CENTER FOR SOCIAL AND ECONOMIC RESEARCH

12 Sienkiewicza st. Tel. (48-22) 622-66-27 or 828-61-33
00-010 Warsaw Fax (48-22) 828-60-69
POLAND E-mail: case@case.com.pl.

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INTERNATIONAL PUBLIC GOODS FOR ECONOMIC DEVELOPMENT: THE CASE OF POST-COMMUNIST TRANSITION

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Marek Dabrowski and Artur Radziwill

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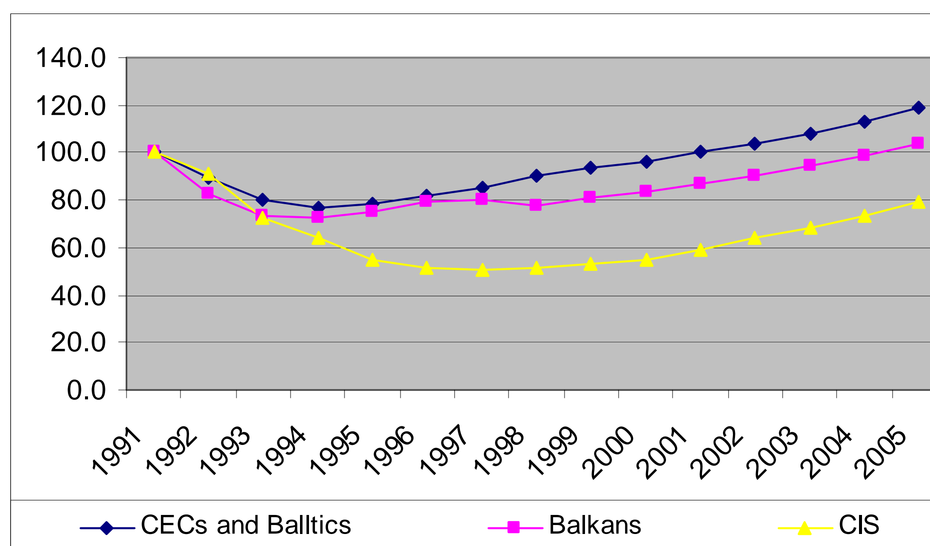
1. Introduction

The end of the 1980s and the beginning of the 1990s saw the rapid collapse of the communist regimes of the former Soviet bloc[1]. This happened first in Central and Eastern Europe in 1989 with the Round Table agreement and the electoral victory of the Solidarity movement in Poland, gradual political liberalization in Hungary, the fall of the GDR and the Berlin Wall, the Velvet Revolution in the former Czechoslovakia, the roundtable agreement between Communist Party and opposition in Bulgaria, and the bloody uprising against the Ceausescu regime in Romania. Then, two years later, the political monopoly of communist parties was broken in Albania, part of the former Yugoslavia, and the former USSR.

After the communist system collapsed, all post-communist countries faced the difficult challenge of political and economic transition to democracy and modern capitalism. While former Soviet satellites in Central Europe and the Baltic republics managed to carry out this process quickly and at relatively low economic and social cost, and were rewarded with the 2004 EU accession, other countries went through much more difficult and painful transformations, accomplishing less in economic and social terms and paying higher prices than their more advanced neighbors. Among this relatively disadvantaged group the Balkan countries have performed better in terms of economic and political reforms than have the twelve former Soviet republics formally belonging to the Commonwealth of Independent States (CIS). GDP evolution in these three groups of countries is presented in figure 1.

Figure 1. GDP evolution (1991=100)



Source: EBRD Transition Report, various issues.

Many comparative studies seek to analyze the causes of such differentiated transition outcomes. They refer to differences in starting conditions (the role of the Soviet structural, institutional and cultural legacy), ethnic conflicts, transition strategies adopted at the

[1] We would like to thank James Cabot, Vitalij Dorofeyev. and Henryk Kalinowski for their excellent research assistance.

beginning of transition, domestic politics and many other factors[2]. Most of these address the role of national policy choices and national institutions even if they attempt to group countries according to similar criteria or into regional subgroups.

While skipping the 'classical' discussion on the role of various transition strategies and national factors determining choice of strategy, we would like to concentrate on the role of the international environment in determining this choice. We would like to focus our attention on three particular factors: (i) external anchoring of national reform process; (ii) international trade arrangements and (iii) international financial stability. If we understand the concept of the international public good (IPG) as '*public goods whose benefits reach across borders*' (see Kaul, 2002) we will deal in this paper with the role of IPGs in determining transition process outcomes in Central and Eastern Europe, the Balkans and the former USSR. This research agenda is justified by the active involvement of international organizations in policymaking across transition countries.

According to classical definition (Samuelson, 1954) public goods are non-rival (i.e. consumption by one person does not reduce consumption opportunities for others) and non-excludable (i.e. nobody can be prevented from consumption). Consequently, '*international public goods (IPG) can be defined as a good, once provided, that has largely global/international (even regional) non-rival and non-excludable benefits. National public goods (NPG), once provided, benefit largely, if not entirely, the residents of the country in question*' (ODI, 2000). From this theoretical perspective none of the three factors analyzed in our paper can be considered as a pure international public good. These kinds of goods are perhaps better defined as club goods (Buchanan, 1965 and Cornes and Sandler, 1996). In the case of club goods, members are tempted to maximize their utility by restricting membership, which leads to insufficient supply. This characteristic seems to reflect particularly well the nature of the regional integration block – the European Union – that has chosen to provide mentioned goods to some, but not all, transition economies[3]. In this respect, global institutions were more willing to provide these goods in a more non-discriminatory fashion. Our discussion will be therefore concentrated on the relative importance of the delivery of regional club and global public goods.

Our paper is organized in the following way: Section 2 focuses on the relative role of the EU as a provider of external anchoring of reforms. Section 3 compares the role of the WTO and regional trade initiatives. Section 4 analyzes the role of the IMF as a provider of international financial stability. Section 5 offers conclusions.

2. External anchoring of national reform process

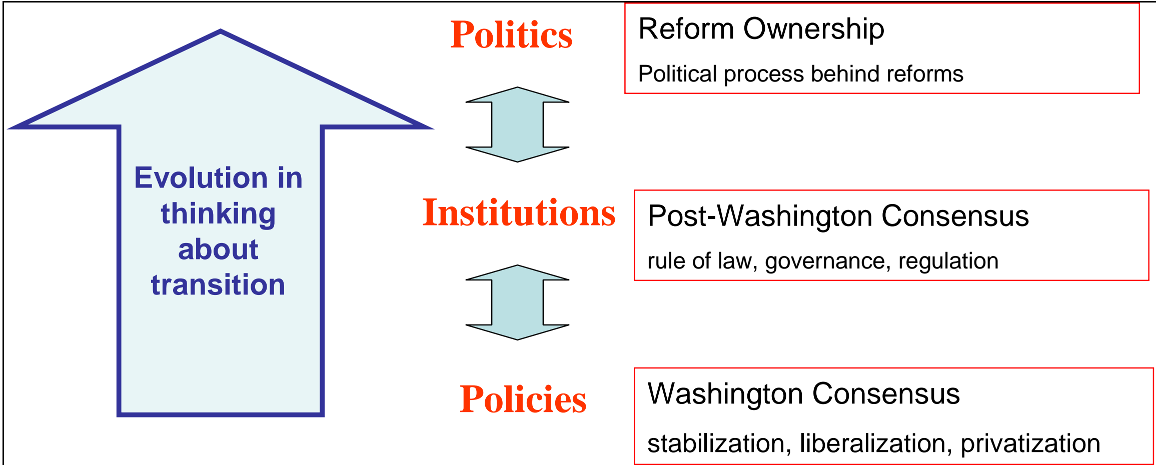
Given the scope and scale of distortions, wide geographical coverage and differentiated initial conditions, transition has provided a new impetus to the study of growth inducing policies. Differentiated results among countries following the recommendations of the Washington Consensus (including macroeconomic stabilization, internal and external liberalization and privatization) surprised observers and pointed to the importance of

[2] See, among others, Aslund (1994); Aslund (2002); Aslund, Boone, and Johnson (1996); Balcerowicz (1994); Balcerowicz and Gelb (1995); de Melo, Denizer and Gelb (1996); Dabrowski (1996); Fischer, Sahay, and Vegh (1996); Havrylyshyn et al. (2000); Fischer and Sahay (2001); Stiglitz (1999a, 1999 b); Dabrowski, Gomulka and Rostowski (2001); Mau (2000); WEO (2000); EBRD (1999; 2000) World Bank (2002)

[3] See the analysis of NATO expansion in the context of club goods theory in Sandler and Hartley (1999).

previously overlooked institutional factors[4]. Ex post this conclusion seems natural, since institutional reforms were at the core of the transition towards democracy and market economy. But institution building processes proved more difficult than expected. Systematic failures in many countries focused attention on the political economy of reforms, incentives and country ownership. This evolution of thinking about factors most crucial to successful transition is represented in figure 2. This new paradigm is relevant for the discussion of international public goods. Although most important institutions have a national character and must be created through the domestic political process, transition experience has shown that external factors can play an important role that we define, following Berglof and Roland (1997), as external anchoring of reforms.

