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DEPARTMENT OF POLITICAL AND SOCIAL SCIENCES

Too Big To Fail

Financial Market Reform in Transition Economies

Ludvig Lundstedt

Thesis submitted for assessment with a view to obtaining the degree of Doctor of Political and Social Sciences of the European University Institute

Florence, 13 December 2017

European University Institute
Department of Political and Social Sciences

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Contents

Abstract i

Acknowledgments iii

1 Introduction 1

1.1 Research Design 3

1.1.1 Reform of What? 5

1.1.2 The Benefits of Mixed Methods 8

1.2 Contribution to the State of the Art 16

1.3 Structure of the Dissertation 20

2 Banking Reform 23

2.1 Economic Institutions 24

2.1.1 State Capacity 29

2.2 The Financial Market Acquis 31

2.2.1 Banking Legislation 32

2.2.2 Financial State Capacity 33

2.3 Institutional Reform 35

2.4 A Review of Existing Measures 39

2.5 A New Measure of Banking Institutions 42

2.5.1 Operationalisation 43

2.6 Pathways of Reform 45

3 Too Big to Fail: A Theory of Institutional Reform 51

3.1 The Actors: Who are They? 52

3.1.1 The Interest of Veto Players 53

3.1.2 The Interest of Banks 58

3.1.3 The Link Between the State and Banks 64

3.2 A Theory of the Reform Process . . . 70
3.3 Alternative Theories . . . 72
3.3.1 Middle-Range Theories of Economic Reform . . . 73
3.3.2 The Power of the Past . . . 75
3.3.3 Concluding Remarks . . . 81

4 Veto Players, Market Fragmentation and Reform 83
4.1 Generalised Estimating Equations . . . 85
4.2 Movement Towards Full Reform . . . 94
4.3 Explaining the Behaviour of Supervisors . . . 99
4.4 Conclusion . . . 99

5 Explaining Diverging Reform Paths 103
5.1 Banking Under Socialism . . . 104
5.2 Diverging Reform Paths . . . 106
5.2.1 Estonia . . . 116
5.2.2 Lithuania . . . 138
5.3 Conclusions . . . 154

6 Conclusion 157
6.1 Main Findings . . . 158
6.2 Limitations and Future Research . . . 160

Appendix A Coding of Progress Reports 163

Appendix B Banking Reform 165

Appendix C Polity IV Score 171

Acronyms

A

Acquis Acquis Communautaire.

ALB Albania.

AR-1 AR-1 autoregressive correlation matrix.

B

BCBS Basel Committee on Banking Supervision.

BGR Bulgaria.

BIH Bosnia & Herzegovina.

BIS Bank for International Settlement.

BoE Bank of Estonia.

BoL Bank of Lithuania.

C

CA Constitutional Assembly.

CAP Common Agricultural Policy.

CBA Currency Board Arrangement.

CDF Cumulative Distribution Function.

CEE Central and Eastern Europe.

CIA Credit Institution Act.

Commission European Commission.

Council European Council.

CPSU Communist Party of the Soviet Union.

CSCS Council of Senior Civil Servants.

CZE Czech Republic.

E

EBRD European Bank for Reconstruction and Development.

ECP Estonian Coalition Party.

EEC European Economic Community.

EEK Estonian Kroon.

EKK Estonian Centre Party.

ENIP Estonian National Independence Party.

EOEI Estonian Office of European Integration.

ERCP Estonian Rural Centre Party.

ERP Estonian Reform Party.

ESB Estonian Social Bank.

ESDP Estonian Social Democratic Party.

ESP Eesti Sotsiaalpank.

ESS error sum of squares.

EST Estonia.

ETAP Eesti Tööstuse Arengu Pank.

EU European Union.

EUB Estonian Union Bank.

F

FBD First Banking Directive.

FDI Foreign Direct Investment.

FEM Fixed Effect Model.

FiW Freedom in the World.

G

GDP Gross Domestic Product.

GEE Generalised Estimating Equations.

GLM Generalised Linear Models.

Gosbank Soviet State Bank.

Group de Contact Contact Group of EEC Bank Supervisory Authorities.

H

HHI Herfindahl-Hirschman Index.

HKI Hannah and Kay Index.

HRV Croatia.

HU Homeland Union.

HUN Hungary.

I

IAS International Accounting Standards.

ICRG International Country Risk Guide.

IMF International Monetary Fund.

L

LAIB Lithuanian Joint-Stock Innovation Bank.

LBA Lithuanian Banking Association.

LCDP Lithuanian Christian Democratic Party.

LCP Lithuanian Communist Party.

LCS Lithuanian Centre Union.

LDLP Lithuanian Democratic Labour Party.

LLiS Lithuanian Liberal Union.

LSCB Lithuanian State Commercial Bank.

LSDP Lithuanian Social Democratic Party.

LTL Litas.

LTU Lithuania.

LVA Latvia.

M

MKD Macedonia.

MNE Montenegro.

MoF Ministry of Finance.

MP Members of Parliament.

MRC Monetary Reform Committee.

N

NATO North Atlantic Treaty Organization.

NEB North Estonian Bank.

NEJSB Northern Estonian Join-Stock Bank.

NS New Union — Social Liberals.

O

OECD Organisation for Economic Co-operation and Development.

OM optimal matching.

P

PCA Principal Component Analysis.

PCC Pearson product-moment correlation coefficient.

PDF Probability Density Function.

PFE Popular Front of Estonia.

PHARE Programme of Community Aid to Central and Eastern Europe.

PM Prime Minister.

POL Poland.

PPU Pro Patria Union.

PwC Price Waterhouse Coopers.

PWT Penn World Tables.

Q

QCA Qualitative Comparative Analysis.

R

REM Random Effect Model.

Riigikogu Estonian Parliament.

ROU Romania.

RU Rural Union.

S

sajūdis Reform Movement of Lithuania.

SBD Second Banking Directive.

SCC Spearman's rank correlation coefficient.

SEA Single European Act.

SEB Skandinaviska Enskilda Banken.

Seimas Lithuanian Parliament.

SOCB state owned commercial banks.

SOE state owned enterprise.

SRB Serbia.

SVK Slovakia.

SVN Slovenia.

T

talonas coupons.

TCB Tartu Commercial Bank.

TUR Turkey.

U

UBB Union Baltic Bank.

UFSA Unified Financial Supervisory Authority.

UK United Kingdom.

US United States.

USD US Dollar.

USSR Union of Soviet Socialist Republics.

W

WGI Worldwide Governance Indicators.

World Bank World Bank.

List of Figures

1.1 Financial Market Composition in Central and Eastern Europe 8
1.2 Bivariate Association Between Veto Players and Banking Reform 15

2.1 A Typology of Reforms 38
2.2 Bivariate Association Between Financial Institutions and Financial Institutions (EBRD) 43
2.3 State Distribution Plots 46
2.4 Frequency Distribution Plots 48

3.1 Public Perception of the Reform Pace in CEE (1991–1994) 54
3.2 Bivariate Association Between POLCON and CHECKS 57
3.3 The J-curve and the inverse J-curve 58
3.4 The Reform Process 70
3.5 Percentage of Seats Held by Communist Parties 73
3.6 Over-imputation Graphs 79
3.7 Screeplot from PCA 80
3.8 Loadings and Biplot 81

4.1 Reform Heterogeneity Across and Within Countries 84
4.2 Density Estimates of Predicted Banking Reform 90
4.3 Density Estimates of Predicted Banking Reform 92
4.4 Estimated Interaction Effect — Poisson Regression 94
4.5 Estimated Interaction Effect — Random Effect Model 97

5.1 Number of Veto Players (1993–2003) 109
5.2 Inflation (1991–1996) 110
5.3 Popular Support for Market Economy in 1991 113
5.4 Banking Reforms in Estonia and Lithuania (1989–2003) 114

5.5 The European Commission (Commission)'s assessment of bank reform in Estonia and Lithuania between 1997 and 2003. The data include an average from all four dimensions of institutional quality. 115
5.6 Estonian Election (20th September, 1992) 122
5.7 Consolidation and State Ownership in Estonia 125
5.8 Asset Share of Top-Five Banks in Estonia (1993–1995) 126
5.9 Estonian Election (5th March, 1995) 130
5.10 Market Share of Commercial Banks in Estonia (1998) 131
5.11 Ownership of Estonian Banks (1997–2003) 133
5.12 Estonian Election (7th March, 1999) 136
5.13 Lithuanian Election (10th March, 1990) 140
5.14 Consolidation and State Ownership in Lithuania 142
5.15 Lithuanian Election (15th November, 1992) 143
5.16 Public Perception of Reform Pace in Lithuania 144
5.17 Market Share of Commercial Banks in Lithuania (1997) 147
5.18 Lithuanian Election (20th October, 1996) 150
5.19 Lithuanian Election (8th October, 2000) 152
5.20 Penetration Ratios in Lithuania (1997–2004) 153

List of Tables

2.1 A Typology of Institutions . . . 27
2.2 EU Financial Service Directives . . . 31
2.3 Transition rates . . . 46
2.4 Substitution Cost Matrix . . . 47

3.1 Average Market Concentration in 17 Countries (1997–2013) . . . 63
3.2 Consolidation Codes . . . 64

4.1 Generalised Estimating Equations . . . 88
4.2 Generalised Estimating Equations . . . 91
4.3 Generalised Estimating Equations — Poisson Regression . . . 93
4.4 Random Effect Models . . . 98
4.5 Random Effect Models . . . 100

5.1 (Effective) Number of Parliamentary Parties . . . 107

A.1 Years of Coding . . . 164

B.1 Legislative Score . . . 166
B.2 Procedural Score . . . 167
B.3 Resource Score . . . 168
B.4 Behavioural Score . . . 169

C.1 Polity IV Score . . . 172

Abstract

This dissertation deals with the issue of institutional reform in transition economies. In particular, it studies banking reform in 17 transition economies during their accession to the European Union (EU). It does so by building on the veto player theory often used in the literature on the political economy of reform. However, the veto player theory as traditionally applied seldom take into account the role of special interests. The dissertation aims to fill this gap in the literature by developing a theoretical account of how veto players and special interests interact.

The empirical part of the dissertation, on whoch the theoretical account is based, consists of two parts. First, a quantitative part that studies the effect of the interaction between veto players and special interest on banking reform during seventeen transition economies accession to the EU. Banking reform is meaured through a new dataset based on the Commission Progress Reports. A measure of market concentration has also been developed for the purpose of the thesis, the measure uses data from BankScope (2016), which consists of yearly data for more than 43 000 banks world-wide. Second, the qualitative part of the dissertation consists of two case-studies of Estonia and Lithuania.

The main finding of the dissertation is that neither veto players nor special interests can be studied in isolation, but rather that they should be studied in tandem. How veto players affect the reform capacity of a country will depend on how special interest is structured in the country. At high level of market concentration, additional veto players will make the movement towrds full reform more likely. Conversly, at low levels of market concentration additional veto players decreases the likelyhood of reform.

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Academic work can often be a solitary endeavour, or at least so I was told when embarking on this journey of writing a dissertation. Thanks to the EUI community I am happy to say that my time in Florence was everything but solitary. At the EUI I met some of the people that I today would call my closest friend. Albert F. Arcarons, Anna Subirats Ribas, Enrique Hernandez and Juan Masullo deserves a special mentioning. Their friendship has given so much to me, and made the PhD, despite all the hard work, a truly joyful experience. After having left Florence I still find my self thinking of all the discussions about research, politics and life in various restaurants around Florence. My late night conversations with Javier Habib over an ice-cream at gelateria dei Neri will also be deeply missed. One of the first persons I met at the EUI, Nele Leosk, has also remained a close friend during this whole endeavour.

In addition to work, football has been an integral part of my stay at the EUI and the

importance of the EUI football team cannot be overstated. Through the Squadra I once again found the joy in playing football, and the welcoming atmosphere in the team made the integration into the EUI community so much easier. I would therefore like to thank to whole team for five wonderful years, and especially I would like to thank my two co-coaches: Johannes Karremans and Vincent Maurin. I would also like to express my gratitude to everyone in my Coppa Pavone team, the Inglorious Ballstars. We made it!

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Chapter 1

Introduction

That institutions matter today represents something close to a consensus among social scientists. They structure actors' incentives, and determine their opportunities and constraints. Modern market economies are governed by a complex web of economic institutions, requiring a well-functioning state apparatus to monitor and enforce the regulatory structure (Bruszt and McDermott, 2014). Conversely, less developed economies lack an institutional framework that is conducive to economic growth (North and Thomas, 1973; Acemoglu and Robinson, 2006). The accession to the European Union (EU) by the former communist countries of Central and Eastern Europe (CEE) represents an unprecedented challenge in this context; membership in the Union requires candidate countries to adopt over 80 000 pages of legislation (or around 80 % of member states' regulatory framework) (Schimmelfennig and Sedelmeier, 2005a, pp. 1–2). The regulator framework stretches over a multitude of diverse policy areas, such as company law, competition policy, energy policy, environmental policy, financial services, food safety etc. However, in the early 1990s the CEE countries lacked the institutional infrastructure required by the EU, leading many countries to embark on a reform effort that is without precedent.

Why do countries decide to adopt and implement institutional reform? Why they decide upon one set of institution over another? These questions have puzzled scholars of economic, political science, and sociologists alike. Many theories have been proposed in the literature, emphasising both agency and structure, or a combination thereof. One of the most fundamental insights, however, was conveyed by Tsebelis (1995, 2002), he argues that institutional reform is inversely related to the number of veto players. Each additional veto player — defined as a political actor with the power to block institutional reform — shrinks, or holds constant, the set of policies that can defeat the status quo. If Tsebelis (2002) is right, we should expect that a country's capacity to implement reform is weaker when powered is shared across numerous actors, and that countries where power is concentrated in the hands of fewer actors should have

a greater reform capacity.

From this point of view, the reform experience in CEE during the integration to the EU presents a puzzle. Countries with a higher number of veto players have in many cases adopted and implemented much more far-reaching reforms than have countries with fewer veto players. Economic reform paths also vary within countries. In Lithuania the number of veto players increased in the second half of the 1990s, making it more difficult for policymakers to adopt reforms. During the same period the country increased its reform efforts, adopting a number of important pieces of legislation pertaining to the economy, such as the long awaited Bankruptcy Law. In an attempt to resolve this conundrum, and to contribute to the literature on the political economy of reform, I propose to study the reform process of 17 CEE countries during their accession to the EU.[1] More specifically, I will study the reform process that took place in the banking sector.

Why veto players? Many authors studying the political economy of reform has instead chosen to direct their focus to for example regime types (cf. Persson, Roland, and Tabellini, 2000). Much of this literature identify one or more criterion in order to define the different regime types. A problem with many of these conceptualisations is the numerous of dimensions over which the political regimes can vary. For example, to compare a presidential regime with little of legislative cohesion and high degree of power sharing with a parliamentary regime that has high legislative cohesion and where power is share only among few actors? The veto player theory simplifies comparisons by reducing different political regimes to one dimensions comparable across countries all countries, namely the number of veto players present in the political system. Thus, I argue that using the veto player theory for analysing reform processes is superior to other types of conceptualisations of regime types.

The research question that guides this research project can be stated as follows. What part does veto players have in the reform process of emerging market economies? To answer this general question I focus on a very specific type of reforms, namely financial market reforms in CEE countries during their accession to the EU.

The chapter proceeds as follows: Section 1.1 outlines the research design adopted in this dissertation. The sections consists of two parts. First, I answer the questions: reform of what, where and when? I make the case that CEE is a suitable region to study reform in because of the similar standards that were applied to the countries during their accession to the EU.

[1] For the purpose of this dissertation I define CEE to include the following countries: Albania (ALB), Bosnia & Herzegovina (BIH), Bulgaria (BGR), Croatia (HRV), the Czech Republic (CZE), Estonia (EST), Hungary (HUN), Latvia (LVA), Lithuania (LTU), Macedonia (MKD), Montenegro (MNE), Poland (POL), Romania (ROU), Serbia (SRB), Slovakia (SVK), Slovenia (SVN), and Turkey (TUR). Admittedly, Turkey does not belong to the group of former socialist economies, but the country is a candidate country to the EU and is therefore included in the study.

Furthermore, I argue that financial markets are particularly important to study, both because of their importance for the economy and welfare of a country, and because they provide a most likely case that the veto player theory can be tested against. Second, I discuss the benefits of a mixed method approach to study financial market reform. Mixed methods have the benefit of combining the analytical leverage of across and within case analyses.

Section 1.2 describes the contribution to the broader literature that is made in the dissertation. First and foremost I hope to contribute to our understanding of the role of veto players in the political economy of reform, by introducing business actors into the analysis. As such, the thesis also belongs to a broader research agenda on the positive political economy of reform, which analizes the interaction between policymakers and interest groups and the effect it has on reform. Last but not least, Section 1.3 presents the structure of the dissertation.

1.1 Research Design

In settling on the research design applied in this study, three questions had to be answered: reform of what, where and when? The answers to these questions are important since they impact the conclusions that can be drawn from the analysis. Thus, I will answer each of them in turn.

The decision to study reforms in CEE during the integration to the EU, and more broadly from socialism to capitalism, is grounded in two observations. First and foremost, the study of the eastern enlargement waves provides a unique opportunity to apply an similar yardstick to reforms across multiple jurisdictions. As mentioned above, the EU stipulated precise policy requirements that each candidate country had to adopt and implement in order to join the Union. Hence, it is possible to judge the reform process using a universal metric, something that simplifies the task of comparing across countries.

Second, the study of the transition from socialism to capitalism has an intrinsic value. Well regulated markets have proven to be the most efficient mechanism for wealth creation, the planned economies found in socialist countries were dwindling in comparison. The dismantling of socialism can be said to have consisted of two types of reform. One type of reforms was all about getting the macroeconomic fundamentals right; this included fiscal discipline, deregulation of prices and trade, financial liberalisation, privatisation etc. Many of these reforms were relatively simple to implement but often came at the cost of massive social dislocation. The other set of reforms aimed to build economic institutions that regulated the market and were responsive to the polity. This set of reforms was much more difficult to implement since it required both know-how and state capacity. Furthermore, many of the old nomenklatura had much to loose

from these reforms and therefore fiercely opposed them. Although most academics would today agree that both types of reform are necessary for a functioning market economy, there is no consensus of the relative sequencing of the different sets of reform.

Some countries managed relatively well in setting establishing regulatory institutions, whereas other countries seem to have become stuck in a low-level equilibrium. It is therefore important to ask why this is the case. The answer(s) to that question will provide an opportunity to draw important conclusions for countries that are in a similar position, and maybe be able to avoid some of the pitfalls identified in the CEE transition.

Some might argue that the seventeen countries included in the study are not as similar as a first glance might suggest. Has the EU played the same role in all of the seventeen countries? Do the countries differ in their initial capacity to reform? Are we comparing different regime types? I will in the following paragraphs try to answer these three possible objections that can be made to the selection of countries included in the study.

First, with regards to the role played by the EU I would not over-emphasise the difference with regards to the influence of the Union. As pointed out by Vachudova (2014), the dynamics of of enlargement remains largelly the same in the later enlargement rounds. By exposing the accession countries to passive and active leverage the EU offers the prospective member states of today a similar set of incentives as they did for the post-communist candidate countries in 1997. The difference, between now and then, instead lies in how domestic actors percievec the potential costs and benefits of a potential EU membership. Hence, I would argue that it is more that unites these countries, with regards to the role played by the EU, than separates them.

Second, it is possible to raise the objection that the seventeen countries not are comparable because of the difference in initial conditions. This is true, that many of the countries that joined the accession process late were worse of in terms of initial conditions than their counterparts in earlier rounds of enlargement. To remedy this problem I control for a number of these initial conditions in the quantitative part of the analysis. It is well documented in the literature that the heritage from communism affected a country's instituional capacity. I have therefor included two proxies that aims to capture exactly this. One the one hand, I distinguish between new countries established after the fall of communism, countries that were part of a federation such as Yugoslavia or the Soviet Union, and countries that were independent states before 1989. On the other hand, I include a continuous variable of the years a country has been governed by central planning. Furthermore, resources can also affect a country's state capacity, I therefore include Gross Domestic Product (GDP) as a control variable in the regression analysis.

Third, the democratic "quality" could also be raised as a possible concern for the comparab-

ility of cases in the study.[2] The scope conditions of the veto player theory is not restricted to democratic countries, the theory can also be used to analyze authoritarian and hybrid regimes. According to the original veto player theory, what is important in any political regime is how power is shared between different actors. The more actors that are entrusted with veto power the more difficult reform will be, all else being equal. A case can however be made that hybrid regimes are less responsive to the will of the populous. While this point is an important point with regards to reforms of high policy salience, the distinction becomes less problematic for cases of low salience reforms. The reforms studied in this dissertation is characterized by low salience, which implies that the number of relevant actors is limited to the actual private stakeholders and political actors.

1.1.1 Reform of What?

The choice to study the banking sector has both empirical and methodological motivations. The economy-wide importance of financial markets is well documented in the theoretical literature. They mitigate transaction costs, reduce the economic actors' exposure to risk, improve the allocation of resources in society, and, consequently, provides a foundation for economic growth. Investments require actors to incur informational costs about market conditions, costs that are potentially high enough to discourage investment. By specialising in the collection and analysis of information banks have the potential to lower informational costs to actors, facilitating the efficient distribution of resources (cf. Boyd and Prescott, 1986, p. 213; Greenwood and Jovanovic, 1990, p. 1085). Similarly, financial intermediaries allow actors to hedge their exposure to risk by allowing them to diversify their risk portfolio; thus directing resources to their most productive use in the economy (cf. Diamond and Dybvig, 1983, p. 408; Acemoglu and Zilibotti, 1997; R. Levine, 1997, p. 691). These ideas date far back. Already in 1934, Schumpeter maintained that "every kind of extension of credit for purposes of 'innovations' is by definition the granting of credit to the entrepreneur, and forms an element of economic development…" (1983, p. 103).[3] A view shared by Nobel Laurent M. H. Miller (1998, p. 14), who argues that the significance of financial markets for economic growth is too obvious to necessitate any serious discussion.

The theoretical predictions found in the literature have also been tested in a number of empirical studies. R. G. King and R. Levine (1993) explore the link between finance and development, covering the period between 1960 and 1989.[4] The theoretical expectations are supported by their analysis. All four indicators of financial development are statistically and substantially

[2] Appendix C depicts the political regime scores of the seventeen countries included in the study.

[3] Italics in original.

[4] R. G. King and R. Levine (1993) use data for 119 countries, but because of the lack of financial data and the elimination of major oil exporters the analysis is typically restricted to 80 countries.

significant, both if economic development is measured as average long-run per capita growth or the rate of physical capital accumulation.[5] A similar conclusion is reached by La Porta, Lopez-De-Silanes, and Shleifer (2002), who collect data on government ownership for the ten largest banks in 92 countries. The evidence support the theoretical prediction that state ownership has a negative impact on economic development, an association that is particularly pertinent for less developed countries.[6]

The cross national evidence has been further supplemented by time-series and panel data analyses. Kugler and Neusser (1998) examine the relationship between manufacturing, total factor productivity and the financial sector in their study of fourteen Organisation for Economic Co-operation and Development (OECD) countries between 1970 and 1991.[7] They find evidence for a causal relationship between financial development and total factor productivity in Germany, Japan and the United States (US). A similar link is demonstrated by Rousseau and Wachtel (1998), using historical data that covers five industrialising countries between 1870 and 1929.[8]

The choice to study financial markets also have a methodological rational. The veto player theory predicts that if the distance between two veto players' ideal preferences increases, then the possible reform options will diminish, regardless of where the status quo is situated (Tsebelis, 2002, p. 30). By extension, institutional reform is expected to be more difficult, ceteris paribus, in policy areas where distributional consequences are great. Hence, reforms that creates winners and losers represent a most-likely case for the veto player theory; for such cases, an increase in the number of veto players is expected to have the greatest negative impact on reform opportunities. Because of their prominent role for the real economy, financial intermediaries occupy a prominent position in the political economy of a country. This is especially true for the CEE countries included in this study.

> Looking at the banking scene in CEE today [2007] we would not imagine that about a decade ago many CEE countries were plagued with problems stemming from excessively close relations between banks and industry, which were the result of

[5] Four different indicators of financial development are employed in the analysis: (1) liquid liabilities to GDP captures the provision of financial services in the economy; (2) the relative importance of financial institutions are operationalised by taking the ratio of deposit money bank domestic assets to deposit money bank domestic assets plus central bank domestic assets; (3) the ratio of claims on the non-financial sector to total domestic credit expresses the proportion of credit allocated to the private sector of the economy; and (4) the ratio of claims on the non-financial sector to GDP is employed as an indicator for the claims on the non financial sector.

[6] To address the issue of causality, R. Levine, Loayza, and Beck (2000) introduce a country's legal origin as an instrumental variable, assuming a link between a country's legal origin and financial development today (cf. La Porta, Lopez-de-Silanes, et al., 1998). They find a substantial and significant effect on the long-run per capita economic growth.

[7] A fine grained measure of financial depth is used for this study, it includes not only commercial banks, but also financial institutions such as savings and loans associations, investment banks, pension funds, and life and casualty insurance companies etc.

[8] The study includes Canada, Norway, Sweden, the United Kingdom (UK) and the US.

> the way the so-called two-tier banking systems had been carved out of the socialist monobank system. (Cecco, 2007, p. 133).

For politicians the financial market is a tool by which the flow of resources can be directed towards important sectors of the economy, the financing of government expenditures, the implementation of monetary policy, the compensation of political supporters, and the punishment of political opponents (Gerschenkron, 1962, Chapter 1; Martinez-Diaz, 2009, p. 4). Furthermore, the profits of business is affected by financial intermediaries, where the product mark-up tend to be smaller in more mature financial markets (Guiso, Sapienza, and Zingales, 2004, p. 956).

> In countries with greater financial development, small-firm industries represent a greater proportion of total manufacturing value added than in countries with lower levels of financial development. Thus, financial development disproportionately boosts both the growth rate of small-firm industries and the level of value added contributed by small-firm industries to total value added. (Beck, Demirgüç-Kunt, Laeven, et al., 2008, p. 1381).

At early stages of financial development income inequalities tend to increase (Greenwood and Jovanovic, 1990; Galor and Zeira, 1993). In their analysis of the link between financial intermediary development and income inequality, Clarke, Xu, and Zou find that income inequality tends to increase initially, but decrease in later stages of financial development (2003, p. 14). This finding is further supported by Beck, Demirgüç-Kunt, and R. Levine (2007), who test the effect of financial development on four different measures of inequality; the results hold independently of which measure of income inequality that is used, and also when instrumental variables are introduced.

Nevertheless, financial markets comprise of more than banking, and also includes insurance and securities products. So why study banking? The answer to this question is mainly practical: financial markets in CEE have to a great extent been dominated by banks during most of the 1990s and early 2000s. Insurance and securities markets started to develop much later on. The predominance of banks sets CEE apart from other countries, most notably the US, in which other types of financial intermediaries are more prominent. Figure 1.1 depicts the relative importance of banking, insurance and securities in CEE as an average between 1997 and 2004.[9] Two observations are worth making with regards to the figure. First, the average size of the banking sector as a share of the economy differs across the countries, from almost 60 % in the Czech Republic to just above 10 % in Romania. Second, it is true for all countries that the banking sector is bigger than the insurance and securities markets combined; in many cases

[9] Because of missing data, Bosnia & Herzegovina and Montenegro are excluded from the graph.

substantially so. Hence, I therefore chose to study banking reforms, and to disregard reforms of both the insurance and securities markets.

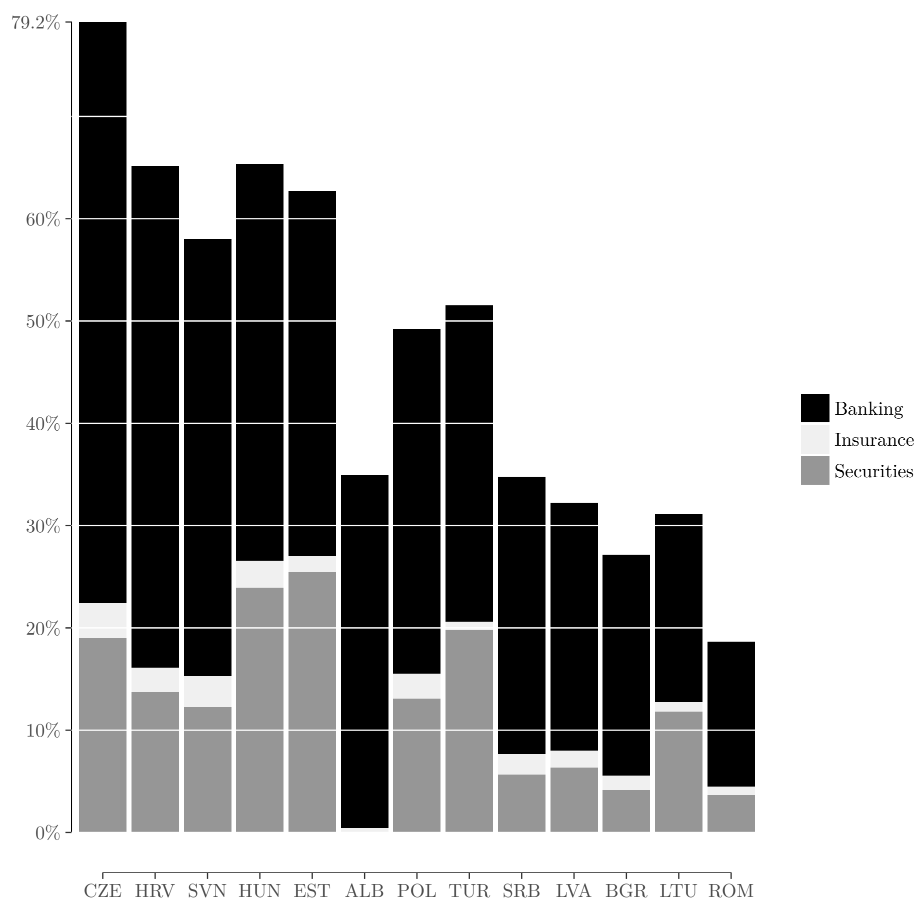


Figure 1.1 – The histogram compares the relative importance of banking, insurance and securities markets in the respective countries. (1) Banking is measured as the deposit money bank assets to GDP; (2) The importance of the insurance market is defined as the percentage of life and non-life insurance premium volumes to GDP; and (3) securities measures the stock market capitalisation to GDP. All measures are an average between the years 1997 to 2004. Source: Demirgüç-Kunt et al. (2013).

1.1.2 The Benefits of Mixed Methods

The debate between qualitative and quantitatively oriented scholars is of long standing (cf. G. King, Keohane, and Verba, 1994; Brady and D. Collier, 2010). Nevertheless, it is increasingly recognised by the social science community that large- and small-n studies should be viewed as complementary, and that by combing the designs the researcher can increase the analytical leverage of the study (cf. Lieberman, 2005; Tarrow, 2010; Beach and Brun Pedersen, 2013; Humphreys and Jacobs, 2015). It does so by combining the two distinct logics of inference that characterise quantitative and qualitative analysis. Large-n studies derive analytical leverage by

facilitating comparisons across cases, and does so by establishing statistical associations between a dependent and one or more independent variables, across a number of cases. Small-n studies instead rely on the logic of within-case inference, unfolding causal processes within one case (White and Phillips, 2012, pp. 5–6). In other words, statistical analysis has the advantage of being able to test the robustness of theories across a large number of cases; whereas case studies derive their analytical leverage from by providing insights into the causal processes. If combined, the two approaches have the potential to inform each other, and to strengthen the insights of the study.

Understanding the difference between quantitative and qualitative analyses as difference in the logic of inference runs contrary to how small-n studies have often been applied. Much of the work in the literature that utilise a small number of cases is instead concerned with gaining analytical leverage by drawing inferences from comparisons across cases (Skocpol, 1979; R. B. Collier and D. Collier, 1991). For example, Mill's methods of agreement and difference — commonly used methodological strategies in the literature — derive analytical leverage not from within, but from between case inference. With regards to the method of agreement, Mill writes "If two or more instances of the phenomenon under investigation have only one circumstance in common, the circumstance in which alone all the instances agree, is the cause (or effect) of the given phenomenon." (Mill, 1843, p. 454). In a similar way, the method of difference derives analytical leverage from comparing two or more instances that differ in their outcomes but are identical in all circumstances except one. If this is the case, "the circumstances in which alone the two instances differ, is the effect, or cause, or necessary part of the cause, of the phenomenon." (Mill, 1843, p. 455).[10] It is acknowledged that the experimental situation that such a controlled comparison aims to emulate should be understood as an ideal type to which actual research is an approximation. Nevertheless, and despite its imperfections, that method is often the best alternative available to researchers (Lijphart, 1971). Controlled comparison claims to gain analytical leverage from comparing across cases rather than process tracing with the different cases.[11]

Qualitative Comparative Analysis (QCA) is another example of a popular method that derives analytical leverage from, as the name suggest, comparing across cases.[12] By comparing

[10]Italics in original.

[11]This is not to say that comparisons across cases should not be made in qualitative work. From a narrative perspective comparisons are often a powerful tool for the researchers to get his/her point across. Neither is this a claim that books like Moore (1966), Skocpol (1979), and R. B. Collier and D. Collier (1991) have not been analytically strong. Rather the opposite, these books have in my way been some of the most insightful analytical studies found in the literature. However, their analytical leverage is gained from the enormous knowledge of the cases, and the processes that are going on within them, that the authors possesses.

[12]Nota bene, some of the strongest proponents of QCA tend to view it "as a methodological 'third way', between 'qualitative' and 'quantitative' methods.." (Wagemanna and Schneider, 2010, p. 377).

cases, QCA aims to establish necessary and sufficient, or a combination thereof, conditions for an outcome. The problem with trying to derive analytical leverage from across cases in small-n analysis is that such an approach will always be second best to the quantitative approach, since increasing the number of cases strengthen the across-cases analytical leverage.

This does, however, not imply that qualitative research cannot contribute to the social science literature. Conversely, because small-n studies derives its analytical leverage from within case inference, they can provide important additional insights to quantitative analyses. D. Collier, Brady, and Seawright (2010) point out that increasing the number of cases is not always an advantage since it carries with it the risk of obscuring the causal mechanisms. "[A causal-process observation] gives insight into causal mechanisms, insight that is essential to causal assessment and is an indispensable alternative and/or supplement to correlation-based inference." (2010, p. 185). Echoing this statement, Bennett (2010, p. 208) suggest that case studies are a powerful tool to examine the evidence within cases, and evaluate the causal process hypothesised. As such, the method gives causal strength to the statistical analysis by examining the direction of causality and whether the association is spurious or not. The within case logic of small-n inference does, however, limit us in our attempts to generalise from the results of a case study. In fact, case studies can help us uncover causal mechanisms and strengthen us in out beliefs that a specific theory is true or false, but these results cannot teach us anything of process outside the case in question, for that large-n analyses are necessary.

Given that the distinguishing characteristic that separates qualitative and quantitative methods is the logic of inference, it should be the case that most research questions are better answered by combining the strengths of the two methods. Building on this insight, Lieberman (2005) suggests the application of a nested analysis to tackle a research question, in which a preliminary large-n study forms the basis of the small-n analysis. Given the different inferential logic it is necessary to shift the level of analysis, and examine the within-case processes in the single cases. "The SNA [small-n analysis] should be used to answer those questions left open by the LNA [large-n analysis] — either because there were insufficient data to assess the statistical relationships or because the nature of causal order could not be confidently inferred." (Lieberman, 2005, p. 440).

In Lieberman's (2005) account, the analysis begins from a preliminary large-n analysis, which tests the association between two or more variables. The findings of this analysis then guide the case selection for the small-n analysis. If the statistical analysis confirms the hypothesis, the research should select cases on the regression line. The benefit of selecting cases on the regression line in these situations is that it allows the researcher to go deeper into the causal

process that have been hypothesised. Ideally, it makes the researcher more secure that his or her findings are robust and not only spurious correlations. If, instead, the large-n analysis does not find a statistical association between the predictor and response variable, the researcher is advised to chose cases that are both on and off the regression line. That the hypothesis was disconfirmed by the statistical analysis forces the researcher to look for alternative explanations; such a endeavour, however, cannot be limited only to cases on or off the regression line. If the aim of the exercise is to build a theory that can explain outcomes across different cases it would be short-sighted to only collect information from cases that either confirm or disconfirm the initial theory.

I follow the method outlined by Lieberman (2005). The dissertation consists of a quantitative part in which I analyse cross national variation in reform across the seventeen countries in the study. I then go one step further and try to unpack the reform process in two specific countries. This exercise aims to provide further evidence to the causal mechanisms outlined in the theory. To be fair, however, this represents an ideal research process, where the large- and small-n analyses are conducted in a clear order. In practice, however, the process of which this dissertation is a result has been iterative in nature, constantly going back and forward between the quantitative and qualitative analyses. The iterative nature of the process, I argue, has been necessary in my attempt to build a theoretical model. It nevertheless carries with it some limitations; namely, the fact that the different parts have continuously informed each other during the research process implies that the dissertation cannot make any claim to test a theory. This would require the selection of additional cases upon which the theory can be tested. I therefore leave that endeavour for future research. While an iterative process is not necessarily wrong in and of itself, I believe that it should be pointed out since it follows that such a process has to give up any claim of being theory-testing, and should be viewed as a theory-building exercise.

Process Tracing

To back the theoretical account of this study, the qualitative analysis relies on the use of process tracing. Originating in the field of social psychology, process tracing aims to examine, or unpack, the intermediate steps in a causal chain. As such it approaches the question from a different angle, and does not rely on variables but rather uses what Bennett and Checkel (2015, p. 7) have termed diagnostic evidence, which is defined as indications of a process that is taking place without transmitting any independent cause on the dependent variable. This distinction between variables and diagnostic evidence is closely related to what D. Collier, Brady, and Sea-

wright (2010, p. 184) have termed dataset observations and causal-process observations. Where a dataset observation refers to the rows in a matrix, whereas the causal-process observation provides insights into a context or mechanism.

The task of the researcher engaging with process tracing then becomes to collect diagnostic evidence that provides insights into the causal processes at play. Bennett (2010, p. 210) distinguishes between four different categories of evidence:

> Straw in the wind evidence is the weakest type of evidence, since the presence of such evidence is neither sufficient nor necessary to establish a causal chain. It presence only confirms the relevance of the hypothesis, but does not indicate causation.
>
> Hoop evidence is necessary but not sufficient for the hypothesised cause to be present. The absence of such evidence is therefore enough to disconfirm the theory, but its present does little to confirm the hypothesis.
>
> Smoking gun evidence operates in the opposite direction, it is a sufficient but not necessary condition for cause to be present. The presence of such evidence is enough to confirm the causal process; its absence, however, is not enough to disconfirm the hypothesis.
>
> Double decisive evidence combines the strength of both the hoop and smoking gun evidence, and is therefore both necessary and sufficient.

In this context it should be pointed out that confirming and disconfirming do not refer to definite answers since such evidence is rare in the social sciences, but should rather be understood in terms of providing evidence in favour and against the hypothesis.

A number of sources have been utilised to collect evidence for the qualitative part of this dissertation. An essential factor in the theoretical account presented in Chapter 3 is the structure of the financial market. A necessary condition for the theoretical propositions to hold is that changes in the financial market structure be associated with subsequent hypothesised changes in the reform efforts. The absence of such an association would clearly speak against the theory in question. Hence, the hypothesised relationship between market structure and reform should therefore be understood as hoop evidence, i.e., its presence is necessary for the theory to be true, but does little to confirm the underlying theory.

To corroborate the theory I therefor rely on other sources of evidence, primarily newspaper articles, but also interviews, press releases and government reports. Here I am mainly looking for information that can provide evidence in favour of the causal processes hypothesised, i.e., smoking gun and double decisive evidence. If correct, I expect policymakers to signal that the

financial market structure is an important factor influencing their reform decisions, through words and/or action. Examples of such evidence could for example be the chairman of a central bank voicing concern over the level of financial market concentration or state ownership for the reform efforts; or, politicians taking decisions to shield certain part of the industry from the potentially negative consequences of reform.

Selecting Cases

Many methods for case selection have been suggested to me during the process of writing up this dissertation. It has been argued that one should not select on the dependent variable. Such a practice refers to when the researcher restricts his/her set of observations to cases in which the outcome has been observed, while excluding cases in which the outcome was not observed. This practice leads to invalid inference since it carries with the risk of excluding cases where the cause was present while the outcome was not. Others argue that sampling on the dependent variable is not always problematic if one is aware of the universe of cases and also includes negative cases in the study. Yet, this debate is increasingly obsolete since it once again implies that the analytical leverage from the study is derived from a comparison across cases.

Instead, it is increasingly common in the methodological literature to suggest a random selection of cases, or stratified random selection, for small-n analyses (Humphreys and Jacobs, 2015, p. 661). This suggestion makes increasing sense if the analytical leverage of qualitative studies is derived from its within case design, random selection has the advantage of controlling for possible selection biases that can occur when cases are selected deliberately. Positive and negative cases are with this method equally likely to be selected. However, randomisation carries with it two problems, one general and one more specific for this study. While randomisation makes a lot of sense for theory-testing studies, the rationale for such approach is not as obvious if one engages in a theory-building exercise. In this case randomisation amounts to saying "'I don't have a good theory, and I don't have an intuition about why a particular case would be illuminating for constructing a theory…'" (Lieberman, 2005, p. 447). A more general point is that randomisation neglects the narrative exercise of research, comparisons across cases that are similar or different might in many cases allow the author to get his/her point through. I would therefore argue that there is in many cases a trade-off between the analytical strength gained from randomisation and the analytical clarity obtained from a strong narrative. Hence, since randomisation does not add much to the analytical leverage when the aim is to build a new theory, I instead opt for a different approach to case selection.

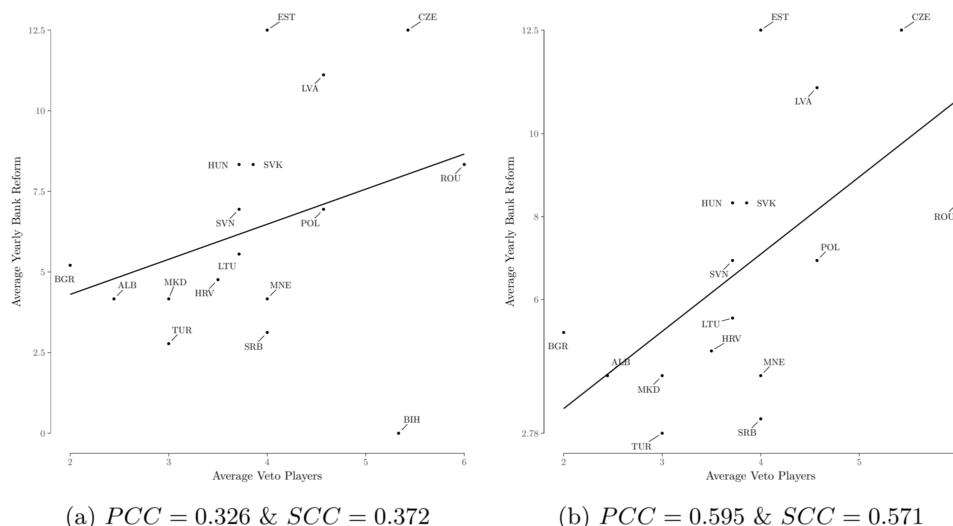
I proceed by selecting cases on the dependent variable, with the aim to ensure variation on the

dependent variable. To this end, I apply a strategy that combines a deviant case with a matching negative case. A deviant case is a powerful tool for the researcher in the development of new concepts, variables and/or theories (George and Bennett, 2005, pp. 114–115); it demonstrates a surprising value on the dependent value, given the predictions of some theory (Gerring, 2007, p. 105). Thus, deviant cases in this study are countries that have numerous veto players, but that, at the same time, have reached far in the reform process. Or, cases that have few veto players but low institutional quality. A matching negative case represents an instance in which the outcome of interest is not present but possible (Mahoney and Goertz, 2004).

A complication for the case selection is the issue of temporal variance, i.e., the variation that occurs within the same case at different points in time (Bartolini, 1993, p. 135). Temporality can be defined in several distinct ways. Grzymala-Busse (2011) distinguish between four different types of temporality: duration, speed, acceleration and timing. I focus on the speed of reform, although the other aspects of temporality also will be discussed in the analysis. The speed of change is understood as the amount of change per unit of time. This dimension of time is important because it tells us something about the degree to which reforms have been implemented. It is expected that it is more difficult to implement far-reaching reforms than just minor reforms, independently of the starting position.

To identify both the deviant case and matching negative case I rely on a simple bivariate analysis of the association between the average number of veto players between 1997 and 2003, and the average yearly banking reform during the same time period. Figure 1.2 illustrates this relationship. Contrary to conventional wisdom a positive association between veto players and banking reform is identified. All 17 countries are included in the bivariate analysis shown in Figure 1.2a; a positive but weak correlation is detected. The weak bivariate association is mainly driven by Bosnia & Herzegovina, with a high average number of veto players but no reforms recorded, just as predicted by the veto player theory. Thus, Bosnia & Herzegovina is dropped from the subsequent analysis depicted in Figure 1.2b. The Pearson product-moment correlation coefficient (PCC) increases from 0.326 to 0.595 and the Spearman's rank correlation coefficient (SCC) from 0.372 to 0.571.

Three countries stand out as deviant cases with regard to the predictions of the veto player theory: the Czech Republic, Estonia and Latvia. All three countries score high on the speed of reform. They also belong to the group of countries that have had the highest number of veto players. Four veto players were present in Estonia during the whole period between 1997 and 2003. Latvia had two veto players in 1997, but the number increased to five a year later, only to remain unchanged until 2003. In the Czech Republic the number decreased from seven to



(a) $PCC = 0.326$ & $SCC = 0.372$ (b) $PCC = 0.595$ & $SCC = 0.571$

Figure 1.2 – The panels illustrate the bivariate association between the average number of veto players and average banking reform between 1997 and 2003. Bosnia & Herzegovina is dropped from the right-hand panel. Sources: banking reform is measured as the average yearly reform over the accession period based on the data collected for this dissertation. Veto players are measured using the CHECKS index developed by Beck, Clarke, et al. (2001).

five in 1998, but then remains constant. The difference in the number of veto players between the three countries should be considered marginal; as pointed out by Henisz (2000), there is a decreasing marginal effect of additional veto players.

The benefit of the Czech Republic and Estonia over Latvia is the higher, albeit marginally faster, reform speed. Furthermore, Estonia has two advantages over the Czech Republic. Estonia reached full alignment with the EU's banking Acquis Communautaire (Acquis) at the end of the accession period. Conversely, the Czech Republic had some outstanding legislation when joining the EU. Second, Estonia reached full alignment already in 2002, two years before becoming a full member state in the EU; whereas, at that time, the Czech Republic were still impaired with deficiencies in all four institutional dimensions. Estonia adopted the main part of the banking acquis only three years into the accession process, and two years before joining the Union the administrative capacity of the regulatory body was in place and functioning well (European Commission, 2002, p. 53). The strong reform effort in Estonia, coupled with the high number of veto players, leads to the conclusion that it is the most efficient deviant case among the available cases.

In identifying a matching negative case two conditions need to be met. First, the country should preferably be as similar as possible to Estonia to facilitate comparisons across countries. However, as discussed above, this criteria should not be applied too strictly since the analytical leverage in the study is not derived from comparing across cases. Second, and more importantly, the outcome of interest should not be present in the negative case. It should be obvious that

especially one case is of interest based on these two criteria: Lithuania. Like Estonia, Lithuania was a former Soviet Republic, entering the transition period with a weak private banking sector and a central bank subordinated to the Soviet State Bank (Gosbank). As such, the two countries are different from many of the other CEE countries who were not part of the Soviet Union, and therefore were allowed more leeway to experiment with market-oriented reforms. Furthermore, both Estonia and Lithuania are relatively small economies although the Lithuanian economy is almost twice the size of the Estonian.

With regard to the outcome, Lithuania's reform path diverges from that of Estonia. In their evaluation from 2003 the European Commission (Commission) writes that Lithuania "is essentially meeting the requirements for membership in the banking sector, [...] and is expected to be in a position to implement this acquis from the time of accession." (European Commission, 2003, p. 20).[13] The Commission nonetheless added that the country still needs continue strengthening the regulatory framework governing the banking sector. Thus, while not fully in line with the EU's requirements, Lithuania had a good institutional alignment. More importantly, Lithuania took substantially longer to reach the institutional quality required by the EU. In 2001, the supervisory department was still deficient in its supervision of banks, in large part because of the deficient resources available to the supervisory authority. The difference between Estonia and Lithuania is also confirmed by other sources. The European Bank for Reconstruction and Development (EBRD) writes that the main difference between the two countries in 2003 was that Estonia has gone further in converging their laws and regulations towards Bank for International Settlement (BIS) standards, and that the country has a well-functioning and efficient banking supervision authority.

1.2 Contribution to the State of the Art

Much has already been written about the political economy of transition. Early on the discussion of big-bang reform contra gradualism emerged. This debate was normative in nature and aimed at answering the question of the optimal speed and sequencing of reforms. Proponents of big-bang reform advocated for fast and comprehensive reform packages that wiped out the institutions of the old planned economy in favour of market institutions such as property rights. According to this school of thought, the fall of communism and the establishment of democracy had created a momentum that allowed for far-reaching reforms. If one waited, however, normal politics risked taking precedence over the political process, slowing the momentum for reform. Hence, this group of academics argued in favour of a speedy and irreversible reform agenda (cf.

[13] Bold and italics in original.

Sachs, 1996).

The gradualists on the other hand pointed out the potential risks of a rapid reform agenda, and argued instead for step-by-step reform whereby the sequencing of reforms was of essence. According to scholars working in this tradition, a correct sequencing of reform would facilitate the establishment of reform constituencies on which support for future reforms could be built (cf. Dewatripont and Roland, 1992a,b). The debate between big-bang and gradualist scholars is, as pointed out by Roland (2002), normative to its nature, i.e., it does not aim to provide insights to the actual reform processes observed in CEE, but rather to point to possible strategies for the adoption and implementation of reforms.

A less explored avenue within the political economy of reform literature, is the positive study of reforms. Broadly speaking this strand of the literature shifted the focus away from the optimal reform path, and instead aimed to answer the question of why countries adopt and implement reforms. As such, here we find studies that explain the actual reform process during the transition from socialism to capitalism. However, this area of the literature still remains relatively understudied, Fish (1997), Shafer (1994) and Hellman (1998) representing three notable exceptions. In the opening sentence of his paper, Fish (1997) asks the question: what determines the extent to which a country in the former communist world undertakes and sustains economic reforms? To answer this question Fish puts forward an argument that emphasises the role played by political elites. He argues that the first election is formative for the future reform process. If the former communists are ousted from power then we should expect a situation where economic reforms are both adopted and sustained. If, instead, the old nomenclature managed to hold on to power they tend to institutionalise rent-seeking and therefore slow down the reform process.

The argument laid out by Fish (1997) relies on a number of mechanisms. As mentioned in the previous paragraph the outcome of the initial election has an impact on the old elite. The replacement of the old ruling elites had an impact on the reform process by its impact on the radicalism of the initial reform process, the marginalisation of the old communist nomenclature and the emergence of a new, liberal class of politicians. Hence, a decisive election result in favour of reformist factions in the country would not only impact the initial reform agenda but also help sustaining the reform process into the future.

