

This article was downloaded by: [University of Denver, Penrose Library]

On: 12 September 2008

Access details: Access Details: [subscription number 790563955]

Publisher Routledge

Informa Ltd Registered in England and Wales Registered Number: 1072954 Registered office: Mortimer House, 37-41 Mortimer Street, London W1T 3JH, UK



Journal of European Public Policy

Publication details, including instructions for authors and subscription information:

<http://www.informaworld.com/smpp/title-content=t713685697>

The social context in conditionality: internationalizing finance in postcommunist Europe

Rachel A. Epstein

Online Publication Date: 01 September 2008

To cite this Article Epstein, Rachel A.(2008)'The social context in conditionality: internationalizing finance in postcommunist Europe',*Journal of European Public Policy*,15:6,880 — 898

To link to this Article: DOI: 10.1080/13501760802196838

URL: <http://dx.doi.org/10.1080/13501760802196838>

PLEASE SCROLL DOWN FOR ARTICLE

Full terms and conditions of use: <http://www.informaworld.com/terms-and-conditions-of-access.pdf>

This article may be used for research, teaching and private study purposes. Any substantial or systematic reproduction, re-distribution, re-selling, loan or sub-licensing, systematic supply or distribution in any form to anyone is expressly forbidden.

The publisher does not give any warranty express or implied or make any representation that the contents will be complete or accurate or up to date. The accuracy of any instructions, formulae and drug doses should be independently verified with primary sources. The publisher shall not be liable for any loss, actions, claims, proceedings, demand or costs or damages whatsoever or howsoever caused arising directly or indirectly in connection with or arising out of the use of this material.

The social context in conditionality: internationalizing finance in postcommunist Europe

Rachel A. Epstein

ABSTRACT When it comes to embracing the European Union's vision of building a fully integrated financial market, central and east Europeans have far out-performed their west European counterparts. This paper addresses not only why levels of foreign ownership in banks are on average so much higher in Central and Eastern Europe (CEE) than in Western Europe, but also why there is variation among CEE states in how willing they have been to accept those high levels of foreign ownership. I develop a theory of international institutional influence on target states that suggests compliance with international institutions' conditionality and advice depends on the existence of a particular social context. I test the argument in five post-socialist states: Poland, Hungary, Romania, Slovenia and Ukraine.

KEY WORDS Banking; conditionality; foreign investment; postcommunism.

INTRODUCTION

When it comes to embracing the European Union's (EU's) vision of building a fully integrated financial market, central and east Europeans have far out-performed their west European counterparts. After all, the EU and its previous incarnations have long aspired to a fully integrated financial market for the Continent that would bring down costs, increase efficiencies and facilitate cross-border transactions of all kinds.¹ Nowhere is the divergence between East and West more striking than in the strategic sector of banking. Across Central and Eastern Europe (CEE) it is now usual to find foreign investment levels in banking at 70 percent and upward. Among the 'old' 15 EU members, however, foreign control over banking assets more commonly hovers below 20 percent, and in many cases well below 10 percent. The outcome in CEE is even more surprising in light of the fact that in virtually no postcommunist country was there an elite consensus at the outset of transition in favour of high levels of foreign ownership. On the contrary, leaders initially sought to protect their banking sectors from foreign control.

In addition to examining the puzzle of why so many CEE states have diverged from their west European counterparts by allowing high levels of foreign investment in banking, this article addresses a second question: Why is there variation within CEE in the timing and extent of openness to foreign investment? Table 1 highlights both kinds of outcomes. I argue that, to a certain extent, the same evidence answers both questions.

Across CEE, transition states in the 1990s and early 2000s faced pressure from an array of international institutions that favoured internationally competitive bidding for state-owned assets. Often that pressure was in the form of

Table 1 Foreign and state ownership in selected industrialized and postcommunist banking sectors, 2002*

<i>Ind. country</i>	<i>Assets foreign owned</i>	<i>Assets govt owned</i>	<i>Postcomm. country</i>	<i>Assets foreign owned</i>	<i>Assets govt owned</i>
New Zealand	99.11	0.04	Estonia†	98.9	0
Luxembourg	94.64	5.05	Czech Rep.†	90	3.8
UK	46	0	Croatia	89.3	5
S. Korea	29.54	39.97	Hungary†	88.8	9
Norway	19.2	0	Slovakia†	85.5	4.4
US	19	0	Lithuania†	78.19	12.16
Portugal	17.7	22.8	Bulgaria††	74.56	17.6
Australia	17	0	Bos. & Herz.	73	10
Cyprus	12.7	4.2	Poland†	68.7	23.5
Greece	10.8	22.8	Latvia†	65.2	3.2
Switzerland	10.71	14.2	Romania††	47.3	41.8
Spain	8.5	0	Albania	46	54
Japan	6.7	0	Moldova	36.7	13.6
Finland	6.2	0	Belarus	26	74
Italy	5.7	10	Kyrgyzstan	24.7	16
Canada	4.8	0	Slovenia†	20.6	12.2
Germany	4.30	42.2	Kazakhstan	17.9	0.5
Turkey	3.47	31.82	Serbia & Mont.	13.2	3.8
Netherlands	2.2	3.9	Ukraine	10.5	12
China	1.9	98.1	Russia	8.8	35.5
Israel	1.2	46.1	Azerbaijan	4.6	58.3
Denmark	0	0			
Belgium	◆	0			
France	◆	0			

Source: Barth *et al.* (2006: 149–50, 152–3).

Notes: *Remaining assets are listed as privately owned (Barth *et al.* 2006: 154).

◆No data available.

†Countries admitted to the EU in 2004.

††Countries admitted to the EU in 2007.

Countries in bold face are those featured in this article.

conditionality. Owing to low levels of domestic capital accumulation in most CEE states, internationally competitive bidding often meant *de facto* sale of banks to foreigners. West European states never faced such an array of internationalizing pressure.² But in answering the second question more precisely about why, despite international pressure from multiple quarters, there was nevertheless variation in the timing and extent of openness to foreign ownership of banks in CEE, I argue that some CEE states were more resistant to international institutions' prescriptions than others.