Figure 2. Main factors of successful transition



The literature on political economy of reform explains why external anchoring might be important or, in other words, why anchoring reforms domestically is not always possible (see Rodrik, 1996 and Fukuyama, 2004 for overview). Dewatripont and Roland (1992) argue that policy makers face two sets of policy constraints. Ex ante political constraints might prevent reforms from being implemented. Not only aggregate but also individual uncertainty about the results of reforms can prove an essential barrier to reforms (Fernandez and Rodrik, 1991). Ex post political constraints deal with the possibility of policy reversal. The two constraints are not always independent; some reforms are not successfully implemented because of the risk of future reversal. Attempts to impose hard budget constraints, for example, or to shed labour by compensating job losers, can fail due to time inconsistency problems. Schleifer et al (1993) and Roland and Verdier (2003) show how multiple equilibria can arise in the transition process due to interactions between incentives to become producers or predators and costs of law enforcement. The trap of 'bad equilibrium' make introduction of private property rights extremely difficult.

External anchoring can have a benevolent role in overcoming these problems[5]. Such role of external factors is not new to the debate in development economics. On the contrary, it has been hotly debated in the literature on external conditionality[6]. While unconditioned

[4] See the brief review of the broader debate on the role of institutions in Rodrik (2004).

[5] Obviously, the reform process is not impossible without external anchoring. China and Vietnam provide important (although somewhat controversial because of the authoritarian nature of their political regimes) examples of the success of a self-anchored transition process.

[6] For discussion, see: Easterly (2001), IMF (2001), Drazen & Isard (2004).

foreign aid often discourages reforms (Sachs, 1994; Casella and Eichengreen, 1996), the role of traditional conditionality is to make sure countries do not delay necessary changes. Unlike, conditionality that is quite often associated with imposing reforms, we define external anchoring as promoting both supply and genuine demand for reforms. Nevertheless, external anchoring requires giving up some aspects of sovereignty and it is rare that any country is willing to do so vis-a-vis any other country, especially a bigger and more powerful neighbour (e.g. Mexico vis-à-vis US). As a result, external anchoring in most cases cannot be provided through bilateral relations but calls for international collective action.

In transition countries, most external anchoring of reforms was provided by two types of actors: regional institutions (the EU and NATO) and global institutions (the IMF, the World Bank and the WTO). The relative influence of regional and global institutions has been different in various countries. For Central Eastern Europe, the Baltics and, increasingly, the Balkans, regional integration has proven essential and very effective in providing external anchoring. In contrast, the CIS countries have depended exclusively on global institutions with much less satisfactory results. In discussion below we focus on the two most important providers of external anchoring: the EU and the IMF[7].

2.1. The role of the EU integration process

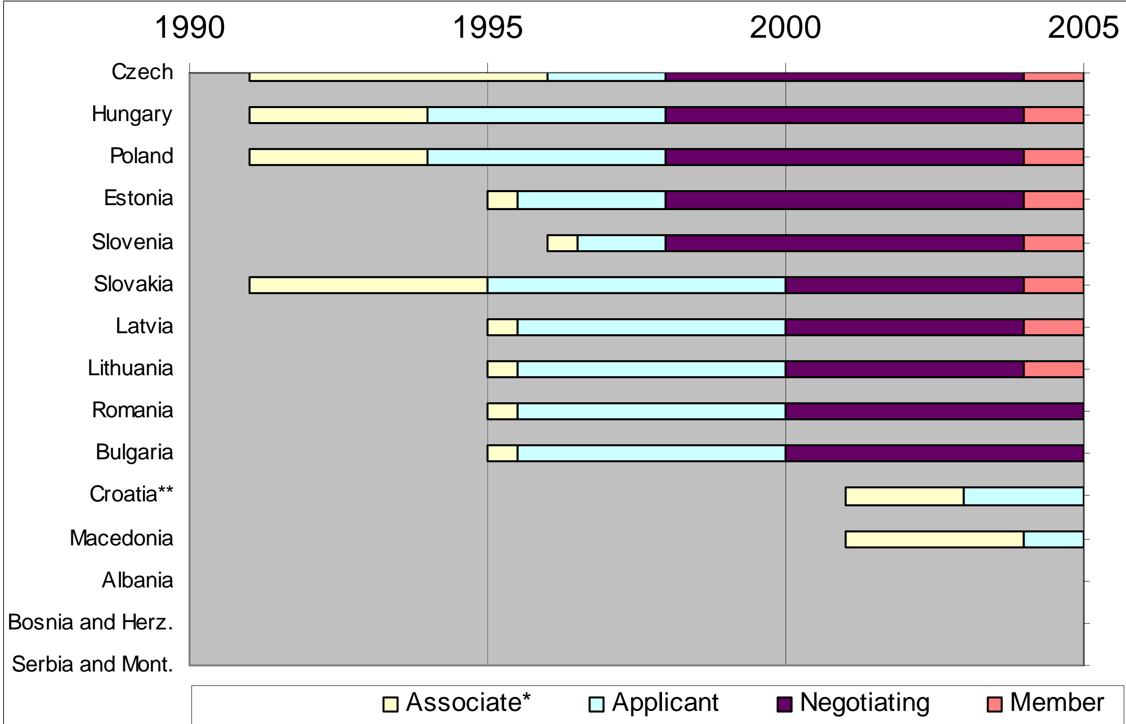
Below we describe the external anchoring provided within the European integration process through incentives, conditions and monitoring. Figure 3 presents the main stages of this process.

For the Czech Republic, Hungary, Poland and Slovakia - countries that started reforms first and implemented them forcefully and decisively, European integration was the strategic direction from day one of transition. However, the very first phase of reforms was driven less by specific consideration about accession strategy than by the general enthusiasm about parting with communism, building a 'normal society' and reintegrating with the 'free world'. This period, known as the 'honeymoon' or 'period of extraordinary politics' (Balcerowicz, 1994), could not last long and the consolidation of reforms required further fuel. Fortunately, the strong desire to 'come back to the west' (Mizsei, 2004) was welcomed by the European Economic Community (European Union since 1993), which signed comprehensive Europe Association Agreements with these countries in 1991. At this moment, newly associate countries had already managed to build the fundamentals of democracy and free market

[7] In the discussion below, we will not comment on the anchoring role of some other important international organizations. The North Atlantic Treaty Organization (NATO) is the most influential and effective regional security organization in the world and, for a number of transition countries, with the dominant strategic goal of "coming back to the West", joining NATO was equally, if not more, important a stimulus for reforms in the political sphere as was EU accession. WTO has not been important so far in providing external anchoring. For countries participating in the EU integration process, EU institutions and conditionality have overriding character compared with the WTO's more narrow and weaker conditionality. This role has changed, to some extent, in the case of big CIS countries such as Russia, Ukraine or Kazakhstan, now applying to become WTO members. For them some WTO entry requirements - avoiding import discrimination in indirect taxation, adjustment of domestic energy prices, protection of intellectual property rights, opening of financial sector to foreign investors – play a helpful role in determining domestic reform agenda. The World Bank was very active in virtually all transition countries and provided both financial resources and technical advice for reform process. However, its external anchoring impact was smaller than that of the IMF for two reasons. First, WB adjustment lending decisions are usually dependent on getting a prior IMF 'stamp of approval', i.e. satisfying the IMF conditionality. Second, WB adjustment lending offers usually much smaller amounts than IMF loans. The impact of other international organizations like OECD, BIS, UNDP, OSCE, Council of Europe was either marginal or purely sectoral.

economy, however sustainability of reforms was still questionable, while the macroeconomic situation was dismal and the prospect for further progress uncertain. What association agreements signalled was a clear commitment to enlargement. This commitment was, however, linked to the conditionality formulated in Copenhagen in 1993.

