In 2001, the Sakskoburggotski government started to sell the state's minority shares in the banks in order to finalize the privatization process (Mihalev 2001, *Darzhavata prodava*). By 2002, foreign investors owned 82 percent of the Bulgarian banking sector, compared to a 57 percent average for Central and Eastern Europe (Mihalev 2002, *Chuzhdi investitori vladejat*). Officially, the bank transformation and privatization were completed in 2003 with the sale of DSK to Hungarian banking group OTP (Vachkova 2004). As in Hungary, the entry of foreign banks improved the quality of the Bulgarian banking system and reduced mismanagement. Additional benefits of increased foreign ownership in the

sector are: better management practices, increased efficiency, diverse banking packages and services (Yalamov 2007, personal interview; Mihaylova 2007, personal interview).

Following the completion of privatization, the current big issue in the Bulgarian banking system is the rapid credit expansion. In March 2005, the loan activities of Bulgarian banks reached a record high. Compared to the previous month, loans grew by 15 percent (Antonova 2005, *Ukrotjavane*). The total loans increased by 63 percent from 1.7 billion leva in 2003 to 2.8 billion leva in 2004 (Antonova 2005, *Potrebiteli*). While some references are made to the imprudent lending practices in the early 1990s, the current credit expansion is predominantly due to personal and household loans, rather than loans to state-owned enterprises (Mihalev 2001, *Zashto bankite*). According to journalist Ivan Mihalev, the banking system experienced "normalization" after the 1996/1997 crisis. The overall economic stability and growth have turned the banks' attention to the profit-making potential of household and personal loans (Mihalev 2001, *Zashto bankite*). Still, the BNB has intervened on multiple occasions to restrain bank lending by increasing the minimal required reserves for the commercial banks. Economist Assenka Hristova suggests that this measure makes it more costly for banks to offer loans, but, on the flipside, it could also lead to a current account deficit and destabilization of the banking system (Hristova 2005, *Aktivnostta*).

We saw so far that banking sector privatization created in Bulgaria the same benefits as it did in Hungary. Banks began to offer more credit to individuals and small businesses, which had very limited access to credit during the "partial reform" period in the early 1990s (Budina *et al.* 2000). What was the fate of those banks that did not survive the 1996/1997 financial crisis? By 2000, some smaller banks such as Mineralbank, Kapitalbank, Kristalbank

had settled their debts (Mihalev 2000, *Mileti poema*). Other banks still owed substantial amounts to the state: Biznesbanka, Banka za zemedelski credit, Mezhdunarodna Banka za investicii i razvitie, Balkanbank, Dobrudzhanska turgovska banka (Mihalev 2000, *Mileti poema*). According to the new bankruptcy procedures, the state could bring those banks to court and seize their remaining assets in order to get back at least some of the money used for bank refinancing in the early 1990s. But as analyst Ivan Mihalev has concluded, "from the free lunch given out by the banks in the mid-1990, the state can now get back only crumbs" (Mihalev 2000, *Bezplaten Objad*). The complicated nature of the cases and the general sluggishness of the Bulgarian judicial system have plagued the settlement of the bankruptcy cases. For example, the bankruptcy procedures for Kristalbank, Kapitalbank, TB Slaviani, and Balkanska Universalna Banka started in 1997, but they still had not finished by 2004 (Kapital 2004, *Nakratko*). Next, we examine the role of international actors in banking sector legal reform after 1997.

2.3 International Actors

I argue that the policy advice of international actors has been crucial in providing templates for economic liberalization in Bulgaria after the 1997 partisan change of government and discrediting of the unreformed communist successor party, BSP. My theoretical framework suggests three mechanisms whereby international actors influence banking sector legal reform—conditionality, selective domestic empowerment, and socialization. Is there convincing evidence that international actors have influenced the path of banking sector legal reform in Bulgaria after 1997? Below I assess the hypothesis that focuses on the use of international conditionality by the IMF and the EU.

Hypothesis 5: We expect good quality banking sector legal reform if a country has been involved consistently in IMF and EU conditionality programs.

In the years following the economic crisis of 1996/1997, the IMF was an important factor in the formulation and implementation of macroeconomic policy and debt management in Bulgaria (Barisitz 2001; Yalamov 2007, personal interview). The Kostov government signed two consecutive Stand-by agreements with the IMF, in 1996-1997 and 1997-1998 (IMF 2007). According to Lena Roussenova, Chief Economist of the BNB in 1996, the IMF played a key role in setting the path of economic reform. Between November 1996 and March 1997, the Bulgarian government and the Fund negotiated the terms of the first Stand-by agreement and whether Bulgaria would adopt a currency board (Roussenova 2007, personal interview). As we saw in Section 2.1, following the Fund's conditionality policies, Bulgaria did implement a currency board and pegged the exchange rate to the euro. Notably, as part of the currency board, the BNB could no longer bail out the government and the commercial banks. Thus, IMF conditionality promoted fiscal discipline and helped overcome the cycle of clientelistic lending practices that led to the accumulation of bad loans in the early 1990s.

The IMF also provided an important impetus to restructure the Bulgarian banking sector in the aftermath of the 1996/1997 economic crisis. Specifically, the Fund advocated privatizing the banking sector to strategic foreign investors. The three-year Extended Fund Facility (EFF) agreement signed by the Kostov government in 1998 included provisions for structural reforms and privatization in the real and banking sectors (Kapital 1998, *Kakvo Obeshtahme*). The EFF agreement also contained capital adequacy guidelines for the banks, measures to facilitate foreign direct investment, and assessment criteria to determine the

viability of state-owned enterprises (Kapital 1998, *Kakvo Obeshtahme*). In 1998, Bulgaria needed $1.6 billion of external financing to support its balance of payments. The IMF could provide half of the amount and coordinate obtaining the other half from the EU and the World Bank (Kapital 1998, *Kakvo Obeshtahme*). Thus, the Kostov government had to take IMF conditionality seriously and implement the recommended measures. Otherwise, the IMF would suspend Bulgaria's funding, which at the time was indispensable in order to maintain the balance of payments and service the country's foreign debt.

Against the backdrop of a more stable economy, the centrist NDSV-DPS coalition government that took office in 2001 pursued greater independence from the IMF. In 2001, the government successfully placed on the international capital market its so-called "euro-bonds" which secured sufficient foreign currency reserves to service Bulgaria's debt (Raeva 2002, *Razvod*). Finance minister Milen Velchev discussed with IMF representative Gerald Schiff a possible waiver of some of the Fund's conditions, especially in the realm of taxation. Despite disagreements with the IMF, the NDSV-DPS government signed another two-year Stand-by agreement in 2002, and renewed it in 2004. According to economist Georgy Ganev, as early as 2000, Bulgaria was no longer threatened by a balance of payments crisis. Thus, the IMF agreements signed by the NDSV-DPS coalition served more as a signaling device to foreign investors and governments that Bulgarian political elites would not reverse reform and return to clientelism (Ganev quoted in Raeva 2002, *Razvod*). Furthermore, most of the macroeconomic parameters stipulated in the country's IMF agreement would be met due to the accession negotiations with the European Union that began in 2000 (Ganev quoted in Raeva 2002, *Razvod*). After Bulgaria's 2004 Stand-by agreement expired in March 2007, the BSP-NDSV-DPS government that took power in 2005 refrained from signing another

agreement with the Fund, arguing that it could maintain sound financial policies without IMF conditionality (Sofia Echo 2007).

So far, we saw that the importance of IMF conditionality gradually diminished after 2000. But the salience of European Union conditionality undoubtedly increased. The release of the 1997 Commission opinion on the application for membership that Bulgaria submitted in December 1995 coincided with the change of the governing elites. The reformist Kostov government paid close attention to the EU's recommendations and moved Bulgaria from the path of partial reform to the path toward EU membership. Nikolay Georgiev, representative of Bulgaria in the IMF, emphasized that as early as 1998, one of the main goals of the ODS government was to start accession negotiations with the EU (quoted in Kapital 1998, *Stabilizacijata*). The IMF advised Bulgaria's cabinet not to pursue the EU Maastricht criteria for membership if that would require too many sacrifices and could destabilize the financial situation in the country (Kapital 1998, *Stabilizacijata*). But as Prime Minister Kostov stressed in February 1999, "our aim for Bulgaria is to start [membership] negotiations with the EU by 2001" (quoted in Kapital 1999). Kostov clarified that while the EU was not an aim in itself, joining the Union would reinforce the political and economic reforms in Bulgaria and prevent policy reversal by future governments (quoted in Kapital 1999).

In Bulgaria, legal harmonization with the EU *acquis communautaire* took place during the period 2000-2004 and required more time than in Hungary. In the realm of finance, Bulgaria closed the Free Movement of Capital negotiation chapter in 2001 and the Economic and Monetary Union and Financial Control chapters in 2002. However, two chapters—Finance and Budgetary Provisions and Competition Policy—posed tough challenges for the government such as the provision of state aid. Bulgaria closed those two

chapters in 2004 (EU Commission Representation 2007). Section 1 provided greater detail of specific changes in Bulgaria's banking sector legal framework due to the EU accession process. According to Vladislav Nikolov, a legal expert at the BNB, since 1997 all laws and regulations governing the banking sector have been subject to review from the EU coordination group in the Bulgarian Foreign Ministry, which examines legislation for compliance with EU laws and issues recommendations when it detects discrepancies (2005, personal interview). In Nikolov's view, the overall quality of the banking sector legal framework in Bulgaria has improved as a result of the EU harmonization process (2005, personal interview). Next, I discuss my hypotheses concerning the role of domestic empowerment and socialization by international actors.

Hypothesis 6: We expect good quality banking sector legal reform if international actors empower organizations such as independent agencies responsible for monitoring the financial sector and independent central banks.