Possible explanations for variation in CEE investment openness revolve around domestic preferences, financial crises, economic best practice, external demand or international institutions' conditionality as such. Instead, however, I argue that CEE susceptibility to international institutions' pressure, including conditionality, hinged on a particular social context (Epstein 2008). Where domestic actors viewed international institutions as authoritative sources of information and potential imprimaturs of their political platforms, postcommunist countries were likely to heed their advice and fulfill the terms of their conditionality. Domestic susceptibility in turn resulted in high levels of foreign ownership in banks. By contrast, where international institutions were unable to displace domestic sources of authority, namely nationalist striving and the desire for autonomy, international institutions' recommendations and conditionality wielded much less power, resulting in lower levels of foreign ownership in CEE banks.

After operationalizing the features of this social context, I test the argument in three core cases: Poland, Romania and Ukraine. These countries vary in terms of the values on the independent variables that constitute a facilitating social context. I also use evidence from both Hungary and Slovenia to provide additional observations on both the explanatory variables and outcomes. Additional variation over time provides still more explanatory leverage, particularly in the case of Romania. Ukraine's inclusion helps me to address possible alternative explanations concerning the effects of conditionality in the absence of a facilitating social context.

Explaining the internationalization of finance in CEE advances the central theme of this volume, 'Beyond Conditionality,' in three ways (see Epstein and Sedelmeier 2008). Most importantly, this article assesses international institutions' power in terms of a new mechanism – the social context – and demonstrates why conditionality is powerful in some instances but fails to elicit its intended effect in others. Second, the evidence draws in part from a case, Ukraine, which is beyond EU membership conditionality, even if that country has faced an abundance of other conditionality agreements with the World Bank and the International Monetary Fund (IMF). And finally, the article goes beyond conditionality in a temporal sense. I conclude that not only is it unlikely that CEE banks will ever recapture national ownership, but that in the decades to come, owing to changing EU law, European banks are even more likely to be transnational in character and ownership. Enduring compliance with international institutions' prescriptions even after enlargement mirrors other outcomes highlighted in this volume (Sedelmeier 2008).

THE SOCIAL CONTEXT IN CONDITIONALITY: ELABORATION OF THE ARGUMENT

The central argument of this article is that if external advice or conditionality is to produce its intended effect, it must be offered in a particular social context. That social context is most concisely described as one in which target states perceive themselves to be embedded in a hierarchy *vis-à-vis* international institutions. Three specific features of social context contribute to perceptions of authority: the discontinuity of sectors and regimes, domestic actors' perceived subordinated status *vis-à-vis* international institutions and the normative consistency underpinning the policies in question.

'Discontinuity' is operationalized here in terms of macro-economic liberalization, the endurance of business networks and party turnover in the transition. Discontinuity contributes to international institutions' power because domestic actors are likely to be uncertain about how to conduct reform and therefore prone to seek their assistance. Second, I measure the perceived subordinated status of domestic actors by assessing repeated political party turnover. Regular party turnover affords international institutions influence over domestic debates because they can take sides, confer legitimacy, mobilize the opposition and influence electoral outcomes. Lastly, normative consistency is assessed in terms of general practice – that is, the extent to which member states of organizations themselves pursue policies that the same organizations try to impose on target states. Where measures on all three variables are high, I would expect greater openness to external advice and stronger compliance with conditionality than where sectors and regimes are continuous, political competition muted, and the credibility of policies undermined by uneven practice.

What a social context informed by discontinuity, status and credibility captures is the power of international institutions to assign particular meanings to policies. From the perspective of CEE reformers in the early 1990s, planning to retain domestic ownership in banking was viewed as rational and desirable (Abarbanell and Bonin 1997; Tsantis 1997; Hjartarson 2004; Piroška 2005). As the evidence will show, however, where international institutions had the most influence over domestic debates by virtue of discontinuity, status and credibility, striving to retain domestic control came to be construed as embarrassing – in some cases as early as 1996. The shift in perception was not due to the availability of new information or incentives but to the exploitation of a permissive social context by international institutions to cast doubt on the wisdom of economic nationalism. They did this by emphasizing the extent to which they believed maintaining domestic ownership reflected communist, central planning instincts, anti-capitalist sentiment and a disregard for constructive relations with the liberal economic order of the West. The evidence also shows that the power of international institutions to orchestrate a shift in perceptions was at times limited by opposite measures on the same variables – i.e., continuity of regimes and sectors, domestic actors' lack of perceived subordinated status and the low credibility of the policies in question.

Another way of stating the argument is that in order for external advice or conditionality to 'work,' target actors must perceive the rewards on offer as worth the costs of compliance. This would seem to replicate other studies that assign objective values to both conditionality and compliance (Kelley 2004; Schimmelfenning 2005; Vachudova 2005). There is an important distinction, however. Although I also use the language of costs and trade-offs, I do so while arguing that incentives, whether they are in the form of money, membership or reputational rewards, have a subjective quality as well as material implications. In practice, the very same actors who reject conditionality in one period may comply with it in the next, not because their political position has changed, but because the social context has. Moreover, apparently similarly situated states may respond quite differently to a uniform set of incentives because perceptions of hierarchy differ, and the power of conditionality accordingly varies.

ALTERNATIVE APPROACHES

At least four rival explanations might also account for variation in the timing and degree of foreign participation in postcommunist bank privatization. The first is domestic preferences. Poland and Hungary in particular, which both saw democratic opposition movements assume power in the transition, might have been predisposed to pursue a liberalizing strategy in any case (Bockman and Eyal 2002; Shields 2003; Vachudova 2005). With respect to Bockman and Eyal's research specifically, liberal economists in Poland, Hungary, Czechoslovakia and Russia might have pushed for a major role for international capital. Although in those four countries such an approach would predict the correct outcome in all but Russia where domestic ownership of banks remained high, three kinds of evidence cast doubt on the power of domestic conditions alone to shape outcomes.

First, in none of the countries under consideration was achieving a high level of foreign ownership in finance an objective in and of itself – even among liberal economists. In fact, politicians across the spectrum explicitly sought to avoid foreign domination in the sector (Abarbanell and Bonin 1997; Tsantis 1997; Hjartarson 2004; Piroška 2005). Second, Romania, and to a certain extent Ukraine, show that even states without a liberal élite at the outset of transition can nevertheless be set on a liberalizing path. Third, political groupings that favoured a national approach to bank restructuring adopted an internationalizing strategy, not primarily in response to domestic pressure but because of international intervention. This was observable in the communist successor parties of Poland, Romania and to a lesser extent Hungary.