Figure 3. Timetable of EU integration process



** Europe Association Agreement (CEECs and Baltic States, Bulgaria and Romania), Stabilization and Association Agreement (Croatia and Macedonia). EAA was first signed by Czechoslovakia and then by Czech and Slovak Republics.*
*** Croatia is expected to start accession negotiations in 2005, it has a status of candidate since 2004.*

Source: http://europa.eu.int/comm/enlargement/index_en.html

The Copenhagen conditionality (box 1) was vague and imprecise, which gave some observers the impression that it was lax. However, in subsequent years, it proved to be extremely demanding because of its open-ended character. It was also made clear during the summit in Madrid in 1995, that administrative capacity and true implementation would be assessed (Gotisan et al., 2004). As a result, the Copenhagen criteria continued to anchor reforms in the region for the next ten years, while the EU continued to play the membership carrot and stick game, promoting reform consolidation and deepening in the region, equally for countries that started to reform later and for whom prospect of membership, both because of geopolitical and economic reasons, seemed initially more distant but not less desirable. The Baltics, Slovenia, Bulgaria and Romania, all signed Europe Agreement agreements with the EC within three years of the Copenhagen summit and, by 1996, all Central European and Baltic states, as well as Bulgaria and Romania, had applied for EU membership.

Box 1. Copenhagen Criteria for EU Accession, June 1993

'Accession will take place as soon as an associated country is able to assume obligations of membership by satisfying the economic and political conditions required. Membership requires:

- stability of institutions guaranteeing democracy, the rule of law, human rights and

respect for and protection of minorities,

- the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union,
- the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union.'

Source: Conclusions of the Presidency, European Council, Copenhagen, 21-22 June, 1993, SN 180/93.

Agenda 2000, adopted by the EU in Luxembourg in 1997, confirmed the commitment to enlargement, but also showed a strong signal that the EU would not tolerate quick accession of countries lagging in the political, economic and administrative reform process. In fact it was concluded after a detailed review of each applicant state that none of them (some in the 8th year of the transition process at this time!) fully satisfied the Copenhagen criteria. Nevertheless, five countries were allowed to start accession negotiations - Czech Republic, Estonia, Hungary, Poland and Slovenia (we refer to these countries in the rest of this paper as the Luxembourg group). Opening negotiations did not imply automatic membership, however. It meant merely that they '*could be in a position to satisfy all the conditions for membership in the medium term if they maintain and strongly sustain their efforts of preparation*'[8].

Bulgaria, Latvia, Lithuania and Romania, on the other hand, were deemed to be so remote from meeting the economic criteria that the opening of negotiations was pointless, while Slovakia was excluded from the Luxembourg group because of the democratic deficit under the Meciar regime. The stick of exclusion was visibly presented. This, together with exclusion from the NATO process, led to a democratic regime change in Slovakia which energetically transformed its political scene. Prospects of membership at this point were perhaps too distant to stimulate more energetic reforms in Latvia, Lithuania and especially Bulgaria and Romania, however. Accordingly, the EU enlargement strategy was modified at the summit in Helsinki to reflect the view that, at that moment, a carrot rather than a stick was the more effective tool with which to promote reform (compare quotes in box 2). Bulgaria, Latvia, Lithuania, Romania and Slovakia were all allowed to start negotiations in 2000 (we refer to these countries in the rest of this paper as the Helsinki group).

Box 2. New Accession Strategy, Helsinki 1999

- 'The risk in taking this 'hard line' approach is that the countries concerned, having already made great efforts and sacrifices, will become disillusioned and turn their backs on us. Their economic policies will begin to diverge, and an historic opportunity will have been lost - perhaps forever'
- 'The time has come to inject new momentum into the enlargement process and give a strong signal of its [the Commission's] determination to bring this process forward as quickly as possible'.
- 'Negotiations should be opened in 2000 with all candidate countries which meet the political criteria for membership and have proved to be ready to take the necessary measures to comply with the economic criteria'

Source: Romano Prodi, speech to European Parliament, 13 October 1999, Speech/99/130 at: *http://europa.eu.int/rapid/start/cgi* and European Commission, Composite Paper, EC Cons Doc 12053/99, 13 October 1999.

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[8] *Agenda 2000*, EC Cons Doc 9984/97, Vol I Part Two (VII).

But if this carrot proved effective, it was only because the stick was firmly in the hands of the European Commission. Negotiations proved difficult. Annual progress reports prepared by the Commission were often critical, with candidate countries being reminded on many occasions that the opening of negotiations did not necessarily lead to early accessions, and with the European Commission revisiting issues previously believed to have been resolved, according to the principle that nothing is agreed until everything is agreed (see box 3 below). Negotiations allowed the European Commission to effectively monitor the comprehensive process of institutional quality improvements in all major areas of public functions (Roland, 2005).

Box 3. EU Accession negotiations

- 'The decision to enter into negotiations does not imply that they will be successfully concluded at the same time. Their conclusion and the subsequent accession of the different applicant States will depend on the extent to which each complies with the Copenhagen criteria and on the Union's ability to assimilate new members'
- 'The decision to close chapters provisionally has generally been taken according to the following criteria: full acceptance of the EU acquis, absence of requests for transitional periods, satisfactory answers to EU questions. Moreover, the EU, while accepting provisional closure, has insisted on the global character of the negotiations (nothing is agreed until everything is agreed), as well as on the need for satisfactory progress in the preparations for accession in each of the candidate countries. In this respect the EU side announced that it will monitor progress under each chapter throughout the negotiations.'
- In the course of negotiations the European Commission has been monitoring progress of implementation of *acquis communautaire* in following chapters (areas): Free Movement of Goods, Persons, Services and Capital, Company Law, Competition, Agriculture, Fisheries, Transport, Taxation, EMU, Statistics, Social Policy, Energy, Industry, Small and Medium Enterprises, Science and Research, Education and Training, Telecommunications, Cultural and Audiovisual Matters, Regional Policy, Environment, Consumer and Health Protection, Justice and Home Affairs, Customs Union, External Relations, CFSP, Financial Control, Financial and Budgetary Provisions and Institutions.

Sources: Luxembourg European Council, December 1997, Presidency Conclusions, para 26 and European Commission, Composite Paper, Reports on progress towards accession by each of the candidate countries, EC Cons Doc 12053/99, 13 October 1999, p 32.

Having successfully concluded negotiation, eight transition countries joined the European Union in May 2004. These countries not only included the Luxembourg group countries, but also Latvia, Lithuania and Slovakia, each of whom had accelerated reforms after Luxembourg and Helsinki sufficiently to catch up with the progress of reforms, negotiations and the adoption of the *acquis*. Bulgaria and Romania are expected to join in 2007. All these countries have made impressive progress in all sorts of reforms on their way to accession, as shown is figures 6-8.

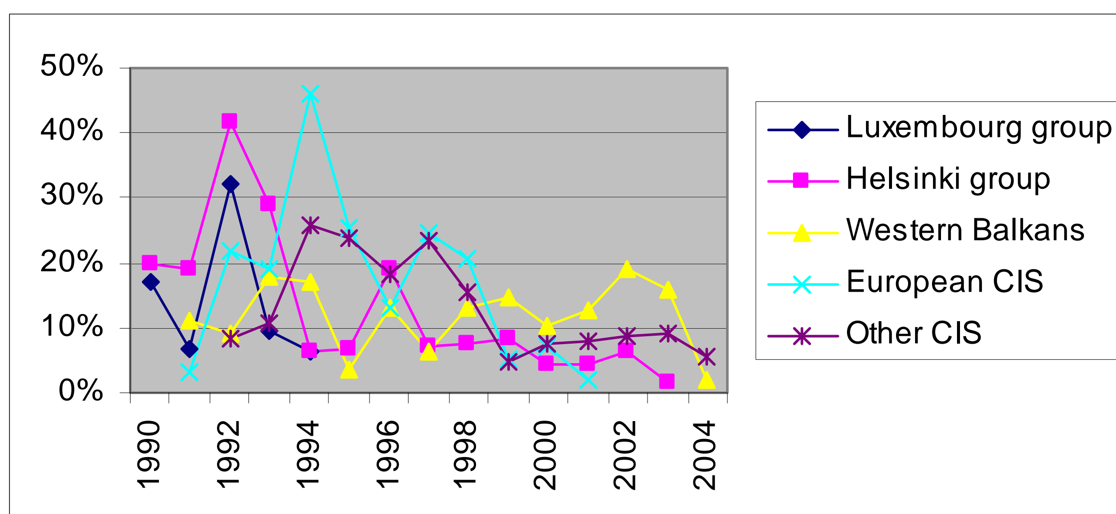
In the Western Balkans, EU accession opportunities followed the resolution of the Kosovo conflict and the establishment of the Stability Pact for South and Eastern Europe in 1999. Croatia was the first country to sign the Stabilization and Association Agreement (SAA) and is expected to start accession negotiations in the near future, while other Balkan countries are understood to be increasingly engaged in the EU enlargement process. Among them Macedonia has already signed an SAA, Albania is negotiating one and Bosnia and

Herzegovina and Serbia and Montenegro are in the stage of preparations. The rapid acceleration of reforms in these countries is visible in figures 6-8.