Both IMF and EU conditionality have also boosted the independence of the Bulgarian National Bank. In Section 1, I emphasized that the 1997 Law on the Bulgarian National Bank increased significantly the central bank's independence from political pressure. Furthermore, the post-1997 legal framework gave the BNB the responsibility to monitor and regulate the commercial banks. Nikolay Nenovsky et al. have demonstrated that after 1997 the BNB has exerted significant influence over the commercial banks by enforcing strict rules for acceptable risk exposure (Nenovsky *et al*. 2003: 27). Of course, central banks need not be supervision agencies. Chapter 2 showed that in Hungary an independent Financial Supervisory Authority, PSZÁF, is in charge of monitoring the commercial banks. Bulgarian banking experts considered establishing an independent supervisory agency as well.

However, they recommended to legislators to keep supervision within the BNB due to the limited number of skilled bank staff and the issue overlap with the central bank's expertise (Miller and Petranov 2001: 54). The BNB's Supervisory Department is undoubtedly risk-averse and has intervened several times to increase the mandatory reserve requirements for the commercial banks in order to discourage risky lending practices (Hristova 2005, *Aktivnostta*). We saw here that the shortage of proficient staff was a problem for the Bulgarian banking sector. This issue brings us to the next hypothesis concerning the role of socialization by international actors.

Hypothesis 7: We expect good quality banking sector legal reform if elite socialization is taking place between the local elites and international proponents of banking reform.

With the start of Bulgaria's EU accession process, several EU programs have promoted socialization between Bulgarian policy-makers, administrators, and professionals and their EU counterparts. Here I focus on the SARA program and the "Twinning" initiative. The themes of the SARA program are performance and oversight of financial institutions. In Bulgaria, SARA helped the government find and contact strategic investors during banking sector privatization and promoted better management practices. For example, in 1998, SARA consultants worked on the privatization of Bulbank and Hebrosbank (Kapital 1998, *Ne sa peril v koronata*; Kapital 1998, *Zapochna razdvizhvane*). The SARA program also paid staff salaries for a two-year period when Dutch bank ABN AMRO assisted Bulgarian bank Biohim to update its management practices. Biohim was in fact one of the few banks that the Bulgarian government refinanced after 1997 with 12 million leva in order to make it more attractive for privatization (Mihalev 2000, *Durzhavata prigotvi*).

Another example of socialization is the "Twinning" initiative launched by the European Commission in 1998. "Twinning" promotes administrative cooperation to help EU candidate countries strengthen their administrative and judicial capacity to implement EU legislation as future Member States (European Commission 2005). In practice, "Twinning" projects entail sending experts from EU Member States to work in the administration of the candidate countries in order to transfer skills, knowledge, and practices (European Commission 2005). Thus, the goal of this program is to alleviate implementation problems in candidate countries that have little prior experience with EU policies and practices. Bulgaria has benefited from the "Twinning" initiative since 1998, including in the realm of finance and banking, as finance is one of the four priority areas of the program (Papadimitriou 2002).

In sum, Chapter 4 has demonstrated that after the 1997 change of the governing elites, Bulgarian governments became much more open to international advice. The IMF influenced significantly the initial moves toward economic liberalization, but the credible prospect for EU membership and the start of accession negotiations in 2000 helped sustain thorough economic reform as a beneficial long-term strategy in Bulgaria, because it would bring about closer ties with European investors, an inflow of aid for implementing the pre-accession requirements, and improved credit standing on international financial markets. The 2001 centrist government of Prime Minister Sakskoburggotski kept the course of reforms, including in the banking sphere. When the BSP returned to power in 2005 in coalition with NDSV and DPS, it did not reverse the economic reforms adopted by preceding governments.

3. Implementation

As I argued in Chapter 1, good laws will be inconsequential if their implementation fails. Taking into account the insights of the law implementation literature, I consider the

impact of two institutional factors—administrative and judicial capacity—on the implementation of banking sector legal reforms in Bulgaria. Chapter 3 showed that the alliance between unreformed communist governing elites and rent-seeking domestic stakeholders was the main obstacle to good quality reform of Bulgaria's banking sector legal framework in the early 1990s. When the early elections in 1997 brought to power a reform-minded right-wing government and this alliance was broken, the quality of banking sector laws improved over time. But successive post-1997 governments still experienced problems with law implementation due to the performance of the state administration and the judiciary. Below, I discuss these two institutional factors in turn.

As one scholar has observed, in the early years of transition, Bulgarian civil servants attended training seminars where they learned the standard package of computing and management skills (Baker 1994). However, technical advisors could not instill in the Bulgarian bureaucracy what it lacked most: "reformist values, strategies, and policies" (Baker 1994). Furthermore, Antoaneta Dimitrova (2002) has argued that at the outset of transition, the state bureaucracy was a discredited institution because it had served as a tool of repression in the hands of the old regime. Thus, the transformation of the administration into a professional and efficient organization has been a persistent challenge in Bulgaria after the separation of party and state in the early 1990s (Dimitrova 2002: 180). In the realm of finance too, Bulgarian governments have been grappling with a deficit in administrative capacity to develop and implement policy coherently (Goetz and Margetts 1999; Dimitrov and Brusis 2001). Yet, as the discussion of the "Twinning" initiative showed, the EU accession process has boosted the development of administrative capacity both in terms of hiring more civil servants who have better technical skills and enhancing the skills and

knowledge of older civil service employees. In that sense, Antoaneta Dimitrova and Rilka Dragneva argue that "while criticisms regarding administrative performance in Bulgaria are justified, the lack of administrative capacity should not be exaggerated" because the European Union is actively helping Bulgarian governments tackle this problem (2001: 92).

Has the Bulgarian judicial system caused similar problems and delays in law implementation? Table 4.4 presents results from a World Bank firm-level survey about the investment climate across the globe. While I only present data on two front-runners and two slow reformers in Eastern Europe, it is clear that Bulgaria's legal system is considered to be more of an obstacle for the business community, compared to that of reform front-runners such as Hungary and the Czech Republic (World Bank 2002).

Table 4.4: Selected legal system ratings from World Bank Investment Survey, 2002

Legal system as business constraint	**Albania**	**Bulgaria**	**Czech Republic**	**Hungary**
No obstacle	9.76%	34.17%	47.33%	66.94%
Minor obstacle	28.05%	26.67%	25.51%	19.83%
Moderate obstacle	29.27%	21.25%	16.05%	8.68%
Major obstacle	32.93%	17.92%	11.11%	4.55%
Number of firm surveys	164	240	243	242

Question wording: Please tell us if the legal system/conflict resolution system is a problem for the operation and growth of your business. Please judge its severity as an obstacle on a four-point scale where: 0 = No obstacle; 1 = Minor obstacle; 2 = Moderate obstacle; 3 = Major obstacle; 4 = Very Severe Obstacle.

The legacy of judicial system appointments in the early 1990s explains to some extent the unsatisfactory performance of this institution. Appointments in the Bulgarian judicial system adhered to the principle of *nesmenjaemost* (permanence). Once appointed, judges, prosecutors, and investigators could not be fired. The only available option was to move them to a different position within the judiciary system (Dzambazov 2005, personal interview). According to prosecutor Bozhidar Dzhambazov, this system of appointment

favored stalwarts from the previous regime. In the early 1990s, most Bulgarian magistrates, especially those in top positions, had been part of the establishment for more than three decades. For those top magistrates, the mission of the judiciary was to preserve the status quo. Consequently, they did not take any initiative to expedite the judicial process and make it more efficient (Dzhambazov 2005, personal interview). Furthermore, the tendency to appoint poorly qualified magistrates in the early 1990s was reinforced by the modest state salaries in the system. As more positions opened up in the private sector, many qualified magistrates left the judiciary to start private practice as lawyers (Dzambazov 2005, personal interview). The new magistrates who filled the vacant positions were often poorly qualified, but due to the *nesmenjaemost* principle, many are still working in the judiciary system today.

It is not surprising then that Bulgarian courts have been very slow to process important bank-related cases. In 1998, three months after the Law on Credit Millionaires entered into force, the BNB released a list of individuals and companies that owed large sums of money to 41 banks (Nikolov 1998, *Kreditnite milioneri*). Yet two years later, in 2000, no guilty verdicts had been reached in the pending bank-related cases. As one analyst pointed out, "The managers of the bankrupt Bulgarian banks have three things in common: all are under investigation; all are free in exchange for colossal bails; all are spending the depositors' money abroad freely" (Milev 2000).

The different branches of the judiciary blamed each other for the inability to punish white-collar crime. Prosecutors were disappointed with investigators because they had not documented properly the evidence. In 1999, several cases of bank fraud from the early 1990s were transferred to the Sofia Municipal Prosecution, and the prosecutors had to learn the case details with a significant delay. Furthermore, the vertical structure of the Bulgarian

prosecution allows higher-ranked prosecutors to annul the conclusions and recommendations filed by lower-ranked prosecutors who actually are the most familiar with the cases (Milev 1998, *Birkata za sudebnata vlast*).

According to reports, the files documenting five important cases of bank fraud and mismanagement had been lost in the computer system of the Interior Ministry (Milev 2000). Thus, investigators blamed their setbacks on the Interior Ministry operatives who had failed to collect good evidence when fraud was first detected. Angel Angelov, Chief of the National Investigation Agency, said that the Bulgarian legal system itself was too convoluted. Some banking cases were processed on the national level. Other cases were handled by the District Investigation Bureaus because the banks in question were registered locally, rather than in the capital (quoted in Nikolov 1998). Frequently, the District Investigation Bureaus did not share banking case information with the National Investigation Agency.

As a consequence, Bulgarian judges hesitated to pronounce a verdict in bank-related cases, because the presented evidence was often slim and unreliable. Judges frequently refused to deal with banking cases, stopped the proceedings, and ordered the cases back for more investigation (Milev 2000). As part of the efforts to join the EU in 2007, Bulgarian legislators undertook a major overhaul of the judicial system in order to improve its efficiency. But it remains to be seen whether the recent re-organization will produce the desired results.