Economic best practice or financial crises may also have pushed states to seek out foreign investors as a way to shield the state from the burden of bank bail-outs. But the best practice argument is undermined by the fact that states clearly disagree on what constitutes an optimal outcome. While Hungary, Romania and to a lesser extent Poland have accepted high levels of foreign ownership,

Slovenia and Ukraine have not. The financial crisis explanation would seem to get at least some of the predictions correct. Hungary and Romania had financial crises and subsequently invited foreign strategic investors to buy their banks; Slovenia was never under the same level of stress and was successful for more than a decade in keeping foreign investment in banking to a minimum. But the financial crisis hypothesis is notably off the mark when it comes to Poland and Ukraine. Moreover, if one is concerned about timing, then Romania, according to the severity of its ongoing financial crises (Cernat 2006), should have been the first to solicit foreign investors. And according to the financial crisis argument, it was *only* through foreign investment that postcommunist states could escape the burden of repeated bail-outs. But in fact a number of state-owned and operated CEE banks have performed well, including in Poland, Slovenia and even Romania.

A third kind of explanation posits that variation in external demand accounts for differences in the level of foreign investment in CEE banks. According to the 'external demand' logic, one would expect Romania and Ukraine to have registered lower levels of foreign investment because of the poor quality of their banking assets. But there has been more demand for CEE banks than supply, and for good reason. The region came out of communism radically 'under-banked' by industrialized standards, with enormous potential for growth. By the end of 2004, banks with headquarters in Western Europe owned around half of all CEE banking assets, and in that year alone those same banks saw a 15 percent increase in the value of their assets, in large measure because of growth in CEE.³ Moreover, heightened foreign interest in both Romania and Ukraine corresponded to rationalization of the business environment as well as improved bank balance sheets – developments that stemmed directly from international institutions' advice and conditionality. Thus my own social context argument subsumes the external demand hypothesis: given pent-up demand for CEE banks in Western Europe, a regulatory shift in Romania and Ukraine in favour of international standards was also a decision to attract foreign capital. External demand on its own is insufficient: regardless of consistently strong demand for Slovenian banks, that state has opted to protect high levels of domestic ownership.

Finally, there is the pure conditionality argument. EU conditionality does not explain the variation in foreign ownership levels for two reasons. Although EU laws governing capital mobility and competition policy are relevant to whether and how EU members protect their financial sectors, a proposed law on cross-border takeovers (the Financial Services Action Plan) did not appear until 1999 and was still being transposed in 2006. This did not stop the European Commission from putting pressure on candidate states to privatize their banks with foreign capital, but only Romania did so before accession. Slovenia, by contrast, prevaricated, appeared to relent, only to backtrack in ways that sustained levels of foreign ownership on a par with Ukraine (at less than a third of assets in 2006). While EU membership says nothing about the discrepancy between Slovenia's and Romania's willingness to embrace internationalized ownership, the social context between these states and the EU does.

Bretton Woods conditionality (imposed by the World Bank and the IMF) was often also applied in order to encourage bank privatization. As the evidence here will show, however, states responded differently to similar incentives. Both Hungary and Poland were receptive to Bretton Woods conditionality in the first half of the 1990s whereas Romania and Ukraine were not. The point here is not to argue that conditionality is a weak instrument, but rather to highlight that its variable power is determined by a social context. Where domestic regimes and sectors underwent a sharp break with the past, where domestic actors perceived themselves as subordinate and where the credibility of policies was not in question, international institutions were likely to wield significant authority. Only then would conditionality appear to be 'worth' the costs of compliance.

DISCONTINUITY, STATUS AND CREDIBILITY: EXPLAINING CEE OPENNESS

Discontinuity (H1)

Sectoral and regime discontinuity are the first features of a social context that allow international institutions access to national reform debates. In theory, discontinuity and the resulting uncertainty about reform will lead politicians to seek out foreign advice to gain greater confidence in their own policy choices. For the purposes of this article, I operationalize discontinuity by assessing the durability of both business networks and political leadership through the transition.

In Hungary and Poland, the measure on discontinuity in banking was the strongest of the five cases. The banking sector was discontinuous with the communist era in that price liberalization in both countries was early and comprehensive. Facing free market conditions for the first time, including competition from foreign banks, Polish and Hungarian financiers were relatively open to international financial institution (IFI) advice about how to upgrade their skills, technology and competitiveness. Moreover, political turnover in the transition in both countries resulted in the rise of leaders who had not governed before. Uncertainty over how exactly to preside over major institutional reform of the macro-economy made them susceptible to external advice.

In Poland, the domestic drive to engage foreign advice presented itself in three ways. The Twinning Arrangements, sponsored by the World Bank and the International Finance Corporation (IFC) and launched in 1991, were an outgrowth of a speech by Jeffrey Sachs in which the economist urged Polish banks to pair up with Western ones as a means of upgrading skills and technology and generating Western interest in investing in the sector.⁴ A second form of engagement consisted of a Polish bank bail-out plan that requested the financial assistance of the IMF to recapitalize selected Polish financial institutions. Although the IMF ultimately agreed to put \$600 million toward the project, it was with the informal condition that Poland privatize six of its remaining state-owned banks by 1996.⁵ Until 1993, Poland also supported liberal

licensing and market entry laws, allowing foreign banks in particular to enjoy tax relief and flexibility concerning foreign currency holdings and capital mobility (National Bank of Poland 2001: 51). Encouraging competitiveness through market openness was consistent with the range of foreign counsel that Poland was receiving at the time (Bonin *et al.* 1998). Hungary, too, in keeping with strong measures on discontinuity, embraced international institutions' advice. In 1990 and 1991, Hungary adopted liberal licensing laws to encourage competition from foreign banks, legislated limits on state ownership and voting rights in Hungarian banks to 25 percent, and embarked on privatization (see Piroška 2005).