In his book Shafer (1994) tries to answer the question of how internal and external forces interact and shape the reform trajectories of countries. He concludes that type of ties between the leading economic sector in a country and the international economy will shape the state's capacity for adjustment. Shafer (1994) suggests that states that faces markets that are domin-

ated by few multinational corporations and high barriers to entry will face difficulties in setting up agencies to monitor and regulate the market. Conversely, competitive markets that consists of many small national firms can easily be monitored and regulated by the state.

A similar explanandum is proposed by Hellman (1998) in his seminal article "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions". Hellman's argument for why economic reform take place relies on interest group explanation. He traces the opposition to deep economic reforms to industry insiders for whom enormous rent-seeking opportunities has been revealed.

> Instead, the most common obstacle to the progress of economic reform in post-communist transitions have come from very different sources: from enterprise insiders who have become new owners only to strip their firms' assets; from commercial bankers who have opposed macroeconomic stabilization to preserve their enormous profitable arbitrage opportunities in distorted financial markets... (Hellman, 1998, p. 204).

These firms gained substantially from the initial move away from the communist planned economy towards a market economy, but had no interest in allowing a further push towards a more mature market economy since that would put their rents at risk. Hence, it was not the losers of economic reform that constituted the main obstacle to a far-reaching and sustained reform agenda, but rather the winners of partial reform. Hellmann, Murdock, and Stiglitz (2000, p. 232) therefore conclude that the main advances in the reform process have been made in countries were politicians have been the most exposed to electoral backlash from the losers of reform. On the other hand, in countries were politicians are insulated from electoral pressure the reform process has often only been partial.

The dissertation at hand builds on this strand in the literature, and further explores the relationship between politics and economics. While Hellman (1998) includes factors such as political rights and size of the coalition government to measure the responsiveness of the political system, I take a somewhat different route and involve yet another strand in the literature. Tsebelis's (2002) theory of veto players supports the intuition that reforms are more cumbersome in political systems where power is shared among numerous actors. Thus, we should expect reform to take place in economies that have fewer veto players compared to countries with numerous veto players. This idea is maybe most eloquently elaborated in The Federalist Papers, in which the argument for checks and balances is outlined. The dispersion of power across different branches of government is set in place to protect the minority from the interest of the majority.

> It can be little doubted that if the State of Rhode Island was separated from the Confederacy and left to itself, the insecurity of rights under the popular form of government within such narrow limits would be displayed by such reiterated oppressions of factious majorities that some power altogether independent of the people would soon be called for by the voice of the very factions whose misrule had proved the necessity of it. (Hamilton and Madison, 1788).

In a similar vein, Tsebelis (2002) argues that an increase in the number of veto players will decrease or hold constant the opportunity for reform.

The connection between veto players and reform has been extensively studied in the literature (cf. Hallerberg and Basinger, 1998; Henisz and Mansfield, 2006; Treisman, 2000). The main take-away from this literature is that reform is less likely to take place when power is shared among numerous actors. This view of the reform process does, however, disregard the interaction between veto players and special interests. As pointed out by Madison (1787), factions can have a potentially devastating effect on society, allowing organised interest to cannibalise less organised members of the polity. It is therefore incumbent on society to "adjust these clashing interests, and render them all subservient to the public good." (Madison, 1787). To Hamilton and Madison (1788) the link between veto players and special interests was clear.

> Ambition must be made to counteract ambition...We see it particularly displayed in all the subordinate distributions of power, where the constant aim is to divide and arrange the several offices in such a manner as that each may be a check on the other that the private interest of every individual may be a sentinel over the public rights. (Hamilton and Madison, 1788).

The connection between political institutions and special interests is however less elaborated in the context of the veto player theory.[14]

The theoretical account presented in this dissertation aims to contribute to this literature by further exploring the interaction between veto players and market structures. I argue that an increasing number of veto players might increase the probability of reform and a movement towards the Pareto frontier. However, how veto players influence probability of reform is dependent on the market structure in the country. More precisely, when market power is concentrated to a small number of special interest groups, numerous veto players are important to counteract the power of special interests. Conversely, when market power is fragmented among a large number of actors reform is often stalled because smaller actors often lack capacity to adapt to the requirement of a mature market economy.

[14] See Lindvall (2010) and Gehlbach and Malesky (2010) for two notable exceptions.

1.3 Structure of the Dissertation

The dissertation is structured as follows. Chapter 2 consists of three sections. In the first part, I set the stage for the subsequent part of the analysis by conceptualising the explanandum, which consists of two parts: institutions and reform. I define institutions as commonly known and socially-constructed rules that structure recurrent behaviour, and that are endowed with an enforcement mechanism, whereas reform is understood to mean the process of carrying a new set of institutions into effect, which includes the adoption of a new set of rules, the creation of organisations, and the enforcement of rules.

In the second part I go on to review the different institutional measures that exists in the literature and how they relate to the indicator that has been developed for this study. I argue that many of the datasets captures institutions at the macro level. Furthermore, several indexes have a one-sided focus on rules, whereas they tend to neglect the enforcement behaviour of an institution. The last part of Chapter 2 describes the dataset that has been used in this study, and provides a descriptive analysis of the different pathways of reform in the 17 countries under study.

Chapter 3 turns to the analytical framework used to explain reform. This chapter consists of two parts. I first define the different actors that are part of the theoretical account, and describe how I will operationalise them. In this stylised version the reform process is assumed to consist of two actors with sometimes opposing interests: veto players and banks. In the second part I outline the theoretical account of the dissertation, building on the veto player theory, as understood by Tsebelis (1995, 2002). To develop this theoretical account I engage with the extensive literature on business and state relationships. Based on the analytical framework derived from the literature I then proceed to specify the hypotheses that will guide the empirical part of the dissertation.

I then advance to the empirical analysis, which is conducted in Chapters 4 and 5. In the statistical analysis I test the association between financial market structure and banking reform, given different numbers of veto players. I do so by using varying conceptualisations of the dependent variable. In the first section of the analysis I define reform as a binary event that either takes place or not. Conversely, the second section understands reform as the quality of the institutional framework — at different points in time — regulating financial markets.

In the qualitative analysis I set out to analyse the pathways of reform in Estonia and Lithuania, using process tracing. I show evidence that the political processes in both Estonia and Lithuania were responsive to the changes in market structure. The early financial crisis in Estonia quickly consolidated the banking sector in the country, creating a couple of leading

private banks that were well prepared for the radical reform agenda implemented in the country. Conversely, the banking sector in Lithuania was more fragmented, and the big players were the badly managed state-owned banks. Lithuanian policy-makers were therefore more cautious in the adoption and implementation of banking regulations. Furthermore, legislation exempting certain banks from regulatory requirements was not uncommon in the mid 1990s.

Chapter 2

Banking Reform

The explanandum of the dissertation is institutional reform in Central and Eastern Europe (CEE) countries that have taken part in or are part of the European Union (EU)'s enlargement process. In this chapter I set the stage for the empirical analysis by conceptualising the two parts of the explanandum: institutions and reform. To this end, I review the literatures on institutions and reform, which will provide the foundation for the subsequent definitions. The chapter proceeds as follows:

Section 2.1 gives an overview of how institutions have been conceptualised in the literature, and identifies a baseline definition that will be used throughout the dissertation. It serves as a good starting point, but is broad enough to include a wide range of institutions, many of which are not of interest for this study. After further demarcation, I settle on a definition of institutions that consists of four parts: rules, organisations, resources and behaviour. In Section 2.2 I put flesh to the bone to the concept of institutions by illustrating how the EU's accession requirements map on to the concept of institutions advanced here. I divide the section in two parts. I first describe the legislative requirements for joining the EU, after which I look at the Union's capacity requirements, consisting of the organisational infrastructure, the resources, and the behaviour of the supervisory agency.

Section 2.3 engages with the literature on reform. While not always explicit, reform, in one way or another, is commonly studied in the social science literature. However, the concept is often underspecified in the literature. To remedy this, I propose a definition of reform that is closely linked to the concept of institutions. More specifically, I denote reform as the process of carrying institutions into effect, i.e., the adoption of a new set of rules, the creation of organisations, and the enforcement of rules.

Following the conceptualisation of the explanandum, I turn to the operationalisation. Section 2.4 provides an overview of the most commonly utilised institutional indexes in the literature.

While these measures gives important insight into the study of institutions, they are too aggregate for the purpose of this study. Building on this discussion, Section 2.5 describes how the dataset that has been compiled for the purpose of this dissertation contribute to the already existing indexes. The coding process is accounted for in Section 2.5.1. Data is obtained from the Progress Reports, which are published annually by the European Commission (Commission), evaluating the strength of the financial market institutions in CEE countries during their accession to the EU. Last but not least, Section 2.6 explores the data collected, and describes the different pathways of financial market reform in CEE.

2.1 Economic Institutions

The notion that institutions matter has today generated something close to a consensus among economists, political scientists and sociologists. Nevertheless, the literature lacks a common definition, and one is sometimes left wondering what exactly is implied by the concepts.

A commonly applied definition in the literature is institutions as the rules of the game; as such, they determine and structures the possible choices and information available to actors (cf. Alchian, 1965, p. 817; Ruttan and Hayami, 1984, p. 204; Ostrom, 1986, p. 5; Shepsle, 1986, p. 52, 1989, p. 135; North, 1990, p. 3, 1991, p. 97; Knight, 1992, pp. 2–3; Weingast, 1996, p. 169). A distinction is here made between institutions that are exogenously given to actors, and preferences that are endogenous and assumed. To optimise their utility, actors must not only consider their own preferences but also the institutional environment facing them. Thus, within this strand of the literature scholars have tended to focus, albeit not exclusively, on the formal rules that structure behaviour in different situations.

A second strand of the literature draws attention to institutions as a set of beliefs and behaviour of actors. Durkheim (1982) defines an institution as "all the beliefs and modes of behaviour instituted by the collectivity…" (Durkheim, 1982, p. 45). Institutions as beliefs and expectations call attention to how social interaction is structured through the formation of social beliefs and expectations (cf. Hechter, Opp, and Wippler, 1990, p. 4; Denzau, 1994, pp. 4–5; Greif, 1994, p. 915; Knight and Sened, 1995, p. 10). In strategic situations, actors pursue their goals subject to their preferences, and their beliefs of the expected behaviour of others. Hence, given that expectations of future encounters exists, cooperation can evolve between two actors, even if both have an incentive to defect (Axelrod, 1984, p. 12). Institutions can also facilitate coordination among actors. Consider, for example, the decision to drive on the left or the right side of the road: actors' dominant strategy will in this case be a function of the expected behaviour of others. If every actor expects every other actor to drive on the right side

of the road, it is everyone's dominant strategy to drive on the right side of the road. According to this view, institutions should be understood as motivational mechanisms that guide actors' behaviour.

Understanding institutions as uniform or established patterns of behaviour shifts the analytical focus from the rules of the game to the outcome of the game (Alchian, 1950, pp. 213–14; Granovetter, 1985, p. 487; Parsons, 1990, p. 320; P. H. Young, 1998, pp. 3–4). What distinguish humans from other animals is their ability to adapt to new situations: by learning they adjust their behaviour to new circumstances and lock it in through social customs (Lal, 1998, p. 7). While insightful, the understanding of institutions as a set of beliefs and behaviour of actors is problematic since it implicitly assumes that no uniform or established pattern of behaviour would exist in the absence of institutions (Glaeser et al., 2004, p. 276). If the outcome is already built into the definition it is impossible to distinguish between cause and effect. Then institutions are not the cause of behavioural patterns, they are behavioural patterns. Thus, I contend that underpinning the study of institutions is the unobserved counterfactual that if institutions were not in place actors would behave differently. Therefore, the behaviour of actors should not be included in the concept of institutions.

Greif (2006) walks down a different path, proposing an encompassing definition of institutions that includes many of the institutional elements found elsewhere in the literature. He dines institutions as "a system of rules, beliefs, norms, and organizations that together generate a regularity of (social) behavior." (Greif, 2006, p. 30).[1] Central to this definition is the idea that the study of institutions is the study of the regularity of social behaviour, caused by a combination of four institutional elements: rules, beliefs, norms and organisations (2006, p. 40). As such, this definition of institutions takes into account both the rules of the game and the outcome of that game. Greif recognises that the inclusion of beliefs and norms complicates the empirical study of institutions, because beliefs and norms are unobservable. He proposes to solve this dilemma by analysing institutions using game theoretical modelling, through which the possible set of beliefs and norms can be deductively restricted (Greif, 2006, pp. 306–308). While acknowledging that beliefs and norms play an important role in structuring behaviour, I instead propose a definition of institutions that is confined to rules and their enforcement mechanism.

Following Voigt (2012) I define institutions as commonly known and socially-constructed rules that structure recurrent behaviour, and that are endowed with an enforcement mechanism.[2]

[1] Italics in original.

[2] Voigt defines instituions in a similar manner, but instead of "enforcement mechanism" he uses the term "sanctioning mechanism" (2012, p. 5). This is, however, a much narrower understanding of the states than the one adhered to in this dissertation. In The Oxford Dictionary sanction is defined as a threatened penalty for

By virtue of being commonly known it is possible to distinguish institutions from privately held rules, which, by definition, only apply to individuals. It is also possible to tell institutions apart from other factors that structure social interaction, such as natural and technological constraints.[3] For example, the beginning of the 1990s was characterised by a sharp drop in effluent in many CEE countries. This was, however, not caused by institutional changes, but rather the fall of the Soviet Union, which drastically reduced the demand for industrial products from these countries. Concordantly, this conceptualisation allows us to distinguish between institutions and non-institutions.

Furthermore, applying this definition I take up an agnostic position with regards to the content of the rules; thus, the ends the institutions serve is not of my concern. This represents a departure from those who have incorporated a normative dimension to institutions, often based on an understanding of a good or just society (cf. Craig, 1997, p. 477). For example North and Thomas seem to suggest that institutions imply a prescribed behaviour that brings private returns in parity with social returns (1973, Ch. 1); similarly, others have conceptualised institutions as welfare enhancing, often, but not always, with a focus on economic performance (cf. DeLong and Shleifer, 1993; La Porta, Lopez-de-Silanes, et al., 1999; Lindvall, 2010). Nevertheless, the inclusion of a normative dimension implies that the concept loses its analytical relevance independent of the underlying normative theory.

At the most general level it is possible to distinguish between economic and political institutions. The former refer to any institution that structure market interaction, and the latter to institutions structuring political contestation. Students of economic institutions have mainly paid attention to property rights, whereas political institutions have often been taken to imply checks and balances between the executive, legislative and judicial power, e.g., the rules stipulating how the leaders of a country are chosen. It should be noted that, while analytically clear, it is not always easy to make a distinction between political and economic institutions in practice. How should one, for example, classify regulations of state-owned enterprises? Nevertheless, I find the distinction helpfull when thinking about the relationship between politics and economics.

I also distinguish between two different types of rules and enforcement (see Table 2.1). Rules

disobeying a law or a rule, whereas enforcement is the act of compelling observance with a law, rule or obligation. Thus, an enforcement mechanism can consist of one or more sanctioning mechanisms, but is not restricted to them.

For example, deposit insurance is an important banking institution with the aim to protect small depositors from losing their savings in the event their bank files for bankruptcy; in so doing it also decreases the risk of bank runs during turbulent times. However, the enforcement of deposit insurance legislation is not dependent on the state's ability to sanction non compliance, but rather its ability to deliver a service, in this case in terms of monetary disbursement to depositors.

[3] Nota bene, that institutions are socially constructed does not necessarily imply that they are the outcome of deliberate human design.

can be either formal (e.g., laws, proceedings, statues, etc.) or informal (e.g., conventions, customs, norms, etc.).[4] Formal rules refer to all rules that are codified by the state or some of its sub-units, including both legislation, decrees, and procedures governing government agencies. By extension, informal rules include all rules that have not been codified by the state or some of its sub-units. This definition of formal rules diverge from Elster who links the distinction between formal and informal rules to the type of enforcement mechanism applied. “Legal norms are enforced by specialists who do so out of self-interest: they will lose their job if they don’t. By contrast, social norms are enforced by members of the general community, and not always out of self-interest…” (1989, p. 100). However, understanding formal rules in terms of their enforcement mechanism excludes arrangements where the enforcement of legislation is organised through private organisations, a practice that is more frequently used today (Shamir, 2008, p. 6).

Table 2.1 – A Typology of Institutions

		Enforcement	
		Private	Public
Rules	Informal	Conventions, language, norms, etc.	
	Formal	Arbitration courts, organisational statues, etc.	Most legislation, bureaucratic procedures, etc.

Enforcement can be organised by the private and/or the public. A public sanctioning mechanism implies that enforcement is conducted by the state or some sub-part of it, while all other types of enforcement are understood to be private. Based on the dichotomies between, on the one hand, formal and informal, and, on the other hand, private and public, it is conceptually possible to distinguish between four types of institutions. Although public enforcement is confined to the realm of formal rules, which leaves three observed categories of institutions. The four types of institutions discerned in Table 2.1 are encompassing categories, and it is therefore possible to make further demarcations within in each category.[5] Moreover, in many cases the type of enforcement employed is a mix of public of private enforcement, and the categories should therefore be understood as ideal types. For example, many countries employ a practice of financial market supervision that is paid for by the market participants but organised by the state; such an arrangement would fall within the realm of public enforcement according to this typology.

[4]In distinguishing between formal and informal rules I follow the terminology found in North (1991). However, North does not clearly specify this distinction. For example, it is not evident from his definition if formal rules have to originate from the state or some of its sub-units? Or even if codification is a requirement? If so, do they have to be in the form of legislation, or are rules in form of procedures also considered formal rules?

[5]For example, applying similar categories Voigt is able to distinguish between five different types of institutions (2012, p. 6).

I restrict the scope of the dependent variable to economic institutions found in the bottom right quadrant of Table 2.1, i.e., formal rules that structure market interaction, and for which the enforcement is organised by the state. More precisely, I am interested in financial market institutions that regulate banking. As such, by institutions I mean legislation that aims to structure the interaction of financial market participants.

After having identified the type of institution of interest for this study, I will now turn to the effectiveness of institutions. Its meaning is contentious because of the many definitions that exists. Examples are the degree to which goals of an organisation, regime or state are attained, the degree to which a prescribed behaviour actually induces a change in actors' de facto behaviour or the extent to which provisions of a treaty are transposed into national legislation (Keohane, P. M. Haas, and Levy, 1993, pp. 7–8). The dispersed meanings originate, according to O. R. Young (1994, p. 142), from the fact that we are dealing with a number of different variables, or at best a multidimensional variable whose separate dimensions do not always co-vary in a simple way.

I understand effectiveness as the capacity of an institution to structure recurrent behaviour, which in turn depends on the clarity of the rules and the degree of enforcement. Obscure rules will increase the uncertainty of what the desired behaviour is, and will therefore impede on the effectiveness of the institutions. In such cases, it does not matter if enforcement is high or low, effectiveness will remain low. Furthermore, clear rules can induce change in actors behaviour independent of how well enforced they are (cf. P. M. Haas, 1989). Thus, rule transparency is a necessary but not sufficient condition if actors are to follow the rules. For example, the Acquis Communautaire (Acquis) codifies a large number of rules that apply to financial market participants in the EU. For many of the financial institutions operating in CEE countries the rules of the Acquis are often difficult to comprehend, and therefore also to comply with.

However, it is not enough that the rules are easy to understand. For prescribed behaviour to translate into actual behaviour actors also need to be motivated to follow the rules. There are at least two ways in which such motivations can come about. In cases where actors' preferred behaviour corresponds to the prescribed behaviour they are motivated to follow the rules.[6] Thus, if the behaviour of the regulated is consistent with the preferences of the regulator there is no need to institutionalise the behaviour.

Instead, the need for legislation most often arises because of the lack of consistency between

[6]Nota bene, that actors' preferred behaviour corresponds to prescribed behaviour is not a sufficient condition for compliance to take place. As argued by Tallberg (2002), among others, actual behaviour might diverge from prescribed behaviour even if actors are motivated to follow the rule. This is for example the case when actors lack the capability to adhere to the prescribed behaviour. However, although actors may not have the capability to adhere to the rules, they should be motivated to do so if the prescribed behaviour corresponds to the preferred behaviour.

the preferred behaviour of the regulator and that of the regulated. In such cases, the motivation to comply with prescribed behaviour is fostered by altering the incentive structure facing actors; although each actor takes an independent decision of whether to adopt to the behavioural prescriptions or not, their decision will be informed by their belief that sanctions will be severe enough in the case of shirking (Greif, 2006, pp. 36–37). Thus, to foster such behavioural beliefs among actors, the degree of enforcement is essential. With this I mean the state's ability to realise its political goals by sanctioning defection and delivering services, i.e., its ability to govern. I will call this state capacity.

State capacity, as understood here, is closely related to what Mann has defined as the infrastructural power of the state, i.e., the state's ability to implement its decisions throughout the realm. Albeit not phrased in terms of behavioural beliefs about enforcement, this is exactly what Mann is referring to, he writes that through its infrastructural power

> [t]he state can assess and tax our income and wealth at source, without our consent; [...] it stores and can recall immediately a massive amount of information about all of us; it can enforce its will within the day almost anywhere in its domain; its influence on the economy is enormous; it even directly provides the subsistence of most of us... (1984, p. 189).

Thus, in the absence of effective infrastructural power it is not possible for the state to reinforce the common belief that enforcement is effective enough to deter deviant behaviour.

A similar definition of state capacity is echoed by Besley and Persson (2014), who argues that a country's state capacity constrains the set of policies a government can implement. In so doing so the authors discuss a number of dimensions of state capacity, such as the investment in public registers, the establishment of and investment in government agencies, the training of officials, to raise revenue etc. To understand the enforcement mechanism it is therefore necessary to unpack the concept of state capacity, to which I turn next.

2.1.1 State Capacity

The concept of state capacity calls our attention to the state as an organisation, which is central to the state's ability to enforce its will upon societal actors (cf. Axelrod and Keohane, 1986; G. W. Downs, Rocke, and Barsoom, 1996; Underdal, 1998).[7] Two dimensions of the state as an

[7]While North understands institutions to be endowed with an enforcement mechanism, he at the same time seems to exclude enforcement orded around organisations as a part of institutions. “A crucial distinction in this study is made between institutions and organizations. [...] Conceptually, what must be clearly differentiated are the rules from the players. The purpose of the rules is to define the way the game is played. But the objective of the team [of which organisations are part] within that set of rules is to win the game — by a combination of skills, strategy, and coordination; by fair means and sometimes by foul means.” (1990, p. 4).

organisation are essential to conceptualise state capacity: its procedures and its resources.

The relationship between organisations and institutions is of a dual nature. They are part of institutions because they constitute their enforcement mechanism; and, at the same time, they are institutions that structure the behaviour of their members (Greif, 2006, p. 50). Consider a situation in which the supervisory authority is provided information about the potential wrongdoing in one of the legal entities under its jurisdiction. The decision to impose fines on the malfeasant is part of the enforcement mechanism of the institution whose rules have been violated. At the same time, the decisions to investigate potential wrongdoings, to impose a fine, define the size of the fine, etc. are all governed by the institutional infrastructure of the organisation. In law, the dual nature of organisations is captured in the distinction between substantive and procedural law. The former refers to laws that govern the behaviour of legal entities, whereas the latter regulate the process that surrounds the substantive legislation. In this context, we often find reference to the rule of law, i.e., the idea that public authorities should act on the basis of a constraining framework of rules rather than on the basis of their own preferences (Weingast, 1997, p. 245; Waldron, 2008, p. 6; Rothstein and Teorell, 2012, p. 24).

Social scientists have generally approached organisations as institutions from the perspective of the principal-agent dilemma. It is well recognised in the literature that bureaucratic shirking — manifesting itself in the form of outright opposition or indifference — may occur when delegating to bureaucrats, which in turn can lead to delays and/or inaccuracies in policy application (cf. Alchian and Demsetz, 1972). Thus, in common to both lawyers and political scientists is the realisation that the enforcement of the substantive rules will depend on the "coordination of the actions and behaviour of the individuals working within the public administration." (Kurtz, 2013, p. 55). It is essential that bureaucrats subordinated themselves to the institutional goals of the organisation rather than self-interested ends, i.e., rent-seeking.

This is not to say that bureaucratic organisation should be detached from society, as has been suggested by some. Instead, it speaks to the ideas proposed by Evans (1995) of an embedded bureaucracy, requiring institutionalised channels of interaction between bureaucrats and society, through which the goals and policies of the bureaucracy can be renegotiated. In other words, bureaucrats should not be isolated, but rather insulated. A prerequisite for a successful bureaucracy is that it is insulated enough that it can engage in mutually-beneficial interactions with business without the risk of capture (Evans, 1997, p. 74).

Enforcement organised by the state is not only a function of the rules and procedures governing the enforcement authority, but also its resources (Evans and Rauch, 1999, p. 762). Resources

Thus, if organisations are distinct from institutions it follows that enforcement organised by the state falls outside the the concept of institutions.

can be divided into three distinct but interrelated categories: budgetary, human, and physical resources.[8] The three categories are interrelated in the sense that the effectiveness of one resource category is dependent on the other resources available. For example, the size of its budget will affect the quality of the human and physical resources of the supervisory agency; likewise, the effectiveness of the software will dependent on the competence of the staff. Thus, for an organisation charged with enforcement to be effective it must have sufficient budgetary, human and physical resources at its disposal.

To recapitulate, I define institutions as commonly known and socially-constructed rules that structure recurrent behaviour, and that are endowed with an enforcement mechanism. From this encompassing definition I focus on institutions that are codified by the state or some of its sub-units, and for which enforcement is organised by the state. Furthermore, enforcement is a function of the procedures governing enforcement and the resources made available to the enforcement authority.

2.2 The Financial Market Acquis

The financial market Acquis falls under the free movement of services, which is one of the cornerstones of European integration. It regulates banking, insurance, and securities, Table 2.2 lists the main directives for each market. However, the analysis will focus on the development and content of the banking directives.

Table 2.2 – EU Financial Service Directives[9]

	Banking Directives		Insurance Directives		Securities Directives	
Stage I	First Banking	1977	Reinsurance	1964	Stock Exchange Listing	1979
	Second Banking	1989	First Non-Life Insurance	1973	Listing Particular Directive	1980
	Solvency Ratio	1989	First Life Assurance	1979	Investment Funds (UCITS)	1985
	Own Funds	1989	Second Non-Life Insurance	1988	Major Holding Notification	1988
	Money Laundering	1991	Second Life Insurance	1990	Public Offer Prospectus	1989
	Large Exposures	1992	Third Non-Life Insurance	1992	Insider Trading	1989
	Deposit-Guarantee	1994	Third Life Assurance	1992	Investment Services	1993
	Capital Requirements Directive	2006			Capital Adequacy	1993
Stage II	Consolidated Supervision	1983				
	Annual and Consolidated Accounts	1986				
	Capital Adequacy	1993				

Source: World Bank (1999), and additional sources.

The first steps towards a common financial market were taken in 1969, when the Commission set up an ad hoc working group, consisting of representatives from all six European Economic Community (EEC) supervisory authorities. The aim of the group was to eliminate "the legis-

[8](1) Budgetary resources refer to the general budget of the organisation; (2) human resources are composed of both the quantity and quality of staff available to the organisation; and (3) physical resources are the premises available to the organisation, and also its computers, software, etc.

[9]It is important to note that many of the directives included in the table have been overhauled numerous times. Thus, the table only depicts the most important pieces of financial market legislation, and when they were adopted for the first time.

lative and administrative disparities with regard to working rules for banks and other credit institutions and at harmonising the control systems to which they are subject." (quoted in Kapstein, 1994, p. 132). In parallel, an informal group of high-ranking officials of the banking supervision authorities — the Contact Group of EEC Bank Supervisory Authorities (Group de Contact) — was established. The group provided important expertise to the Commission's banking and financial service directorate of DGXV, and should be understood as a predecessor to the Commission's Advisory Committee on financial services and the Basel Committee on Banking Supervision (BCBS) (Goodhart, 2011, 24, note 13). Complete harmonisation turned out to be too difficult, mainly because the inconsistencies between national regulations made it impossible to reach an agreement (Dixon, Rob, 1991, p. 55). Instead, the EU opted for a piecemeal approach to financial integration.

2.2.1 Banking Legislation

The fundamental pieces of the single financial market are covered by the Stage I directives, Stage II directives refers to all other pieces of legislation adopted by the EU (European Commission, 1995, p. 21).[10]

Any cross-national regulation of banking activities requires that banks are well defined, establishing a difference between them and other financial institutions. Banks are defined in the First Banking Directive (FBD) of 1977: "'credit institution' means an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account…" (European Council, 1977, article 1).[11] Only one minor addition to this definition has been made throughout the years. In 2000 the concept of electronic money institutions was incorporated.[12] The definition also shows the exceptional standing banks have compared to other financial institutions in the EU; they serve as baseline against which other types of financial institutions are defined, i.e., as an undertaking "other than a credit institution." (European Council, 2006, article 4 § 5).

The principles of mutual recognition of authorisation — sometimes referred to as the passport principle — and the prudential supervision requirements by individual member states were established in the Second Banking Directive (SBD) of 1989.[13] Allowing banks in one jurisdiction

[10] From 2010 the financial market was regulated by the Financial Services chapter. Before that financial market regulation was incorporated into the Right of Establishment and Freedom to Provide Services chapter.

[11] In the parlance of the EU banks are referred to as Credit Institutions. Thus, for the purpose of this thesis I will use the two labels interchangeably.

[12] Directive 2000/46/EC stipulates that "'electronic money institution' shall mean an undertaking or any other legal person, other than a credit institution as defined in Article 1, point 1, first subparagraph (a) of directive 2000/12/EC which issues means of payment in the form of electronic money…" (European Council, 2000, article 1 § 3a).

[13] The principle of mutual recognition is defined by the SBD's article 6, "[h]ost Member States may no longer

to conduct business in other member states significantly lowered barriers to entry (Matthews, 1992, p. 99). But to uphold the principle of mutual recognition it was necessary to establish some minimum prudential standards that would help foster trust between countries, and guarantee that supervised entities take on risk in a controlled and responsible manner. The SBD is seen by many to have significantly improved the integration of financial markets across countries in the Union (Angelini and Cetorelli, 2003, p. 664). The SBD is said in its recital to "constitute the essential instrument for the achievement of the internal market…" (European Council, 1989, recital 1); a course set out in the Single European Act (SEA) and the Commission's White Paper of 1985.[14]

Many of the supplementary directives adopted in the late 1980s and the early 1990s intended to further strengthen the prudential requirements for banks, safeguarding the financial strength of credit institutions operating within the EU. The Own Funds Directive and the Solvency Ratio Directive were adopted shortly before the SBD. Both directives provide supervisory authorities with important yardsticks against which they can assess the financial strength of a bank. In the beginning of the 1990s three additional directives were adopted: the Large Exposure Directive, the Capital Adequacy Directive, and the Deposit-Guarantee Schemes Directive. The first two handles the type of risk that banks are allowed to take on, either by exposing themselves to a single client or a group of economically-dependent clients (European Council, 1992, article 4, §§ 1–2), or by not having sufficient capital when entering the market (European Council, 1993, articles 3–4). The Deposit-Guarantee Schemes Directive was adopted to protect deposits in the case of bank failure; and, by so doing, to reduce the risk of a bank run, with its potentially severe economic consequences.

2.2.2 Financial State Capacity[15]

The main aim of the legislation just covered is to level the playing field for the member states. If banks are to move freely across borders it is essential that authorities can trust that they at the very least fulfil a set of minimum requirements. Nonetheless, for this legislation to be effective, authorities in each country must trust that their counterparts enforce it properly. If not, the free movement risks collapsing. This concern became especially prevalent with the first enlargement after the fall of communism. Many of these countries did not have the administrative structures to be able to guarantee proper enforcement of the EU directives. The Commission therefore spent

require authorisation, as provided for in Article 4 of directive 77/780/EEC , or endowment capital for branches of credit institutions authorised in other Member States." (European Council, 1989, article 6 § 1).

[14] The White Paper states that it ought to be possible to further facilitate the exchange of financial products at the Community level, "using a minimal coordination of rules […] as the basis for mutual recognition by Member States of what each does to safeguard the interest of the public." (European Commission, 1985, pp. 27–28).

[15] This section draws heavily on the European Commission (2005) working document.

considerable effort and time to improve what in EU lingo was called administrative capacity. It represented a clear break with the neoclassical idea that the state is the enemy of the market (Krueger, 1974, pp. 301–303), and instead echoes the Weberian idea of bureaucratic organisation. Weber argued that the demand for administration originates from the increased complexity of society, and that the bureaucratic organisation was technically superior to any other forms of organisation in cooping with this complexity (Weber, 1978, pp. 972–73).

Candidate countries were required to set up a supervisory authority, with the responsibility to regulate credit institutions, including the granting and withdrawal of authorisation of banks, and the monitoring of prudential requirements (European Commission, 2005, p. 31). In its evaluation of the supervisory authority the Commission attached great importance to its independence. Budgetary independence refers to the financing of the supervisory authority. If financed through the state budget it risks finding itself in a situation of dependence towards the state. Operational independence concerns the selection procedures for top officials within the supervisory agency. Once again, it is essential that top officials are not selected in a way in which politicians and/or business can exert pressure on them.

In addition to being independent, the supervisory authority must also be endowed with appropriate powers, including both monitoring and enforcement powers. In some candidate countries the supervisory authority did not have the mandate to investigate market participants through on- and off-site inspections. Furthermore, laws in some countries precluded the supervisory agency from demanding relevant business information from banks. The increased interconnectedness between financial markets made information sharing between supervision authorities essential for monitoring.[16] More common, however, was the insufficient enforcement powers. Supervisors must be able to impose sanctions on market participant that are high enough to deter future wrongdoings.

At the end of the day, organisational infrastructure means little if it does not have sufficient resources. There are many different dimensions of resources, the most apparent ones being the budget of the supervisory authority and the premisses it disposes over. I was told by one respondent that one of the main obstacles in the day-to-day work was lack of paper for the photocopier. However, sufficient resources also implies that enough staff are hired and are competent enough to carry out inspections. This was a problem for many supervisory authorities in CEE. One respondent from Estonia recalls how salaries were so low in the early stage of transition that it was impossible to attract competent staff. While this was less of a problem for banking supervision, salaries were still far below those in the private sector in the mid 1990s.

[16]If supervision of the three sectors of the financial market is organised into one supervisory authority, the concern relates to relations between the different departments within the supervisory body.

Because banking regulations are constantly changing, it is important that the staff are kept up-to-date with the latest legislation through internal training. To evaluate the behaviour of the supervisory authority the Commission relies on the number and frequency of inspections.

It is important to note that the organisational infrastructure, the resources and the behaviour of the supervisory authority should be seen as interdependent. For example, a sound financial standing is a necessary but not sufficient condition for acceptable levels of physical and human resources, which in turn are necessary, but again not sufficient, conditions for the quality of and frequency of banking inspections.

2.3 Institutional Reform

The concept of reform has been approached by diverse fields of scholarship, including economics, international relations, political science, and sociology. I build on these literatures in developing a definition of reform that will form the basis for this dissertation. Two perspectives on the concept of reform can be identified. The first perspective understands reform as the outcome of actors's cost-benefit analyses, a perspective that is prevalent among students of game theory, new institutional economics, and collective action theory. While this diverse body of literature has provided important insights into the causes of reform, the concept itself is often under-theorised. Proponents of the other perspective emphasise that reforms, or the lack thereof, are not just the outcome of actors' preferences, but also their capacity to carry through reforms. As such, researchers working in this tradition tend to provide a thicker definition of reform.

Arguably, it is fair to say that the former socialist countries' transition to market economies represent one of the biggest reform efforts of the 20$^{\text{th}}$ century. This, of course, spurred a great interest from academics in trying to explain the diverging outcomes seen on the ground. Economists approached the phenomenon from two directions. In the framework of normative reform theory students developed models that aimed to understand the decision-making problems that reformers faced. The positive political economy of reform, on the other hand, studied how different interest groups affect the reform process (Roland, 2002, p. 31). However, independently of the approach taken, reform was often conceptualised solely as the adoption of policy (cf. Fernandez and Rodrik, 1991; Dewatripont and Roland, 1992a,b; Wyplosz, 1993; Rodrik, 1994; Roland, 1994). In other words, the obstacles to reform came from political opposition rather than capacity limitations. Once adopted, compliance was assumed to follow automatically.

Reform, understood in this way, is prevalent in much of the positive and normative political economy of reform literature, also outside the former socialist economies. Tsebelis's formalises this conceptualisation. He defines reform as all points, or policy proposals, in a x-dimensional

space that can defeat the status quo (1995, p. 295). An increase in the number of possible policy proposal that can defeat the status quo, increases the political systems propensity to reform.

To be fair, the rationales behind a superficial conceptualisation of institutional reform are many, and often perfectly sensible. The focus in many of these studies is on the political process behind policies. Hence, a thicker understanding of reform would not add any additional analytical value to our understanding of these processes. Furthermore, many economists have been concerned with a specific type of market-oriented reform, frequently making use of the reform suggestions supplied by Williamson (1994, pp. 26–27), commonly known as the Washington Consensus.

> "Reform" could mean different things at different times. In order to focus our stories we start with a definition of reform. We have in mind: macroeconomic stabilization, trade liberalization, privatization, deregulation, and related market oriented measures. To avoid definitional quarrels we simply point to the list supplied by John Williamson's (1994) account of the "Washington Consensus"... (Sturzenegger and Tommasi, 1998, p. 9).

The Washington Consensus refers to a narrow set of specific reforms that require little or no institution building (cf. Naím, 1994, pp. 35–37; Rauch, 2010, p. 153), which makes the assumption that the effect on behaviour is automatic more plausible. Hence, a shallow understanding of institutions is warranted.

Another strand of the literature, rooted in international relations and sociology, has called for a deeper understanding of reform. Researchers working in this tradition argue that a shallow understanding of reform is too narrow, because it does not take into account the implementation process. Focusing only on the adoption of reforms can only teach us about the initiation of reform; it will, however, not provide us with any deeper understanding about the institution building process.

> Governments are increasingly unable to make reliable promises about exactly what they will be willing and able to implement, since large shifts in domestic policy necessarily requires highly capable systems of public administration and affect important national interest groups in ways that are hard to predict with precision. (Keohane and Victor, 2011, p. 9).

A policy proposal is only as effective as its implementation, which depends on the governments capacity to muster compliance from public and private actors. Limited capacity has different sources, most commonly economic limitations. Everyone reading the news knows that it is not

uncommon for government agencies to complain that they have not been assigned sufficient resources to carry out their duties. Another source of capacity limitations is deficient access to human capital. The developmental literature describe countless occasion in which reforms fail because of knowledge limitations.

Capacity limitations are especially prevalent in emerging economies, where government agencies in many cases lack resources and know-how to carry out reforms (Easterly, 2006, p. 61). Bruszt and McDermott (2012) show how the main obstacle to reform of food safety standards in Czech Republic, Romania and Mexico was limited administrative capacity. The focus here is often on what Naím (1994) has termed the second stage of reform, i.e., reforms where compliance is not automatic, and which therefore requires substantial institutional upgrading.

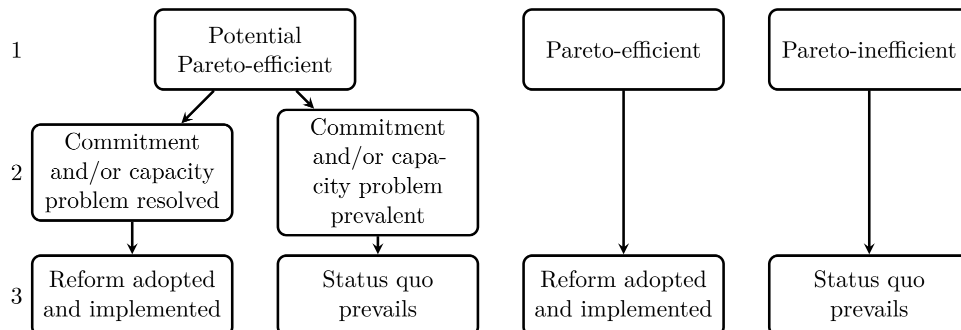
I opt for a thicker understanding of reform, definin reform as the process of carrying a new set of institutions into effect, that includes the adoption of a new set of rules, the creation of organisations, and the enforcement of rules. Thus, whereas institutions are a system of social factors that motivate behaviour, reform is the process of specifying this system of social factors (Jackson, 2001, p. 656; Maskin and Sjöström, 2002, p. 239). It engages with the concept of implementation, commonly found in the literature, which is defined as the strive for compliance with as set of rules or norms (cf. Rein and Rabinovitz, 1978, p. 308; Simmons, 1998, pp. 77–78; Victor, Raustiala, and Skolnikoff, 1998, pp. 4–5; Raustiala and Slaughter, 2002, p. 539).

It is further possible to make an additional distinction between three types of reforms: Pareto-inefficient reforms, Pareto-efficient reform, and potentially Pareto-efficient reforms (see Figure 2.1). The outcomes of the Pareto efficient and inefficient reforms are straight forward. If everyone is made better or worse off the reform process will either go forward or stall. The more interesting set of reforms fall under the category of potentially Pareto-efficient reforms, I define this set of reforms that have the potential to make all actors better off if the winner compensate the losers. This type of reform has been studied extensively in the edited volume by Bruszt and McDermott (2014). They find that in successful instances of transnational regulatory integration the capacity of weaker actors has been increased so that they can benefit from the reforms, i.e., the winners of reform have successfully compensated the losers. The inability of reform might also originate from commitment problems, a situation that has been extensively studied by Acemoglu and Robinson (2006). They find that the winners of reform have few incentives to compensate the losers after the reforms have been adopted and implemented.

We know from the literature on enlargement that reforms generally are to be considered potentially Pareto-efficient (Schimmelfennig and Sedelmeier, 2005b; Vachudova, 2005). Guiso, Jappelli, et al. (2004, p. 553) find that the there are significant growth gains to be made for all

CEE countries integrating their financial markets with the EU. This implies that actors must overcome the trade-off between efficiency and reform (Acemoglu, S. Johnson, and Robinson, 2005, p. 436).

Figure 2.1 – A Typology of Reforms



The definition of reform supplied here is also different from another concept commonly found in the literature, namely compliance.[17] Compliance is defined as the state in which de facto behaviour conforms to prescribed behaviour (O. R. Young, 1979, pp. 4–5; R. Fisher, 1981, p. 20; Mitchell, 1994a, p. 30, 1994b, p. 429). While reform often implies a move towards compliance, it is not necessarily the case that compliance entails reform. Instead, compliance is agnostic about it causes.

Compliance is automatic and reforms unwarranted when de facto behaviour already concurs with preferred behaviour. Alternation in behaviour can also be caused by changes in preferences or the external environment. Conversely, it is possible to identify at least two occurrences in which reform does not lead to compliance. In the first instance, the external environment precludes compliance to take place. For example, it has been argued that low agricultural productivity in tropical countries is due to high mean temperatures in combination with unevenly distributed rainfalls, which severely reduces soil fertility and formation (cf. Weischet and Caviedes, 1993, p. 13; Gallup and Sachs, 2000, p. 734). If true, it might be the case that reforms to increase agricultural productivity are futile, or at best partial. In the second scenario, noncompliance is driven by lack of information, or erroneous beliefs about how to carry through reforms. In the literature we find ample of examples of good intentions that are dashed because of ill-devised reforms. For example, in Implementation: How Great Expectations in Washington Are Dashed in Oakland, Pressman and Wildavsky (1973) study the Economic Development Administration's failed attempts to create jobs for unemployed in Oakland; after three years only 50 new jobs had been created, despite an investment of US Dollar (USD) 23 millions into the programme.

[17] That compliance and reform are distinct but related concepts is most obvious in the work of O. R. Young (1979, p. 5), where he instead of reform uses the term compliance mechanisms.

I also understand reform to be indifferent with regard to the direction of change. As such, Tsebelis, 2002's multidirectional understanding of reform as any shift in policy away from the status quo. Alternatively, I am interested in a subset of reforms, namely the ones that bring a country closer to compliance with EU requirements. This does not imply that reforms are only understood to comprise of the adoption of socially-efficient policies (cf. Lindvall, 2010). I take an agnostic position with regard to the social efficiency of reform, and instead stipulate that countries taking part in the accession process have all declared their desire to conform with EU requirements.

2.4 A Review of Existing Measures

Despite its multidimensional character, many scholars still opt for a unidimensional measure of institutions. This has the advantage of minimising measurement errors, and, if well designed, can still capture the underlying concept of institutions. Once such measure that is commonly applied is the state's extractive capacity. A state that collects more taxes is a more capable state, so the argument goes: "The development of state power, or the state's authority over society and the market economy, is usefully examined by highlighting its ability to get citizens to do something that they would rather not do — namely, pay taxes." (Lieberman, 2002, p. 92).

For this measure to be a useful proxy of institutions at least two assumptions must hold. First, taxation is a specific type of institution for which tax compliance is the concern. It is not obvious how the capacity to induce tax compliance travels to other areas of the economy. However, this is often assumed to be the case. Taxation is often understood to be intrinsically linked to the emergence of the moderns state (Ardant, 1975). However, while taxation is a necessary condition for state capacity in other domains, it is not evident that it is also a sufficient condition. Thus, the assumption that an efficient tax agency implies equally efficient institutions in other realms of the economy is not straightforward and at least need further elaboration.

Second, although tax institutions are the main concern, it is not evident that the best way to capture their strength is to measure taxation as a percentage of Gross Domestic Product (GDP) (cf. Cheibub, 1998). For this to be the case, it must be true that states always prefer an increase in tax revenue, i.e., that the decision to tax x only reflects a capacity limitation and not a preference for lower taxes. But it might well be the case that it is in the interest of the state to tax less than it is capable of (Olson, 1993, p. 571). It is not self-evident that Sweden's high tax rates, compared to for instance the tax rates in the United States (US), are the cause of a stronger state. The incongruence between the proxy and capacity can be derived from its neglect of the rule dimension of institutions, and, by extension, the preferences of the state. It

therefore becomes impossible to evaluate the degree of congruence between intended extraction and de facto extraction.

Alternatives to extractive capacity have been proposed in the literature. Lee and Zhang develop an indicator of the state's knowledge about its citizens that measures the discrepancy between the true age distribution in a country and the census results (2013, pp. 6–7). Conceptually, this understanding of state capacity approximates Mann's 1984 idea of infrastructural power, which emphasises the state's knowledge about its subjects. Although the indicator solves some of the problems earlier mentioned, it only captures capacity at the general level of the state, and it is therefore unclear how the indicator translate to other parts of the state, such as the regulation of financial markets.

Indexes that rely on expert judgements are increasingly used by scholars, and several interest groups and international organisations have compiled their own institutional measures, often containing long time-series that cover many countries. While their number is so large that a comprehensive survey of them is outside the scope of this study, it is worth reflecting on some of the most commonly used indicators in the literature: the Freedom in the World (FiW), the International Country Risk Guide (ICRG) and the Worldwide Governance Indicators (WGI).[18]

A common critique of this type of measure concerns the broad concepts that they aim to measure. A striking example is the concept of governance found in the WGI, which is defined as "the traditions and institutions by which authority in a country is exercised." (Kaufmann, Kraay, and Mastruzzi, 2010, p. 4). A definition as broad as this, risks falling into the trap of concluding that everything matters. Other indicators include GDP per capita, GDP growth, inflation, etc. (ICRG, 2016). Consequently, rather then capturing the institutional characteristics of a country, it reflects the economic and political realities of that country, and therefore confuses institutions with political and economic outcomes (cf. Glaeser et al., 2004).

A multidimensional indicator building on the Weberian conceptualisation of the bureaucracy is compiled by Evans and Rauch (1999, 2000), and the dataset uses expert evaluations of the bureaucracy in 35 countries between 1993 and 1996 (Evans and Rauch, 1999, p. 753). The main disadvantage of the dataset is that it only measures institutions at one point in time, making it impossible to study institutional reform, and has relatively limited cross-national scope compared to other indicators. According to the authors this is not a problem since "bureaucratic structures are notoriously resistant to change, we felt secure in assuming that the differences we discovered

[18] The FiW index includes only one indicator of political freedom. The ICRG consists of five indicators measuring (1) Law and Order, (2) Bureaucratic Quality, (3) Corruption, (4) Risk of Expropriation by the Government, and (5) Risk of Government Contract Repudiation.

The WGI compiles six indicators, (1) Voice and Accountability, (2) Political Stability and Absence of Violence/Terrorism, (3) Government Effectiveness, (4) Regulatory Quality, (5) Rule of Law, and (6) Control of Corruption.

among bureaucratic structures would characterize the situation in place at the beginning of the period [1970–1990]." (Evans and Rauch, 1999, p. 755). That this assumption does not hold for CEE countries — which have experienced profound institutional change since the fall of communism — most probably explains why no countries from this region are included in the dataset.

The transition indicators, compiled by the European Bank for Reconstruction and Development (EBRD), approaches institutions from the sectoral level rather than the general state level. Data has been complied for a number of economic sectors in the former socialist countries of Europe and Asia, and the data covers the period between 1989 and today (with some indicators ranging from 1994 and onwards).[19] Of special interest for this dissertation is the indicator that evaluates financial market institutions: banking reform, and interest rate liberalization.

An evaluation of each country is made by the EBRD's Office of the Chief Economist, which uses three criteria as its basis for the evaluation: (1) contributions to competitive market structures; (2) contributions to institutions and policies that support markets; and (3) contributions to market-based conduct, skills and innovation (Besley, Dewatripont, and Guriev, 2010, p. 1). The indicators rely on a number of underlying indicators, e.g., inflation, interest rates, prices, and also the country reports produced by the International Monetary Fund (IMF), which are then assessed based on a common scale and weighting scheme (Campos and Horváth, 2006, pp. 7–8). The scores range from 1 to 4.33, with 1 indicating the lowest and 4.33 the highest institutional standard (European Bank for Reconstruction and Development, 2015). Countries that receive a score of 1 for the banking sector have implemented few market-supporting institutions beyond the introduction of two-tier banking. A score of 3 indicates that the country has established a framework for prudential supervision, in addition to a significant presence of private banks. The highest score is awarded to countries whose banking laws and regulations fully converge with the Bank for International Settlement (BIS) standards.

The transition indicators are by far the most commonly-used indicator of institutional quality in the post-communist context. Their advantage is the sectoral focus with long time-series, but they still suffer from some shortcomings. While institutions certainly are incorporated in the composite indicators, it is not obvious how they are understood. The index incorporates a number of outcome variables, such as inflation, prices etc. This conflates institutions with the outcomes that they are trying to explain.

Barth, Capiro, and R. Levine (2006) collects a dataset of bank regulations and supervisory

[19] The transition indicators are (1) Large-Scale Privatization, (2) Small-Scale Privatization, (3) Governance and Enterprise Restructuring, (4) Price Liberalization, (5) Trade and Foreign Exchange System, (6) Competition Policy, (7) Banking Reform and Interest Rate Liberalization, and (8) Securities Markets and non Bank Financial Institutions.

practices in 150 countries based on surveys that were conducted in 1998/1999 and 2002/2003, respectively. The latest survey consisted of 275 questions from which a number which different indicators of banking legislation and supervisory practices have been constructed. The benefit of such a dataset is of course its broad coverage across countries. However, weakness of the dataset is that it only covers two time-points, and that is based soley on official government sources. Thus, the dataset does not provide any insights into how wellfunctioning and/or efficient different superviory practices are in a country.

2.5 A New Measure of Banking Institutions

I go beyond the indicators found in the literature introducing a novel dataset over banking institutions in 17 countries during their accession to the EU. This also constitutes the empirical contribution of the dissertation.[20] The data collection builds on a the approach developed by Hille and Knill (2006), who collected data on institutional quality in 13 countries between 1999 and 2003.[21] In a similar vein, the dataset utilised for this dissertation make use of the annual Progress Reports, compiled by the Commission. In 1997, the European Council (Council) gave the Commission the task of monitoring applicant countries' progress towards accession. The outcome of this exercise was synthesised in the annual Progress Reports, which were intended to help accession countries align themselves with EU requirements (European Council, 1997, p. 3).