4. Conclusion

As we saw in Chapter 3, an economic crisis can highlight the problems in the banking sector, but crisis alone is not enough to produce policy change. Chapter 4 illuminated the political processes driving banking sector legal reform in Bulgaria after 1997. I emphasized

the overriding importance of having governing elites who are knowledgeable and willing to undertake the necessary reforms, and reach out to potential international and domestic allies. What countries like Bulgaria needed during transition was a far-reaching transformation of the economy and a different structure of domestic incentives. In particular, IMF conditionality and the credible prospect for membership in the EU created opportunities for an inflow of investment, increase in trade, and access to international aid and loans that simply did not exist in Bulgaria in the early 1990s. This chapter showed that even though the quality of Bulgaria's banking sector laws improved significantly after 1997, the inefficiency of the state's administration and judiciary have slowed down law implementation. Reforming those two institutions is a laborious process, but the strong institution-building component of the EU accession process has helped Bulgarian governments tackle the unsatisfactory performance of the administrative and judiciary systems.

CHAPTER FIVE

I focus on legal reform of the banking sector in this thesis because it is a pivotal part of economic restructuring after the fall of communism. In Chapter 1, I argued that the post-communist transition has generated incentives for governing elites to pursue good quality legal reforms of the banking sector, but also incentives to stall these reforms. 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 capital allocation, as was the case during communism. 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 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 (Ditlbacher *et al.* 2002; 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.

Yet 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 in the post-communist region face incentives to implement partial banking reforms, which would give them greater discretionary power over

the allocation of capital. 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, and the state budget can be used to write off the bad loans in the portfolios of the state-owned banks. In the post-communist region, there have been numerous cases when public financial resources were misused for the private benefits of influential political and economic elites (Hellman 1998; Ganev 2001; Barnes 2003; Gould 2003; Hoff and Stiglitz 2004). In particular, Juliet Johnson (2000) has shown how heightened political uncertainty, a half-hearted democratization process, and failure to uphold the rule of law facilitate the development and perpetuation of distorted incentives in the banking sphere.

There are legal remedies that help prevent the misuse of the banks such as laws that promote transparency in bank operations and information-sharing concerning large loans; laws that allow the central bank to operate independently of political pressure; and institutional mechanisms to monitor the risk exposure and compliance of banks with the legal rules. The puzzles that animate my dissertation are: How do governments decide whether to reform the country's banking sector legal framework and which course of legal change to pursue? Which mobilized actors, both domestic and international, influence legal change in the banking sector?

Chapter 5 tests the theoretical framework and hypotheses that I presented in Chapter 1. I analyze data from twenty-five post-communist states using pooled cross-sectional time series. Section 1 below defines the dependent variable in my analysis: the quality of banking sector legal reform. In Section 2, I summarize the argument put forward in my dissertation and the hypotheses concerning the impact of the independent variables, which I have

organized into three categories: government partisanship, domestic alliances, and international conditionality. Subsequently, Section 3 introduces two alternative hypotheses concerning the role of economic development and culture. Section 4 presents the estimation approach that I use and discusses the results of the analysis. In Section 5, I sum up the findings of this chapter.

1. Dependent Variable: Quality of Banking Sector Legal Reform

How do we judge the quality of legal reform? It is indeed hard to define the components of "good" banking sector legal reform in absolute terms. My analytical strategy is to use benchmarks which the literature has established as "best practices." The literature developed in the last decade has demonstrated that in the banking sphere it is desirable to: provide clear market entry and exit conditions (Kroszner 1998; Fries 2005); ensure the ability of banks to function without excessive 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; Johnson 2006); and establish independent banking oversight (Nord 2000; Holthausen and Ronde 2003). Those are key policy standards, according to which I will judge the quality of a country's legal framework at any given time point. My quantitative analysis uses a measure of banking reform developed by the European Bank for Reconstruction and Development (EBRD) that takes into account the policy benchmarks described above. Appendix III presents a detailed description of the scale and coding of this variable.

2. Explaining Variation in the Quality of Banking Sector Legal Reform: The Role of Government Partisanship, Domestic Alliances, and International Conditionality

In this chapter, I test the impact of a range of domestic and international factors on the quality of banking sector legal reform in post-communist countries using pooled cross-sectional time series analysis. I probe two characteristics of the domestic political system that have a strong impact on the quality of banking reform: government partisanship in Section 2.1 and domestic alliances in Section 2.2. My analysis draws on the partisan politics literature with respect to the role of government coloration. To understand the role of domestic alliances, I use the comparative democratization literature on hybrid regimes and the comparative political economy literature on foreign direct investment and trade. Section 2.3 examines the effect of international conditionality on banking sector legal reform.

I argue in this thesis that the actions of the government and the domestic stakeholders are mutually reinforcing. So far, the literature on the post-communist transitions has focused primarily on the economic policy impact of government partisanship, but it has missed the extent to which governments of different partisan coloration respond to, and even cater to, the demands of salient domestic stakeholders such as organized economic interests. International pressure for economic liberalization, including the banking sector, is important to achieve good quality legal change, but it is not sufficient if the government and the domestic stakeholders are opposed to change. The case study on Hungary (Chapter 2) demonstrated that a configuration where all three factors—the partisan coloration of the governing elites, the character and strength of the mobilized domestic stakeholders, and the influence of international actors—are favorable to economic liberalization translates into an incremental improvement of the banking sector legal framework. In the first case study on

Bulgaria (Chapter 3), however, I showed that the unreformed left governments that dominated policy-making in the country in the period 1989-1997 forged strong alliances with rent-seeking domestic stakeholders and engaged extensively in clientelism. Even though international actors such as the IMF advocated economic liberalization in their meetings with successive Bulgarian governments, international pressure alone was not sufficient to bring about good quality reform of the banking sector legal framework.

The case studies on Hungary and Bulgaria helped understand the relative importance of the three factors in my analysis under different political circumstances, and revealed the mechanisms through which the explanatory variables have influenced the quality of banking sector legal reform. Now we turn to a large-n test that will assess whether the impact of government partisanship, character and strength of the mobilized domestic stakeholders, and international actors that we observed in the case studies holds in a larger sample of twenty-five post-communist states. Below, I summarize the hypotheses that will be tested in this chapter.

2.1 Government Partisanship

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). A widely recognized finding in the comparative politics literature with respect to partisan politics in the post-communist area is that center-right and reformed communist successor parties in power have performed 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).

Hypothesis 1: We expect good quality banking sector legal reform if the domestic political process is characterized by center-right or reformed communist successor parties in power.

What might account for this association? The literature has emphasized two mechanisms that help to explain the association between partisanship and the quality of economic reform in the post-communist region. The first mechanism is party ideology. According to Valerie Bunce (1999), the correlation between the right-wing opposition in power and better economic reform can be attributed to the ideological foundations of the right-wing opposition parties in the region. Because they rejected the economic policies pursued under communist rule, the opposition parties in most Eastern European states have adopted a market-liberalizing economic agenda. The second mechanism is political competition. Milada Vachudova (2001; 2005) shows that due to the increased quality of political competition, in countries where the right-wing opposition defeated the communist incumbents in the first post-1989 elections, the communist successor parties were forced to become more transparent, revised significantly their policy agenda, and endorsed at least some form of market-liberalizing reforms in order to "get back in the political game." Thus, I expect the general proposition about the role of center-right and reformed communist successor parties in economic restructuring to be valid in the particular case of banking sector legal reform.

I use the dataset developed by Klaus Armingeon and Romana Careja (2005) to code the partisanship of the governing political parties in the region. The categories of partisan coloration relevant for my analysis are: right/liberal, left, and populist/personalistic. Substantively, my research yields hypotheses concerning the role of the first two partisanship

categories, so I have not included the populist category as an explanatory variable. I use the year of joining the Socialist International as a proxy for the switching point between being an unreformed or reformed left post-communist party. The Socialist International is an international alliance of Social Democratic parties. It would not admit left parties from the post-communist region as full members unless they prove their democratic credentials, minimize their vulnerability to corruption and clientelism, and break from their authoritarian past (Socialist International 2006a; 2006b). Appendix III provides detailed descriptions of the variables in my model, the coding, and the data sources.

The argument about the salience of partisanship rests on the assumption that political parties are key actors in setting public policy. This may be a plausible hypothesis for many Western advanced industrialized countries, but less so for post-communist states. 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). Petr Kopecky demonstrates in his case study of the Czech Republic that even in political systems where relatively cohesive and programmatic parties are prevalent, political parties are rather insulated from their grass-root citizen supporters (1995: 517). Therefore, we need to investigate the influence of other groups such as organized business and economic interests on the policy positions of the political parties in the region.

2.2 Domestic Alliances

One way to gauge what groups influence the policy positions of political parties is to examine the relationship between the governing parties and organized 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. A first strategy to understand the impact of those actors focuses on the role of rent-seeking domestic stakeholders. I argued in Chapter 1 that unreformed communist successor parties preserve and enhance clientelistic linkages among state officials, enterprise managers, and bankers inherited from the old regime.

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

What are some examples of rent-seeking domestic stakeholders that have mobilized against the introduction of comprehensive economic reforms? At the outset of the transition process, Adam Przeworski (1991) and Stephan Haggard and Robert 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 Joel Hellman (1998) has demonstrated that the obstacles to economic reform in post-communist countries have come from a different source. Hellman 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. Branislav Slanchev (2006) has confirmed statistically this finding. According to Hellman, the post-communist experience has shown 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). To detect the presence of a strong clientelistic relationship between the governing elites and rent-seeking domestic stakeholders, I use a composite variable developed by Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi (2006) at the World Bank that taps into the presence of corruption in the domestic political system. Appendix III contains further details of the coding of this variable.

A second strategy to understand the impact of mobilized domestic stakeholders focuses on the role of foreign investors. I have argued that in contrast to the clientelistic alliances forged by unreformed communist governing elites, right-wing and reformed left governments have pursued economic stability and growth by establishing domestic alliances with foreign investors, big domestic enterprises, and export-oriented domestic businesses.