Whereas Poland and Hungary are the most similar cases in terms of the discontinuity variable in the early 1990s, Romania and Slovenia were different. Romanian price liberalization in 1991 was fairly comprehensive (with the exception of some utilities, food and housing prices) so bankers were facing an unfamiliar environment. But the potential access that international institutions would have to the sector based on uncertainty was limited in Romania by regime continuity (the National Salvation Front (FSN) was led by marginalized figures from within Ceaușescu's regime). As a consequence, IFI conditionality failed to elicit compliance: the Romanian governing class simply did not need IFI advice to bolster confidence in its policies. Thus, when the IMF predicated its 1994 stand-by agreement on the drafting of a bank privatization law, and linked subsequent agreements to banking reform, including its 1995 stand-by agreement that called for commercial bank restructuring and the privatization of the Romanian Bank for Development (BRD), Romania failed to comply. That failure led to the World Bank's 1996 Financial and Enterprise Structural Adjustment Loan, which also called for the privatization of the BRD and restrictions on the financing of commercial bank losses by the Romanian central bank (Ghizari 1992: 115, 121; Tsantis 1997: 173, 200), but which Romania also neglected to fulfill. Whereas Poland and Hungary were responsive to IFI counsel and were reluctant to rupture relations with the IMF and the World Bank, Romanian politicians through the first half of the 1990s entered into agreements with which they had no intention of complying or about which they were highly ambivalent.⁶

There was even more economic and political continuity in Slovenia's transition. Slovenia did undertake macro-economic liberalization. But because it had developed strong trading ties to the West under state socialism, the economic transition was not as radical as elsewhere, the transition recession was shorter, and many business networks remained intact (Feldmann 2007). Moreover, although Slovenia did undergo party turnover in the transition that resulted in the Democratic Opposition of Slovenia (DEMOS) taking power, a coalition composed of critics of the state socialist regime, it collapsed in April 1992 less than a year after Slovenia declared independence. The main political force thereafter was the Liberal Democratic Party (LDS) that drew on the nationalist and youth segments of the former state socialist regime, and, apart from six months in 2000, dominated every governing coalition until 2004.

Because of continuity in both the economy and leadership, Slovenia did not seek out external advice to gain confidence in its early policy choices. In contrast to Poland where Jeffrey Sachs was the catalyst for a bank twinning program, his 1992 trip to Slovenia to try to convince politicians there to adopt an IMF-backed privatization plan failed. As one high-level Slovenian politician noted in reference to outside counsel, 'We listened to them, but didn't follow their advice' (quoted in Lindstrom and Piroška 2007: 119).

According to the discontinuity hypothesis, the IFIs should have exercised the least influence over Ukraine's banking reform early in the transition. Not only was there strong continuity in the regime, but sectoral continuity was also bolstered by the fact that price liberalization was initially only slowly implemented and on a stop-and-go basis (see Sochan 1996: 10; Dąbrowski and Antczak 1995: 4). Consistent with what the discontinuity hypothesis would predict, Ukraine's bank reform strategy revealed the least international influence during the 1990s. Two banks remained in state hands while three other banks hived off from the socialist-era monobank were nominally privatized, but to state-owned enterprises, bank managers and employees. Ukraine, in contrast to Poland and Hungary, also maintained restrictions on most kinds of foreign participation in the domestic banking market. There was also little movement towards compliance with international accounting and business standards – itself a symptom of Ukraine's resistance to foreign influence in restructuring the banking sector.

In sum, strong discontinuity in the economy and in leadership, as in Poland and Hungary, corresponded to active engagement with IFIs. Romania, Slovenia and Ukraine were much less susceptible to external influence and, in the case of Ukraine, slow price liberalization and insider privatization of banks left financial institutions beholden to government ministries.

Status (H2)

The status variable assesses the extent to which domestic actors seek international institutions' approbation. I operationalize this variable in terms of regular party turnover or the threat of party turnover (Grzymała-Busse 2002; Vachudova 2005). The status hypothesis suggests that domestic actors are more beholden to international institutions' policy prescriptions when there is a robust opposition with the potential to unseat those in power. Under conditions of political competition and repeated turnover, international institutions not only provide information that potentially exposes the failure of leaders to comply (Vachudova 2005), they also broaden the scope of what political parties compete about as external actors become another constituency to whom politicians must answer. International institutions also gain the ability to confer legitimacy on one set of policies at the expense of another. The status hypothesis thus predicts that international institutions' preferences will act as an anchor, causing political parties to mimic and contest each other on the basis of external actors' advice (or disapproval).

The predictions of the status hypothesis are confirmed for Poland and Hungary. In Poland, political competition had been robust since the outset of transition, continuing with the communist successor parties' surprising electoral victory in 1993. Upon coming to power, the Democratic Left Alliance (SLD) and the Polish Peasant Party (PSL) viewed the diminishing scope for state intervention in the economy with concern. In this connection, they proposed a state-led bank consolidation program, with the end goal being to find domestic buyers who could turn the new banking conglomerates into internationally competitive financial institutions (the details of the plan are outlined in the following section on credibility). In keeping with the status hypothesis, the SLD–PSL coalition abandoned their bank consolidation plans as they discovered how dependent their political reputations were on the approval of international institutions. Indeed, in light of IMF, US Treasury and European Bank for Reconstruction and Development (EBRD) disapproval, the SLD–PSL coalition dramatically changed track, ending their administration with fast-track privatization for a number of Polish banks, soliciting foreign investors as they did so. The socialists in Hungary (MSzP) were similarly responsive to IFI advice, making constructive relations with the Bretton Woods institutions and the EBRD a top priority during their tenure beginning in 1994 (Hanley *et al.* 2002). As ex-communists, complying with international institutions through liberalizing strategies, including the privatization of banks with foreign capital, was one method of remaking their image in the postcommunist era.

Limited party turnover in Romania and Slovenia curtailed international institutions' access to reform debates. The lack of a viable opposition until 1996 in Romania resulted in slower internationalization of the banking sector than in Poland or Hungary. The FSN and its successor parties dominated from 1989 until 1996. Without a viable opposition, EU pre-accession guidelines had little influence on reform and, as we have already seen, Bretton Woods conditionality failed to elicit compliance. After the Democratic Convention of Romania (CDR) came to power in late 1996, however, bank privatization policy changed, largely because this new (if unstable) coalition fashioned its platform to win international approval, in contrast to the FSN. CDR oversaw the privatization of two of Romania's state-owned banks to foreign strategic investors, including the BRD and BancPost. Preparations were also made for Banca Agricola's privatization. Under CDR's leadership, the percentage of banking assets held by foreigners increased from 15.2 percent in 1998 to 43.56 percent two years later (Doltu 2002: 289). Also as the status hypothesis would predict, when the socialists returned to power again in 2000, they continued to pursue bank privatization with foreign capital, much to the West's surprise.⁷ Because there was no commensurate threat of party turnover or actual party turnover in Slovenia until 2004, the same year that Slovenia joined the EU, Slovenia had remained relatively immune to international pressure to open up its banking market.