The main advantage of the Progress Reports compared to the EBRD transition reports is that data has been collected for the four institutional dimensions discussed in Section 2.1. This makes it possible to identify differences across these four dimensions and how they relate to each other. The main disadvantage is of course the smaller scope of data, which only covers countries that are or have been candidate countries to the EU, which also explains the shorter time-series. Another possible objection to the data is that the Progress Reports may contain a political bias, i.e., that the reports world tend to shy away from criticising countries because of political or other reasons. While a possibility, it is difficult to find anything in the data that points in the direction of a systematic under- or over-evaluation of one or more countries. Furthermore, comparing the index with the transition indicators shows a high correlation between the indexes.

The bivariate association between the two indexes is shown in Figure 2.2. It is evident from the panel that there is a high degree of congruence between the two indicators. That the Spearman's rank correlation coefficient (SCC) is substantially higher than the Pearson product-

[20] The dataset has been compiled together with Professor Bruszt (2016), in the framework of the MAXCAP 7 project.

[21] The thirteen countries included in their dataset are: Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia and Turkey.

moment correlation coefficient (PCC), 0.753 and 0.646 respectively, indicates that the two indicators change together but not at a constant rate. This is most probably explained by the fact that the two variables are based on somewhat different evaluation criteria, implying that the same importance is not always given to the same reforms.

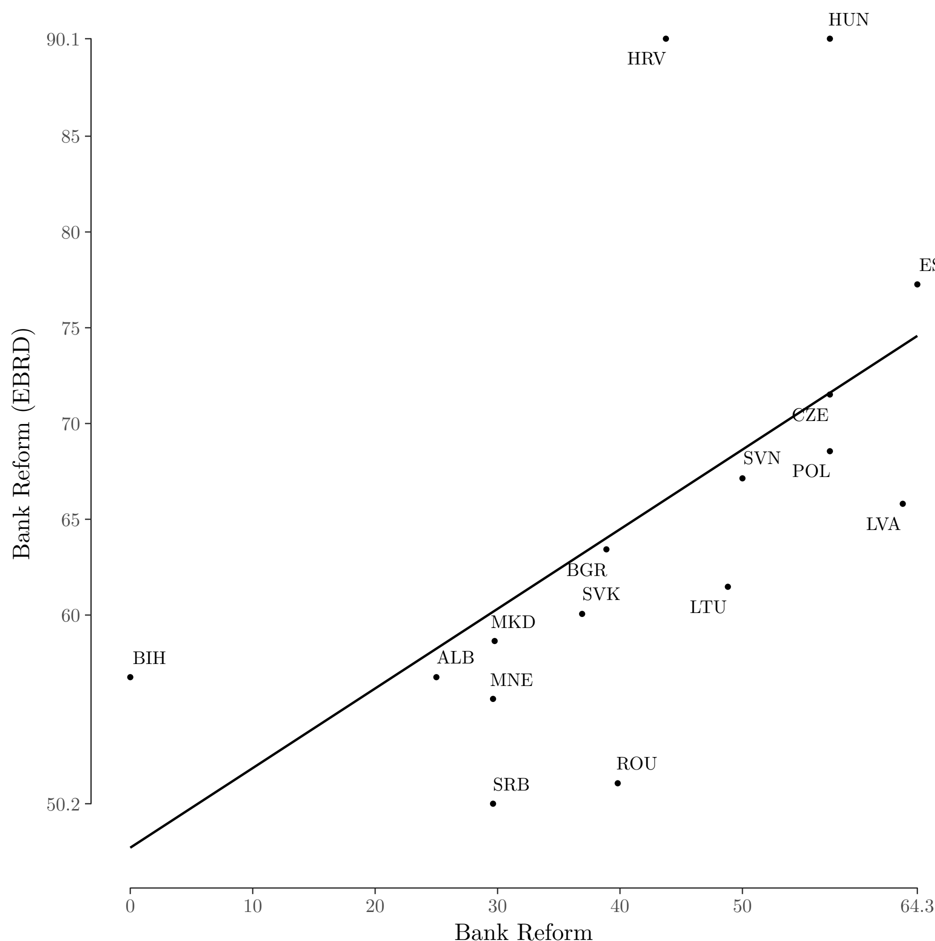


Figure 2.2 – The plot depicts the bivariate association between the average quality of financial market institutions and the average quality of financial market institutions as coded by the EBRD. $PCC = 0.583$ & $SCC = 0.779$.

2.5.1 Operationalisation

For the coding of the Progress Reports content analysis has been used. It is admittedly an indirect method to gather insights about institutional quality, but, despite its imperfections, it provides an opportunity to collect meaningful data at the sectoral level. Thus, it is possible to shed new light on financial market reform in CEE countries.

A manual coding process was used. An alternative would have been to follow the method applied by Hille and Knill (2006). They use a computerised word-in-context method, quantifying progress and/or regress based on the text. As such, they measure the frequency, intensity and

directionality of words closely connected to or mentioned in the same context as sentences related to the Acquis, accession partnership priorities, or specific policy areas (2006, p. 541). Mainly two reasons speaks in favour of abandoning the computerised coding in favour of a manual process. First, because the Progress Reports contains multiple dimensions that would have been difficult to separate based on a computerised procedure. The aim was to collect data on several dimensions of the financial market Acquis, distinguishing between different aspects of institutions. A manual coding procedure simplified this procedure. Second, to comprehend the Progress Report for any given year, knowledge about previous years is often required. Because references to earlier reports are sometimes made, if not fully understood the coding risks being wrong.

Critiques might object, saying that a manual coding procedure decreases reliability since the text becomes subject of subjective judgements. To remedy this potential problem, two persons coded each report, and where potential disagreements existed a third person made the final judgement.

To systematise the process a codebook has been constructed. Four dimensions have been coded: legislation, procedures, resources and behaviour. For each dimension a scale between 1 and 4 has been introduced, it ranges from No or Severe Deficiencies in the Conformity with EU Requirements to Full Conformity with EU Requirements. Codes of 1 and 2 captures states where substantial further efforts are needed to reach the requirements set up by the EU; codes of 3 and 4 indicate stages where little or nor reform is needed to be in compliance with EU requirements.

Each country received a code between 1 and 4 annualy, resulting in a total of 150 observations for each dimension.[22] Unfortunately, the years included in the coding process do not correspond across countries, this because candidate countries took part in the accession process at different points in time. Roughly speaking two groups can be distinguished. On the one hand, the countries that became candidate countries in the late 1990s and was granted membership in the early to mid 2000s. On the other hand, countries that embarked on the road to accession in the mid 2000s, and are still in the process to join the EU.[23]

For country-years where information was lacking for one or more of the dimensions, but coding exists for the previous year, that code was extrapolated also to the next year. Consider, for example, a case in which the year 1997 was coded as a 1, but no information for 1998 can be

[22] The years for which each country is coded and the country-score for each dimension is displayed in Appendicies A and B.

[23] Croatia and Turkey are notable exceptions to these broad groups. Croatia became a candidate country in 2005 and joined the EU on the 1st of January, 2013. Turkey became a candidate country as early as 1998, but has still not join the Union.

retrieved. In this case 1998 was coded based on the 1997 coding. If, however, no coding exists for the previous year, but for the subsequent year, the code was extrapolated back in time.[24]

2.6 Pathways of Reform

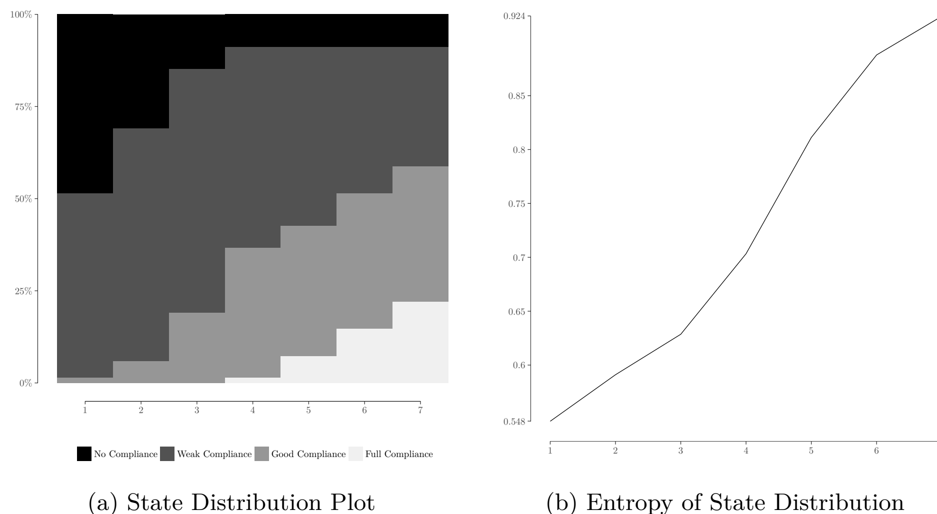
Because of the multidimensionality of the panel data, it is difficult to get an overview and detect patterns within it, and the number of possible pathways of reform grows exponentially with the length of the data. For example, seven years of accession reforms and four different states of compliance at each point in time yields $4^7 = 16384$ potential reform paths. Fortunately, cross-sectional time-series share many similarities sequential data. Hence, to describe the data collected I will make use of the optimal matching (OM) technique, which is commonly used to detect patterns in sequences.[25] A sequence is in this context defined as a list of elements that is fixed and ordered by time (Brzinsky-Fay and Kohler, 2006, p. 435). Here an element represents a state of institutional compliance, ranging from no or little alignment, to full alignment with EU requirements.

Figure 2.3a gives an overview of the data at the most aggregate level by plotting the distribution of compliance levels for each point in time. The occurrence of No Compliance drops over time, from around 50 % at t_1 to just under 10 % at t_4. Weak Compliance also decreases at later stages in the accession process, but not to the same degree as No Compliance. Conversely, the occurrence of Good Compliance and Full Compliance increases with time. These findings conform to what one would expect from the reform process in CEE. At the early of stage the accession process countries generally did not comply with the requirements set up by the EU. However with time, reforms were implemented, which increased the average compliance level among countries. That reforms generally took a long time to implement speaks in favour of a thicker understanding of the reform process, were capacity limitations often posed an obstacle to countries in their reform process.

This interpretation of the data is supported by the Shannon entropy index, shown in Figure 2.3b. It measures the uncertainty of predicting the distribution of institutional compliance at any given point in time. Higher levels of uncertainty are reflected by higher entropy scores, i.e., greater variation in institutional compliance is observed. It is evident from Figure 2.3 that the increasing variation in compliance rates over time is matched by higher entropy scores. A substantial interpretation of the entropy scores would imply that as the uncertainty of predicting

[24]Nota bene, these rules only applies if no information is to be found. Often it is the case that coding for a specific year can be derived from the information in other Progress Reports.

[25]The OM method is used to measure the similarity between sequences. I then use this measure to cluster the data according to Ward's method of hierarchical clustering.



(a) State Distribution Plot (b) Entropy of State Distribution

Figure 2.3

complinace increases the divergence in reform pathways becomes more pronounced. In other words, some countries are not able to overcome their capacity limitations.

The transition rates reported in Table 2.3 measure the likelihood of different reforms. They are defined as the probability of a transition from state i at time t_i to state j at time t_{i+1}, where i is allowed to equal j.[26]

A number of observations are worth making with regards to Table 2.3. First, the highest probability, at any given level of compliance, is for a non-event to occur, i.e., it is more likely that institutional compliance at t_i equals institutional compliance at t_{i+1} than not. This implies that major reforms are relatively uncommon. Second, the likelihood of reform decreases with the institutional level of compliance, i.e., reform is more likely between stage 1 and 2, than between 2 and 3, and 3 and 4. It is only possible to speculate why this is the case, but an educated guess is that reforms at later stages of institutional development requires more efforts and are therefore more difficult to carry through. Third, reforms that jump one stage are highly uncommon in the data; in fact, in only 0.02 % of the cases is such a jump observed. Fourth, no cases of backsliding is recorded in the data.

Table 2.3 – Transition Rates[27]

	–>1	–>2	–>3	–>4
1 –>	0.67	0.30	0.02	0
2 –>	0	0.83	0.17	0
3 –>	0	0	0.84	0.16
4 –>	0	0	0	1

[26] Each row in Table 2.3 sums to 1, implying that the probability to move from one state to any of the possible states is equal to 1.

To compare the similarity between two sequences I calculate the Levenshtein distance (Levenshtein, 1966). The similarity between two sequences is a function of the minimum number of transformations required to transform one sequence into the other. It does so by relying on three different operations: substitution, deletion and insertion.[28] Following standard practice in the literature I assign a cost of 1 for deletion and insertion operations (Gabadinho et al., 2010, p. 96). To calculate the substitution-costs I calculate the transition rates between two states, defined as the probability of observing state j at time $t+1$ given that state i was observed at time t. For $i \neq j$. Formally the substitution-cost is equal to

$$2 - p(i \mid j) - p(j \mid i) \tag{2.1}$$

where $p(i \mid j)$ is the transition rate between state i and j. The substitution cost matrix is displayed in Table 2.4. The minimum cost of substitution is 0, substituting a state by itself. The highest cost is 2, implying that this transition never occur in the data. Based on the substitution cost matrix it is possible compute the OM distance, defined as the minimal cost of transforming one sequence into another.

Table 2.4 – Substitution Cost Matrix

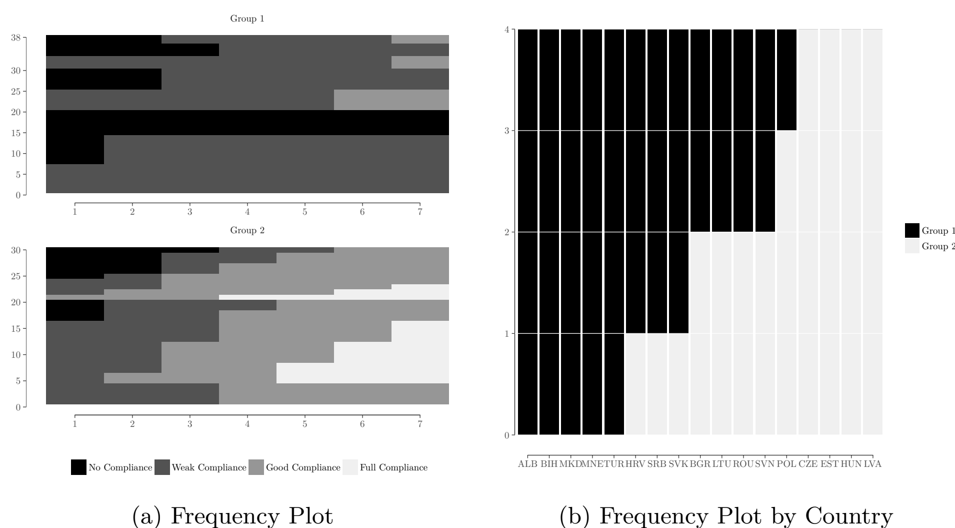
	1–>	2–>	3–>	4–>
1–>	0	1.70	1.98	2
2–>	1.70	0	1.83	2
3–>	1.98	1.83	0	1.84
4–>	2	2	1.84	0

In a subsequent step the OM distance can be used to cluster similar sequences. To this end, I apply Ward's 1963 hierarchical clustering method, which optimises the minimum variance within a cluster, also referred to as the within-groups sum of squares or the error sum of squares (ESS). The method then compares every possible sequence pair, and combines those sequences into a cluster that results in the smallest increase in the ESS, i.e., the minimum increase of information loss.

Two clusters can meaningfully be extracted from the data, consisting of 30 and 38 sequences respectively. The sequences that occurs in each group are depicted in Figure 2.4a. Group 1 consists of sequences in which reforms have been largely absent or recently initiated. Almost half the sequences in this group consists of reform paths were no reform has been recorded. In the other half only one reform event took place, and only in a few sequences are more than one

[28] Substitution is the transformation of one element in a sequence by another. Insertion and deletion generates a one position of all elements on its right.

reform event identified. Conversely, Group 2 contains reform sequences for which substantial progress over time can be identified. In this group we do not find any sequence where no reform has been recorded, and in a majority of the sequences more than one reform event has been recorded. Not surprisingly, a closer look at the two groups show that of the 38 reform sequences in Group 1 only 8 belong to countries of the first enlargement wave, and of the 30 reform sequences in Group 2 only 6 represent countries in subsequent enlargements. Figure 2.4b goes one step further and looks at how often each country occurs in a group. Of the six sequences that belong to the subsequent enlargement rounds in Group 2, five belong to countries that have successfully joined the EU.



(a) Frequency Plot

(b) Frequency Plot by Country

Figure 2.4 – The left hand panel shows the most frequently occurring sequences based on the Ward distribution divided by the two groups. The right hand panel illustrates how often a sequence for a country occurs in each group.

This confirms the findings of earlier studies, namely that the first enlargement wave — which resulted in eight new countries joining the EU in 2004 — was relatively successful, whereas later enlargement rounds have been slower and less thriving. In the year of 2000, the then ten accession countries “were almost all moving forward with political and economic reform, [...] by adopting EU rules.” (Vachudova, 2005, p. 105). Ten years later, enlargement consisted of a different set of countries, under much more difficult circumstances, and some have argued that political and economic reforms have reached a standstill in many of the current accession countries.

Despite the clear divide between the first and subsequent enlargement rounds, we still see some variation within the two groups. Lithuania, Poland, Slovakia and Slovenia have one ore more reform sequences in Group 1, indicating a less smooth transition to full EU compliance. In a similar vein, Bulgaria, Croatia, Romania and Serbia have managed to go further in their reform efforts than their counterparts in Group 2.

It is not possible to find a similar pattern if one instead looks at how the different dimensions of institutional compliance are distributed across the groups. A similar number of observations exists in each group for each dimension. The exception is the resource dimension, which is tilted towards Group 1. That this dimension is lagging behind makes perfect sense, since it is most demanding on a country's finances.

Chapter 3

Too Big to Fail: A Theory of Institutional Reform

A central goal in this dissertation is to build a theory that can, backed up by empirical evidence, explain variation in institutional reform in emerging market economies. Institutional reform is a cumbersome process, even more so in emerging market economies, and one should not be surprised if it fails. It requires a large number of political actors to come together and agree on an agenda to build complex administrative systems, which often come with a high cost for both private and state actors. To explain institutional reform we must therefore understand the politics of reform, and the forces behind it. The language in this chapter is couched in terms financial market reform since this is the empirical focus of the dissertation. Nonetheless, the mechanisms described should be general enough to also apply to other areas of the economy.

I argue that the reform process is best theorised as an interaction between policymakers and banks. For institutional reform to take place, banks must be perceived as capable enough to be able to comply with the reform agenda. However, stronger banks also increase the risk for state capture, it is therefore important that checks and balances that can protect against this are in place. This relation between the state and business is maybe best elaborated by Madison (1787), who was concerned with how to build a government that could cushion the potential negative influences of factions without removing the causes of their existence. More precisely, I build on the work of Gehlbach and Malesky (2010), who theorise the relationship between interest groups and veto players. However, Gehlbach and Malesky (2010) do not consider the capacity of business as a factor that has an impact on reform. This theory is specified with regard to banking during eastern enlargements of the European Union (EU), but is, nevertheless, general enough to also apply to other areas of the economy.

The theoretical account that is presented below builds on the extensive literature that covers

the relationship between business and the state, and the conclusions drawn from this research agenda have often been conditioned by the conceptualisation of business (Haggard, Maxfield, and Ross Schneider, 1997, p. 36). Broadly speaking it is possible to distinguish between business as a structure and business as actors.[1] Students that have analysed business as a structural condition that faces policymakers have generally emphasised the limitations business puts on the possible pathways to reform. Business in this account consists of numerous small actors that react to political decisions, rather than engages with politicians over policy. Conversely, business as actors emphasise the proactive role of business. In these accounts, business takes an active role in the formulation of policy, by channelling resources and information to politicians it influences the direction of economic reform. This is not to say that business power over policy is total, but rather that it helps shape the direction and intensity of reform (Gourevitch, 1986). Independently of the conceptualisation of business, different conclusions are reached with regard to the effects of state-business relations. Some conclude that closer ties between policymakers and business have the potential of creating positive synergies that benefit society at large. Others point to the potential negative synergies resulting from a tight relationship between the state and business.

The chapter proceeds as follows. I start by defining the actors and their preferences in Section 3.1, and how they relate to each other. This section also describes how I will go about and operationalise the different actors for the quantitative analysis. Section 3.2 then proceeds to describe the theoretical account that forms the basis for this dissertation; this section also specifies a number of propositions that will be tested in the subsequent empirical chapters. The chapter ends with an account of alternative theories of reform present in the literature.

3.1 The Actors: Who are They?

I identify two types of actors that constitute domestic politics: one or more veto players (one agenda setter and one or more ratifiers) and banks. Both groups are assumed to have well-defined preferences over policy outcomes. This does not imply that all actors share the same preferences, they might well differ in their preferences over policy reform, both with regard to the direction and intensity of the preferences. They do, however, evaluate the different options available to them according to the perceived consequences for their utility. At any given point in time actors are faced with three options — no reform, partial reform or full reform — and they will prefer the option that is closest to their ideal point. The actual policy chosen however

[1] Both approaches can be furthered divided into subgroups (cf. Haggard, Maxfield, and Ross Schneider, 1997). However, for the purpose of the theoretical account built here I limit my self to these two conceptualisations of business.

is subject to constraints, and the interaction between veto players and banks.

3.1.1 The Interest of Veto Players

Actors that want to reform society will ultimately have to act through the institutions of the state, which constrain and enable actors, and therefore influence the direction of policy in a country. But what political institutions matter? To this question there is no one unequivocal answer. Persson, Roland, and Tabellini (2000) find that majoritarian systems, in contrast to presidential ones, tend to perform better with regard to public goods and redistribution. Falaschetti and G. Miller (2001) argue that the diffusion of power between multiple stakeholders allows the state to guard against opportunistic behaviour, i.e., institutions that constrain the political elite to act only in the public interest, and at the same time are strong enough to punish free-riders, are conducive to efficient economic outcomes.

A generalised version of the institutions matter argument is offered by Tsebelis (1995, 2000, 2002), he argues that institutions are important because of the veto power they vest in actors, defined as the power of individual or collective actors to block a reform proposal (Tsebelis, 2000, p. 442). As such, veto players include political parties, presidents, supreme courts, central banks, bureaucrats, and other actors in a position to exercise veto power over policy. The configuration of veto players therefore affects the potential number of proposals that can defeat the status quo, what Tsebelis calls the winset. Formally the winset can be defined as all the points in a x dimensional space that can defeat the status quo. Hence, a smaller winset decreases the number of possible reforms available to policymakers, and vice versa (Tsebelis, 1995, p. 295).

According to Tsebelis two factors are of primary importance for the size of the winset. First, the number of veto players taking part in the reform process, if more institutions are endowed with veto power, we should expect that reforms become increasingly difficult to enact. Put differently, an increase in the number of veto players will decrease, or keep constant, the size of the winset, i.e., decrease, or keep constant, the opportunity for reform. Second, the size of the winset is a function of the ideological distance between veto players in the x dimensional policy space. If the ideological difference between the veto players increases, the size of the winset decreases; which, once again, decreases reform opportunities for policymakers. While recognising that the preferences of veto players matter, Tsebelis (2002) does not offer a cue for how they should be modelled. Henisz (2000) solves this dilemma by assuming that the preferences of veto player are independently drawn from a uniformly distributed policy space, implying a decreasing marginal effect of an additional veto player.

I take a different approach and follow Gehlbach and Malesky (2010) and Grossman and

Helpman (1994) in assuming that veto players, as a baseline, wants to maximise social welfare, i.e. the well-being of the entire society. This does not imply Pareto optimality. Many of the reforms that are of interest for this dissertation are only potentially Pareto optimal, i.e., all parties are better off if the losers of reform are compensated by the winners. The assumption that veto players maximise welfare is not new, and has been used extensively in the economic literature. However, as has been proved by Wittman (1973), politicians driven by a genuine desire to do good will, just as politicians driven by more gloomy motivations, seek to hold office. To this end, they must adopt policies that can win the majority of the electorate's votes (Hotelling, 1929; A. Downs, 1957; Lindbeck and Weibull, 1987). In the context of Central and Eastern Europe (CEE), economic reforms were greatly encouraged by the electorate; as shown in Figure 3.1 the main concern of the general public was that reforms were not implemented fast enough.

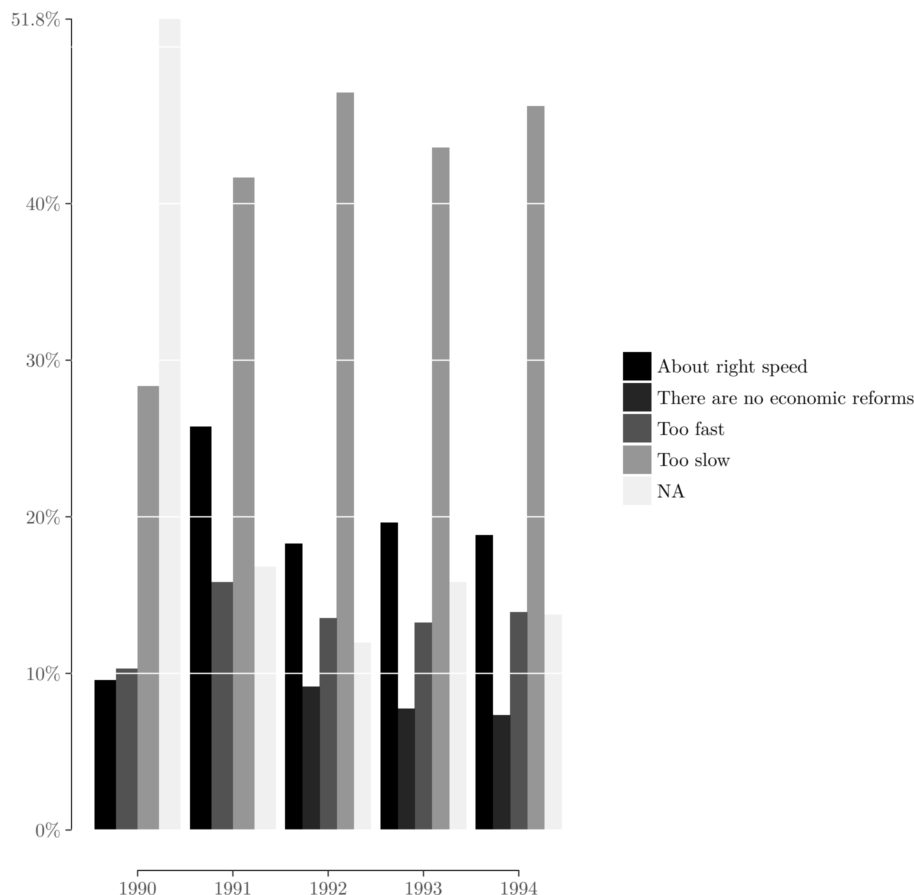


Figure 3.1 – The bar graph depicts the percentage of respondents in a number of former post-communist countries that, between the years 1991 to 1994, answered about the right speed, there are no economic reforms, too fast or too slow to the following question: The way things are going, do you feel that your country government's economic reform programme is going...?. The light-gray bars represent non-respondents. Source: Central Archive for Empirical Social Research (1997).

Another actor that in several countries was vested with de facto veto power, but was not accountable to the electorate was the central bank. Many of the reforms — like capital adequacy requirements, supervision structure etc.— were under the competence of the central bank, whose commitment to economic reform was facilitated by insulation from policymakers. A number of factors contributed to this insulation: (1) central banks were generally granted some form of independence vis-à-vis government institutions; (2) central banks held the power over the purse, and were therefor less affected by government budgets; and, (3) central bankers were recruited from a relatively small circle of people to which barriers to entry were small (J. Johnson, 2016, p. 13). It is well documented in the literature that central banks, as a baseline, are driven by a desire to maximise welfare. The central bank community in CEE and beyond is united by a set of widely shared principles and practices on economic policy, much in line with those found in the EU's financial market Acquis Communautaire (Acquis). Among other things, this includes monitoring and supervision of the banking sector, in accordance with the Bank for International Settlement (BIS) standards, of the banking sector to prevent possible financial meltdowns (Issing, 2012).

From Concept to Indicator

The importance of veto players for the social sciences has spurred a number of indicators measuring political constraints. Especially two are worth taking note of: the CHECKS index developed by Beck, Clarke, et al. (2001), and the POLCON variable made available through Henisz (2000). As noted by Keefer and Stasavage (2003), both indicators are based on objective criteria, and capture the existence of coalition governments or the divided control of two chambers in a bicameral system. This represents a great improvement from other measures used in the literature, which are based in subjective assessments of political institutions.

The POLCON indicator ranges between 0 and 1, and increases concurrently with the policy stability of the polity. It consist of two elements: "the number of independent veto points over policy outcomes and the distribution of preferences of the actors that inhabit them." (Henisz, 2000, p. 5). Thus, it takes into account not only the number of government branches with veto power, but also the distribution of preferences within and across these branches. Five actors are considered for the POLCON variable: the executive, the lower and the upper house of the legislature, sub-federal units, and the judiciary. Assuming that each actor is endowed with veto power over policy decisions, the political constraint can be calculated as "one minus the expected range of policies for which a change in the status quo can be agreed upon by all political actors…" (Henisz, 2000, p. 5). This requires information about the preferences of the different political

actors, which is derived from the assumption of uniformly distributed preferences, supplemented with information on the actual preferences of actors, when available.

Another approach is used for the computation of the CHECKS index, with the main difference being that uniformly distributed preferences are not assumed. Instead, the number of veto players is adjusted with regard to their independence from each other, as determined by the level of electoral competition, party affiliation, and electoral rules (Beck, Clarke, et al., 2001, p. 170). Political systems in which the legislature is not competitively elected are assumed to only have one veto player. In presidential systems, a value of 1 is assigned for the president and an additional point for each legislative chamber. However, if elections take place under closed-list rules and the president's party exercises control over a particular chamber, then the chamber is not counted as a check. For parliamentary systems, the index takes the value of 1 for the Prime Minister (PM) and 1 for each party in the government coalition, including the PM's own party, with the exception of a closed-list system in which the PM's party is the largest in the government coalition; in that case the sum is reduced by one.

Despite their conceptual differences, the two indicators are highly correlated with each other, indicating that they are tapping in to the same concept. I plot the bivariate relationship between annualy POLCON observations and annualy CHECKS observations in Figure 3.2. As expected, the correlation is strong and positive, with a Pearson product-moment correlation coefficient (PCC) and Spearman's rank correlation coefficient (SCC) of 0.641 and 0.740, respectively. That the SCC is higher than the PCC is explained by the fact that a diminishing marginal effect of an additional veto player is assumed for the POLCON index, i.e., the impact of an additional veto point on the probability that two random Members of Parliament (MP) belong to the same party. Conversely, the CHECK index increases linearly with additional veto points whose party affiliation is not from that of the government.

The assumption of a decreasing marginal effect from additional veto players is in line with the theoretical predictions made by Tsebelis, who argues that additional veto players do not necessarily increase policy stability (2002, Section 1.3). I do not make such an assumption in the theory presented in this chapter, and I will therefore apply the CHECKS indicator in the statistical analysis conducted in Chapter 4. An additional limitation that applies to both indexes is the sole focus on de jure veto players. However, as pointed out above, central banks were paramount in the reform of the financial markets in CEE, and were often vested with de facto veto powers. To my knowledge, no indicator that measures the veto power of central banks exists. For the quantitative analysis I will therefore have to rely on the second best option, not taking into account the importance of central banks. I will, however, include the role of central

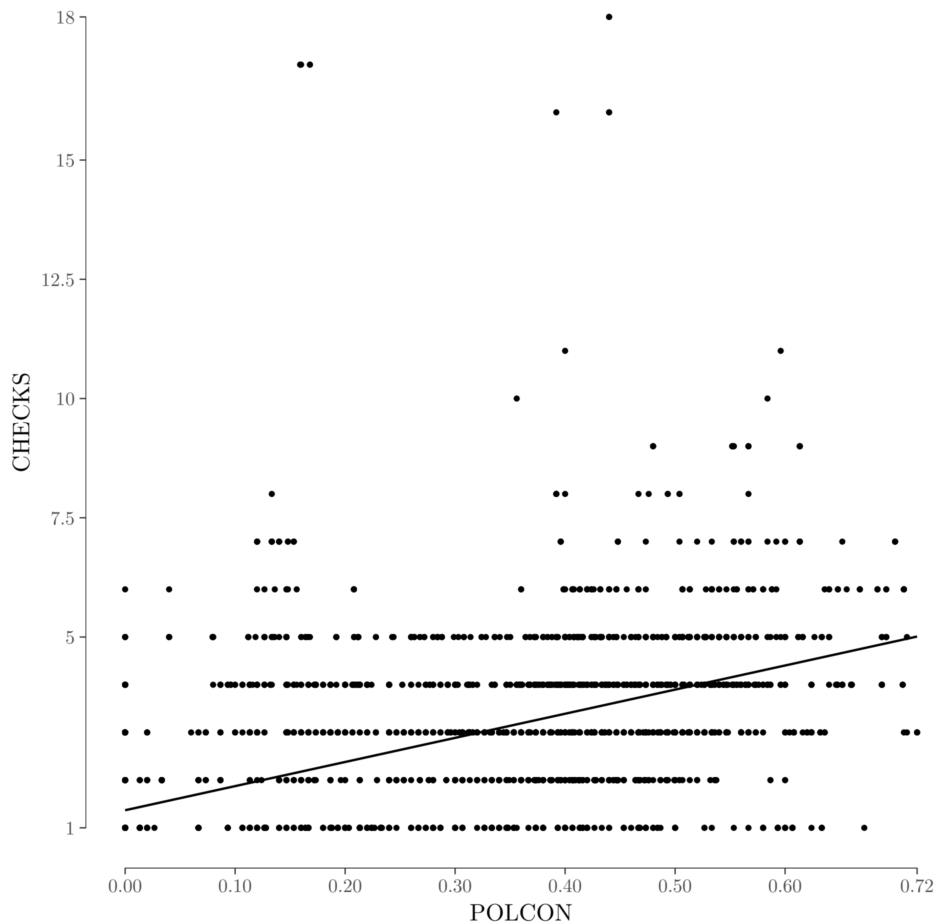


Figure 3.2 – The bivariate relationship between yearly POLCON observations and yearly CHECKS observations. $PCC = 0.641$ & $SCC = 0.740$.

banks in the qualitative analysis that has been done for this dissertation.

Missing values are recorded for 15.9 % of the cases in the CHECKS variable. Because the number of observations in the dataset is relatively small, it is important not to lose any additional information. I therefore impute missing values based on the methodology applied by Gehlbach and Malesky (2010, p. 968). The method uses the lagged values of the same index together with the concurrent values of the POLCON index. In cases with only one veto point both indexes assign the lowest possible score. Thus, if a country-year is recorded as missing in the CHECKS index, but given the lowest score in the POLCON index, I impute 1. For cases where no contemporaneous values exists, the last previous non-missing observation is carried forward; for all other cases the next non-missing observation is extrapolated back in time.

3.1.2 The Interest of Banks

Financial intermediaries, or banks, constitute the other group of actors in this account of financial market reform.[2] They are assumed to be motivated by profits, i.e., the desire to maximise current and future revenues streams, while at the same time cutting costs. Early theories of the political economy of transition reforms assumed that initial reforms would lead to increasing costs before the economic gains were realised (cf. Fernandez and Rodrik, 1991). This relationship between the benefits of reform and time is known as the J-curve in the literature and is illustrated by the dashed line in Figure 3.3. Thus, over time, the most efficient strategy for any society was to chose reform over no reform or partial reform, and take on the costs at an initial stage to later reap the rewards.

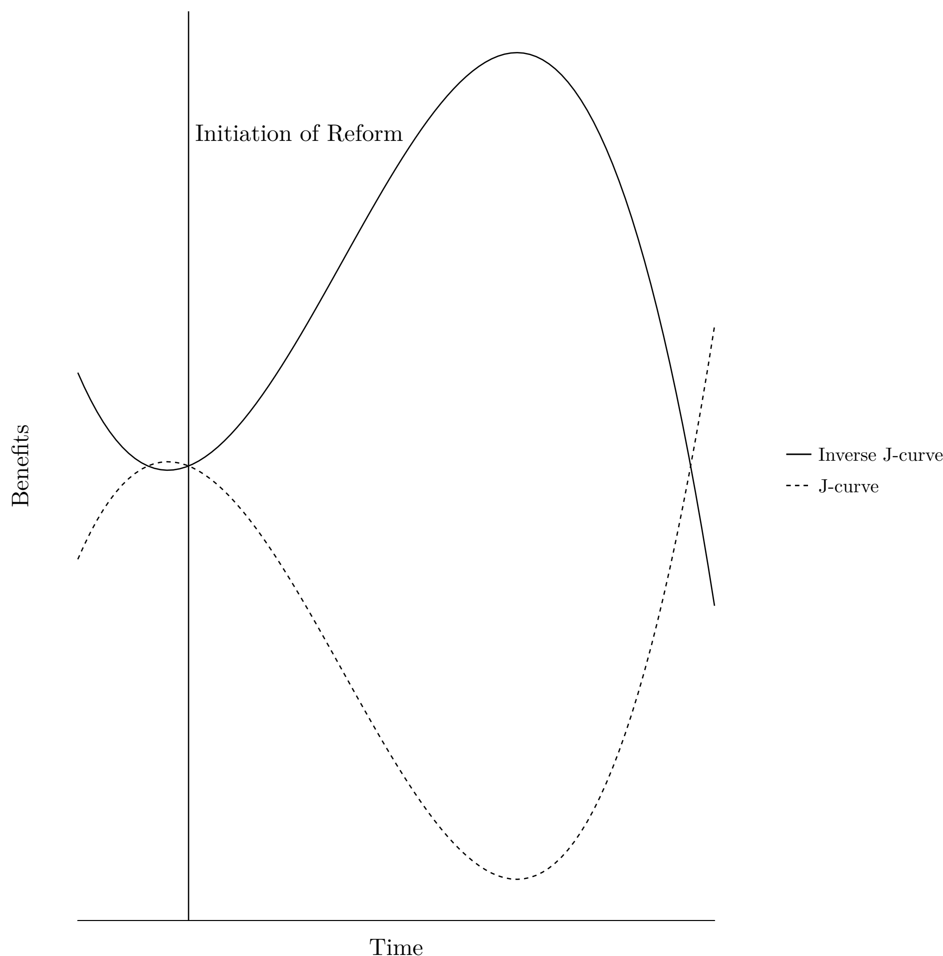


Figure 3.3 – The J-curve and the inverse J-curve

However, and as argued by Hellman (1998), the idea of the J-curve is too simplistic and obscures important differences in society. Many actors in society gained extensively from partial

[2] Financial intermediaries include, but are not restricted to banks. However, because all CEE countries' financial markets are dominated by banks, I focus only on them while disregarding other financial intermediaries, such as insurance and security companies.

reforms, which allowed them to engage in rent-seeking behaviour.

> These net winners did not oppose the initiation of the reform process, nor have they sought a full-scale reversal of reform. Instead, they have frequently attempted to block specific advances in the reform process that threaten to eliminate the special advantages and market distortions upon which their own early reform gains were based. (Hellman, 1998, p. 204).

The proposed relationship between costs and benefits for this group of actors is depicted as an inverse J-curve in Figure 3.3. Actors in this group welcomed partial reform efforts, but opposed attempts of full reform. Examples of such behaviour are abundant in the literature. On the one hand, banks may support high capital-to-asset ratios since they function as a barrier to entry, which allows them to worry less over competition (Djankov et al., 2002) On the other hand, the capital to asset ratio limits the amount of risk that banks are allowed to engage in, and by extension their potential profit.

But banks are not only driven by a desire to maximise profits, their preferences over reform proposals will also be dependent on their capacity to comply with the new reforms. If capacity is restricted, banks will not be able to meet the new requirements imposed on them. In the extreme case this implies that they will be forced to exit the market. Based on this observation, I argue that the banking sector should be understood as consisting of two types of actors: banks with high adaptation costs and banks with low adaptation costs. The former consists of small banks whereas in the latter we find larger banks. Concentrated markets face lower adaptation costs for mainly three reasons: (1) they are more diversified than smaller banks, which makes them less vulnerable to economic shocks in one sector of the economy; (2) higher concentration leads to higher profits for banks, while this might impose higher costs on consumers, it also allows banks to better absorb market failures; and, (3) the costs of supervision decreases with concentration of the markets, it is easier for supervisors to monitor few but large banks, rather than many small banks (on the benefits with concentrated financial markets, cf. Petersen and Rajan, 1994; Hellmann, Murdock, and Stiglitz, 2000; Beck, Demirgüç-Kunt, and R. Levine, 2003).

State-owned banks constitute an exception to this general rule. Although government-controlled banks are usually large they are often highly inefficient, and the adaptation costs for them are therefore high. In their study of the ten largest commercial banks in 92 countries, La Porta, Lopez-De-Silanes, and Shleifer (2002) find that government ownership of banks in the 1970s are associated with lower subsequent financial development. Similarly, applying a different dataset, Barth, Capiro, and R. Levine (2001) find that high levels of government ownership is correlated with less efficient financial markets. To conclude, fragmented markets

or markets dominated by large state owned banks are assumed to face high adaptation costs, whereas concentrated markets are characterised by low adaptation costs.

From Concept to Indicator

Two operationalisations follow from the previous sections: an indicator of the importance of state owned banks, and one that captures market concentration. To measure the importance of state owned banks I use the asset share of state owned banks provided by the European Bank for Reconstruction and Development (EBRD), where state owned banks are defined as banks in which the state has the controlling share.[3] To measure market concentration I rely on the Hannah and Kay Index (HKI). To construct such an index I rely on data from BankScope (2016), which collects time-series data for 43 000 banks world-wide. The construction of such index is, however, difficult and requires that one define the product and geographical scope of the market. Indexes of market concentration aim to capture a range of structural features of the market, reflecting changes that arise when new actors enter and when already existing participants exist. Any market concentration index therefore requires knowledge about who the market participants are, and their market share at any given point in time, which, in turn, necessitates that both the product and the geographical market are properly defined.

In general terms the product market is defined as the whole range of products that are considered substitutes by consumers. Banks offer potential customers a variety of financial instruments in which they can invest their money. To determine if two products are substitutable, assume a situation where consumers have made their choice of investment between two financial assets. If, in a situation where the price of one asset increases, consumers starts to transfer their investment to the other asset, then the two financial assets belong to the same product market. In reality this definition is not all that easy to make since it requires knowledge about consumer preferences with regard to financial products. As a solution to this difficult problem, I follow the practice in the literature, and define the product market as the whole range of financial products that are traded by banks, i.e., its total assets (cf. Bikker and Haaf, 2002).

Equally difficult is the definition of the geographical market, which requires the identification of existing and potential contacts between actual and potential market participants. If consumers are able and willing to move their investments from one locality to another, then the geographical boundaries of the market should be draw around the two localities; if, however, they are not, then the geographical market only includes the original locality. To define the geographical market is especially problematic with regard to banking. On the one hand, the scope of the

[3] The data for this indicator is based on the EBRD's Transition Reports.

market seems to be dependent on the type of banking product under discussion. For example, the local dimension is most probably of concern in the case of retail banking; whereas, the national, and sometimes even the international, level should be the focus for inquiry in the case of corporate banking. On the other hand, in the case of the EU the geographical scope is a moving target, since the overarching aim of the financial market Acquis is to expand the geographical boundaries of banking. A simplifying assumption is once again called for. I therefore define the geographical scope of the market at the national level, only including foreign banks that operate in the domestic market of a specific country.

After having defined the product and geographical market it is necessary to define market concentration in such a way so that the corresponding measures answer to one's needs. It is widely assumed that at least three components affect market concentration: customers decisions of where to spend their money, entry of new market participants and the exit of old ones, and mergers of already existing actors. Following Hannah and Kay (1977, pp. 48–50), I propose four criteria that the measure for this study should be judged against.

The concentration ranking criteria. If the concentration curve of one market constantly exceeds the concentration curve of another market, then the concentration index should yield a higher value for the former market as compared to the latter.[4]

The sales transfer criteria. If buyers on a market transfer from a smaller to a larger bank the measured concentration should increase, and vice versa.

The entry and exit criteria. If a bank with total assets smaller than the industry average enters the market, then market concentration should decrease. Conversely, the exit of a bank below the industry average should cause an increase in the concentration index.

The merger criteria. If existing banks merge a higher degree of concentration should be recorded in the index.

Several of the indexes found in the literature does not meet the above criteria. The k bank concentration ratio — which aggregates market shares of the k largest banks — is maybe the most commonly applied measure to market concentration, but it fails to conform to criteria 2 to 4.[5] Because the index assigns equal relevance to the k biggest banks, while disregarding all other market participants, it does not take into account changes in the market structure that occur below this level.

[4] The concentration curve ranks all banks from the smallest to the largest in terms of their total assets, and plot them (on the horizontal axis) against their total assets (on the vertical axis).

[5] Note that no convention for how to determine k exists in the literature, the cut-off point should therefore ideally be derived from theory.

Another widely used measure of market concentration is the Herfindahl-Hirschman Index (HHI); its main advantage compared to the k bank concentration ratio is that it utilise information from all market participants, and it is constructed in such a way that it meets all four criteria outlined above. Formally the measure can be expressed as:

$$\mathrm{HHI} = \sum_{i=1}^{N} s_i^2 \tag{3.1}$$

where s is the market share of bank i. By construction, the HHI weighs the individual bank's market shares by itself, which implies that the index will give priority to larger banks (Marfels, 1975, p. 490). However, the decision to raise the market shares to the power of two is arbitrary, and should therefore reflect theoretical considerations about the effect of sales transfers, entry and exit, and mergers upon market concentration. As has been suggested by Hannah and Kay (1977, p. xxx), it is therefore possible to generalise the HHI according to the following equation:

$$\mathrm{HKI} = \sum_{i=1}^{N} s_i^{\alpha} \tag{3.2}$$

where α is a weight chosen to reflect the assumption of the importance of different market characteristics on concentration. When $\alpha \rightarrow 2$, the HKI converges with the HHI. The HKI provides greater freedom to chose a weight that emphasises the importance of different segments of the market. An increase in the value of α gives greater emphasise to the larger banks on the market, whereas a smaller α gives prominence to the bottom segment of the market.

Equation (3.2) can also be expressed in terms of its number equivalent, which is the number of equally-sized banks for which the index would take the same value. The number equivalent is inversely correlated with market concentration. The benefit of such a transformation is that the index is made more intuitive, and is therefore easier to interpret. Formally the number equivalent of HKI can be expressed as:

$$\mathrm{HKI_n} = \left(\sum_{i=1}^{N} s_i^{\alpha} \right)^{1/(1-\alpha)} \qquad \alpha > 0 \quad \text{and} \quad \alpha \neq 1 \tag{3.3}$$

The relation between the two equations is best illustrated with an example. If α is set to 2, Equation (3.2) returns a value of 0.35; whereas Equation (3.3) returns the value of 2.86. This indicates that 2.86 equally sized banks would yield a concentration value of 0.35, given that $\alpha = 2$. As noted above, the choice of α reflects different assumptions of how sale transfers, market entry and exit, and mergers affect market concentration. When $\alpha \rightarrow 0$, the HKI converges to the number of banks in the industry, therefore emphasising the lower segments of the market. Conversely, when $\alpha \rightarrow \infty$, the index approaches the market share of the largest bank, drawing

attention to the upper segment of the market.

Table 3.1 applies four measures of market concentration to the countries of CEE between 1997 and 2013. Market concentration varies substantially across in time in the region, what is important here is, however, the relation between the different measures rather than the actual scores for the different countries. In the quantitative analysis I use concentration indexes for each year. Although there is great variation between the different concentration values, the rankings are relatively consistent across the indexes. This suggests that the indexes, despite their differences, are tapping into the same underlying concept. The table illustrates the effect of α. When α is approaching 0, the index converges towards the number of banks in the respective countries. If α is instead set to 10, and importance is given to the larger banks, the index shifts downwards.

Table 3.1 – Average Market Concentration in 17 Countries (1997–2013)

	Values				Rankings				
Countries	CR(5)	HHI	HKI(0.005)	HKI(10)	CR(5)	HHI	HKI(0.005)	HKI(10)	No. Banks
ALB	0.9	0.32	8.09	2.99	3	2	2	3	8
BGR	0.73	0.15	17.17	4.94	11	13	8	13	17
BIH	0.65	0.12	21.23	5.39	15	17	12	14	21
CZE	0.77	0.16	27.34	4.7	8	12	13	12	28
EST	0.98	0.51	6.31	1.69	1	1	1	1	6
HRV	0.76	0.17	32.95	3.88	9	11	16	8	33
HUN	0.63	0.13	32.08	4.01	16	15	15	9	32
LTU	0.93	0.29	8.72	2.82	2	3	3	2	9
LVA	0.79	0.17	14.94	4.33	7	10	6	10	15
MKD	0.81	0.24	12.43	3.15	5	4	5	5	12
MNE	0.85	0.23	9.06	3.35	4	5	4	6	9
POL	0.63	0.13	31.66	5.8	17	16	14	16	32
ROU	0.74	0.18	20.53	3.74	10	9	10	7	21
SRB	0.67	0.18	21.17	5.63	13	8	11	15	21
SVK	0.79	0.18	16.16	4.41	6	7	7	11	16
SVN	0.7	0.18	17.24	3.04	12	6	9	4	17
TUR	0.66	0.14	49.84	6.02	14	14	17	17	50

Bank data is derived from the BankScope database, which collects data for over 43 000 private and public banking institutions worldwide, and has been used in several cross-country studies (cf. De Bandt and Davis, 1999; Corvoisier and Gropp, 2001). While offering a unique coverage of banking institutions in the world, the database does not cover the entire population of banks in a country. For example, Bhattacharya (2003) finds that the BankScope database underreports regional rural banks and foreign banks in India. However, others find that BankScope in most cases covers over 90 % of the banks in a country (Cunningham, 2001). For this study, information about a total of 534 unique banks have been collected between years 1997 and 2013.

Total assets are retrieved from the banks' balance sheets. Unfortunately, financial statements are not always available, and their consolidated status differs across countries, which can potentially cause problems for the comparability of data. The six different consolidation codes found in the BankScope database are shown in Table 3.2. The dataset for the countries included

in the study are heavily skewed to unconsolidated statements, not taking into account possible controlled subsidiaries. The reminder is constituted by consolidated statements.

Table 3.2 – Consolidation Codes

Name	Definition	No.
C1	Statement of a mother bank integrating the statements of its controlled subsidiaries or branches with no unconsolidated companion.	520
C2	Statement of a mother bank integrating the statements of its controlled subsidiaries or branches with an unconsolidated companion.	3471
C*	Additional consolidated statement.	NA
U1	Statement not integrating the statements of the possible controlled subsidiaries or branches of the concerned bank with no consolidated companion.	14 324
U2	Statement not integrating the statements of the possible controlled subsidiaries or branches of the concerned bank with an consolidated companion.	NA
U*	Additional unconsolidated statement.	NA

The consolidation codes differ in how they account for the bank's total assets, so ideally one should use the same consolidation code across all banks for all years. However, this comes with the cost of increasing the amount of missing values. To compile a dataset as complete as possible, but at the same time avoiding double counting, I make use of both consolidated and unconsolidated statements. Hence, for cases where the same bank has multiple observations for the same year, I drop duplicate statements according to the following seniority rule: $C1 > C2 > C^* > U1 > U2 > U^*$. Although the ranking can be accused of being arbitrary, a rule like this one is necessary for a systematic treatment of the data. 2370 unique observations were identified after the seniority rule had been applied.

