

The Central European University

**THE POLITICS OF SOFT CREDITS IN EASTERN EUROPE:
BULGARIA, ESTONIA, AND POLAND COMPARED**

BY GALLINA ANDRONOVA VINCELETTE

THESIS SUBMITTED TO THE POLITICAL SCIENCE DEPARTMENT OF
THE CENTRAL EUROPEAN UNIVERSITY
IN PARTIAL FULFILLMENT OF THE DEGREE OF DOCTOR OF PHILOSOPHY

DOCTORAL DEFENSE COMMITTEE

SUPERVISORS:

LORAND AMBRUS LAKATOS
BELA GRESKOVITS
MIHALY LAKI

EXTERNAL MEMBERS:

JULIET JOHNSON
HEATHER ELMS

BUDAPEST
MAY 2003

I hereby declare that this thesis contains no materials accepted for any other degrees in any other institutions. This thesis contains no materials previously written and/or published by another person, unless otherwise noted.

Acknowledgements

This study has greatly benefited from the academic advice and guidance of my supervisors Lorand Ambrus Lakatos, Bela Greskovits and Mihaly Laki. I am thankful to them not only for useful comments on earlier drafts but also for making the process intellectually interesting, challenging and a great learning experience for me. They have encouraged me to keep exploring new ideas and develop my own all through the writing of this dissertation. Thank you for your trust, patience, and support during the years!

I would like to thank Juliet Johnson and Heather Elms for coming on board in the final stages of my project. Much appreciated!

Also, special thanks go to Andrew Horton for copy-editing my thesis at such a short notice.

In the research stages of this dissertation, I spent time at the Woodrow Wilson Center for International Scholars in Washington, DC, the Institute for Policy Studies at Johns Hopkins University in Baltimore, MD, and the Institute for Human Sciences (IWM) in Vienna. I am indebted to the many people and colleagues who made my stay at each of these places academically stimulating and wonderful, but I am especially thankful to Janos Kovac, Steve Hanke, and Maryann Feldman for useful comments and discussions on transition and development.

I have benefited tremendously from discussions and lively seminars with my fellow colleagues and professors at the Political Science department at CEU. It is to them whom I owe my first interest in the political and economic transition of Eastern Europe. Thank you for giving ME the opportunity to explore the field!

Last, but not least, my family and friends have given me unfailing love and support during the process. This makes me very happy and only hopeful that I can give them back what I have received from them.

TABLE OF CONTENTS:

ABSTRACT.....	1
CHAPTER I	2
INTRODUCING THE STUDY OF SOFT CREDITS.....	2
1. MOTIVATION FOR THE RESEARCH	2
1.1. <i>Research Questions</i>	2
1.2. <i>Approach</i>	4
1.3. <i>Comparative Rationale</i>	5
2. THE ARGUMENT.....	6
3. STRUCTURE.....	7
CHAPTER II.....	12
THEORETICAL DIMENSIONS OF THE SOFT LENDING PROBLEM IN TRANSITION	12
1. INTRODUCTION.....	12
2. THE POLITICS OF SOFT BUDGETS	12
3. RIVAL VIEWS OF INSTITUTIONAL CHANGES IN THE FINANCIAL SECTOR	15
4. THE POLICYMAKERS' OBJECTIVE FUNCTION.....	19
5. THE PILLARS OF ANTI-REFORM RESISTANCE	24
5.1. <i>The Link between Entry and Soft Budgets</i>	25
5.2. <i>The Link between Enterprise Restructuring and Soft Financing</i>	25
5.3. <i>The Link between Insider-Owned Firms and Soft Lending</i>	27
5.4. <i>The Link between Soft Credits and "Firm" Ties</i>	29
6. TOWARD A STORY.....	30
CHAPTER III	32
THEORY APPLIED: SOFT CREDITS IN THREE EAST EUROPEAN COUNTRIES.....	32
1. INTRODUCTION.....	32
2. FINANCIAL FRAGILITY IN THE BANKING SYSTEM	33
2.1. <i>Variations in Banking Restructuring in Eastern Europe</i>	33
2.2. <i>Bulgaria, Poland, and Estonia Compared</i>	35
3. THE STRENGTH OF ANTI-REFORM GROUPS	41
3.1. <i>Distortions in Transition</i>	41
3.2. <i>Restructuring and Exit</i>	43
3.3. <i>Entry</i>	44
3.4. <i>Privatization and Corporate Governance</i>	45
3.5. <i>Nurturing Informal Ties</i>	49
3.6. <i>A Short Methodological Note</i>	53
3.7. <i>Firms' Gains and Losses in Transition</i>	54
4. CONCLUSION.....	59
CHAPTER IV	63
THE BULGARIAN BANKING SECTOR DEVELOPMENT.....	63
1. INTRODUCTION.....	63

2. THE STORY OF BANKING PRACTICE IN BULGARIA PRIOR TO 1997.....	64
2.1. <i>Banking Sector Structure and Operation</i>	64
2.2. <i>Channels for Soft Crediting</i>	67
2.3. <i>Bad Debt Resolution Attempts</i>	68
3. POLITICIANS, INDUSTRIAL MANAGERS, AND FINANCIERS.....	74
4. THE STRONG ANTI-REFORM INTEREST.....	75
4.1. <i>The Strong Receiving End Supported by Informal Institutions</i>	75
4.2. <i>Entry</i>	78
4.2. <i>Inactive Restructuring</i>	79
4.3. <i>Insiders' Access to Assets and Weak Corporate Governance</i>	84
5. THINGS TURN AROUND:	88
THEY NEED TO GET WORSE BEFORE GETTING BETTER.....	88
5.1. <i>The Crisis</i>	88
5.2. <i>Restoring Fiscal Responsibility</i>	90
5.3. <i>Establishing Formal Rules</i>	93
6. THE LONGED-FOR CHANGES	95
6.1. <i>The Real Sector</i>	95
6.2. <i>Banking Sector Privatization</i>	99
7. LESSONS FROM THE BULGARIAN EXPERIENCE.....	101
CHAPTER V	103
POLAND: BANK-LED ENTERPRISE RESTRUCTURING	103
1. INTRODUCTION.....	103
2. THE BANKING REFORM CONTEXT.....	104
2.1. <i>The Emerging Banking Sector</i>	104
2.2. <i>Banking Restructuring</i>	107
3. BANK-LED ENTERPRISE RESTRUCTURING	111
3.1. <i>The Program's Implementation and Inactive Restructuring of SOEs</i>	111
3.2. <i>Restructuring Program Caveats</i>	113
4. THE POWER OF INFORMAL TIES	115
4.1. <i>The Fate of the Nine Regional Banks</i>	115
4.2. <i>Banking Consolidation: Round One</i>	119
5. PRO-REFORM GROUPS AND ENTRY	121
6. REAL SECTOR PRIVATIZATION	124
6.1. <i>Institutional Structures and Organs</i>	124
6.2. <i>Methods</i>	126
6.3. <i>Privatization outcomes</i>	128
7. ROUND TWO OF THE BANKING SECTOR CONSOLIDATION.....	132
8. CONCLUSION.....	137
CHAPTER VI	140
ESTONIA: NO MONEY FOR BAILOUTS.....	140
1. INTRODUCTION.....	140
2. THE ESTONIAN BANKING SECTOR IN THE EARLY 1990S	141
2.1. <i>Banking structure</i>	141
2.2. <i>The Stock and Flow of Risky Lending</i>	143
3. RESOLUTION OF FINANCIAL DISTRESS	145
3.1. <i>Exchange-Based Stabilization</i>	145
3.2. <i>Consequences for the Banking System</i>	146

3.3. <i>The Government Approach to Banking Sector Restructuring</i>	148
4. THE AGENTS OF CHANGE.....	150
5. MARKET STRUCTURE CHANGES.....	152
5.1. <i>De Novo Creation</i>	152
5.2. <i>Restructuring and Exit</i>	154
6. PRIVATIZATION	156
6.1. <i>Methods and Time Line</i>	157
6.2. <i>Owners and Corporate Governance in the New Firms</i>	160
7. IMPLICATIONS FOR THE BANKING SYSTEM	161
7.1. <i>Abolishing Informal Ties</i>	161
7.2. <i>Banking Consolidation and Privatization</i>	163
7.3. <i>Overall Outlook on the Banking System</i>	166
8. CONCLUSION.....	169
CHAPTER VII.....	170
COMPARATIVE OVERVIEW	170
1. INTRODUCTION.....	170
2. DIRECTION OF CAUSALITY OR FEEDBACK?.....	171
3. COMPARATIVE EXPERIENCES WITH ANTI-REFORMERS	173
3.1. <i>Structural Comparisons</i>	173
3.2. <i>Incentives</i>	177
4. APPROACHES TO BAD DEBT RESTRUCTURING	182
5. CONCLUSION.....	185
REFERENCES.....	187

LIST OF TABLES:

TABLE 1 COST OF BANK RESTRUCTURING IN BULGARIA, ESTONIA, AND POLAND, 1991-1998.....	40
TABLE 2 SIZE OF AND GOVERNMENTS' APPROACH TO THE SOFT LOAN PROBLEM	41
TABLE 3 MARKET STRUCTURE AND INFORMAL TIES HYPOTHESES.....	53
TABLE 4 DISTORTED MARKETS AND QUALITY OF INSTITUTIONS: BULGARIA, ESTONIA, AND POLAND .	61
TABLE 5 DISTORTED MARKETS AND QUALITY OF INSTITUTIONS: DEFINITIONS AND SOURCES	62
TABLE 6 BULGARIAN BANKING SECTOR STRUCTURE, 1990-1996.....	65
TABLE 7 MONTHLY DYNAMICS OF TOTAL, OVERDRAFT, AND OVERDUE CREDIT EXTENDED TO THE COMMERCIAL BANKS IN BULGARIA, DEC. 1995-DEC. 1996	68
TABLE 8 THE COST OF BANK RESTRUCTURING AND DEPOSIT COMPENSATION FOR THE BULGARIAN GOVERNMENT AS A PERCENTAGE OF GDP, 1991-1998.....	73
TABLE 9 NUMBER OF PRIVATIZATION TRANSACTIONS IN BULGARIA, 1 JAN. 1993-15 OCT. 1999.....	84
TABLE 10 SELECTED ECONOMIC AND BANKING INDICATORS IN BULGARIA, 1995-1999.....	92
TABLE 11 MAIN PRUDENTIAL STANDARDS FOR BULGARIA.....	94
TABLE 12 BANKS IN POLAND, 1993-1999	106
TABLE 13 BANK ASSETS RESTRUCTURING IN POLAND, 1994-1996	113
TABLE 14 REVENUES FROM PRIVATIZATION IN POLAND, 1991-1999.....	129
TABLE 15 SELECTED BANKING SECTOR INDICATORS FOR POLAND, 1998-1999	133
TABLE 16 IRREGULAR CREDITS IN POLAND: SHARE AND PROVISIONS, DEC. 2001 AND JUNE 2002.....	137
TABLE 17 ESTONIAN BANKING SECTOR CAPITAL AND ASSETS, 1991-1995.....	143
TABLE 18 ECONOMIC INDICATORS FOR ESTONIA, 1991-1995	147
TABLE 19 PERCENTAGE BREAKDOWN OF FIRMS BY OWNERSHIP IN ESTONIA, 1993-1994	153
TABLE 20 SUMMARY OF THE ESTONIAN PRIVATIZATION EXPERIENCE.....	160
TABLE 21 BANKING REGULATORY REQUIREMENTS IN ESTONIA, 1992-1999	162
TABLE 22 FINANCIAL INDICATORS FOR ESTONIA, 1990-1999	168

LIST OF FIGURES:

FIGURE 1 NON-PERFORMING LOANS AS A PERCENTAGE OF TOTAL LOANS, 1990-2001.....	37
FIGURE 2: ECONOMIC ACTORS' OBJECTIVE FUNCTION IN TRANSITION.....	58
FIGURE 3 STRUCTURE OF BULGARIAN BANKING ASSETS (IN %).....	66
FIGURE 4 BASE INTEREST RATE DYNAMICS, FEBRUARY 1991-MAY 1997	71
FIGURE 5 OUTPUT DYNAMICS IN BULGARIA, 1990-1995	80
FIGURE 6 MONTHLY EXCHANGE RATE AND FOREIGN EXCHANGE RESERVES IN BULGARIA.....	88
FIGURE 7 DISTRIBUTION OF CONCLUDED TRANSACTIONS BY SECTORS IN BULGARIA, MARCH 2000	98
FIGURE 8 BREAKDOWN OF BANKING SECTOR DEPOSITS IN POLAND, 1991	105
FIGURE 9 NEW PRIVATE SECTOR ENTRY AND PRIVATE SECTOR EMPLOYMENT IN POLAND, 1993-2001	
.....	122
FIGURE 10 COMPOSITION OF OUTPUT IN POLAND, 1989-1998.....	123
FIGURE 11 CAPITAL PRIVATIZATION BY SECTOR, AS OF 31 DECEMBER 1999.....	128
FIGURE 12 EQUITY CAPITAL DISTRIBUTION IN THE POLISH BANKING SECTOR, 1999	135
FIGURE 13 IRREGULAR CLAIMS AS A PERCENTAGE OF GROSS CLAIMS IN POLAND, 1993-2000.....	136
FIGURE 14 ESTONIAN BANKING CONSOLIDATIONS: BREAKDOWN BY ASSETS	164
FIGURE 15 PRIVATE SECTOR CREDIT (<i>LEFT SCALE</i>) AND BAD LOANS (<i>RIGHT SCALE</i>) IN ESTONIA, 1992-	
1998.....	166

LIST OF ABBREVIATIONS

ASMEs	AGENCY FOR SMALL AND MEDIUM ENTERPRISES (BULGARIA)
BCC	BANKING CONSOLIDATION COMPANY (BULGARIA)
BGL	BULGARIAN LEV
BGN	BULGARIAN LEV (NEW)
BGZ	AGRICULTURAL BANK (POLAND)
BIG	BANK FOR ECONOMIC INITIATIVE (POLAND)
BNB	BULGARIAN NATIONAL BANK
BPH	BANK PRZEMYSŁOWO-HANDLOWY (POLAND)
BSK	BANK ŚLASKI (POLAND)
CEE	CENTRAL AND EASTERN EUROPE
CMEA	COUNCIL FOR MUTUAL ECONOMIC ASSISTANCE
DZU	NATIONAL INSURER (BULGARIA)
EBRD	EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT
EC	EUROPEAN COMMISSION
EEK	ESTONIAN KROONI
EIU	ECONOMIST INTELLIGENCE UNIT
EPA	ESTONIAN PRIVATIZATION AGENCY
EUR	EURO
GDP	GROSS DOMESTIC PRODUCT
HF	HERITAGE FOUNDATION
IFIs	INTERNATIONAL FINANCIAL INSTITUTIONS
IMF	INTERNATIONAL MONETARY FUND
IPO	INITIAL PUBLIC OFFERING
JSC	JOINT-STOCK COMPANY
LIBOR	LONDON INTERBANK OFFERED RATE
MEBO	MANAGEMENT-EMPLOYEE BUYOUT
MOT	MINISTRY OF OWNERSHIP TRANSFORMATION
NBP	NATIONAL BANK OF POLAND
NEC	NATIONAL ELECTRICITY COMPANY (BULGARIA)
NPL	NON-PERFORMING LOANS
OECD	ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT
PBK	COMMON CREDIT BANK
PKO BP	STATE SAVINGS BANK (POLAND)
PKO S. A.	STATE BANK FOR TRADE CREDIT (POLAND)
PLN	POLISH ZLOTY
PSL	POLISH PEASANT PARTY (POLAND)
PZU	NATIONAL INSURER (POLAND)
RUB	RUSSIAN RUBLE
SLD	DEMOCRATIC LEFT ALLIANCE (POLAND)
SMEs	SMALL AND MEDIUM ENTERPRISES
SOEs	STATE-OWNED ENTERPRISES
SSB	STATE SAVINGS BANK (BULGARIA)
SU	SOVIET UNION
UN	UNITED NATIONS
UNECE	UNITED NATIONS ECONOMIC COMMISSION FOR EUROPE
USD	UNITED STATES DOLLAR
USSR	UNION OF SOVIET SOCIALIST REPUBLICS
WB	WORLD BANK
WBK	THE CREDIT BANK OF WIELKOPOLSK (POLAND)
WDI	WORLD DEVELOPMENT INDICATORS
WIIW	THE VIENNA INSTITUTE FOR INTERNATIONAL STUDIES
ZUNKs	LAW ON THE SETTLEMENT OF NON-PERFORMING CREDITS (BULGARIA)

ABSTRACT

This study develops a political economy argument of the successes and failures of the policy processes aimed at hardening budget constraints and establishing a market-driven financial system in Eastern Europe in the 1990s. It examines the forces behind the different policy choices that the governments of Bulgaria, Poland, and Estonia undertook to restructure their banking sectors from the bad debt problem in the system. I argue that the observed variance in the strategies to combat the non-performing loans was a product of the relationship between the suppliers of soft loans and their beneficiaries. The analysis suggests that the policymakers were unable to implement further market reforms and enforce financial discipline where politically important interest groups supported the partial reform equilibrium of soft credits. The motivation behind the interest of the anti-reform groups to block financial reforms resulted from their ability to extract privileged financial support from non-market-based intermediation of financial resources. For as long as such groups held dominant market positions, they could compel the state to secure their demands, and consequently they resisted the hardening of budget constraints. This study argues that the beneficiaries of the soft lending policies were successful where distorted markets and informal ties were present. Governments were prone to initiate market changes in the allocation of resources where potential beneficiaries of such changes outweighed the status quo “winners” of the soft loan system. Specifically, this study demonstrates the decisive role of four factors in the successful resolution of the non-performing loans problem and the weakening of soft-credits beneficiaries: (i) active restructuring and exit mechanism; (ii) low barriers to new business creation; (iii) privatization, which does not favor insiders; and (iv) abolishing the informal ties between the supplier of soft credits and the enterprise incumbents.