The status variable receives some confirmation in the case of Ukraine, although the effect in terms of soliciting foreign investors was not as dramatic

as in Poland, Hungary or Romania. In support of the status hypothesis, political competition intensified in Ukraine with the 1999 presidential race in which Leonid Kuchma portrayed himself as a pro-Western reformer in contrast to Petro Symonenko, the Communist Party candidate who stood against Kuchma in the presidential run-off. Although Kuchma's pro-Western rhetoric during the campaign could be construed as only that – rhetoric – it is notable that in 2000 Ukraine began complying with World Bank recommendations for rationalizing the business environment to attract large-scale foreign investment. Increasing compliance between 2000 and 2004 set the stage for heightened levels of foreign investment in the banking sector after Viktor Yushchenko's victory in the 'Orange Revolution'. Within a short period, foreign ownership of Ukrainian bank assets rose from 10 to 30 percent.

Credibility (H3)

The credibility of policies depends on the normative consistency underpinning them. Normative consistency is measured here in two ways – by observing consensus and practice. Consensus among international actors in favor of privatization was very strong, and when asked to weigh in, international institutions urged internationally competitive tenders. When it came to bank privatization, however, normative consistency in terms of practice was much weaker, particularly at the outset of transition. For although western members of the EU, EBRD, IMF and World Bank were eager to encourage CEE states to open their markets, the lack of substantial foreign ownership in most industrialized states' banks told a different story about what states should maximize (see Table 1 for comparison; see also Johnson (2008) for a similar point about European monetary union). Early in transition, the example set by western states figured in every CEE debate about how to privatize banks, causing friction between domestic reformers and their external advisers, and in some cases limiting international institutions' power to direct outcomes.

In Poland, the most serious bid to break with the liberalizing agenda of the first Solidarity reformers, who had spearheaded the Twinning Arrangements and agreed with the IMF to sell a number of Polish banks before the end of 1996, was the SLD–PSL bank consolidation program, first outlined in 1995 (*Życie Warszawy*, 29 November 1995: 8). Pointing precisely to the fact that industrialized and developing countries in North America, Europe and Asia had protected domestic ownership in banking,⁸ the communist successor coalition took a more nationalist approach to commercial bank restructuring (Balcerowicz and Bartkowski 2001). They wanted to commercialize and consolidate six to eight banks into two groups for which the Ministry of Finance would find domestic buyers. Not only would the plan have allowed Poles to control a greater degree of domestic capital allocation, but it would have also potentially given the state more control over the economy. Not sharing these concerns, however, the IMF, EBRD and US Treasury would ultimately dissuade the SLD–PSL coalition from following through on the plan. Slovenia

was most similar to Poland in terms of viewing the credibility of competitive international tenders for banks skeptically throughout the transition and beyond. Even in the early 2000s, Slovenian economists arguing against foreign investment in banks pointed explicitly to the fact that foreign penetration in CEE was 'disproportionately high' compared to the EU15 (Lindstrom and Piroška 2007: 122).

Romania's initial reluctance to embrace high levels of foreign investment in banking, like everywhere else, stemmed from the sentiment that 'banks [were] considered to be among the most important, strategic assets of the state' (Tsantis 1997: 201). Hungarians also questioned the wisdom of foreign investment in strategic sectors, for although the first postcommunist government in Hungary (led by the Democratic Forum, MDF) was keen on bank privatization, it envisioned maintaining a strong domestic presence in the sector. In fact, two international deals between 1990 and 1994 fell apart over exactly such concerns: foreign investors wanted a guarantee that if they invested on a small scale in Hungarian banks in the early 1990s, they could ultimately buy larger stakes in the same institutions. The MDF-led government refused to agree (Hjartarson 2004: 10 and 17). But Romania and Hungary share another similarity that does not provide strong support for the credibility hypothesis. After 1994 in Hungary and after 1996 in Romania, neither bank privatization debate evidenced strong concern about disproportionate foreign penetration in a strategic sector. And both countries ended up with very high levels of foreign ownership in banks, at 90 and 80 percent of assets, respectively. Although the growing consistency of the international institutions' message could partly explain the relative lack of debate in the late 1990s and early 2000s,⁹ the credibility hypothesis would reasonably predict greater controversy than was manifested.

In keeping with the credibility hypothesis, Ukraine prioritized power over efficiency in its approach to bank privatization, at least until the early 2000s when international institutions' prescriptions about how to rationalize the business environment gained traction. The IMF Standby Agreements of 1995 and 1996, as well as the Extended Fund Facility of 1993, were consistently tied to privatization, but Ukraine failed to fulfill the terms of any of these deals. Lack of compliance with conditionality suggests that the social context did not allow external actors to wield much authority. By the early 2000s, not only had political competition in Ukraine intensified (see previous section on 'status') but international institutions were changing their approach, as well. Rather than focus on the number of privatizations, for example, the IMF shifted its focus to their quality, with particular attention to transparency and foreign access (Elborgh-Woytek and Lewis 2002: 14). Noting that low levels of foreign participation in finance were symptomatic of Ukraine's lagging economic performance, other organizations, including the World Bank, the Organization for Economic Co-operation and Development (OECD) and the US Treasury, all recommended reducing non-payment in the economy, rationalizing the tax structure, improving the financial sector's regulatory framework, ending political protection for weaker banks and limiting arbitrary political

interference (see variously: OECD 2001; Roe *et al.* 2001; Brown 2004; Duenwald *et al.* 2005). Research indicated that foreign interest would naturally follow from better business conditions – which it did beginning in late 2004.

As a snapshot of both conflicts over bank privatization and outcomes, the five countries featured here provide strong confirmation of the credibility hypothesis. Where practice in Western Europe was inconsistent with what international institutions were prescribing, one would expect CEE compliance to vary – and indeed it did. However, given the high level of foreign investment across a greater number of CEE countries (see Table 1), the credibility hypothesis looks weaker. Indeed, taking the CEE region overall, the credibility hypothesis is better for predicting the contours of conflict over bank privatization than it is for predicting individual outcomes.