3.1.3 The Link Between the State and Banks

The baseline assumption that veto players are driven by a desire to increase welfare is mitigated by the influence of business, or more specifically banks.[6] This tension between aggregate social welfare and business interest is present in both advanced industrial societies and developing

[6]Much of the literature surveyed here deals with business in general and not with banks in specific. I will therefore often refer to the more generic term business in this section.

economies (cf. Bates, 1981). Financial markets are no exception, and banks occupy a prominent position in the political economy of a country because of their significance for the functioning of the real economy.

> In countries with greater financial development, small-firm industries represent a greater proportion of total manufacturing value added than in countries with lower levels of financial development. Thus, financial development disproportionately boosts both the growth rate of small-firm industries and the level of value added contributed by small-firm industries to total value added. (Beck, Demirgüç-Kunt, Laeven, et al., 2008, p. 1381).

For politicians the financial market is a tool with which the flow of resources can be directed towards important sectors of the economy, the financing of government expenditures, the implementation of monetary policy, the compensation of political supporters, and the punishment of political opponents (Gerschenkron, 1962, Chapter 1; Martinez-Diaz, 2009, p. 4).

Banks influence veto players through mainly two channels: structural power and the power of special interest. It is often difficult to distinguish the two sources of power in practice, and they should not, in fact, be understood as mutually exclusive, but rather as two strategies with the potential to reinforce each other. That business has access to policymakers is of course a consequence of its structural power. It is, nevertheless, important to make an analytical distinction between the two channels of influence, because they do in fact constitute two distinct strategies to influence government policy (cf. Hirschman, 1970).

The Structural Power of Business

The literature has explored in depth the notion that business does not need to organise into association or engage in explicit lobbying to influence policymakers. In fact, given business plays such a crucial role in social wellbeing, it naturally accrues tremendous structural influence. The mere potential that business might be harmed by a reform, forces policymakers to take its reaction into account. If not, they risk suffering the punishment of numerous uncoordinated business responses, with potentially adverse consequences for the economy and society.

> Do we want businesses to carry a larger share of the nation's tax burden? We must fear that such a reform will discourage business investment and curtail employment. Do we want business enterprises to reduce industrial pollution of air and water? Again we must bear the consequences of the costs to them of their doing so and the resultant declines in investment and employment. Would we like to consider

> even more fundamental changes in business and market — worker participation in management, for example, or public scrutiny of corporate decisions? We can hardly imagine putting such proposals as those on the legislative agenda so disturbing would they be to business morale and incentive. (Lindblom, 1982, p. 325).

In his seminal work — Exit, Voice, and Loyalty — Hirschman (1970) described this mechanisms of punishment and how it is frequently used in the market place. The option the consumer has to exit the market, Hirschman writes, carries with it the potential to inflict financial damage on the firm with whom the consumer is doing business. The management of the firm knows this, and is therefore cautious not to trigger the exit option among its consumers (1970, pp. 23–24).

The importance of exit in the relationship between business and its consumers is easily extended to the interaction between business and the state because business can be said to be for the state, what consumers are for business. In his later work, Hirschman acknowledges this extension of his argument: "exit of capital often takes place in countries intending to introduce some taxation that would curve excessive privileges of the rich or some social reforms designed to distribute the fruits of economic reform more equitably." (Hirschman, 1978, p. 100). Exit does not have to be exercised; it is enough that policymakers know that business has the opportunity to exit, which will force them to incorporate the possibility of exit in their utility function. Policymakers therefore carefully study the potential impact of policies upon business, and by extension their electorate.

There is, however, one caveat with the use of exit as a strategy. Once an actor has exited, he/she has forgone the opportunity to exercise any further influence over policy. Exit not only imposes costs on policymakers, but also on business itself. The importance of exit as a strategy therefore increases as the cost of exit to policymakers grows, and/or the cost to business decreases.[7] Hence, following the logic laid out by Hirschman (1970, 1978) we should expect policymakers to be more vulnerable to the exit option as the ease with which firms can relocate their business increases. Empirically, this proposition has been extensively researched by students of international political economy, arguing that the increasing mobility of capital has caused a regulatory convergence across the world. Capital mobility "restricts but do[es] not eliminate the possibility for national economic policy." (Frieden, 1991, p. 426). In a world with mobile capital, expansionary macroeconomic policies risk leading to business investing its capital elsewhere, a downward pressure on exchange rates, and the subsequent need to implement austere macroeconomic policies. This is especially true for emerging economies, for which the cost of exit is often lower. It is well documented that increasing capital mobility across the world

[7] If one incorporates uncertainty into the theory, business has an incentive to understate the true cost of exit.

has pushed emerging economies towards financial market deregulation, i.e., the liberalisation of international capital flows and regulations governing international operations of banks and other financial intermediaries (Haggard and Maxfield, 1996). Increasing capital mobility has reduced the cost of international economic exchange, resulting in an corresponding increase in the relative cost of regulations (Epstein, 2014, p. 773).

Exit does not have to be voluntary; it can also be forced because of the economic circumstances imposed on business, which may not always possess the capacity to comply with the rules and regulations. Emerging market economies that are trying to comply with the rules and regulations designed for the social and economic realities of more advanced economies, often lack the capacity to implement and enforce regulations, and, by extension, to fully benefit from the global economy (cf. Stiglitz and Charlton, 2005). This dynamic is increasingly common with the proliferation of regional trade agreements. Domestic capacity limitations are often a major obstacle for transnational market integration (cf. Bruszt and McDermott, 2014). McDermott and Avendaño Ruiz (2014, p. 40) find that small producers of fresh fruits and vegetables are prohibited from producing for the export market because of the high adaption costs of upgrading production to the standards required by foreign markets.

The Power of Special Interest

Public choice theorists have tended to conceptualise the relationship between policymakers and business as a market, governed by the forces of supply and demand. In this account, reform is a good demanded by business and supplied by the government. Through its monopoly of violence the state has the power to regulate, subsidise and tax markets etc., which can be used to greatly benefit selected market participants over other business and consumers (Stigler, 1971; Posner, 1974; Djankov et al., 2002). In return, business provides politicians with resources to win elections. Thus, “the incumbent politicians' objective is to maximize a weighted sum of total political contributions and aggregate social welfare.” (Grossman and Helpman, 1994, p. 836). Hellman, G. Jones, and Hellman (2003) and Hellman and Kaufmann (2001) shows that some transition economies have developed into high capture states, in which “public officials appear to have created a private market for the provision of typically public goods, [...] that a relatively small number of firms can obtain either through state capture or influence.” (Hellman, G. Jones, and Hellman, 2003, p. 753).

Numerous ways through which business can impact elections have been documented in the literature. Through the provision of financial contributions to campaigns with similar preferences, business tries to sway the electorate in their preferred direction (Hillman and Ursprung,

1988; Fordham and McKeown, 2003). There is some support in the empirical literature for the intuition that political campaigns can persuade voters to support a specific candidate, although the effect differs between different groups of voters (Huber and Arceneaux, 2005, p. 14). Unengaged voters tend not to respond to political advertising, whereas engaged voters with an initial preference for a candidate respond positively to political advertising (Clinton and Owen, 2006, pp. 18–23)

An alternative view holds that information asymmetries creates electoral incentives for voters to bias policy towards interest groups that are better able to monitor the policymaking process (Lohmann, 1998). With concentrated benefits and dispersed costs, special interests are often better informed than the average voter, about the reforms policymakers wants to enact. It is therefore more costly for politicians to go against special interests than the general voter. An case in point is the EU's Common Agricultural Policy (CAP). The farmers that are directly affected are often well-informed about policy, and how their political representatives stand on the issue. Conversely, the average voter is often ignorant about the politics behind CAP, and is therefore less likely to act upon any changes in the policy.

Nevertheless, others have viewed business influence "not so much as investments in the outcomes of elections, but more as a means to influence government policy." (Grossman and Helpman, 1994, p. 848). By providing information and financial resources to policymakers who lack the resources to pursue his/her reform agenda, business can influence the intensity and direction of policymaking (Hall and Deardorff, 2006, p. 72). The opportunity for business to influence the policy agenda is further increased as the policy-salience of the issue decreases (Culpepper, 2011).[8] Lower salience of an issue implies that policymakers will allow reforms to diverge further from the ideal point of the electorate, since its impact on the re-election chances is small.

Independently of which view one takes with regard to the channels through which business influences policymakers, most scholars writing in this tradition share an emphasis on the negative synergies that emerge from state-business relationships. Business uses its power over policy to gain benefits at the expense of the general public, a phenomenon described as state capture: "Self-interested politicians and constituents exchange objects of utility — a price or entry certificate for votes and money — and what matters to each actor is their wealth or utility, not the aggregate social wealth." (Peltzman, M. E. Levine, and Noll, 1989, p. 7). The key role that financial markets play, through the distribution of resources, for the business community and as well as the general public (Guiso, Jappelli, et al., 2004), makes the regulation of banking

[8]Kollman (1998, p. 9), defines political salience as the importance of an issue to the average voter, relative to other political issues.

highly attractive to politicians and private interests. Captured politicians will use banking regulations to restrict entry and generate large rents for insiders; in return, banks help to finance expansionary government policies, direct credit to politically-efficient, but not necessarily economically-efficient, ends, and maximise their chances for re-election (Barth, Capiro, and R. Levine, 2006, p. 35). Political capture was maybe most visible in Russia, where banks diverted government funds intended for agricultural medium- and long-term loans to the more, for them, profitable treasury bill market (J. Johnson, 2000).

Others have emphasised the potential positive synergies resulting from the link between the state and business. While recognising the potential for capture, studies in the tradition have focused on how policymakers are embedded in social networks from which trust and cooperation can emerge. This view is maybe most associated with Evans (1995), who argues that the need to insulate the state from business pressure has been overemphasised in the literature. Instead, the capacity of the state to create economic development is dependent on its ability to embed its officials in a "concrete set of social ties that bind the state to society and provide institutional channels" (1995, p. 59) for continued cooperation.

Embedded polities have the advantage of increasing the information available to actors about all other actors, something that can increase trust and generate cooperation among actors. Stark and Bruszt show how associative networks give rise to deliberation between actors that reduces uncertainty and facilitate the implementation of policies.

> Deliberations cannot harmonize interests or make them compatible because, if they indeed involve multiple logics, there is no single common principle of equivalence, but they can promote integration and coordination among competing, coexisting, and diverse evaluative principles and organizational logics. (1998, p. 134).

Similarly, Culpepper (2002, 2003) identifies how the link between business associations and the bureaucracy affects the state's ability to access private information about firms willingness to cooperate.

While the potential benefits of close ties between the state and business has been recognised in the literature, this group of scholars also recognises the risk that embedded policymaking carries with it. The first part of the concept of embedded autonomy emphasises the importance of a Weberian bureaucracy that is recruited based on meritocracy and empowered by enough autonomy not to be captured by special interests (Evans, 1995, p. 12). Stark and Bruszt highlight the conflict between embedded and autonomous: "[s]trong networks are a resource, but they are not unproblematically so. They have the capacity to be agencies of development — or to be rent seekers depleting the public treasury and inhibiting economic growth." (1998, p. 129).

3.2 A Theory of the Reform Process

It is now possible to specify in detail the different steps in the reform process. To simplify, I assume that actors are faced with three options — $R \in \{0, 1, 2\}$ — at any given point in time; where $R = 0$ is no reform, $R = 1$ is partial reform, and $R = 2$ is full reform.[9] The first veto player, who is also the agenda setter, decides which reform proposal to put on the agenda. Each subsequent veto player then decides whether to either accept or to veto the proposal. The process, involving four veto players, is illustrated in Figure 3.4. Veto player 1, the agenda setter, puts forward a proposal of either no reform, partial reform or full reform. If no reform is chosen the reform process ends. If, however, partial reform or full reform is chosen the turn goes to veto player 2, who can decide to either veto (V) or accept (A) the proposal. In the case of a veto the reform process ends, if the proposal is accepted the next veto player follows. The process continues until all veto players have accepted the proposal or at least one veto player has decided to exercise its veto power.

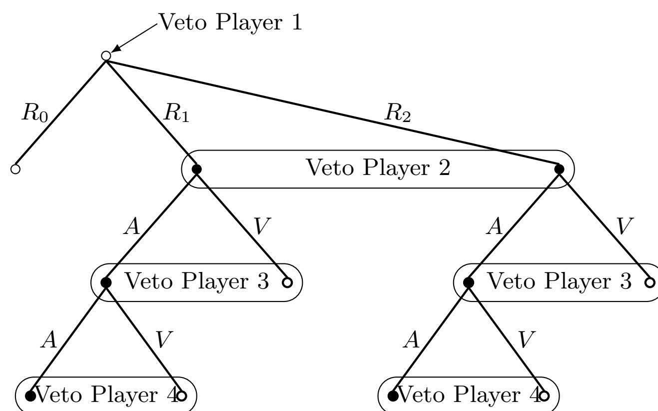


Figure 3.4 – The decision tree illustrates the reform process with four veto players.

As noted in Section 3.1, the type of reform chosen by veto players will be determined by the desire to maximise total welfare, mitigated by the power of special interests. Let's analyse each part of this statement in turn, beginning with the desire to maximise social welfare. In a hypothetical world without special interests, veto players' preferences for reform are determined by its impact on society, of which an important part is the effect it has on the banking market. If adaptation costs are high, i.e., financial markets are fragmented or dominated by state-owned banks, full reform might force banks out of business, and depositors risk losing their savings. In a world of perfect information veto players knows this, and we therefore expect them to prefer no reform or partial reform over full reform. I derive the following propositions:

[9]This notation follows what has been suggested by Gehlbach and Malesky (2010).

Proposition 3.2.1 An increase in market fragmentation will make the movement towards full reform less likely, all else being equal.

Proposition 3.2.2 An increase in the asset shares of state owned banks will make the movement towards full reform less likely, all else being equal.

If the assumption of perfect information is relaxed, it might be the case that individual veto players make a misinformed judgement about the true costs of reform for the financial market, and prefer a suboptimal policy. However, the risk of such a judgement becoming enacted decreases with the number of veto players. I therefore expect the following propositions to hold true:

Proposition 3.2.3 At high levels of market fragmentation, an additional veto player will make the movement towards full reform less likely, all else being equal.

Proposition 3.2.4 If asset shares of state owned banks are high, an additional veto player will make the movement towards full reform less likely, all else being equal.

I now proceed to analyse a world in which veto players' decision-making is mitigated by the influence of special interests. For a country where the banking sector faces high adaptation costs this does not change the conclusions in Propositions 3.2.1 to 3.2.4. If banks know that veto players will not attempt to implement reforms because of their adverse consequences, there is no need to engage in lobbying activity.

Now consider a market were adaptation costs are low. In such a situation the veto players have the following preference ranking $P_2 > P_0 > P_1$, whereas banks prefer $P_1 > P_2 > P_0$. The bank has to make an offer to the veto player so that $P_1 + C > P_2$, where C is the contribution made by the bank. Because P_0 is preferred over P_1 by the veto players, banks must compensate all veto players to chose P_1. However, banks will only make contributions to veto players as long as the expected utility of that contribution exceeds the expected utility from full reform. In other words, if banks do not expect that their contribution has an effect on the reform pathway they will decide to withdraw that contribution. As has been proven formally by Gehlbach and Malesky (2010), it might be the case that as the number of veto players rises the costs for banks to compensate veto players increase, until a point where: $P_2 > P_1 + C$. I therefore expect the following proposition to be true:

Proposition 3.2.5 At low levels of market fragmentation, adding an additional veto player will make the movement toward full reform more likely, all else being equal.

The theory proposed here departs from the original veto player theory proposed by Tsebelis (2002). It does so by including the structure of the financial market into the theory of the reform process. I argue that the importance of institutional veto players will depend on the market situation in the country. If financial markets are fragmented, consisting of many small and weak banks, economic actors are not able to capitalise on the economic reforms, an argument that finds support in the literature on transnational market integration (Bruszt and McDermott, 2014). Thus, as pointed out by Tsebelis (2002) adding an additional veto point to the political system will decrease, or keep constant, the probability of reform. As argued in Chapter 1, this account incorporates into the veto player theory the widely acknowledged idea of the importance of factions in the political economy. As such, there is no one institutional prescription that can be implemented in all countries. Instead it highlights the importance of taking countries' diverging market structures into account when setting up institutional infrastructure. Political institutions must be crafted in such a way that no faction is allowed to dominate and engage in rent-seeking behaviour, or as Hamilton and Madison (1788) put it, ambition must counteract ambition.

At high levels of market concentration additional veto players are expected to have the opposite effect. As described in Section 3.1.3, it is not uncommon that the interests of private economic actors and socially-optimal policies diverge. Hence, as Hellman (1998) has argued it is often in the interest of powerful economic actors to stall reform efforts even if they benefit society at large. However, at the same time I depart from the theory proposed by Hellman (1998), which argues that the responsiveness of the political system is key to understanding reform efforts. Instead, I put forward a theory where the institutional checks and balances are key to understanding reform efforts. In a similar fashion, I also depart from the theoretical account provided by Fish (1997), who argues that the decisive factor in the reform effort is the formative election. Although it is most probably the case that elections have an effect on the reform process it is not evident how such an event reverberates into the future.

3.3 Alternative Theories

The political economy of economic transition has been extensively studied in the literature, and numerous explanations have been proposed. Broadly speaking it is possible to distinguish between middle-range theories and theories based on a country's initial conditions. The former aims to establish a causal connection between regime type, interest groups, governance, or the EU, and economic transformation. The latter has shifted the focus to structural factors that shape reform efforts in a country.

3.3.1 Middle-Range Theories of Economic Reform

Political parties are essential for the policymaking process in well-functioning democratic societies, they represent different interests, and, depending on their size, they can influence the direction of economic reform in the country. In the post-communist setting, the old communist parties were often prominent opponents to market reforms in the transition period (cf. McFaul, 1995; Åslund, Boone, and S. Johnson, 2001). Communist parties with strong ties to the old regime did not always disappear immediately after the fall of socialism, and in many countries they still exists today (Åslund, 2013, p. 253). Figure 3.5 shows the average percentage of seats held by unreformed communist parties in each country included in the dataset since the beginning of the respective transition period. It is evident from the figure that the success with which the old nomenklatura has been ousted varies greatly across countries.

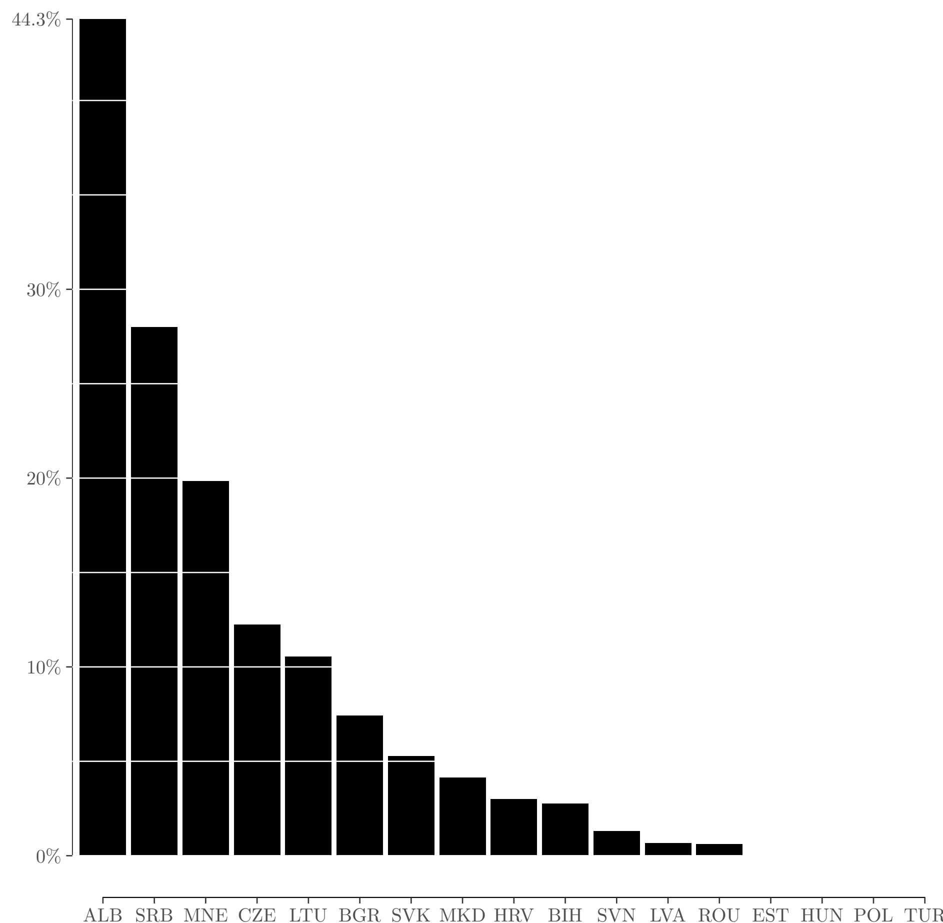


Figure 3.5 – Average percentage of seats in the legislature held by unreformed communist parties since the beginning of the transition period. Source: Armingeon et al. (2011).

In Lithuania the Communist Party of the Soviet Union (CPSU) successfully transformed itself in to a left-wing opposition party. The radicalisation of the Reform Movement of Lithuania (sajūdis) into a nationalist movement that sought confrontation with Moscow, pushed the

Lithuanian brach of the CPSU to distance itself from Kremlin, and in December 1989 it declared itself independent from Moscow (Nørgaard and Johannsen, 1999, p. 87). This allowed the party to play an important role in Lithuanian politics also after the independence, and in the spring of 1992 the sajūdis lost its majority in the parliament to the old communist party. This development differs from the one found in Estonia, where the local brach of the CPSU totally collapsed after the attempted coup d'état in Moscow 1991. Reform oriented left-wing politicians tried to transform it into a social democratic party, but failed win seats in parliament in the elections of 1992 and 1995 (Nørgaard and Johannsen, 1999, p. 73).

Åslund, Boone, and S. Johnson find that in countries where old communist parties stayed in power, reforms were initially delayed because of the strong incentives for the old elites to preserve the status quo, redistributing resources to themselves and their supporters (2001, pp. 226–227). A similar mechanism has been identified in subsequent work by McFaul (1995), who demonstrates how the old elite used their leverage to to engage in rent-seeking behaviour, with potentially detrimental effects on the privatisation process. An alternative theory has been proposed by Fish (1997), which differs from Åslund, Boone, and S. Johnson (2001) in that it only considers the outcome of the first election after the transition to democracy, while disregarding the outcomes of subsequent elections. It is, however, not evident why the impact of the first election should be greater on the reform process than that of subsequent elections.

To measure the seats held by unreformed communist parties I utilise the dataset compiled by Armingeon et al. (2011), in which election results for 28 post-communist countries are coded according to the party family they belong to. To that end, the party labels developed by J.-E. Lane, McKay, and Newton (1997) are used, and for the classification of the different parties Bugajski (2002) constitutes the main source. However, the dataset only covers the years between 1990 and 2009, to not lose further information I therefore extend the coding to also include the years between 2009 and 2014. In cases where new parties entered the political arena, a number of different sources have been used to cross-validate which party-family they belong to.

Parties that are part of the communist and post-communist party families have been included in the variable. Both party families include parties that are generally against market reforms and rapprochement with the EU.

> They supported continuing state control over the most vital economic sectors and have voiced skepticism if not outright opposition to their countries' joining the NATO and the European Union (EU). Some have underscored national protectionism against foreign "takeovers" and "alien influences" and have veered into the nationalist camp. (Bugajski, 2002, p. xlix).

Nota bene, the two party families exclude communist successor parties that have departed from orthodox Marxist-Leninist ideology. Although some of these parties have advocated state intervention and welfare-state protection, they have often been pro-business and proponents of EU membership.

Another middle-range theory commonly adhered to in the literature is the power of the EU (cf. Schimmelfennig and Sedelmeier, 2005b; Vachudova, 2005). The eagerness in many CEE countries to join the EU and become part of Western Europe allowed the Union to exert what Vachudova (2005) has termed a passive and active leverage over economic reforms in the potential member states. By applying conditionality the EU managed to empower pro-reform coalitions in the accession countries, and potential membership increased the benefits of reform to an extent that exceeded the costs of such reforms. Concerns about the direction of causes and effects have been raised. Did the EU exert leverage over economic reform in these countries, or were these reforms that the countries would have pursued anyway because of their preferences for market economy? However, for now it suffice it to say that since I am interested in studying variation of EU reforms across accession countries, the EU should not be considered as an explanatory factor.

3.3.2 The Power of the Past

The causal link between a country's initial conditions — what Frye (2007, p. 958) calls deep causes — and economic and political reform has been examined in a number of studies (cf. S. Fisher and Gelb, 1991; Sachs, 1996). The multiplicity of deep causes proposed in the literature, as well as the relatively small number of cases, renders the choice of initial conditions difficult. To remedy this problem, I follow the solution proposed by de Melo et al. (2001), who conduct a Principal Component Analysis (PCA) on a large number of initial conditions. Since many of the variables proposed in the literature are highly correlated such an approach is justified to reduce the dimensionality of the original variables. Students of initial conditions have generally focused on the years leading up to the fall of communism (Kitschelt, 2003, p. 49). However, while initial conditions of the early 1990s might be helpful in explaining the early transitional choices, they are less convincing explanations for subsequent economic reforms. I therefore collect data on 12 variables for the year before the accession process was initiated.

While all the countries in CEE shared a history of a communist past, the organisation and macroeconomic distortion of these countries varied substantially, leading to differences in their initial conditions. Countries where market institutions — such as private property rights, fiscal and financial structures, social safety nets etc.— were non-existent represents a completely dif-

ferent challenge to countries where these institutions existed but were severely distorted (Bruno, 1992, p. 743). This speaks to the idea of a positive relationship between initial economic development and subsequent economic reform. Following Ekiert (2003, p. 93), I identify three initial conditions of economic development commonly used in the literature: economic growth, economic distortion and urbanisation.

Gross Domestic Product (GDP) per capita has been collected using the Penn World Tables (PWT) with constant prices across countries and over time.[10] I use expenditure-side real GDP, a measure based on prices for final goods, rather than output-side real GDP — measuring prices for final goods, exports and imports — which is developed to capture the productive capacity of a country (Feenstra, Inklaar, and Timmer, 2015, p. 3151).[11] In addition to the GDP per capita I also include the change in living standards five years prior to the accession process, operationalised as the average yearly change in GDP in the five years leading up to the accession. Data is collected from the Total Economy Database (Conference Board, 2015).

Since the dissertation studies financial market reforms I also include additional variables that measure the strength of the financial market. The ratio of liquid liabilities to GDP is commonly used in the literature and captures the overall size of the financial market (cf. McKinnon, 1973; R. G. King and R. Levine, 1993; Alfaro et al., 2004). However, one should be careful not to interpret the size of the financial market as an indicator of its efficiency, bigger markets are not always more efficient (R. Levine, Loayza, and Beck, 2000, p. 37). Additional variables are therefore added. The share of private credit by deposit money banks and other financial institutions to GDP is an indicator of the development of financial intermediaries. The main function performed by commercial banks is to funnel credit to the most productive sectors of the economy. To measure how efficient banks perform this function I include banks' net interest margins and overhead costs, measures that are both extensively used in the literature (cf. Beck, Demirgüç-Kunt, and R. Levine, 2000, p. 601).

The policy requirements during the enlargements reflect the need of business in advanced market economies, characterised by business competing in the high-end of the quality segment of the market. Early on, economists saw a risk that transition countries would be trapped in low-quality production, and therefore would face few incentives and high costs of implementing EU policy requirements (Dulleck et al., 2004). Following this line of reasoning, we should expect the level of economic distortion to have a negative effect on the likelihood of economic reform.

I operationalise economic distortion as, on the one hand, a country's level of urbanisation.

[10] Prices are reported in US Dollar (USD), with 2005 as the base year.

[11] While the two indicators captures different aspects of the economy in a country, the disparity between the two measures is marginal for the countries included in the study. Moreover, changing the indicator does not substantially alter the results.

Countries with low levels of urbanisation are on average more rural with lower levels of industrialisation. On the other hand, I collect data capturing the difference between actual value of added industry production as a percentage of GDP, and the share one would expect based on the country's level of development. To this end, I apply the method developed by Syrquin and Chenery (1989). The data has been collected from the World Bank's World Development Indicators 2015.

Others have interpreted initial conditions in terms of the institutional heritage from communism, arguing that the time under and the degree of central planning affected negatively a country's ability to handle the market economic disequilibriums that arise under transition. Conversely, peoples' experience with the functioning of market economies seems to facilitate subsequent economic reform efforts (de Melo et al., 2001, pp. 8–9). Following de Melo et al. (2001), two variables captures the institutional legacy of communism. First, a discrete variable that expresses the difference in quality of political institutions, distinguishing between: (1) new countries established after the fall of communism; (2) countries that were part of a federation such as Yugoslavia and the Soviet Union; and, (3) countries that were independent states before 1989. Second, a continuous variable indicating years under central planning.

It is commonly argued in the literature that the diffusion of norms, resources and institutions from the centre to the periphery positively affects economic reforms (Kopstein and Reilly, 2000, p. 25). Lesson drawing is the "response to domestic dissatisfaction with the status quo…" in which "[p]olicymakers review policies and rules in operation elsewhere and make prospective evaluation of their transferability, that is, whether they could also operate effectively in the domestic context." (Schimmelfennig and Sedelmeier, 2005a, p. 21). Rose (1991, p. 13) points out that an important factor influencing the possibility for lesson-drawing is the familiarity of other political systems. I operationalise the diffusion theory by two variables: geographical proximity and trade dependence. Spatial proximity to the West is a binary variable indicating whether a country share borders with a EU-15 country.[12] An alternative would be to have used the variable utilised by Kopstein and Reilly (2000), which measures the distance between the country's capital and Berlin or Vienna, whichever is closer. Although the outcome of the two measures are similar the problem with using the distance calculated in miles is the arbitrariness in the choice of end points. It is not clear to me why Berlin and Vienna should be chosen as the cities against which the distance is measured. Why not Rome, Helsinki or Stockholm? I therefore chose to use the binary measure of if a country share borders with the EU or not. Trade dependence is measured as the percentage of trade to GDP with advanced market economies

[12] Borders are here understood to also include maritime borders.

(as defined by the International Monetary Fund (IMF)).Countries with high levels of trade dependence are expected to be better integrated into the global production chain, with the opportunity to benefit from closer ties with advanced market economies.

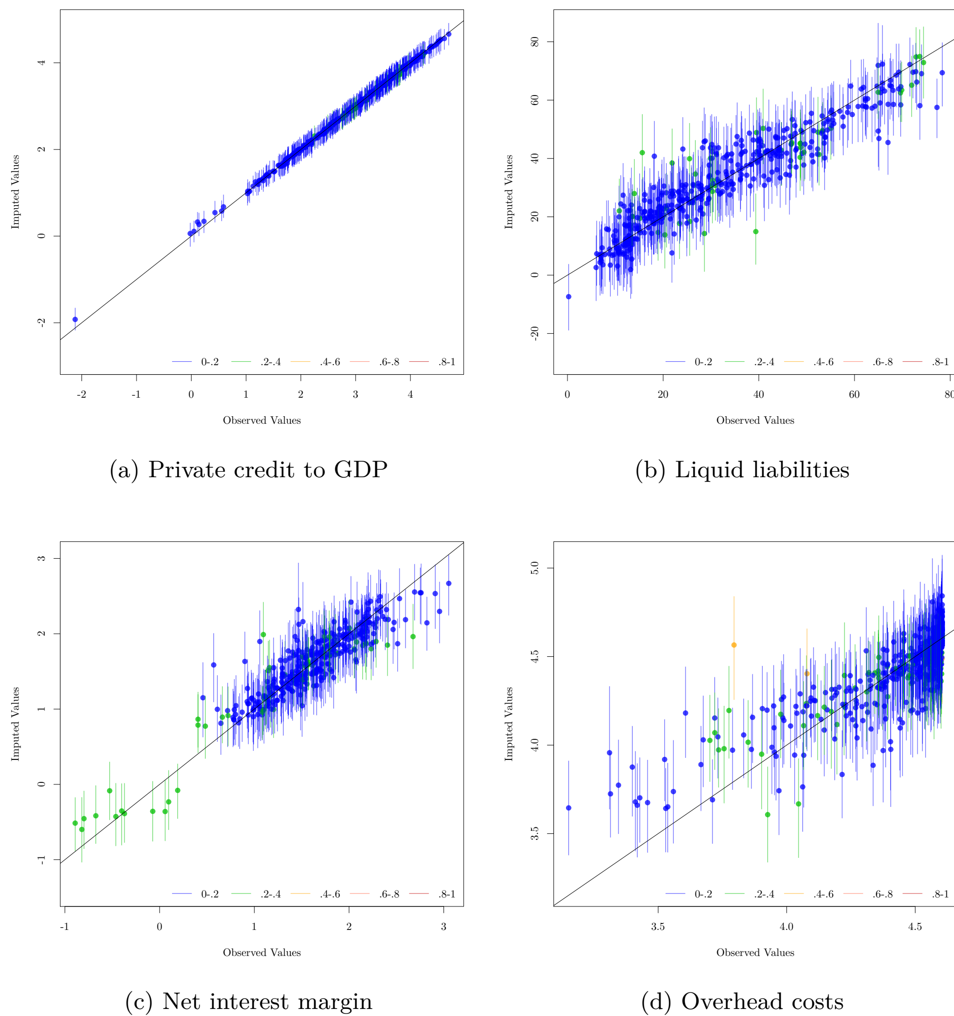
Principal Component Analysis

To express the initial conditions in fewer dimensions I apply a PCA, which is a data-reduction technique that transforms a multidimensional phenomenon into fewer dimensions. It does so by identifying principal components that capture the greatest possible variation in the original variables, i.e., the first component accounts for the maximum possible variation in the data, and the second principal component captures the maximum variance not accounted for by the first principal component etc.

Missing values for some of the variables poses a problem for the PCA.[13] The average missing rate for the for the four variables is 18 %, ranging from 4 % in Bulgaria to 26 % in Bosnia & Herzegovina. Most countries, however, has a missing rate below 10 %. Three approaches to solve this problem come to mind. One possibility would be to use the value of the time period that is closest in time to the missing value. Alternatively, it is possible to rely on some ad hoc technique, such as mean imputation to account for the missing values. However, experiments show that such methods are prone to create biased results (Honaker and G. King, 2010, p. 562). Instead, I use the technique developed by G. King, Honaker, et al. (2001), which, based on the information in the dataset, imputes 10 values for each different cell, generating 10 different datasets. The new datasets are later combined by taking the average of each cell. To avoid that the imputation technique depends too heavily on outliers I take the natural logarithm of the variables with a skewed initial distribution.

To test the accuracy of the imputation technique I generate multiple imputed values for each observed value. The result is seen Figure 3.6, which plots the imputed values against the true values. The diagonal line represents a perfect agreement between imputed and observed values. The lines connected to each dot represents a 90 % confidence interval, and the colour of the dots represents the fraction of missing observations in the dataset in the pattern of missing values for that observation. Panel 3.6a describes a close-to-perfect relationship between imputed and true values. All the dots cover the diagonal line, and we can there be confident in the assumption that the imputed values will be close to the true values. Although the three remaining panels depicts a higher degree of noise, the assumption that the imputed values are close to the true values is still warranted. Over 90 % of the confidence intervals covers the diagonal line.

[13] The variables concerned are liquid liabilities to GDP, private credit by deposit money banks and other financial institutions to GDP, net interest margin, and banks' overhead costs as a share of total costs.



(a) Private credit to GDP (b) Liquid liabilities

(c) Net interest margin (d) Overhead costs

Figure 3.6 – Over-imputation Graphs

Because PCA aims to maximise the variance explained in the data, the method is sensitive to scale differences in the variables. To correct for this I standardise all the variables included in the analysis to have a mean of 0 and a variance of 1. Around 50 % of the variation in the twelve variables can be accounted for by the two first principal components. Adding the third and the fourth variable, over 75 % of the variation is explained. The number of variables to include in the statistical analysis is a choice between simplicity (as few variables as possible) and completeness (accounting for as much of the variation as possible). Kaiser's rule suggests that all principal components with a variance greater than one should be retained for the analysis. This is because a variance of one or greater implies that the principal component explains at least as much of the variation as any of the original variables, i.e., principal components with a variance of less than one explains less of the variance then any of the original variables.

The screeplot in Figure 3.7 elucidates the relationship between the principal components and the variance. Principal components five to twelve all have variance below 1, which, according

to Kaiser's rule, implies that they should be dropped, retaining only four variables for the analysis. Nevertheless, a clear break between the second and the third principal component is also evident from the figure, which tells us that the residual principal components, 5 to 12 explains substantially less of the variation in the data. Hence, this represents a natural break in the data, and given the limitations of the statistical analysis with regards to degrees of freedom I opt for including only these two principal components into the analysis.[14]

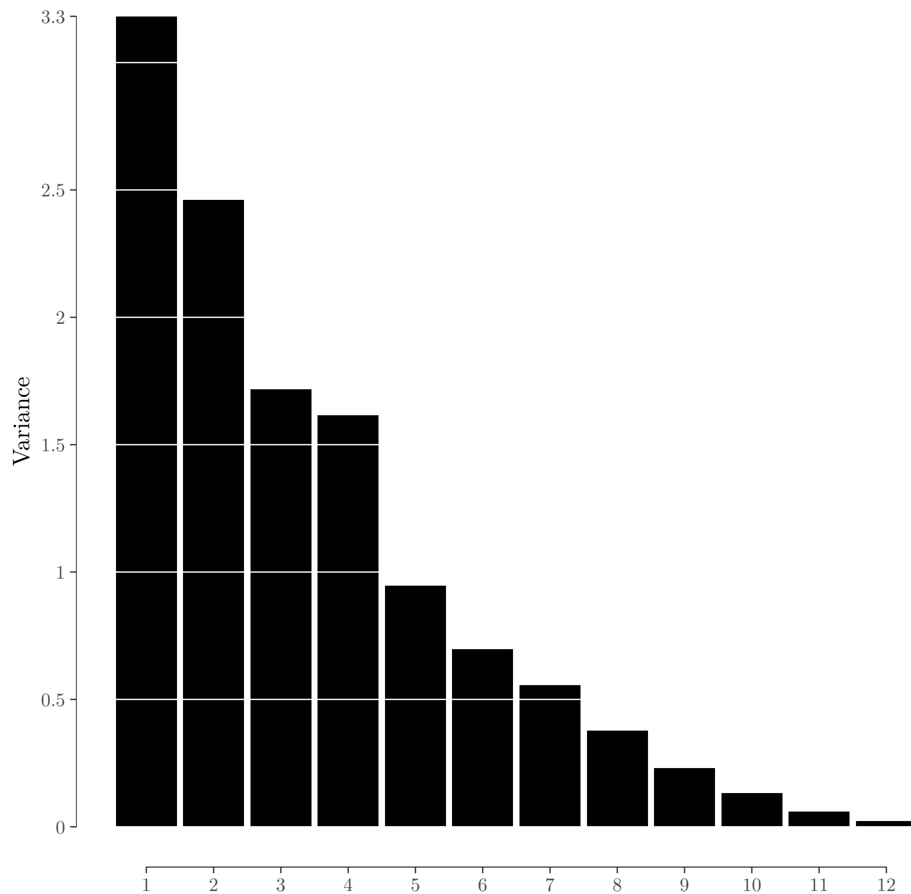
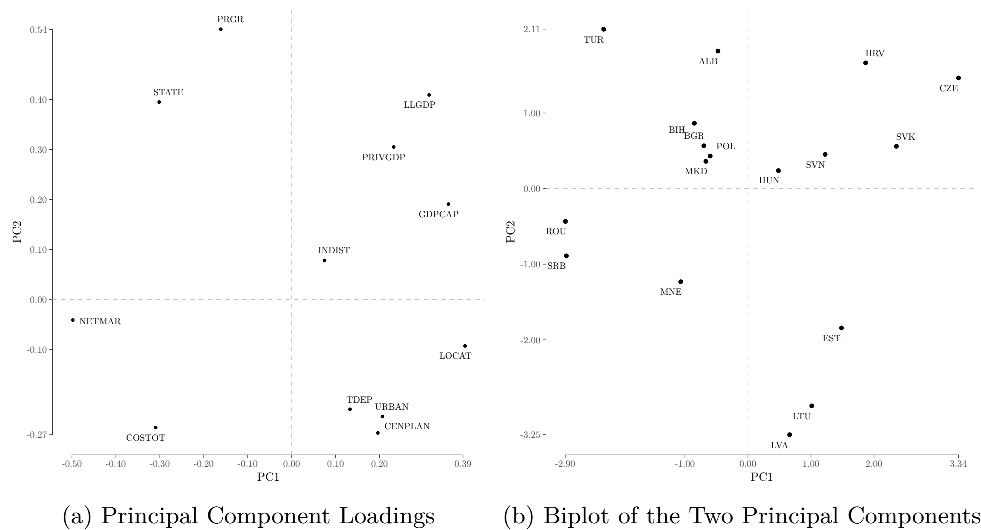


Figure 3.7 – The screeplot depicts the variance that by the respective principal components.

The interpretation of the two principal components is facilitated by the left hand panel in Figure 3.8, which plots the loadings of the original 12 variables against the two principal components selected for the analysis. Four variables loads heavily on PC1, which explains 26 % of the variation in the data: net interest margin, overhead costs, geographical location and GDP per capita. Thus, this principal component should be interpreted as an index of financial and economic efficiency, and geographical proximity to the West. The PC2 accounts for an additional 20.5 % of the variation in the data. Panel 3.8a shows that both years under central planning

[14]However, running the regression with more variables included into the analysis do not alter the results substantially.

and the quality of political institutions are highly correlated with PC2, which can therefore be interpreted to capture the initial political conditions after the fall of communism. Depth of financial intermediation is also captured by the second principal component, and so is trade dependence, urbanisation, and prior growth rates.



(a) Principal Component Loadings (b) Biplot of the Two Principal Components

Figure 3.8 – In the left hand panel I plot the loadings of the original variables on the first two principal components. The right hand panel plots the biplot of the (scaled) first two principal components.

It is now possible to plot the countries against the two principal components, as depicted in Figure 3.8b. The three Baltic states group together in the bottom-right quadrant of the plot. This is driven by many years under central planning, high trade dependence and urbanisation. Montenegro, Romania and Serbia are all located in the bottom-left quadrant, driven to a large extent by relatively inefficient financial markets and distance to thriving market economies. The majority of the countries are found in the upper half of Figure 3.8b. In the left quadrant we generally find countries with higher growth rates, and a history of independence. In the right hand quadrant, on the other hand, we find countries higher GDP per capita levels and with greater depth of financial intermediation.

3.3.3 Concluding Remarks

A central goal of this dissertation is to put forward a theory of reform that can explain institutional reform paths in emerging market economies. In so doing, I build on the extensive literature that deals with the interplay between special interest and policy-makers.

At each point in time the policy-maker (i.e. veto player) makes a decision on whether to put forward a reform proposal or not, if the policy-maker decides not to put forward the policy proposal the reform process end, if, however, the policy-maker decides to put forward a reform proposal the decision on whether to veto the reform or not goes to the next policy-maker. The

process then continues until the proposal is accepted or at least one policy-maker has decided to veto the decision.

The decision of a policy-maker to veto a reform proposal or not will depend on the perceived impact of the reform upon society. In the case of the financial market this will to a large extent be dependent on how well the company operating on the market will be able to handle the reform. This understanding of a reform process therefore departs from the original account of the veto player theory, as developed by Tsebelis (2002). It does so by including the structure of the market as a factor that the policy-makers have to take into account when deciding upon a reform proposal.

Chapter 4

Veto Players, Market Fragmentation and Reform

Based on the theoretical framework presented in Chapter 3 I now turn to the statistical analysis of the dissertation. Formally the data can be described as:

$$Y_{it} = f(\alpha + \beta \boldsymbol{X}_{it} + \varepsilon_{it}) \tag{4.1}$$

where i represents the $1, \ldots, N$ distinct groups observations, which in this dissertation are made up by the 17 countries; and t indexes the $1, \ldots, T$ repeated time observations within each country. Panel data has the advantage of offering repeated measures for the same country over time, allowing for both within and between effects on the outcome variable. The latter refers to the average impact on Y that originates from a one unit difference in X across units; whereas the within effect is the effect on Y of a one unit increase in X within a group. This is maybe most obvious in the box plot in Figure 4.1, which shows substantial variation across the different countries in the dataset. Within country variation is also observed for most countries, with some notable exceptions: Bosnia & Herzegovina, Macedonia, Montenegro and Serbia, where only small, to no, changes over time have taken place.

Panel data also differs from pooled cross-sectional data in that it follows the same group of countries over time. As such, the observations are correlated over time, but independence across countries is assumed. That observations are correlated over time renders Generalised Linear Models (GLM) obsolete since they assume independence across observations. One is therefore forced to seek alternative statistical methods that are able to deal with dependent observations.

The dataset at hand can be studied from different perspectives. It is possible to understand reform as binary variable that records whether reform has taken place or not in a specific year.

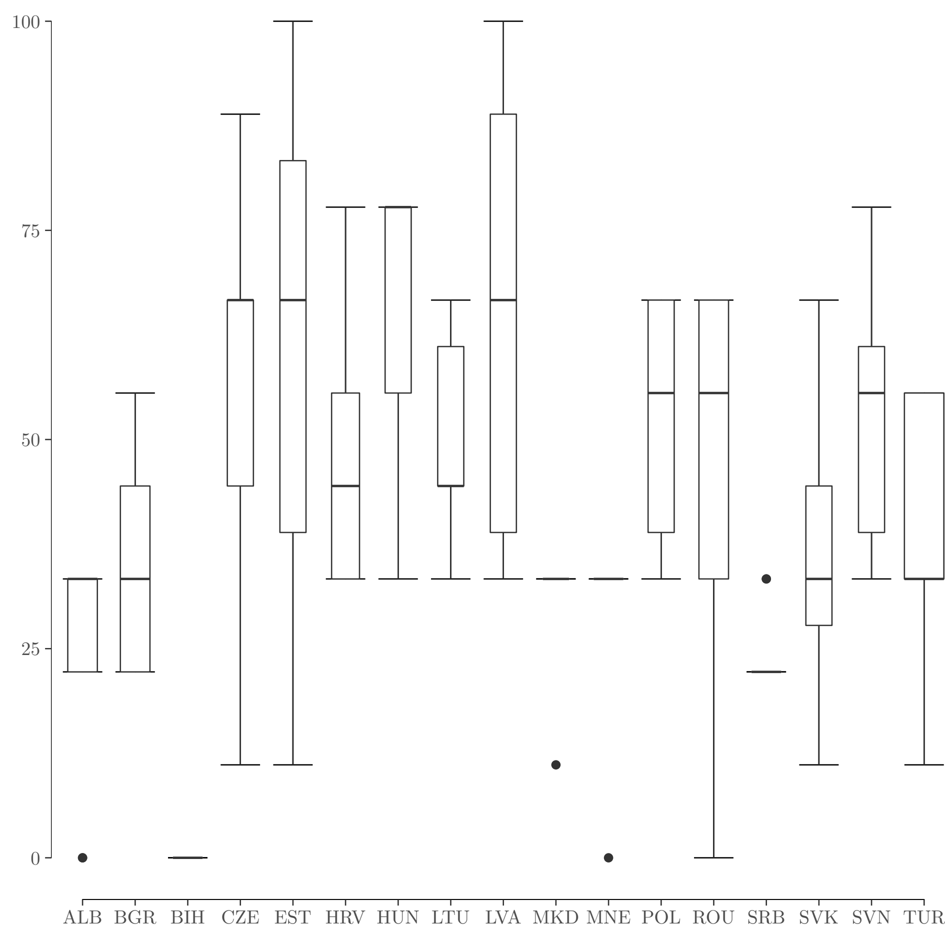


Figure 4.1 – The boxplot depicts the reform heterogeneity across and within the 17 countries in the dataset. The median is represented by the black line, the two hinges are the first and the third quantiles in the data. The two whiskers connect the quartiles to the extreme values on each side of the box. The black dots show the outliers in the dataset.

Furthermore, because the dataset contains information about reform according to three different dimensions, it is also possible to treat the data as a count variable, recording the number of reforms that have taken place in a given year.[1] A third way to approach the dependent variable is to study it as the movement towards full reform. As such the different levels of compliance become interesting. To deal with this different approaches to the dataset I have divided the chapter into two sections. In the first part I use the Generalised Estimating Equations (GEE) model, which has been developed to study patterns of change over time were observations are dependent (Liang and Zeger, 1986). The model is applied to binary and polychotomous transformations of the outcome variable. The second part of the analysis treats the data as a continuous variable, ranging from 0 to 100 applying the Random Effect Model (REM).

[1]I exclude the behavioural dimension at this point in the analysis. This is done because the predictor variables included in the analysis are not expected to have an impact on the behaviour of the supervision authority. I will instead explore the relationship between legislation, procedures and resources on the one hand, and, behaviour on the other hand in Section 4.3 of this chapter.

4.1 Generalised Estimating Equations

At the first stage in the analysis I treat reform as a dichotomous event, from which I construct two related but distinct indexes. The first is a binary variable that is based on the occurrence of reform in at least one of three dimensions for which data has been collected: legislation, procedures, and resources. The outcome variable takes a value of 1 if reform took place that year and a value of 0 if no reform was recorded. For example, if reform was observed in only one dimension, that country-year is coded as 1. Similarly, if reform was implemented for all three dimensions, that country-year is also coded as 1. Reform has been recorded in 37.1 % of the 124 country-year observations.

The second variable is a polychotomous outcome variable for which the number of reforms in all three dimensions and for each country-year is counted. Thus, the variable ranges between 0 and 3, where 0 implies that no reform took place that year and 3 that reform in all three dimensions were implemented for that specific year, which can be expressed formally as $Y_{it} \in \{0, \ldots, 3\}$. The most common outcome is no reform, which occurred in 62.9 % of the cases, 1 reform event was recorded for 24.2 % of the observations, with 2 and 3 being recorded in 10.5 % and 2 % of all cases, respectively.

To analyse the two outcome variables I use GEE, which is well suited for longitudinal analyses with a small number of observations per unit, especially when the response variable is either binary or in the form of counts (Hanley et al., 2003). GEE models have the advantage of allowing the researcher to define a correlation matrix — also known as the "working correlation matrix" — that specifies the dependencies across the yearly observations within a cluster. That observations are are not independent within a cluster should be assumed for the dataset at hand. Reform at any given point in time will necessarily be correlated with earlier reform efforts. An unlimited amount of correlation matrices can be specified, and should ideally reflect theoretical expectation about the correlation between observations. However, three correlation matrices are worth discussing in depth since they are used more extensively in the literature.

The independence correlation matrix assumes that values of Y_i do not correlate, meaning the working correlation matrix is therefore equal to the identity matrix. This implies that estimates are equal to pooled GLM. The exchangeable correlation matrix is formally defined as $corr(Y_{it}, Y_{it'}) = \rho$ and $t' \neq t$; as such, all observations are assumed to be identically correlated within the cluster. Conversely, the AR-1 autoregressive correlation matrix (AR-1) assumes the dependency of Y_i to be equal between observations 1 and 2 and 2 and 3, but that the covariation between 1 and 3 is an exponential function of the lag length between the two observations. In other words, the correlations between observations decrease exponentially over time. AR-1 can

be expressed formally as $corr(Y_{it}, Y_{it'}) = \rho^{|t'-t|}$, and $t' \neq t$. In the unstructured correlation matrix no restrictions are placed on the correlations, which can then be estimated from the data. The advantage of this correlation matrix is that it results in the best possible fit. However it does comes at the expense of potentially losing many degrees of freedom.