2.2. The role of the IMF

Characteristically, all CIS countries have been excluded from the EU integration process. While some sort of cooperation between the EU and the CIS countries has been institutionalized in the form of Partnership and Cooperation Agreements (PCA), none of them has been considered eligible for the EU membership, even in the distant future. As a result the international financial institutions have been the most important actors, attempting to provide external anchoring of reforms to CIS countries. This is particularly true of the IMF which, following the debt crisis of 1982, started to place '*more emphasis on structural reforms and achievement of sustainable economic growth*' (IMF, 1987)., and which seemed to be prepared to assume the responsibility of monitoring, managing, and supporting the post-communist transition process. Most post-communist countries became members of this organization at the very beginning of their transition[9]. Long-lasting and active presence in the CIS countries and some other transition countries (see figure 4) has meant that the IMF has played the most prominent role in the post-communist economic transition process of all global international organizations and its conditionality has become an important reference point in domestic policymaking (Dabrowski, 1998; Gomulka, 1995).

Figure 4. Disbursements under IMF programs: percent of country quota



Luxembourg group (Czech Republic, Estonia, Hungary, Poland, Slovenia), Helsinki group (Bulgaria, Latvia, Lithuania, Romania, Slovakia), Western Balkans (Albania, Bosnia and Herzegovina, Macedonia, Serbia and Montenegro), European CIS (Belarus, Moldova, Russia, Ukraine), Non-Euoropean CIS (Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan).

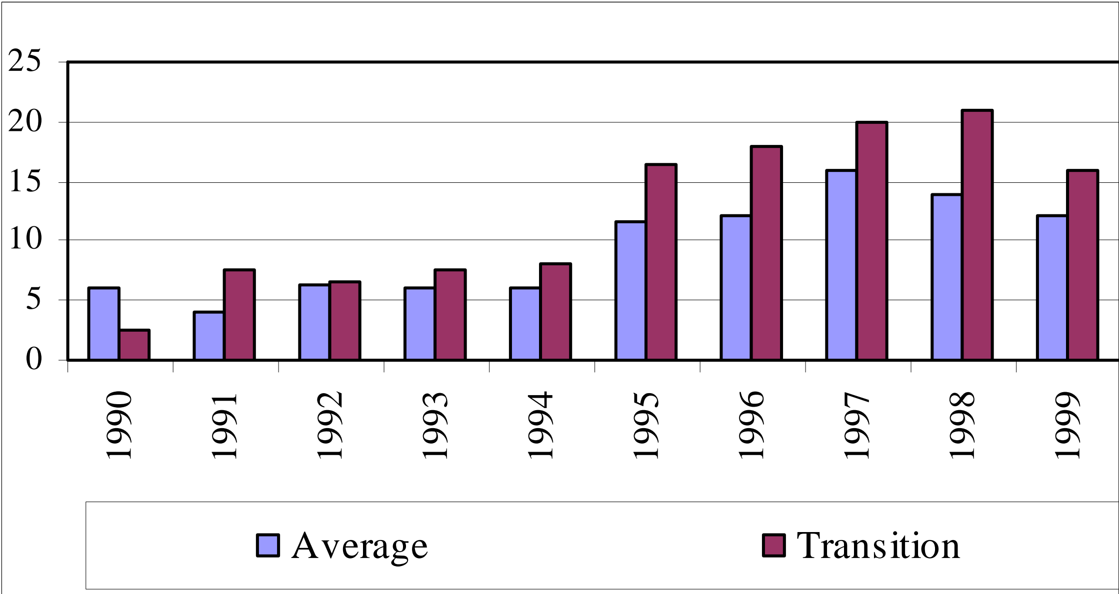
Source: own calculations based on IMF, Country Information, Transactions with the Fund, www.imf.org.

Figure 5 shows that, at the time of transition, the incidence of structural benchmarks in IMF supported programs indeed increased dramatically. Unfortunately, it is clear from figures 6-8 that CIS countries that were most exposed to IMF conditionality, reformed the least.

[9] Four communist countries - the former Yugoslavia, Romania (from 1972), Hungary (from 1982) and Poland (from 1986) - belonged to the IMF earlier. However, with the exception of the former Yugoslavia, there were not Fund-supported programs in these countries.

Moreover, the period of peak of IMF structural conditionality in the second half of the 1990s was a period of reform stagnation and even reversal in most countries.

Figure 5. Average number of structural benchmarks for programme (1987-1999)



Source: IMF (2001)

2.3. Progress in political, institutional and structural reforms

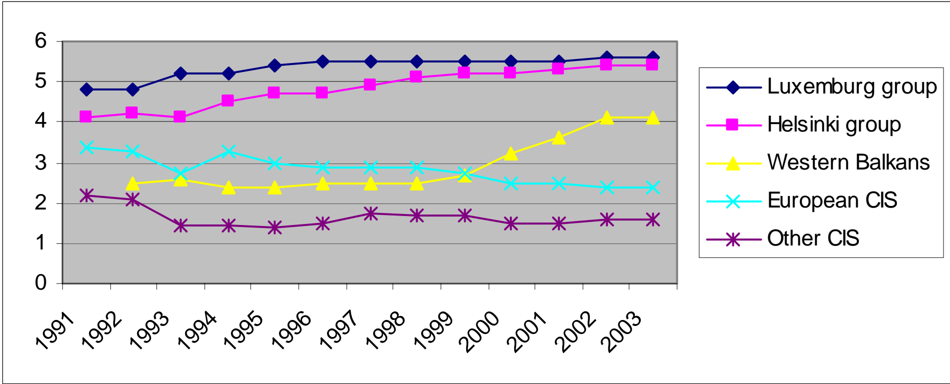
To illustrate these differences in the effectiveness of external anchoring we compare the results of transition across groups with different levels of engagement in the European integration process and IMF cooperation. Figures 6, 7 and 8 present the aggregate indicators of reforms in political, institutional and structural spheres, respectively. Among countries in the EU accession process, we distinguish the fast starters, which opened EU accession negotiations during the summit in Luxembourg, the late comers which opened negotiations after the shift in European enlargement strategy in Helsinki and the Balkan countries which joined the EU integration process within the Stability Pact framework. CIS countries have all been excluded so far from the European integration process and so they were entirely dependent on international financial institutions to anchor reforms. Reflecting at least partly the heterogeneity of the group, we have split the CIS countries into European and non-European groups. In most instances, the European CIS have faced transition problems comparable to, although more intense than, other European transition economies, while for non-European CIS, these similarities are less obvious (lower level of initial development in Central Asia, oil discoveries in Caspian Sea countries, etc.). We shall analyze not only differences across countries but also in timing of reforms.

Transition countries belonging to the Luxembourg group achieved relatively high standards of democratization, quality of institutions and structural reforms early in the transition process. In the following years, all countries of this group consolidated these initial gains. While the goal of going back to the west guided these countries throughout the transition process, IMF programs were discontinued early in the transition process. For countries belonging to the Helsinki group, the reform progress was more uneven. The gap in democratization, institution building and structural policies temporarily increased, as some

countries experienced periods of reform reversals. In particular, Slovakia experienced episodes of sharp political reversal under Meciar. However, the growing fear of being left from the European integration and NATO processes, helped Slovakia to produce one of the most spectacular turnarounds. Slovakia not only managed to catch up with the Luxembourg countries in accession negotiations, but is viewed today as the most advanced transition economy. Latvia and Lithuania were devoted reformers, but compared to Estonia and given the level of post-Soviet distortions, the reform process was delayed and less systematic. Again those countries managed to orchestrate sharp accelerations in reforms following the opening of the window of opportunity to join the EU together with the Luxembourg countries. Bulgaria, and especially Romania, proved to be rather reluctant reformers in the first years of the transition process. For those countries as well, the decisions taken in Luxembourg and Helsinki were instrumental in speeding up reforms. It shall be noted that the Helsinki group countries that had a longer history of cooperation with the IMF, especially Bulgaria and Romania, exhibited the characteristic pattern of longer-term dependence on this organization. However, the role of international financial institutions was reduced substantially once the EU accession process had been launched.