CHAPTER I

INTRODUCING THE STUDY OF SOFT CREDITS

1. Motivation for the Research

1.1. Research Questions

In the East European economic transition of the 1990s, the development of the financial sector is often acknowledged as an integral part of the transformation process and a necessary element for the revival and growth of the economy. Financial sector policies are dynamic and adaptive, as they seek out an evolution from centralized financing to “external finance, the development of intermediation, and the subsequent development of markets for direct credit, increased access to world capital markets, and finally, narrowing of the spread between loan and deposit rates” (Gertler and Rose 1991, 32). In addition, developing a market-driven intermediation of resources requires not only abandoning the practices of central planning but also introducing new rules of market conduct for creditors and borrowers.

The East European countries have shared a common communist past and often faced common transition challenges. At the outset of transition, financial sector reforms had to overcome the legacies of the socialist regime, during which the granting of credits was based solely on the realization of centrally planned targets. Resolving the problem of the high “stock” of non-performing loans, which were present in every former socialist economy, was of immediate importance. However, the deficiencies of the financial market would not have been overcome if the banking sector had continued to accumulate bad debts after the fall of the old regime. Thus, creating effective incentives and institutions for the banks to allocate financial

resources to the most productive investments in the economy was key to establishing Western-style financial intermediation in Eastern Europe.

While substantial progress was made in dismantling the old socialist banking system, nowhere in Eastern Europe did the financial sector swiftly deliver the expected results of Western-type finance. Various economic models and theories were developed and implemented in these countries with the aim of terminating soft financing and bringing about market-driven allocation of financial resources through the financial system. Yet, the countries showed a significant disparity in implementing such models during the 1990s. Political circumstances in many transition states delayed the introduction of market reforms that would engender efficient financial intermediation and supporting institutions based on the principles of private property rights, competition, and prudent regulation. As a result, many countries found themselves in partial reform equilibriums, with, on the one hand, a two-tier banking system replacing the monobank, specialized banks no longer being sector-restricted, and private banks entering the market due to liberalization of licensing. On the other hand, the reformers fell short in pursuing effective banking restructuring and continued to extend soft credits in these countries. In other cases, however, such pitfalls were avoided and countries went forward with abolishing soft lending and strengthening financial discipline on the market. These differences have provoked deeper inquiries about the specific forces behind the successes and failures in restructuring of the banking industry in post-communist Europe.

The questions that this study deals with are precisely these: Why was the resolution of bad debts stalled in some countries, and what exactly determined the choice to clean up the system swiftly in others? What forces underpinned the different policy approaches in tackling the credit problem? In more general terms, why did

some East European states make solid progress in setting up a financial environment similar to those in the mature economies of the West, and what made others delay financial reforms?

1.2. Approach

This study investigates the characteristics of the political-economic environment in the transition period in order to understand what forces shaped the relationship between the anti-reform groups and the government. At the same time, I treat the non-performing loans problem as an incentive problem, where banks have no stimuli to invest in productive projects, as the government bails out banks and firms for political reasons in order to retain office. Thus, actors' incentives, shaped by the institutional environment in which they operate, gain relevance for understanding the motivation of the East European governments in terminating soft lending.

Hence, by taking into account the changes in the market structure of the transition economies, this study applies a view similar to the structure-based arguments in understanding the determinants of the strengths of anti-reform groups. The explanation would not be complete, however, if the role of the actors in bringing about institutional change is disregarded. By emphasizing actors' preferences, motivations, and actions, I come close to the rational choice theories, which in essence "blame" the actors for their fates. Thus, I argue that the successful dismantling of the political system that used to allocate resources based on pure political considerations (the Plan) requires the emergence of institutions that support financial intermediation based on efficiency and profit considerations. This shift necessitates a weakening of the beneficiaries of soft credits and the emergence of potential "winners" of financial reforms, so that the government is motivated to carry

out successful banking restructuring and enable the emergence of the supporting market institutions for financial discipline.

1.3. Comparative Rationale

Although at the onset of their transition periods, the post-communist countries were confronted by the same problem – the effective restructuring of the banks’ credit portfolios – they applied different approaches in solving it. Three general roads to combating the soft-lending problem in Eastern Europe existed, based on the recipient of the costs of the bad debt restructuring. I look at the way the governments of Bulgaria, Estonia, and Poland have tackled the insolvency and bad debts problem in their banking systems as examples of the three approaches.

The three governmental strategies shifted the ultimate cost of the bad debt restructuring to three distinct actors, accordingly: (i) to the government in Bulgaria, by numerous recapitalizations of the commercial banks; (ii) to the commercial banks (also their shareholders and depositors) in Estonia, by closing insolvent financial intermediaries; and (iii) to the firms in Poland, by transforming the bad loans into new liabilities for the borrowers. As a result, the government of Bulgaria pursued a strategy of *unconditional bailouts*; Poland opted for *bank-led enterprise restructuring*, while Estonia chose a *no-money-for-bailouts* approach to the bad debt problem. Understanding the underpinning reasons for the choice of a particular approach to bad debt restructuring of the East European governments is behind the rationale to study and compare the experience of the three countries.

This study applies mainly qualitative methods that rely on secondary sources of information, and also interviews with bankers, practitioners and experts in the field conducted between 1999 and 2002. In each of the country cases, I trace the evolutionary path in restructuring the banking sector.

2. The Argument

What are the forces behind the East European governments' strategic choices in reforming the bank portfolios? This study argues that the three distinct policy approaches to restructuring of the bad debt in the banking sector in Bulgaria, Poland, and Estonia are a product of the relationship between the "supplier" of soft loans and the enterprises. The premise behind the argument is that the policymakers are unable to implement further market reforms and enforce financial discipline when politically important interest groups support the partial reform equilibrium of soft credits.

The beneficiaries of the soft lending policy are successful in countries where distorted markets *and* informal ties are present. Distorted markets delay the emergence of competitive markets and engender the domination of anti-reform groups. Unsound firms stay afloat for years and prevent the allocation of capital and human resources to more productive uses, while the entry of new players onto the market is burdensome. Restructuring of firms in such an environment is sluggish due to the lack of an incentive structure to pursue efficiency gains from enterprise production. In addition, exiting the market is not a punishment for poor performance.

The beneficiaries of soft credits are strong where privatization favors insiders' methods of divestiture. Insider sales of state firms solidify the power position and the political weight of the anti-reform groups, as insiders retain control over the enterprise assets. In addition, the established informal channels left from the communist regime between the incumbent industrial elite and the state further support the strengths of the anti-reform incumbents. Hence, distorted markets become supportive of the existence of firms, whose structure is inapt to operate in a market environment. Moreover, "new" types of firms – such as *de novo* firms, restructured enterprises, or foreign firms – could not emerge or be mobilized to counterbalance the allocation of

credits to incumbents as long as the markets remained distorted and protective and informal channels continued to support collusion for rents between the beneficiaries of the status quo and politicians in office.

This study presents how competitive markets and the lack of informal ties between firms and banks erode the strength of the anti-reform groups, and spur institutional changes, which support the market allocation of credits. Four factors play a decisive role for the resolution of the non-performing loans problem in the three countries under review here: (i) active restructuring and exit mechanism; (ii) low barriers to new business creation; (iii) privatization, which does not favor insiders; and (iv) abolishing the informal ties between the supplier of soft credits and the enterprise incumbents.

3. Structure

The study is organized into six chapters. Chapter II presents a review of the analytical work with direct relevance to this study. It frames the problem of non-performing debt in the transition economies of Eastern Europe as a soft-budget constraint issue at the core of which lie the institutional disincentives for the banks to make productive investments and for the firms to utilize and repay borrowed funds. In this light, the chapter launches a discussion on the theoretical approaches to investigate what spurs institutional change. This digression allows me to place the effect of the distorted market structure and informal arrangement in the center of the explanatory mechanism of the strengths of the anti-reformers. Since institutional changes bring about winners and losers, the institutional design in which the allocation of bank credit occurs depends on the strengths of the beneficiaries of soft credits and their opponents. The outcome of this inherent conflict makes governments choose their policy on soft lending.

Chapter III builds on the theoretical discussion in the preceding chapter and presents the analytical framework of the study. It offers an elaboration on the explanatory mechanism of the analysis, focusing on the determinants of the strength of the anti-reform industrial incumbents. It presents a standard for evaluation of the strength of the anti-reform incumbents and their pro-market opponents and formulates the hypotheses of this research with respect to the three East European countries under study. It also presents a succinct assessment of the strategies that the three governments engaged in to restructure non-performing debt in the financial sector.

The next three chapters trace the evolutionary path in banking restructuring of Bulgaria (Chapter IV), Poland (Chapter V), and Estonia (Chapter VI) and test the hypotheses put forward in Chapter III. Chapter IV claims that prior to 1997, no comprehensive program for the resolution of the bad debt in the banking system in Bulgaria was initiated due to the ability of strong industrial incumbents to remain powerful after the fall of the communist system and manipulate the state for soft financial support. The government in Bulgaria failed to restructure the old, but instead kept generating new non-performing debt in the banking system, as the beneficiaries of the soft credits remained the dominant market group in the country for most of the early 1990s. The strengths of the incumbents were solidified by the presence of distorted markets, which did not support the emergence of new entrants. The slow restructuring of the enterprise sector and low level of product competition in Bulgaria indicated that managers had no incentives to improve enterprise performance and sought soft credits for their survival.

In addition to the inactive restructuring of the economy and the slow rate at which new businesses were created, insider-based privatization methods allowed the industrial lobbies to remain in a strong position for most of the 1990s. Insider groups

were fully capable of misallocating the flows of resources within the existing institutional arrangements between the branch and sectoral ministries and indebted firms. The incumbents in Bulgaria managed to capture the state and seek soft financing in exchange for political support and/or a share of the rents. The alliance survived until the banking system collapsed in 1997. As a result, Bulgarian commercial banks were turned into vehicles for industrial support of an economy captured by its anti-reform insiders. The resolution of the bad debt was forestalled, and the bank restructuring practically became a victim of the perverse government-industry relationships.

Chapter V is dedicated to Poland. In the Polish case, the restructuring of the bad debt in the banking system was left in the hands of the commercial banks. This arrangement encouraged the banks to provide new lending to their most indebted borrowers. In a weak regulatory environment at the beginning of the transition period, this arrangement was ineffective in hardening the budget constraints, as the informal ties between banks and their old borrowers were still in place. In addition, the chapter points out that the privileges that such “old” borrower received in divestiture of the state assets did not ensure that the “right” incentives for profits and efficiencies of the firms would materialize after their privatization. Additionally, their restructuring would be expensive and slow. Yet, the Polish government opted for this strategy because a more radical approach to bad debt restructuring would have entailed higher political costs in the presence of strong industrial incumbents in the early 1990s.

However, Chapter V also reviews the strong current of new firms that affected the market structure of the Polish economy in the 1990s. Private *de novo* firms emerged rapidly, as the barriers to entry were low. New firms and effectively restructured enterprises comprised the groups of constituencies with interest in a

developed banking sector. The second part of the country case study reveals how such changes in the market structure and improvements in the regulatory environment of the financial system formalized the relationship between banks and firms. These changes ultimately fostered the hardening of budget constraints on banks and firms, and made the government abandon the *bank-led enterprise restructuring* strategy of the early 1990s.

Chapter VI traces the experience of Estonia with hardening of budget constraints and cleaning the bad debt problem in the banking system. This chapter presents an argument of how the Estonian governments' commitment to financial discipline minimized the capability of old industrial interests to press for directed financing. The durability of the economic recovery was ensured through rapid privatization and restructuring of the industrial sector. The predominant outsider privatization method ensured the transparency of ownership structures and suppressed the avenues through which the industrial lobby could control former state firms. Restraining the demand for preferential credits allowed the government to seek advancement in the Estonian financial sector and to establish an environment of financial intermediation similar to those in advanced capitalist economies. In addition, the rapidly emerging *de novo* firms spurred the competition for higher quality loans.

The government's strategy of credible commitment to no bailouts dismantled expectations for soft-credits on the side of the borrowers. The players in the economy were forced to compete for financial resources, which in effect hardened budget constraints.

Chapter VII reviews the main arguments of the study. In a comparative manner, it dissects the experiences of Bulgaria, Poland, and Estonia to draw lessons

from the resolution of the bad-debt problem in each of the countries and its relevance for the overall development of the financial sector in the region.

* * *

Overall, this study asserts the importance of hardening the budget constraints and enforcing financial discipline in the market development of the East European transition economies. The pertinent role of the banking sector is not only in channeling financial resources to the economic participants, but also in finding and investing in the ones with highest returns. In this sense, terminating soft lending and encouraging the financial intermediaries to look for the most promising ventures, brings not only profits to the firm and its investors but also stimulates economic growth and prosperity of the nations.

CHAPTER II

THEORETICAL DIMENSIONS OF THE SOFT LENDING PROBLEM IN TRANSITION

1. Introduction

This chapter presents the theoretical underpinnings of the study and focuses on the nature of the financial development process in Eastern Europe, as it relates to the emergence of financial institutions with market features. Section 2 advances the proposition that the soft-lending problem should be studied as an institutional issue, as it goes beyond the cleaning of non-performing loans from the banks' balance sheets. Two questions in sections 3 and 4 will help us untangle the underlying differences in the approach of the East European governments to building efficient institutional mechanisms for intermediating savings into investment. First, how do institutional changes come about? And second, given the inefficiencies in the credit allocation under soft budget constraints, why do governments delay reforms? The last section presents the links between the hardening of budget constraints on credit allocation and the characteristics of the systems that facilitate institutional changes in the financial sector in Eastern Europe.

2. The Politics of Soft Budgets

Bad loans in the banking sector are a form of soft budget constraint, where banks have no incentives to make productive investments in the enterprise sector *ex ante*, as they know that they will be bailed out *ex post*.¹ The concept of soft budgets

¹ In proposing a taxonomy for classification of models of soft budget constraint, Mitchell offers a more formal definition of the issues: "A firm has a soft budget constraint if: (1) it has negative expected net

was introduced in the 1980s by Kornai's (1980) seminal work on the fundamental causes of chronic shortages in the socialist economies. Soft budget constraints were a structural characteristic of the socialist system, and Kornai associated them with the paternalistic role of the state to avoid costly layoffs and closures. In the socialist state, soft subsidies, soft taxation, and soft credits were all sources of soft budget constraints. However, ample evidence from the transition economies suggests that soft budgets persisted for years after the fall of communism in Eastern Europe. Hence, from a legacy of the socialist economy, the soft budget constraints became one of the more pressing challenges of the post-communist transitional environment (see for example, Berglof and Roland 1997a; Schaffer 1998; Anderson and Kegels 1997; Mitchell 2001; Kornai 1998).

Theories of the accumulation of bad debts on banks' balance sheets in Eastern Europe point to several sources of soft credits in the transition economies, which are succinctly summarized by Berglof and Roland. These are: the *ex post* benefits of refinancing; the high costs of liquidation in the presence of strong enterprise interdependencies; the poor quality of alternative projects; the banks' incentives to hide bad loans and gamble for resurrection; and the rent-seeking motivation of banks to extract resources from the state (Berglof and Roland 1997a). The consequences of these channels, through which soft credits are distributed, are general inefficiencies in resource utilization but also structural distortions and rigidities. As commentators have pointed out, through soft lending firms become less sensitive to competitive pressures, less likely to restructure, and immune to any external or policy shocks

present value but receives financing; or (2) if a financial decision of a creditor or the government following default allows the firm to continue in operation although its assets would yield a greater return in an alternative use" (Mitchell 2000, 66).

(Nagaoka and Atiyas 1990). In addition, as Litwack (1993) has demonstrated, “macroeconomic stability may be jeopardized because soft budget constraints in state-owned enterprises (SOEs) make it difficult to keep government expenditures under control” (in Roland 2000, 214). As a result, not only is financial sector development impeded but the structural transformation and the macro-stability of the economy also come under question.

Dewatripont and Maskin (1995) make a ground-breaking contribution in the study of soft budgets, in which they evaluate the soft-budget constraints as endogenous to specific institutional arrangements. They treat soft lending as a dynamic commitment problem, where due to a project’s sunk costs, the optimal action for the investor (the bank/the state) *ex post* is to bail out its borrowers instead of liquidating their activities (Dewatripont and Maskin 1995). Note that *ex ante* the borrowers know that regardless of their efforts the investor will lend them more again *ex post*.

The Dewatripont-Maskin interpretation of soft-budget constraints also allows us to seek their causes in the institutional environments of the transition countries (Roland 2000, 214). Abolishing soft loans is not only a clean up of banks’ balance sheets. The effective hardening of budget constraints on banks is the establishment and enforcement of such rules that provide for the allocation of financial resources toward the most productive ventures. In this vein, observers have pointed out that “hardening of budget constraints is thus not simply a direct policy variable, but rather the result of institutional design” (Dewatripont and Roland 2000, 247). Thus, understanding how governments solved the problem of soft lending in Eastern Europe entails understanding of how the institutions of market discipline and respect for property rights and contracts emerged.

The governments have pursued different strategies to solve the problem, and the record after over a decade of reforms shows that in many cases they have succeeded. Despite this encouraging result, I argue that the early resolution of the non-performing debt problem was key for the overall institutional development of the financial sector in Eastern Europe. Unveiling the motivation of East European governments to follow particular paths in abolishing soft credits brings in an important dimension in the study of soft budget constraints and the overall banking sector development in the region.

3. Rival Views of Institutional Changes in the Financial Sector

What changes need to be made in the institutional mechanism through which credits are distributed to abolishing soft lending? Structuralism would look for answers in the economic forces that underpin the prevailing “superstructure” or institutions in order to understand institutional changes. For structuralists, institutions are a product of the underlying economic, political, or social arrangements and in fact restrain the scope of action of the actors in the system. Structuralists look at the economic conditions in a society and inquire as to how they shape the conduct of different social actors, including the relations between states and societies. But it is the relationships, not solely the individual attributes of the actors in the society that emerge from the “interdependencies and interactions among the parts of some system” (Lichbach 1997, 247). For this school of thought, institutional change is not likely to come about through individual actions or agency but rather through changes in the “structure” of the system that, for example, will entail dominance of a different group to seek institutional changes. Thus, institutional change is driven by the characteristics of the system over which actors have no control.