Unfortunately the literature does not provide much help on how to best specify a working correlation matrix. Nevertheless, the estimates main parameters β are consistent even if the correlation matrix is not correctly specified, and it has been shown that the efficiency losses for a wrong specification are modest (Zorn, 2001, p. 476). The regressions estimated in Table 4.1 are using the AR-1 working correlation matrix with one period of dependency. This assumes that reform events in years that are close in time are more highly correlated than those further apart. However, the results are similar also with other specifications of the working correlation matrix.

To estimate $\boldsymbol{\beta}$ for the binary outcome variable I apply the GEE logistic and probit models. The difference between the two models is in their link function. The logistic regression is based on the Probability Density Function (PDF), whereas the probit model uses the Cumulative Distribution Function (CDF). This implies that the probit curve has flatter tails, and therefore approaches the axes more quickly. However the results from the two models are very similar. The GEE logistic regression can formally be expressed as:

$$PR(Y = 1|X) = \frac{1}{1 + exp(-\beta \boldsymbol{X}_{it})}, \tag{4.2}$$

where Y is the dichotomous dependent variable, X_{it} an vector of covariates for unit i at time t, and β represents the vector of coefficients. The GEE probit model is expressed as follows:

$$PR(Y = 1|X) = \Phi(\beta \boldsymbol{X}_{it}), \tag{4.3}$$

where Φ is the CDF of the normal distribution with mean 0 and unit variance.

The results of the statistical analysis are depicted in Table 4.1 the direction of the effects are similar for both the logistics and probit models, and are statistically significant. The goodness of fit reported in the table shows that the models correctly predict around 70 % of the observations.[2] This implies that the model provides some additional predictive capacity compared to randomness.

Recall Proposition 3.2.1 of the theory, which hypothesised a negative association between

[2]The goodness of fit measure is based on the predicted probabilities of the models, i.e., $\hat{\pi} = F(X'\hat{\beta})$. If the predicted probability is greater or equal to 0.5 $y = 1$, for all other cases $y = 0$. Goodness of fit is then derived by dividing the number of correctly predicted values by the total number of observations.

market fragmentation and the likelihood of a move towards full reform. Models 1 and 4 test this proposition. The market fragmentation predictor is negative and statistically significant, whereas the statistical effect of veto players is not separated from 0, this supports the proposition that more fragmented markets are more difficult to implement reform in. However, Proposition 3.2.2, which stipulates a negative relationship between the movement towards full reform and state ownership of banks, is not supported by the data. The effect goes in the opposite direction and is both small and statistically insignificant.

In Models 2, 3, 5 and 6 the interaction effect between veto players and market fragmentation is tested. The results indicates that at high levels of market concentration, the effect of an additional veto player is positively associated with a movement towards full reform. Conversely, there is a negative relationship between reform and an additional veto player at high levels of market fragmentation, just as we would expect from Propositions 3.2.3 and 3.2.5.

A drawback of Models 1 to 6 is that substantial interpretations of the result are difficult to make since the coefficients do not provide information about the magnitudes of the effects. To correct for this I calculate the marginal effects, which reflect the change in probability of reform given a one point increase in the variable of interest. However, because the marginal effects are a non-linear function, it is necessary to estimate the effects at specific values of the predictor values. Following what is custom in the literature, I estimate the average marginal effects.[3] Formally they can be expressed as:

$$AME_i = \beta_i \frac{1}{n} \sum_{k=1}^{n} f(\beta x^k), \tag{4.4}$$

where β_i is the coefficient for variable x_i, and βx^k is the observed value of x_i times the coefficient for the kth observation.

The average marginal effects of Models 1 to 6 are shown in Table 4.2 with a 95 % confidence interval.[4] According to Model 1 the average marginal effect of increasing market fragmentation is small and negative, and tells us that a one point increase in the bank number equivalent — i.e., increasing the number of equally-sized banks with one — is, on average, associated with a 5.6 % decrease in the probability of reform, give or take around five percentage points. In other words, we are on average more likely to observe financial market reforms in countries with more fragmented markets. The margins of error for both the veto player and state ownership

[3] Another common method applied in the literature is to calculate the marginal effect at the mean, which can be expressed as $MEM_i = \beta_i f(\beta \bar{x})$. This method calculates the effect for the average country in the sample, which might be a problem if no such country exists. Nevertheless, in most cases the difference between the average marginal effect and the marginal effect at the mean is negligible.

[4] Because the effects of the both the GEE logistic and probit are almost identical I will base the substantive interpretation of the data on the logistic ones. However, the same reasoning can of course be applied also for the probit models.

Table 4.1 – Generalised Estimating Equations

	Dependent Variable: Banking Reform					
	GEE Logit			GEE Probit		
	(1)	(2)	(3)	(4)	(5)	(6)
Intercept	−0.316	−2.724***	−3.699***	−0.223	−1.669***	−2.259***
	(−1.581, 0.948)	(−3.734, −1.714)	(−5.208, −2.190)	(−0.985, 0.540)	(−2.238, −1.100)	(−3.139, −1.379)
Veto Players	0.172	0.927***	1.009***	0.099	0.560***	0.602***
	(−0.062, 0.406)	(0.603, 1.251)	(0.596, 1.422)	(−0.044, 0.243)	(0.382, 0.738)	(0.369, 0.834)
Market Fragmentation	−0.258**	0.330**	0.567***	−0.148**	0.199**	0.341***
	(−0.471, −0.045)	(0.093, 0.567)	(0.314, 0.819)	(−0.270, −0.026)	(0.067, 0.331)	(0.201, 0.480)
State Owned Assets	0.010	0.004	0.014	0.007	0.003	0.010
	(−0.007, 0.027)	(−0.014, 0.021)	(−0.004, 0.033)	(−0.003, 0.018)	(−0.008, 0.013)	(−0.002, 0.021)
Initial Conditions 1			0.335***			0.203***
			(0.192, 0.479)			(0.119, 0.287)
Initial Conditions 2			−0.145			−0.098
			(−0.351, 0.061)			(−0.223, 0.027)
Communists in Legislature			−0.001			0.001
			(−0.020, 0.019)			(−0.011, 0.013)
Veto Players * Market Fragmentation		−0.183***	−0.211***		−0.109***	−0.124***
		(−0.285, −0.080)	(−0.312, −0.110)		(−0.166, −0.053)	(−0.179, −0.070)
Goodness of fit	0.669	0.710	0.694	0.661	0.694	0.686
Observations	124	124	124	124	124	124

Note: *p<0.1; **p<0.05; ***p<0.01

variables are so large that we cannot say — given a 95 % confidence interval — whether the average marginal effect is positive or negative.

If we include the interaction effect between veto players and market concentration — Models 2 and 3 — the results changes. On average, a one unit increase in the number of veto players or number of equally-sized banks is associated with a decrease in the effect of veto players and market fragmentation of 3.8 % to 4.1 %, give or take around 2.5 percentage points. Thus, an additional veto player is, on average, associated with a 15 % increase in the likelihood of reform. Similarly, a one unit increase in the number of equally-sized banks increases, on average, the likelihood of reform by 3 %.

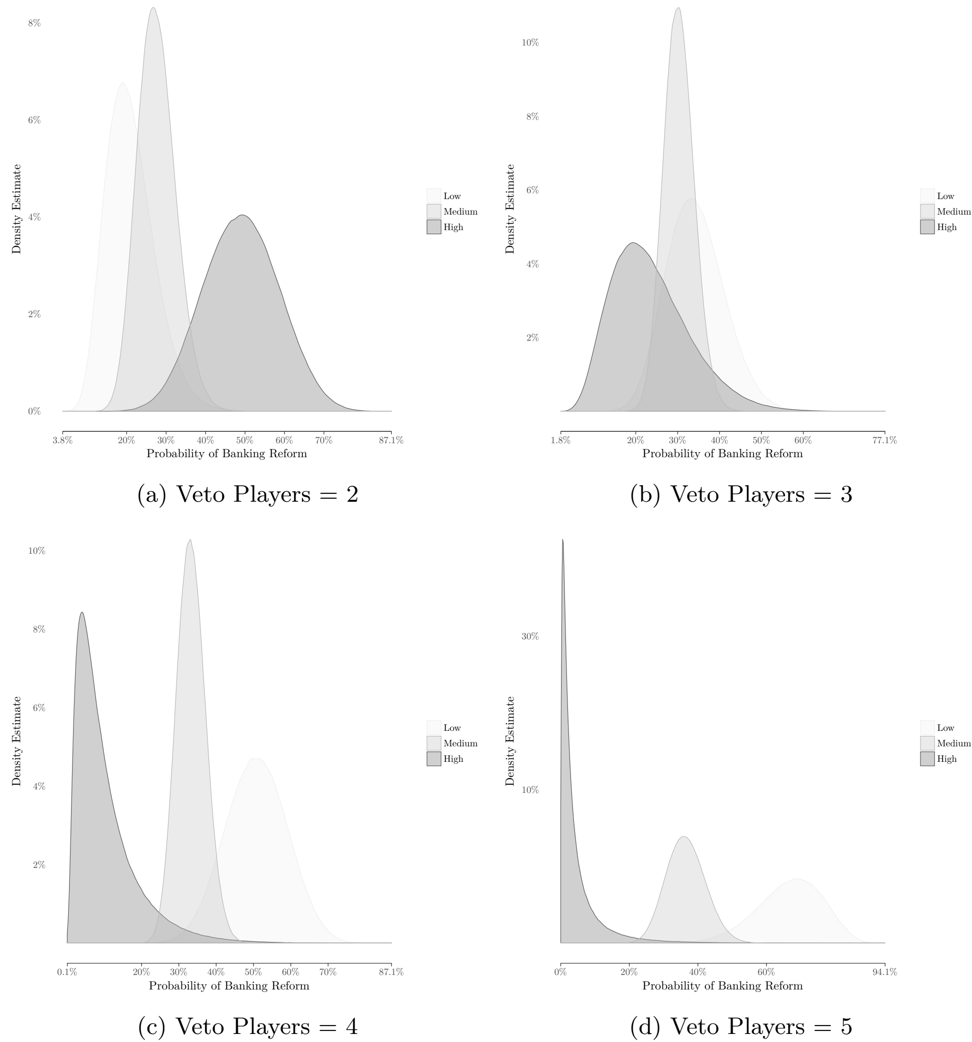
I further explore the dynamic of the interaction effect by allowing the predictor variables to vary.[5] Figure 4.2 simulates the predicted probability of a movement towards full reform at different levels of market fragmentation and number of veto players, keeping the other covariates at their mean value. I define market fragmentation as high, medium and low, based on the highest, average and lowest values of observations in the dataset, i.e., the equivalent of 10.55, 4.14 and 1.47 uniformly-sized banks, respectively. Accordingly, I follow the work of G. King, Tomz, and Wittenberg (2000) in simulating the predicted probability of reform, which can be defined formally as:

$$E(Y) = \pi_c = \frac{1}{1 + exp(-X_c\beta)}, \tag{4.5}$$

given draws of β from its sampling distribution, and where X_c is the vector of covariates used in the model. If the number of draws is sufficiently high ($M = 1\,000\,000$) the simulations will approximate the full probability distribution of the predicted probability of reform. In other words, the estimation uncertainty of Model 3 is illustrated by the width of the density curves in Figure 4.2, which arises from not having an infinite number of observations, i.e., the wider the density curve the more uncertain the predicted probability of reform. For example, the certainty of the estimations — when market concentration is low (blue density curves) — increases with the number of veto players. The opposite is true when market concentration is high.

Panel 4.2a illustrates the situation with only two veto players for three different levels of market fragmentation. The density plot shows that the probability of reform increases as the market becomes more fragmented, although it is not possible to distinguish the probability of reform at high a medium levels of market concentration. This is in line with the expectation of Proposition3.2.5, that when the number of veto players are few, a decrease in market fragmentation increases the risk for capture, and therefore lowers the probability of reform.

[5] The following analysis is based on Model 3.



(a) Veto Players = 2

(b) Veto Players = 3

(c) Veto Players = 4

(d) Veto Players = 5

Figure 4.2 – The above panels plot the density estimates of predicted banking reform for countries where financial market fragmentation is high (blue density curve), medium (green density curve), and low (red density curve). The Panels illustrate the interaction effect between veto players and financial market concentration. Estimations are based on Model 3 in Table 4.1.

Table 4.2 – Generalised Estimating Equations

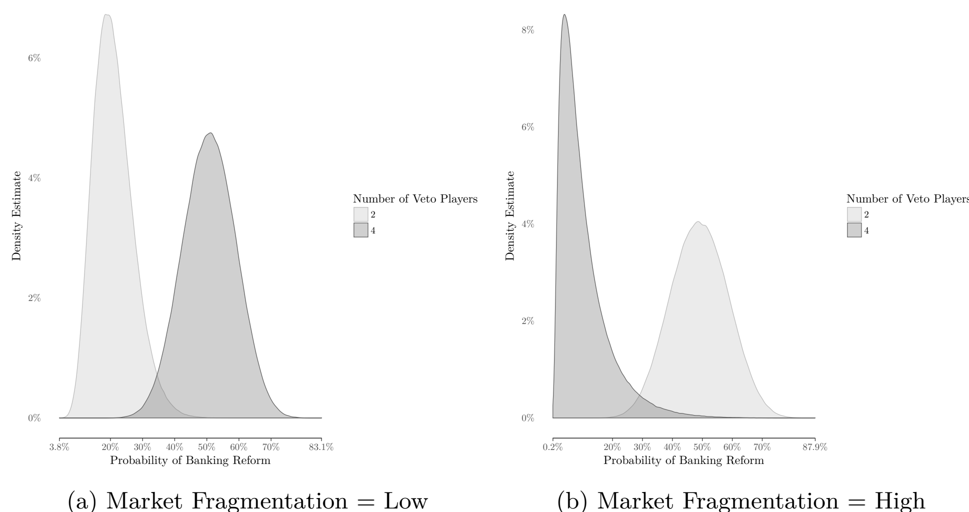
	Dependent Variable: Banking Reform					
	GEE Logit			GEE Probit		
	(1)	(2)	(3)	(4)	(5)	(6)
Intercept	−0.068 (−0.392, 0.256)	−0.562 (−0.811, −0.314)	−0.714 (−1.061, −0.367)	−0.079 (−0.401, 0.243)	−0.570 (−0.801, −0.338)	−0.728 (−1.066, −0.390)
Veto Players	0.037 (−0.023, 0.097)	0.191 (0.112, 0.271)	0.195 (0.10, 0.29)	0.035 (−0.025, 0.096)	0.191 (0.119, 0.263)	0.194 (0.105, 0.283)
Market Fragmentation	−0.056 (−0.110, −0.001)	0.068 (0.010, 0.126)	0.109 (0.051, 0.167)	−0.52 (−0.104, −0.001)	0.068 (0.014, 0.121)	0.110 (0.056, 0.163)
State Owned Assets	0.002 (−0.002, 0.007)	0.001 (−0.003, 0.005)	0.003 (−0.001, 0.007s)	0.003 (−0.002, 0.007)	0.001 (−0.003, 0.005)	0.003 (−0.001, 0.007)
Initial Conditions 1			0.065 (0.032, 0.098)			0.065 (0.033, 0.098)
Initial Conditions 2			−0.028 (−0.075, 0.019)			−0.031 (−0.079, 0.016)
Communists in Legislature			0.000 (−0.005, 0.004)			0.000 (−0.004, 0.005)
Veto Players * Market Fragmentation		−0.038 (−0.063, −0.013)	−0.041 (−0.312, −0.110)		−0.037 (−0.060, −0.014)	−0.040 (−0.061, −0.019)
Goodness of fit	0.669	0.710	0.694	0.661	0.694	0.686
Observations	124	124	124	124	124	124

Note: The parentheses represents a 95 % confidence interval.

The situation is somewhat different in the upper right panel, in that the probability of reform has now decreased for high levels of market fragmentation, and, in a similar fashion, increased for low and medium levels of market fragmentation. Nevertheless, the high degree of overlap between the different density estimates renders it impossible to tell the different probability estimates apart at any conventional level of statistical significance, i.e., in cases with three veto players we cannot say with any degree of confidence if the effect on reform differs at different levels of market fragmentation.

In Panels 4.2c and 4.2d the observed trend is further accentuated. The density estimates are moving further apart, with lower levels of market fragmentation being associated with higher probability of reform. The small overlap between the density curves supports the conclusion that the distributions are statistically distinguishable, i.e., that there is a difference in the predicted probability of reform for different levels of market fragmentation. Hence, the Figure 4.2 supports the theoretical expectation that less fragmented markets are associated with lower adaptation costs for the industry, which implies that reforms are more frequent.

Figure 4.3 takes a somewhat different approach, and compares the difference in the probability of reform between two and four veto players, for two levels of market concentration: low and high. Once again, we see that the when market concentration is low, going from two to four veto players substantially increases the likelihood of reform. The opposite is true for high levels of market concentration. This confirms the expectations of Propositions 3.2.3 and 3.2.5.



(a) Market Fragmentation = Low

(b) Market Fragmentation = High

Figure 4.3 – The above panels plot the density estimates of predicted banking reform for countries with two (red density curve) and four (blue density curve) veto players. The Panels illustrate the interaction effect between veto players and financial market concentration. Estimations are based on Model 3 in Table 4.1.

The models in Table 4.1 treated the response variable as a dichotomous event, coded 1 if reform took place and 0 if no reform was recorded. I now go one step further and treat the

outcome variable as a count, using the Poisson regression model, which estimates the number of events that occur during a period of time. The results of the Poisson regression model reinforces the conclusions drawn from the logistic and probit models. If the interaction effect is not included, see Model 1 in Table 4.3, the effect of market fragmentation is negative and statistically significant. More specifically, a one unit increase in the number of equally-sized banks is associated with a decrease in the predicted number of reform counts, equal to the multiplicative order of $exp[-0.236] = 0.79$. Conversely, the number of veto players, in this model, is associated with an increase in the number reform counts, where an additional veto player is expected to increase the number of reform counts by 18.6 %, or $exp[0.171] = 1.186$. State ownership is not statistically significant in this model.

Table 4.3 – Generalised Estimating Equations — Poisson Regression

	Dependent Variable: Banking Reform		
	GEE Poisson		
	(1)	(2)	(3)
Intercept	−0.347	−1.650***	−2.810***
	(−1.200, 0.507)	(−2.500, −0.797)	(−3.710, −1.920)
Veto Players	0.171**	0.537***	0.740***
	(0.048, 0.293)	(0.251, 0.823)	(0.464, 1.020)
Market Fragmentation	−0.236**	0.126	0.358***
	(−0.411, −0.061)	(−0.151, 0.403)	(0.136, 0.581)
State Owned Assets	−0.005	−0.009**	−0.003
	(−0.013, 0.002)	(−0.017, −0.002)	(−0.011, 0.005)
Initial Conditions 1			0.235***
			(0.176, 0.295)
Initial Conditions 2			−0.027
			(−0.133, 0.079)
Communists in Legislature			−0.001
			(−0.010, 0.007)
Veto Players * Market Fragmentation		−0.100	−0.145***
		(−0.202, 0.002)	(−0.228, −0.061)
Goodness of fit	0.532	0.540	0.597
Observations	124	124	124
Note:			*p<0.1; **p<0.05; ***p<0.01

In Models 2 and 3 I introduce the interaction term between veto players and market fragmentation. From the table we see that the interaction is negative, indicating that the effect of veto player decreases over time. Figure 4.4 plots the interaction effect based on Model 3. When market concentration is high the effect of an additional veto player is positive in terms of the predicted number of reform counts. This effect is decreasing, and reaches zero at just above five equally-sized banks. After that the impact of an additional veto player decreases the estimated

probability of observing a reform count.

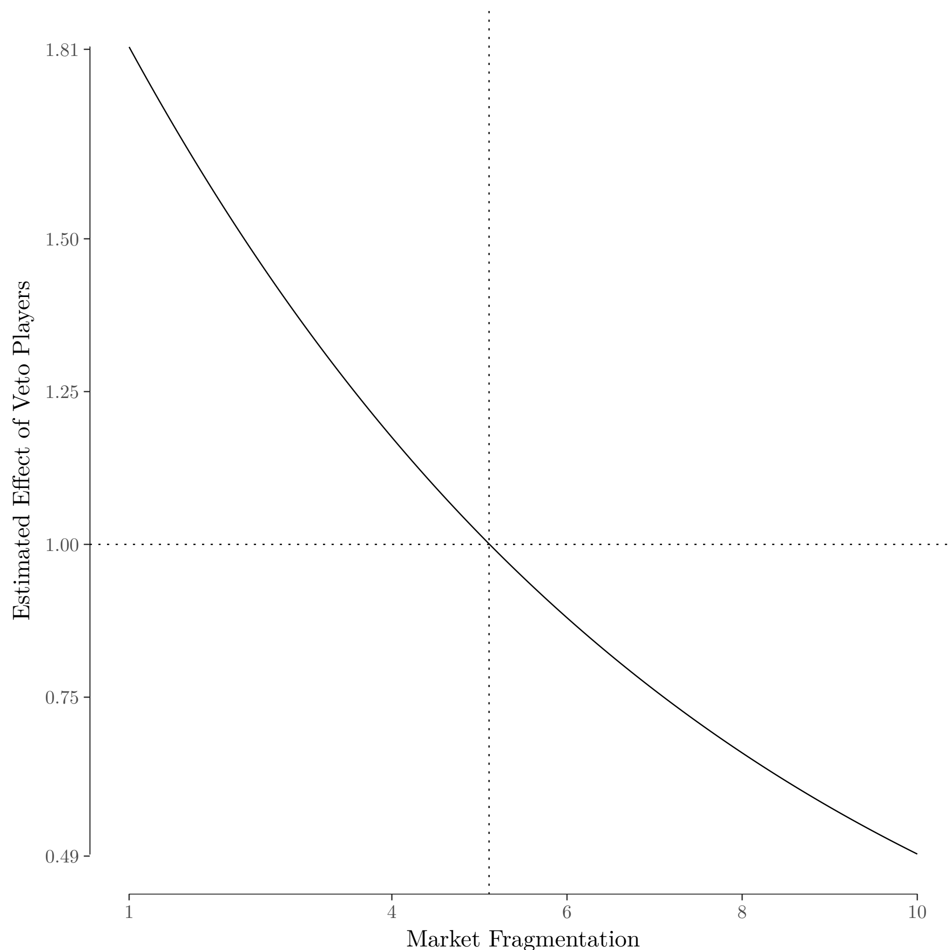


Figure 4.4 – The two panels plot the estimated interaction effect at different levels of veto players and market fragmentation, respectively. Estimations are based on Model 3 in Table 4.3.

4.2 Movement Towards Full Reform

The evidence presented so far is in line with the theoretical predictions presented in Chapter 3. I now proceed to study the movement towards full banking reform, which I define as $Y_{it} = max[Y_{it}, Y_{it-1}]$. To this end, I treat the response variable as a continuous variable, ranging from 0 to 100. As such, the new variable measures the level of compliance with European Union (EU) requirements, where 0 indicates severe compliance deficiencies, and 100 denotes full compliance.

The two dominant approaches to panel data found in the literature are the Fixed Effect Model (FEM) and the REM. Although much has been written about the theoretical underpinnings of the models (cf. Wooldridge, 2010), practical suggestions on when to use which models are scant (Gelman and Hill, 2007, p. 245). It is common in the econometrics literature to find reference to the Hausman test (Hausman, 1978), where a significant result is taken as a pretext for using

the FEM. However, the Hausman test is biased in favour of the FEM, and should therefore be used with caution (Bell and K. Jones, 2015, pp. 138–139).

The FEM can encounter problems in its estimation of $\boldsymbol{\beta}$, and this is especially true for datasets with few observations per group, and/or a small variance within each regressor, compared to the variation in the response variable (Clark and Linzer, 2015, p. 402).

> The typical problem addressed by models of Class I [FEM] is the analysis of experimental data such as occur in agronomic investigations, while the typical problem addressed by models of Class II [REM] is the analysis of nonexperimental, observational data such as are the norm in astronomical or economic investigations. (Nerlove, 2002, p. 8).

Clark and Linzer find that REM performs better in cases when the number of groups and/or group observations is small, except at very high levels of correlation between the predictors and the unite effects (2015, pp. 404–405). I therefore follow their suggestion and apply the REM in the subsequent analysis.

The REM assumes unobserved heterogeneity across countries that is constant over time, and captured by the term δ_i, and/or unobserved heterogeneity over time that is constant across countries, defined by η_t. Hence, in addition to the regressors included in the model there are additional factors that vary across countries and/or over time. An obvious example of this is the size of a country, which — while differing across countries — is nevertheless constant over time. Furthermore, it is assumed that the country, and time, specific effects, δ_i and η_t, are distributed independently of the predictor variables, and can therefore be included in the error term, $\varepsilon_{it} = \delta_i + \eta_t + \epsilon_{it}$. The REM can be expressed formally as:

$$Y_{it} = \alpha + \beta \boldsymbol{X}_{it} + \gamma \boldsymbol{Z}_i + \varepsilon_{it}, \tag{4.6}$$

where α is the intercept and y_{it} is the movement towards full reform for country i at time t. X is a vector of time-variant factors for country i, and Z the observed time-invariant characteristics for country i. Two different definitions of ε_{it} are applied in the Models shown in Table 4.4: (1) $\varepsilon_{it} = \eta i + \epsilon_{it}$ for year specific effects only; and (2) $\varepsilon_{it} = \delta_i + \eta_t + \epsilon_{it}$ for country and year specific effects.[6]

Models 1 to 6 in Table 4.4 summarise the results of the statistical analysis with the movement towards full reform as the dependent variable. In Models 1 to 3 only time fixed effects are

[6] The main difference between the REM and the FEM is mainly that βZ_i is included in α_i, which is distinct from the error term in REM. FEM can therefore be rewritten as $y_{it} = \alpha_i + \beta X_{it} + \varepsilon_{it}$, with the implication that α_i is now allowed to correlate with the regressors. While controlling for time-invariant factors such as size, location etc., the FEM model does not allow us to estimate the effect of time invariant factors.

included, allowing for both within and between variation to affect the outcome variable. In the three subsequent models I include both country and year controls, capturing the influence of aggregate time-invariant country effects. The number of veto players are positively associated with the movement towards full reform, but the effect is mitigated by the fragmentation of the market. The importance of state-owned banks, however, only finds support in Model 1, where the effect is negative and significant, albeit small. For example, a ten percent increase in state-owned assets of banks is associated with a just above three unit increase in the movement towards full reform. I return to the effect of state-owned banks in the next chapter.

Models 3 and 6 includes an autoregressive effect by lagging the response variable by one year. By so doing, we lose the first observation for each panel, because the first observation for the lagged response variable is not available. Formally it can be expressed as

$$Y_{it} = \alpha + \lambda Y_{it-1} + \beta \boldsymbol{X}_{it} + \gamma \boldsymbol{Z}_i + \varepsilon_{it}, \tag{4.7}$$

where λ is the unknown coefficient of y_{it-1}. This, however, comes with the cost of introducing endogeneity into the equations. Hence, both models should be treated with caution. Nevertheless, both Models 3 and 6 are consistent with the results in the other Models in Table 4.4.

The interaction term is statistically significant and negatively associated with a movement towards full reform in all six models, providing support for Propositions 3.2.3 and 3.2.5. At highly concentrated markets, the effect of an additional veto player is positive, but as the number of veto player increases the effect diminishes, and at a certain point becomes negative. The substantial effect of the interaction term is plotted in Figure 4.5, which is based on the data from Model 5 in Table 4.4. The average associated effect on the movement towards full reform at markets with just below three equally-sized banks is positive, ranging from 0 to 2.36 for every additional veto player, i.e., at high levels of market concentration veto players have positive and statistically significant effect on the movement towards full reform.

In markets with more than three uniformly-sized banks the effect of veto players turn negative, which is in line with the prediction of Proposition 3.2.3. For example, in markets with eight equally-sized banks every additional veto player is associated with a decrease in the movement towards full reform of 6.95 units on the normalised scale. As such, Figure 4.5 emphasises the main theoretical point of the dissertation, namely that presence of veto players has distinct effects depending on the level market concentration. At low levels of market fragmentation, veto players function as a check against special interests, whereas in more fragmented markets they tend to protect small banks from to tough reforms.

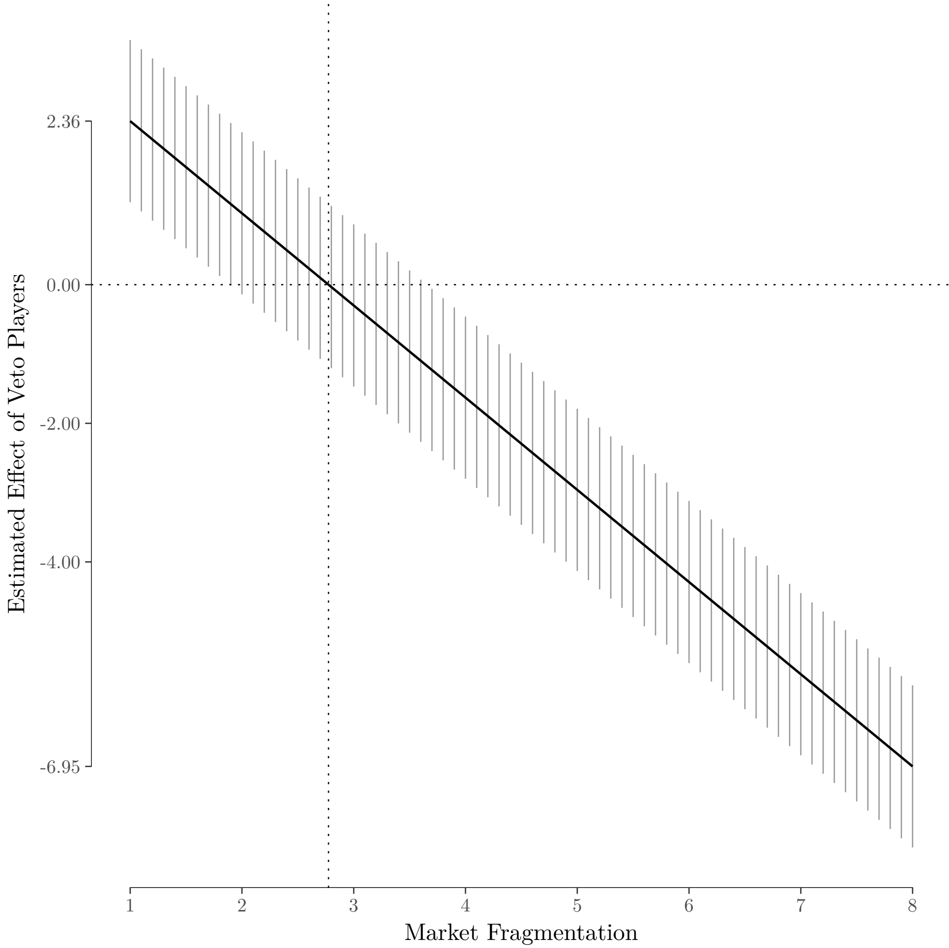


Figure 4.5 – The Figure depicts the estimated marginal e ect of veto players on the movement towards full reform. The vertical lines represents a 95 % confidence interval, estimated with robust standard errors. The graph is plotted based on the results of Model 5 in Table 4.4.

Table 4.4 – Random Effect Models

	Dependent Variable: Movement Towards Full Reform					
	Time Effect				Two-way Effect	
	(1)	(2)	(3)	(4)	(5)	(6)
Intercept	8.420	2.570	−4.410	−3.960	−14.200	−1.640
	(−6.700, 23.500)	(−13.100, 18.200)	(−12.900, 4.080)	(−25.100, 17.200)	(−36.200, 7.800)	(−19.200, 15.900)
Veto Players	9.710***	10.100***	4.790***	4.570*	3.690*	3.880**
	(5.300, 14.100)	(5.760, 14.400)	(2.210, 7.380)	(−0.383, 9.510)	(−0.609, 8.000)	(0.660, 7.100)
Market Fragmentation	10.400***	12.100***	3.170***	8.910***	7.440***	5.360***
	(7.690, 13.200)	(9.150, 15.000)	(1.340, 5.000)	(4.780, 13.100)	(3.520, 11.400)	(2.870, 7.840)
State Owned Assets	−0.321***	−0.059	−0.017	−0.099	0.103	−0.087
	(−0.482, −0.159)	(−0.251, 0.133)	(−0.123, 0.090)	(−0.323, 0.125)	(−0.158, 0.364)	(−0.281, 0.106)
Initial Conditions 1		5.110***	1.950***		6.630***	2.350*
		(2.880, 7.330)	(0.509, 3.400)		(3.090, 10.200)	(−0.360, 5.060)
Initial Conditions 2		−3.520***	−0.828		−5.190***	−1.570
		(−5.620, −1.410)	(−2.010, 0.355)		(−9.020, −1.350)	(−4.100, 0.956)
Communists in Legislature		−0.136	−0.009		0.115	0.041
		(−0.347, 0.075)	(−0.138, 0.121)		(−0.206, 0.436)	(−0.190, 0.272)
Lagged Bank Reform			0.877***			0.633***
			(0.784, 0.971)			(0.455, 0.811)
Veto Players * Market Fragmentation	−2.900***	−3.080***	−1.000***	−1.750***	−1.330**	−1.040***
	(−3.880, −1.910)	(−4.010, −2.150)	(−1.610, −0.397)	(−2.990, −0.502)	(−2.500, −0.162)	(−1.820, −0.256)
Country Effects	No	No	No	Yes	Yes	Yes
Year Effects	Yes	Yes	Yes	Yes	Yes	Yes
Panels	17	17	17	17	17	17
Observations	141	141	124	141	141	124
Adjusted R^2	0.188	0.296	0.811	0.556	0.596	0.685
F Statistic	8.040*** (df = 4; 136)	8.650*** (df = 7; 133)	101.000*** (df = 8; 115)	11.300*** (df = 20; 120)	13.000*** (df = 23; 117)	24.500*** (df = 23; 100)

Note: *p<0.1; **p<0.05; ***p<0.01

4.3 Explaining the Behaviour of Supervisors

The fourth dimension of banking reform attempts to measure the behaviour of the supervisory authority. In Chapter 3 I hypothesised that the quality of supervision will be an effect of the resources, procedural rules, and legislation in place. In this section, I aim to test this proposition by estimating a random effect model, which can expressed formally as:

$$Y_{it} = \alpha + \beta \boldsymbol{X}_{it-1} + \gamma Z_i + \varepsilon_{it-1}, \tag{4.8}$$

where Y_{it} is the behaviour of the supervisory authority in country i, at time t; and, β is the unknown coefficient for the lagged value of $\boldsymbol{X}_i$.

Table 4.5 shows the results for the random effect models. In Models 1 to 3, banking legislation, procedural regulations and resources are included as predictor variables one at a time. Veto players, market fragmentation and state-owned banking assets are not significant in any of the models. But, the three new predictor variables are both statistically and substantively significant. A one point increase in banking legislation is associated with a 0.22 points increase in the behavioural compliance of the supervisory authority, give or take 0.2 points. Similar conclusions can be drawn from Models 2 and 3, namely a positive correlation of 0.203 and 0.385 between procedural requirements and resources on the one hand, and the behaviour of the supervisory authority on the other hand.

In Model 4 all three predictor variables are included. In this model, only the resource variable is statistically significant; both the banking legislation and procedural variables have lost their significance levels. That resources are important for the behaviour of the supervisory authority is a finding that is also backed up by the qualitative data that has been collected for this dissertation. All the respondents that have been interviewed for this study singled out resources as the most important factor for the efficient functioning of the supervisory department. Additionally the other sources that have been consulted in the research process also confirm this view that resources are essential for supervision efficiency. However, that procedural regulations are not statistically significant contradicts the qualitative findings of this study, many of the interviewees in this study point out that the independence of the supervisory authority is essential to protect the integrity of the supervisory agency.

4.4 Conclusion

In this chapter, I have explored Propositions 1 to 5 using different statistical models. The propositions are tested based on data from 17 countries during their accession to the EU.

Table 4.5 – Random Effect Models

	Dependent Variable: Behaviour of Supervisory Authority			
	Two-way Effect			
	(1)	(2)	(3)	(4)
Intercept	0.296	−0.570	5.240	3.360
	(−21.200, 21.800)	(−23.000, 21.900)	(−16.700, 27.100)	(−19.200, 25.900)
Veto Players	1.890	2.330	1.000	1.400
	(−0.797, 4.570)	(−0.457, 5.120)	(−1.560, 3.570)	(−1.350, 4.150)
Market Fragmentation	2.560	2.700	2.190	1.970
	(−0.686, 5.800)	(−0.832, 6.230)	(−0.802, 5.180)	(−1.320, 5.250)
State Owned Assets	−0.135	−0.153	−0.174	−0.168
	(−0.404, 0.134)	(−0.437, 0.131)	(−0.447, 0.099)	(−0.451, 0.114)
Banking Legislation	0.220**			0.058
	(0.020, 0.420)			(−0.163, 0.279)
Procedural Regulations		0.203*		0.052
		(−0.019, 0.426)		(−0.186, 0.290)
Resources			0.385***	0.329**
			(0.164, 0.606)	(0.074, 0.584)
Country Effects	Yes	Yes	Yes	Yes
Year Effects	Yes	Yes	Yes	Yes
Panels	17	17	17	17
Observations	141	141	141	141
Adjusted R^2	0.502	0.505	0.533	0.527
F Statistic	8.620*** (df = 20; 120)	8.730*** (df = 20; 120)	10.000*** (df = 20; 120)	9.110*** (df = 22; 118)
Note:				*p<0.1; **p<0.05; ***p<0.01

Consistent with the theory presented in Chapter 3, I find that the proposed relationship between market fragmentation and banking reform finds support in most of the models estimated in this chapter. This speaks to the theoretical point made in Proposition 3.2.1, where I argue the costs of reform for private enterprises increases with the fragmentation of the market. Being aware of this situation, veto players decide not to enact new reform proposals.

Furthermore, in the statistical analysis I find support for the interaction effect that was hypothesised in Propositions 3.2.3 and 3.2.5. Veto players are positively correlated with banking reform, but this effect is mitigated by the fragmentation of the banking sector. At high levels of market fragmentation, the effect of an additional veto player on banking reform is negative. This supports the idea that veto players act as a check on each other, not to hurt a weak banking market. Conversely, at high levels of market concentration, when the costs of reform can easily be absorbed by the banks, the effect of additional veto players is positive. This finding supports the proposition that more veto players makes it more costly for dominant market players to capture politicians and direct reforms to their own benefits.

Propositions 3.2.2 and 3.2.4 hypothesised the relationship between state ownership on banks and reform. I argued, based on the literature, that the higher the share of state ownership in banks, the less likely it was that reform would take place. However, this effect is only present in some of the models, and, when it is, the effect is small. Hence, the statistical analysis does not find any support for the proposition of a substantial effect between state ownership and reform. I will, however, explore this relationship closer in the qualitative analysis in Chapter 5.

In the last section of this chapter I explore the relationship between legislation, procedures and resources, and the behaviour of the supervision department. This section should be treated with great caution because of the risk of endogenity in the model. Nevertheless, I find that the factor that has the strongest association with the behaviour of supervision is the resources that are made available to the supervisory authority.

Chapter 5

Explaining Diverging Reform Paths

In Chapter 4 I presented the quantitative analysis of the dissertation. I made the case that a country's political institutions cannot by themselves explain banking reform, and it is also necessary to consider the country's market structure (especially the consolidation of the banking market), and how it interacts with that country's political institutions. I now go one step further by analysing the pathways to reform in Estonia and Lithuania (for the justification underlying the case selection, see Chapter 1). To this end, I outline the major banking reforms in the two countries, and examine the process underlying the reforms.

As such, the scope of this chapter extends all the way back to the fall of the Soviet Union, and, with that, the beginning of the transition period. The aim is to identify how the market structures in the two countries shaped the incentives and capacities of domestic public and private actors. In line with the theory and the evidence presented in Chapter 4, I argue that the consolidation and strength of the banking sector is an essential factor for understanding banking reforms.

At an early stage of the reform process, both Estonia and Lithuania were characterised by scattered banking sectors, with many of the banks being small and/or undercapitalised. The early banking crisis in Estonia substantially consolidated the banking sector, which made it possible for the government and the central bank to forge a strong reform coalition with the market-leading banks. Conversely, consolidation of the banking sector in Lithuania lagged behind, and it was therefore difficult for the government and the central bank to create a reform coalition with the banking sector.

For this chapter I draw on four different sources of information. Official documents — such as annual reports, press releases, decrees etc.— from the government and the central bank are useful for tracing the official position with regards to policies at the time. In addition to domestic sources, a number of international organisations — e.g., the European Bank for Reconstruction

and Development (EBRD), International Monetary Fund (IMF) and World Bank (World Bank) to name a few — have produced empirical studies and analyses of the banking market in both Estonia and Lithuania. Newspaper articles published between 1991 and 2004 has also been an essential source of information. I have gone over more than 6000 newspaper articles. A complementary source of information has been interviews with policymakers and regulators that have knowledge about the process in the respective countries.[1]

The chapter is structured as follows. I start by sketching a rough picture of banking under socialism in Section 5.1. The aim is to give the reader an idea of the status quo in Estonia and Lithuania at the dawn of the transition period. Both countries inherited a mono-bank system, which was controlled and owned by the state, and substantial reforms were therefore needed in order to transform the financial system into one based on market principles. Because banking in the Soviet republics was similar (cf. Claessens, 1998, p. 115; Gabrisch and Hölscher, 2006, Ch. 3), and because the aim of the section is only to provide a brief overview, few references will be made to the specifics of the two countries.

I then proceed to the analysis, which is conducted in Section 5.2. I start by giving an overview of the political and economic structures in Estonia and Lithuania, describing the important players, core constituencies, and economic structures in the reform process. I then proceed to Sections 5.2.1 and 5.2.2, which offer a detailed account of the reform process in the respective countries, its turning points, and the crucial actors involved in the specific reforms. I conclude the chapter in Section 5.3 by bring the two country analyses together, and identifying cautionary notes to the analysis.

5.1 Banking Under Socialism[2]

Like most other economic functions in Estonia and Lithuania, banking was controlled and owned by the state. The mono-bank system implied that no separation between the central bank and commercial banks was made. Although a number of formally independent banks — e.g., investments banks, foreign trade banks, saving banks etc.— with the responsibility to issue loans and take deposits existed, in practice they were all under the complete authority of the Soviet State Bank (Gosbank), and by extension the party (cf. McKinnon, 1991b, p. 44; Kornai, 1992, pp. 131–32; Thorne, 1993, p. 961).

[1]It has not always been easy to find people willing to be interviewed that were part of the reform process during the 1990s and the early 2000s. The interviews should therefore only be seen a complementary source of information. All in all, 11 interviewees were conducted, 7 with Estonian and 3 with Lithuanian policy-makers and regulators. One interview was conducted with a Swedish banker who had worked extensively in the region. The interviews were conducted during late 2015 and early 2016.

[2]This section draws heavily on Kornai (1992, Ch. 8.1).

That central banking was subordinated to the party and the production plan implied that it lacked discretion with regard to credit allocation and monetary policy.[3] Every state owned enterprise (SOE) in the former socialist countries had an account in the mono-bank, which in turn was divided into a number of sub-accounts, i.e., one account for wages another for investments etc. (McKinnon, 1991a, p. 109). Credit for each sub-account was set by the production plan, and decided upon by the central planers, paying little attention to the profitability of their investments. The credit could not be transferred from one sub-account to another; it was, for example, not possible to pay wages with money from the account for material inputs, and vice-versa.[4] Money therefore ceased to perform one of its most vital functions, namely to integrate all the transactions in the economy (Kornai, 1992, p. 133).

The mono-bank system also had repercussions for the availability of credit to the general public. Citizens could only invest their money in the deposit accounts of the savings bank; and credit lines to the general public were prohibited.[5] The interest rates for the deposit accounts were generally set at a low level by the central planners, and the amount of credit available in the former Soviet republics was therefore small in comparison to more advanced market economies. All in all, the role of banks, especially their strict subordination to the production plan, in the socialist countries of Central and Eastern Europe (CEE) has led some scholars to conclude that their role in socialist economies were largely insignificant (Cecco, 2007, p. 136).

To make the transition to a market economy, both Estonia and Lithuania had to break with the mono-bank system, and implement a two-tier regime. Advanced capitalist economies of today all operate regimes of two-tier banking, which detach the central bank from all commercial banking functions. In such a system, the central bank is responsible for the regulation of commercial banks and monetary policy, whereas commercial banks issue loans and take deposits.[6] In other words, the main difference between the mono-bank system and two-tier banking is the withdrawal of the state from commercial banking. While the central bank together with the political power set the rules of the market, they have no direct power over the day-to-day operations of the commercial banks.

[3] It is worth pointing out that it is not obvious how an independent central bank under a planned economy would be able influence key macroeconomic outcomes the same way as it does in market economies. central banks, operating under a free-market regime, use monetary policy as an instrument to influence interest rates, economic output, employment and prices. However, the mono-banks in Estonia and Lithuania did not have leverage over these outcomes since their levels were all set by the central planners.

[4] In addition, all exchanges involving foreign currencies had to be conducted by the central bank or its subsidiary, the foreign trade bank.

[5] Only in Hungary and Poland were the savings banks allowed to offer their customers smaller amounts of credit, usually for housing loans.

[6] In two-tier banking systems the responsibility to regulate banks is often shared between the central bank and the political power of the country.

5.2 Diverging Reform Paths

The political arenas in Estonia and Lithuania differed going into the transition period. After the fall of communism Estonia opted for an electoral system based on the principles of the Single Transferable Vote System, aimed at creating proportional representation in the legislature. Conversely, Lithuania relied on single-member electoral districts, a system that tends to promote a two-party system with stable majorities (Kulik and Pshizova, 2005, p. 127). Nevertheless, the founding elections were similar, both with regard to process and outcome. In both countries, the founding elections were free and fair, and they resulted in the pro-independence parties winning a stable majority of the seats in the respective legislative assemblies.

Fish builds on this insight, arguing that governments with a clear pro-independence majority behind them "pursued substantial economic liberalization in the wake of the first elections." (Fish, 1997, p. 60). The decisive results in favour of the pro-independence parties created a substantial turnover in the ruling elites, something that paved the way for future reforms. This conclusion is supported by Mart Laar, Estonia's former Prime Minister (PM). He writes that: "The initial secret to Estonia's success was the 'sweep the place clean' policy, which severed a large number of links dating back to the Soviet era and brought a generation untouched by earlier 'experiences' into government." (Laar, 2009, p. 9). While it is true that the initial election might have had an impact on post-socialist reform trajectories, the theory cannot account for the diverging reform paths in Estonia and Lithuania. According to Fish's 1997 own coding, the outcomes of the elections in the two countries should be considered comparable. Furthermore, the pro-independence party in Estonia, the Popular Front of Estonia (PFE), is considered to be centre-left, while its Lithuanian counterpart, the Homeland Union (HU), is a centre-right party. This is something that should speak in favour of, if anything, a more substantial economic liberalisation in Lithuania than in Estonia.

After its founding election, Estonia retained the principle of proportional representation, but modified its electoral system along the lines of the Finish model. Conversely, Lithuania opted for a mixed electoral system in which 70 Members of Parliament (MP) were elected based on nation-wide proportional representation, and 71 MP were elected in single member districts (Rose and Munro, 2009, p. 174). It can be argued that the two electoral systems have created somewhat diverging outcomes with regards to party politics. Looking at the average number of parties, as shown in Table 5.1, for the two countries we see that the number of parliamentary parties is substantially higher in Lithuania than in Estonia. With the exception of the second election, the number of parties that won a seat in the Lithuanian Parliament (Seimas) is (nearly) more than twice as high than the number of parties that were represented in the Estonian Parliament

(Riigikogu). A lower number of parties could speak in favour of reform since it makes it easier to form strong coalitions, reducing the potential number of veto players. However, this is a crude measure, and misses the relative strength of the parties represented in the two parliaments.

Table 5.1 – (Effective) Number of Parliamentary Parties

Country	Election Date	Number of Parties	Effective Number of Parties
Estonia	18th March, 1990	3	3
Estonia	20th September, 1992	9	5.9
Estonia	5th March, 1995	7	4.15
Estonia	7th March, 1999	7	5.5
Estonia	2nd March, 2003	6	4.67
Lithuania	10th March, 1990	8	3.21
Lithuania	15th November, 1992	9	2.99
Lithuania	20th October, 1996	14	3.32
Lithuania	8th October, 2000	17	6.26

Source: author's own calculation, using the method proposed by Laakso and Taagepera (1979), based on data from Döring and Manow (2016). Data for the founding election of Estonia is based on data provided by Kulik and Pshizova (2005, p. 129).

A better yardstick is the effective number of parliamentary parties (also shown in Table 5.1). The effective number of parliamentary parties is an fruitful method to measure the number of viable parties represented in the parliament, and it is commonly accepted in the literature that this measure is better suitable for comparisons across countries.[7] By weighing each party's seat share by itself the measure gives priority to larger parties in the parliament. Hence, if one party dominates the parliament, the effective number of parties will be low, whereas if the parliament consists of many equally sized parties the effective number of parties will be high. Comparing Estonia and Lithuania a different reality appears. The effective number of parties in the two systems are similar, but is often lower in Lithuania. Although many parties managed to enter the Lithuanian parliament, they were often small and insignificant (only controlling one or two seats in the Seimas).

Turning to the legislative mechanism, both countries adopted a procedure in which the legislative power was vested in the parliament. After Estonia's referendum on independence — on 3rd March, 1991 — the Constitutional Assembly (CA) was established, consisting of member from both the Supreme Council and the Estonian Congress. After six months of work the CA presented a draft proposal of the new constitution, which was with some changes accepted in a referendum in June of 1992 (Solska, 2016, p. 393). The constitution established the Riigikogu as the legislative body, with the right, together with the executive branch and the president, to initiate legislation. The president of the Republic promulgates the legislative acts adopted by

[7] In accordance with Laakso and Taagepera (1979), the effective number of parliamentary parties is defined as: $N = 1/\sum_{i=1}^{n} p_i^2$, where n is the number of parties, and p_i^2 is the square of each party's proportion of all seats. A similar result is retrieved if one uses the the definition provided by Golosov (2010).

the Riigikogu; or refuses to do so, in which case the legislation returns to the Riigikogu for new deliberations. Lithuania also opted for a semi-presidential system after series of discussions about the role of the president in the new constitution. The new constitution came into force on 2nd November, 1992, following a referendum (Urdze, 2016, p. 443). Also the Lithuanian constitution establish the parliament as the supreme legislative body, albeit allowing the president and the government to adopted other legislative instruments as long as they are in compliance with other laws. The president of the republic has the power to return a legislative act to parliament for re-consideration.

Figure 5.1 illustrates the two political systems in terms of veto players. Estonia managed to implement a relatively radical reform agenda with regards to banking early on in the transition period, albeit with a relatively large number of veto players. Important legislation such as the new Credit Institution Act was implemented in 1995 just as the number of veto players had increased from three to five. Many important banking reforms were delayed in Lithuania, and the country only got up to speed in the later part of the 1990s and early 2000s, despite seeing a substantial increase in the number of veto players. If anything, however, the data points to a more conducive reform environment in Lithuania, especially at the beginning of the 1990s.