In the Western Balkans, improvements in the political situation started to take place after 1999. Importantly, the end of the conflict and the fall of authoritarian regimes coincided with the creation of the Stability Pact for Southern Eastern Europe sponsored by the EU, which gave the Balkan countries a clear membership perspective. As a result Serbia, and Montenegro democratized particularly rapidly, however strong improvements were also characteristic of Albania and Croatia. This period also marked the acceleration of structural reform with chances for moderate gains in institutional quality. These countries cooperated with the IMF throughout the transition process; however spectacular reform gains happened only when EU prospects opened.

Figure 6. Aggregate index of civil liberties and political rights



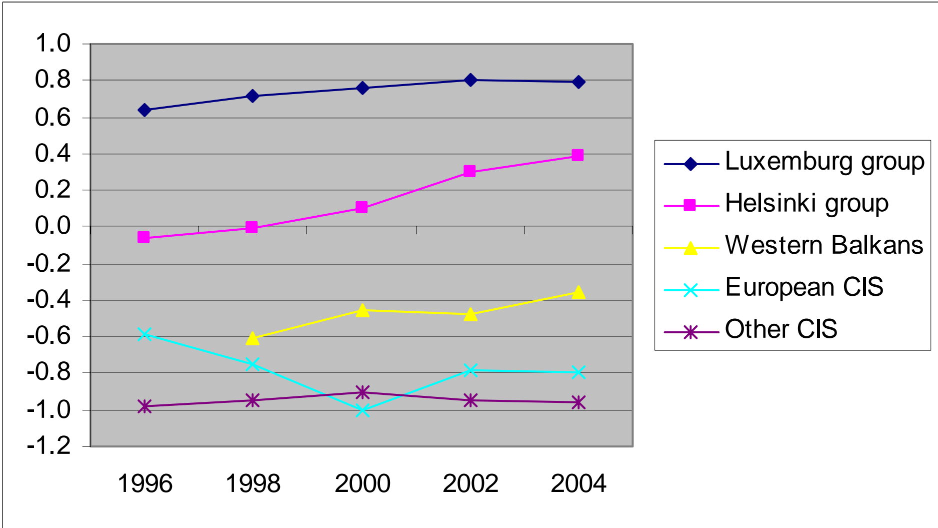
Country grouping: see description of figure 4

Source: Freedom House, unweighted average of indices of political rights and civil liberties

In summary, all countries involved in the European integration process seem to be converging to high standards of democratization and functional market economy, although the process is far from complete in the Balkans. Unfortunately, nothing can be less true about the direction of changes in CIS countries. This 'great divide' (Berglof and Bolton, 2002) might be only partly explained by less favourable initial conditions in CIS countries. Indeed the start of reforms in these countries was relatively successful. Following the collapse of the Soviet Union, the European CIS countries managed to build the fundaments of democratic societies

and achieved standard comparable to that of the Helsinki group and higher in comparison to the Balkans. In terms of structural reforms, these countries were almost at par with the Helsinki group countries as late as 1995. However, all CIS countries failed to consolidate these early achievements. On the contrary, standards deteriorated and started to diverge from the European standards during the second half of the 1990s. Until the recent wave of democratic revolutions in the region, negative political tendencies characterized most other CIS countries, although the reversal of democracy was strongest in Central Asia and Belarus. This was accompanied by a stagnation in institutional quality and deceleration of structural reforms. All these negative developments happened in states in which there was a strong presence of international financial institutions, but which were unconditionally excluded from the European integration process.

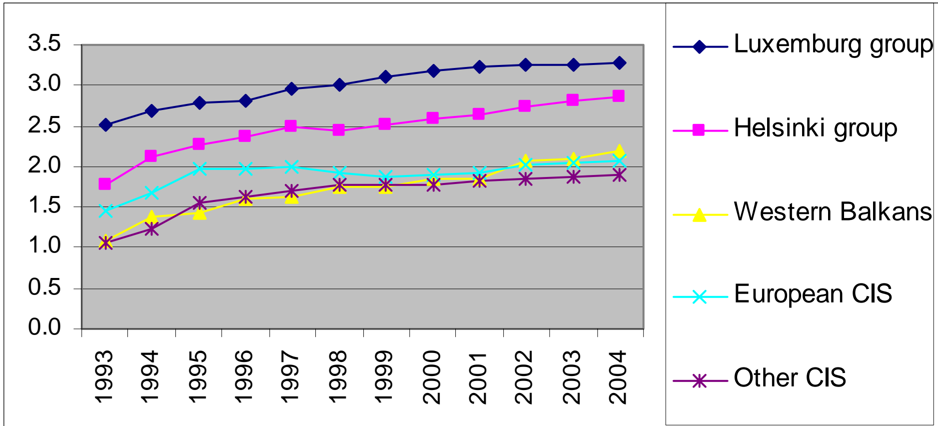
Figure 7. World Bank Index of institutional quality



Country grouping: see description of figure 4

Source: World Bank, Unweighted average of rule of law, government effectiveness, control of corruption and quality of regulation.

Figure 8. EBRD index of structural reforms



Country grouping: see description of figure 4

Source: EBRD Transition Reports, various issues. Unweighted average of competition policy, enterprise reform, banking and non-banking financial sector reform

2.4. Comparing EU and IMF conditionality

The table below might provide some hints about what has made the EU so much more effective in anchoring reforms. We distinguish three factors: incentives, conditions and monitoring. EU integration, as seen from the accessing country point of view, was a civilization process with understandable, realistic and highly desirable benefits. Being inside or outside the EU could determine the fate of the nation and its people in the decades to come. Therefore, incentives to meet accession criteria could not have been stronger. Moreover the criteria themselves were largely in line with popular desire to live in democratic, free market economies, ruled by law. It is also well understood in transition economies that accessing to the EU would be a difficult process and countries in non-compliance with the Copenhagen criteria would not be admitted to the EU. As focus was on implementation and long-term progress, faking real action through "paper reforms" and only temporary improvements were excluded. Characteristically, most countries involved in the European integration process managed to maintain consistent reform strategies despite unstable political environments, frequent elections and weak and short-lived coalition governments. In countries without the European anchor, political instability translated into policy inconsistency and reversals. Although Sachs (1994) underlines that the initial widespread desire to 'return to Europe' did not automatically translate into consensus on specific policies, the EU accession conditionality with subsequent progress reports provided much of the roadmap for reform consolidation and deepening.

Table 1. Comparing EU and IMF conditionality

EU accession criteria	**IMF program conditionality**
Incentives	***Incentives***
• strong carrot/stick mechanism (EU membership/exclusion)	• weak carrot/stick mechanism (loan disbursement/ non-disbursement)
• important to public at large	• irrelevant to broader public
Conditions	***Conditions***
• broadly defined (democracy, free market, European law)	• narrowly defined (abstract macroeconomic, technical or specific structural benchmarks)
• strong public understanding and support	• scant public understanding and support, opposing interest groups
Monitoring	***Monitoring***
• high credibility of enforcement (strong interest to keep non-performers outside EU)	• low credibility of enforcement (IMF staff interested in loan disbursements)
• full compliance required – 'nothing is agreed until everything is agreed' (prevents paper reforms and policy reversals)	• frequent non-implementation - waivers, new programs following program failures (allows for paper reforms and policy reversals)
• long term horizon ('it will take as much time as needed')	• short term horizon (short-term, e.g. quarterly point deadlines)

On the contrary, incentives to make IMF programs a success among the general publics were weak or non-existent. Some people obviously disliked the idea of cooperation with international financial institutions in the first place; but, more importantly, the silent majority could not see any obvious personal gains from its success. Attached conditions were either abstract (macroeconomics), highly technical or controversial (like privatization of certain enterprises). Furthermore, IMF officials assessed progress in short term perspectives at predetermined intervals, facing perverse incentives to overlook underperformance to keep programs going. As the Russian Boris Fedorov put it, "*the IMF was pretending that it was*

seeing a lot reforms. Russia was pretending to conduct reforms".[10] In short, it seems that the IMF, despite its recent attempts to do so through public discussions (Drazen & Isard, 2004), can do little or nothing to provide external anchoring to reform, i.e. to promote the willingness to reform when it is not already in place.

3. International trade arrangements

Historically, centrally planned economies were isolated from international markets by state monopolies on foreign trade, lack of trade, investment and production autonomy on the enterprise level and total administrative price controls, which caused huge price and allocative distortions. Their bilateral and multilateral trade flows were organized on the basis of central planning decisions and inter-governmental transactions coordinated in the organizational framework of the Council of Mutual Economic Assistance (CMEA, sometimes known as Comecom). Although four communist countries – Yugoslavia (from 1966), Poland (from 1967), Romania (from 1971), and Hungary (from 1973) – belonged to GATT, their membership was mostly formal due to the incompatibility of their trade and economic systems with other members and the obligatory character of intra-CMEA trade decisions[11].