While focusing on structural conditions and legacies adds important value to understanding institutional change, a major drawback of this approach is that it associates characteristics of systems with predictable outcomes. In other words, structuralists fall short in explaining why countries with different socio-political and economic features encounter the same problem. For example, if soft-budget constraints are a structural characteristic of the socialist system, why do they persist in the system after the fall of socialism? At the same time, why do countries with similar characteristics/structures embark on different institutional choices? Or once in a transition environment, why do countries with similar structures (for example, underdeveloped markets) pursue different strategies for hardening budget constraints?

An alternative view attributes institutional changes to the actors and their objectives, and in essence argues that individuals (or society as a whole) are responsible for the prevailing institutional outcomes. According to what has become known as the Political Coase Theorem, “political and economic transactions create a strong tendency toward policies and institutions that achieve the best outcomes given the varying needs and requirements of societies, irrespective of who, or which social group, has political power” (Acemoglu 2002, 1). Put differently, efficient exchanges or the “right” institutions occur, as interest groups (or economic actors in the original Coase Theorem) bargain for as long as efficient outcomes are achieved (Parisi 2003). The essence of the Coase’s argument is that regardless of the initial distribution of property rights, resources will be allocated efficiently, but only in the absence of transaction costs to negotiations/contracts (Coase 1960).

Following Coase’s argument, inefficient allocation of resources or inefficient institutions, as in the soft-lending problem I examine here, is simply an outcome of high transaction costs to bargaining between the interested parties. Thus, research has

looked at assessing the costs of institutional changes. Indeed, plenty of empirical examples show that societies end up with inefficient institutions because of the high costs of change, despite the inefficient outcomes generated by the misallocation of resources. The main argument, which advocates of this position advance, is that if the cost of reform outweighs the cost of keeping the status quo arrangement of institutions, inefficiency will prevail. In light of this reasoning, Demsetz (1967) and later on North (1990) formulated an influential theory in the study of institutions, which emphasizes that although generally beneficial for society, property rights (i.e. institutional changes) are enforced only when the gains exceed the costs of enforcement.

Apart from the fact that the world in reality is indeed not transaction cost-free, Acemoglu forcefully argues that there is also a serious commitment problem to the applicability of the Coase theorem in arriving at efficient institutional outcomes. He writes, the problem is “twofold: first, those in power, e.g. the rulers, cannot commit to not using their power – as long as they do not relinquish it – in ways that benefit them in the future. Second, if the rulers relinquish their power, the citizens cannot commit to making side payments to them in the future, because the former rulers no longer possess the political power to enforce such promises” (Acemoglu 2002, 3-4). Put simply, the ones in power cannot commit that they would not renege the terms of their “contract” with the rest of the society.

This insight brings us to another approach in the study of institutions – the rational choice perspective, which also holds the agency, but not the structure, in the center of its theoretical models. Rational choice theories adopt the proposition that people are indeed rational, self-interested and “calculate the value of alternative goals and act efficiently to obtain what they want” (Zuckerman 1991, 45). In their view,

institutions are a product of interest groups' choices, which are driven by maximization of rents, or, put differently, by rent-seeking (see Buchanan and Tullock 1962, Buchanan et al. 1980).² In a way, this reflects the neoclassical school and its basic assumptions of profit maximization, stable preferences, and market equilibrium. However, it is important to understand that institutional choices do not reflect the goal of maximization of benefits for everybody but rather present the preferences of only a group of people. In fact, as already pointed out, institutional choices are not a product of the preferences of the whole of society but rather of the preferences of the group that holds the political power to make institutional changes (Acemoglu and Robinson 2003, 8). Thus, the outcomes that institutions deliver are not necessarily efficient from a public/collective perspective. (Understanding the objective function of the governments in approaching the soft-credits problem is in the center of the discussion in the next section).

In this study, I rely mainly on the propositions of the rational choice theory approach to understand East European governments' motivation to embark on different strategies for banking restructuring. In the transition economies of Eastern Europe, banks extend soft credits primarily through a "political" mechanism (Wunner 2000). The governments shield certain borrowers because the costs of bailing out

² Palda offers a picturesque but informative definition of rent-seeking as a category in the public choice theories: "Rent-seeking is a term that evokes images of landlords shaking down tenants for a few coppers. Such imagery is unfortunate because it cuts off policymakers and the public from seeing the dangers of a political system that encourages pie cutters above pie makers. The Holy Grail of rent-seeking research is to discover whether in the contest for government favours interest groups together spend as much or more than the prize being sought" (Palda 2002, 7)

these borrowers are far less than the potential political losses.³ At the same time, banks have incentives to lend to non-performing debtors, as they know that the more such borrowers they tide over the less the probability that the government will let them all fail (assuming that politicians care about re-election and thus employment). The argument in the literature is that keeping artificially high employment in the enterprise sector translates in larger political support/more electoral votes. For example, Shleifer and Vishny (1994) model the soft budget constraints phenomena as a game between politicians and firms: politicians extend soft credits to prevent layoffs and social unrest, while incumbents keep employment at higher than optimal level.

To summarize, I argue that governments continue to use soft credits when the beneficiaries of these resources are strong and have no incentives to favor the introduction of market institutions for allocation of resources. Institutional changes in the financial sector occur with the weakening of the power of soft credit beneficiaries.

4. The Policymakers' Objective Function

The sections above advanced the proposition that the soft lending problem in transition economies should be studied as an institutional issue because it goes beyond the depositing of the bad debts. Here, I consider the objectives of the East European governments in relation to resource allocation, as they are key in understanding the institutional changes and outcomes that institutions deliver. Also, I will briefly review the reasons behind the resistance to changes, even when the overall benefits outweigh the losses.

³ For example, Perotti (1993) points to the dangers of repeated lending to former bad debtors, given the guarantee from the state for a potential repayment of these debts.

Governments may pursue “strategic” objectives and thus direct the allocation of financial resources toward projects with long-term strategic purposes. In the literature of economic development, observers have adopted similar views in understanding government’s motivation in allocating resources. For example, Gerschenkron argues that in order to stimulate financial and economic development, capital should be allocated toward “strategic” industries. Moreover, in institutionally underdeveloped nations, government should retain control over investment decisions in banking to achieve its strategic development goals (Gerschenkron 1962). Direct ownership and control over financial resources is a way to deliver such objectives by allowing the government to advance industries of its choosing (Lewis 1950 in La Porta et al. 2002).

An alternative view, and one more in line with the rational choice perspective discussed in the previous section, argues that since the ones in power are rationally driven individuals, they allocate resources toward politically desirable projects. Here, the objective function of policymakers is at odds with maximizing welfare. Instead, the government’s aim is to direct resources in such a way as to “provide employment, subsidies, and other benefits to supporters, who return the favor in the form of votes, political contributions, and bribes” (Shleifer and Vishny 1994; 1998). Keeping the politically convenient arrangement for soft credits through the banks and the malfunctioning of the banking system reveals, what Stark calls, “the real preferences” of politicians (Stark 1992, 52).

These two broad approaches to governments’ motivation to pursue soft credit policies recognize the inability of “strategic” and politically motivated projects to receive financing through markets. Yet, important distinctions exist between the two objective functions. As La Porta et al. (2002, 267) point out, according to theories in

the camp of Gerschenkron such projects are "socially desirable," while in the politically driven allocation approach they serve the narrow goals of the ones in office. This is not to say that the politicians with "socially desirable" objectives deliver better outcomes, however. On the contrary, both objective functions of the government produce inefficient results, as resources do not finance the most competitive projects.

An extension of the second approach to assessing the governments' objective functions is the view that considers the preferences of the electorate. In democratic societies, the ones in power are elected officials with a limited time horizon before their position is contested in elections. Therefore, their objective function is determined by the objective function of their supporters. Political structures in a democracy "stipulate institutions with the explicit purpose to nurture relations of representation" (Kitschelt 1999, 43). However, the democratic process assumes accountability to their constituencies if they are to retain power. Thus, in a democratic political system, the interaction between politicians and political groups is a two-way street. On the one hand, through the threat of no re-electing them, citizens hold elected representatives accountable for their policies. On the other hand, the democratic process makes public representatives responsible for delivering their constituencies' demands. Therefore, the bargaining position of interest groups determines their influence on the policy of public resource allocation.

The view presented above, however, assumes that the actors' preferences are well defined. In reality, the economic actors may be myopic and unable to recognize the potential benefits of reforms and therefore resist change. For example, the hardening of budget constraints and the termination of soft credits allow resources to reach projects with the highest returns and consequently bring economic growth and

prosperity. However, firms may not recognize the link between removal of soft credits and economic growth and hence oppose reforms. Moreover, if the beneficiaries of soft credits happen to be politically strong, they can even block reforms. They will try to make the institutions for soft credits sustainable through “locking into” the current arrangement.

In this vein, Hellman makes an important contribution to the study of the political economy of transition by focusing attention to the beneficiaries of partial reforms (Hellman 1998, 217). He argues that the main obstacle to advancing further with reforms comes from the early reform winners; “partial economic reforms produce winners in the short term, with gains partly or wholly determined by rents [which are] highly concentrated, benefiting those in a position to arbitrage between the reformed and unreformed sectors of the economy” (Hellman 1998, 220). Thus, while the transitional costs of reforms are dispersed throughout the economy, the short-term gains from partial reforms are assumed by a particular group favored by the ones in power. Hellman (1998) emphasizes the need to restrain partial reform winners by increasing competition with other groups or restraining their ability to block reforms in order to successfully implement further market reforms. However, the model falls short in demonstrating the path between the points of partial reforms and fully functioning markets.

In addition, the partial reform view does not account for the uncertainty about the outcome of reforms. Uncertainty about the costs and gains, which further reforms might bring, makes potential beneficiaries of reforms resistant to institutional changes, even when the status quo does not favor them.

Two important contributions in the literature examine uncertainty about the outcome of reforms. First, Alesina and Drazen (1991) attribute resistance to change to

the unwillingness of politicians to bear the stabilization costs of reform, even though a former consent upon the reform process might have been principally agreed upon *ex ante* or negotiated between the two groups. As a result, a war of attrition starts over the cost of implementation, which obstructs the actual execution of reforms, as each group is uncertain about the other group's gain from the changes and refuses to give in first.

Second, Ferenandez and Rodrik (1991) opt for a different explanation of the resistance to reforms. In their model, the majority of the actors expect actual losses from the reforms, and since the political system cannot commit to compensate them properly, they oppose reforms *ex ante*. Given the uncertainty about the distribution of benefits and losses from the reform process *ex ante*, they argue, groups that support the reform may hardly be identified prior to the actual implementation of these reforms. Thus, even the potential “winners” may be unwilling to support reforms, and instead, vote for the status quo.

Hence, not only political losers but also sometimes potential winners of reforms may indeed oppose reforms. In order to successfully weaken the strength of anti-reform groups, potential beneficiaries need to be mobilized and gain political power. The contestability of political power in a democratic society allows new interest groups with different political agendas to seek and gain political representation. In addition, new groups provide countervailing forces against status quo beneficiaries with incentives to block reforms and oppose the emergence of a more open and competitive polity and economy.

* * *

To sum up, the basic premise behind the theory developed in this study is that an inherent conflict exists between the interest groups in the transition countries. Each

group has opposing preferences over the institutional arrangements of credit allocation, as they recognize the differences in outcomes institutions yield to. Thus, the institutions that emerge in society reflect the preferences of the group that has political power, as they can influence the way resources are distributed. Institutional changes can “lock in” benefits for a particular group of the society, however, and as a result they inevitably create winners and losers of reforms. Hence, there is a conflict, which emerges among competing interest groups with respect to how economic resources are distributed. This particular conflict, which reflects the policies and consequent institutions, is in the core of this study. The stronger group will influence the government’s approach to changes in the institutional environment that affect not only the present outcome of distributional arrangements in lending but also the conduct of economic actors until a new change comes about.

5. The Pillars of Anti-Reform Resistance

As already noted, the nature of transition entails structural changes in the economy that dynamically affect the economic position of different groups. But in order to understand what makes the emergence of market institutions for intermediation of financial resources more likely in some countries than in others, one needs to unveil the factors that stimulate the emergence of groups with demand for changes. Thus far, I have argued that governments are prone to initiate changes in the allocation of financial resources when the potential beneficiaries of such changes outweigh the status quo beneficiaries of soft credits. In this section, I discuss the characteristics of the system that facilitates institutional changes and elaborate on the links between soft credits and the ability of status quo beneficiaries in a post-communist society to block reforms.

5.1. The Link between Entry and Soft Budgets

Berglof and Roland (1997b) have advanced the idea that the source of soft budget constraints is the poor quality of new projects, and increased competition in turn contributes to the hardening of budget constraints. Their main argument is that market entry is important in terminating soft credits, because with many firms on the market the quality of the projects will probably improve, and the banks would lose incentives to bail out existing projects. They observe, “competition from other projects serves as a credible commitment to terminate loans on poor projects” (Berglof and Roland 1997a, 20). The essence of their insight is that soft budget constraints would not be a problem where new projects of sufficient quality existed. At the same time, the flip side of this reasoning suggests that when soft lending prevails, the refinancing of lower (bad) quality ventures crowds out new projects.

This study argues that the anti-reform groups in Eastern Europe, threatened with losing their access to soft credits, fear the emergence of new firms on the market, which will bring the quality of projects up and consequently attract funds that currently go to incumbent firms. In addition, mass *de novo* entry intensifies not only market rivalry, but also weakens the political power of status quo beneficiaries by creating new interest groups with agendas at odds with those of the incumbents. Anti-reform groups will lobby the state for placing barriers to entry in order to solidify their market domination. Thus, liberalization of entry and mass *de novo* creation contributes to the weakening of anti-reform groups. Consequently, weak status quo beneficiaries have less chance for prolonging their ability to extract soft credits.

5.2. The Link between Enterprise Restructuring and Soft Financing

Restructuring the economy can be associated with the Schumpeterian phenomenon of creative destruction, where the economic structure increasingly

revolutionizes “from within, increasingly destroying the old one, increasingly creating a new one” (Schumpeter [1942] 1950, 83). In this sense, economic development, which comes from within the system “by its own initiative” is not a mere adaptation, but rather a product of the process of innovation – defined as: new goods, processes, or methods of production; a new market; a new form of organization (Schumpeter [1934] 1983, 63-66).

In the East European post-communist transition context, if the state firms are to survive, they need to change their product lines, to close old plants and build new ones in order to improve their performance and prompt economic development according to the Schumpeterian definition.⁴ However, such changes presume a discontinuation of financial transfers especially to industries with distorted production processes. Abolishing soft financing to such firms becomes a serious threat to their survival.

Successful restructuring of enterprises in an economy is associated with the closure of unsound firms, i.e. the threat of bankruptcy. In contrast, where the exit mechanism is not a credible punishment for poor performance, restructuring is inactive. As Kornai has pointed out, a major problem of the socialist planning system was the lack of financial discipline derived from the “unenforceability of bankruptcy threats, together with various subsidies, credits, and price-supports,” i.e. soft budget constraints (in Maskin and Xu 2001, 2).

⁴ There is abundant evidence from the literature on transition economies, summarized in Djankov and Murrell (2002) through meta-analysis, that discusses the link between soft budget constraints and weaker firm performance. In addition, Schaffer (1998) demonstrates how poor performance by firms leads to bailouts by the state.

At least two consequences of the lack of bankruptcy mechanisms are worth mentioning here. First, unprofitable firms stay afloat, seek soft credits and at the same time prevent the development of competitive markets, as the flow of resources goes toward inefficient investments. In such cases, creditors are passive and do not resort to bankruptcy procedures when faced with a defaulting borrower (see for example, Hashi 1997; Claessens et al. 2001; Stiglitz 2001). Second, the lack of exit mechanism can create a domino effect in the economy and “infect” good firms. As observers have commented, “without restructuring, chains of insolvency among SOEs can form with insolvency from bad firms spilling over to good firms, creating a ‘too many to fail’ problem that leads to generalized bailouts” (Roland 2000, 292).

Thus, in countries where the industrial structure of state firms has remained largely unchanged, anti-reform groups will remain powerful. Where such interest is strong, the demand for state-driven and politically motivated transfers to these industries is substantial. Enterprises unsuccessful in actively restructuring their production do not rely on market principles for financial resources but on the government. Thus, support for policies that facilitate directed financial transfers to the industrial sector varies across countries depending (amongst other factors) on whether active economic restructuring has occurred.

5.3. The Link between Insider-Owned Firms and Soft Lending

Privatization is usually a necessary component of successful restructuring of the enterprise sector, as it supposedly “depoliticizes” the enterprises and allows managers to make profit-maximizing decisions. But while privatization in principle has gained overwhelming support everywhere in Eastern Europe, the way state ownership should be dismantled has become highly controversial. In the literature on transition, we see proponents of mass giveaways to insiders or outsiders as well as

supporters of revenue-generating sales.⁵ However, the debate has gone far beyond the comparison of the economic results that different privatization methods yield to. Instead, the identity of the new owners in privatized firms has become the focal point of concern, as it entails a direct impact on the corporate governance of the new firms and consequently on the incentives of their new managers.

There is an important link between the identity of the managers – insiders versus outsiders – in the privatized firms and the hardening of budget constraints. While “privatization in principle provides incentives for high efforts,” Roland draws attention to the fact that insider privatization ensues not only profit-maximizing but also rent-seeking incentives for soft financing from the government (Roland 2000, 250). Debande and Friebe (1999) advance this argument and demonstrate that insider privatization in fact improves managers’ incentives for rents from the government (in the form of soft credits) and makes the soft budget constraint problem worse, as firms are stripped of their assets and their managers obtain additional cash by threatening the government with layoffs.