In the short term, two sets of policies were especially high on the reform agenda. It was essential to create a stable macroeconomic environment by curbing inflation, and to impose strict financial discipline on the old economic system, requiring policymakers to abolish automatic budgetary financing of enterprises and introducing new bankruptcy procedures. This set of policies aimed mainly at dismantling the old state, so that market forces could be allowed to operate. Already in the years leading up to independence inflation in the two Baltic states was high, with monthly levels reaching as high as 20 % (see Figure 5.2). However, inflation rates skyrocketed in the two countries after the Union of Soviet Socialist Republics (USSR) recognised their independence. The highest levels were recorded in January 1992, with inflation rates reaching as high as 87.5 % in Estonia and 53.97 % in Lithuania.

Hyperinflation damaged prospects for establishing a well-functioning banking sector. To manage the situation, companies and households started demand to less money and more goods, which in turn created a disequilibrium in the banking market. Thus, it was necessary for policymakers to come to grips with inflation if banking reforms were to have the desired effect. To this end, a number of proposals were floated. In Estonia, this reached a pinnacle when four leading social scientists put on the table a new ambitious economic framework (the so-called four man proposal), which aimed to dismantle the foundations of the planned economy (Kallas et al., Sept.1987). A corner stone of the economic framework presented was the introduction of a

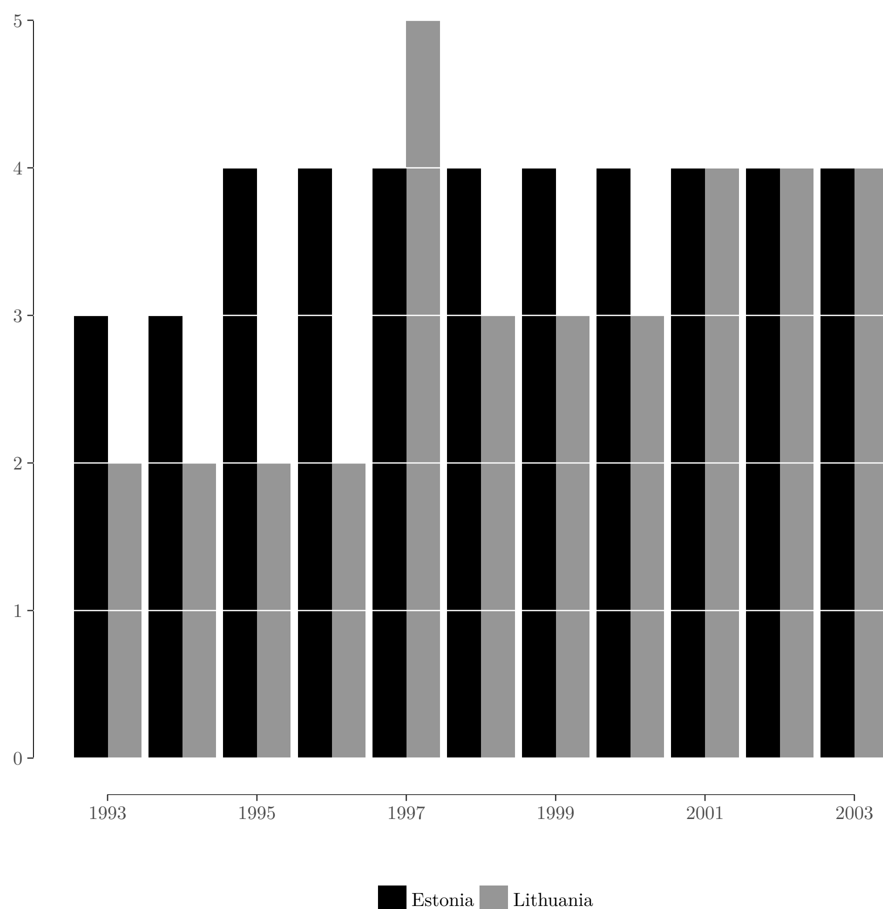


Figure 5.1 – The bar graph shows the number of veto players in Estonia and Lithuania between 1993 and 2003. Source: Beck, Clarke, et al. (2001).

national currency, based on the model of the Scottish pound (a local currency tied to the rouble) (Lainela and Sutela, 1994, p. 40; Knöbl, Sutt, and Zavoico, 2002, p. 4). By introducing a national currency the advocates expected to achieve three goals: (1) the elimination of inflationary pressure from the Soviet republics; (2) a macroeconomic balance between supply and demand; and (3) the conquering of persistent cash crises (Sõrg and Vensel, 2000, p. 115). The aim of the reform program was to lay the economic foundation for further reforms. The four man proposal spread quickly to Lithuania, and was already in the summer of 1988 taken up in the reform programme of the Reform Movement of Lithuania (sajūdis).

A second set of policies aimed to build a two-tier banking system through the establishment of an independent central bank separated from its commercial banking functions. In the medium- to long-term, this implied the adoption of financial regulations meeting international standards, especially those of the European Union (EU). As pointed out by Naím (1994), this set of reforms required the building of a new state, able to regulate economic activity in the public interest. Some initial attempts to move the financial market in a more market-oriented direction had

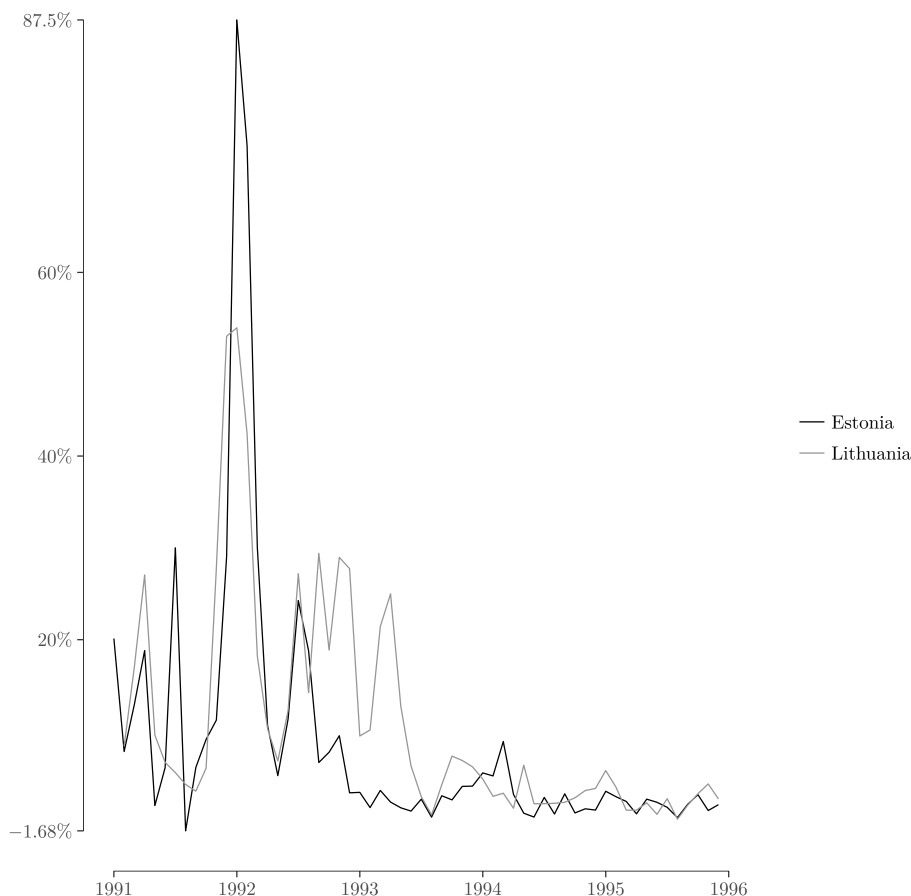


Figure 5.2 – The figure depicts the monthly rate of inflation (consumer price index, previous month = baseline) between 1991 and 1996 in Estonia and Lithuania. Source: WIIW (2016).

already been made in the years leading up to the fall of USSR. Mikhail Gorbachev's accession to power in 1985, and the beginning of glasnost and perestroika, opened up the possibility to discuss alternative ways to structure the power-relationship between the Soviet Republics and the Kremlin. This was a window of opportunity that both countries tried to take advantage of.

The first commercial banks in the Baltic states were established in 1988 when the Tartu Commercial Bank (TCB) opened its doors to the public. Soon thereafter the countries witnessed an influx of new commercial banks. Many of these were both small and weakly capitalised, often established by state enterprises or cooperatives to serve their own banking demands. At this point in time, the USSR banks were still dominating the market. The rapid increase in the number of commercial banks can be explained by the erosion of capital requirements to open a new bank and almost non-existent legal environment. Capital requirements had withered away because of hyperinflation. Hansson (1995) estimates that the capital needed to open a new bank in Estonia during 1992 was something close to 40 000 US Dollar (USD).

The first substantial steps towards financial self determination were taken in 1989. On 27th

November, 1989 the Law on Economic Independence was passed by the USSR. It granted the Baltic states a certain degree of economic autonomy, including the authority to establish their own banking sector. Estonia immediately seized on the opportunity, and only one month later — on 28th December, 1989 — the Law on Banking was adopted, which re-established the Bank of Estonia (BoE) as the country's central bank (EBRD, 2000, p. 158).[8] The Law on Banking was modelled on the legislation for commercial banking found in the Soviet Union. The act should therefore be regarded as having mainly a symbolic importance. Only three months later — on 1st March, 1990 — the Bank of Lithuania (BoL) opened, when the Supreme Council of Lithuania passed the Law on the Bank of Lithuania.

The early attempts to further economic independence were, nevertheless, met with resistance from the Kremlin. Gorbachev was determined not to let the Baltic republic create an independent financial system, which would risk the stability of the USSR (T. Lane, 2001, p. 102). For example, when Lithuania, in early 1990, began to set up its own financial system, the Gosbank responded by freezing all the republic's banking assets. A government official — Laima Andrikiene, an economist working for the Lithuanian government at the time — described the situation in the following way: "Any time we try to take a small part of our economy into our hands, they [the USSR] usually say that it contradicts some law." (quoted in NYT, Feb.1990). Similarly, when Estonia was trying to remodel its banking system more after Western standards the Gosbank interfered. In a statement, the chairman of the BoE voiced concerns that "[t]he central bank in Moscow is not obeying the Soviet laws, constitution or Soviet government decisions." (quoted in Independent, Aug.1990).

Despite some relief in terms of Soviet control, most of the more market-oriented banking legislation passed in the Baltic States before independence were of mostly symbolic importance. Neither the BoE or the BoL successfully achieved any substantial authority; most central bank functions were carried out by the respective national branches of the Gosbank in the years leading up to independence (EBRD, 1994, p. 23).[9] The two central banks instead focused on solving practical issues — such as resolving political constraints and logistics (e.g., printing banknotes) — rather than taking part in the introduction of a two-tier banking system, and addressing the broader issues of foreign exchange regimes and macroeconomic institutions (Knöbl, Sutt, and Zavoico, 2002, pp. 4–5). Thus, the Baltic experience diverges from that of other CEE countries, most notably Hungary and Poland, which introduced two-tier banking already before the fall of

[8]The BoE was founded in 1919, but was reorganised into the Estonian Republican Office of the State Bank of the USSR following the country's annexation by the USSR (See Bank of Estonia, 2015).

[9]Gosbank was in charge of serving the two republics with banknotes, acting as a fiscal agent of the government, providing clearing services for bank transfers within the republics and between them and the other Soviet Republics, and exercising banking supervision (Drēvina, Laurinavičius, and Tupits, 2007, p. 10).

socialism (McKinnon, 1991a, p. 118).[10]

The task ahead was in many ways daunting, requiring policymakers to adopt and implement far-reaching and often painful reforms. In a World Bank assessment of the banking sector in Estonia and Lithuania it is concluded that “[n]one of the [two countries] had a human resource base skilled in modern banking practices and none had an appropriate legal, regulatory, and supervisory framework governing the banks.” (Fleming, Chu, and Bakker, 1996, p. 3). The reform process was, however, facilitated by the respective countries’ initial political and social environments. Public attitudes in both Estonia and Lithuania towards market-oriented reforms were highly favourable (see Figure 5.3). In 1991, more 70 % of the survey respondents in Lithuania answered that they supported the transition to a market economy, whereas only just above 10 % opposed such a transition. The corrsponding figures for Estonia were 59 % and 25 %, respectively. Economic reforms in the Baltic states not only had an economic rationale, they were also seen as an essential part in (re)-building their nations and distancing themselves from the Russian sphere of influence. This also explains the somewhat lower support for market-oriented reforms in Estonia, a difference most probably driven by the large Russian population in the country, which was more skeptical of a break with Moscow. This, however, this cannot be said with certainty.

Notwithstanding the many similarities between Estonia and Lithuania, the two countries differed, at times substantially, with respect to the speed and coherence of subsequent reforms (Bohle and Greskovits, 2012, p. 96). Initially both countries embarked on a radical reform agenda, dismantling the operations of Gosbank and merging them with the newly established national central banks, transferring all the commercial functions of the central banks to the newly founded banks: Northern Estonian Join-Stock Bank (NEJSB) and Lithuanian State Commercial Bank (LSCB),[11] and introduced their own national currencies. Nevertheless, after the initial reforms the pace slowed in Lithuania, state-aid to banks was not dismantled, state-owned banks were not privatised, and the bankruptcy legislation was not properly enforced. Conversely, Estonia continued on the course that it had entered upon, raising the minimum capital requirements, dismantling state aid and state ownership of banks.

An overview of the reform paths in Estonia and Lithuania is given by Figure 5.4. Although it is difficult to make any substantiated claims about the legislation from the time lines in the

[10]It is important to note that the introduction of two-tier banking did not necessarily imply the privatisation of banks. In many countries a number of state owned commercial banks (SOCB) were created “by hiving off the commercial portfolios of the national banks and dividing the clients along regional (for example, Poland) or sectoral (for example, Hungary) lines.” (Bonin et al., 1998, p. 3). This was also the case in Estonia and Lithuanian when they introduced two-tier banking in their respective countries.

[11]Both the NEJSB and the LSCB were fully owned and controlled by the countries respective central banks (Hansson, 1995, p. 147).

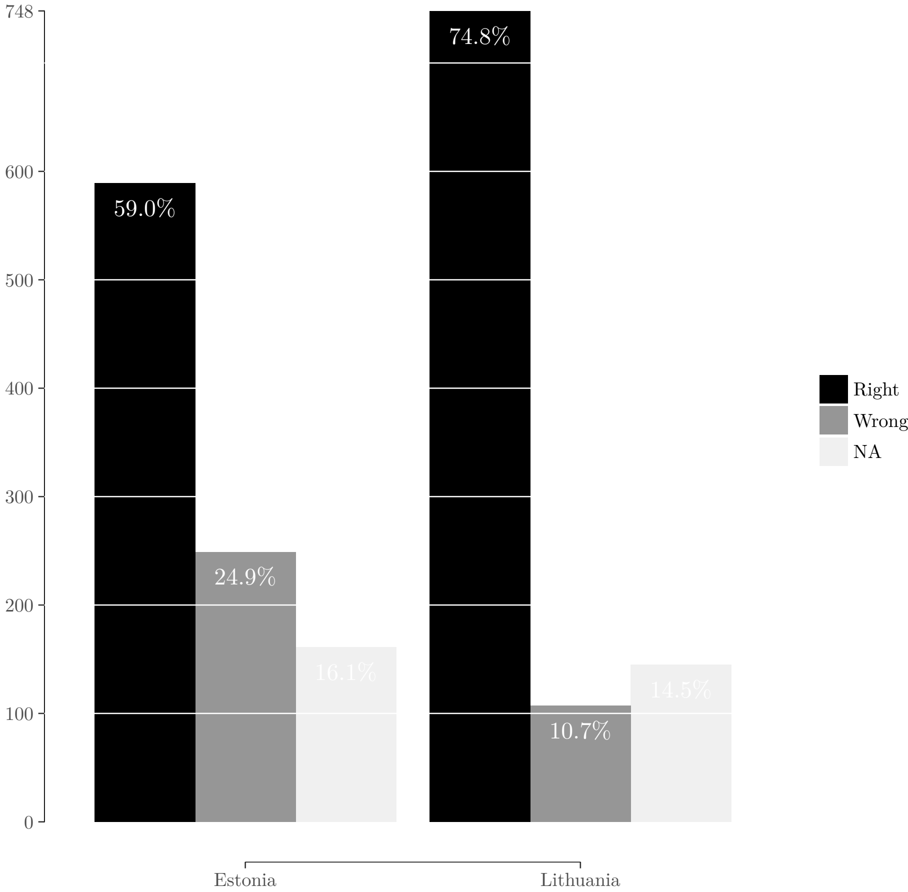
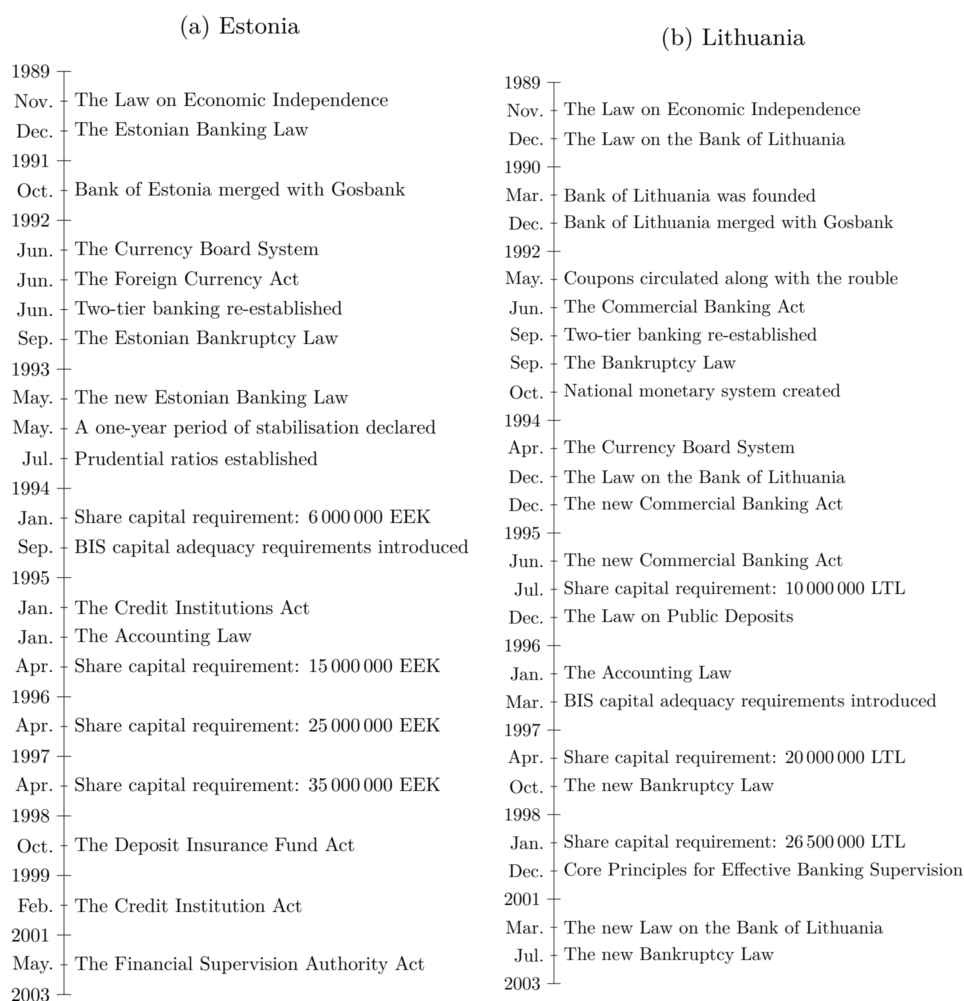


Figure 5.3 – The bar graph depicts the number and percentage of respondents that, in 1991, answered Right or Wrong to the following question: Do you personally feel that the creation of a free-market economy, that is one largely free from state control, is right or wrong for Estonia/Lithuania's future? The light grey bars represents non-respondents. Source: Central Archive for Empirical Social Research (1997).

figure, one thing is especially worth noting. Important pieces of legislation — such as accounting rules, legislation governing credit institutions, capital requirements. bankruptcy legislation etc.— were persistently adopted earlier in Estonia than in Lithuania. The radical reform agenda, I will argue below, adopted in Estonia, was facilitated by the consolidation of the banking sector in the country. The banking crisis of 1992 consolidated the banking market in the country, creating a couple of leading banks that were strong enough to comply with the transition to the market economy. Already in 1994, the Estonian government had sold most of its shares in the banking sector and in 1997 the banking sector was completely in private hands. Conversely, Lithuania did not successfully consolidate its banking market to the same extent as Estonia, which made it harder for the government to transpose and implement the EU requirements during the accession negotiations. Furthermore, as late as 2000 the Lithuanian government still owned substantial shares in the banking market, and it took until 2001 before the banks where fully privatised.

Figure 5.4 – Banking Reforms



If we instead look at how the European Commission (Commission) has evaluated reform in Estonia and Lithuania during their accession to the EU (see Figure 5.5), we see that the reform process was substantially slower in Lithuania and that the move towards full reform took place later than in Estonia. At the beginning of the reform process the two countries were relatively similar in their compliance with EU requirements, the Commission finds that both countries needs to make substantial improvements in their legislative and organisational structure in order to be able to comply with the Acquis Communautaire (Acquis). Estonia moved forward quickly with the reform process, and already in 2000 the country had brought institutional quality in line with EU requirements, although the Commission saw that further improvements in all four dimensions were possible. However, in 2002 the country was considered to be in full compliance with EU requirements. Conversely, Lithuania only managed to reform its banking system in the beginning of the 2000s, and despite the late reform efforts there was still rooms for improvements in the country according to the Commission.

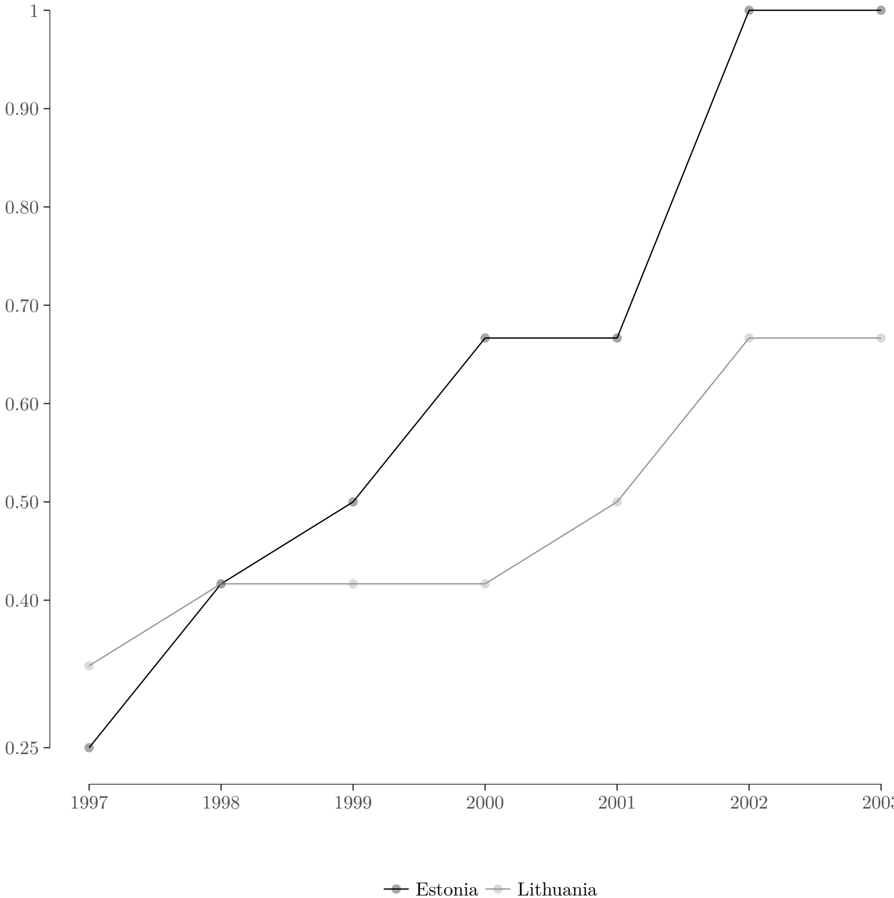


Figure 5.5 – The Commission's assessment of bank reform in Estonia and Lithuania between 1997 and 2003. The data include an average from all four dimensions of institutional quality.

5.2.1 Estonia

To understand the trajectory of banking reform in Estonia, it is necessary to first look at the implementation of the new currency and its effect on the consolidation of the banking sector. As discussed above, the preparation for the introduction of the new currency had already begun before the country regained its independence. The issue of currency reform had also become a politically loaded question, the currency being an important symbol of national self-determination. In an address to the Riigikogu, the then PM, Edgar Savisaar, reassured its members that the currency reform was on its way (FT, May.1990). In a similar vein, the chairman of the central bank, Rein Otsason, promised reporters that the new currency would be circulating already in December 1990 (Reuters, Jan.1990).

Three arguments were brought forward in favour of currency reform: curbing inflation, establishing macroeconomic balance between supply and demand, and solving the cash shortage (Sõrg and Vensel, 2002, p. 36). However, the choice of how to implement the new currency was not evident, and several alternatives were available to Estonian policymakers. The original four man proposal by Kallas et al. (Sept.1987) advocated a convertible rouble as an internationally accepted medium of exchange, and Latvia and Lithuania opted for an interim currency in which the rouble was gradually replaced by the new national currency. In the end, Estonia opted for a Currency Board Arrangement (CBA), pegging the Estonian Kroon (EEK) to the German D-mark, which it was believed would stabilise the economy, bring about structural change and facilitate Estonia's integration into the world economy (Lainela, 1993, p. 430).[12] The idea of a CBA as the mechanisms behind the currency reform was launched, and later advocated, by the central bank governor Siim Kallas in early 1992.[13] The main advantage of this arrangement is that it provides an efficient mechanisms for governments to get inflation under control, since it renders inflationary spending impossible by tying the hands of central bankers and politicians (Hansson and Sachs, 1994, p. 2). For the same reasons, the currency board, also has disadvantages. Because inflationary financing is impossible and the exchange rate is fixed, other factors — such as interest rates, prices and wages — must adapt. Hence, the social costs — and for that reason also the political costs — of the CBA are often high (see Nørgaard (2000) for some

[12] To support the new currency a number of new laws were passed by the Riigikogu — the Currency Law, the Law of Backing the Estonian Kroon, and the Foreign Currency Law — laying the foundation for Estonia's financial system for years to come (Cavalcanti and Oks, 1998, p. 1).

[13] While it is difficult to substantiate from exactly where the idea of the CBA originated, scholars have tended to attribute it to the American economist Jeffrey Sachs: "Sachs proposed to Kallas that Estonia adopt a currency board arrangement (CBA). [...] Kallas was attracted immediately to this concept because currency boards were associated with the same transparency and high degree of confidence as the gold standard. The implementation of a CBA would also immediately solve the problem of resisting demands for credit from the government and enterprises and at the same time side-step the challenge of managing an independent monetary policy..." (Knöbl, Sutt, and Zavoico, 2002, p. 11).

of the social costs associated with the CBA).

The implementation of the EEK culminated in the summer of 1992 when the new currency was introduced into circulation. All the money issued by the central bank was backed by an equal holding of foreign currency reserves. The CBA also prohibited the central bank from bailing out governments, commercial banks and enterprises, which, if enforced, would coerce private actors to become more efficient instead of relying on state support.(Hansson, 1994, p. 135).[14]

During the preparation of the currency reform the main political force in the country was the PFE under the leadership of Edgar Savisaar, established on 13$^{\text{th}}$ April, 1988 as an umbrella organisation for numerous political groups. The movement was critical of the Soviet Union, even including some factions of the national communist party (Bugajski, 2002, p. 71). In the 1989 election to the Congress of the USSR People's Deputies, the PFE won 29 out of 36 seats (Lagerspetz and Vogt, 2004, p. 63). A year later — on 18$^{\text{th}}$ March, 1990 — the election to the the Supreme Council of the Republic of Estonia was held, 45 out of the 105 seats were won by candidates of, or closely related to, the PFE. All in all, 73 of the seats were held by nationalist-minded politicians, whereas 27 seats were held by the politicians supporting Estonia's continuing existence as a Soviet Republic, and five seats were occupied by members of the USSR army. Edgar Savisaar was elected as the country's PM (Riigikogu, 2017). Although the PFE was an encompassing movement, which included many different factions of the political spectrum, Savisaar is best characterised as a centre-left politicians who advocated a gradual break with the USSR.

Despite his gradualist approach the Soviet Union soon started to crumble, leading Estonia to declare its independence from the USSR on 20$^{\text{th}}$ August, 1991. Nevertheless, this did not substantially change the distribution of political power within the Riigikogu.[15] The Supreme Council of the Republic of Estonia continued to be the highest political body in the country. Thus, a strong consensus on the direction of reform existed among the political elites in Estonia, although the PM did not have a political majority behind him in parliament.

In addition to the government and the Riigikogu, the other important player for the introduction of the new currency was the chairman of the BoE. Rein Otsason had assumed the position on 28$^{\text{th}}$ December, 1989, just three days before the central bank recommenced its operations. Otsason had been a leading figure in Estonia's struggle for economic independence. In the late 1980s he had challenged a number of Soviet laws on banking in an attempt to introduce Western style banking operations to the country (Independent, Aug.1990). The role of the central bank

[14] Exceptions to the no bailout clause were allowed in the case of a severe banking crisis.

[15] The declaration of independence had been preceded by a referendum on 3$^{\text{rd}}$ March, 1991. 79 % of the voters voted in favour of independence, with a turnout of 83 %. However, two thirds of the Russian minority voted to stay in the USSR.

and its relationship to the other political institutions in the country was unclear at this early stage of the transition. Early on a conflict between the central bank and the government erupted, on the surface concerning the timing of monetary reform (BBC, Nov.1990; Times, Sept.1991). However, the conflict is better understood as a power struggle between the government and the central bank, with Savisaar trying to subordinate the BoE to the government (Zirnask, 2002, 27f.). Otsason resigned on 13th September, 1991 after a disagreement over policy with the government. New legislation allowed Russian banks to operate freely in the country, which, according to Otsason, risked creating an influx of inflationary roubles into the country (BBC, Sept.1991), and in the long-term risks destroying the Estonian banking sector. According to Otsason: "In Sweden and Finland, foreign banks were kept out for 40 years after the second world war to let their own banks establish themselves." (quoted in FT, Sept.1991).

Otsason was replaced by Siim Kallas on 23rd September, 1991. As one of the authors of the four man proposal, Kallas had been an important part of Estonian politics early on in the transition process, and he was a strong proponent of currency reform. In an interview with the Financial Times Kallas said that "[t]he desire to have our own currency is so big that the advantages outweigh the possible disadvantages." (quoted in FT, June.1992). Already before he was appointed governor of the central bank, Kallas had been part of the small group of policymakers that prepared for the introduction of the new currency. Kallas was one of the founding members of the Monetary Reform Committee (MRC), which was established in 1991 with the task of putting forward a reform plan for an independent currency.[16] The committee was given extensive powers to deal with all issues regarding currency reform, and its decisions were legally binding (Drēvina, Laurinavičius, and Tupits, 2007, pp. 12–13). Furthermore, to ensure its full commitment to market-oriented reforms, the staff of the MRC was hand-picked (Knöbl, Sutt, and Zavoico, 2002, pp. 5–7).

The power struggle between the central bank and the government soon intensified. Despite being committed to the transition, Savisaar had begun to lose political support among important constituencies, and, consequently, the reform process had begun to sag. The confidence in the rouble was lost, which was revealed by the high dollarisation of the Estonian economy. As a consequence, the PM started to look for ways to appease the electorate, seeking support further to the left on the political spectrum, increasingly relying on the Russian minority in the Riigikogu. Savisaar proposed to introduce a state of emergency, substantially increasing the government's powers to run the economy, even if it contradicted Estonian law (Park, 1994, p. 151). Had such a

[16]The founding members of the committee consisted of three members: Edgar Savisaar (PM), Rein Otsason (chairman of the BoE), and Siim Kallas (expert appointed by the Riigikogu). In early 1992 the MRC was reorganised to include: Tiit Vähi (PM), Siim Kallas (chairman of the BoE), and Rudolf Jalakas (expert appointed by the Riigikogu).

proposal managed to gain sufficient support in the Riigikogu, the powers of the BoE would have substantially diminished. The proposed state of emergency would have steered the country on a less liberal path, allowing the government to once again take control of prices, impose boarder controls, and ration food products etc.

The opposition to the proposal presented by the PM was intense with some parliamentarians calling it an act of "war communism" (quoted in Reuters, Jan.1992). Mart Laar, the then opposition leader, expressed the critique of the Savisaar government in the following way: "[t]he government has promised us a market economy, privatization and land reform, but none of it has materialized." (quoted in AP, Jan.1992). At first, the parliament supported the bill, but after intense lobbying from the right-wing opposition, enough members were persuaded to vote against the new measures. The failure to pass the state of emergency forced Savisaar's resignation, and he was shortly after — on 27th January, 1992 — replaced by the transition government of Tiit Vähi.

The cabinet was formed by the Estonian Coalition Party (ECP) — the party of the PM and the senior party in the government coalition — together with the Rural Union (RU). The ECP is best characterised as a centrist party, with their main constituency being previous managers of small SOEs favouring economic transition and former communists from the Free Estonia Movement (Bugajski, 2002, p. 61). The main architects behind the party were former communist party officials. Many of the more reform-minded politicians were concerned with the party's ties to the former Soviet nomenklatura. Marju Lauristin, leader of the Estonian Social Democratic Party (ESDP), told journalists that: "A lot of people are fond of Mr. Ruutel as a person, but they were suspicious about his connections with the old networks." (quoted in CHSM, Oct.1992).

The new government came to play an important part in the introduction of the new currency. PM Vähi set out three goals for his tenure: currency reform, the adoption of a new constitution, and new elections by the end of 1992 (Laar, 2009, p. 8). At a press conference Vähi made it clear that Estonia could not continue to be part of the rouble zone, despite the fact that the implementation of the new currency would be demanding given the troublesome economic situation in the country (AFPR, May.1992). The rouble zone had quickly deteriorated after the fall of the Soviet Union, and more and more countries now realised that exit was the only viable option.

The first hurdle to the introduction of the new currency came in May 1992, when Vähi, in response to the cash shortage in the country, suggested that Estonia should circulate the EEK as a parallel currency to the rouble. Such a proposal ran contrary to the idea of strict

fiscal discipline underpinning the proposed CBA. Kallas objected strongly to the plans, and Vähi was not able to secure support for the idea in the Riigikogu (Kukk, 2014, p. 26). After having successfully buried the proposal by Vähi, Kallas moved quickly with the introduction with the of the new currency and on the 20th of June the EEK became the sole legal tender in Estonia. The speed of the reform was, according to Kallas himself, paramount for the success of the reform: "you have to move fast, since after a certain period all reforms can drown into discussions." (Kallas, 2003, p. 511). One weak later the Estonian citizenry approved the new constitution in a referendum, establishing the BoE as the sole issuer of Estonian currency. It also further safeguarded the independence of the central bank. Article 112 holds that the BoE should carry out its duties according to the law and should report to the Riigikogu.

To be sure, international organisations — especially the IMF — were important for the implementation of the CBA. However, their involvement was mainly in the form of technical assistance and training for public servants. As one former PM puts it: "Our desire to get to capitalism was enormous, but the details of what this involved were lacking. We saw the Fund as the repository of market and financial knowledge that we needed." (quoted in Knöbl and R. Haas, 2003, p. 22). Nevertheless, decisions over monetary reform were taken by Estonia, sometimes despite the disapproval of the IMF. As late as 1992, the IMF argued that the country was not prepared to implement a CBA, arguing that it could have negative implications for the country's economy (Knöbl, Sutt, and Zavoico, 2002, pp. 12–13). In an interview with Demokratizatsiya, Kallas describes the situation:

> [W]hen we [the BoE and the IMF] agreed that monetary reform would happen, they actually put enormous resources to assist us. So in this final stage we had very close and fruitful cooperation. In this sense, I also appreciate very much their role in this. But on the stage where we discussed the ideology or concept, it was our choice. (Kallas, 2003, p. 512).

Thus, the importance of the international community should not be overstated. Its role was mainly to strengthen the capacity of Estonia to pursue its reform agenda. In terms of policies, Estonian authorities often wanted to go further than advocated by international organisations, and it is therefore not possible to claim that Estonian currency reform is best explained by the role of international pressure. As I will show below, this pattern of disagreement between the IMF and the Estonian authorities also recurred at later stages in the reform process.

Consolidation and Regulation of Banking

Shortly after the new currency was introduced, Estonia held its first election as an independent country. Figure 5.6 shows the distribution of seats among the nine parties that managed to enter the Riigikogu. The PFE lost much of its prominence in the election and only managed to secure 14.9 % of the seats in the parliament. Instead, the big winner in the election was the Pro Patria Union (PPU) which managed to gain control of almost 30 % of the MP seats. It was a radical nationalist party, aiming to establish a homogeneously Estonian nation-state (Bugajski, 2002, p. 72), and with regards to economic policy the party advocated a liberal free-market agenda. The party managed to form a coalition government together with the Moderates and the Estonian National Independence Party (ENIP). The Moderates was a coalition consisting of ESDP — which was the senior party in the coalition — and the Estonian Rural Centre Party (ERCP), advocating a more gradual approach to transition. The cabinet consisted mainly of politicians, although some non-party experts also were brought in (Meleshevich, 2007, p. 55). The main opposition party, the Secure Home, was a coalition in which the ECP constituted the most important part.

The 1992 election has to be interpreted as a clear victory for the right-wing parties in Estonia. As noted above, because of the poor performance of the PFE the centre-left lost much of its influence over Estonian politics in the coming four years. To be sure, the Moderates managed to become part of the government, but they were of course well aware that other potential coalition partners to their right existed, especially the ECP. This was something that clearly diminished their bargaining power. Although the ECP was still viewed as a party with ties to the old regime, the former PM and party leader Vähi had shown a commitment to market-oriented reform.

Because of several scandals, unrelated to reform agenda, and a vote of no confidence in the Riigikogu, Laar was forced to resign in 1994, almost one year before the next national election was scheduled. The president, Lennart Meri, first nominated Kallas — still chairman of the central bank — but did not manage to secure the necessary support in parliament for his election. Instead a compromise was reached to elect Andres Tarand as the new PM. Tarand stood to the left of the political spectrum, but was not beholden to any party (FT, Oct.1994). He promised that he would not change the course of the government's policy before the election.

The Laar government inherited a banking sector in an early stage of development. The early years of the transition period had been characterised by a rapid increase in the number of new banks; more than 40 authorised banks existed by 1992 (see Figure 5.7a). A number of reasons for this surge can be advanced. As mentioned above, the high inflation had de facto eroded the minimal capital requirements needed to start a bank, and the nascent financial market allowed

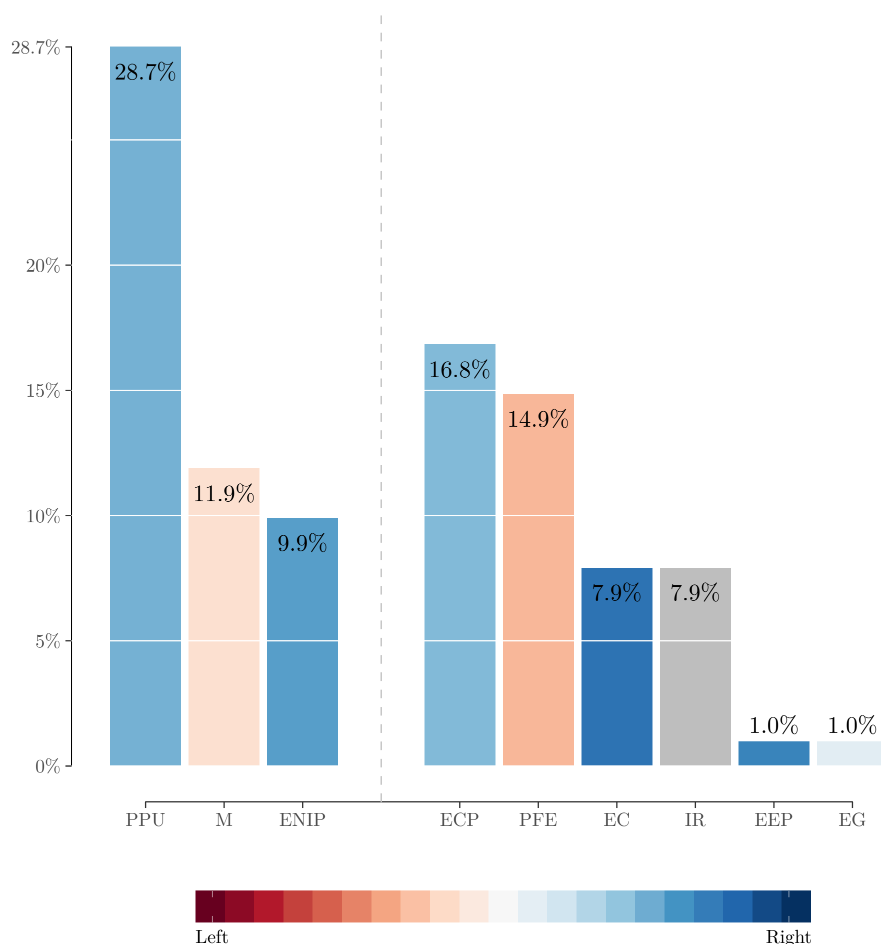


Figure 5.6 – The composition of the Riigikogu as of the election on the 20th September, 1992. The intensity of the colours of the bars represent the parties' position on the left-right dimension. The cabinet parties are located to the left of the dashed line. The grey bar represents NA values. Source: Döring and Manow (2016).

banks to access cheap central bank credit, obtain high profits from foreign exchange trading, and arbitrage between cash and non-cash money (Hansson and Tombak, 1999, pp. 205–206). Commenting on the necessity to establish a banking supervision system, Bo Kragh, a Swedish banker advising the Estonian government at the time, told news reporters that it "is a Wild West situation here." (quoted in FT, Dec.1990). In short, banking had become a business for easy profits, and many of the credit institutions were small and undercapitalised. Only two banks, the TCB and Union Baltic Bank (UBB), controlled a significant market share (World Bank, 1993, p. 51).[17]

In an audit conducted by Price Waterhouse Coopers (PwC), it was discovered that the risk level of assets was high. Supervision was obstructed, both because of the inadequate legal environment and the insufficient resources available to the supervisor agency: "The work of

[17]The three leading banks, the TCB, the UBB and the NEJSB, had a combined market share of around 40 % of total banking assets. This can be compared to the situation in 1997, when the largest bank, Hansa Bank, controlled a market share of more than 50 %.

bank supervision is impeded by the inadequacy of a legal framework regulating the activities of banks, so that bank inspectors often have difficulties in finding a legal basis for their views and requirements." (Bank of Estonia, 1993). Most banking supervision had been directed towards the activities of the small banks, while not taking sufficient steps to enforce prudential regulations with regards to the larger banks. The decision was probably the result of several factors, such as an insufficient understanding of the possible systemic consequences of unregulated larger banks, a naive expectation that the problems faced would disappear with time, and powerful bank owners using their political influence to muster support for their failed large banks (Hansson and Tombak, 1999, p. 210). The Estonian Social Bank (ESB) is a case in point. Its liquidity problems were well known in the Estonian banking community, but the authorities did not take the necessary steps to enforce prudential regulations. Conversely, only a few weeks before a moratorium was imposed on the bank, the central bank had declared it financially sound, encouraging other commercial banks to provide it with interbank loans. The ESB was liquidated in 1994 (Fleming, Chu, and Bakker, 1996, p. 10).

The adoption of the CBA was instrumental in the emergence of the first financial crisis in 1992. The main factors underlying the first banking crisis were domestic. Hansson and Tombak (1999) identify three main causes: (1) unexpected changes in the macroeconomic environment; (2) carless behaviour by insiders (managers, owners, and state officials); and (3) deficient enforcement of existing prudential regulations.

Before the currency reform many banks earned large profits by speculating on the rouble (Sõrg and Vensel, 2002, p. 43). When real interest rates rose, the availability of credit tightened, and exchange rates stabilised as a consequence of the macroeconomic stabilisation program, many of the Estonian banks turned out to be insufficiently efficient to operate in the new macroeconomic environment. Before the currency reform the main source of income for commercial banks was currency speculation. This changed drastically after the implementation of the CBA (Sõrg, 2003, p. 3). In addition to the increased macroeconomic pressure, many bank managers were inexperienced. Two Estonian banks — the Eesti Sotsiaalpank (ESP) and the Eesti Tööstuse Arengu Pank (ETAP) — found themselves in difficulties due to a series of bad management choices, reflecting the banks' poor corporate governance. In another matter the BoE concluded that "the shareholders were unduly influencing management, were involved in making credit decisions, and received a large portion of the loan portfolio." (Castello Branco, Karnmer, and Psalida, 1996, p. 35).

Supervision of commercial banks between 1990 and 1992 was almost nonexistent, and little had had been done to change this status quo. The BoE did not have the resources or the

competence to conduct supervision. For example, the prudential rules established by the central bank were of little use since the accountancy standards did not give a correct overview of the banks financial situation. A World Bank report stated that:

> The abandonment of Soviet accounting practices was not followed by the adoption of clear accounting standards. As a result, financial transaction reporting is inadequate. The financial statements of individual institutions are not strictly comparable, and consequently it is difficult to determine the solvency of banks. Internal audit is not practiced, and only one commercial bank has submitted its accounts to external auditing (with the purpose of attracting foreign capital).[18] (World Bank, 1993, p. 54).

Adherence to the IAS took until 1995 in Estonia. That it took so long for the central bank to adhere to these standards is partly because of the fear that commercial banks would not be able to comply with the stricter accounting standards (Bank of Estonia, 1994). Indeed, as pointed out by Zirnask (2002, p. 41) a number of commercial banks were actively working against the adoption of new accounting standards at this early stage.

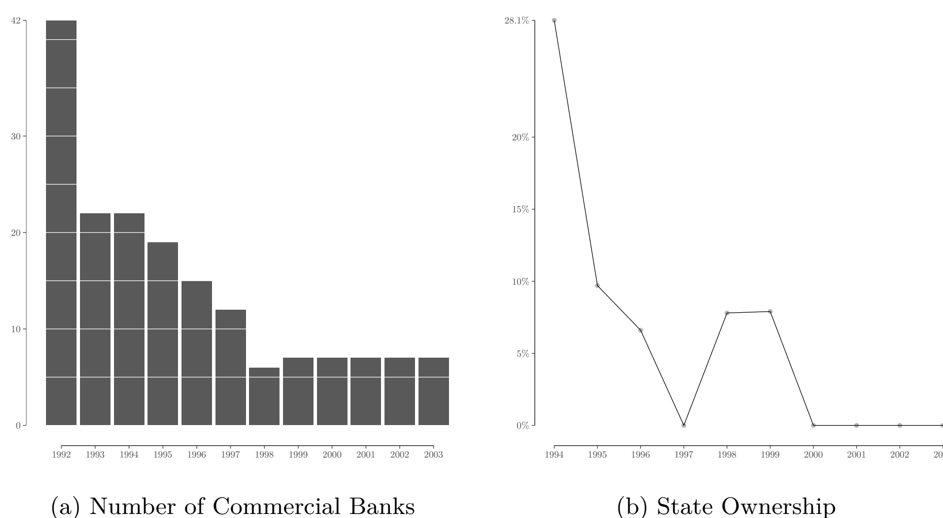
When the banking crisis hit, the central bank, together with the government, acted swiftly to resolve the crisis, which according to some analysts "paid off spectacularly" (Bonin et al., 1998, p. 122). In a meeting between the government and the central bank on 17th November, 1992 it was decided to suspend the operations of the country's three largest commercial banks — UBB, NEJSB, and TCB — and eight smaller banks.[19] The government and the central bank also agreed to remove the chairmen of the UBB and the TCB from office, a decision that was taken in spite of strong opposition from the banks concerned (Reuters, Nov.1992). While handing over the cases to the state prosecutor, Siim Kallas told the press that "[w]hite collar crimes must not go unpunished…" (quoted in Reuters, Dec.1992). Some time later, the TCB was placed into compulsory liquidation, its assets were auctioned, and depositors were only compensated to the extent that assets were recovered. The UBB and NEJSB, on the other hand, were merged into a new bank, the North Estonian Bank (NEB). Solvency for the new bank was provided by the Estonian government, whereas the central bank supplied liquidity. By acting quickly and resolutely the government and the central bank wanted to send a signal to other banks that their behaviour had to be redirected towards the demands of the market economy (Bank of Estonia, 1993). PM Laar described the reaction of the old nomenklatura when they realised that the government would not bail them out:

[18] The commercial bank that first adopted IAS was Hansa Bank.

[19] The three largest banks together controlled 40 % of the country's deposit base.

> [A]s I bankrupted the first bank, all I said was that the bank was in bankruptcy, and he [the bank management] came to the government to ask for money, and he was totally sure that he would get it because he always had gotten it, and he didn't understand me at all, he didn't believe me. (Laar, 2003, p. 501).

The resolution of the crisis had two major effects on the banking sector: it consolidated the market and reduced the involvement of the state. Figure 5.7a plots the number of commercial banks in Estonia between the years 1992 and 2003. After just one year the number of banks had dropped from 42 to 22. In a similar fashion, the state's involvement in the banking sector also decreased rapidly. Between 1994 and 1995, the asset share of state-owned banks decreased from 28.1 % to 9.7 %. The banks that survived the crisis were mainly commercial banks that were established after 1991. Hence, most of the banks that were allowed to fail during crisis belonged to the category of commercial banks that started operations before 1991 (Lainela and Sutela, 1994, p. 99).



(a) Number of Commercial Banks

(b) State Ownership

Figure 5.7 – The left hand panel depicts the number of commercial banks in Estonia between 1992 and 2003. The right hand panel plots the asset share of state-owned banks between 1994 and 2003. Source: author's calculations based on data published in the EBRD Transition Reports.

The consolidation of the banking market is best illustrated by looking at the asset share as a percentage of total assets for the five largest banks in the country. As shown in Figure 5.8, between 1993 and 1995 three banks came to control an increasingly large share of the banking sector. In only two years, the three largest banks had gone from a market share of around 46 % to 59 %, a trend that would continue in subsequent years. The centralisation of capital in the hands of a fewer actors strengthened the banking sector, making it more resilient to external shocks in the macroeconomic environment and able to better comply with new regulations. The importance of this development for further reforms was acknowledged by both politicians and

regulators, although they also saw a need for further consolidation. “The restructuring of the banking sector is a priority,” (quoted in Reuters, May.1993) PM Laar told journalists at a press conference. Also the BoE send clear signals that it would continue to encourage the further consolidation of the banking sector (Zirnask, 2002, p. 96). As a consequence, in April 1993 the central bank declared a period of stabilisation until January 1994, during which no new banking licenses were granted.