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

Comparative political economists have established that inflows of foreign direct investment (FDI) have a positive effect on 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 offset current account and fiscal deficits. Moreover, FDI supplements the low domestic resources to finance both ownership change and capital formation. 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 may influence banking sector legal reform? Foreign direct investment is a long-term type of international capital flows, in contrast to short-term types such as portfolio investment. The purpose of FDI is to establish lasting commercial relations and exert a noticeable managerial influence in the foreign country (Barrell and Holland 2000: 478). Leslie Lipschitz, Timothy Lane, and Alexandros Mourmouras find evidence 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). Thus, the long-term commitment of FDI investors may motivate 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 sector laws.

A third strategy to understand the influence of economic interest refers to a country's pattern of trade and its impact on domestic political institutions. Trade patterns are influenced predominantly by considerations about economic efficiency, comparative advantage, and production costs. But is there a relationship between trade patterns and domestic political arrangements? The political economy literature has shown that since the 1970s, the world economy has become more integrated and the degree of trade liberalization has increased (Helleiner 1996; Jordan and Majnoni 2002). Similarly, the degree of financial liberalization in the world economy has also increased since the 1970s (Helleiner 1996; Eichengreen 1998). The higher level of integration of the global markets has led to the harmonization of important domestic financial laws (Aliber 1984; Jordan and Majnoni 2002).

Helen Milner has pointed out that the impact of trade on domestic institutions is strongest and most visible in trade regimes such as the EU, NAFTA, and ASEAN (1999:106). Milner's analysis contains a possible mechanism through which trade can

influence the domestic legal framework. To the extent that regional trade regimes are deeply institutionalized and have the capacity to enforce trade rules, they can demand compliance with legal benchmarks observed within that regional trade regime.

Hypothesis 4: We expect good quality banking sector legal reform if a country has strong trade relations with deeply institutionalized trade regimes.

The European Union (EU) 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 to adopt better banking sector laws? Bartolomej Kaminski (2001) has argued that until the mid-1990s, the EU did not have a significant impact on economic reform in Central and Eastern Europe, because the Union's policy lacked credible incentives and punishment mechanisms. However, the EU became a much more influential factor in the region after the so-called Europe Agreements were put in place. The Europe Agreements obliged Central and Eastern European countries (CEECs) to open their markets to EU imports and eliminate trade barriers in general. Kaminski emphasizes that even before the formal completion of the eastward Enlargement of the EU in 2004 and 2007, the Europe Agreements promoted not only trade openness but also the adoption of Western-style company and competition laws, banking laws, laws on mergers and state aid, and intellectual property laws (2001: 5).

Overall, I operationalize the role of foreign investors in two ways: the inflow of FDI as percentage of the country's GDP, and the assets of foreign-owned banks as a percentage of the total assets in the country's banking system. To operationalize the trade hypothesis, I use the percentage of trade with industrialized countries from a country's total trade flows. Next, we turn to the impact of international actors on the quality of banking sector legal reform.

2.3 International Conditionality

In this thesis, I have argued that apart from responding to the demands of organized domestic stakeholders, post-communist governments have also considered policy advice from international actors. Political scientists have examined the growing social and economic interactions among the world's states, and the increased policy salience of international organizations such as the European Union (EU), the International Monetary Fund (IMF), and the World Bank. In particular, the use of conditionality by international actors has received significant attention (Mayhew 1998; Schmitter 2001; Schimmelfennig and Sedelmeier 2004). Conditionality entails a package of rewards and punishments attached to demands for specific policy changes. In the realm of banking sector legal reform, the IMF has requested that certain legal standards be met as a prerequisite for releasing funding. The EU has also demanded that the post-communist candidate countries adopt the banking legal standards of the Union as part of the obligatory pre-accession transposition of the *acquis communautaire*.

Hypothesis 5: We expect good quality banking sector legal reform if a country has been involved consistently in IMF and EU conditionality programs.

IMF conditionality was introduced in the 1950s as a way of ensuring that governments did not squander the financial support provided by the Fund. The IMF offers financial assistance only on condition that the target government agrees to pursue a range of economic stabilization and adjustment policies that are specified in a "letter of intent" document signed by the government and the Fund (Williamson 1983; Dreher and Vaubel 2003; Bird and Willet 2003). The IMF claims that its conditionality policies have a positive effect on the stability of the target country's financial system and help to attract capital inflows. The Fund argues that conditionality serves as a signaling device that increases the

markets' confidence in the economy of the target country and encourages private market actors to become involved, whereas without conditionality they would be 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 pushed for legal provisions that guarantee the independence of the central bank from political pressure; open the banking sector to foreign investors and competition; strengthen banking supervision; and improve the bankruptcy legal framework (Bonin and Wachtel 1999; Berglof and Bolton 2001). As described in greater detail in Appendix III, I have coded four types of relations with the IMF in the post-communist area: 1) no IMF agreement; 2) Stand-by agreement; 3) Poverty Relief and Growth Facility; 4) no IMF program and reform front-runner.

European Union conditionality is broader in nature and scope than IMF conditionality. For credible future members of the Union, the specific policy demands of EU conditionality in banking 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 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. As described in greater detail in Appendix III, I have coded five levels of EU conditionality in the post-communist region: 1) no EU conditionality program, but the country is eligible; 2) Accession conditionality program; 3) Stabilization and Association Agreement program (SAA); 4) European Neighborhood Policy program (ENP); and 5) no EU conditionality program, but the country is practically ineligible. However, in Section 4, I explain in greater detail my decision to

exclude the EU conditionality variables from the statistical test, because they would produce multicollinearity in the estimation process.

3. Alternative Explanations

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 sector 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.

3.1 Economic Development

Adam Przeworski et al. (2000) examine systematically the relationship between regime type (democratic or authoritarian) and economic performance. As part of the analysis, the authors draw conclusions about the relationship between the nature of political and institutional arrangements and the level of economic development of different regime types. Although Przeworski et al.'s analysis is more sophisticated and nuanced than modernization theory accounts, it contends, in essence, that "poor countries cannot afford a strong state" (2000: 163). According to the authors' analysis of cross-sectional 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 those 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). Following the logic of the economic development argument, we should expect predominantly wealthy countries in the post-communist region to pursue good quality banking sector legal reforms.

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

I use several indicators that tap into a country's level of economic development. A country's GDP per capita is a widely-used measure of economic development that I incorporate in the model. In addition, my analysis employs a measure of the country's stock market capitalization as a percentage of its GDP. In the literature on welfare states, this variable is commonly used to distinguish between Coordinated Market Economies and Liberal Market Economies (Hall and Soskice 2001: 8), but in post-communist states stock market capitalization gauges the strength of the emerging financial sector. I also consider the potential effects of a large agricultural sector and a strong industrial sector, measured as percentage of GDP. We generally expect a large agricultural sector to indicate a low level of economic development. A strong industrial sector could indicate a high level of economic development, but in the post-communist context, it could also indicate that the economy is not very diversified and much of the GDP is generated by the remnants of the big state-owned industrial conglomerates from the previous regime.

3.2 Culture

In "The Protestant Ethic and the Spirit of Capitalism" Max Weber wrote that, historically, Protestantism encouraged the rational pursuit of economic gain and gave worldly activities such as developing one's own enterprise, engaging in trade, and accumulating wealth for investment a positive spiritual and moral meaning (1904/2003: 35-37). Writing in the early 1900s, Weber observed that the strong religious underpinnings of the protestant ethic in society were slowly disappearing. However, the emphasis on individualism, hard work, frugality, and profitable investment persisted in society. Such cultural values would be favorable for economic development. Of course, Weber stressed that while protestant cultural values had exerted a major influence on the course of economic development in Europe and United States, they were one important factor among many. According to Weber, equally significant factors for the development of capitalism were the pursuit of rationalism and scientific reasoning, the growing role of jurisprudence, and the development of large government and enterprise administrations to implement and monitor complex organizational planning (1904/2003: 25-27, 108, 136-147).

Although it is difficult to capture the concept of culture in quantifiable terms, some scholars have attempted to study systematically the impact of culture on institutions and governance. Amir Licht et al. (2006) have analyzed the impact of culture on the rule of law, curbing corruption, and democratic accountability, which they regard as social norms. The authors identify seven broad types of world culture and examine the systematic influence of culture type on the social norms in their research project, including a norm called "respect for the law." The scholars find statistical evidence that "national cultural profiles predict governance outcomes some thirty years later," and they argue that the direction of causality

flows from culture to social norms, including respect for the law (Licht *et al.* 2006: 29). It is particularly relevant for my project that Licht et al. (2006) claim that different cultural patterns are associated with systematically different levels of respect for the law. According to Licht et al.' s analysis, the wide acceptance of social norms such as law abidingness, absence of corruption, and adherence to democratic principles is strongly related to the existence of "a broad cultural endorsement of individual autonomy" (2006: 30).

Alternative hypothesis 2: We expect good quality banking sector legal reform if there is an existing culture that supports the development of law-abidingness and market institutions.

Finding a reliable measure of the impact of culture is a daunting task. In the absence of adequate cross-sectional measures of cultural attitudes such as individual autonomy and support for market institutions, I use two general variables that measure the percentage of protestant and muslim population in the twenty-five post-communist countries in my dataset. The percentage of protestant population measure is based on Weber's argument (1904/2003), while the percentage of muslim population draws on Licht at al.'s (2006) finding that predominantly muslim societies exhibit lower levels of support for market institutions. I discuss the limitations of this operationalization of culture when I present the results of the time series analysis in Section 4.

The EBRD refined its coding procedure starting in 1997. Therefore, I included a control dummy variable to check for the potential effects of coding refinement. In addition, I have included a set of dummy variables to control for the constitutional set-up of the post-communist states in my dataset. Those variables test whether the distinction between a parliamentary and presidential institutional-set up has an impact on the quality of banking

sector legal reform. Appendix III contains detailed information about the coding and the sources of the data used in this chapter. In Table 5.1 below, I present a succinct description of the variables included in the final specification of my model and the hypothesized effects.