However, when the communist system, CMEA and the USSR collapsed, GATT/WTO agreements did not become the dominant trade regulations in the region. In the case of Central Europe and the Baltics, the European Union (the European Economic Community before 1993) offered early on the Trade and Associations Agreements (TAA)[12], going far beyond the GATT/WTO arrangement and including the EU membership option. In trade policy terms, EU membership means the full custom union with the common external trade policy and access to the Single European Market.

Table 2: Transition economies: Milestones in global and regional trade integration

	WTO (GATT)		TAA/SAA/PCA	
	accession year (1st / last country)	membership (% of countries)	signature year (1st / last country)	coverage (% of countries)
CEECs +Bulgaria + Romania	1948/1996	100%	1992/1993	100%
Baltic States	1999/2001	100%	1994	100%
Western Balkans	2000/2003	60%	2001	100%
CIS	1998/2003	33.3%	1994/1998	75%

Source: World Trade Organization, European Commission

In some cases (Baltic countries) TAA were signed before individual countries became GATT/WTO members (see Table 2). The same happened at the end of the 1990s and the beginning of the 2000s in the Western Balkan region in the framework of the Stability Pact for South Eastern Europe, when post-Yugoslav countries and Albania got an opportunity to

[10] Cited in McQuillan (1998).

[11] The former Yugoslavia represented the most market-oriented trade system among the four mentioned countries. Its economic links with the rest of the communist bloc and the USSR was also the weakest – it had only 'observer' status in the CMEA.

[12] They were supplemented by free trade agreements with the then European Free Trade Area (EFTA) countries and free trade zone between the future EU members themselves (Central European Free Trade Area – CEFTA).

negotiate and sign the Stabilization and Association agreements (SAA) with the EU[13]. Although signed later and including weaker EU membership guarantees than TAA, the SAA also was far more radical in terms of removing trade and investment barriers than were WTO provisions. Again, the WTO accession of Balkan countries happened either contemporaneously or after the signing of the SAA.

The generous trade liberalization offer of the EU led to rapid trade creation between the entire Central and Eastern Europe and the EU, on the one hand, and trade diversion vis a vis other trade partners of CEE countries, on the other (see Table 3).

Table 3: Transition countries: geographical structure of export (in % of total export)

		Western Europe	Transition economies	Others
CEE	1995	64.2	23.1	12.7
	2003	74.2	17.2	8.6
Baltic States	1995	47.1	47.4	5.5
	2003	61.4	30.5	8.1
CIS	1995	34.1	40.4	25.5
	2003	39.1	31.2	29.7

Source: World Trade Organization, International Trade Statistics 2004

The CIS countries were left out of the EU integration process and even out of the opportunity to liberalize trade with the EU[14]. Contrary to Central European, Baltic and Balkan practice, the EU did not offer CIS countries the opportunity to negotiate and sign even limited trade liberalization agreements prior to, or in parallel with, their WTO accession, insisting instead on different sequencing: WTO accession first and only starting after free trade feasibility studies and negotiations. Furthermore, four CIS countries, which are already WTO members - Kyrgyzstan (from 1998), Georgia (from 2000), Moldova (from 2001) and Armenia (from 2003) – did not get a free trade negotiation offer yet and any hypothetical timetable in this respect is unclear.

Most CIS countries have not become WTO members yet in spite of the quite intensive accession negotiations of some of them (particularly, Russia and Ukraine). Those who are already WTO members (see above) cannot demonstrate any serious evidence that their membership contributed to expanding their trade flows (Mogilevsky, 2004). It seems that as long as the biggest CIS countries (Russia, Ukraine and Kazakhstan) stay outside the WTO, the benefits of smaller countries coming from their participation in the global trade arrangements will remain limited due to lack of regional network externalities.

Left outside global and European trade liberalization processes, CIS countries took several, mostly unsuccessful attempts to build their own regional trade block (see Table 4). The CIS itself, among other goals (like setting the mechanism of peaceful political dissolution of the former Soviet empire) was to be a kind of post-Soviet common market. However, the subsequent multilateral and bilateral free trade agreements between CIS countries were never fully implemented. The same concerned more ambitious integration projects between smaller number of countries such as the Custom Union between Belarus, Kazakhstan, Kyrgyzstan, Russia and Tajikistan, later renamed into the Eurasian Economic Union (the Russian acronym

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[13] Similar to TAA, they have been also supplemented with a network of bilateral free trade agreement between current and future SAA beneficiaries.

[14] Apart from the Partnership and Cooperation Agreements (PCA) with the EU, which included limited trade provisions like the most-favored-nation (MFN) clause.

EVRAZES), the Union of Belarus and Russia and the Single Economic Space between Belarus, Kazakhstan, Russia and Ukraine. Their failure was caused by a number of political, economic and institutional reasons: lack of political trust between partners, asymmetry of their economic and political potentials, divergence of national economic interests, various pace of economic reforms (countries such as Belarus, Turkmenistan and Uzbekistan try to maintain, at least partly, a non-market economic system), the lack of effective enforcement and arbitrage mechanism and others. To the extent to which this 'spaghetti bowl' type of regional trade liberalization partly works, it helps very little in restructuring and modernizing CIS economies, because all partners represent the same development problems. In this respect CIS trade liberalization mechanisms cannot be considered a substitute for global or European trade and economic integration.

Table 4: Intra-CIS trade agreements

Name of organization/ agreement	Date of foundation	Member countries	Trade aim
Agreement on Economic Union	1993	11 CIS states initially, Georgia joined later	free-trade area
Custom Union / Union of Belarus and Russia / Union State of Belarus and Russia	1995/1997/1999	Russia, Belarus	integration towards full economic union
Central Asian Economic Union / Central Asian Economic Cooperation / Central Asian Cooperation Organization CACO	1994/1998/2002	Kazakhstan, Kyrgyzstan, Uzbekistan, Tajikistan (since 1998), Russia (since 2004)	free movement of goods, services, labor and capital
Custom Union / EVRAZES – Eurasian Economic Community	1995/2000	Russia, Kazakhstan, Belarus, Kyrgyzstan (since 1996), Tajikistan (since 1998)	customs union
GUUAM, Free Trade Area since 2002	1996	Georgia, Ukraine, Azerbaijan, Moldova and Uzbekistan (since 1999)	free-trade area, (counterbalancing Russian influence)
Single Economic Space	2003	Belarus, Kazakhstan, Russia and Ukraine	free movement of goods, services, labor and capital

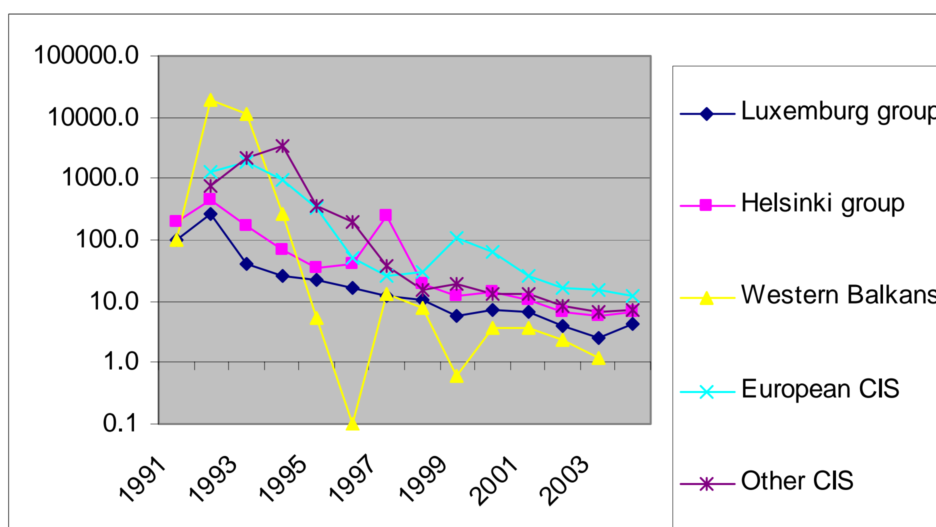
Sources: I. Burakovsky, Regional economic integration as an element of economic security *http://www.unece.org/trade/workshop/OSCE_0304/presentations/Burakovski.doc*, International Economics, Regional Trading Agreements, *http://intl.econ.cuhk.edu.hk/rta*, Regional Trade Agreements, *http://ecetrade.typepad.com/rtas/ses_rta*, Central Asian Cooperation Organization, *http://ecetrade.typepad.com*, Commonwealth of Independent States, Central Asian Gateway, *http://www.cagateway.org*

Summing up, in the area of international trade arrangements the former centrally planning economies (similar to the entire Europe) benefit mostly from regional public goods. The role of global public good (WTO arrangements) is marginal at the moment as the trade exposure of transition countries to non-EU WTO members remains limited. Those transition countries which have already joined the EU, or are going to join this bloc in the near future, have to participate in the common EU external trade policy for good and bad. Their economies benefit from the huge Single European Market and its four basic freedoms (movement of goods, services, capital and people) and from relatively low common external tariffs for most manufactured products. At the same time, they participate in the EU Common Agriculture Policy, probably the biggest global public bad in the trade sphere. Most CIS countries remain outside not only European, but also global, trade arrangements, continuing in some respects their previous autarkic way of development. The WTO and the international community at large can do little to change this situation.