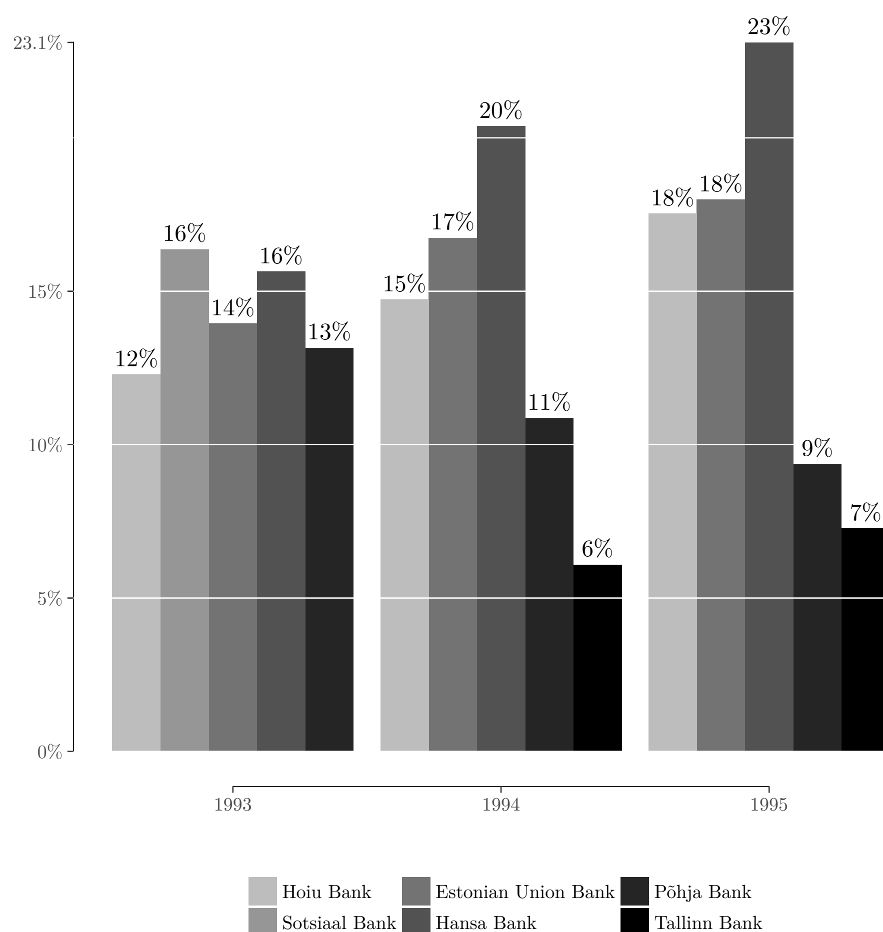


Figure 5.8 – The bar graph shows the asset share as a percentage of total assets, for the five largest commercial banks between 1993 and 1995. Source: Zirnask (2002)

In this context, two banks that emerged as market leaders are particularly worth mentioning: Hansa Bank and the Estonian Union Bank (EUB). The former was founded in 1991 by a group of young Estonian bankers that that saw a business opportunity in the emerging market. The bank was founded as a subsidiary to the TCB, but with its own management. In contrast to many other banks, Hansa Bank management decided to follow a more risk-adverse path, which made it possible to capitalise on the financial meltdown of 1992 by picking up parts of the business that were left by the banks that exited the market. The then vice-chairman of the board of Hansa Bank commented on the crisis in the following way: “Probably we were the bank that

gained the most from the crisis… Luck was partly on our side, and good timing. We got most of the customers from the other banks…" (quoted in WSJ, Feb.1995). The history of EUB is somewhat different, the bank was created by a merger of ten small banks in the beginning of 1992.

The BoE saw an opportunity in the new banking landscape, working closely with the new market-leading banks to further consolidate the market would make it easier to build support for the reform agenda. Weaker banks no longer posed a systemic threat to the economy, and could be easily absorbed by the larger banks or be ignored by the central bank. The then deputy head of banking supervision expressed it in the following way: "We have a couple of smaller banks that are weak. I think four of them will merge at the end of this year. They are too little and do not play any role in our economy." (quoted in Reuters, May.1994).

In the spring of 1993, the central bank, in close cooperation with Hansa Bank, started the work to establish the Estonian Savings Bank (ESB) on the market. The ESB was the legal successor to the Savings Bank of the USSR, and at this point in time was controlled by the BoE. On 1st March, 1993 the BoE arranged the acquisition, in which Hansa Bank controlled one third of the share capital in the bank. As a part of the deal it was agreed that Hans Bank would invest 20 million EEK to develop the operations of the ESB; the BoE invested 40 000 000 EEK (Bank of Estonia, 1993). In addition, Hansa Bank also agreed to help strengthen the management team of the ESB (IMF, 1999, p. 27). A similar story can be told with regards to the second largest bank in the country at that time: the EUB. In September 1995, after negotiations with the BoE, EUB acquired a minority share in the NEB, but effectively took over the bank management (Reuters, Jan.1997). Shortly after the purchase it turned out that the bank was heavily insolvent. To enable the bank to meet the prudential ratios in the country the owners had to provide a guarantee against bad loans in the bank (IMF, 1999, p. 28). Two years later, in January 1997, the government and the central bank sold their remaining shares in the NEB to EUB creating a bank on equal footing with Hansa Bank in terms of total assets (BNS, Jan.1997).

The banking crisis had revealed a number of flaws in the Estonian legislative and regulatory environment, setting off two parallel processes. With regard to legislation the Riigikogu together with the government begun the work on a new Credit Institution Act (CIA) that would improve the legislative environment in the country. Parallel to this the central bank started a process of strengthening the prudential requirements of the banking market, and reorganising the supervision department of the BoE. On 18th May, 1993, the Riigikogu adopted the Bank of Estonia (Eesti Pank) Act, which further strengthened the BoE's independence vis-à-vis the

government. The act states that the central bank is obliged to report to the parliament and is not subordinated to the government or any government agency (Riigikogu, 1993, Ch.1, §. 3). In addition, a number of legislative acts were adopted: the Accounting Law introduced modern accounting practices, and the new Business Law strengthened the legal authority of banking supervisors in their demands that banks follow modern risk management principles. The new CIA was adopted in December 1994, based on the principles of EU law, although it also aimed to take into account the developmental level of the Estonian banking sector. The act dealt with most aspects of banking, such as banking supervision, the foundation, reorganisation and termination of credit institutions, the establishment of subsidiaries or branches of a credit institution of a foreign state, accounting and reporting, and money laundering (Bank of Estonia, 1994). The legislative changes were strongly supported by the largest banks in the country. In a press conference one of Hansa Bank's spokespersons, Marko Err, told reporters that he was certain that the positive reform agenda would continue after the next general election (Reuters, Mar.1995).

Parallel to the legislative agenda, the BoE started to strengthen the prudential requirements of banks. The earlier rules had only regulated banks' exposure to a single borrower, but the new rules, taking effect in July 1993, took into account a number of prudential ratios: solvency ratio, liquidity ratio, and risk concentration. The solvency ratio was set to a minimum of 8 %, the liquidity ratio to a minimum of 30 %, and the risk-concentration ratio to 800 % (Bank of Estonia, 1993).

The central bank acknowledged that the new prudential ratios only constituted the beginning of reform and that more needs to be done in the future. However, the strength of the Estonian banking market had also to be taken into account. The regulatory push from the BoE was strongly supported by the leading banks in the country: "Imposing the [prudential] requirements above has greatly increased the credibility of Estonian banks in the eyes of both local and foreign customers." (Hansa Bank, 1993). For the leading banks in the country the more prudent ratios were not only a way to increase the credibility of the banking sector, but also allowed them capture a larger share of the banking market when smaller banks were liquidated. In addition to the prudential ratios, the central bank also strengthened the minimum capital requirements and the equity capital requirements in the country for existing commercial banks. The minimum equity capital was set at 6 000 000 EEK in January 1993, 15 000 000 EEK in April 1995, 25 000 000 EEK in April 1996, and 35 000 000 in April 1997. Equity capital had to be at least: 50 000 000 EEK by January 1996, 60 000 000 EEK in January 1996, increasing to 750 000 000 EEK by January 1998. The larger banks, especially Hansa Bank and the EUB, took a lead in raising

the share capital, aiming to increase their share capital to between 150 and 200 million EEK, already in 1994 (EEBL, Apr.1994).

The central bank's decision to raise capital adequacy was partly driven by a will to consolidate the banking market, based on the idea that it was easier to monitor a small number of banks. However, the causality goes both ways. As pointed out by Zirnask (2002, p. 96), the strength of the banking sector also made it possible for the central bank to push forward with the increase in share and equity capital.

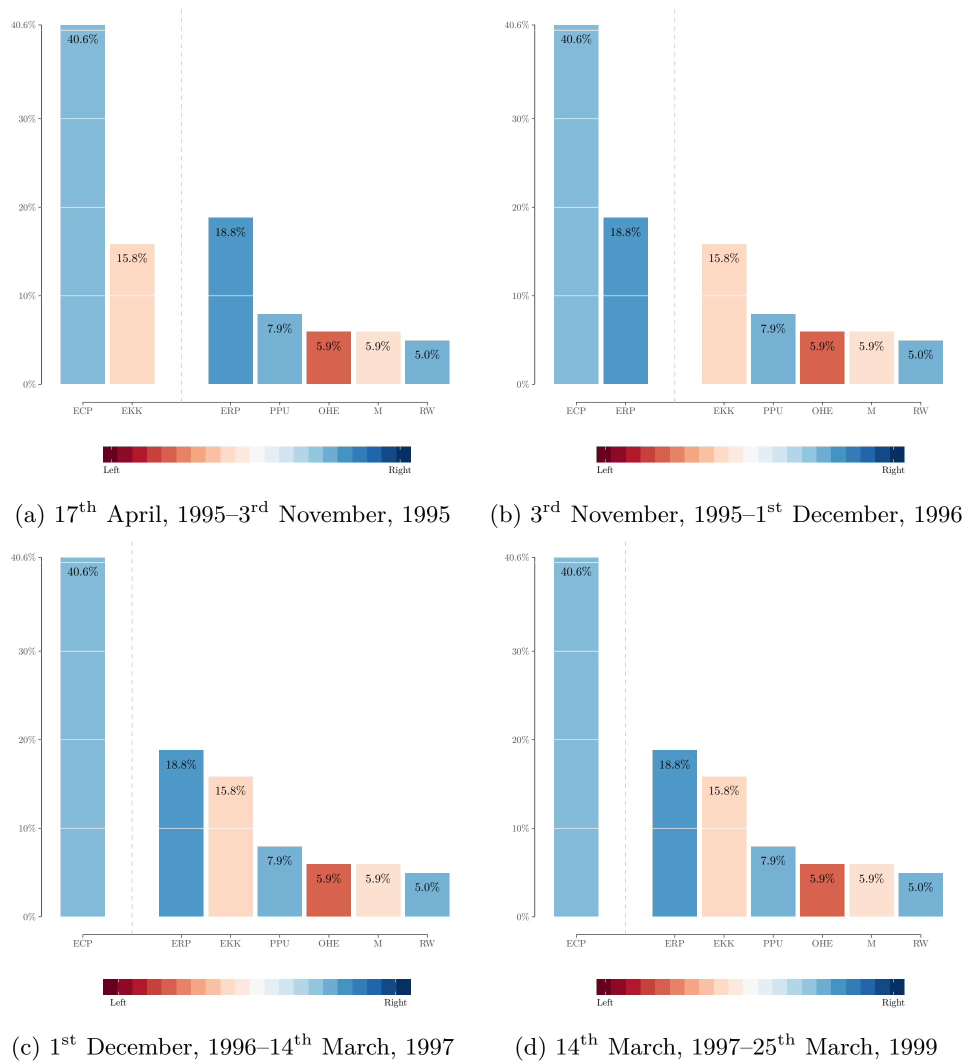
The Modernisation of the Banking Sector

The next election was held on 5$^{\text{th}}$ March, 1995, shortly after the banking crisis had fully abated. The outcome of the election is shown in Figure 5.9. Once again the government parties lost substantially in the election. The PPU lost almost 21 percentage points of their seats in the Riigikogu despite having joined forces with the ENIP. The results were widely interpreted as a rejection by the voters of "ferocious pace of post-Soviet reforms" (Reuters, Mar.1995).

The electoral winner was the alliance between the ECP, RU and two smaller parties. As described above, the ECP was considered a centre party, consisting of people from the old nomenklatura. Initially a government was formed between the ECP and the centre-left Estonian Centre Party (EKK) party, under the leadership of former PM Edgar Savisaar. However, the cabinet was forced to resign because of a phone-taping scandal involving the then interior minister Edgar Savisaar. To solve the situation Vähi restructured the cabinet basing his support on the Estonian Reform Party (ERP), a centre-right party chaired by Siim Kallas. The cabinets during this period is best characterised as partly political and partly technical, although the technical positions also were party nominees (Müller-Rommel and Sootla, 2001, p. 20). Kallas' election to the Riigikogu forced his resignation as the chairman of the BoE. He was succeeded by Deputy chairman Vahur Kraft, who committed to continue the reform agenda initiated under Kallas' leadership (BBC, Apr.1995).

The banking sector continued to consolidate during this period, and by 1998 Hansa Bank and EUB had taken a firm grip over the Estonian financial market. Figure 5.10 depicts the asset share as a percentage of total assets for the six banks that were present at the Estonian banking market in 1998. Hansa Bank and Estonian Union Bank together constituted more than 80 % of the banking market at this point in time. Furthermore, the state had disposed of almost all of its banking assets.[20] The consolidation of the banking market was the consequence of, on the one hand, the central bank's policy to further strengthen prudential ratios, and, on the other

[20] As a consequence of the second banking crisis the state took control over Optiva Bank. Nevertheless, only one year later Optiva Bank was once again in private hands.



(a) 17th April, 1995–3rd November, 1995

(b) 3rd November, 1995–1st December, 1996

(c) 1st December, 1996–14th March, 1997

(d) 14th March, 1997–25th March, 1999

Figure 5.9 – The composition of the Riigikogu as of the election on the 5th March, 1995. The intensity of the colours of the bars represent the parties' position on the left-right dimension. The cabinet parties are located to the left of the dashed line. The grey bar represents NA values. Source: Döring and Manow (2016).

hand, a second banking crisis forced some banks into bankruptcy.

The second banking crisis started in late 1997 when the Tallinn stock exchange plunged by 62 %. There are many reasons behind the crash, ranging from the East Asian financial crisis to the rapid expansion of the banking market. Instead of increasing the liquidity of the banking sector the central bank adopted an approach to further strengthen the regulations governing the financial market: "Banks' adequate capitalisation and sufficient liquidity have been the cornerstones of the Estonian financial system's credibility and its sustainable development." (Bank of Estonia, Oct.1997). Within only one week of the outbreak of the crisis the BoE had adopted a range of new standards; liquidity, minimum reserve and capital adequacy requirements were raised, and banks were forced to set-up a common banking reserve. The strategy adopted by the central bank was firmly supported by the government, which in a press release issued

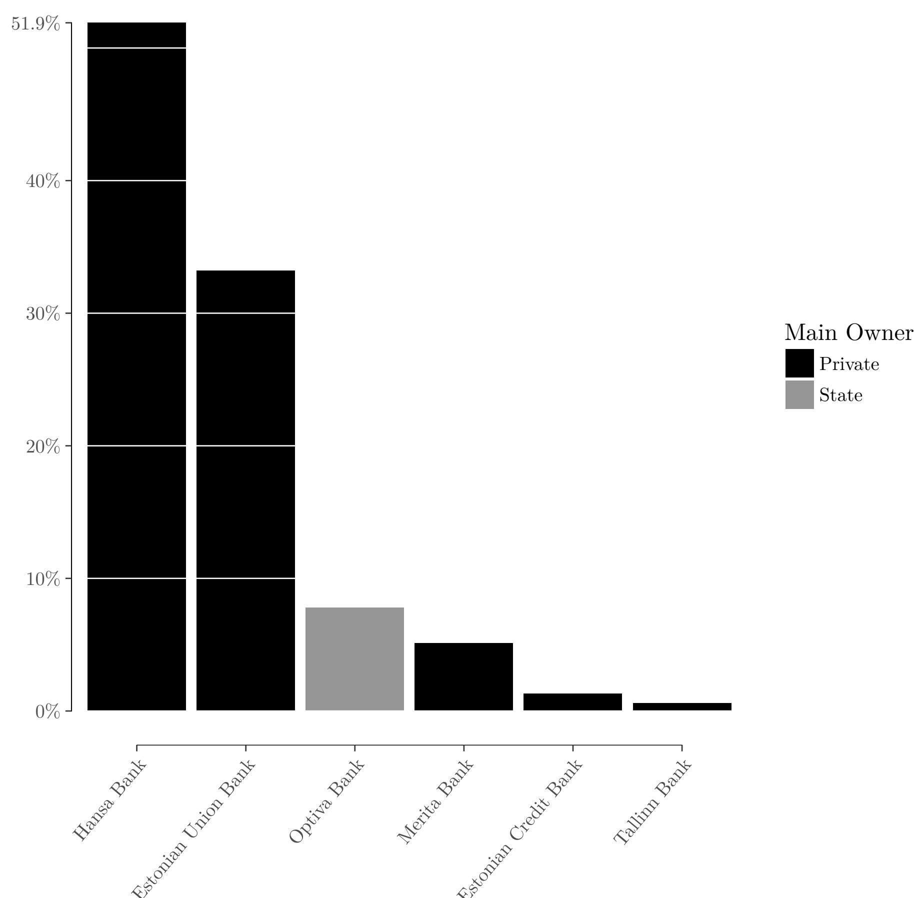


Figure 5.10 – The bar graphs show the market share of commercial banks in Estonia 1998.

with the bank stated that:

> We are of the opinion that the recent increase in interest rates and correction of share prices on Tallinn Stock Exchange should be regarded mainly as an adequate reaction of the market to the changed situation, not as a crisis of confidence in the credibility of the perspectives for economic growth in Estonia. Competition has forced the interest rates to fall below their medium-term trend average and assets have been overpriced because of excess market optimism. Now these two are going through a necessary correctional phase, which has been unarguably influenced by turmoil in the international capital markets. Consequently, regardless of the significant fall in share prices and rise of interest rates, there is no reason to claim that this will be accompanied by a significant fallback in the economy or a decrease in the credibility of the financial sector. On the contrary, these developments will decrease excess optimism in the whole economy and force economic agents to a more conservative behaviour. (Bank of Estonia, Nov.1997).

The crisis sped up the consolidation of the banking market in the country: Hansa Bank merged with Hoiu Bank, and the Estonian Union Bank merged with Tallinn Bank, and Maapank was liquidated. Between 1997 and 1998 the number of commercial banks dropped from 12 to 6. The central bank once again took advantage of an external crisis to implement stricter prudential requirements. According to one interviewee, before the second banking crisis many banks were too small to survive the stricter requirements that were imposed by the EU. The BoE attempt to strengthen the rules regulating the banking sector was supported by the commercial banks in the country. In a meeting between them and the central bank, the banking sector expressed its support for the handling of the crisis, also acknowledging their own responsibility to take into account the changing economic environment around them and to adhere to more conservative banking practices in their subsequent operations (Bank of Estonia, June.1998).

The consolidation and further strengthening of the banking sector was coupled with increasing foreign ownership. Scandinavian banks, in particular, were large investors. Figure 5.11 depicts this development. The entry of foreign banks had started already in the mid 1990s, when a number of Swedish and Finnish banks had started to buy shares in local banks, but it took until 1999 before two major Swedish banks (Swedbank and Skandinaviska Enskilda Banken (SEB)) decided to acquire controlling stakes in the two largest Estonian banks. The reason behind this was assurance that these markets were developing in the right direction. One respondent, working with the Baltic states at one of the major Swedish banks, stated that “we would never have entered the Baltic market if we did not saw the potential for them to develop in to modern financial markets.”

That the entry of foreign banks had positive effects on both the banking market and banking supervision is corroborated by the interviews made for this study. In order to cope with the increased competitive pressure many domestic banks also saw the need to grow the range of services offered to customers, e.g., by increasing the share of operations involving securities. At the same time, the entry of new owners into the banking sector was vital for the functioning of financial intermediation in the country, whereby “the loan portfolios of banks were cleared up, and the corporate governance and risk management schemes were effectively improved to bring them into line with those of their Swedish counterpart.” (Lättemäe, 2007, p. 176).

The improved standards and governance structures applied by banks also spilled-over to banking supervision. Both Swedbank and SEB saw their investments in the Estonian banking market as long-term commitments. As such, the Swedish banks did much to strengthen their newly acquired banks, both through the injection of capital, and by improving the governance and management of the banking market (IMF, 2000). According to an interviewee with insight

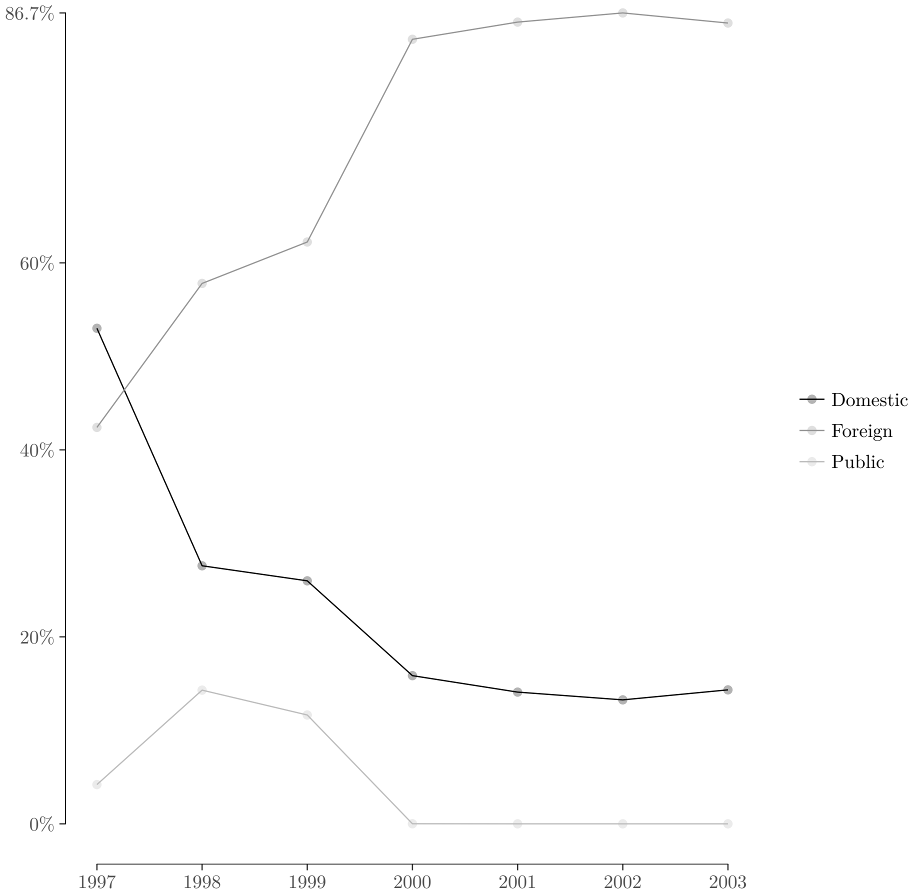


Figure 5.11 – The graph depicts the percentage of Estonian banks that are controlled by public (the BoE and the government), domestic and foreign owners, respectively. Source: author's calculations based on data found in the BoE's annual reports.

into the Baltic banking market, "the main contribution [of SEB and other foreign banks] has been in terms of transferring knowledge about how different banking process working in a modern financial market." The improved standards forced the central bank to make further investments into banking supervision so that they could keep up with the standards of the foreign banks. One respondent, working with banking supervision, said that the "new practices implemented by the foreign owned banks was one factors that caused the central bank to improve banking supervision, among other things by increasing their cooperation with their Swedish and Finish counterparts."

Despite the voters' rejection of the radical reform agenda of the PPU, reforms in the banking sector did not lose pace in the aftermath of the election. At a press-briefing Vähi told reports that he did not see "any chance of Estonia leaving the market economy track." (quoted in WSJ, Mar.1995). Estonian authorities began a process to strengthen the legal and supervisory framework regulating the banking market by implementing a number of prudential ratios —

solvency ratio, liquidity ratio, and risk-concentration ratio — and the adoption of the CIA, on 9th February, 1999.

The 1995 CIA laid the foundation of Estonia's banking legislation, covering foundation, reorganisation and termination of credit institutions. The act — together with a number of decisions by the BoE that brought solvency ratios and own funds close to EU requirements — incorporated the following EU directives into EU legislation: the First Banking Directive (FBD), the Own Funds Directive and the Solvency Directive. However, on a number of issues Estonian banking legislation was still not in accordance with EU requirements. The Second Banking Directive (SBD), the Annual Accounts and Consolidated Accounts, and the Large Exposure Directive were only partially transposed into Estonian legislation, whereas the Money Laundering Directive, the Deposit Guarantee Scheme Directive, and the Capital Adequacy Directive belonged to the category of directives that were covered by Estonian financial market legislation (European Commission, 1997).

To account for the outstanding legislation the government initiated work on a new CIA and numerous other reforms that aimed to harmonise the legislative framework in the country. Not only including the harmonisation of the directives listed in the Commission's 1995 White Paper (cf. European Commission, 1995), but also legislation that fell under the competence of the BoE. In parallel with these very concrete reforms, there was a constant effort to improve the quality of banking supervision.

Just as during the early transition years, the BoE and the government took the drivers seat in the reform process. The preparation for the EU accession was fully supported by the Estonian banking industry, which expected to be strong enough to compete with other European banks. Chief executive of Hansa Bank, the country's largest bank, told a reporter at a press conference that "the local banks do not fear the greater competition that would follow the country's probable admission to the European Union [...] they would be more than a match for the few European banks wishing to move in." (quoted in FP, Sept.1997). To prepare for the accession process, the Estonian government established two agencies — the Estonian Office of European Integration (EOEI) and the Council of Senior Civil Servants (CSCS) — consisting of government and central bank representatives, with the task to facilitate information exchange between the Ministry of Finance (MoF) and the BoE, and to work out a road map for integration with the EU (Bank of Estonia, 1996).

Legislative harmonisation proceeded without major interruption in Estonia. One interviewee described the legislative harmonisation as a "process of copy and pasting," referring to how EU directives were incorporated word-by-word into Estonian legislation.[21] The major legislative

[21] In 1998 the Law on Deposit Guarantee Funds was adopted by the Riigikogu (EBRD, 1998, p. 165; European

step was taken in February 1999, when the Riigikogu adopted a new CIA, which laid down the legal foundations of the country's current banking system. Albeit with some minor gaps, the act harmonised Estonia's banking legislation with EU requirements (European Commission, 1999, p. 31; Estonia, 2000, p. 129; BSCEE, 2001, p. 78). One year later the act was amended to also include the statues of banking supervision, credit institution reporting, and the rules for the acquisition of the qualifying holding in a bank (European Commission, 2000, p. 38). As such the act "regulates the principles of credit institutions' activities, founding conditions and requirements, fit and proper requirements, internal audit, prudential ratios, reporting, merger issues, moratorium, liquidation, supervision and liability." (BSCEE, 2002, p. 83).

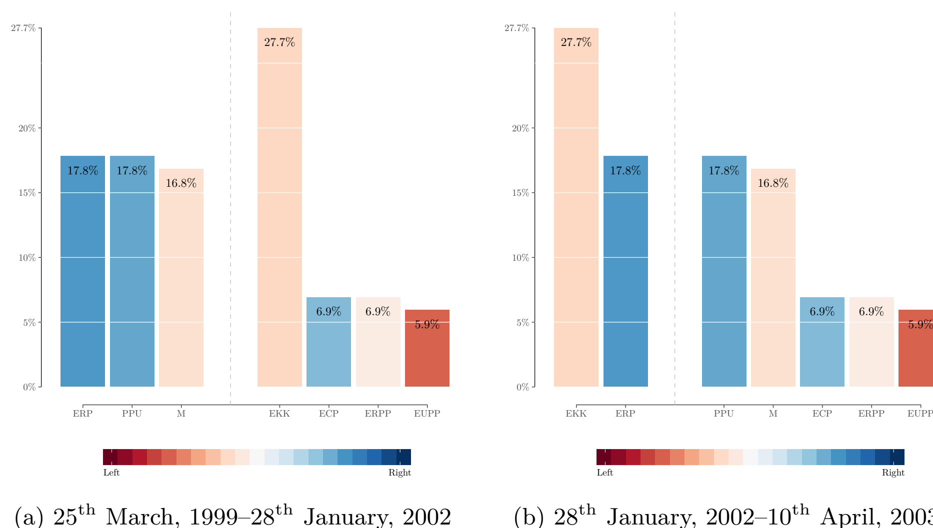
With the adoption of the CIA, Estonia had materially harmonised its legislation with the current Acquis. In late 1999, the EBRD judged the country's banking sector to be almost in full compliance with Bank for International Settlement (BIS) standards, emphasising the country's effort to comply with international norms (EBRD, 1999, p. 48). And although the Commission finds certain legislative improvements to be necessary — such as provisions related to the recognition of contractual netting and home and host country supervision are not covered by the current legislation — they also conclude that Estonia in general apply the Acquis (European Commission, 2000, p. 39).

A month after the CIA was adopted, Estonians went to the ballot box again. This time, the country witnessed a further shift to the left, as shown in Figure 5.12. The biggest party from the 1995 election, the ECP, lost more than 33 percentage points of the seats in the Riigikogu. PPU regained some of the seats that it lost in the 1995 election, whereas the vote share of the ERP only changed marginally. The big winner in 1999 election, however, was the EKK, which gained 12 seats compared to the previous election. The EKK was headed by the former PM Edgar Savisaar. Nevertheless, the PPU together with the ERP and the Moderates managed to form a coalition government to keep the EKK out of power. This coalition remained in power until Laar resigned as PM in late 2001. EKK then formed a government coalition with the ERP until the next election.

The challenge facing the new government after the election was the need to improve the work of the supervisory authority. The classification of the information provided by banks for off-site monitoring was inadequate, and the supervision department had not been provided with credible sanctions to enforce prudential regulations (Odling-Smee, 1994, p. 25).

> Estonia's financial system has remained fragile, but the authorities have de-

Commission, 1998, p. 23); and a year earlier legislation on consolidated supervision and capital adequacy had been adopted, encompassing many prudential regulations concerning market risk, which includes off-balance sheet risks, underwriting commitment risks, derivative risks, and equity position (own and trading portfolio) risks (European Commission, 1998, p. 23). These items were all incorporated in the calculation of the capital adequacy ratio.



(a) 25th March, 1999–28th January, 2002 (b) 28th January, 2002–10th April, 2003

Figure 5.12 – The composition of the Riigikogu as of the election on the 7th March, 1999. The intensity of the colours of the bars represent the parties' position on the left-right dimension. The cabinet parties are located to the left of the dashed line. The grey bar represents NA values. Source: Döring and Manow (2016).

> veloped an action plan for materially strengthening bank supervision during 1995, and the recent enactment of the Credit Institutions Act has enhanced enforcement powers with respect to bank supervision and prudential regulations. (IMF, 1995).

In its evaluation of Estonia's financial market supervision, the Commission found that effective administration of the financial market acquis would require "considerable efforts to establish the necessary management and control mechanisms." (European Commission, 1997), with special emphasis being put on additional resources and training of the staff. The position was echoed by the World Bank, who wrote that "[t]he single most important challenge of Estonia's strategy for financial sector integration into the EU is the further upgrading of its prudential regulation and supervisory capacities to gain recognition from its EU counterparts." (World Bank, 1999, p. 28). The need for further reform was also supported by the Estonian banking industry, which saw a great need to continue reforming the country's banking sector and to push the reform process forward. In a comment to reporters Hansa Bank stated that "there is a broad-based consensus that economic reform must not be tampered with…" (WSJ, Mar.1997).

Bank supervision was divided into three sub-units: general supervision, off-site supervision, and on-site supervision. The aim of the reform was to encourage specialisation, which in turn would lead to better results. The general supervision unit is in charge of establishing the legal basis for banking supervision in the country, in addition to carrying out the procedure for licensing new banks. The off-site and on-site units of the Supervision Department are in charge of monitoring banking activities. Off-site supervision is dependent on the financial reports that are handed to them by banks, although other data is used as well. Supervisors form an opinion

on the financial strength of a specific bank based on the reports, and also evaluates the strength of the banking system as a whole. As such, off-site supervision constitutes an important early warning system, and provides information to on-site supervisors of potentially weak banks. On-site inspectors evaluates the bank in more depth by evaluating its management system, strategies and policies. Furthermore, on-site supervision determines the accuracy of the financial reports that the credit institutions is presenting to the off-site supervisors.

Responding to the challenges identified by independent experts, and to keep the supervisory authority up-to-date with the developments in the banking sector, the BoE identified several necessary changes in the organisation of banking supervision (Bank of Estonia, 1997a). First was the centralisation of all banking supervisory functions under one authority, from the establishment of a database, the application of sanctions, design of banking regulations, and management of international cooperation. Second, the implementation of consolidated supervision. Third, substantially increasing the resources available to the supervisory agency.

While the harmonisation of EU legislation proceeded fairly smoothly in Estonia, the upgrading of administrative capacity required more effort. The effect of the Russian banking crisis highlighted the interconnectedness between the financial markets in the country; but banking, insurance and securities markets were supervised by three different agencies, which resulted in an inefficient use of resources and coordination deficiencies between the three supervisory agencies. With the maturity of financial markets, banks had increasingly come to engage in operations covered by the insurance and securities inspectorates. The increasing interconnectedness between the financial markets implied that decisions taken by one supervisory agency would affect the whole banking group, and therefore also the work of the other supervisory agencies (Bank of Estonia, July.1998). According to one respondent, who worked in the banking supervision department at the time, this was the main problem of the Estonian banking market in 1997: "When banks came to engage in other financial markets outside our jurisdiction we lost the oversight over these aspects of the banks, especially since cooperation between the supervisory authorities were non existing.". To remedy this problem, the MoF decided to go ahead with the creation with a Unified Financial Supervisory Authority (UFSA); on 4th March, 1998, the board of the BoE gave its support to creation of the new supervisory agency (Bank of Estonia, Mar.1999).

However, the organisation of the UFSA turned into a power struggle between the government and the central bank. Early on, the MoF stated its preference to set-up the new supervisory agency under the authority of of the ministry, similar to the way the insurance and securities supervisory agencies were organised. Conversely, for the BoE it was essential that banking

supervision remained under the authority of the central bank, since moving the UFSA to the MoF threatened the agency's independence and could impair its budgetary funding. In a response to the position of the government, the central bank stated that "[c]hanging positions of the finance ministry concerning unified financial supervision are causing a feeling of danger with the Bank of Estonia with regard to the further well-being of the Estonian financial system." (quoted in BBD, Dec.2000). According to the interviewees, this fear was well founded, given that the inferior functioning of insurance and securities supervision was to a large degree rooted in the MoF being the responsible authority. The insurance and securities inspectorates were underfunded compared to banking supervision. According to one respondent salary levels were up to three times higher in the banking supervision department.

Despite the complaints from the central bank, the MoF put forward a draft legislation to the parliament, removing the supervisory authority of banks from the BoE. After lengthy parliamentary discussion on the proposal the central bank emerged triumphant when the parliament decided to not accept the proposal. The MoF backed down, and put forward a proposal, based on the Finnish model, where the new UFSA would remain under the authority of the central bank, but be financed by the banking industry by applying fees to the supervised financial entities, a financing model that had only been applied by the insurance inspectorate previously. Based on a recommendation by the central bank a task force was set-up, within the framework of Programme of Community Aid to Central and Eastern Europe (PHARE),[22] to prepare for the implementation of the new supervisory agency (Bank of Estonia, Mar.1999). That the task force was led by the head of banking supervision, provides an indication of how important the BoE was in the process of setting up the UFSA. The group also consisted of other experts from the central bank and the MoF, and although the financial industry did have any formal powers in the process they were constantly consulted during the process. All interviewees with insight into the matter, corroborated that the banking industry supported the merger of the three supervisory authorities, despite the imposition of new costs on a majority of the supervised entities. One respondent even said that the proposal to set-up a UFSA originated because of signals from the market.

5.2.2 Lithuania

Turning to the reform pathway that took place in Lithuania, one strong difference with Estonia in particular can be observed. The country could not forge a strong reform coalition between the BoL, the government and the banking sector. On the contrary, in the early reform years the

[22]The PHARE project was running during 24 months, offsetting 33 twinning experts with the task of setting up the UFSA and training its staff (PHARE, 1998).

government and the central bank often clashed over the issues of banking reforms, something that resulted in a more sluggish and less radical reform agenda. And, when reforms were adopted Lithuanian authorities, in many cases, failed to properly enforce the rules and regulations.

The first general election to the Supreme Soviet of Lithuania was held in 10th March, 1990. The two main political actors in Lithuania at the time were the sajūdis and the Lithuanian Communist Party (LCP). While the sajūdis was not a political party, receiving its endorsement had a substantial impact on the electability of a candidate. This become obvious if one studies the distribution of seats in the first free election that took place on the 10th March, 1990. Figure 5.19 shows the result of this election. All members of the largest party, the HU, were endorsed by the sajūdis, and the party managed to secure 58 of the 135 available seats. In addition, as many as one-third of the politicians of the LCP enjoyed the support of the sajūdis (Times, Feb.1990). All in all, 80 % of the mp in the Supreme Soviet of Lithuania had been endorsed by the sajūdis movement.

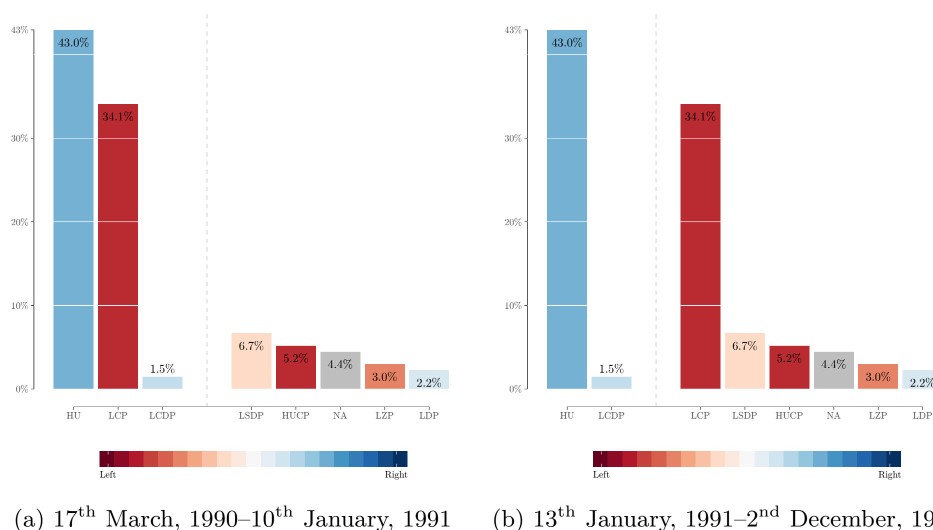
The election saw Kazimiera Prunskienė, an economist, was elected PM and Vytautas Landsbergis selected as president of Lithuania.[23] However, the sajūdis coalition did not manage to stay united, and slowly started to dissolve into several factions. Then, in January 1991 the PM resigned after a disagreement with parliament over the independence struggle and her decision to raise prices by 500 %. The price hike was rejected by the parliament after a wave of protests. "[T]he price hikes, thrown at the people over the weekend, could be another source of tension, when there is already so much tension with the military," (quoted in AP, Jan.1991) one lawmaker told the Associated Press. Prunskienė was replaced by Gediminas Vagnorius on 13th January, 1991.

The sajūdis advocated a quick break from Moscow, and the initiation of market-oriented reforms. This was something that was echoed by the parliamentary branch of the movement, which was positioned to the right of centre. Conversely, the LCP favoured a more gradual secession from the USSR. Hence, the main opposition to the sajūdis movement came from the left in Lithuania. "[I]n Lithuania the political circle started a bit earlier [than in Estonia]. In 1990 the conservatives [the anti-communists] won the elections. In Estonia, we didn't. Here, we had a different kind of opposition." (Laar, 2003, p. 504). This was something that came to have implication on the election in 1992.

Only three days after the election, and before the first government had taken office, the BoL was founded, and nine months later its operations were merged with the Lithuanian branch of Gosbank. Vilius Baldišis was elected the chairman of the BoL on 31st July, 1990.[24]

[23] Landsbergis was also the chairman of the sajūdis.

[24] Bronius Povilaitis acted as the chairman of the central bank between 13th March, 1990 and 28th July, 1990.



(a) 17th March, 1990–10th January, 1991 (b) 13th January, 1991–2nd December, 1992

Figure 5.13 – The composition of the Seimas as of the election on the 10th March, 1990. The intensity of the colours of the bars represent the parties' position on the left-right dimension. The cabinet parties are located to the left of the dashed line. The grey bar represents NA values. Source: Döring and Manow (2016).

Just as in Estonia, the Lithuanian authorities realised the need to get the macroeconomic fundamentals right. For this reason, currency reform became a top priority. Although some preparations for the introduction of the new currency had already taken place in 1989, they formally begun in late 1991, when the country decided follow the path of gradually introducing the Litas (LTL) as advocated by the central bank. According to the central bank, Lithuania did not have the capacity to introduce its own currency immediately, and instead opted for an interim currency (Lainela and Sutela, 1993, p. 24). The responsibility for the introduction of the new currency was handed to the newly formed MRC. Convertible coupons (talonas) were introduced on 1st May, 1992 to supplement the rouble shortage. In October that same year the rouble was withdrawn from circulation and completely replaced by the talonas.

The introduction of the LTL was delayed because of a conflict between the chairman of the central bank and the new parliament that had been elected on 15th November, 1992. Then president, Algirdas Brazauskas, a former leader of the LCP, together with the Parliament had accused Baldišis of delaying the introduction of the new currency (BBC, Jan.1993). Baldišis, in his own defence, accused the political leadership of the country of hindering his attempt to introduce the new currency and overhaul the banking sector (Reuters, Mar.1993). Baldišis was of the opinion that currency reform had be introduced gradually in order for the Lithuanian economy to better handle the economic chock that it would imply. The chairman of the central bank was replaced by Romualdas Visokavičius, who had experience in banking both during the Soviet Union — where he managed the Industry and Construction Bank — and commercial banking after independence. The LTL was introduced on 25th June, 1993.

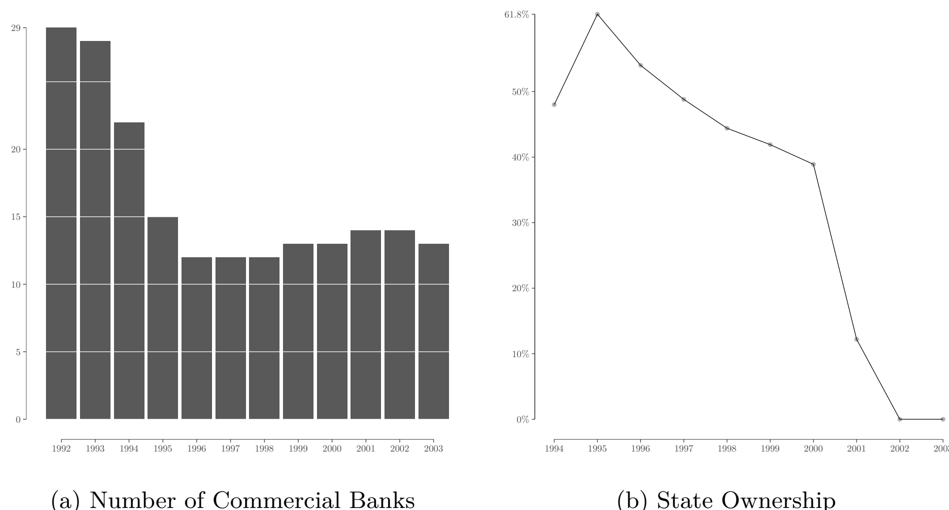
Nevertheless, not until the 1st April, 1994 was the currency tied to the USD. The president of Lithuania floated the idea of tying the LTL to a Western currency for the first time in December 1993, after a meeting with the chairman of the BoE (BBC, Dec.1993). Later that same month the PM introduced a bill to the Seimas which intended to establish a CBA, arguing that this would ensure the stability of the currency system (BBC, Dec.1993). The LTL was pegged to the USD at a rate of 1 to 4.

Opposition to currency reform had, however, started to grow. Commercial banks had started to oppose the introduction of the CBA since it severely restricted their profit margins, potentially forcing banks to merge or file for bankruptcy. Just as in Estonia, the majority of the banks in the country were both small and weakly capitalised. Many banks lacked loan officers who could evaluate loan application based on their expected profitability (Grennes, 2000, p. 179). In addition, the Lithuanian banking market was dominated by state-owned banks, with the state controlling around 50 % of banking assets in 1994 (see Figure 5.14). An important source of income for many of these banks speculation in the Lithuanian currency. In a comment to the press the deputy chairman of Vilniaus Bankas, Raimondas Kvedaras, expressed his worry that profit margins had plunged, making it increasingly difficult for commercial banks to operate. The chairman of the central bank stood behind the commercial banks, arguing that the CBA would force some banks to close down: “There are probably a few banks which will not be able to solve their problems, and with the currency board system, there is nothing we can do to help.” (quoted in Reuters, May.1994). Although the LTL was in the end pegged to the USD, the delay of nearly two years compared to Estonia is best explained by the opposition from the banking community.

As can be seen in Figure 5.14a, the CBA had an effect on the consolidation of the Lithuanian banking sector. Between 1992 and 1996 the number of banks in the country decreased from 29 to 12. However, this was not coupled with a privatisation process in the country, and the largest banks in the country remained under state control until the early 2000s. This had implications for the banking sector in the sense that private banks had a difficult time capturing market shares since they were competing with the government owned banks.

Stabilisation and Regulation of Banking

One and half years before introducing the CBA, Lithuania held its first election since independence. The HU suffered a major defeat in the 1992 election, only managing to secure 21.3 % of the seats in the new Seimas, compared to 43 % in the 1990 election. The major winner of the election turned out to be the Lithuanian Democratic Labour Party (LDLP), which managed to



(a) Number of Commercial Banks (b) State Ownership

Figure 5.14 – The left hand panel depicts the number of commercial banks in Lithuania between 1992 and 2003. The right hand panel plots the asset share of state-owned banks between 1994 and 2003. Source: author's calculations based on data in the EBRD Transition Reports.

secure more than 50 % of the votes in the Seimas, allowing them form a majority government by themselves. The LDLP consisted of former reformist members from the communist party. The other major parties in the parliament were the Lithuanian Christian Democratic Party (LCDP) and the Lithuanian Social Democratic Party (LSDP), receiving 12.8 % and 5.7 % respectively. With regards to market-oriented reforms the two parties belonged to the centre of the political spectrum. All in all, the Lithuanian election on the 15$^{\text{th}}$ November, 1992 must be seen as a clear shift towards the left, which should be evident if we compare Figure 5.15 with Figure 5.19.

That a centre-left party, with roots in the former LCP, had managed to take control of the government was a consequence of mainly two factors. First, the economic hardship in Lithuania had severely diminished voters' trust in the HU. The proportion of the population that thought that the transition to a market economy had gone too fast rose from 19.8 % to 27.6 % between 1991 and 1992. In 1993, when Lithuania managed to curb inflation this figure plunged to only 12.3 % (see Figure 5.16). Second, the only viable opposition to the HU came from the left in Lithuania. In this sense Lithuania's early transition experience diverges from that of Estonia, where the main opposition to the Savisaar government came from the nationalist conservative PPU.

On 21$^{\text{st}}$ October, 1993, the chairman of the BoL resigned after only six months in office. Visokavičius, backed by Šleževičius' government, had switched to a much more conservative monetary policy than his predecessor, and inflation was brought under control, after having exceeded an annual rate of 1000 % in 1992 and more than 400 % in 1993. However, the new policy direction was met with fierce resistance in some corners, and the consensus that more

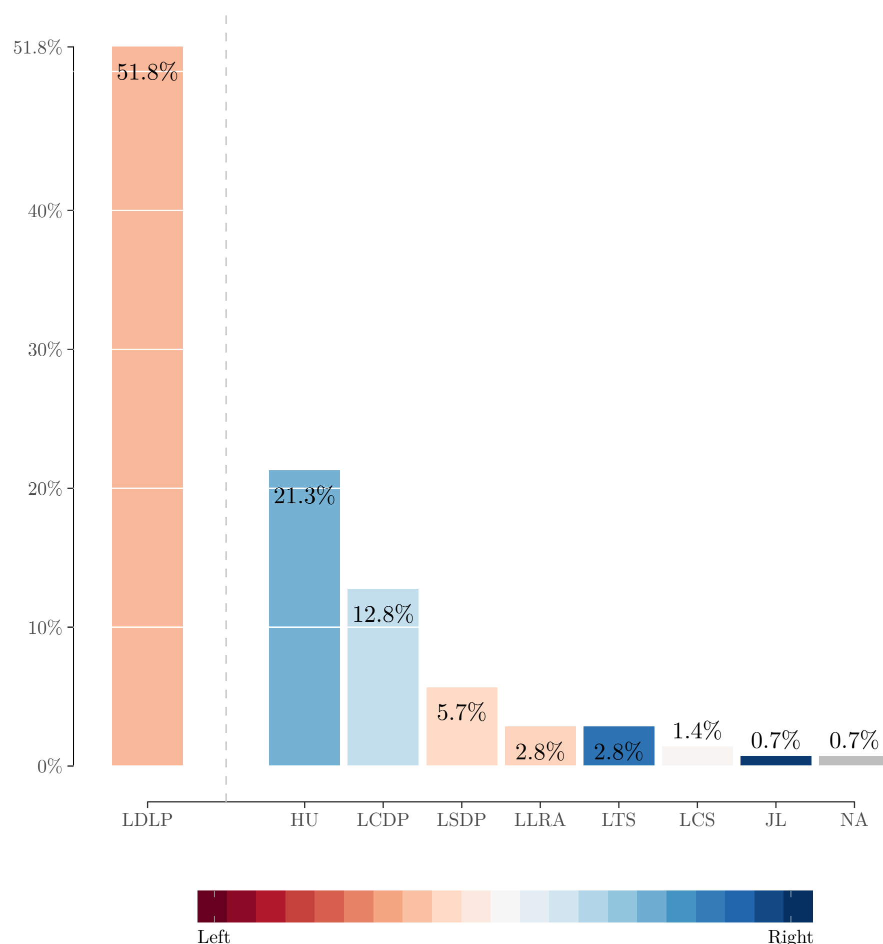


Figure 5.15 – The composition of the Seimas as of the election on the 15th November, 1992. The intensity of the colours of the bars represent the parties' position on the left-right dimension. The cabinet parties are located to the left of the dashed line. The grey bar represents NA values. Source: Döring and Manow (2016).

market-oriented reforms were needed soon crumbled. A couple of weeks after the introduction of the new currency, the Lithuanian business community expressed a lack of confidence in the central bank president, threatening not to pay taxes and to impose a no-business zone in Lithuania (BBC, June.1993). Two months later the prosecutor's office launched an investigation against Visokavičius on the charge of power abuse. Although Visokavičius was cleared of any wrongdoing, the majority coalition in the parliament, controlled by LDLP, started a parliamentary investigation against him. On 19th October, 1993, the parliament ousted Visokavičius amid criticisms of the monetary policy conducted by the central bank (BBC, Oct.1993). The motion presented to the parliament by the LDLP reads:

> [The consequences of Visokavičius economic policies,] as well as the conflicts which arose during this period with the confederation of industrialists, the agricultural workers and most of the commercial banks, the completely ruined system of settling of accounts among the economic subjects and the illegal transactions with

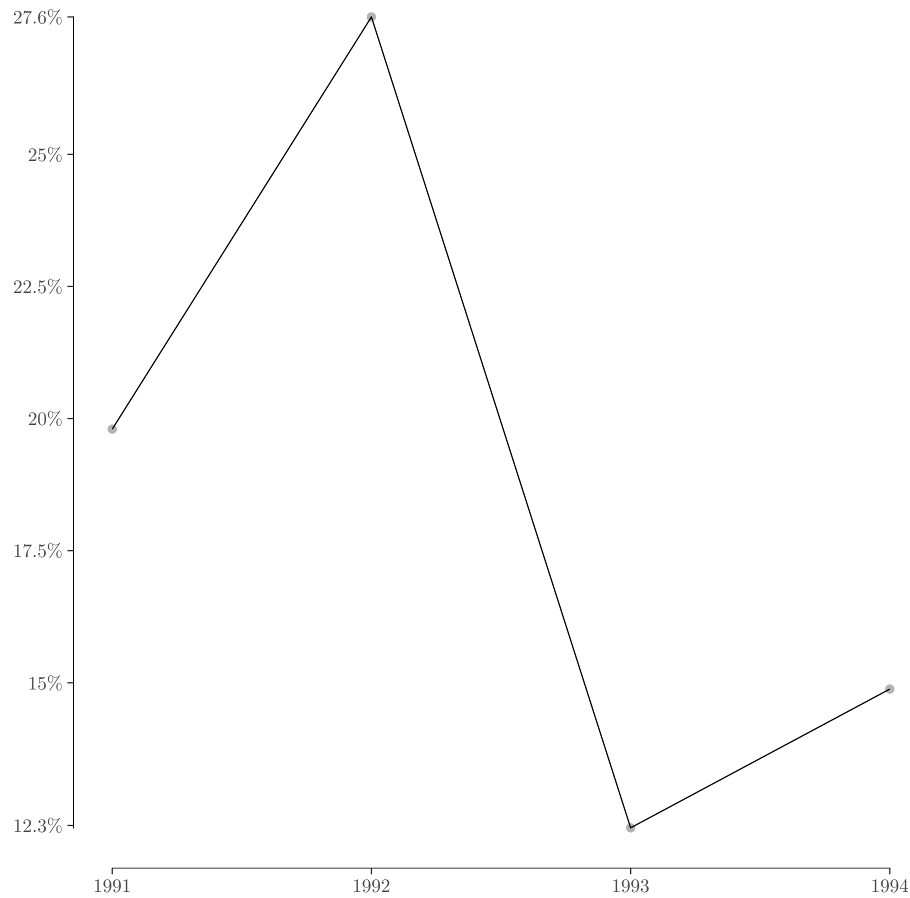


Figure 5.16 – The plot depicts the percentage of respondents in Lithuania that, between the years 1991 to 1994, answered too fast to the following question: the way things are going, do you feel that Lithuania's government's economic reform programme is going...? Source: Central Archive for Empirical Social Research (1997).