Thus, insiders tend not only to abuse their control rights and divert restructuring capital but also to “blackmail” the government for additional soft financing (Debande and Friebe 1999, 4). Moreover, the mere introduction of property rights to private participants may not diminish the scope of distortions in the form of government-directed policy lending to firms and moral hazard in the form of reliance on future government support. Insider privatization may, in fact, bring serious resistance to hardening budget constraints, as it does not create incentive structures

⁵ For an excellent review of privatization methods, their objectives, advantages and flaws see Roland (2000, Chapter 10.)

that motivate incumbent managers to seek profits for their firms but rather creates channels for rent-extraction.

5.4. The Link between Soft Credits and “Firm” Ties

Mutually beneficial exchanges, patronage, and soft financing amount to, what I refer to in this study as, the informal ties between the “supplier” of privileged resources (be it a commercial bank or the state) and the “receiver” of such funds (the enterprises shielded from the market). In socialism, the links between the government administration and the economy, comprised of firms with dominant state interest, were driven by the motivation of the Plan. Commentators describe the behavior of a classic socialist enterprise, as receiving “a plan on output levels and on inputs to be used in the production process” (Djankov and Murrell 2000, 3). Thus, in order to meet the production goal, the government had to make sure that the enterprise in question had the appropriate inputs, including financial resources. A labyrinthine bureaucracy evolved along the channels of “planned” exchanges.⁶

In the transition period, when communism was replaced by democracy, the anti-reform groups aimed to preserve precisely these channels and ties with the state organs, because through them their firms could obtain soft credits. Blanchard and Kremer (1997) put forward an important hypothesis that links strong input-supply relationships with weak institutional protection and enforcement of contracts.⁷ They

⁶ The term “labyrinthine bureaucracy” is borrowed from Djankov and Murrell (2000, 3). It describes the state administration as “a contract-generating and a contract-enforcing agency,” which operates on a one-year plan, a centrally determined investment projects, administratively determined prices, and soft budgets.

⁷ Blanchard and Kremer (1997) argue that the general “disorganization” of the economy, i.e. the loss of the coordinating function of the socialist bureaucracy, is the main reason for the output contraction in

imply that the breakdown of old ties, or the loss of the coordinating function of central planning, might be of utmost importance for the establishment of market economies in Eastern Europe.

Thus, I argue that informal channels for selective resource distribution toward privileged firms place the government in a position to abuse its power and extend soft credits in exchange for its patrons' support. When informal ties between politicians and firms prevail, the strength of the anti-reform groups solidifies.

6. Toward a Story

To recap, this chapter has outlined the major theoretical contributions, which underpin this study. I have laid the foundations for an argument, which considers the soft credits from the banking system as a problem beyond the technicalities of the cleanup of balance sheets of the commercial banks. Instead, the hardening of budget constraints should be viewed with an institutional dimension: only by establishing the rules that govern market exchanges can government effectively commit to hardening budget constraints and stop soft lending in the early transition period.

Inevitably, the governments of the East European countries will meet resistance in trying to implement policies of hard budgets, as such institutional choices will turn the status quo beneficiaries of soft lending into losers of the financial reforms. I argue that four characteristics of the political-economic environment enable anti-reform groups to influence the government approach toward soft lending in the banking system. These are restricted entry of market participants, inactive

the early transition period in Eastern Europe. In the same article, they demonstrate that output has fallen the most in sectors with the most complex production processes.

restructuring of the enterprise sector, insider privatization of firms, and the presence of informal ties between the supplier of soft credits and the firms.

CHAPTER III

THEORY APPLIED: SOFT CREDITS IN THREE EAST EUROPEAN COUNTRIES

1. Introduction

This chapter presents the analytical framework of the study. It builds upon the literature in the field of the political economy of post-communist development. It argues that the success in enforcing financial discipline and market-based allocation of resources is contingent upon easing the pressure from anti-reform insiders on the state for directed credit in the changing economic and political environment in Eastern Europe. With the fall of communism, observers have pointed to the danger of subverting public institutions by the “powerful through ... corruption and political influence,” as they – the beneficiaries of the status quo – strive for generating concentrated gains at public expense (Shleifer 1994; Hellman and Kaufmann 2000, 2001). The argument of this study is built to emphasize the mechanism through which the “powerful” firms of the day sought to shape the credit allocation decisions in order to gain specific advantages during the early periods of transition in Eastern Europe.

I investigate the implications of state capture for the development of the financial industry, as the banking sector is the vehicle through which preferential transfers are made. The main claim is that when anti-reform incumbents were strong, the state opted to keep its control and influence over credit allocation in commercial banks and was discouraged from creating the institutional conditions that spur financial development in accordance with the principles of the market. Thus, this study focuses on the determinants of the strength of the anti-reform interest for

manipulation and extraction of financial resources in the process of economic transformation in the 1990s.

The logic of the explanatory mechanism as well as the dependent variable is elaborated in the following sections.

2. Financial Fragility in the Banking System

2.1. Variations in Banking Restructuring in Eastern Europe

The fragility of the banking sector in the early 1990s in most of Eastern Europe stemmed from the overload of bad loans in commercial banks. Depositing the stock of non-performing loans and enforcing financial discipline in extending new ones had an overall economic significance, as non-performing loans affected not only the conduct of the commercial banks in their credit policies but also the expectations of companies with regards to how to invest financial resources and who bears the consequences of poor market performance. In this sense, tightening the soft budget constraints is a fundamental step in establishing the link between the allocation of financial resources and the credit-worthiness of borrowers, but not their political importance. In contrast, soft credits imply that credit contracts are not enforced effectively and debt service is irregular and unreliable, but new credits are extended anyway to assist firms with chronic financial problems and there are no expectations for repayment (see for example, Dewatripont and Maskin 1995, Nagaoka and Atiyas 1990).

Governments play an important role in hardening the budget constraints of banks and firms. They make different choices at different times in relation to solving the bad debt problem in the banking system (Wagner and Iakova 2001; Tang et al. 2000). The success of their bank restructuring strategies transpire in the

accomplishments to clean up the initial level of inherited bad debts and to prevent a subsequent accumulation of new bad debts in the transition period, while creating the institutional shell for Western-type financial intermediation.

One can distinguish between three general approaches to solving the soft-loans problem in the East European transition countries. The three approaches differ significantly from each other, as they place the responsibility for the ultimate cost of the bad debt restructuring on each of the three parties in the interplay among banks, firms, and the government.

First, the government may assume the costs of bad debt restructuring through recapitalization of the commercial banks. This approach has been common among troubled banks that emerged from the central planning institutions. In addition, it has usually been applied for restructuring banks that were considered too large to fail, due to the risks of systemic crisis their closure might bring (EBRD 1997, 85). Instilling financial discipline, while recapitalizing, is the biggest challenge to the success of this strategy.

Second, the government may shift the burden of restructuring the non-performing debt to the banks, which in turn, will seek repayment of past obligations from their borrowers. In this approach, the bad debt is transformed into new liabilities for firms, which makes enterprises effectively responsible for recovering past obligations. Repaying past obligations while restructuring production and recovering from the transformational recession makes this approach difficult to implement in the early transitional environment.

Third, by closing the insolvent banks, the ultimate receivers of the costs of bank restructuring are the suppliers of credit, i.e. the intermediaries, but also their shareholders and depositors. This approach has been considered as the most

straightforward one, provided the legal framework for suspending bank licenses of unsound intermediaries is in place (EBRD 1997, 85). However, gaining wide political support for the implementation of this approach constrains its applicability.

The transition experience with banking restructuring in Bulgaria, Poland, and Estonia presents an illustration of each of the government strategies outlined above. The three countries are the focus of the discussion in the sections to follow.

2.2. Bulgaria, Poland, and Estonia Compared

At the onset of transition, the three countries had a sizeable share of non-performing loans, as the newly established commercial banks assumed their loan portfolios from the central bank after the desegregation of the socialist monobank (see Figure 1). Experts assess the magnitude of the bad loans inherited from the monobank at 54 percent of total loans in Bulgaria (Dobrinisky 1995, Tang et al. 2000). For Estonia, estimates for the size of the non-performing debt prior to its independence are more difficult to gauge, as much of the debt overhang was erased by hyperinflation in the early 1990s. However, experts evaluate the initial bad debts in the country at “moderate” levels in 1991, and at 7 percent in the subsequent two years (EBRD 1997; Tang et al. 2000, 4). In Poland, 16 percent of total loans were classified as losses, 22 percent as doubtful, and 24 percent as substandard in 1991 (Tang et al. 2000, 60). To illustrate the magnitude of the problem there, one should consider the fact that in 1991 among the nine regional banks in Poland two had a share of 60 percent or higher in non-performing loans, four held over 40 percent bad debt in their portfolio, three held over 20 percent bad debt, and the remaining two held slightly less than 20 percent (Gray and Holle 1996, 36).

Certainly, the commercial banks in Eastern Europe did not want to bear the responsibility for the stock of bad loans from the past. These loans were made under a

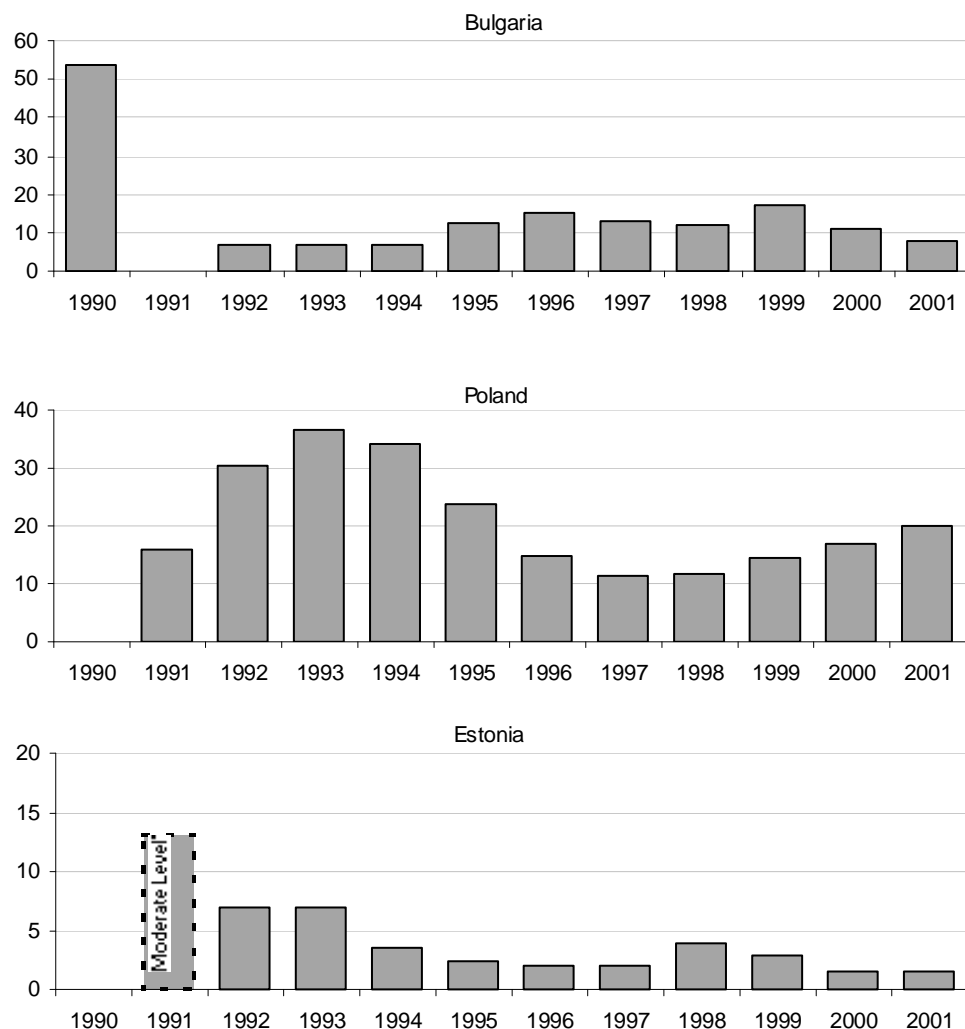
different economic reality and irrespective of the borrowers' creditworthiness. A tacit understanding between governments and banks that the state would eventually take care of the problem existed. This agreement, however, urged the banks to engage in risky lending. The expectations of bailouts allowed the banks to amass new loans with questionable quality and thus create a new flow of bad loans.

Figure 1 illustrates the dynamics of the non-performing loans in the three countries during the period of transition. The levels shown on the three graphs should be treated with caution, due to the lack of a unified classification for non-performing loans both within a country and across the three countries. Differences in classifying debt as qualified (or bad) among the three countries occur due to the differences in evaluating the riskiness of bank assets and the scope of discretion in classifying debt, while differences within countries stem from regulatory changes in the categorization of bank assets during these years.

For example, the high level of non-performing debt in the Polish commercial banks at the end of the 1990s is due to the presence of old non-performing loans, kept on the banks' balance sheets for fiscal reasons (see Chapter VI). At the same time, the level of bad debt between 1993 and 1996 in Bulgaria does not include categories of non-performing loans to reflect the actual amount of accumulated new debt of doubtful quality (see Chapter IV). In addition, while in Estonia debt that is more than 149 days overdue is considered as "bad" and written off, in Poland loans that are overdue for more than 30 days are labeled "substandard", for more than 60 days "doubtful", and for more than 90 days "losses". The level of provision on each of these three categories of debt is determined on a case-by-case basis depending on the borrower. In Bulgaria, there have been five categories of exposure since August 1997:

standard, watch, substandard, doubtful, and loss. Thus, cross-country comparisons are difficult to make.

Figure 1 Non-Performing Loans as a Percentage of Total Loans, 1990-2001



Source: EBRD (2002), except for Bulgaria (1992) and Estonia (1992-1993) data from EBRD (1997); Bulgaria (1990) and the *estimate* for Estonia (1991) in Tang et al. (2000).

In addition, the data presented in Figure 1 does not provide a clear-cut separation between the stock and flow component of bad loans in these countries, which makes it difficult to evaluate the magnitude of accumulated new debts with questionable quality. Despite these flaws, the charts are informative, as they present a

clear trend of declining bad loans as a percentage of total loans as the transition advanced in each of the countries.

Although the problem of combating the accumulation of new bad debt and cleaning the banking portfolios from the non-performing loans inherited from socialism was common for the three countries, they took different approaches to resolving the issue in the 1990s. Poland pursued a strategy of bank-led restructuring of the banking and enterprise sector, a strategy which tried to distance the government from the creditor-debtor relationship. The Polish banks alone were engaged in restructuring their debtors. The level of non-performing loans contracted sharply from over 35 percent in the early 1990s to 11.5 percent in 1997 (Figure 1), and the banks engaged in prudent screening and monitoring of their borrowers in the following years. Although the share of bad loans as a percentage of total loans has been climbing in Poland since 1999, the actual significance of the trend is much smaller than the numbers suggest due to the above-mentioned stringent classification of loans in the country and the fiscal disincentive for debt writeoffs.⁸

Estonia took the most radical approach to bank restructuring in Eastern Europe. In the early 1990s, many small undercapitalized banks emerged, which engaged in financial intermediation through financing existing inefficient enterprises through easily accessible credits from Moscow. As a result, in 1992 and 1994 Estonia experienced episodes of bank crises associated not so much with a legacy of central planning but unsound lending during the early 1990s. By 1994, insolvent banks accounted for some 40 percent of the financial system assets in Estonia (Caprio and Klingebiel 2003, 4; Tang et al. 2000, 4). However, the initial bad debt problem and

⁸ Banks mark loans as non-performing loans to creditors whose economic condition has deteriorated, although the borrower will often continue to service their loans in timely manner (NBP 2002).

the early reckless lending behavior of the Estonian banks did not fulfill the expectations of bailouts after banks became illiquid. Instead, the government pursued a no-money-for-bailouts strategy at the onset of transition. Its credibility was tested when the central bank withdrew the licenses of the three largest commercial banks and simultaneously restructured (once and for all) most of the initial bad debt. The signal that banks ought to be cautious in lending was sent out and effectively prevented the buildup of new bad debts.

In stark contrast to the approach pursued in Estonia, Bulgaria kept pouring “good money after bad” in the banking system prior to its crash in 1996. By 1995, an estimated 75 percent of non-government loans were non-performing in the country (Tang et al. 2000, 59). The Bulgarian experience points to a series of unconditional bailouts of banks and firms by the state. Consequently, the policy approach raised expectations of additional soft financing. The government attempted to recapitalize the banks and clean their portfolios from the burden of bad debts, but instead of solving the problem it indicated to market participants its readiness for future bailouts.

At least two aspects of the restructuring of bad debt approaches pursued by the three East European governments ought to be considered for a fair assessment of their effectiveness. These are the fiscal cost of the policy over the restructuring period, as well as the duration of the process. During the first decade of transition, Estonia (in 1993) and Poland (by 1996) managed to restore solvency in the banking system and establish sanctions against late debt servicing. Although it took several years to clean the banking portfolios and gain solvency in the banking system, the ultimate cost for the Polish government was moderate. Recapitalization outlays in Estonia were comparatively small, and the Estonian government managed to combat the problem swifter than the Polish policymakers. Conversely, in Bulgaria the failure to credibly

solve the stock problem created incentives for Bulgarian firms and banks to seek new debts in anticipation of future bailouts. As a result, the fiscal cost of the faulty bank restructuring was very high.⁹ Table 1 presents an annual breakdown of the cost of bank restructuring for the period 1991 to 1998.

In addition, while the costs of financing the write-off or the take over of bad debts are ultimately borne by the taxpayers and are calculable, the costs of disrupting or providing restricted financing to the emerging private sector are more difficult to gauge. Nonetheless, their potential scale should also be kept in mind when assessing the cost of bank recapitalization and bailouts.

Table 1 Cost of Bank Restructuring in Bulgaria, Estonia, and Poland, 1991-1998

Country	'91	'92	'93	'94	'95	'96	'97	'98	Total*
Bulgaria	0.0	3.4	12.2	26.0	3.2	10.7	1.3	0.4	26.5
Poland	8.0	0.5	1.9	1.6	0.7	0.44	0.33	0.22	8.2
Estonia	0.0	0.0	2.1	0.1	0.15	0.5	0.0	0.0	1.4

Source: Tang et al. (2000, 22).