Table 5.1: Description of the variables and hypothesized effects for the analysis of banking sector legal reform in the post-communist region

Variable	Description	Hypothesis
Dependent Variable		
EBRD Banking reform	EBRD score measures progress in adopting "best practices" banking regulations. Scale: 1 to 4.3	
Explanatory Variables		
Government partisanship		
Reformed left in government	Scored 1 for each year of reformed left party in government; reflects total years since 1989.	+
Unreformed left in government	Scored 1 for each year of unreformed left party in government; reflects total years since 1989.	-
Liberal/right in government	Scored 1 for each year of liberal/right party in government; reflects total years since 1989.	+
Domestic Alliances		
Lack of corruption	Composite expert survey score. Scale -2.5 to 2.5	+
Foreign direct investment	Inflow of FDI as percentage of GDP. Scale 0 to 1	+
Foreign-owned bank assets	Assets of foreign-owned bank as percentage of total bank assets. Scale 0 to 1	+
Trade with industrialized countries	Trade with advanced industrialized countries as percentage of total trade flows. Scale 0 to 1	+
Conditionality		
No IMF program	Dummy variable coded 1 when the country has no agreement with the IMF, all other=0	-
Stand-by agreement with IMF	Stand-by agreement with IMF=1, all other=0	+
Poverty relief and growth facility agreement with IMF	Poverty relief and growth facility agreement with IMF=1, all other=0	+
No IMF program and reform front-runner	No IMF program (and reform front-runner)=1, all other=0	none
Inflow of IMF funding	Total funding received from the IMF expressed as percentage of GDP. Scale 0 to 1	+ or none
Economic development		
GDP per capita	GDP per capita in thousands USD	+
Stock market capitalization	Stock market capitalization as a percentage of GDP. Scale 0 to 1	+
Percentage of GDP from industry	Percentage of GDP that comes from industry. Scale 0 to 1	+ or -
Percentage of GDP from agriculture	Percentage of GDP that comes from agriculture. Scale 0 to 1	-
Culture		
Percentage population protestant	Percentage of the population with protestant religion. Scale 0 to 1	+
Percentage population muslim	Percentage of the population with muslim religion. Scale 0 to 1	- or none
Controls		
Constitutional set-up		
Presidential system	Dummy variable coded 1 for presidential political systems, all other=0.	-
Semi-presidential system, dominated by president	Semi-presidential political system, where president is dominant=1, all other=0	-
Parliamentary system	Parliamentary political system=1, all other=0	+
Coding refinement	Dummy variable scored 1 for period 1997-2005, Scored 0 for period 1995-1996.	+ or none

4. Estimation Approach and Results

This chapter employs pooled cross-sectional time series analysis, which allows me to get leverage on important factors contributing to a good quality of banking sector legal reform that vary both cross-sectionally and over time. Time series analysis also makes it possible to test the effect of a broad range of factors on the dependent variable. The number of observations in my model is higher than what those would be in a single-year ordinary least squares (OLS) regression model, which generates more degrees of freedom in the estimation process (Plümper *et al.* 2005).

The units of analysis are twenty-five states in the post-communist region: the Central European states, the Baltic states, the Southeast European states, and all post-Soviet states over a period of eleven years, 1995-2005. From the states of ex-Yugoslavia, I have excluded Bosnia-Herzegovina and Serbia-Montenegro due to frequently missing data. In total, my model has 275 observations. The panel that I use is balanced: It contains twenty-five countries and observations on each variable for the eleven-year period. Table 5.2 displays the means of the dependent variable and selected independent variables for the countries in my dataset.

Table 5.2: Means of the dependent variable and selected independent variables

	EBRD Banking reform	Cumul. Ref. Left	Cumul. Unref. Left	Cumul. Right/ Liberal	Control of Corruption	FDI (percentage of GDP)	Assets of foreign-owned banks	GDP per capita (thousands $)
Albania	2.20	.55	5.72	5.72	-.57	.03	.38	1.41
Armenia	2.28	0	0	0	-.72	.05	.45	.74
Azerbaijan	2.11	0	6	0	-1.08	.20	.04	.72
Belarus	1.35	0	12	0	-.73	.01	.08	1.59
Bulgaria	2.88	.09	5.91	6	-.36	.06	.51	1.96
Croatia	3.28	1.64	0	.27	-.18	.05	.53	5.38
Czech Republic	3.36	3.27	3	5.72	.43	.06	.56	7.18
Estonia	3.53	0	0	12	.52	.08	.73	5.23
Georgia	2.28	0	9.45	.55	-.89	.05	.25	.77
Hungary	3.82	3	2	7	.66	.07	.65	6.18
Kazakhstan	2.47	0	12	0	-.97	.07	.18	1.77
Kyrgyzstan	2.32	0	0	0	-.88	.03	.38	.36
Latvia	3.23	1.73	4	6.27	-.11	.05	.59	3.71
Lithuania	3.06	1.36	7	3.64	.12	.04	.60	3.93
Macedonia	2.97	.91	8.72	0	-.68	.03	.31	2.11
Moldova	2.25	0	12	0	-.65	.05	.27	.49
Poland	3.25	3.64	0	8.36	.39	.03	.49	5.03
Romania	2.75	.45	8.73	2.82	-.33	.03	.37	2.22
Russia	1.97	0	5.27	0	-.80	.01	.07	2.66
Slovakia	3.06	0	3	2.55	.26	.05	.53	4.94
Slovenia	3.19	.09	0	11.9	.99	.02	.12	11.87
Tajikistan	1.28	0	0	0	-1.3	.03	.33	.21
Turkmenistan	1	0	11	0	-1.31	.04	.01	.73
Ukraine	2.15	0	6.82	.55	-.90	.03	.11	1.67
Uzbekistan	1.75	0	11	0	-1.03	.01	.03	.42

The literature has shown that using OLS estimation techniques on pooled cross-sectional data violates several regression assumptions. Such techniques lower the size of the standard errors and artificially increase the significance of the estimated coefficients (Beck and Katz 1995). The most serious problems that arise are the following: errors in time series data tend to be serially correlated; errors are likely to show cross-sectional heteroskedasticity such that variances differ across units; errors may be cross-sectionally correlated as well; errors may reflect causal heterogeneity across space, time, or both (Ostrom 1978; Sayrs 1989; Hicks 1994; De Boef 2004). A commonly used strategy to correct for the shortcomings

outlined above follows Beck and Katz's work. Beck and Katz (1995) recommend using OLS estimation with a lagged dependent variable to correct for the serial correlation, alongside with panel-corrected standard errors.

However, the use of a lagged dependent variable can interfere with the theoretical goals of the project. When we include the level of the dependent variable from the previous year as a control, the analysis essentially turns into a study of annual change. Usually, the lagged dependent variable becomes the most significant explanatory factor. If we pursue this analytical strategy, we cannot say much about the role of institutional and political factors that may be of important theoretical interest in the project (Plümper *et al.* 2005). Christopher Achen has demonstrated that a lagged dependent variable "does bias the substantive coefficients toward negligible values and does artificially inflate the effect of the lagged dependent variable" (2000:13).

In my dataset, the year-to-year change in the evaluation of the countries' banking reform does not change drastically. Therefore, the coefficient of the lagged banking sector evaluation score is likely to explain virtually all the variance in the model (Bradley 2001; Kittel and Obinger 2002). In cases of small year-to-year change, the lagged dependent variable washes out the effect of the other independent variables, while substantively it does not contribute much to the explanation (Nickell 1981; Baltagi 2001). In addition, the very interpretation of the lagged dependent variable is problematic. Because the lagged dependent variable can be expressed as a function of the independent variables, the coefficient of the lagged dependent variable actually measures the weighted average effect of the independent variables (Cochrane and Orcutt 1949).

In order to test the substantive theoretical propositions outlined in this chapter, I have chosen not to use the lagged dependent variable approach in my analysis of the quality of banking sector reform in the post-communist region. Instead, I will correct for the serial correlation in the data by applying a Prais-Winsten transformation model (AR1) with panel-corrected standard errors. This technique has been advocated by Thomas Plümper, Vera Troeger, and Philip Manow (2005) as an estimation strategy that allows researchers to test substantive theoretical propositions more accurately than models that employ fixed country effects or a lagged dependent variable.

The Prais-Winsten transformation model (AR1) is an example of what George Judge et al. (1985) call *Estimated Generalized Least Squares* (EGLS) models. The goal of the EGLS analytical approach is to determine the nature of the autoregressive process that generates the errors, estimate its parameters (in the case of a first-order process AR1 this is a single parameter), then transform the data, and apply an OLS estimation procedure to derive the coefficient estimates (Ostrom 1978). The Prais-Winsten approach uses conditional maximum likelihood estimation and incorporates all available observations.

To evaluate the robustness of the coefficient estimates that I obtained from applying a Prais-Winsten transformation model (AR1) with panel-corrected standard errors, I re-estimated the model using a different estimation technique. I used an error components time series model (also called a random coefficients model). Appendix VI presents the estimates obtained from the random coefficients model. This technique estimates the parameters of the distributions of the different components of the error term to derive efficient and unbiased estimates (Sayrs 1989). The main strategy is to break down the error into three separate components resulting from three sources of variation: variation in the time periods; variation

in the cross-sections; and "true" random error variation (De Boef 2004). The advantage of using the random effects model is that the estimates will be relatively efficient. However, the downside is that if the error variances are correlated with the explanatory variables, the estimators will be biased. Overall, the additional estimation technique provided estimates that are generally in line with the ones obtained from the Prais-Winsten transformation model.

Before I present and discuss the coefficient estimates, I need to consider the relationships among the variables in the model. Appendix III provides a detailed description of the explanatory variables, the sources of the data, and the measurement scales. After conducting a variance inflation factor analysis that I discuss in the following paragraphs, I have excluded from the final model specification the state institutional capacity variables: administrative and judicial capacity, and the EU program participation dummy variables. The results of the variance inflation factor analysis are reported in Appendix V.

I have excluded the measures for EU conditionality from the analysis for two main reasons. First, when we examine the correlations among the independent variables, it becomes clear that participation in the strictest and most effective EU conditionality program—the Accession process—is highly correlated with the GDP variable, the liberal/right government variable, and the corruption variable, and thus it will produce multicollinearity in the estimation process. Countries in the post-communist region display significant variation in the degree of economic development, transparency, trade integration with the Western economies, and political stability. Yet the data shows that the states that have been involved in the strictest and most effective EU conditionality program—the Accession process—are largely the ones with stable liberal democratic governments, the highest degree of economic development, trade integration with the West, and transparency.