> some commercial banks, the Seimas faction of the LDLP is of the opinion that such activity of the Bank of Lithuania has discredited the bank as the central state banking institution and has violated the interests of the Republic of Lithuania and the economic interests of the subjects of Lithuanian economy. (quoted in BBC, Oct.1993).

The PM added fuel to the fire by blaming the BoL for the country's economic troubles, such as the high inflation in previous years, and its handling of the macroeconomic policy etc. (Samonis, 1998, 80f.). In an interview Šleževičius told the reporter that "Visokavičius has taught the government the art of banking. We realized the negative effect of the central bank on the economy too late. This is my great mistake." (quoted in BBC, Jan.1994). Ratkevičius was elected as the new chairman of the central bank.

The first signs of a banking crisis were seen in the summer of 1995, when the operation of the country's eight-largest bank, Aurasbankas, were suspended. Almost a year later the government took the decision to transform Aurasbankas into Turto Bank, and compensate all its depositors

(most of which were government agencies). Also Vakurabankas experienced problems around the same time, and the government decided to inject capital so that the bank could cover its bad debt. Despite the early signs that not everything was good in the Lithuanian banking sector, politicians and bank representatives continued to reassure the public that the country's banks were in a good state. In a statement president Brazauskas told the country that Lithuania was not facing any banking crisis (BBC, May.1995). Although the causes were similar, the reaction to the first major banking crisis diverged from the experience found in Estonia.[25] Pressure for a more active government policy was immense by commercial banks and leading Lithuanian policymakers, who advocated for an interventionist policy to solve the crisis. Liquidity was injected into the banking sector, and a limited deposit insurance scheme was provided for individuals.[26]

Some months later, in December 1995, the banking crisis broke out in full, when a moratorium was imposed on the operations of the country's two largest commercial banks — Lithuanian Joint-Stock Innovation Bank (LAIB) and Litimpeks Bank — and three top officials at the two banks were arrested, charged with allegations of fraud (FT, Dec.1995). Both banks suffered from capital inadequacy and weak loan portfolios. At the initial stage, the central bank was praised by international donors for its quick and resolute actions against the two banks. However, the reaction from important parts of the private sector was different. Just some days after the crisis had erupted, the president of the Lithuanian Commercial Bankers Association, Eduardas Vilkelis, told reporters that: "I think the government will take some action… you're not going to have a total collapse. The fact that it is a fairly large bank means the government does have to come in and take some steps to help them out." (quoted in Reuters, Dec.1995). Bowing to the pressure, the PM promised voters that the government would pick up the bill for the banks' depositors. "The state guarantees that the deposits and other property kept by individuals and legal entities in the Innovation Bank and Litimpeks Bank will not be lost." (quoted in BNS, Jan.1996). The parliament also turned against the central bank president's handling of the crisis and forced Kazys Ratkevičius to resign.

By the end of January, the government together with the IMF and the World Bank had worked out a plan on the restructuring of the Lithuanian banking market. The plan set out to merge three of the country's troubled banks — LAIB, Litimpeks Bank and Vakaru Bank — into a state-owned bank that would open later that same year. In addition, new capital to a value of 1.3 billion LTL was to be injected into the banking market (FT, Jan.1996). Despite

[25]The three main cause of the banking crisis were (1) unexpected changes in the macroeconomic environment; (2) deficient enforcement of existing prudential regulations; and (3) careless behaviour by insiders (managers, owners, and state officials). It is worth pointing out, however, that the abusive behaviour of the state through forced public policy lending was more common in Lithuania than in Estonia.

[26]For two of the banks, Innovation and Litimpeks, the government decided to go even further by granting full insurance for all depositors in the banks.

the agreement of a rescue plan, the authorities gave the affected banks the authority to work out a rescue plan of their own, something that the banking community had lobbied hard for (Hansson and Tombak, 1999, 204, footnote 17). To this end, the parliament played an important role in pushing policy away from the deal between the government and international donors. The parliamentary commission that had been summoned as result of the banking crisis strongly criticised the rescue plan, and called for the reopening of the affected banks (Reuters, Feb.1996).

Both LAIB and Litimpeks Bank soon presented their own proposals for restructuring. The rescue plans were rejected by the central bank, saying that “[t]his is not realistic. They are asking for guarantees from the government and bailout.” (quoted in BNS, Jan.1996). But, on the 21st of May, 1999 the government decided to save LAIB by nationalising it (Reuters, May.1996), despite not living up to requirements set by the BoL (Reuters, May.1996). In June 1996 Litimpeks Bank was allowed to open again, even though the bank remained insolvent under international accounting standards (World Bank, 1998).

The Lithuanian banking crisis only marginally consolidated the banking sector, between 1995 and 1996 the number of banks dropped from 15 to 12 (see Figure 5.14a) (Bank of Lithuania, 1997, p. 68). Figure 5.17 depicts the Lithuanian banking sector one year after the banking crisis. The two biggest banks in 1997 controlled 22 % of the assets in the banking sector. Furthermore, of the five largest banks in the countries, three were controlled by the government. Privatised banks controlled only just above 50 % of the financial market in Lithuania. The banking sector diverges substantially from the one found in Estonia, where more than 80 % of the banking sector was controlled by the two largest banks, both privately owned.

Despite their size, the three government-owned banks were all relatively weak. The Savings Bank was the largest retail bank in Lithuania, with more than 60 % of all individual deposits in the country, and the largest holder of treasury bills. The Agricultural Bank was the third largest bank in the country, with a total asset worth of 1.5 billion LTL. The smallest of the three government-owned banks, the Commercial Bank, was in deep economic trouble due to liquidity problems that emerged as consequence of an audit by the banking supervision department of the BoL. Although, the Commercial bank was the weakest of the three state-owned banks, the other two banks were also showing signs of distress. Both the Savings and the Agricultural Bank were undercapitalised and had problems meeting the capital-adequacy and large exposure regulations that existed in the country (Bank of Lithuania, 1997, p. 69). To remedy the problem and meet the capital-adequacy regulations the government, in June 1997, decided to boost the Agricultural Bank’s capital (Reuters, June.1997).

The regulatory environment in Lithuania had started to take shape already in December

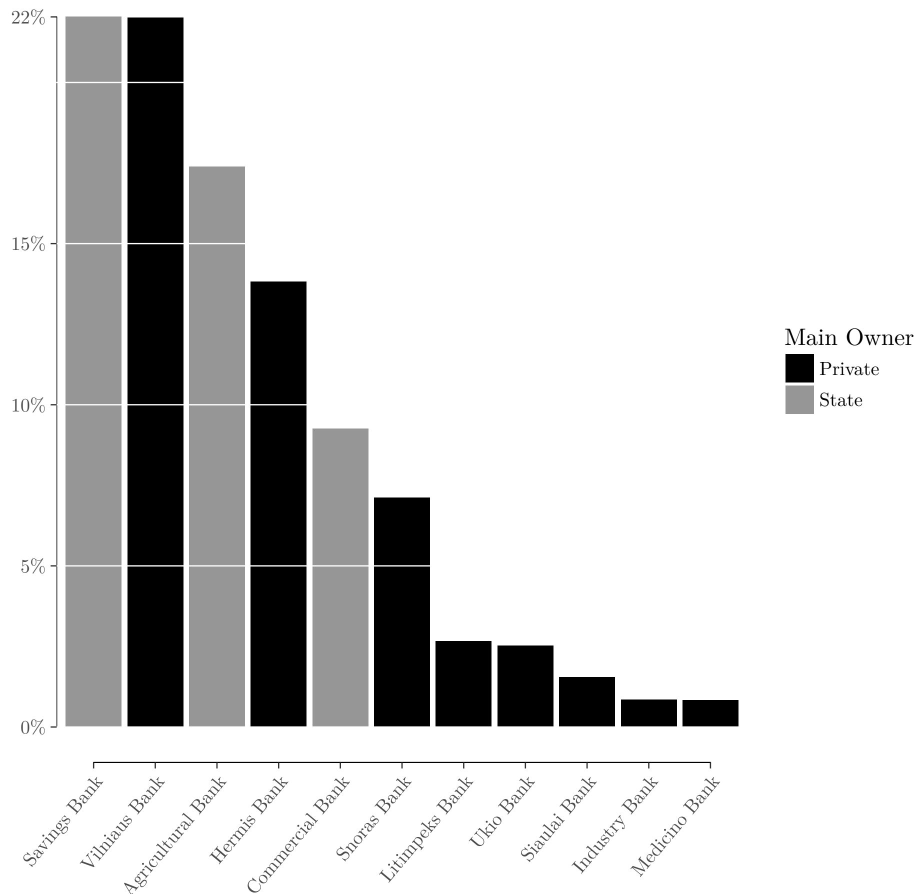


Figure 5.17 – The bar graphs show the market share of commercial banks in Lithuania in 1997. Source: World Bank (1998).

1992 when the Seimas adopted the Commercial Banking Act. This law was later amended in December 1994, together with adoption of the Bank of Lithuania Law. In addition the Seimas had passed the Bankruptcy Law in September 1992 (see Figure 5.4b). Albeit with minor amendments in the years to come, these legislative acts constituted the regulatory framework for the banking sector for a considerable amount of time. However, despite legislative attempts, banking legislation were in an early stage at this point. While the FBD and the Own Funds and Solvency Directive had both been incorporated into national legislation, other directives such as the Deposit Guarantee Scheme and the Prevention of Money Laundering were completely missing. A number of directives had been partially aligned: the SBD, the Annual and Consolidated Accounts Directive, the Large Exposure Directive and the Capital Adequacy Directive.

Not only were substantial pieces of legislation missing in Lithuania, the country also needed to strengthen its supervisory department. The right to revoke and grant banking licenses, and to supervise them was grated the BoL, but the supervision department was wrestling with several substantial problems at this point. Key among these was the lack of independence of

the central bank, which allowed the government to gain knowledge about future decisions of the bank, and to influence some decisions in favour of the banking community. The influence of the banking community is best illustrated by the board of directors of the BoL, which consisted of 14 members, many of whom represented the national banking association. An example of the politicisation of the banking sector was the resignation of the chairman Ratkevičius. He was pushed out after accusations of not being able to fulfil his duties to supervise the financial market, culminating in threats of a vote of no confidence in the Seimas (BBC, Mar.1996). He was replaced by Reinoldijus Šarkinas on the 15th February, 1996, who was the former finance minister in the ruling LDLP government. Šarkinas had been sitting on the board of the central bank for many years before and was a highly respected economist in Lithuania. However, some MP had concerns about the fact that he did not have any experience working in the banking sector (BNS, Feb.1996).

Furthermore, several attempts by the BoL to impose stricter requirements on the state-owned banks had been undermined by the Lithuanian parliament in a series of emergency laws, overriding decisions made by the central banks. For example, in 1996 the board of the BoL adopted a resolution On Prudential Requirements for Bank Activities, setting the capital adequacy requirements for banks to 13 %, a requirement that was later reduced at 10 %. Any bank that failed to comply with the new rules by January 1st, would get its license revoked by the central bank (Bank of Lithuania, 1996a). However, when it became obvious for the authorities that the two state-owned banks were not able to meet the requirements set up by the central bank, the parliament passed the Law on the Privatisation of the State Commercial Bank and the Agricultural Bank, which effectively excepted state-owned banks from the new capital adequacy rules until they had been privatised. As the BoL noted, this contradicted the rules regulating banking supervision set up the Basel Committee, particularly since it concerned large banks that were important to the system as a whole (Bank of Lithuania, 1997, p. 68).

Another case in point is the treatment of Litimpeks Bank. Not only the state-owned banks were in bad shape in Lithuania, but also some of the private banks. After a period of great economic stress, the BoL decided to terminate the activities of Litimpeks Bank. Nevertheless, less than a year after the decision the Lithuanian parliament adopted law I-1385, which required the central bank to allow Litimpeks Bank to resume its operations, despite its fragile economic state (Sejmas, 1996). Although the government pledged not to provide any further support to the troubled bank, state-owned enterprises increased their holdings, while private investors withdrew their support for the bank (World Bank, 1998, p. 11). The government's attempt to protect the weaker banks also became evident in its handling of the State Commercial Bank,

which faced serious liquidity problems in mid 1996. The government decided to force all state departments to switch their accounts to the troubled bank, something that outraged the two major private banks in the country, Vilnius Bank and Hermis Bank. In a comment on the decision the deputy head of Vilnius Bank, Gintautas Bareika, said that: "This government decision (on the accounts) is unconstitutional and goes against competition rules." (quoted in Reuters, July.1996).

The next Lithuanian election took place on the 20th October, 1996; the result is depicted in Figure 5.18. Voters had grown increasingly disillusioned by the centre-left government that had controlled the Seimas during the preceding four years. The LDLP lost 43 % of its seats in the election. On the one hand, the LDLP government was burdened by a number of corruption scandals pointing in the direction of the party's top-level politicians. On the other hand, the banking crisis and the economic conditions imposed on many Lithuanias had resulted in a loss of voters' confidence in the party's ability to solve the economic problems of the country (Bugajski, 2002). Conversely, the HU managed to regain the seats it had lost in the previous election and now controlled a majority of the seats in the parliament. Despite this, the HU formed a government with the LCDP and the Lithuanian Centre Union (LCS). Gediminas Vagnorius of the HU was elected the new PM.

Despite the change in government, attempts to protect the banking sector continued. In a country study of the Lithuanian banking sector the World Bank writes:

> The practice of proposing and enacting laws that target individual banks, and selected issues surrounding those banks, needs to be stopped. The practice creates the impression of a lack of foresight on the part of the government, inadequacy in the existing laws, and/or political intrigue in the application of laws and policies. It also rewards inappropriate actions in the banking sector and raises competitive issues for well-run banks, ultimately promoting inequitable treatment of banks... (World Bank, 1998, p. 10).

Furthermore, only two of fourteen sanctions against commercial banks that were imposed by the supervisory department were later confirmed by the fourteen-member board of the BoL, many of whom were members of the banking association. Common to all these occasions of state interference was the eagerness of policymakers to step in and protect domestic banks from stricter regulatory requirements and competition.

The consolidation and privatisation of the banking market are closely intertwined. A more consolidated banking market in Lithuania would have required the government to allow commercial banks to take controlling stakes in the state-owned banks. However, this process was

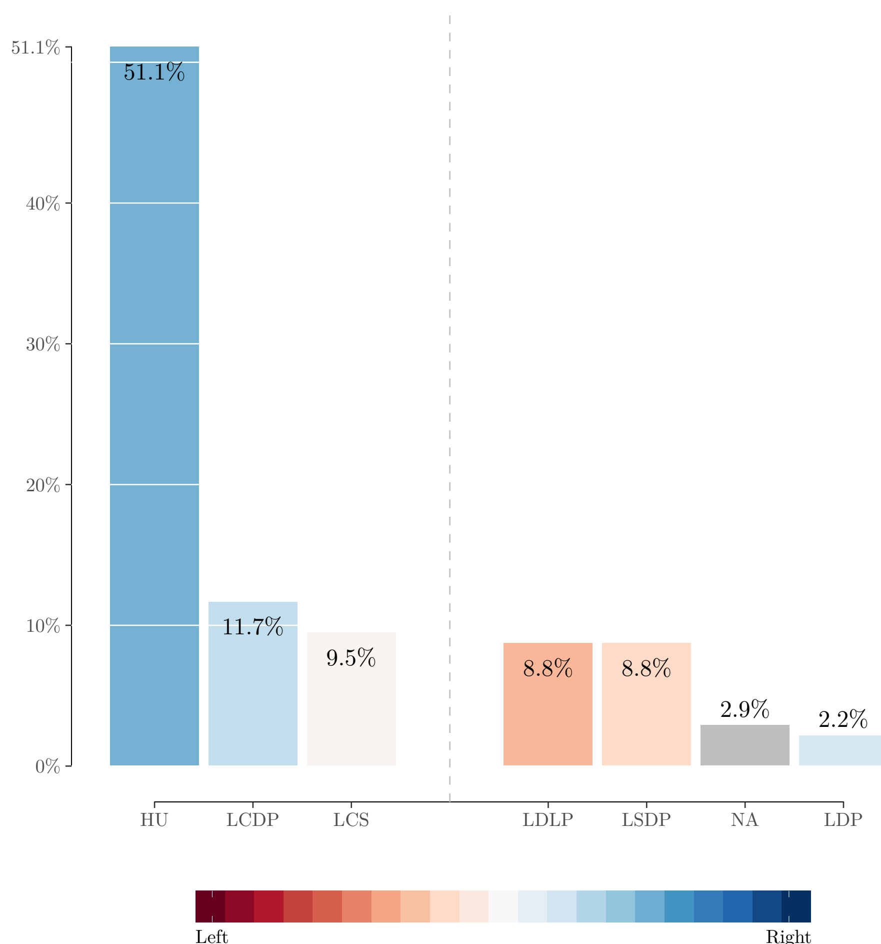


Figure 5.18 – The composition of the Seimas as of the election on the 20th October, 1996. The intensity of the colours of the bars represent the parties' position on the left-right dimension. The cabinet parties are located to the left of the dashed line. 14 parties were won seats in the 1996 election. However, because of the lack space parties that control less than 2 % of the seats are excluded from the graph. The grey bar represents NA values. Source: Döring and Manow (2016).

constantly delayed, not only because of the importance that the state-owned banks had come to play for the Lithuanian government, but also because of the difficulty to find buyers for the state-owned banks due to the bad condition they were in. The government knew that they would have to accept a substantial discount on the state-owned banks if they were to be sold in the current condition.

Already in early 1997 the government announced the privatisation of the state commercial bank and the Agricultural Bank (Reuters, Feb.1997).[27] The privatisation of the Savings Bank was not the agenda at this early stage, since the government understood the bank to be necessary for them carry out state business and obligations (Reuters, Feb.1997). A number of private banks from both Lithuania and abroad had shown some interest in the Agricultural Bank in the early stage of the privatisation process. The vice-chairman of Estonia's Hansa Bank told journalists at

[27] The State Commercial Bank was in the end wound up because of its deep liquidity problems, and its assets were transferred to the Savings Bank.

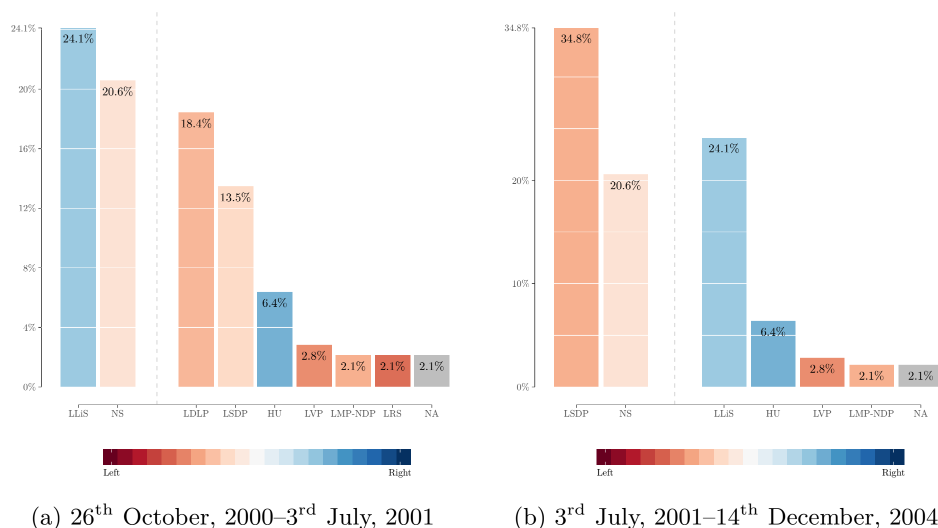
a press conference that "[Hansa Bank] are seriously considering participating in the privatisation of the Agricultural Bank." (quoted in Reuters, May.1997).

However, the poor condition of the state banks soon became obvious for private market participants, with the president of the Lithuanian Banking Association (LBA), Eduardas Vilkelis, commenting that the Agricultural Bank and the Savings Bank were in an equally bad shape as the State Commercial Bank (BBD, Nov.1997). This opinion was echoed by the chairman of the central bank, Reinoldijus Sarkinas, who told the parliament that "[t]he basic problem today is state banks still in operation, for which exceptions are made, allowing them not to fulfil risk-limiting normatives. This does not help the banking system." (quoted in BBD, Mar.1998). Thus, the government was unable to sell the bank in mid 1998, because of the insufficient offers received, despite that the government having taken over many of the bank's bad loans (Reuters, June.1998). Similar problems soon emerged for the Savings Bank, and the government, once again, had to postpone the sale of the bank (Reuters, Dec.2000). In the end, the two banks were only privatised in 2000 and 2001, respectively, mainly due to increased pressure from the EU.

The last election before the accession to the EU took place on the 8th October, 2000. Once again the pendulum swung towards the left, with the HU's vote share in the parliament dropping from 51.1 % to 6.4 %. The two major winners in this election, however, were one centre-right and one centre-left party. Both the Lithuanian Liberal Union (LLiS) and the New Union — Social Liberals (NS) were a pro-market liberal parties that advocated a smaller role for the Lithuanian state in the Economy. Rolandas Paksas was elected PM. Nevertheless, the Paksas government only managed to stay in power for a year, after which it had to resign after major disagreements within the government coalition. The new government was headed by Algirdas Brazauskas, and consisted of a merger between four centre-left parties in the parliament: the LDLP, the LSDP and two minor parties. The new party controlled a total of 34.8 % of the votes in the Seimas.

Brazauskas had been an important figure in the Lithuanian struggle for independence as a leader for the LCP. Although there was a certain distaste for the PM because of his communist past, especially in more conservative circles, Brazauskas mostly came to disappoint many who had hoped for a left-turn in Lithuanian politics. Many of the ministers from the former administration stayed on, and with regards to banking the country continued to make important improvements to the upgrading of supervisory capacity.

Just as Hansa Bank in Estonia had strengthened out of the banking crisis, Vilniaus Bank was viewed by many as the safest bank during the banking crisis. It had benefitted greatly in terms of customers moving their assets from smaller banks that were often perceived to be less stable. Nevertheless, the bank had a difficult time to grow further in the aftermath of



(a) 26th October, 2000–3rd July, 2001 (b) 3rd July, 2001–14th December, 2004

Figure 5.19 – The composition of the Seimas as of the election on the 8th October, 2000. The intensity of the colours of the bars represent the parties' position on the left-right dimension. The cabinet parties are located to the left of the dashed line. 17 parties won seats in the 2000 election. However, because of the lack space parties that control less than 2 % of the seats are excluded from the graph. The second government was formed after a merger between four parties: the LDLP, the LSDP and two minor parties controlling a total of six seats. The grey bar represents NA values. Source: Döring and Manow (2016).

the crisis, mainly because of the prolonged privatisation process, which left large parts of the market under continued state control. The consolidation of the banking market was, however, also prevented by the policy of the central bank not to allow any mergers that would result in a combined market share that exceeds 40 %, since this was seen as a systemic risk to the banking sector. Hence, in 1998, when Vilniaus Bank, the country's largest bank, attempted to buy a controlling share in the second largest bank, Hermis Bank, the central bank decided against the purchase (BBD, Apr.1998). The creation of a big privately-owned bank was also opposed by the government, since such a move would make it more difficult to sell the state-owned banks at a favourable price (Reuters, June.1999). Only one and a half year later, Vilniaus Bank was given the go ahead for the merger with Hermis by the central bank.

The merger between the two largest banks had a positive impact on the consolidation of the banking market, something that had been a major concern of many foreign investors wanting to enter the country. Swedfund executive vice-president Karin Isaksson said that: "Definitely, Lithuania should have one very strong national commercial bank...If you look at it in a regional perspective a merged bank would not be a very big bank, it would be about the same size as some of the larger Estonian banks." (quoted in Reuters, Apr.1998). And shortly after the merger SEB announced its intention to acquire a majority share in the new bank, stating the upcoming merger as one of the core reasons for why the bank was now ready to acquire a majority stake in the Vilniaus Bank (BBD, Oct.1999). The increasing involvement by the Swedish bank was

reflected in the steep increase in the Foreign Direct Investment (FDI) during the year 2000; SEB invested USD 57 million in 2000 alone. Indeed the depth of the banking sector increased substantially with the FDI of early 2001. As shown in Figure 5.20, deposit money bank assets to GDP started to increase substantially in 2001, when the SEB increased it holdings in Vilniaus Bank.

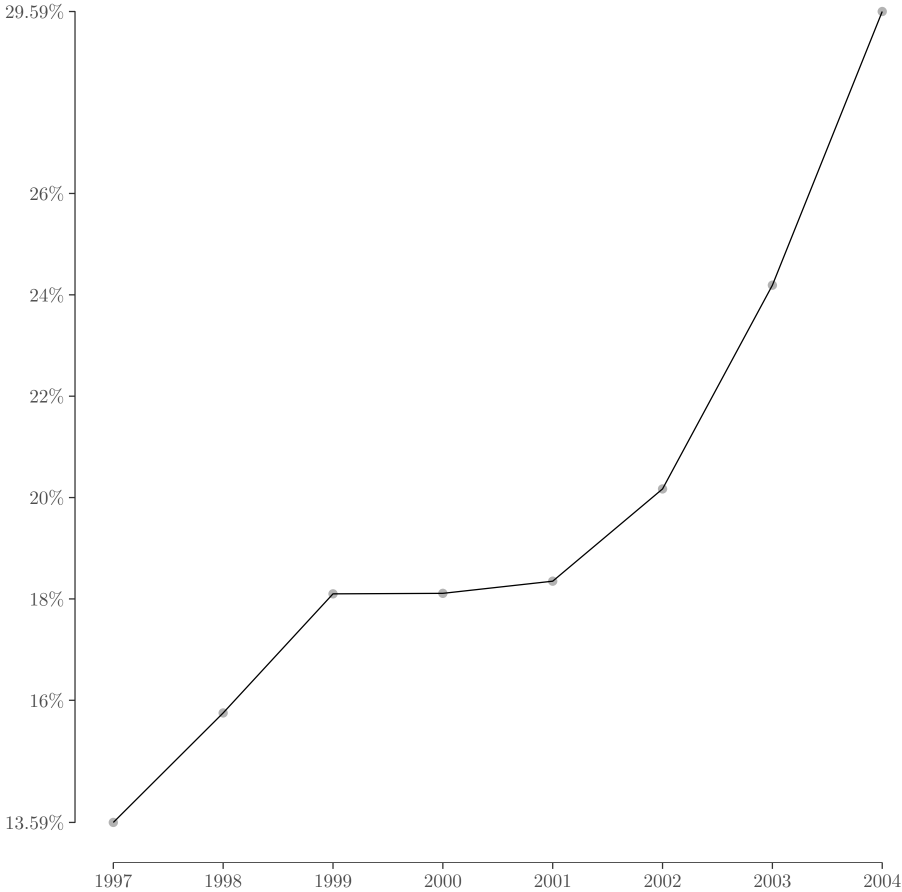


Figure 5.20 – The graph shows the level of bank sector penetration ratios between 1997 and 2004, measures as deposit money bank assets to Gross Domestic Product (GDP). Source: Demirgüç-Kunt et al. (2013)

The importance of the merger is confirmed by one of the interviewees, working for the Swedish bank, who told me that the fragmentation of the Lithuanian banking market was one major concerns of the bank before entering the country. Shortly after SEB had acquired a majority stake in Vilniaus Bank, another Swedish bank, Swedbank, began to buy shares in the Lithuanian Savings Bank, through its Estonian subsidiary Hansa Bank. In April 2001, the government together with the central bank agreed to sell 90.73 % of the Savings Bank to Hansa Bank.[28]

[28]It is worth noting that the agreement between the government and the Swedish/Estonian bank was put on hold for almost two months during the beginning of 2001 because of rumours that Swedbank was about to merge

The consolidation of the bankings sector coincided with a take off in Lithuanian reform efforts. In 2001, the Commission wrote that Lithuania had made substantial progress in the area of banking, and that the country now largely had aligned its legislation with EU requirements (European Commission, 2001, p. 43).

5.3 Conclusions

The difference between how banking reform in Estonia and Lithuania progressed should now be evident. Where as Estonia pursued a hard line of liquidating troubled banks, the strategy of the Lithuanian government was rather one of rehabilitating. The result of the diverging policy-choices in the two countries also led to diverging outcomes in the banking sector. Shortly after the transition period had begun Estonian policymakers managed to lock the country into a self-reinforcing circle. Conversely, Lithuania got locked into a vicious circle, where important reforms of the banking sector were delayed again and again.

The first turning point in the case of Estonia was the banking crisis that took place in late 1992. Before the crisis of 1992, the central bank and the government did not do much with regards to regulating and supervising the banking market, this despite the then chairman of the central bank acknowledging the nascent stage of Estonian banks (AFPR, Sept.1991). The banking crisis opened a window of opportunity for Estonian authorities, which they took. It allowed them to rapidly consolidate the bankings sector in the country. As shown in Figure 5.7a, the number of commercial banks operating in Estonia dropped from 42 to 22 in 1993 alone. The consolidation of the banking sector was coupled with a rapid decrease of in the share of total banking assets controlled by the state. Many of the state-owned banks lost either important market shares or were liquidated, e.g., the ESB, the NEJSB and the UBB. Unfortunately, I have only been able to collect data for state ownership from 1994 onwards (see Figure 5.7b), but between 1994 and 1995 the asset share of the state plunged.

The Estonian banking sector that emerged from the crisis consisted of mainly two banks, Hansa Bank and EUB. Both banks were financially strong and able to compete. Thus, for these banks it became increasingly important that Estonia would adopt and implement regulatory standards that were in compliance with international norms. The lower segment of the market had become relatively unimportant for the country's banking sector, and the central banks and politicians did not need to pay much attention to smaller banks. In addition, Hansa Bank and EUB saw an opportunity to absorb many of the smaller banks' market shares either through merging or liquidation.

with SEB, something that led the Estonian authorities to cancel the talks.

The banking crisis and the consolidation of the banking sector took place much later in Lithuania. To be sure, the currency reform of 1994 that pegged the LTL to the USD had an effect on the number of bank operating in the country. However, most of the banks that exited the market during this period were small and relatively unimportant for the economy. The first signs of a banking crisis were seen in the summer of 1995. However, the BoL together with the government decided on a very different approach than their counterparts in Estonia. Many of the banks, especially the ones in which the state held a major stake, were bailed out in one way or another. Hence, we do not see the same consolidation in Lithuania. More importantly, however, was the fact that state-owned banks continued to operate in the country, despite being financially weak and badly run. Because of the protected position of state-owned banks on the market, the private banking sector never took off in Lithuania.

In the case of Lithuania — with few veto players, a semi-concentrated market and high degree of state ownership — much of the evidence is pointing in the direction of capture, but also a concern that the banking sector was too weak for a radical reform agenda to be implemented. In many cases more modern banking legislation was adopted by the parliament and the central bank, but when banks started to show signs of problems exceptions were made, and in some case even legislation targeting specific banks was passed. For example, in an attempt to consolidate the banking sector after the crisis, the BoL raised the minimum capital requirements to 20 000 000 from 10 000 000 LTL, in addition to demanding that banks comply with the IAS. In connection to the new regulations the central bank signalled that it expected to see an increase in bank mergers during the year as smaller banks struggled to meet the more stringent requirements: "It will be necessary for some banks to look for partners because they are not very competitive and cannot provide a wide range of services." (quoted in Reuters, Mar.1997) the deputy chairman of the BoE told reporters. Counteracting the attempts of the central bank the parliament, only one month later, passed laws that exempted the state-owned banks from the new requirements.

Important steps in the Lithuanian reform process took place in the late 1990s and early 2000s. Several events during this period seem to have played an important role for this process. It had become increasingly obvious for the Lithuanian authorities that the state-owned banks were badly managed and deeply insolvent. A process of selling this banks therefore started. At the same time, two of the major Swedish banks had begun to show an interest in the Baltic banking market, buying controlling stakes in the one of the state-owned banks, and taking over the country's largest private bank. This move substantially consolidated the Lithuanian banking sector, facilitating the further reform effort. In parallel with the Swedish banks entering the banking sector, the central bank further strengthened the capital adequacy calculation rules,

making them fully compliant with EU requirements.

This is not to say that no other factors played a role in the reform process in Estonia and Lithuania. To be sure, political ideology, international organisations etc. also affected the speed and direction of banking reform in the two countries. Nevertheless, it is difficult to discern any pattern in reform efforts with regards to political preferences from the major political parties. During the first half of the 1990s Lithuania was governed by both centre-left and centre-right parties, controlling more than 50 % of the seats in the Seimas. Despite this, reforms were slow during this time and the government together with the parliament stepped in on numerous occasions to overrule the regulatory efforts of the central bank. Similarly, the reform efforts that took place during the early 2000s happened under both a centre-right and centre-left government. It is more difficult to discern any pattern with regard to Estonia, since the centre-right have been substantially stronger than the centre-left during the whole period leading up to the accession.

There is no doubt that the international community has played an important part in the reform efforts of both Estonia and Lithuania. Both countries aimed to become members of the EU, something that surely influenced both the speed and the direction of the reform. Nonetheless, it is obvious from the data studied for this dissertation that the international community played a secondary role. They provided indispensable assistance in terms of know-how and financial resources to both countries, and they could probably also exert some influence over policymakers in the two countries. Still, the decisions to go in one direction or another were taken by domestic players in the respective countries.

Chapter 6

Conclusion

I have with this dissertation examined the politics behind reform. I have particularly focused on the reform of the banking sector in Central and Eastern Europe (CEE) countries during their transition from planned socialist economy to a capitalist market economy. The issue of reform is important to understand for academics and policymakers alike, especially in the context of economic development. To integrate into the global economy, emerging market economies must comply with regulations that reflect the socio-economic conditions of the Western world rather than the priorities of emerging economies. The eastern enlargements of the European Union (EU) are good examples of this integration process. To join the Union these countries had to adopt and implement wide ranging reforms of "economic, political and social structures, especially public administration." (Bachtler, Mendez, and Oraže, 2013, p. 2). Notwithstanding the often similar starting positions of the different countries from CEE, the outcome of the reforms process often diverged both across countries and between policy areas within polities.

Two aspects of reform captured my interest early on. First, I was interested in the role political institutions were playing in the reform process. The work of Tsebelis (2002) had made the case that political institutions mattered to the extent that they provided actors with veto power, i.e., the power to block a decision; and, the more actors with veto power the less prone to reform the political system would be, everything else being equal. Tsebelis's account of the reform process is stripped from other actors than veto players, despite the fact that a large literature in both economics and political science have pointed to the crucial role that special interests play in the reform process, which also leads to the second aspect of the reform process that I was interested in exploring. If business and veto players are both important in shaping economic reforms, how do they the interact? This was the point of departure for this dissertation.

To further explore the relationship between veto players and special interest I decided to study reforms of the banking sector. Financial markets are an interesting study object both from

a methodological and empirical standpoint. Methodologically the financial market represents a case were we would expect a high concentration of special interest. Financial intermediaries are important to any market economy since they affect how resources are distributed throughout the economy, business therefore have high stakes in policies that affect the operations of finance in a country. Empirically, financial intermediaries are important for the exact same reasons. As has been shown in the literature, banks are pivotal for the economic development of a country. Well functioning financial intermediaries funnel credit to the most productive sectors in the economy.

In this chapter I will briefly give an overview of the main findings of the dissertation, identify its limitations and point to possible avenues for future research.

6.1 Main Findings

In the broadest sense, the explanandum of this dissertation concerned institutional reform. Based on Voigt (2012), I defined institutions as commonly known and socially-constructed rules that structure recurrent behaviour, and that are endowed with an enforcement mechanism. Reform was defined as the process of carrying a new set of institutions into effect, including the adoption of a new set of rules, the creation of organisations, and the enforcement of rules. Hence, whereas institutions are rules that motivate behaviour, reform is the process of specifying these rules. This definition is broad and includes a range of different institutions, such as conventions, norms, organisational statues, legislation etc. It was therefore necessary to further narrow the definition. I focused on formal rules that are enforced by the public.

To study financial market reform in CEE a dataset was constructed. Based on the Progress Reports compiled by the European Commission (Commission) during the accession period I coded institutional quality according to four dimensions: rules, organisation, resources and behaviour. The coding aimed to capture the distance between the institutional quality of a country and the requirements set up by the EU. The dataset adds to the existing measures already out there. For example, the transition indicators compiled by the country experts at the European Bank for Reconstruction and Development (EBRD) tend to have a strong focus on the rule aspect of institutions, while neglecting the organisational, resource and behavioural dimensions. Nevertheless, it should be pointed out that the two indexes are highly correlated with each other.

To explore the different pathways of reform across the 17 countries included in the study I used the optimal matching (OM) method. It is a technique that is commonly used in the sciences to detect patterns in sequences, defined as a list of elements that is fixed and ordered by time. The accession period can therefore be understood as a sequence in this context. Especially

one main finding is worth mentioning. A clear pattern can be detected, whereby countries that were part of the first enlargement process by and large managed to adopt and implement the reform agenda of the EU, whereas countries that are taking part in the enlargement of today lag behind. This finding is supported by the literature. One should, however, mention that there is an overlap between the two groups.

The analytical part of the dissertation consisted of two parts. In the first part I conducted a statistical analysis that aimed to corroborate the theoretical account. To this end different statistical methods were employed: Generalised Estimating Equations (GEE) and Random Effect Model (REM). The aim of this chapter of the dissertation was to test the statistical association between veto players and special interest, on the one hand; and, financial market reform, on the other hand. The other empirical chapter took a qualitative approach and studied the reform pathways of Estonia and Lithuania. As such, the scope of this part stretches beyond the accession process and take as a point of departure the beginning of the transition period in the two countries.

For the GEE analysis reform was treated as a binary and a polychotomous variable, which implied that reform was understood to be an event that does or does not occur each year. For the polychotomous variable I counted the number of reform events in any of the dimensions. In the REM analysis I treated reform somewhat differently. Instead of being an event, I defined reform as movement towards full reform. Thus, reform in this context measures the level of compliance with EU requirements at different points in time.

Through the statistical analysis the dissertation contributes to our understanding of how political institutions interact with market structures. I show that if the interaction effect was not included into the analysis, market fragmentation had a negative impact on the reform process. I theorised that this was because actors operating in more fragmented markets were restricted in their ability to absorb the regulatory impact. Policymakers therefore refrain from adopting and implementing reform that can potentially harm the market participants. This is an important finding since it implies that it more difficult to implement reform in fragmented markets than in markets with few but strong actors.

If the interaction effect is introduced into the analysis a different pattern manifests itself. The analysis showed that when veto players are few, the probability of reform increased as the market becomes more fragmented. Conversely, when veto players are numerous the likelihood of reform increased with market concentration. This is in line with the theoretical account presented in Chapter 3. More concentrated market are associated with lower adaptation costs for the banking industry, implying that reforms are more frequently occurring. But, when the number of veto

players are few, a decrease in market fragmentation increases the risk for capture, and therefore lowers the probability of reform. I also find some evidence for the association between state ownership and reform; the effect is negative but seldom statistically significant.

The qualitative analysis conducted in Chapter 5 largely supports the findings found in the statistical analysis. The Estonian authorities managed to perpetuate a positive reform cycle, where the initial consolidation of the banking sector created a group of commercial banks that demanded more reforms from the government. Conversely, in Lithuania the banking sector took longer to consolidate and many of the largest banks were controlled by the state. Lithuanian authorities were therefore more reluctant to adopt and implement string requirements, and when regulations were adopted exceptions on a case-by-case basis were often made in a later stage. The country only managed to exit this vicious circle after international banks had entered the market, pushing the country towards a more stringent regulatory environment.

What implications do these findings have outside the realm of academia? One of the most important issues for any society concerns the relationship between the state and the market. For markets to function properly the state must be able to regulate the activities of economic actors, but the state must also be strong enough to shield itself from the risk of capture from powerful private interests. As pointed out in Chapter 1, this was already one of the main concerns for the American founders, who argued that power must be dispersed among enough state actors so that no faction can use the government for its own ends. Nevertheless, it is also the case that the separation of power often create a weaker state with regard to its ability to regulate economic activity and uphold basic economic rights. This dissertation speaks to this issue by pointing out that there is no one solution to the conundrum. The big issue that faces state builders is to find a balance between the market and the state, where both forces can counteract the power of the other. Only then is it possible to create a virtuous circle of reforms.

6.2 Limitations and Future Research

A number of avenues for future research arise because of the limitations to this dissertation. One of these limitations that comes to mind is to further test the theoretical account outlined in Chapter 3. Throughout this project my effort had always been to build a theoretical account that can shed light on the interaction between veto players and special interested. As mentioned in Chapter 1, the aim was never to causally test a theory, but rather to build a theoretical account based on the data collected.

There are several ways in which the theoretical account that has been proposed in this dissertation can be further tested. The dissertation has an exclusive focus on CEE and the

financial sector, further research is need to see how the theory hold up if the scope of the study is broadened. One possible path to walk down is to test the theory on other sectors of the economy. This would of course require identifying the relevant actors for that particular sector, which would most likely be different from the actors that involved in this study. Another possible avenue is to expand the number of countries that theoretical propositions could be tested on. Market building is a process that is going on numerous countries around the globe, albeit under different conditions. Such an exercise would however require us to rely on different sources of data.

Despite the limitations this thesis makes a valuable contribution to the literature on economic reforms and political institutions. It broadens the scope of other studies by exclusively focus on the interaction of veto players and market structures, and enhances the debate on the balance between the market and the state.

Appendix A

Coding of Progress Reports

Table A.1 shows the years that each country has been coded in the Progress Reports.

Table A.1 – Years of Coding

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Albania	No	No	No	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Bosnia & Herzegovina	No	No	No	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Bulgaria	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	No	No
Croatia	No	No	No	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Czech Republic	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	No	No	No	No
Estonia	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	No	No	No	No
Hungary	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	No	No	No	No
Latvia	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	No	No	No	No
Lithuania	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	No	No	No	No
Macedonia	No	No	No	No	No	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Montenegro	No	No	No	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Poland	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	No	No	No	No
Romania	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	No	No
Serbia	No	No	No	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Slovakia	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	No	No	No	No
Slovenia	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	No	No	No	No
Turkey	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Appendix B

Banking Reform

Tables B.1 to B.4 shows the coding of the seventeen countries included in the study.

Table B.1 – Legislative Score

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Albania	NA	NA	NA	NA	NA	NA	NA	NA	1	1	2	2	2	2	2	2	2
Bosnia & Herzegovina	NA	NA	NA	NA	NA	NA	NA	NA	1	1	1	1	1	1	1	1	1
Bulgaria	1	1	1	1	1	1	1	2	2	NA	NA	NA	NA	NA	NA	NA	NA
Croatia	NA	NA	NA	NA	NA	NA	NA	NA	2	2	2	3	3	3	3	3	NA
Czech Republic	1	1	3	3	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Estonia	2	2	3	3	3	4	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Hungary	2	3	3	3	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Latvia	2	2	3	3	4	4	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Lithuania	2	2	2	2	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Macedonia	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	2	2	2	2	2	2	2
Montenegro	NA	NA	NA	NA	NA	NA	NA	NA	1	2	2	2	2	2	2	2	2
Poland	2	2	3	3	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Romania	1	1	2	3	3	3	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA
Serbia	NA	NA	NA	NA	NA	NA	NA	NA	2	2	2	2	2	2	2	2	2
Slovakia	2	2	2	2	2	2	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Slovenia	2	2	3	3	3	4	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Turkey	NA	2	2	2	2	2	2	2	2	2	3	3	3	3	3	3	3

Table B.2 – Procedural Score

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Albania	NA	NA	NA	NA	NA	NA	NA	NA	1	1	2	2	2	2	2	2	2
Bosnia & Herzegovina	NA	NA	NA	NA	NA	NA	NA	NA	1	1	1	1	1	1	1	1	1
Bulgaria	2	2	2	3	3	3	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA
Croatia	NA	NA	NA	NA	NA	NA	NA	NA	2	2	2	2	2	3	3	4	NA
Czech Republic	1	2	3	3	3	3	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Estonia	1	2	2	3	3	4	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Hungary	2	2	2	3	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Latvia	2	2	2	3	3	3	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Lithuania	2	3	3	3	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Macedonia	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	1	2	2	2	2	2	2
Montenegro	NA	NA	NA	NA	NA	NA	NA	NA	1	2	2	2	2	2	2	2	2
Poland	2	2	2	2	2	2	2	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Romania	1	2	2	2	3	3	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA
Serbia	NA	NA	NA	NA	NA	NA	NA	NA	1	1	1	1	1	1	1	2	2
Slovakia	1	2	2	2	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Slovenia	2	2	2	3	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Turkey	NA	1	1	2	2	2	2	2	2	2	2	3	3	3	3	3	3

Table B.3 – Resource Score

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Albania	NA	NA	NA	NA	NA	NA	NA	NA	1	1	1	2	2	2	2	2	2
Bosnia & Herzegovina	NA	NA	NA	NA	NA	NA	NA	NA	1	1	1	1	1	1	1	1	1
Bulgaria	2	2	2	2	2	3	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA
Croatia	NA	NA	NA	NA	NA	NA	NA	NA	2	2	2	2	2	2	2	3	NA
Czech Republic	2	2	3	3	3	3	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Estonia	1	2	2	3	3	4	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Hungary	2	3	3	4	4	4	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Latvia	2	2	2	3	4	4	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Lithuania	2	2	2	2	2	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Macedonia	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	1	2	2	2	2	2	2
Montenegro	NA	NA	NA	NA	NA	NA	NA	NA	1	2	2	2	2	2	2	2	2
Poland	2	2	2	3	4	4	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Romania	1	1	2	2	2	2	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA
Serbia	NA	NA	NA	NA	NA	NA	NA	NA	2	2	2	2	2	2	2	2	2
Slovakia	1	1	2	2	2	2	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Slovenia	2	2	2	2	2	2	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Turkey	NA	1	1	2	2	2	2	2	2	2	2	2	2	2	2	2	2

Table B.4 – Behavioural Score

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Albania	NA	NA	NA	NA	NA	NA	NA	NA	1	1	2	2	2	2	2	2	2
Bosnia & Herzegovina	NA	NA	NA	NA	NA	NA	NA	NA	1	1	1	1	1	1	1	1	1
Bulgaria	1	1	2	2	3	3	3	3	3	NA	NA	NA	NA	NA	NA	NA	NA
Croatia	NA	NA	NA	NA	NA	NA	NA	NA	2	2	2	2	2	2	2	2	NA
Czech Republic	2	2	3	3	3	3	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Estonia	3	3	3	3	3	4	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Hungary	1	1	2	2	2	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Latvia	2	2	2	3	3	3	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Lithuania	2	2	2	2	2	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Macedonia	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	1	2	2	2	2	2	2
Montenegro	NA	NA	NA	NA	NA	NA	NA	NA	1	2	2	2	2	2	2	2	2
Poland	2	2	3	3	4	4	4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Romania	1	1	1	2	2	2	2	2	3	NA	NA	NA	NA	NA	NA	NA	NA
Serbia	NA	NA	NA	NA	NA	NA	NA	NA	1	1	1	3	3	3	3	3	3
Slovakia	2	2	2	2	2	2	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Slovenia	2	2	2	2	2	3	3	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Turkey	NA	1	1	1	2	2	2	2	2	2	2	2	2	2	2	2	2

Appendix C

Polity IV Score

Table C.1 accounts for the political regime in each country between the period 1997 and 2013 according to data collected by the Polity IV project. The score ranges from 10 (strongly democratic) to −10 (strongly authocratic). It is evident from the table that during the period for which data has been collected in the Progress Reports most countries have a score of 7 or above, implying a relative strong democratic regime. Bosnia & Herzegovina is an exception with a score of −66, which idicates a case of foreign interruption. One country-year in Croatia (1999) is coded as −88, defined as a case of transition.

Table C.1 – Polity IV Score

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Albania	5	5	5	5	5	7	7	7	9	9	9	9	9	9	9	9	9
Bosnia & Herzegovina	−66	−66	−66	−66	−66	−66	−66	−66	−66	−66	−66	−66	−66	−66	−66	−66	−66
Bulgaria	8	8	8	8	9	9	9	9	9	9	9	9	9	9	9	9	9
Croatia	−5	−5	−88	8	8	8	8	8	9	9	9	9	9	9	9	9	9
Czech Republic	10	10	10	10	10	10	10	10	10	9	9	9	9	9	9	9	9
Estonia	6	6	7	9	9	9	9	9	9	9	9	9	9	9	9	9	9
Hungary	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Latvia	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8
Lithuania	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Macedonia	6	6	6	6	6	9	9	9	9	9	9	9	9	9	9	9	9
Montenegro	NA	NA	NA	NA	NA	NA	NA	NA	NA	9	9	9	9	9	9	9	9
Poland	9	9	9	9	9	10	10	10	10	10	10	10	10	10	10	10	10
Romania	8	8	8	8	8	8	8	9	9	9	9	9	9	9	9	9	9
Serbia	NA	NA	NA	NA	NA	NA	NA	NA	NA	8	8	8	8	8	8	8	8
Slovakia	7	9	9	9	9	9	9	9	9	10	10	10	10	10	10	10	10
Slovenia	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Turkey	7	7	7	7	7	7	7	7	7	7	7	7	7	7	9	9	9

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