OUTCOMES

The communist successor coalition that took power in Poland in late 1993 initially tried to increase the state's role in the economy through a bank consolidation and domestic sales strategy. The SLD–PSL government dropped the plan in 1996 in response to international pressure, however. Of most immediate concern to Poland's external advisers was the fact that one of the banks slated for consolidation (Bank Przemysłowo-Handlowy) had already been partially privatized, including by the EBRD (15.06 percent). Although Finance Minister Grzegorz Kołodko was inclined to pursue the program despite misgivings in the domestic and international press, he changed course only when he and his deputy, Krzysztof Kalicki, confronted direct pressure from the US Treasury, which in this instance was the last arbiter of IMF and EBRD preferences. In addition to cautioning the government against bank consolidation because it risked sending the wrong signal to foreign investors everywhere (that the communist successors in Poland still harbored central planning instincts), US Treasury officials threatened to withhold the next tranche of bank recapitalization funds, worth \$200 million. They argued that state-led bank consolidation was not in the spirit of the IMF's earlier agreement with the post-Solidarity government that six of Poland's state-owned banks be privatized by 1996, and Kołodko dropped the plan accordingly.

Despite the proximity of \$200 million in conditionality funds to Poland's abandonment of state-led bank consolidation, the outcome actually highlights the ways in which a social context constitutes the power of conditionality. That it was the social context rather than conditionality taken on its own that contributed to the internationalization of Polish bank ownership is borne out both by facts from the Polish case and by a comparison with Romania.

On the face of it, a transition state would likely prefer to have an additional \$200 million than not. However, if money had been the only consideration for the SLD–PSL coalition, it could have marshaled the funds from other sources. They could have refrained from implementing their tax cut, for example, which had only been made feasible by the additional bank privatization

and recapitalization funds. Or, given that the Polish parliament had legislated \$400 million for adjustment assistance to sensitive enterprises facing restructuring but that the World Bank had agreed to provide those funds instead, the SLD–PSL would have had resources to devote to bank recapitalization. If these alternatives are not persuasive, then consider the fact that Romania over the same period had three separate conditionality agreements linked to bank privatization with the Bretton Woods institutions and fulfilled not one of them (Tsantis 1997: 173, 200).

The difference between Poland and Romania was clearly not the presence or absence of credible conditionality. The difference was in how much the leadership in each country valued constructive relations with external advisers and by extension whether those external advisers had been afforded the power to assign particular meanings to particular policies. The SLD in Poland was highly sensitive to international opprobrium because the first post-Solidarity government had had such a close working relationship with IFIs on account of sharp discontinuity (H1). Moreover, the SLD was a communist successor party in a country where political competition allowed the opposition to use international criticism to undermine the coalition in power (H2). Although communist successors were also governing Romania, they were not similarly susceptible to international opinion because they had governed continuously through the transition and because there was only very weak opposition until late 1996 (H1 and H2).

All measures on the social context changed in the late 1990s in Romania, affording international institutions more access to the country's reform debates. The CDR came to power in late 1996, providing discontinuity in governing personnel (H1) and establishing political competition (H2). As noted in the previous section on the credibility hypothesis, the IFIs and the EU began coordinating their message on bank privatization, even if western practice continued to undermine the preponderant use of foreign capital (H3). As a consequence of Romania's new susceptibility, foreign ownership in banking increased to over 40 percent under the CDR, and when the socialists resumed leadership in 2000, they too embraced international institutions' prescriptions and conditionality. This included preparation and privatization of the Commercial Bank of Romania to the EBRD, the IFC and Austria's Erste Bank in 2004 and 2005. That there was international pressure to embrace internationalization is not in question. Privatization remained a key condition of World Bank and IMF support and Romania was pursuing the earliest possible date for EU accession. But such pressure is unlikely to secure compliance independent of a particular social context. One need only to compare Romanian compliance with the IFIs in the early 2000s to the situation five years earlier to see that conditionality – a feature of both periods – is insufficient on its own to elicit compliance (Tsantis 1997: 200–805). By 2006, foreign ownership in Romania's banking sector had reached over 80 per cent.

Bank privatization and the role of foreign investors in Hungary are largely what the social context would predict, with somewhat less debate after 1994 than one would expect about whether western protection of domestic bank

ownership should serve as a model (H3). Sectoral and regime discontinuity (H1) gave international institutions access to Hungarian reform debates during the first postcommunist administration, which undertook liberalization of bank licensing laws and encouraged foreign participation in the banking market. MDF also had a strong commitment to privatization, legislating a 25 percent state ownership or voting rights limit on banks by 1997. But when it came to actually increasing the level of foreign ownership of Hungarian assets, it was the socialists starting in 1994 who enlisted the assistance of the IFIs' that were uniquely qualified to redefine the communist successors' image. The socialists' exploitation of the IFIs power to confer legitimacy is in keeping with what the status hypothesis would predict (H2). By the end of 2002, close to 90 percent of Hungarian banking assets were foreign owned and most of the privatization that produced those levels took place during the socialist administration of 1994–98. When the socialists returned to power in 2002, they again allowed foreigners to buy still larger stakes in the banks that they already controlled.

The measure on discontinuity was the weakest in Ukraine because of delayed price liberalization and continuity in personnel from the communist to the postcommunist regime (H1). The absence of political competition until 1999 and 2000 also limited IFI influence, allowing Ukrainian priorities centred on domestic control to prevail in bank restructuring (H2). The pace of internationalization was increasing by late 2004, however, when Sweden's SEB Group bought 94 percent of Ukraine's Agio Bank. In 2005, Austria's Raiffeisen and France's BNP Paribas bought substantial stakes in Aval and UkrSibBank respectively, two of Ukraine's largest banks. In early 2006, Italy's Banca Intesa purchased another of Ukraine's former state banks, UkrSotsBank (*Kyiv Post*, 15 February 2006). The Orange Revolution of late 2004 no doubt played a role in changing foreign investors' perceptions of Ukraine as an increasingly democratic and western-oriented power. But compliance with IFI prescriptions that would open Ukraine's economy actually started in 2000 when Kuchma began seeking IFIs' assistance to bolster his domestic credibility. In 2001, for example, Ukraine passed the Law on Banks and Banking Activities that eliminated restrictions on foreign investment in the sector. Comparing World Bank assessments, there was little Ukrainian compliance between 1995 and 2000 in connection with a \$300 million Financial Sector Adjustment Loan (Roe *et al.* 2001: 4, 33) but much stronger compliance between 2000 and 2005. Whether foreign investment in Ukraine's banking sector would climb above its 2007 level of 30 percent would likely depend on how Ukraine's ongoing political crises would be resolved.