4. International financial stability

The former communist economies have experienced several episodes of financial instability during the last 15 years: high inflation/ hyperinflation in the early transition years, and a series of currency and debt crises in the second half of 1990s. The latter involved several countries: Bulgaria (1996-1997), Czech Republic (1997), Russia (1994 and 1998), Ukraine (1998-1999), Moldova (1998), Georgia (1998), Kyrgyzstan (1996, 1998-1999), Kazakhstan (1999) and others[15]. Inflation rates in different groups of transition countries are shown in figure 9. The Luxembourg group countries managed a gradual but swift and largely monotonic disinflation process. The disinflation process in Helsinki group countries was disturbed by financial crisis in Bulgaria and, to a lesser degree, instability in Romania in 1996-1997. The Western Balkans experienced years of hyperinflation but later kept inflation under control. It took many years for the CIS countries to reduce the very high levels of inflation that followed the collapse of the Soviet Union. Eventual disinflation occurred after the regional financial crisis in 1998.

Figure 9. Annual inflation rates (logarithmic scale)



Country grouping: see description of figure 4

Source: EBRD Transition Reports, various issues. Unweighted average of competition policy, enterprise reform, banking and non-banking financial sector reform

While the question remains as to what extent the macroeconomic and financial stability of an individual country depends on the quality of its own macroeconomic policy and financial regulations (evident NPG) and to what extent on external factors and international collective actions (IPG), it is difficult to claim that the international dimension of financial crises does not exist at all. Empirical evidence clearly shows that the August 1998 financial crisis in Russia was triggered to some extent by the Asian financial crises of 1997-1998, as well as by serious flaws in domestic policies. In turn, the Russian crisis had a very serious contagion effect for other CIS countries (see Rawdanowicz, 2003) and, to a smaller extent, for other transition economies (EBRD, 1999). It also contributed to destabilization on global

[15] For a more detailed analysis of currency crisis episodes in transition economies and their roots and consequences – see Dabrowski et al. (2003).

financial markets in the fall of 1998 and to the acceleration of the Brazilian crisis in the beginning of 1999.

The International Monetary Fund (IMF), as the main international actor responsible for addressing the issue of financial stability at both the global and the regional level, went generally in the right direction with its policy advice to individual countries and its program conditionality[16]. The IMF insisted on fighting inflation, keeping the money supply under control, strengthening central bank independence, decreasing fiscal deficits, improving financial regulation and conducting various structural reforms. On the other hand, looking back and with the benefit of hindsight, one may demonstrate a number of IMF systemic failures in relation to transition economies.

First, conditionality of the so-called first-generation Fund programs (compare figure 4) launched in the first half of 1990s was generally very weak and could not prevent high or even very high inflation caused by high fiscal deficit and its monetary financing, avoid huge balance-of payments imbalances. This relates, in first instance, to the Systemic Transformation Facility (STF), a special window of soft-financing for transition countries existing in 1993-1995, under which the Fund accepted *de facto* inflation targets of 5 to 10% per month and budget deficits around 6 to 10% of GDP. This type of adjustment program could not help in macroeconomic stabilization in individual countries and in the entire region (see Dabrowski, 1998).

Second, the IMF had problems with adopting a clear strategy with respect to the further existence or dissolution of the ruble area in the former USSR in 1992-1993, which led to serious macroeconomic destabilization in almost all USSR successor states[17]. Already in 1990-1991 the State Bank of the USSR lost control over the credit emission conducted by most of its republican branches (see Dabrowski, 1997) and this situation became even more dramatic after the formal dissolution of the Soviet Union at the end of 1991. Fifteen *de facto* independent central banks[18] issued the same currency, which led to dangerous free riding behavior (see Sachs & Lipton, 1993). Continuation of the single currency area would require either very close coordination of monetary policies of new national central banks and strong mutual trust, or giving up monetary sovereignty of national central banks in favor of the Central Bank of Russia. Both variants were politically unrealistic.

Third, the IMF was unable to prevent the Russian financial crisis in August 1998 and the series of follow-up crises in other CIS countries. It was closely connected with the weakness of the so-called second-generation Fund's programs: Stand-by Arrangements (SBA) and Extended Fund Facility (EFF) in the case of Russia, Kazakhstan, Moldova and Ukraine

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[16] We do not want to neglect the important role of other organizations like the World Bank group, regional development banks, Bank of the International Settlements (BIS), OECD. However, their role is either supplementary to IMF (WB and regional development banks), or cover only certain group of countries (OECD), or their institutional mandate is very narrow (BIS – related to prudential banking regulations). Some monitoring role can be played by private institutions such as rating agencies, NGOs and research institutes but they have neither financial resources, nor enforcement mechanism to take the active policy steps.

[17] Odling-Smee and Pastor (2001) describe in detail the IMF position regarding the ruble zone, presenting a lot of internal Fund documents. They claim that the IMF was neutral with respect to two major options, i.e. continuing the ruble area vs. introducing national currencies. However, many experts (see e.g. Lipton and Sachs, 1992) considered the Fund's position as *de facto* supporting continuation of the ruble area which was politically unrealistic.

[18] At the same time most of them were politically dependent on both the legislative and executive branch of the newly formed national governments, preferring populist monetary policies.

and the Enhanced Structural Adjustment Facility in low-income CIS countries such as Georgia and Kyrgyzstan. Generally, there were four main type of flaws in the IMF programs in the CIS region in the second half of the 1990s: (1) Unrealistic assumptions concerning GDP growth, exports, and budget revenues led to the formulation of stabilization programs that were sustainable only if these assumptions were realized. (2) Lax conditionality undermined macroeconomic discipline, while (3) Improved access to international sources of deficit financing was a source of accumulation of debt while accumulation of domestic arrears was implicitly tolerated. Finally, (4) ineffective conditionality in the area of structural reforms stimulated only 'paper reforms' and not real restructuring of the economy (Antczak, Markiewicz, and Radziwill, 2003).

Fourth, in concentrating on policy surveillance and policy advising of its members, the IMF often overlooks regional and cross-country consequences of individual countries' policies. Again, the best example can be demonstrated by the 1998-1999 series of financial crises in CIS countries where nobody was conceptually prepared in advance to deal with the contagion effects created by the sharp devaluation of the Russian ruble; an event which was likely to happen. But even in more 'normal' times, IMF advice on, for example, the choice of the exchange rate regime does not always take into account 'network externalities' for neighbors and major trade partners[19]. This may be a bit surprising as the IMF's original historical mandate was to facilitate exchange rate stability and discourage the competitive devaluations that damage international trade.

Fifth, in many transition economies the IMF supports *de facto* intermediate (hybrid) monetary/ exchange rate regimes[20], which proved to be particularly vulnerable and fragile in cases of unexpected shocks and speculative attacks (see eg. Obstfeld & Rogoff, 1995; McCallum, 1999; Eichengreen & Hausmann, 1999). This seems to be the unintentional by-product of the Fund's recent reluctance to support 'hard' peg in the form of a currency board or unilateral dollarization/ euroization. After limited involvement in some currency board experiments in the 1990s (Bulgaria in 1997 was the last such episode) the IMF became increasingly hesitant to support this 'corner solution,' which can be a very attractive option for a small open economy with inherently limited monetary policy credibility[21] Instead, many small transition economies have been pushed by the IMF to experiment with independent monetary policy and more flexible exchange rate arrangements (this is true, for example, of the CIS countries after 1998-1999 financial crises). As many of those countries suffer serious credibility problems and have operational difficulties with introducing free floats and direct inflation targeting,[22] the actual effect of IMF policies has been a continuation of the intermediate (hybrid) regimes, most frequently close to the fixed but adjustable peg or narrow band, which usually offer the worst solutions from the point of view of financial stability.