Note: * Total cost is the net present value at the end of 1998 of the annual costs during the period 1991-98; Calculations in Tang et al. (2000), based on the relevant interest rate for each cost item.

Table 2 summarizes the magnitude of the stock and flow of bad loans and the governments' approach to restructuring bad credits in the three economies. The unconditional bailouts in Bulgaria delivered the least successful banking restructuring, in contrast to the no-money-for-bailouts strategy of the Estonian governments, which brought a creditable and quick resolution to the bad debt problem and created

⁹ The fiscal cost of bank restructuring, including deposit compensation, in the period 1991 to 1998 was estimated at 37.8 percent of GDP in 1998 (Zoli 2001, 28031). See Table 8 for a detailed breakdown of the costs. Also, Caprio and Klingebiel (2003, 3) report that by early 1996, the Bulgarian banking sector had a negative net worth equal to 1 percent of GDP. Table 1 does not report deopsit compensations.

favorable conditions for more financial reforms. The bank-led enterprise restructuring strategy of Poland fared somewhere in between.

Table 2 Size of and Governments' Approach to the Soft Loan Problem

Soft-Loans	Bulgaria	Estonia	Poland
"Stock" of bad loans	High	Moderate	Moderate/High
"Flow" of bad loans	High	Moderate/Low	Moderate
Duration of bank restructuring	Long	Short	Long
Fiscal cost of bank restructuring	High	Low	Moderate
Approach to the soft-loan problem	Unconditional bailouts	No money for bailouts	Bank-led restructuring

* * *

Thus, given that the three East European governments were faced with the problem of non-performing loans and soft lending in the banking sector in the early 1990s, why did they pursue different policy approaches in restructuring the banking sector? In the sections to follow, a framework for explaining the differences in resolving the bad debt problem in the financial sector in these three countries is offered. The explanation focuses on the level of political influence that anti-reform incumbents managed to exercise over the allocation of financial resources in the 1990s.

3. The Strength of Anti-Reform Groups

3.1. Distortions in Transition

This study builds upon the premise that soft financing is the bargaining chip of politicians in exchange for electoral support (see for example, Shleifer and Vishny 1994). As observers have bluntly put it, "governments choose policies to benefit themselves – to stay in power and get rich" (Djankov et al. 2003). I argue that governments do not take fiscally responsible stances to restructure the channels for soft credits after the initial reforms are implemented when the beneficiaries of soft

credits are the dominant economic constituency. After the fall of communism, strong anti-reform incumbents kept countries in partial reform equilibrium due to the slow emergence of new groups. The new entrants were composed of a group of pro-market constituencies with political agendas differing from those of the incumbents. These entrants would eventually contest the preferential treatment of the group that supports the status quo. Pro-reform groups favor the establishment of markets rules, which engender the emergence of institutions based on well-defined and respected property rights and contracts, market competition, and no unsanctioned digressions for preferential actors (i.e., overall hardening of budgets).

Incumbents are threatened by such new constituencies and block market reforms in order to solidify their own market and political domination. Incumbents do not favor financial reforms, as the banking sector is the vehicle for soft financing. In addition, anti-reform groups oppose financial reforms, because the entry of new players will bring greater competition for the scarce financial resources.

Thus, this study argues that two groups of characteristics support the dominance of the anti-reform industrial groups in post-communist Europe: (i) the presence of distorted markets and (ii) the existence of informal ties between the “supplier” of soft credits and the incumbent firms. What interest groups exist depends largely on the structure of the economy, but the extent of the pressure they exert over the government is determined by their political strength.

These two characteristics of the political economy – distorted markets and informal structures – were typical for every post-communist country at the onset of transition. The sections below emphasize these two features of the transition environment, which keep anti-reform groups in a dominant position after the fall of

communism and trigger soft budget allocation of resources, in relation to the experience of Bulgaria, Estonia, and Poland.

3.2. Restructuring and Exit

Active restructuring of incumbent enterprises is vital to induce not only efficiency gains from the operation of state firms but also to reallocate resources from nonviable firms to more productive uses and create economic space for new entrants. Restructuring is associated with productivity gains, the exit of inefficient firms, and contraction of less efficient ones. The process is unpopular among incumbents, as it entails sensitive labor reduction and possible change in management. Active restructuring also presumes a decrease in the financial transfers to uncompetitive industries, which given their inability for self-sustainability, becomes a serious threat to the survival of enterprises and incumbents.

In the countries, which do not engage in active restructuring of their enterprise sector, the threat of bankruptcy is usually dormant. The lack of effective exit mechanism practically makes the firms apathetic not only to their restructuring but also to financial market reform. In this sense, observers have pointed out that “delaying financial market reform has proven an extremely effective way of maintaining soft budget constraints in transition economies” (Wunner 2000, 69). In contrast, countries that have made efforts in restructuring their enterprise sector, enforcing the bankruptcy procedures, and strengthening the institutional environment for market allocation of resources have tackled the soft credits problem and enforced financial discipline more successfully.

Thus, my hypothesis is that active restructuring of the economy is likely to diminish the power position of the anti-reform industrial incumbents, and ultimately their ability to extract soft financing from the state through the banking sector.

Countries that fail to engage in active restructuring forestall the speed and the direction of its industry transformation as well as financial sector reforms.

The success of restructuring can be evaluated through the concept of active restructuring. Landesmann (2000), among others, interprets the term as a change in the behavior of industrial enterprises as they shift to new markets, upgrade the composition and quality of their products, and restructure their production processes. For the three transition cases that I investigate in this study, enterprise restructuring is thoroughly reviewed in the country chapters. Here, I only list indicators such as the gains in total labor productivity, the recovery of industrial output, and the EBRD index of enterprise restructuring in order to gauge roughly the progress of the three transition countries with their overall restructuring.¹⁰ The indicators are summarized in Table 4 and show that Poland fares slightly better than Estonia, while Bulgaria is a laggard in enterprise restructuring.

3.3. Entry

Distorted markets discourage not only the restructuring of inefficient firms and the exit of unsound ones but also the emergence of new market participants. New entry is important for economic development and growth, because it offers new goods and services to the market, new technology, and management techniques, as well as new jobs. New entry spurs competition and brings efficiency gains and innovation. With increasing competition, the power of anti-reform groups subsides.

Countries, which discourage the emergence of new firms, have kept high barriers to entry and implicitly supported the market position of incumbent firms.

¹⁰ The indicators are obtained from the UN Economic Survey of Europe (2000) and the EBRD Transition Report (2002).

High obstacles to the emergence of new firms effectively create an uneven playing field tilted especially against startups. New firms are created and develop slowly. While incumbents benefit from soft budgets, allocative efficiencies diminish as financial resources reach the “old production line” and the beneficiaries of the status quo remain protected “against productive destructions and thus impede innovation and development” (Kornai 1986). New constituencies cannot come forward or be mobilized to counterbalance anti-reform groups, while markets remain distorted.

The Heritage Foundation publishes an index that measures how easy (or difficult) it is to open and operate a business. The earliest available data for Estonia, Poland, and Bulgaria are for 1995, according to which the regulatory environment for startups in Estonia is the most favorable one, followed by Poland and then Bulgaria. Lower values indicate more favorable conditions for starting and developing a business. The data are summarized in Table 4 below. Again, the country chapters look at entry and private sector development in detail, and the numbers here are only presented to help formulate the hypotheses.

3.4. Privatization and Corporate Governance

Restructuring implies not only changes in the structure and organization of production but also changes in the ownership of state firms. Privatization is usually a necessary component of a successful restructuring program. By transferring property rights to private owners, it diminishes the financial engagement of the state to SOEs as well as the expectations for future financial rescue. It introduces Western-style property rights to private participants, which are a basic and critical necessity for the development of a vibrant market economy.

With the process of privatization being in the center of the economic reforms in Eastern Europe, however, the control over enterprise assets is at stake. The only

way for anti-reform groups to remain politically influential is to retain their economic importance. For this, they need to ensure that the privatization methods favor them before any other potential economic actors. Anti-reform groups are usually composed of insiders at old firms – typically incumbent managers who are products of socialism and accustomed to its principles in conducting their business in a politically and economically protected network. In the countries where the anti-reform groups are strong, insider privatization becomes a very politically acceptable method of divestiture of the state assets.

However, insider privatizations impose disadvantages that make the hardening of the budget constraints and the termination of politically driven credits more problematic. Among the challenges, the new owners lack the managerial know-how, experience, and the capital for enterprise investments to operate in market conditions (as management remains unchanged), and might face difficulties in shedding inefficient labor. In addition, tradability of their ownership shares is limited in the absence of functioning stock exchanges and capital markets. As commentators have pointed out, “in the absence of strong outside investors and an institutional framework supporting corporate governance, managers are unable to raise the capital needed for investments in new technology and capacity” (Berglof 1994, 3). Where incumbent managers have become owners of the state-assets, the emerging corporate governance in the enterprise sector is likely to suffer, because effective checks and balances on managerial performance evolve with more difficulty. These flaws slow down restructuring and are likely to prompt the management of such firms to engage in bargaining with politicians for the continuation of soft financing, as they used to do in the “old” times.

If the government fails to disengage from the insider-owned firms, their restructuring will be unsuccessful. The firms will continue receiving credits of questionable quality and reform in the banking sector will require new political effort to overcome the pressure of anti-reform groups. Such a banking system will fail to engender strong creditors' rights or require scrupulous payment of credit and instead continue amassing new bad debts.

In contrast, privatization to outsiders, and especially to core investors, has been associated with more successful restructuring and productivity gains (Djankov and Murrell 2000). In addition to clearly defined property rights, fresh capital, and know-how, the outsider-owned firms also have better corporate governance structures, as management and workers are rewarded according to their performance. Thus, when outsiders become owners of former state firms, anti-reform groups lose their significance due to the changing ownership and governance structures in privatized companies. The state also dismantles its corporate involvement, as property rights are transferred to owners who actually paid for their corporate shares, bear the responsibilities and can take the rewards of their business conduct.

When discussing the impact of the types of new owners on the governance structure in privatized companies, it is important to consider the product of mass privatization techniques in Eastern Europe, too, i.e. the companies with dispersed shareholders. Diffused owners are outsiders, whose ownership remains disseminated across large number of people. Such companies have difficulties bringing about the benefits of concentrated outsider-ownership (discussed above) for the separation of ownership and control in such firms. With control delegated to managers and passive ownership of shareholders (without the experience in exercising knowledge of small shareholders' rights), an important principal agent problem arises: diffused owners

cannot be assured that managers act in their best interest in an environment of weak corporate governance. This may lead to management corruption, asset stripping, and appropriation – or even theft – in the company. Thus, corporate governance needs to ensure the protection of shareholders' rights, so managers can be held accountable for their decisions, rewarded for the company's successes, and punished for its failures. In the early transition environment, such standards were not met; consequently, the corporate governance structures were inherently weak.

On the one hand, managers of companies with diffused ownership formed early in the transition countries are likely to be part of anti-reform groups with the aim of continuing to exercise control without accountability in the firms. On the other hand, although diffused owners are potential beneficiaries of financial reforms, they might not support such reforms because of their disappointing privatization experience. Thus, both groups are most likely to line up against pro-reform constituencies.

The discussion above suggests that different privatization methods will probably have different effects on the hardening of budget constraints, because of the diverse corporate governance mechanisms they engender. Hence, the expectations for soft credits from privatized companies will depend on the type of their new owners.

The early experience of Bulgaria, Estonia, and Poland with privatization of their state assets is quite diverse. While Estonia turned very early to outsider-methods of privatization, privatization was not very popular in Bulgaria. Sales to insiders (management and employees) and mass privatization efforts prevailed in the country, but by 1995 only 2.5 percent of the state's assets had been privatized (Claessens 1997). In Poland, the pace of the privatization process was much faster than in Bulgaria, but also gave privileges to incumbents. In both countries, mass privatization

techniques were also used in the early 1990s, but with less economic significance than other privatization methods. In the second half of the 1990s, Bulgaria and Poland turned to direct sales as the main privatization technique in their search for high quality owners to put in charge of the assets.

3.5. Nurturing Informal Ties

As noted above, the strength of the anti-reform interests depends not only on the market structures in the transition period of Eastern Europe, but also on the institutional environment that supports soft credits. Politics, as a process of negotiations among different interests, relies on the ability of these various sides to articulate their positions, gain representation, and consequently influence the shape of new institutions that broadly regulate economic exchanges. Thus, where governments succeeded in politically mobilizing wider than the anti-reform group of incumbents, they tended to favor pro-market reforms. Incumbents' success in blocking the hardening of budget constraints on financial resources made governments unable to carry out further reforms.

With the fall of the communist regime, the East European countries embraced democracy but lacked the institutional system that supported the structures of democratic governance, a structure of checks and balances on the conduct of politicians. At the onset of transition, the alignment between incumbent industrial interests and political leaders had the strongest political weight. The incumbent managers of state firms were the most influential power group, to which policymakers supplied the necessary resources for the operation of their distorted industries in exchange for their political support. For as long as the established informal channels between the policy makers and the industrial incumbents left over from the old regime prevailed, the countries remained in partial reform equilibrium and failed to constrain

the status quo beneficiaries in their pursuit for soft financing. For example, in countries where the bureaucratic structure continued to support the vertical and horizontal production webs of the planned system, politicians tended to align with the members of such networks, i.e. SOEs' incumbent managers, explore the existing informal arrangements and even capitalize on personal gain. Indeed, observers have described the collusion for rents between the socialist nomenclatura and incumbent SOE managers in the early 1990s as a central challenge to the post-communist transformation (Alsund et al. 1996).

Hence, the absence of transparent formal relations between the supplier of soft credits and the enterprise sector implies that the “big game in town” is corruption. Mutually beneficial exchanges, patronage, and soft financing are examples of such informal ties. Unconditional financial support from sectoral ministries to firms in their field, industrial export subsidies, tariffs, and other arrangements facilitate such informal ties. Thus, the institutions of informal exchanges are the practices that not only ensure the survival of incumbent firms but also help sustain their market position. Consequently, the economic agents have no incentives to establish or abide by the formal rules and instead engage in a quest for rents. Beneficiaries of partial reforms oppose institutional changes that would bring structures supporting market exchanges (Hellman 1998).

In contrast, formal links imply the existence of institutions, underpinned by well-defined property rights and contracts as well as the respect and enforcement of the general rule of law. For example, enforcing prudential regulations in the banking sector, which promotes transparency, clearly defined rules, and procedures in loan-making, will probably break the channels for soft credits and informal exchanges. Also, banking privatization to strategic investors, with disengagement of the state

from the banks' loan decisions, helps establish a "new" type of profit-motivated relationship between banks and firms, free of political influence. When formal market institutions arrange the interaction between banks and incumbents, rarely does either actor consider deviating from the established rules without bearing the consequences of sanctions against such conduct. The earlier in transition the soft-credit alliance between politicians and incumbent managers is undercut, the greater the chance for effective restructuring of the allocation of resources and the smaller the likelihood that the government will engage in allocative policies toward insiders.

With the development of democratic structures in Eastern Europe, however, such alliances weakened, because new political actors with a pro-reform agenda confronted the anti-reform groups in the contest for office. In countries where market-dedicated reformers gained political support from potential beneficiaries of the reforms early in the democratic experience, they were capable of taking advantage of the window of opportunities to promote market reforms that consequently generated even more constituency (Balcerowicz 1995; Kitschelt et al. 1999, 58). However, for the weakening of the anti-reform groups, the reformers had to demolish the existing informal ties between the incumbents and the state (a legacy from the past) and replace them with formal institutions supporting market exchanges. Failure to do so would create out of the earlier potential beneficiaries of reforms partial reform winners who would oppose further reforms.

Thus, this study attributes an utmost importance to the channels through which constituencies exercise pressure on resource allocation. In this sense, I look at the emergence of those rules and laws in the three countries that effectively facilitated the hardening of budget constraints and the termination of politically motivated credits.

Suitable overall measures of the degree of informal ties in the economy are the indexes of corruption and security of property rights and contracts. Various sources provide information on both dimensions, although their coverage does not necessarily go back to the early 1990s and is much broader in content for the narrow purposes of investigating the institutions that enabled soft financing. Nonetheless, the indexes are informative measures of the quality of the institutional environment in the countries. The index of corruption compiled by Kaufmann, Kraay, and Zoido-Labaton (1999) measures perceptions of corruption, defined as the exercise of public power for private gain. The same authors offer a measure for the “rule of law” index, which they qualify as “the success of a society in developing an environment in which fair and predictable rules form the basis of economic and social interaction” (Kaufmann et al. 1999, 8). High ratings on the “rule of law” index and low ratings on the “graft” index indicate better functioning of formal institutions and security of property rights. Both indexes are based on data for 1997.

In addition, the Heritage Foundation index of banking and finance examines the extent of relative openness of a country’s banking and financial system. The index is derived by determining whether foreign banks and financial services firms are able to operate freely, whether it is difficult to open domestic banks and other financial service firms, how heavily regulated the financial system is, the presence of state-owned banks, whether the government influences allocation of credit, and whether banks are free to provide customers with insurance and invest in securities (Heritage Foundation). This index provides the closest comparable measure among the three countries on the presence of informal institutions for soft lending. The less “open” a country on the index of banking and financial sector, the higher the score. In 1995 (the first year for which information for Bulgaria, Estonia, and Poland is available),

Estonia was ranked with a “low” score of 2, while Bulgaria and Poland were given a “moderate” score of 3 (see Table 4). The indexes for Bulgaria, Estonia, and Poland are presented in Table 4.

In addition, the timing of the weakening of the power of the partial reform equilibrium beneficiaries may bear some significance too, as the sooner the informal structures are broken, the higher the likelihood of entrenching good institutions. In the country chapters, I look at the efforts that the governments in the three countries made to dismantle the old ties between the industrial enterprises and the state by mapping the evolution of events.