Paradoxically, Slovenia, a liberal democracy, outstanding economic performer, early entrant to the EU and first postcommunist euro adopter, looked more like Romania before 1997 or even Ukraine when it came to opening its banking sector to foreign investment. Strong continuity in the regime and even in the economy as well as the lack of repeated political party turnover between 1992 and 2004 limited the extent to which Slovenians accepted

external advice (H1 and H2). In addition, many Slovenians remained deeply affected by the disparity between foreign investment in banks in the East versus the West (H3).

The failure of international institutions to persuade was not for lack of trying. All of the European Commission's annual monitoring reports on Slovenia between 2000 and 2003 were critical of the country's failure to privatize two state-owned banks, in particular NLB and NKBM. The EBRD, the IMF and the World Bank all expressed similar concerns in their own publications and consulting missions, in addition to cautioning about higher than average bank operating costs (from muted market competition) and a risky level of interconnectedness in the financial sector (IMF 2004). It was not that Slovenia refused to do everything the international institutions were asking. In 1999 the government passed legislation that scuttled a previous upper limit on foreign bank ownership, allowed foreign bank branches and subsidiaries to operate, and liberalized capital flows.¹⁰ And by 2001 it even looked like they would privatize NLB and NKBM. In the event, however, the NKBM privatization was cancelled because of domestic political pressure, while the NLB deal was compromised by Slovenia's reluctance to allow the would-be Belgian strategic investor KBC to buy as big a share as it wanted in 2006.¹¹ In that year foreigners controlled just over 27 percent of Slovenia's banking assets (Bank of Slovenia 2006: 43).

CONCLUSION: BEYOND CONDITIONALITY

This study of conditionality and CEE openness to international institutions' policy prescriptions provides a new interpretation of how information and incentives are constituted in ways that make them 'worth' the costs of compliance. Key to the analysis is the idea that only a narrow social context affords international institutions the power to assign particular meanings to policies. In Poland, Hungary and Romania after 1996, international actors were able to orchestrate a shift in which domestic actors, who began the transition believing that protecting domestic ownership was rational and desirable, ended up embracing policies premised entirely on the efficiency of financial institutions, regardless of power considerations. Looking beyond accession conditionality, there is little reason to think that CEE states will ever be able to revert to national control over banking assets that they have already sold.

Although this article has implications for the power of international institutions globally, the processes through which many CEE states internationalized their banks tell us little about financial sectors in Europe because of forthcoming changes in EU law. For as EU law changes, so, undoubtedly, will the patterns of European compliance. Yet the internationalization of bank ownership as it has transpired in CEE over the last 20 years is more emblematic of that future than the West's long tradition of protecting domestic ownership. The EU and its previous incarnations have long envisioned a fully integrated financial market for the Continent that would bring down costs, increase efficiencies and facilitate

cross-border transactions of all kinds. But it is only in the current period – with the directive on takeover bids of publicly traded financial institutions, adopted by the European Parliament in April 2004 and projected for transposition by the member states by May 2006 – that EU law is finally coming to reflect much older European integration aspirations.

Biographical note: Rachel A. Epstein is Associate Professor of International Political Economy and European Politics at the Josef Korbel School of International Studies, University of Denver, USA.

Address for correspondence: Rachel A. Epstein, Josef Korbel School of International Studies, University of Denver, 2201 S. Gaylord St., Denver, CO 80208, USA. email: repstein@du.edu

ACKNOWLEDGEMENTS

I would like to thank Jeff Chwioroth, Juliet Johnson, Uli Sedelmeier, two anonymous reviewers and all the participants of the ‘Beyond Conditionality’ workshop at the London School of Economics on 31 May–2 June 2007 for their comments on previous drafts of this paper.

NOTES

- 1 Such efforts began with the 1973 directive on ‘The Abolition of Restrictions on Freedom of Establishment and Freedom to Provide Services for Self-employed Activities of Banks and Other Financial Institutions’, continued with provisions in the Single European Act of the mid-1980s, the Maastricht Treaty of 1992 concerning monetary union, and finally the Financial Services Action Plan, initiated by the Commission in 1999 (Barth *et al.* 2006).
- 2 And to the extent that West European states have felt any pressure, they have used their national regulatory authorities to protect domestic ownership of their banks. See *The Economist*, ‘Eastern promise’, 28 August 1999: 58.
- 3 Liz Salecka, ‘CEE: A land of opportunity’, *European Banker*, 18 January 2006: 10.
- 4 Author’s interviews with Anthony Doran and Stefan Kawalec, Warsaw, 1999.
- 5 Author’s interviews with Jan Krzysztof-Bielecki, London, 1999, and Stefan Kawalec, Warsaw, 1999.
- 6 Author’s interviews with Sebastian Vlădescu and Daniel Dăianu, Bucharest, 2004.
- 7 *European Report*, ‘EU/Romania: reluctant reformers chase accession carrot’, 22 May 2004.
- 8 Author’s interview with Grzegorz Kołodko, Washington, DC, 2000.
- 9 The 1999 Accession Partnership with Romania states that from 1998 the European Commission had worked closely with the IFIs and the EBRD to facilitate compliance with pre-accession priorities. The Commission also used data from a range of sources in its annual ‘Regular Reports’, including from the Bretton Woods institutions (Sasse 2005). Finally, the World Bank and the IMF included in their own publications assessments of how well Romania was doing *vis-à-vis* its EU accession commitments. See, for example, IMF, *Public Information Notice* 06/49, 4 May 2006.

- 10 'Slovenia – keeping it in the family', *The Banker*, 1 September 2002.
- 11 For a fuller treatment of these events, see Lindstrom and Piroška (2007). On KBC's pull-out from NLB, see 'Belgian KBC bank reassessing role in Slovene NLB bank is "bad news"', *BBC Monitoring Europe*, 11 May 2006.