Second, the kind of conditionality program that the EU is likely to offer depends on the target country's location, degree of political stability, and level of economic development. For example, it is not reasonable to expect that the EU will offer the accession conditionality package to Belarus, or to stretch this reasoning even further – to Uzbekistan. Because some countries in the post-communist region by virtue of their geographical location are not eligible for the strictest and most effective kind of EU conditionality, it becomes problematic to disentangle the flow of causality between the bundle of factors that *qualify* a country to participate in a particular kind of EU conditionality program and the *independent impact* of EU conditionality on the target country. In my view, in-depth case study analysis would be a more appropriate method to analyze this dynamic. Overall, taking into account the correlations among the variables and the variance inflation factor analysis, I have decided not to include in the statistical test the administrative and judicial capacity variables and the EU conditionality dummy variables in order to avoid multicollinearity: The variance inflation factor of these variables is well above or close to 10.

Table 5.3 presents the results of the time series analysis. The model put forward in this chapter fits the data well. The explanatory variables account for seventy-eight percent of the variance in the quality of banking sector legal reform in the post-communist region. The positive intercept of 2.271 suggests that there is a tendency to introduce some good quality legal reforms of the banking sector that is common to all countries in the post-communist region.

Table 5.3: EGLS regression analysis of banking sector legal reform in the post-communist region

Explanatory variables	**Effect**	**pcse**
Government partisanship		
Reformed left in government	.073***	(.016)
Unreformed left in government	.002	(.007)
Liberal / right in government	-.006	(.012)
Domestic alliances		
Lack of corruption	.175**	(.087)
Foreign direct investment	1.064***	(.335)
Foreign-owned bank assets	.178*	(.107)
Trade with industrialized countries	.192	(.252)
Conditionality		
No IMF agreement - baseline category -		
Stand-by agreement with IMF	.125*	(.069)
Poverty relief and growth facility agreement with IMF	.135*	(.078)
No IMF program and reform front-runner	.076	(.092)
Inflow of IMF funding	1.136	(.848)
Economic development		
GDP per capita	.044***	(.014)
Stock market capitalization	.513**	(.211)
Percentage of GDP from industry	-1.331***	(.384)
Percentage of GDP from agriculture	-.980**	(.457)
Culture		
Percentage population protestant	.682***	(.187)
Percentage population muslim	-.179	(.112)
Constitutional set-up		
Presidential system - baseline category -		
Semi-presidential system, dominated by president	.152	(.097)
Parliamentary system	.453***	(.105)
Coding refinement	.024	(.074)
Constant	2.271***	(.254)
Adjusted R-squared	.783	
275 observations		
AR1 autocorrelation process: rho	.581	

Note: The table presents estimated generalized least squares (EGLS) unstandardized regression coefficients obtained by applying a Prais-Winsten transformation model (AR1), with panel-corrected standard errors (pcse) in parentheses. The significance levels are as follows: *p< .10, **p< .05, ***p< .01, two-tailed test.

The empirical analysis supports my theoretical argument that reformed left parties in government perform significantly better than their unreformed left counterparts in the initiation and implementation of good quality banking sector legal reform. Because the reported coefficients are unstandardized, I have assessed the impact on the dependent variable of a comparable move from a low to a high level in the statistically significant explanatory variables. Table 5.4 below summarizes those effects. Thus, a move from the 10th to the 90th percentile in the cumulative years of reformed left government produces a 0.219-unit increase in the quality of banking sector legal reform, which is a sizeable increase given the 4-point scale used by the EBRD. Substantively, a move from the 10th to the 90th percentile in the reformed left variable translates into a move from 0 to 3 cumulative years of reformed left in government since 1989. The presence of a liberal or right party in government is associated with a lower quality of banking sector legal reforms, which runs contrary to my theoretical expectations. However, the result is not statistically significant.

Table 5.4: Analysis of the effects of the statistically significant explanatory variables on the quality of banking sector legal reform

Statistically significant explanatory variables	**Effect of move from 10th to 90th percentile in explanatory variable on EBRD score**
Government partisanship	
Reformed left in government	0.219-unit increase
Domestic alliances	
Lack of corruption	0.305-unit increase
Foreign direct investment	0.088-unit increase
Foreign-owned bank assets	0.146-unit increase
Economic development	
GDP per capita	0.285-unit increase
Stock market capitalization	0.130-unit increase
Percentage of GDP from agriculture	0.249-unit decrease
Percentage of GDP from industry	0.241-unit decrease
Culture	
Percentage population protestant	0.171-unit increase

The test of the domestic alliance variables supports my argument about the dynamics of partial reform in the post-communist region. I use the level of corruption in the political system as a proxy variable to measure the presence of partial reform alliances that hinder comprehensive banking sector legal reform. The time series analysis confirms that the less corruption is present in the domestic system, the better the quality of banking legal reform. A move from the 10th to the 90th percentile in the control of corruption variable results in a 0.305-unit increase of the quality of banking sector legal reform, which is the biggest effect in the model. Substantively, this is equivalent to a move from the extent of control of corruption in Azerbaijan in 2000 to the extent of control of corruption in Hungary in 2000.

The presence of foreign direct investors is also a statistically significant predictor of good quality banking legal reform. A move from the 10th to the 90th percentile in the share of FDI of a country's GDP results in a 0.088-unit increase in the quality of its banking legal reform. Moreover, a move from the 10th to the 90th percentile in the presence of foreign banks in the domestic banking sector leads to a 0.146-unit increase in the EBRD score. Substantively, this translates into a move from a 2-percent share of foreign banks' assets in the total banking system assets to an 84-percent share.

Does enrollment in an IMF program influence the quality of banking reform in the post-communist region? According to the statistical test, participation in the stricter Stand-by Agreement program and participation in the Poverty Relief and Growth Facility program both register a statistically significant positive effect on the quality of banking sector reform in post-communist countries, compared to the baseline category which is "no IMF agreement." For countries that have taken part in the Stand-by Agreement the value of the intercept is 2.396, and for countries that have taken part in the Poverty Relief and Growth

Facility the intercept is 2.406. However, the amount of funding that a country has obtained from the IMF is not a statistically significant predictor of the quality of its banking sector legal reform.

The results show that the economic development variables in the model are also strong and significant predictors of the quality of banking sector legal reform in the post-communist region. A move from the 10th to the 90th percentile in the GDP per capita variable produces a 0.285-unit increase in the EBRD score, and a move from the 10th to the 90th percentile in the stock market capitalization variable results in a 0.130-unit increase in the EBRD score. Substantively, this translates into a move from Tajikistan's GDP per capita in 2005 to Latvia's GDP per capital in 2005. A higher share of both agriculture and industry in a country's GDP is associated with a statistically significant decrease in the quality of banking sector legal reform. A move from the 10th to the 90th percentile in the agriculture variable produces a 0.249-unit decrease, and the equivalent move in the industry variable leads to a 0.241-unit decrease in the EBRD score. Substantively, the move in the industry variable translates into a move from the share of industry in GDP in Macedonia in 2005 to that in Russia in 2005.

The effects of culture, broadly operationalized as the percentage of citizens that have protestant or muslim religious affiliation, turn out to be statistically significant in my analysis. However, cultural, or in this case religious, boundaries frequently coincide with regional boundaries. In particular, the Central European and Baltic front-runners of economic reform have the highest percentages of protestant population, whereas the Central Asian countries have the highest concentration of muslim population. Due to the overlapping regional and cultural cleavages, the culture variables probably also tap into regional effects.

With that caveat in mind, the analysis suggests that having a largely protestant population is associated with a higher quality of banking sector legal reform. A move from the 10th to the 90th percentile in the protestant variable results in a 0.171-unit increase in the EBRD score. However, the effect of the percentage muslim population variable is not statistically significant. The constitutional set-up also has an impact on the quality of banking sector legal reform: For parliamentary systems the value of the intercept is 2.724 and statistically significant.

5. Conclusion

I seek to understand what factors push governments to pursue good quality banking sector legal reforms in the post-communist region. In this chapter, I have tested the hypotheses put forward in my thesis using a pooled cross-sectional time series model. The agent-driven theoretical framework that I have developed assumes that actors such as the government elites, foreign direct investors, and organized domestic business interests have shaped banking sector legal reform in the post-communist region after 1989. The time series analysis has confirmed the importance of government partisanship and, in particular, the significant difference between the performance of reformed and unreformed communist successor parties in power. Reformed left governments implement significantly better quality of banking sector legal reform. The analysis also confirmed that the higher the level of foreign direct investment in a country and the presence of foreign banks, the better the quality of its banking legal reform. Curbing corruption is also strongly related to a better quality of banking sector legal reform. Participation in the stricter Stand-by program or the looser Poverty Relief and Growth Facility program administered by the IMF is associated with a better quality of banking legal reform in the post-communist area.

In Chapter 1, I conceptualized structural factors such as the level of economic development and intrinsic cultural characteristics as alternative explanations of why some countries in the region have implemented better reforms of their banking sector legal frameworks after 1989. The results of the time series analysis suggest that rather than being an alternative to agent-driven accounts, structural factors play an important complementary role in the overall explanation of the quality of banking sector legal reform in the post-communist region. Some of the economic development and culture variables such as GDP per capita, stock market capitalization, and prevalence of protestant religion are statistically significant predictors of the quality of banking sector legal reform. It turns out then that the structural variables set the broad parameters within which reforms take place. However, as the case studies on Hungary and Bulgaria have demonstrated, the theoretically important agency variables in my argument help understand what pieces of the domestic political system need to move for reform to happen, and how good quality reforms do take place in cases with adverse structural conditions such as Bulgaria until 1997.