* * *

The table below summarizes how the three countries fare along the dimensions of distorted market structure and informal ties that affect the strengths of the anti-reform groups in the period of transition to markets (see Table 3).

Table 3 Market Structure and Informal Ties Hypotheses

Market Structure	Bulgaria	Estonia	Poland
Entry of new firms	Low	High	Moderate
Restructuring efforts	Inactive	Active	Active
Dominant early privatization method	Insider	Outsider	Insider
Presence of informal ties	High	Low	Moderate

Note: Based on indicators presented in Table 4. For definitions, see Table 5.

3.6. A Short Methodological Note

In reality, the indexes in the tables in this chapter only partially present some of the relevant country variations or take into account the structural effect of entry, restructuring, privatization and the quality of institutions on the emergence of pro-reform groups. In addition, the lack of consistent and comparable information for the early period of transition as well as the dynamic nature of the political process and the

development of political institutions in Eastern Europe make the methodological choice of this study – to map the evolutionary sequence of the interaction between anti-reform groups and policymakers – a more promising approach to understanding the differences in the restructuring of the banks' portfolios. Thus, in the country chapters, I present how the three countries combated the problem of soft financing through the banking system and look at the factors behind their choices.

3.7. Firms' Gains and Losses in Transition

To understand the interaction between the enterprise groups and the government in the East European economies with respect to the presence (or termination) of soft loans, one needs to analyze the gains and losses that the various economic players faced. The objective function of the enterprise sector in a reforming post-socialist economy is traced graphically in Figure 2. In general, I follow Hellman's presentation of gains and losses in income of the losers and winners of reforms, but adapt it to the peculiarities of this study.

First, I associate the partial reform equilibrium with the presence of soft credits. Partial reforms lead to "selected introduction of market mechanism into an economy in which substantial spheres of economic activity still operate according to alternative mechanisms of coordination, [and] generate rent-seeking opportunities arising from price differences between the liberalized sectors of the economy and those still coordinated by nonmarket mechanisms" (Hellman 1998, 218-19). Soft loans lead to inefficiencies and misallocation of resources skewed toward the partial reform winners. The outcome deviates from the one expected in a developed market economy. The latter is depicted by the point T_2 , while the former by T_1 (Figure 2). Thus, I adapt Hellman's partial reforms model to the politics of soft credits and assume that the loans distributed through politically driven motives (but not the

principles of a functioning market) are beneficial to a relatively narrow group of short-term winners.

Second, T_2 is associated with banking restructuring and enforcement of financial discipline, i.e. the hardening of budget constraints in the allocation of credits by the banks. Advancing banking sector reforms overcomes the market and institutional distortions typical for T_1 .

Third, the actors are driven by the objective of profit maximization. In this sense, the winners in T_1 will try to keep their stream of rents (the status quo) for as long as possible and oppose the hardening of budget constraints.

This study distinguishes between five types of firms in the enterprise sector: non-restructured and restructured SOEs, insider-privatized and outsider-privatized firms, and new private entrants. Each of these types of enterprises possesses a different objective function, responding to the softness of budget constraints in the distribution of credits.

- i. *Non-restructured SOEs* are the main beneficiaries of soft credits. They enter the transition period (T_0) with a history of government- led or -planned financing for their operations. The initial transformational recession imposes challenges to the survival of such firms, but due to their government protection they continue to receive the resources needed without exerting restructuring efforts. The flow of soft credits to non-restructured industries in T_1 maximizes their benefits. With the progress of reforms, the market distortions of T_1 as well as the rents from soft crediting decline. In a fully functioning market (T_2), non-restructured firms are eventually forced to exit due to the hardening of the budget constraints on credit allocation.

- ii. *Insider-privatized firms* are the second group of firms that benefit from partial reforms through the extraction of soft financing. This group is described as one “with substantial de facto control rights over state assets and close ties with the political elite inherited from the previous command system. [...] They reap concentrated gains in the early stages of reform from the opportunities for arbitrage, rent seeking, and tunneling that arise if liberalization and privatization are not combined with discipline and encouragement” (World Bank 2002, xxii-xxiii). With the termination of soft lending in T_2 , the gains from the initial market and institutional distortions disappear, which forces the insider-owned firms to adjust to the new market environment or exit. The inverted U-shape curve flattens out after T_1 due to the adjustment costs to the insider-owned firm. The income curve originates at 0, implying that the typical privatized firm was born during the transition period.
- iii. *Restructured SOEs* suffer a drop in income initially due to downsizing, cutting overemployment, modernizing, and investing in technology in the process of restructuring of production. I assume that since soft credits do not create incentives for active restructuring, restructured SOEs by definition receive no or limited soft financing in T_1 .¹¹ In most of the cases, successful restructuring implies privatization or exit. Hence, the income curve of firms restructured through privatization will converge with one of the curves of the privatized firms (depending on the method used). However, I assume that at T_2 there will still be

¹¹ See above Chapter II, section 5.2.

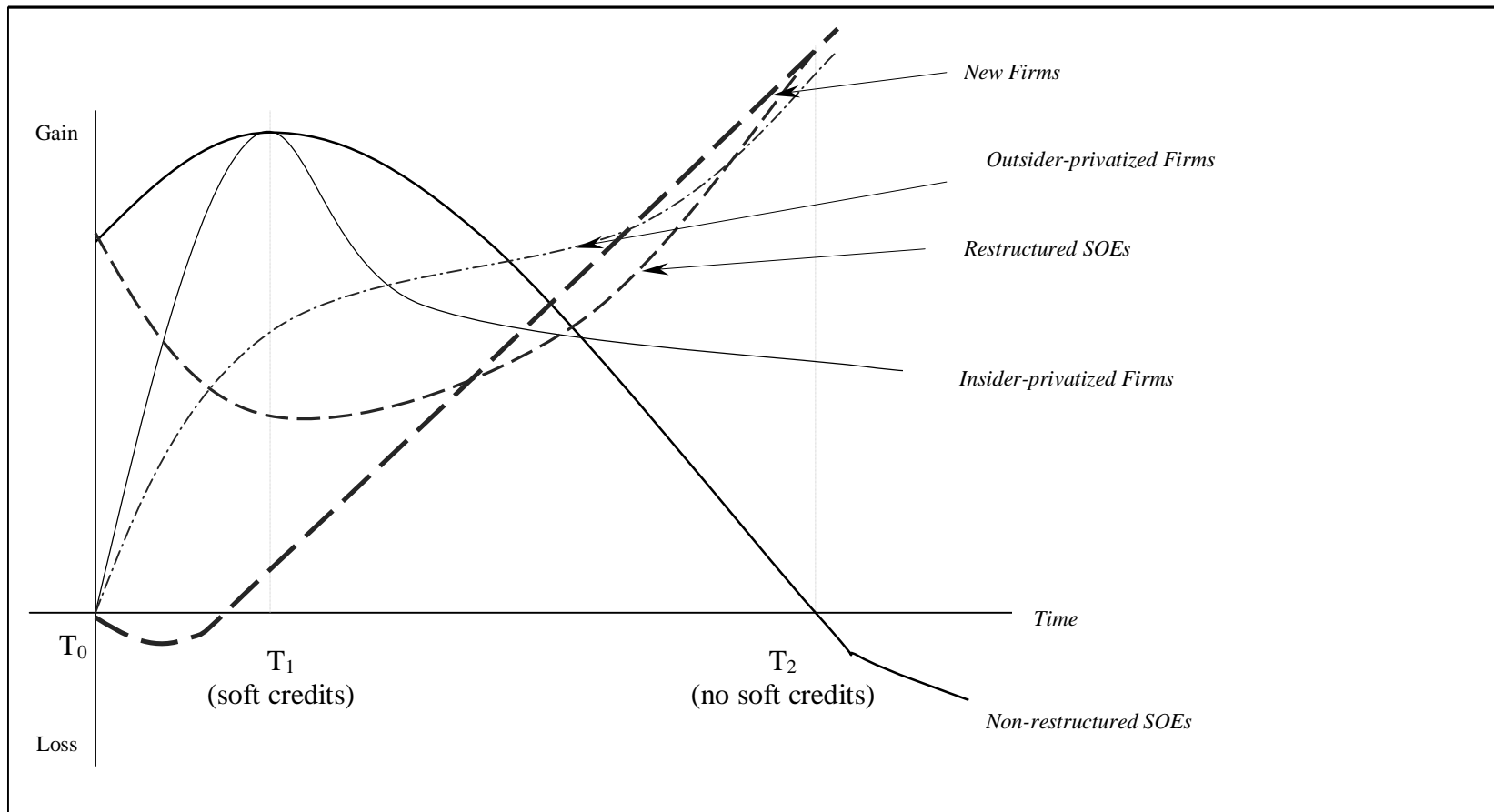
some restructured SOEs. The majority of such firms will mimic the behavior of private firms in a functioning market environment.¹²

- iv. *Outsider-privatized firms* are generally losers in the period of soft credits. Such firms have the know-how, skills, and resources to compete on the market, but their gains are restricted because of the uneven playing field tilted toward the recipients of soft loans. Rapid banking restructuring and reform as well as the termination of soft credits puts such firms on equal ground with the rest of the market participants and their gains increase with the advancement of reforms.
- v. *New private firms* have a classic J-curve pattern of income, due to the high entry costs at low levels of reform. In T_1 , soft lending to other market participants deprives *de novo* firms of access to credit and slows their growth. Such firms realize gains in a competitive environment (T_2), in the absence of privileged, politically driven lending.

Figure 2 presents a stylized picture of the gains and losses of the participants in the enterprise sector with respect to the hardening of budget constraints on the credit market and reforming the banking sector. A major drawback of the picture (as well as of the Hellman's partial reform model) is that it does not capture the forces behind the tightening of the financial discipline and the evolution of the market institutions for financial intermediation in from T_1 to T_2 . This is precisely the task of the explanatory mechanism relayed in the sections above.

¹² There may be a small portion of SOEs that have adapted to the market which behave differently in the second period due to their state ownership or market protection by the government. Such firms, like the natural monopolies for example, may retain monopoly power, in which case the assumption of fully functioning market forces would not hold and firms may extract rents from their monopoly position but not competitive advantages. Such income gains are not presented on the chart.

Figure 2: Economic Actors' Objective Function in Transition



Source: Elements adapted from World Bank (2002, xxii).

In addition, the interaction between policymakers and their enterprise constituencies should not be viewed as a static one; rather it evolves as transition progresses. While the legacies from the past affect which political groups emerge in the early transition period, their strength is shaped sequentially, as a response to the dynamic changes of the political-economic environment during the transition period. What drove the reforms in the banking sector toward abolition of soft lending is the emerging group of constituencies of new and restructured firms, which benefited from functioning markets, and counterbalanced the beneficiaries of soft credits and partial reforms. Thus, the explanatory mechanism of this study focuses on the evolutionary path of interaction between the policymakers and their constituencies and the outcomes of such interactions translated into new institutions and rules in the financial sector.

4. Conclusion

To sum up, the theoretical claims of this thesis may be considered relevant to the study of the political economy of transition countries, telling a subtle story about the forces shaping the fate of the financial industry in Eastern Europe. Economic actors interacted with policymakers in the transition period and shaped the rules of the game as transition progressed. Countries, unable to restrain strong anti-reform groups, ultimately failed to enforce hard budget constraints on credit allocation and hindered the development of the financial industry. Such anti-reform groups captured the state and extracted rents in the form of preferential credits or bailouts through the financial system.

In general, under what circumstances are the anti-reform industrial lobbies weakened? The alliance between politicians and anti-reform groups is broken when

new entrants such as new firms, restructured enterprises, and foreign companies, outweigh the influence of insiders over the state. Thus, partial reform equilibriums are overcome and budget constraints on firms and banks are hardened when:

- barriers to entry and exit are removed;
- incentive structure for effective restructuring is in place;
- good corporate governance structure through privatization is in place;
- and informal ties between incumbent firms and the “supplier” of soft financing are replaced with formal institutions that regulate market exchanges.

Table 4 Distorted Markets and Quality of Institutions: Bulgaria, Estonia, and Poland

	Characteristics	Source	Bulgaria	Estonia	Poland
Distorted Markets					
Restructuring and Exit					
	Labor productivity gains (1993-2001)	EBRD	20.4	59.2	82.2
	Industrial output recovery 2000, 1989=100	UNECE	44.1	63.2	131.6
	Relative productivity gains (1995-2001)	WIIW	3.5	10.0	9.1
	Enterprise restructuring index (1993-2001)	EBRD	2.07	3.04	3.04
Entry					
	Business regulation index, 1995	HF	4	2	3
Privatization					
	Early dominant method	Cases	insider	outsider	insider
Overall Quality of Markets			low	high	mid
Quality of Institutions					
	Graft	KKL	-0.557	0.593	0.492
	Rule of law	KKL	-0.15	0.507	0.538
	Banking and finance, 1995	HF	3	2	3
Overall Quality of Institutions			low	high	mid-high

Sources: EBRD (2002), UNECE (2000), WIIW(2003), Heritage Foundation, Kaufmann et al. (1999)

Table 5 Distorted Markets and Quality of Institutions: Definitions and Sources

	Indicator	Scale	Source
Distorted Markets			
Restructuring and Exit			
	Labor productivity gains	Cumulative gain in labor productivity over the period 1993-2001.	EBRD
	Recovery of industrial output	Level of industrial output in 2000 as a percentage of industrial output in 1989.	UNECE
	Relative productivity gains	Relative gains in productivity over the period 1995-2001	
	Enterprise restructuring index	Index 1 to 4. Low score indicates the presence of soft budget constraints and ineffective restructuring.	EBRD
Entry			
	Business regulation index, 1995	Low=2: Simple licensing procedures; existing regulations relatively straightforward and applied uniformly most of the time, but burdensome in some instances; corruption possible but rare. Moderate=3: Complicated licensing procedure; regulations impose substantial burden on business; existing regulations may be applied haphazardly and in some instances are not even published by the government; corruption may be present and poses minor burden on businesses. High=4: Government-set production quotas and some state planning; major barriers to opening a business; complicated licensing process; very high fees; bribes sometimes necessary; corruption present and burdensome; regulations impose a great burden on business.	Heritage Foundation
Privatization			
	Dominant privatization method	Insider – divestiture of state assets mainly through management/employee buy-outs. Outsider – mainly direct sale of state assets to core investors (not dispersed investors).	EBRD
Quality of Institutions			
	Graft	Perceptions of corruption, defined as the exercise of public power for private gain.	KKL (1999)
	Rule of law	The success of a society in developing an environment in which fair and predictable rules form the basis of economic and social interaction	KKL (1999)
	Banking and finance, 1995	Low=2: Government involvement in the financial sector is minimal; there are few limits on foreign banks; country may maintain some limits on financial services; and that domestic bank formation may face some barriers. Moderate=3 Substantial government influence on banks exists; government owns or controls some banks; government controls credit; domestic bank formation may face significant barriers.	Heritage Foundation

CHAPTER IV

THE BULGARIAN BANKING SECTOR DEVELOPMENT

1. Introduction

The real reforms in the Bulgarian financial sector only started in 1997, after the collapse of the banking sector, when 14 out of the 35 registered commercial banks failed. Observers estimate that the overall cost of restructuring and bailouts for the period between 1991 and 1998 reached as much as 38 percent of the nation's GDP (Ulgenerk and Zlaoui 2000). The crisis could hardly have been surprising for the policymakers in office, given the poor performance of the financial sector (see Table 7). Inevitably, however, one asks the question: Why was the reform in the financial sector delayed so much?

This chapter builds on the theory presented in Chapter III to understand the motivation of the Bulgarian state in forestalling the restructuring of the banking sector. It examines the characteristics of distorted market structures and informal institutions in order to determine the strength of the anti-reform incumbents in blocking financial reforms.

The country case study is structured as follows: The next section reviews the government's approach in tackling the problem of non-performing loans in the banking system by looking at the structure of the banking sector and its operation in the early years of transition. It elaborates on the channels of soft financing as well as the costs it incurred. Section 3 discusses the interaction between politicians, industrial managers, and financiers and their motivation for stalling reforms in the banking sector. The section that follows discusses the characteristics of the political-economic environment in Bulgaria that nurtured strong anti-reform interest groups. Section 5

reviews the impact of the resolution of the financial crisis on the development of the financial sector after 1997. Section 6 elaborates on the major shifts in the policy process with regard to the reform in the real and banking sectors, including the introduction of new privatization methods in the real sector, regulatory changes, and the consequent banking privatization. The last section draws together conclusions.

2. The Story of Banking Practice in Bulgaria Prior to 1997

2.1. Banking Sector Structure and Operation

Similarly to the other East European countries after the fall of the communist regime, Bulgaria tried to move out of the inherited planned model of centralization of the management, allocation, and monetary functions of the Bulgarian National Bank (BNB) toward a system of financial intermediation of a Western type (see for example, Minkov 1993). Transition to the new banking system started with the liberalization of entry into the Bulgarian financial sector. By the end of 1990, there were 70 commercial banks, of which seven were sectoral, two specialized (the State Savings Bank and the Foreign Trade Bank), and 59 commercial banks that emerged from the branches of the monobank (see Table 6).

However, the expansion of the number of banks in Bulgaria did not foster competition in the sector. Instead, the early liberalization of entry into the banking market brought about instability in the sector, partly due to the lax supervision and cumbersome regulations at the time. For example, in addition to the low capital requirement for licensing commercial banks, no regulatory prerequisite for the origin of the funds existed in the early 1990s.¹³ A widespread practice was to borrow funds from already existing banks and use them to register new private banks in the country.

¹³ The required capital for licensing a commercial bank in 1991 was approximately USD 500,000.

As a result, private banks with a questionable capital base mushroomed in the early years of transition in Bulgaria, in addition to the already troubled state-owned financial sector.