[19] We think that this kind of dilemma can be observed even more in regions other than Central and Eastern Europe and the former USSR.

[20] These are the regimes in which central banks tried to control both the exchange rate and monetary aggregates (or interest rates).

[21] This probably came on the top of strong critique of peg exchange rates after the Mexican, Asian, Russian and Brazilian crises in the second half of 1990s. The collapse of the Argentinean currency board in 2000-2001 could additionally have contributed to this reservation. However, this position does not make a sufficient distinction between the intermediate (hybrid) regimes like fixed but adjustable peg and credible currency board or unilateral dollarization/ euroization.

[22] Calvo and Reinhart (2000) call this phenomenon 'fear of floating'.

In order to give a correct and fairly balanced picture regarding the IMF role after the series of financial crises in the second half of 1990s one cannot forget, on the positive side, the huge effort to increase the transparency of the Fund's operations themselves (on-line publication of practically all country, regional and thematic reports, policy assessments, analyzes, lending decisions, country data, etc.), data dissemination of its members and data quality and comparability (the Special Data Dissemination Standard), regular reports on the Observance of Standards and Codes (ROSCs) in member countries, related to such issues as accounting; auditing; anti-money laundering and countering the financing of terrorism (AML/CFT); banking supervision; corporate governance; data dissemination; fiscal transparency; insolvency and creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and securities regulation. It helps to decrease uncertainty, information asymmetry, herding and moral hazard behavior on the international financial markets.

As the post-transition macroeconomic situation stabilizes in the region, an increasing number of countries no longer require the IMF sponsored adjustment programs. The Fund's lending activity increasingly concentrates on low-income CIS and Balkan countries, which are the subject of PRSP programs. In other transition countries the IMF monitoring role has been gradually decreasing, being limited to regular Article IV consultations and the above mentioned reports on the Observance of Standards and Codes (ROSCs).

On the other hand, the IMF role in the first period of transition is partly being taken over and crowded out by the EU. This relates to EU new member states, formal EU candidates (Bulgaria, Romania, Croatia) and potential EU candidates (Western Balkan countries). The scrutiny about meeting Copenhagen accession criteria (functioning market economy) meant that macroeconomic and financial sector indicators were closely monitored and signs of instability would definitely be interpreted as arguments against accession. Certain elements of the *acquis*, in particular full independence of central banks and an explicit ban on central bank financing of fiscal deficits, have had a direct positive impact on financial stability. Eventually the new member states are expected to join the Economic and Monetary Union and adopt the Euro[23] which should eliminate completely the risk of currency crises and significantly reduce the risk of debt crisis (due to the EU fiscal discipline mechanism). From this perspective the EU fiscal rules, EMU, the Euro as a common currency and the Stability and Growth Pact (SGP) should be considered the real regional public goods in the area of financial stability[24]. In fact, in anticipation of future EMU membership, international financial markets already at the beginning of 2000s decreased risk premia in relation to EU candidates and then new member states.

5. Conclusions and recommendations

Our reading of the evidence is that the EU, through the enlargement process, acted as the international public (club) good provider, whose influence across time and countries was correlated with better transition outcomes. In particular, the consolidation phase in

[23] Six new member states – Estonia, Lithuania, Slovenia (all three from June 2004), Cyprus, Latvia and Malta (all three from April 2005) - already entered the European exchange rate mechanism ERM-2, which serves as the probationary two years period before eventual joining the EMU.

[24] Unfortunately, recent weakening of the SGP and the inability of several EU members to meet the EU fiscal criteria (deficit not exceeding 3% of GDP and public debt not exceeding 60% of GDP) may significantly decrease the value of this IPG (see Rostowski, 2004; Coricelli, 2005; Tanzi, 2005).

democratization, institution building and structural transformation was successful in countries reforming under EU accession conditionality, but not under other forms of conditionality. In the area of trade, gains from WTO accession were dwarfed by the impact of the opening of the EU trading block for accession countries. Finally, countries participating in EU integration showed more discipline in maintaining macroeconomic stability, while IMF programs were less effective in inducing stability in the absence of the European factor. It is most characteristic that apart from trade effects, this positive impact was connected to the intangible effects of accession prospects.

While the evidence of correlation between EU accession and the successful reform process is rather clear, it is much more difficult to prove causality. Our preferred explanation is that the membership perspective anchored reforms (for similar explanation see Mizsei, 2004 and Roland, 2005). However other observers might argue that the membership perspective emerged as a result of progress in reforms or claim that some unobservable and fundamental factor, like geography, culture and religion could simultaneously drive both processes.

These are not mutually exclusive explanations and we suspect a virtuous circle. Better initial conditions of some countries made future EU membership more realistic, which stimulated reforms through an external anchoring mechanism. Reforms in turn enabled subsequent stages of integration process and raised hopes of membership even more. This again stimulated reforms to complete the virtuous circle. The circle was reinforced by trade and investment integration that promoted growth, made reforms more popular and strengthened constituencies for accession, while obviously was itself conditional on progress of reforms and EU membership prospects. In our view, the incidence of these virtuous circles does not reduce the benefits of European integration prospects, on the contrary, it makes the cost of early exclusion from the process even higher in terms of reforms. Even more importantly, we have some direct evidence of the existence of causality from integration towards reform. In particular, the exogenous shift in the European integration strategy in Helsinki led to the acceleration of reforms in affected countries. The open threat of the permanent exclusion of Slovakia from the EU and NATO enlargement clearly triggered the turnaround in political developments in that country. It is also noteworthy that reformist governments in CIS countries that have emerged as a result of recent democratic revolutions tend to declare EU and NATO as their strategic goals (Georgia, Ukraine). It suggests that countries actively seek the external anchoring.

These results support the view that regional integration has delivered public (club) goods more effectively than global providers. This points to a new mechanism through which geography might influence development and indicate constraints to successful implementation of external anchoring on a wider scale. On the other hand, the same experience suggests that the impact of geography is not deterministic and can be overcome. The Baltic states, new EU member states, are among the most successful reformers, but neighboring Belarus is an authoritarian outcast with a centrally planned economy. Turkey is about to open accession negotiations, while until very recently, the possibility of Ukraine's EU membership was a taboo[25]. It seems that the regional integration process is not launched by countries that share geographical proximity but rather the desire for political integration.

[25] It should be clear that we believe that Ukraine should be included in the European integration process (rather than Turkey excluded) to correct this 'geographical inconsistency'.

Unfortunately, looking into the future, it seems that momentum for further EU enlargements is currently very low. EU politicians, faced with a rejection of the Constitutional Treaty, linked by many to 'enlargement fatigue', are unlikely to push for new rounds of accessions soon. Indeed many explicitly criticize treating European enlargement as a 'civilization project' and suggest focusing attention on the interests and problems of current members. This leads to questions as to whether any lessons about external anchoring might be productively used in the future. Can European Neighborhood Policy, directed at CIS and Northern Africa countries, be successful if it excludes future membership? Pushing the question even further, is it possible to emulate the European integration model on other continents? Finally, can any lessons be drawn for global international organisations attempting to anchor reforms worldwide? We believe the answers to these questions are positive.

What our analysis says is that external anchoring should make the long-term benefits of reforms realistic, understandable and widely desirable. While benefits of economic growth and poverty reduction are desirable and understandable, they might seem too distant and uncertain to strongly influence domestic reform effort. On the other hand, European neighbourhood countries (and developed countries more generally) might be highly responsive to the carrot of inclusion and the stick of exclusion from an international initiative with membership benefits that are close to irresistible. The EU has offered to emerging democracies at least two such benefits, both in the form of extending basic privileges previously available only to members: external security (in connection with NATO membership) and access to four basic economic freedoms. While the early free movement of goods was an important benefit and the immediate proof of goodwill, the ultimate reward likely lies in the free movement of persons. Theoretically, these benefits can be delivered without actual EU membership and could become a part of European Neighbourhood Policy or an even wider development compact. The credible commitment on the part of developed countries to deliver them, when the conditionality is fulfilled, should suffice to anchor reforms throughout the preparation process. To ensure this, conditionality must be broad-based (democracy, rule of law and free market), demanding and focused on implementation, as it was in the case of the Copenhagen EU accession criteria. In other words, the offer consisting of honest conditions and irresistible rewards best summarized by the simple phrase: 'do as we do, be one of us', must be made. Such an offer is perhaps the international public good in greatest deficit today.

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