CONCLUSION

Following the collapse of the Soviet bloc in the early 1990s, policy-makers in the region faced daunting tasks. The orthodox principles of running a socialist planned economy no longer applied. Governments faced the challenge of laying the foundations of a market economy: Which economic reforms should be implemented and in what order? One fundamental challenge was to reduce the involvement of the state in the economy and, consequently, amend and update the legal framework to bring regulations in line with the new economic conditions. Legal reform of the banking sector is a crucial component of economic liberalization and reveals the difficulties of building market institutions in the post-communist region.

My dissertation illuminates the political processes that determined the outcome of legal reform in the banking sector, given the persistence of economic practices and political alliances from the old regime. I have asked: How do governments decide whether to reform the country's banking sector legal framework and which course of legal change to pursue? Which mobilized actors, both domestic and international, influence legal change in the banking sector? My argument emphasized that the interaction of three factors—the partisan coloration of the governing elites, the strength and character of the mobilized domestic stakeholders, and the influence of international actors—has shaped the quality of banking sector legal reform in the post-communist area. In particular, this project has enhanced our knowledge of the political configurations that promote the adoption and implementation of good quality laws.

Since 1989, the reform trajectories of post-communist states have differed. One set of cases is exemplified by Hungary, which took a path of incremental improvement of the legal framework in banking. The Hungarian case demonstrated that the reform front-runners in the region introduced more private ownership in the economy, but at the same time they enhanced the regulatory capacity of the state. Another set of cases is exemplified by Bulgaria until 1997, where partial reforms weakened the regulatory capacity of the state and generated benefits only for a small group of political and economic actors.

The case study on Hungary (Chapter 2) showed that a configuration where the three factors in my explanation—the partisan coloration of the governing elites, the character and strength of the mobilized domestic stakeholders, and the influence of international actors—are favorable to economic liberalization translates into an incremental improvement of the banking sector legal framework. In contrast, the first case study on Bulgaria (Chapter 3) showed how the unreformed left governments that dominated policy-making in the country in the period 1989-1997 forged strong alliances with rent-seeking domestic stakeholders and engaged extensively in clientelism. Even though international actors such as the IMF advocated economic liberalization in their meetings with successive Bulgarian governments, international pressure alone was not sufficient to bring about good quality reform of the banking sector legal framework.

Yet policy change did eventually take place in Bulgaria, revealing how a realignment of domestic and international forces could bring reform following electoral turnover. In the second case study on Bulgaria (Chapter 4), I argued that the observed significant improvement of the banking sector legal framework after 1997 resulted from the confluence of two factors: a change in the partisan coloration of the government and the reinforced role

of international actors. After a severe financial crisis in 1996/1997, the Bulgarian political system experienced a shift from an unreformed communist party in power to a center-right party in power. International actors such as the IMF and the EU had provided blueprints for economic liberalization to the Bulgarian governments even before the watershed electoral change of 1997, but only after 1997 did their message receive serious consideration from Bulgarian policy-makers. In order to lock in and sustain the process of economic liberalization, the governing elites reached out to foreign investors and domestic business groups that favored transparency and trade with Western economies.

According to my theoretical framework, actors such as the governing elites, organized business and economic interests, and international organizations have shaped banking sector legal reform in the post-communist region after 1989. The time series analysis that I conducted in Chapter 5 confirmed the importance of government coloration and, in particular, the significant difference between reformed and unreformed communist successor parties in power. Reformed left governments in power introduce significantly better quality of banking sector legal reform than their unreformed left counterparts. The analysis confirmed that the higher the level of foreign direct investment in a country and the presence of foreign banks, the better the quality of banking sector legal reform. Curbing corruption is also strongly related to a higher quality of banking sector legal reform. Participation in the stricter Stand by program or the looser Poverty Relief and Growth Facility program administered by the IMF is associated with a better quality of banking legal reform in the post-communist area.

In Chapter 1, I conceptualized structural factors such as the level of economic development and intrinsic cultural characteristics as alternative explanations of why some

countries in the post-communist region have implemented better reforms of their banking sector legal framework. The results of the statistical test presented in Chapter 5 suggest that rather than being an alternative to agent-driven accounts, structural factors play an important complementary role in the overall explanation of the quality of banking sector legal reform. Some of the economic development and culture variables such as GDP per capita, stock market capitalization, and prevalence of protestant religion are statistically significant predictors of the quality of banking sector legal reform. Thus, the structural variables set the broad parameters within which reforms take place. However, as the case study analyses of Hungary and Bulgaria have demonstrated, the theoretically important agency variables in my explanation help understand what pieces of the domestic political system need to move for reform to happen, and how good quality reforms do take place in cases with adverse structural conditions such as Bulgaria until 1997.

My dissertation confirmed that post-communist political parties, on the left and on the right alike, are heavily influenced by organized economic interests. But the relationship with economic actors that unreformed communist successor parties build and sustain is very different from that of reformed communist successor parties and right-wing parties. Unreformed communist successor parties in government use their political power to restrict the access of new actors to the economic arena. At the same time, they preserve the clientelistic linkages among state officials, enterprise managers, and bankers inherited from the old regime. In turn, political elites from the unreformed communist successor parties depend on the continued support of their economic "clients" in order to obtain revenues and maintain their grip on power.

By contrast, liberal/right and reformed left governments seek to create a more pluralistic economic environment that can accommodate a variety of economic actors. Right and reformed left governments pursue economic stability and growth by enabling emerging domestic economic actors to operate and grow, and by seeking foreign capital. For that reason, big domestic enterprises, export-oriented domestic businesses, and foreign investors have significant power to pressure the right-wing and reformed left governments for favorable legislation. These actors are important pro-reform constituents that create a positive feedback loop to sustain economic liberalization and lock in the concomitant institutional and policy changes. We saw that post-communist governments can use legal reform to influence the number and kinds of actors that operate in the economy. An important implication of this finding in the region is that clientelistic economic relations are very likely to persist unless an electoral change of the governing elites brings a reformed left or a liberal/right political party in power.

Furthermore, I found that reformed communist successor parties and right/liberal parties adopt very similar economic policies when in government: They undertake measures to liberalize the economy and seek to improve the regulatory capacity of the state. In that sense, the economic policy choices of reformed communist successor parties in the region are similar to the centrist policy behavior of “Third Way” parties of the left such as New Labour in the UK.

My analysis showed that front-runners of economic reform such as Hungary have made policy choices characteristic of modern regulatory states. Their governments have ceded some state control and allowed for a greater role of the market in economic affairs. At the same time, the governing elites have enhanced the regulatory capacity of the state in areas

such as supervising the bank licensing regime, enforcing more transparency in bank transactions, and monitoring capital adequacy ratios in order to reduce imprudent behavior in this vital sector. Thus, rather than giving up altogether state power in the financial sector, governments have accepted the increased importance of market forces, but they have also enhanced the regulatory capacity of the state.

By contrast, in partial reform regimes such as Bulgaria until 1997, the political elites dismantled the monitoring mechanisms of the state in order to have more discretionary power over credit allocation. In this way, they jeopardized the long-term stability and sustainability of the domestic financial sector. My analysis has underscored the importance of reinforcing the rule of law. Since 1997, the Bulgarian governing elites have used legal reform to create a more pluralistic and competitive economic environment that can accommodate a variety of economic actors. The quality of Bulgaria's legal framework in the banking sector has gradually approached that in Hungary. However, deficiencies in the state's administrative and judicial capacity have hindered the efficient implementation of the overall good quality laws that are now on the books. Reforming the administrative and judiciary systems is a laborious process, but the strong institution-building component of the EU accession process has helped Bulgarian governments tackle the unsatisfactory performance of those two institutions.

APPENDIX I:

List of Interviews

HUNGARY

Andor, László. 2006. Personal interview. Budapest, Hungary, 18 April.
Csaba, László. 2006. Personal interview. Budapest, Hungary, 11 April.
Csoór, Klára. 2006. Personal interview. Budapest, Hungary, 12 April.
Győrrfy, Dóra. 2006. Personal interview. Budapest, Hungary, 10 April.
Horvath, Julius. 2006. Personal interview. Budapest, Hungary, 13 April.
Jenne, Erin. 2006. Personal interview. Budapest, Hungary, 3 April.
Mérő, Katalin. 2006. Personal interview. Budapest, Hungary, 19 April.
Mihályi, Péter. 2006. Personal interview. Budapest, Hungary, 6 April.
Pap, András László. 2006. Personal interview. Budapest, Hungary, 14 April.
Soós, Károly Attila. 2006. Personal interview. Budapest, Hungary, 10 April.
Tóka, Gábor. 2006. Personal interview. Budapest, Hungary, 19 April.

BULGARIA

Alexiev, Emil. 2005. Personal interview. Sofia, Bulgaria, 19 December.
Anonymous interview at Bulgarian National Bank. 2005. Sofia, Bulgaria, 12 December.
Dimitrov, Philip. 2005. Personal interview. Blagoevgrad, Bulgaria, 26 September.
Ganev, Venelin. 2005. Personal communication, 21 November.
Karafeizov, Cezar. 2005. Personal interview. Haskovo, Bulgaria, 9 December.
Mihaylova, Gergana. 2007. Personal interview. Sofia, Bulgaria, 23 July.
Nenovsky, Nikolay. 2007. Personal interview. Sofia, Bulgaria, 23 July.
Roussenova, Lena. 2007. Personal interview. Sofia, Bulgaria, 22 July.
Stanchev, Krassen. 2005. Personal interview. Sofia, Bulgaria, 2 December.
Staneva, Zhivka. 2005. Personal interview. Sofia, Bulgaria, 19 December.
Yalamov, Todor. 2007. Personal interview. Sofia, Bulgaria, 19 July.

APPENDIX II:

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.*

APPENDIX III:

Description of the variables, coding, and data sources for Chapter 5

Variables included in the final model specification

Quality of banking reform

`ebrd_banking:` 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). Overall, the scale comprises 11 categories: Scores such as 2.3 or 3.7 are possible and occur in the EBRD dataset. The following qualitative description of the four main 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 liberalisation 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>.