Table 6 Bulgarian Banking Sector Structure, 1990-1996

Banks	1990	1991	1992	1993	1994	1995	1996
Total banks, end of year	70	78	59	41	45	47	35
of which Foreign banks	0	0	0	1	3	5	7
Licensed during the year	61	8	2	7	10	4	2
of which Foreign banks	0	0	0	1	2	1	2
Consolidated banks	0	0	22	29	9	3	0

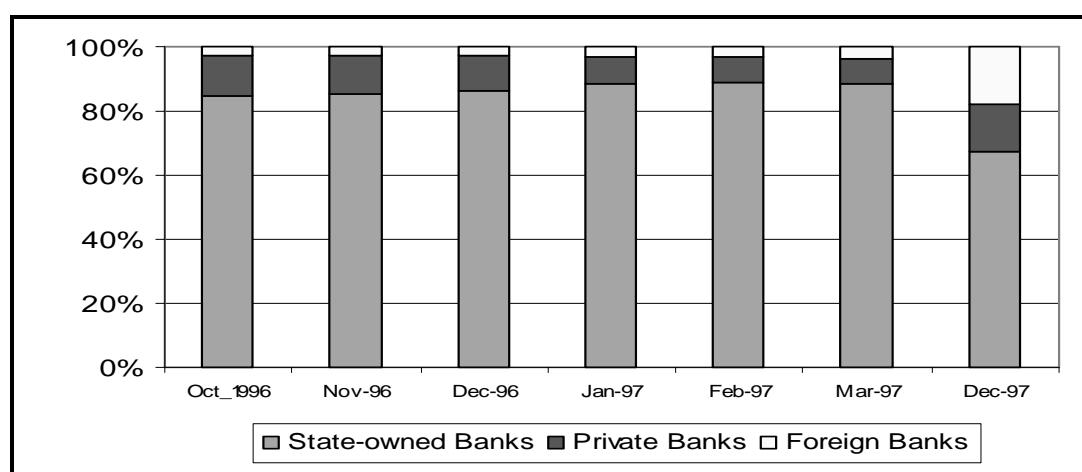
Source: Yonkova, Aleksandrova and Bogdanov (1999, 19).

Regardless of the large number of commercial banks, the market was very concentrated (see Figure 3). For example in 1994, 45 banks were operating on the financial scene in Bulgaria, of which the ten largest state-owned banks constituted over 80 percent of the banking sector. Despite the low barriers to entry, the Bulgarian banking sector was not competitive enough to attract foreign participants, as only two foreign banks and one branch of a foreign bank were present on the market (Table 6). Their share in total banking assets was negligible (see Figure 3). At the same time, the level of state assets in the banking system never came below 85 percent prior to March 1997. Certainly, no state bank had undergone a privatization procedure at that time, even though bank privatization was on the agenda of all the governments of this period.

In response to the increasing number of commercial banks, the government established the Banking Consolidation Company (BCC) in 1992. The BCC was launched in an effort to decrease the number of the undercapitalized commercial banks, which held about 73 percent of total assets in 1991. The problem banks were merged with more financially viable banks that had generally better prospects for

privatization. The process started right away, when 21 state-owned banks were consolidated into one bank – the United Bulgarian Bank – and another 12 were united into the Express Bank. After the early consolidation, the Bulgarian banking sector consisted of 35 commercial banks, among which newly established small private banks and 11 state-owned banks (Dobrinsky 1994, 343).

Figure 3 Structure of Bulgarian Banking Assets (in %)



Source: Yonkova, Aleksandrova and Bogdanov (1999, 16).

However, these banks were not financially sound institutions with adequate capital bases and quality loan portfolios. In addition, the high interest rates further burdened the intermediation of financial resources. For example, the interest rate on short-term credits at the end of 1994 was 45 percentage points higher than the interest rate on time deposits, which constituted nearly a 15-percentage-point increase over the previous year (BNB 1995, 1: 27). Borrowing was expensive, but the banks kept lending to clients with no prospects of repayment. As a result, the large share of non-performing loans in commercial banks became the most pertinent problem in the banking system (Table 7).

2.2. Channels for Soft Crediting

The deterioration of the banking portfolios turned into an acute problem for the financial system in Bulgaria after the fall of the communist regime. The “baggage,” which the newly established state banks inherited after the dismantling of the monobank was certainly burdensome. At the end of 1990, the non-performing loans amounted to BGL 21.3 billion and accounted for more than 50 percent of the commercial banks’ outstanding loans. Their volume was over 34 percent of the nation’s GDP at the time (Ravitz 1992, 33). In addition to the big portfolio of non-performing loans, their denomination was mainly in hard currency, which meant that their value remained high even in the conditions of high inflation.

The drop in industrial output aggravated the inability of the borrowers (mainly SOEs) to meet their past obligations to the banks, and made them seek new loans in order to continue operations of their distorted industrial firms (see Figure 3; also Bristow 1996). Obtaining new bank credits was not difficult, as borrowers’ screening and monitoring were neither popular, nor practically required techniques in loan making by the commercial banks. The commercial banks began to encounter additional liquidity problems, amassing new bad loans toward projects with low returns. Overdue credits and overdrafts, for example, were over 69 percent of total loans at the end of 1995, only to reach 96.76 percent of all loans to the banking sector in November 1996 (Table 7). As a result, the state banks became overburdened not only with a high level of old non-performing loans, but also a considerable flow of new credits with questionable quality.

Table 7 summarizes the dynamics of bad debt to the banking system for the year prior to the financial collapse of the system in Bulgaria.

Table 7 Monthly Dynamics of Total, Overdraft, and Overdue Credit Extended to the Commercial Banks in Bulgaria, Dec. 1995-Dec. 1996

	Dec. 1995	Jan. 1996	Feb. 1996	Mar. 1996	Apr. 1996	May 1996	Jun. 1996	Jul. 1996	Aug. 1996	Sep. 1996	Oct. 1996	Nov. 1996	Dec. 1996
Total credit to the banking system	9548	10083	9811	5801	5794	8578	11676	19891	16093	22862	84473	92484	123387
Overdrafts	5626	4904	4381	255	255	255	255	255	107	107	31140	42010	61147
Overdue credit	789	839	1110	1210	1221	3928	7038	10130	12897	16136	47475	47474	56090
Overdraft and overdue credit (%, total credits)	67.19	56.96	55.97	25.25	25.47	48.76	62.46	52.21	80.81	71.05	93.07	96.76	95.02

Source: BNB and own calculations

2.3. Bad Debt Resolution Attempts

The ZUNKs. The ZUNK bonds were the first system-wide attempt by the Bulgarian government to solve the problem of bad loans in the banking system.¹⁴ The initial goal of the bonds was to clean the banks of the stock of bad debts from the previous regime. The ZUNK bonds were issued in accordance with the Law on the Settlement of Non-performing Credits to replace a group of bad loans in the commercial bank portfolios accumulated by enterprises prior to 1990 with 25-year government securities.

There were two types of ZUNK bonds: denominated in Bulgarian leva and denominated in US dollars. The former ZUNK bonds amounted to some BGL 23 billion and the latter to USD 1.8 billion. The ZUNK bonds paid interest semiannually. The yield of the leva-denominated bonds was equivalent to a third of the primary interest rate in the first two years, half of the primary interest rate in the third and fourth years, two-thirds of the primary interest rate in the fifth and sixth years, and the full primary interest rate during the remaining years to the maturity date. The ZUNK

¹⁴ ZUNK stands as an abbreviation from Bulgarian for the Law on the Settlement of Non-performing Credits. See APIS (1996; vol. 7, "Financial Law").

bonds denominated in dollars paid six months LIBOR. Both kinds of bonds were designed to pay principal after the fifth year in 20 equal installments.

The exchange of these enterprise loans for government securities affected the government budget by creating an obligation to pay interest on the bonds. However, since the ZUNKs paid only part of the base interest rate, the government attempted to regulate the ZUNKs' prices via restrictions on the minimal price level and privatization eligibility of the bonds, although both types of bonds were envisaged to be used in privatization deals of the SOEs. Observers have concluded that this was a clear attempt to finance part of the government debt at less than market interest rates (Nenova et al. 1997, 24).

In addition, the ZUNK bonds were inadequate as privatization instruments due to the unfavorable institutional environment in Bulgaria, including an underdeveloped bond market, real sector privatization that had slowed to a crawl, and a very thin stock exchange. The combination of these factors created an obstacle to the market realization of the ZUNK bonds.

Apart from the losses from keeping ZUNKs on the banks' balance sheets, the bonds led to an alarming liquidity draw in two of the biggest state-owned banks – the Mineral Bank and the Economic Bank. Since the two banks held most of the inherited soft credits from before 1989, the majority of the ZUNKs promptly reached them.

The situation in these two banks did not improve, however. In 1994, the BNB had to extend additional funds for refinancing to both banks in such an amount that it became difficult to maintain control over its monetary base and the base interest rate (see Figure 4; and Balyozov 1995). The two banks were bailed out again in mid-1995 at the expense of another central bank refinancing (see Table 8). Eventually, the Ministry of Finance replaced the ZUNK bonds with government securities paying full

market interest, and the BNB stopped the refinancing of Mineral Bank and the Economic Bank; the new securities had a maturity of seven years, a four-year grace period, and carried a yield equal to the BNB's central rate (Balyozov 1995). Regardless of this expensive refinancing, both of these banks were among the first to be closed in 1996.

Unconditional Bailouts. The ZUNKs failed to solve the bad debt problems of Bulgarian commercial banks. An obvious flaw of the program was the mismatch between the return and maturity of these bonds and the government's initiative to cover this difference. Moreover, the government continued to bail out problem banks, in addition to Mineral Bank and the Economic Bank. Credits of millions of leva were also extended to private banks to provide liquidity in their balance sheets, troubled by bad credits.

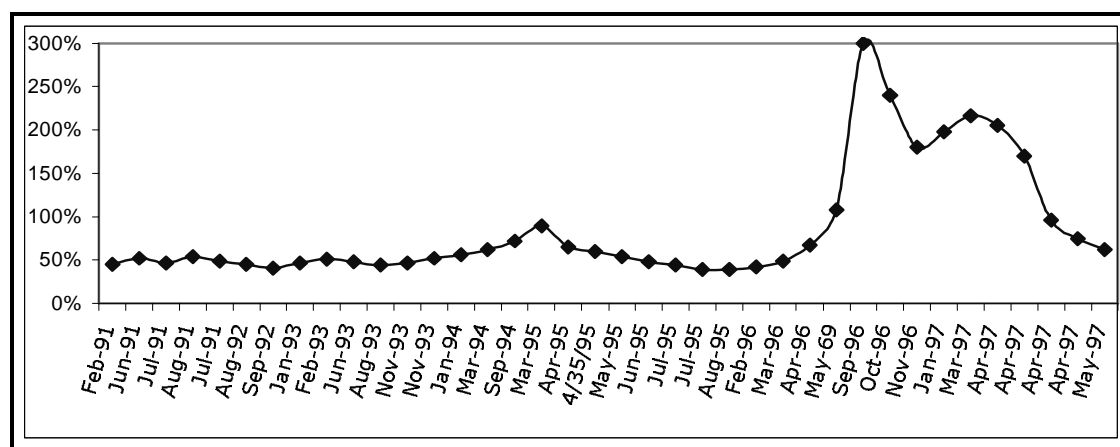
Numerous examples illustrate the government's policy of unconditional bailouts to illiquid (and often insolvent) banks: First Private Bank got BGL 91 million; Agrobusiness Bank, BGL 50 million; the Bank for Agricultural Credit, BGL 35 million; and Balkan Bank, BGL 35 million – all from the BNB prior to 1996 (*Capital* 1998, no. 3). A glaring example of a lender-of-last-resort rescue was the Plovdiv's Agrobusiness Bank, bailed out on several occasions by the BNB prior to 1997, regardless of the fact that more than 50 percent of its non-performing credits were extended toward companies owned by the bank's managers. The financial obligations of this bank were transferred to the BNB balance sheet after the decision of the central bank to purchase the failed bank for one lev.

The same pattern was observed in Elit Bank, where nearly 80 percent of its non-performing debt was held by a small number of management-connected

borrowers, but the BNB still recapitalized it (*Capital* 1998, no.3). Similar was the story of the Business Bank of Petrich, with the sole difference being that the refinancing agency was the State Savings Bank (SSB). Another example was the Dobroudja Bank, to which refinancing of 350 percent of its non-performing credits was extended by the state, and still the bank went bankrupt (*Capital* 1998, no. 3). The list could continue with many more examples of repeated refinancing of unsound banks prior to 1996.

The repeated recapitalization attempts and bailouts signaled to the banks that the government was ready to provide liquidity as needed. The state kept extending numerous liquidity injections to the commercial banks with the idea of restoring the functioning of the inter-bank payments system (Balyozov 1995, 6). However, the threat of a systemic failure became more and more real, as the government preferred to fuel liquidity in the banking system instead of strengthening the financial discipline or the viability of the borrowers. The net result of the above-mentioned recapitalization operations, and ones like it, was the sharp increase in interest rates and further instability on the banking market, as the bad debt problem in the banks was only aggravated (see Figure 4).

Figure 4 Base Interest Rate Dynamics, February 1991-May 1997



Source: BNB.

The Cost of Bank Recapitalizations. The repeated recapitalization of the commercial banks resulted in unsuccessful attempts to resolve the existing bad credit in the system and allowed for a new accumulation of bad debt. As pointed out, the majority of the refinancing of the troubled commercial banks came straight from the central bank prior to 1997.¹⁵ As a result, the restructuring attempts of the Bulgarian government incurred very high fiscal costs. The overall estimate stood at 37.7 percent of GDP (see Table 8). As the table reveals, for a period of eight years the Bulgarian government spent the equivalent of 26 percent of 1998 output in trying to resolve the problems in the banking system. In addition to these government expenses, the central bank's costs amounted to nearly 12 percent of output for the period between 1991 and 1998. Generally, the funds aimed to not only clean up the banks' portfolios from inherited socialist-era bad loans but also provide financial support to illiquid and/or insolvent borrowers. A breakdown of the government and central bank expenses during the period is presented in Table 8. The table also summarizes the policy actions undertaken (discussed above) and instruments in the restructuring of the banking system in Bulgaria.

* * *

To sum up, the process of banking sector restructuring that was initiated was difficult mainly because of the huge amount of inherited bad debts, but also because of the “never-ending practice” to make economically nonviable but politically motivated credits.¹⁶ The banking operations were conducive to the government's

¹⁵ Generally, four categories of refinancing from the central bank exist. These are the Lombard loans, discount loans, overdrafts and unsecured loans.

¹⁶ Interviews with Bulgarian bank officials conducted in May 2000.

policy of repeated refinancing of commercial banks. The introduced changes in the structure of the banking sector did not make a difference in the way loans were made, because the financial resources were intermediated toward projects not screened and evaluated on their quality but on their political patronage. The concentration of state ownership in the banking industry made it possible to keep the pattern of “directed” intermediation of financial resources. As a result, the failure to harden soft budget constraints on banks and firms placed the state in a dangerous situation, putting at stake the stability of the overall financial system.

Table 8 The Cost of Bank Restructuring and Deposit Compensation for the Bulgarian Government as a Percentage of GDP, 1991-1998

		'91	'92	'93	'94	'95	'96	'97	'98	Total
1991-1994 Clean-up of bank portfolio from inherited bad loans	Bonds issue	0.0	2.0	10.9	19.0	0.0	0.0	0.0	0.0	21.9
	Interest payments	0.0	1.3	1.3	2.9	1.6	2.5	0.5	0.4	
1995: Solvency and liquidity problems in two state-owned banks*	Bonds issue	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0	0.4
	Interest payments	0.0	0.0	0.0	0.0	1.3	7.8	0.3	0.0	
1996-97: Widespread solvency and liquidity problems	Bank Restructuring									
	Bonds issue	0.0	0.0	0.0	0.0	0.0	0.0	0.5	0.0	0.4
		0.0	0.0	0.0	0.0	0.0	0.0	0.02	0.04	
	Interest payments	Deposit Compensation								
		Bonds issue	0.0	0.0	0.0	0.0	0.0	3.3	1.3	0.04
	Interest payments	0.0	0.0	0.0	0.0	0.0	1.4	0.2	0.1	
Central bank costs	Provisions for losses on credit extended to banks	na	na	na	na	2.8	6.6	2.3	0.0	11.7

Source: Zoli (2001, 28-31).

Note: * The two banks in question were Mineral Bank and the Economic Bank.

3. Politicians, Industrial Managers, and Financiers

Why was it so difficult, though, for the state to lead a policy process that would facilitate the reform of the financial industry in Bulgaria? The easy access to liquidity from state institutions (BNB or SSB) created politically driven and irresponsible lending by the commercial banks. It was a lucrative business, which served a wide range of anti-reform industrial interests. The privileged borrowers were private companies with links to politicians, big state-owned enterprises, or organized private economic groups that emerged as a product of the extended political connections of industrial managers.¹⁷ The latter group of borrowers, as with analogous groups in other East European countries, were often believed to be money-laundering financial-industrial structures of former nomenclatura members or nouveau riche interest groups.¹⁸ All of these beneficiaries of the status quo turned into a powerful group with unfailing access to government financial support.

But how did anti-reform interests maintain the political strength to siphon off liquidity from the financial system for close to eight years after the fall of the socialist regime? I would argue that the anti-reform groups were the most economically important interest in the early 1990s, and their market position translated into political domination, too.

Industrial incumbents accounted for nearly 60 percent of output in Bulgaria at the beginning of the transition period. The industrial sector employed the majority of the labor force for years, too. New private entry and business development was

¹⁷ After the financial crisis broke, a list of credit millionaires was published by the BNB, containing individuals and firms to whom large credits were given. For an interesting commentary on the list see *Capital* 1998, no. 3.

¹⁸ Multigroup, Orion, Euroenergy, and others were examples of such groups in Bulgaria

difficult, except for private firms set up for asset-stripping (Peev 2001). In fact, the private sector share of output in 1993 was only 35 percent. In addition, the standard of living was falling with the deepening of the transformational recession. In a time of economic instability, people wanted to keep their jobs, as new job creation and labor mobility were dormant. Thus, the main constituencies of the political parties in the early 1990s in Bulgaria were to be found in the still state-owned enterprises. Keeping employment at the SOEs was possible only by keeping the enterprises afloat. Thus, politicians made sure the industrial firms were supplied with the financial resources they needed. In return, politicians received votes, political contributions, and even rents from their “faithful” supporters. The next sections look at the characteristics of the political and economic environment that became conducive to the nurturing of anti-reform groups in Bulgaria.