REFERENCES

- Abarbanell, J. and Bonin, J. (1997) 'Bank privatization in Poland: the case of Bank Śląski', *Journal of Comparative Economics* 25(1): 31–61.
- Balcerowicz, E. and Bartkowski, A. (2001) *Restructuring the Development of the Banking Sector in Poland: Lessons to be Learnt by Less Advanced Transition Countries*, Warsaw: Center for Social and Economic Research.
- Bank of Slovenia (2006) *Annual Report*, Ljubljana: Bank of Slovenia.
- Barth, J.R., Caprio, G. Jr. and Levine, R. (2006) *Rethinking Bank Regulation: Till Angels Govern*, New York: Cambridge University Press.
- Bocknat, J. and Eyal, G. (2002) 'Eastern Europe as a laboratory for economic knowledge: the transnational roots of neoliberalism', *American Journal of Sociology* 108(2): 310–52.
- Bonin, J., Mizsei, K. and Szekély, I. (1998) *Banking in Transition Economies: Developing Market Oriented Banking Sectors in Eastern Europe*, Cheltenham: Edward Elgar.
- Brown, M. (2004) *Review and Analysis of the Ukrainian Banking Sector*, Washington, DC: United States Treasury.
- Cernat, L. (2006) *Europeanization, Varieties of Capitalism and Economic Performance in Central and Eastern Europe*, Basingstoke: Palgrave Macmillan.
- Dąbrowski, M. and Antczak, R. (1995) *Economic Transition in Russia, the Ukraine and Belarus in Comparative Perspective*, Warsaw: Center for Social and Economic Research.
- Doltu, C. (2002) 'Banking reform in Romania', in Ž. Šević (ed.), *Banking Reforms in South-East Europe*, Cheltenham: Edward Elgar, pp. 285–308.
- Duenwald, C., Gueorguiev, N. and Schaechter, A. (2005) *Too Much of a Good Thing? Credit Booms in Transition Economies: The Cases of Bulgaria, Romania and Ukraine*, Washington, DC: International Monetary Fund.
- Elborgh-Woytek, K. and Lewis, M. (2002) *Privatization in Ukraine: Challenges of Assessment and Coverage in Fund Conditionality*, Washington, DC: International Monetary Fund.
- Epstein, R.A. (2008) *In Pursuit of Liberalism: International Institutions in Postcommunist Europe*, Baltimore, MD: Johns Hopkins University Press.
- Epstein, R.A. and Sedelmeier, U. (2008) 'Beyond conditionality: international institutions in postcommunist Europe after enlargement', *Journal of European Public Policy* 15(6): 806–25.
- Feldmann, M. (2007) 'The origins of varieties of capitalism: lessons from post-socialist transition in Estonia and Slovenia', in B. Hanké, M. Rhodes and M. Thatcher (eds), *Beyond Varieties of Capitalism*, New York: Oxford University Press, pp. 328–50.
- Ghizari, E.I. (1992) 'Banking reform in Romania', in D.M. Kemme and A. Rudka (eds), *Monetary and Banking Reform in Postcommunist Economies*, New York: Institute for East-West Security Studies and Westview Press, pp. 115–22.
- Grzymała-Busse, A. (2002) *Redeeming the Communist Past: The Regeneration of Communist Parties in East Central Europe*, New York: Cambridge University Press.
- Hanley, E., King, L. and János, I.T. (2002) 'The state, international agencies, and property transformation in postcommunist Hungary', *American Journal of Sociology* 108(1): 129–67.

- Hjartarson, J. (2004) 'Foreign banks, domestic networks and the preservation of state capacity in internationalized financial sectors: a study of two transition economies', unpublished manuscript.
- International Monetary Fund (2004) *Republic of Slovenia: Financial System Stability Assessment Update, including Reports on the Observance of Standards and Codes on the Following Topics: Banking Supervision and Insurance Supervision*, Washington, DC: International Monetary Fund.
- Johnson, J. (2008) 'The remains of conditionality: the faltering enlargement of the euro zone', *Journal of European Public Policy* 15(6): 826–41.
- Kelley, J. (2004) *Ethnic Politics in Europe: The Power of Norms and Incentives*, Princeton, NJ: Princeton University Press.
- Lindstrom, N. and Piroška, D. (2007) 'The politics of privatization and Europeanization in Europe's periphery: Slovenian banks and breweries for sale?', *Competition & Change* 11(2): 115–33.
- National Bank of Poland (2001) *Summary Evaluation of the Financial Situation of Polish Banks*, Warsaw: National Bank of Poland.
- OECD (2001) *Ukraine Investment Policy Review: The Legal and Institutional Regime for Investment: Assessment and Policy Recommendations*, Paris: Organization for Economic Co-operation and Development.
- Piroška, D. (2005) 'Small post-socialist states and global finance: a comparative study of the internationalization of state roles in banking in Hungary and Slovenia'. Ph.D. dissertation, Department of Political Science, Central European University.
- Roe, A., Forgacs, K., Olenchuk, A., Peachey, S., Prigozhina, A., Vlasenko, Y. and Zhyliaev, I. (2001) *Ukraine: The Financial Sector and the Economy*, Washington, DC: World Bank.
- Sasse, G. (2005) 'EU conditionality and minority rights: translating the Copenhagen criteria into policy', *EUI Working Paper*, RSCAS No. 2005/16.
- Schimmelfennig, F. (2005) 'Strategic calculation and international socialization: membership incentives, party constellation, and sustained compliance in Central and Eastern Europe', *International Organization* 59(4): 827–60.
- Sedelmeier, U. (2008) 'After conditionality: post-accession compliance with EU law in East Central Europe', *Journal of European Public Policy* 15(6): 806–25.
- Shields, S. (2003) "'Charge of the right brigade": transnational social forces and the neoliberal configuration of Poland's transition', *New Political Economy* 8: 225–44.
- Sochan, P. (1996) *The Banking System in Ukraine*, Warsaw: Center for Social and Economic Research.
- Tsantis, A. (1997) 'Developments in the Romanian banking sector', in *The New Banking Landscape in Central and Eastern Europe*, Paris: Organization for Economic Co-operation and Development, pp.167–216.
- Vachudova, M.A. (2005) *Europe Undivided: Democracy, Leverage, and Integration after Communism*, New York: Oxford University Press.