Government partisanship

The party in government and its party family (i.e. reformed left, unreformed left, and liberal/right) are coded using the Armingeon et al. dataset. The distinction between reformed and unreformed left for the communist successor parties in the region is established by taking the year of joining the Socialist International as a switching point.

`ref_left_cum:` Each year of reformed left party in government is scored 1. Then I create a cumulative variable ref_left_cum that reflects the total years of reformed left in government since 1989.
`unref_left_cum:` Each year of unreformed left party in government is scored 1. Then I create a cumulative variable that sums the years of unreformed left in government since 1989.
`liberal_right_cum:` Each year of a liberal or right political party in government is scored 1. Then I create a cumulative variable that sums the years of a liberal/right government since 1989.

Source: Armingeon, K. and Careja, R. *Comparative Data Set for 28 Post-Communist Countries, 1989-2005*, Institute of Political Science, University of Berne, 2005.
The Socialist International website <http://www.socialistinternational.org/main.html>
Minutes from voting in the Socialist International Congresses after 1989.
Available at: <http://www.socialistinternational.org/5Congress/previous-e.html>.

Domestic alliances

`corruption:` Lack 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: Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi. 2006. *Governance Matters V: Aggregate and Individual Governance Indicators, 1996-2005.* Washington, D.C.: The World Bank.

`fdi_gdp:` Inflow of foreign direct investment as percentage of GDP
The scale runs from the lowest score (=0) to the highest score (=1)
`foreign-owned:` Assets of foreign-owned bank as percentage of the total assets in the banking system.
The scale runs from the lowest score (=0) to the highest score (=1)

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

`trade_industrialized:` Percentage trade with industrialized countries from the total trade flows.
The scale runs from the lowest score (=0) to the highest score (=1)

Source: International Monetary Fund. 1999-2004. *Direction of Trade Statistics Yearbook.* Washington, D.C.: IMF Publication Services.

<u>Conditionality</u>
`imf1:` No IMF agreement=1, all other=0
`imf2:` Stand-by agreement with IMF=1, all other=0
`imf3:` Poverty relief and growth facility agreement with IMF=1, all other=0
`imf4:` No IMF program (and reform front-runner)=1, all other=0

Source: *IMF Members' Financial Data by Country Database.*
Available at: <http://www.imf.org/external/np/fin/tad/exfin1.aspx>.

`imf_gdp:` This variable represents the inflow of IMF funding as percentage of the country's GDP.
The scale runs from the lowest score (=0) to the highest score (=1)

Source: Author's calculations based on data from The World Bank. 1997, 1999, and 2005. *Global Development Finance.* Washington D.C.: The World Bank Publications Department.

<u>Economic development</u>
`gdp_pc:` GDP per capita, in thousands of USD
`stock_mkt:` Stock market capitalization as percentage of GDP
The scale runs from the lowest score (=0) to the highest score (=1)
`industry:` Percentage of GDP from industry
The scale runs from the lowest score (=0) to the highest score (=1)
`agri:` Percentage of GDP from agriculture
The scale runs from the lowest score (=0) to the highest score (=1)

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

<u>Culture</u>
`protestant:` Percentage population protestant
The scale runs from the lowest score (=0) to the highest score (=1)
`muslim:` Percentage population muslim
The scale runs from the lowest score (=0) to the highest score (=1)

Source for both indicators above: The annual editions of the CIA World Factbook
Available at: https://www.cia.gov/cia/publications/factbook/

Constitutional set-up

pres: Presidential political system=1, all other=0
semi-pres: Semi-presidential political system, where president is dominant=1, all other=0
parl: Parliamentary political system=1, all other=0

Source for the three indicators above: Armingeon, K. and Careja, R. *Comparative Data Set for 28 Post-Communist Countries, 1989-2005*, Institute of Political Science, University of Berne, 2005.

coding: The coding of the EBRD banking reform variable became more nuanced starting 1997. This is a dummy variable coded by the author to capture any effects of the coding improvement. The variable=1 for the period 1997-2005 and =0 for the period 1995 and 1996

Variables excluded from the final model specification

admin: Administrative capacity
The scale runs from the lowest score (= –2.5) to the highest score (=2.5)
judiciary: Judicial capacity
The scale runs from the lowest score (= –2.5) to the highest score (=2.5)

Source for both indicators above: Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi. 2006. *Governance Matters V: Aggregate and Individual Governance Indicators, 1996-2005.* Washington, D.C.: The World Bank.

EU conditionality

eu1: No EU conditionality program, but eligible=1, all other=0
eu2: Accession conditionality program=1, all other=0
eu3: Stabilization and Association Agreement program=1, all other=0
eu4: European Neighborhood Policy program=1, all other=0
eu5: No EU conditionality program, and ineligible=1, all other=0

Source: Author's coding based on the information available at the official website of the European Union: <http://europa.eu/index_en.htm>.

APPENDIX IV:

Summary statistics of the variables in the model in Chapter 5

Variable	N	Mean	Standard Deviation	Min	Max
EBRD banking reform	275	2.552	.778	1	4
Government coloration					
Reformed left in government	275	.669	1.47	0	8
Unreformed left in government	275	5.215	4.878	0	17
Liberal / right in government	275	2.935	4.082	0	17
Domestic alliances					
Lack of corruption	275	-.405	.673	-1.76	1.15
Foreign direct investment	275	.047	.052	.001	.451
Foreign-owned bank assets	275	.343	.309	0	.994
Trade with industrialized countries	275	.482	.202	.062	.887
Conditionality					
No IMF agreement - baseline category -	275	.175	.380	0	1
Stand-by agreement with IMF	275	.415	.494	0	1
Poverty relief and growth facility agreement with IMF	275	.207	.406	0	1
No IMF program and reform front-runner	275	.204	.403	0	1
Inflow of IMF funding	275	.031	.037	0	.159
Economic development					
GDP per capita	275	2.902	3.012	.114	17.263
Stock market capitalization	275	.089	.113	0	.719
Percentage of GDP from industry	275	.254	.076	.071	.574
Percentage of GDP from agriculture	275	.143	.102	.025	.463
Culture					
Percentage population protestant	275	.056	.129	0	.6
Percentage population muslim	275	.243	.349	0	.934
Constitutional set-up					
Presidential system - baseline category -	275	.2	.401	0	1
Semi-presidential system, dominated by president	275	.258	.438	0	1
Parliamentary system	275	.542	.499	0	1
Coding refinement	275	.818	.386	0	1

APPENDIX V:

Variance inflation factor analysis to detect multicollinearity

Model specification *including* the administrative and judicial capacity variables and the EU program participation dummy variables.

Variable	VIF	1/VIF
eu2	25.53	0.039163
parl	19.45	0.051420
eu5	17.42	0.057401
admin	15.45	0.064704
judiciary	10.70	0.093463
corruption	8.71	0.114817
liberal_ri~m	7.23	0.138289
gdp_pc	6.87	0.145511
trade_indu~r	6.28	0.159153
imf4	5.80	0.172557
agri	5.34	0.187277
eu3	4.67	0.214277
muslim	3.86	0.259207
imf2	3.72	0.269160
imf3	3.24	0.308835
foreign_ow~d	3.06	0.326416
semi_pres	3.04	0.329241
eu4	2.88	0.347232
stock_mkt	2.82	0.354387
imf_gdp	2.71	0.368579
unref_left~m	2.59	0.385621
protestant	2.41	0.415471
ref_left_cum	2.33	0.429381
industry	2.28	0.437790
coding	1.99	0.502165
fdi_gdp	1.42	0.703944
Mean VIF	6.61	

Model specification *excluding* the administrative and judicial capacity variables and the EU program participation dummy variables.

Variable	VIF	1/VIF
parl	7.95	0.125863
corruption	6.57	0.152096
gdp_pc	5.73	0.174540
imf4	4.95	0.202172
liberal_ri~m	4.89	0.204529
trade_indu~r	4.85	0.206330
agri	4.80	0.208297
imf2	3.32	0.301018
muslim	3.31	0.301787
imf3	3.04	0.329173
semi_pres	2.91	0.343104
stock_mkt	2.55	0.392340
foreign_ow~d	2.49	0.401481
protestant	2.24	0.446276
unref_left~m	2.16	0.463231
ref_left_cum	2.12	0.470839
imf_gdp	2.12	0.472491
industry	1.96	0.509981
coding	1.75	0.571963
fdi_gdp	1.34	0.746675
Mean VIF	3.55	

APPENDIX VI:

Model estimation using an error components time series technique

Explanatory variables		Effect	S.E.
Government coloration			
Reformed left in government		.051**	(.020)
Unreformed left in government		.014**	(.007)
Liberal / right in government		.005	(.014)
Domestic alliances			
Lack of corruption		.174***	(.067)
Foreign direct investment		1.202***	(.401)
Foreign-owned bank assets		.187**	(.089)
Trade with industrialized countries		.551**	(.219)
Conditionality			
No IMF agreement - baseline category -			
Stand-by agreement with IMF		.132**	(.064)
Poverty relief and growth facility agreement with IMF		.179**	(.072)
No IMF program and reform front-runner		.163*	(.099)
Inflow of IMF funding		.729	(.829)
Economic development			
GDP per capita		.044**	(.018)
Stock market capitalization		.603**	(.265)
Percentage of GDP from industry		-1.036**	(.419)
Percentage of GDP from agriculture		-.624	(.449)
Culture			
Percentage population protestant		.612*	(.344)
Percentage population muslim		-.196	(.166)
Constitutional set-up			
Presidential system - baseline category -			
Semi-presidential system dominated by president		.209	(.136)
Parliamentary system		.383**	(.154)
Coding refinement		-.045	(.055)
Constant		1.924***	(.249)
R-squared	within	.427	
	between	.875	
	overall	.818	
sigma u= .148			
sigma e= .221			
rho= .312			
275 observations			

Note: The table presents unstandardized regression coefficients obtained by applying an error components (random coefficients) time series estimation technique, with the corresponding standard errors in parentheses. The significance levels are as follows: *p< .10, **p<.05, ***p<.01, two-tailed test.

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