4. The Strong Anti-Reform Interest

4.1. The Strong Receiving End Supported by Informal Institutions

Due to structural changes, state firms suffered massive deteriorations in output (see Figure 5) and profitability. The SOEs were unable to repay their debts to the commercial banks in the short term without restructuring their production processes so they could become operationally efficient, reach new markets, and realize profits. Although the government managed to dramatically cut the direct subsidies to SOEs in just a year – from 8 percent of GDP in 1992 to 1.9 percent – it had found a convenient way of keeping the anti-reform borrowers alive by channeling financing through the state-owned banking system and payment arrears (Pissarides et al. 2001, 4). Most credits were granted on the government’s or the sectoral ministries’ guarantees. Informal links underpinned the exchanges between firms and politicians in office. As

observers have pointed out, the companies were practically required to “focus on political lobbying in expectation of the next restructuring campaign” and its financing (Keremedchiev and Gradev 1999, 72).

The power of the branch and sectoral ministries and the local administration was a legacy from the past, which did not quickly find an alternative institutional solution in the new environment of emerging democracy and markets in Bulgaria. In fact, the sectoral ministries and municipalities were given even more oversight. In July 1991, parliament passed the Bill on Incorporating State-Ownership Companies with Limited Liability, under which the state or a municipality became the single shareholder in any new joint stock or limited-liability companies. Effectively, the Bill of July 1991 established the beginning of a broad discretion given to sectoral ministries and municipalities. According to the Bill, they were not only financially responsible for the enterprises under their umbrella, but also in charge of the process of ownership transformation in these firms. The procedure of privatizing a state firm envisaged that after its identification by the respective Ministry or municipality, its management would handle the sale. The supervision was again under the control of sectoral ministries or local administrative bodies.

In 1992, after heated debates around the organizational structure and methods of privatization in Bulgaria, the Privatization Agency was formed but received only a limited role in the ownership transformation process under the Transformation and Privatization of State and Municipal Enterprises Act (*State Gazette* 1992, no. 38). The Agency, however, was made subordinate to the Council of Ministers, which did not ensure its decision-making independence with respect to the upcoming sales of enterprises. Moreover, most of the privatizations of state firms were not under its direct discretion. The ownership transformation of state-owned companies with asset

value of less than BGL 10 million or more than BGL 200 million was not handled directly by the Privatization Agency. The former firms remained under the decision-making authority of the sectoral ministries, and the latter group of enterprise privatization was to be handled by the Agency, but with the approval of each transaction by the sectoral ministers in the Council of Ministers. Municipalities were to decide on the privatization of their property and firms themselves. Effectively, the political authority was to decide the fate of each enterprise in the country.

The rigid sectoral structure and power of branch ministries and local administration made informal arrangements between the distorted firms and the bureaucracy easy to exploit. Rent-seeking became overwhelming. For example, company resources could be “legally” drained through many mechanisms. Among these, the so-called spider-web arrangement, also known as the “entry-exit scheme,” was notorious. Under it, firms with close relations with the managers of an SOE supply inputs at market prices to the state-run firm, buy the SOE’s products at state-determined prices, and distribute the products at market prices. At the same time, the state financially supports the operation through the same state-owned firm. Such spider webs existed around SOEs, in which restructuring and potential privatization was usually under the control of the sectoral ministries. Obviously, branch ministers and industry managers worked hand-in-hand in making this arrangement work in Bulgaria.

While big changes in polity from totalitarianism to democracy happened shortly after 1989 (such as changes in the constitution, demonopolization of public resources, and pluralism), the dismantling of the state bureaucracy and its hierarchy did not occur, and its interactions with the SOEs were left unchanged. Thus, informal relations and mechanisms of influence emerged as a response to the inherited

institutional structure of dependence on the Plan (dictated by the ministry or local administration) and provided an avenue for easy transfers on the discretion of those in office. Inevitably, such informal ties cultivated political clientelism, in addition to the interest of the politicians in office in keeping the SOEs afloat.

4.2. Entry

One of the reasons for the misallocation of resources toward preferential borrowers was the lack of a politically represented domestic interest in discarding the status quo and pushing for financial reforms. Instead, the industrial lobby managed to capture the state structures and siphon off resources without much accountability for their use. Hence, encouraging new entry was not attractive for the politically powerful incumbent enterprises, as new firms would bring more competition on the market. In contrast, the incumbent companies, and especially the monopolists, were used to a secure domestic market and no competition. The entry of new firms would turn the incumbents from economic “winners” into “losers” in an environment where they needed not only to figure out how to restructure their distorted firms but also to learn how to compete for scarce financial resources. Thus, new entry was not economically beneficial for the incumbent firms, and they channeled this message to those in office.

In turn, bank financing was hardly available to the *de novo* ventures. The Agency for Small and Medium Enterprises (ASMEs) in Bulgaria estimates that in 1996 a micro-firm, almost by definition a new entrant, had on average almost 800 times less debt and utilized on average 1873 times less in loans in comparison to the big firms. With a fair degree of cautiousness in interpreting such broad comparisons, it is reasonable to recognize the limited access to bank financing of the *de novo* firms. In fact, the same group of firms reported that 60 percent of their debts were toward suppliers, not banks (ASMEs 1999).

In an environment of strong anti-reform groups, new business creation was not only economically but also politically unattractive. Massive business entry would mean the quick emergence of new constituencies with conflicting preferences from the incumbent group of supporters to the politicians in office. This would create tension between the two groups and would require compromises. For the politicians in office, new entrants meant insecurity and potential loss of political power.

In fact, the available numbers support the claim that the emergence of new companies in Bulgaria was slow. Although the number of registered private firms rose from 23,000 in 1989 to 513,504 in 1995, observers have noted that more than a half of these firms were practically dormant.¹⁹ For example, in manufacturing the share of working enterprises was estimated at 20 percent (Pissarides et al. 2001). The new entrants were predominantly small firms, which employed less than 35 percent of the labor force in 1994 and accounted for 21 percent of gross output in 1996. In addition, the administrative structure did not make the entry of new players easy. Lengthy and complicated procedures as well as numerous licensing requirements restrained the emergence and development of new firms (ASMEs 1999).

Hence, in the early 1990s new firms in Bulgaria were not a dynamically emerging group of constituencies that could benefit from financial reforms and oust the political support for incumbent firms through the banking sector. The potential beneficiaries of such reforms were dispersed.

4.2. Inactive Restructuring

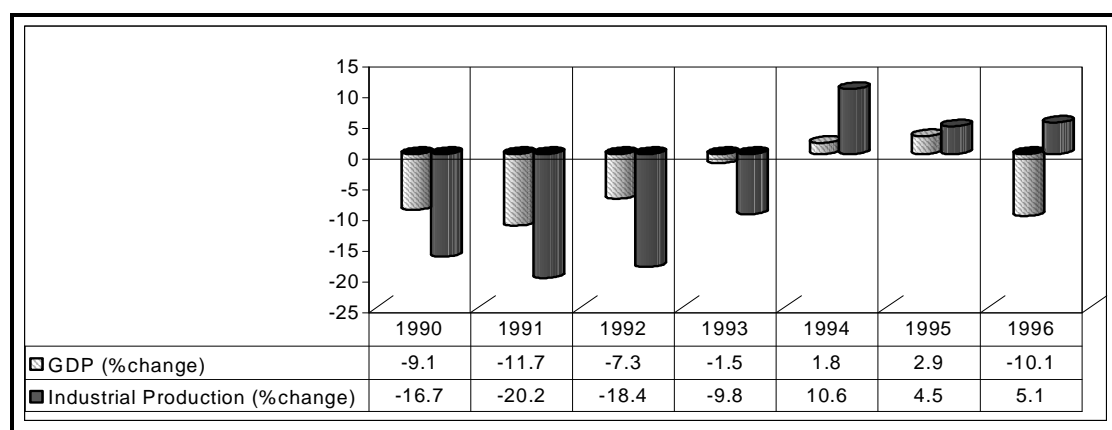
The process of delayed and sluggish restructuring of the industrial complex was another characteristic of the political-economic environment that kept the anti-

¹⁹ EBD data reported in Pissarides et al. 2001.

reform groups strong. After the collapse of the system at the end of the 1980s, Bulgaria did not embark quickly on an active restructuring strategy of its economy. Industrial output contracted manifold, but the private sector and especially services did not expand to offset the stagnation in the state-owned industrial complex (see Figure 5). This fact left the mostly state-owned industries, and the ones associated with it, in a relatively dominant position for the first half of the 1990s.

However, if industrial firms were to survive they needed major restructuring efforts to move into new markets, upgrade the composition and quality of their products, and restructure their production. Output collapsed, and it is yet to recover to its pre-transition levels. Industrial production picked up pace in 1994, but its overall growth was slow.²⁰ Labor productivity in industry has followed the overall trend for sluggish industrial growth. By and large, the restructuring results prior to 1997 in Bulgaria were disappointing.

Figure 5 Output Dynamics in Bulgaria, 1990-1995



Source: *Business Central Europe*.

Bankruptcy. The worrisome outcome of output performance did not spur changes, however. One of the reasons was the lack of an effective exit mechanism for

²⁰ In 2002, industrial production reached 62.6 percent of its 1990 level, which was the highest ever (WIIW 2003).

companies in financial distress. While in the West, firms and their managers are responsible for their financial situation, this was not the case in Bulgaria for most of the 1990s.²¹ A bankruptcy law was adopted in July 1994, but the law was hardly implemented prior to 1997 (Pissarides et al. 2001). Moreover, major problems existed in the institutional and economic environment, such as the length of time court cases dragged on, the gaps in legislative norms, and the low liquidity of assets, which made bankruptcy procedures particularly unattractive to creditors.²²

Nonetheless, successive governments' policies with respect to insolvent firms in the enterprise sector had an utmost impact on the restructuring of SOEs. The politically undesirable implications of exit of an SOE prompted Bulgarian politicians to favor reorganization alternatives to liquidation. Hence, the government, the SOE sector and the state-owned banks engaged in lengthy and repeated programs of enterprise reorganization but not in exiting of unsound firms. Since the ownership rights of the majority of industrial firms were still in the state's hands, the state was ultimately responsible for dealing with the financial distress in its firms, too.

In addition, the lack of effective bankruptcy procedures created the notion among incumbent enterprises that the government was willing to give out bailouts regardless of the financial situation of the SOE. If these firms were unable to service their debt, banks knew that the state would back them up and not hold them liable for the loans they extended to loss-makers (OECD 1997, 90-102). Since there was no

²¹ The possible reasons for insolvency of a typical firm in the transition period were be numerous. They span from a disruption to production, to external shocks, to the collapse of common trade markets (see for example, Hashi 1997, 23-24).

²² See Claessens et al. (2001) for a general discussion of the issue.

effective incentive mechanism to restructure, the arrangement between firms and governments affirmed the usage of soft credits through the banking system.

Practically, no real principal-agent relationship existed between the management of SOEs and their actual owners – the state, ministries, or municipalities in Bulgaria; both were on the same side of the fence. Anecdotal evidence illustrates well this point. In an interview for a Bulgarian economic newspaper, the Minister of Industry publicly shared his view regarding the persistent practice of financial transfers to loss-making SOEs and the accumulation of bad loans in the commercial banks. His point was that as long as both lenders and borrowers were state-owned, there was no reason to worry about the BGL 30 million of bad debt extended to the state-owned industrial complex (*Banker* 1995). In the same interview he adamantly opposed the idea of liquidating inefficient enterprises or selling them to cover their financial obligations to the banks and, ultimately, the state.

Thus, apart from the inability of the government to tackle the inherited non-performing credits problem in the banking system, it encouraged the commercial banks to keep lending to their “old” financially troubled borrowers. In other words, government-directed financing precluded the banks from enforcing their creditors’ rights, as bankruptcy of their borrowers was politically undesirable and avoided.

Restructuring via Privatization. Privatization was another avenue for restructuring of state-owned assets. However, the early years of transition did not form discernible supporters of industry-wide privatization in Bulgaria, given that the capital stock was misallocated and obsolete, the sources of new investments were scarce, and a lack of external financing and expertise was persistent (Frydman and Rapaczynski 1994, 141-142; Frydman et al. 1998).

In addition, unlike in the West, the privatization of industry in Eastern Europe was not expected to bring huge revenues because of the bad economic conditions of the SOEs. The Bulgarian state, similarly to other post-communist countries, publicly took a stance to restructure and stabilize before selling firms. In reality, both the incumbent management and the state organs preferred to keep control of industrial firms for as long as possible. This was profitable for the state bureaucrats and the management of the firms, as the expected value of a state-owned firm from the process of privatization would be less than the personal rents they extracted prior to the sales.

A glaring example was the restructuring of the Pernik's Stomana Joint Stock Company (JSC), a metallurgical plant. Its fate had been one of continuous heavy indebtedness and asset-stripping from the companies' insiders. After being exhausted as an entry-exit source of rents, the basic assets of Stomana JSC were leased out to one of its former suppliers (Eurometal) to which financial obligations were overdue. One wonders about the motives for such a decision, given the incentive of the leaseholder and the company management to continue to drain the firm for its own benefit, as no property rights were transferred to the tenant, only exclusive control. At the end of the lease, Eurometal purchased the depreciated assets of the plant, which were later sold to a third party investor profitably.

Indeed, the sectoral ministries and municipalities did not venture to sell off the industrial firms in the first half of the 1990s on a massive scale. By the beginning of 1996, the Privatization Agency had recorded only 116 transactions (see Table 9). As a whole, in a period of six years, Bulgaria's new leaders had managed to transform a mere 2.5 percent of the state's assets (Claessens 1997).

The inactive enterprise restructuring in fact strengthened the position of the incumbent anti-reform managers. The SOEs remained a source for sectoral ministries' patronage. Under pressure from anti-reform industrial interests, the state kept encouraging the banks to transfer resources for "restructuring" to the firms in order to avoid bankruptcies and unemployment that might disregard the political stance of the government. The intermediation of financial resources was easy to control, as the banks were state-owned. The politicians were unwilling to give up their access to credits, which they allocated according to their political priorities.

Table 9 Number of Privatization Transactions in Bulgaria, 1 Jan. 1993-15 Oct. 1999

Body	1993	1994	1995	1996	Total
Privatization Agency	11	36	69	146	262
Sectoral ministries of which:					
Industry	5	19	23	54	101
Trade & Tourism	32	39	68	124	263
Transport	0	9	24	56	89
Agriculture	8	40	41	37	126
Construction	7	13	35	39	94
Culture	0	0	4	23	27
Health	0	0	0	0	0
Committees ²³	0	9	45	37	91
Sectoral ministries total	52	129	240	370	791
Total	63	165	309	516	1053

Source: Bulgarian Privatization Agency.

4.3. Insiders' Access to Assets and Weak Corporate Governance

Two types of state assets' sales were mainly used as a strategy for restructuring in the first half of the 1990s, even though the pace of the privatization process was slow. First, firms were sold to managers and/or employees through the management-employee buyout (MEBO) procedure. The new owners of such firms

²³ The Committee on Tourism, Committee on Energy, Committee on Post and Telecommunications included.

usually got the firms under very favorable conditions, as the government recognized their lack of available capital.

Second, approximately 3.5 million Bulgarian citizens received financial instruments (vouchers), which allowed them to partake in the mass privatization process.²⁴ The vouchers were intended for investments in some 1040 firms, which were selected by the government to undergo mass privatization. The majority of the companies (684) were small, with capital of less than BGL 100 000, but at least two-thirds of their assets (but no more than 90 percent) were offered in the mass privatization. There was another group of big firms in the pool (some 303 firms), for which the government limited the share of assets to be privatized to 50 percent or less. The actual privatization through vouchers took place much later than intended, mostly in 1996 and 1997.

Several problems related to corporate governance surfaced in the post-privatization firms that were surprisingly common for both types of sales.²⁵ There was no private ownership motivation, as in both cases individuals became owners without paying for their ownership stake.

In addition, although many of the privatized companies adopted a two-tier management structure, the role of their supervisory boards and the boards of directors was superficial. For example, often company insiders ended up with positions on the governance boards that were designed for “outsiders” to ensure effective monitoring

²⁴ Some 3 million people held shares in 81 privatization funds, and half a million people held shares in over 1000 enterprises offered under the mass privatization program (Proharska and Tchipev 2000, 9).

²⁵ As widely recognized in the literature of corporate governance, a principal-agent problem arises in firms with diffused owners if shareholders are unable to exercise control over managers' decisions. In insider-controlled firms (MEBOs or employee-buy-outs), managers under the pressure of employees may pursue output or employment maximization objectives, but not profit.

of managerial performance and to report to shareholders. As Proharska and Tchipev (2000, 10) report, the results of a survey of companies privatized prior to 1996 showed that de facto 44 percent of enterprises had insiders as company members on their boards of directors or supervisory boards. The majority of companies with such governance structures were MEBOs, but the problem existed in joint-stock companies, too.²⁶

Part of the reason lay in the fact that shareholders (individuals or employees) were not “real” investors, i.e. with a source of capital. Often, they were passive and distant participants in the governance of the company. In contrast, the managers in both cases kept control of the enterprises, exploiting the lack of clarity on the side of shareholders regarding corporate governance and control. In fact, the managerial turnover in privatized firms was very low, as only in 3 to 7 percent of senior managers were replaced at the end of the privatization process (Proharska and Tchipev 2000).

Also, in the newly privatized firms the state did not distance itself effectively. To illustrate, in the same study Proharska and Tchipev report that over 50 percent of firms had representatives of the state as members of their boards of directors after their privatization. The involvement of the state in appointing executives in the firms with minority state ownership was even more pronounced and political (Peev 2001, Proharska and Tchipev 2000). The lack of available capital from shareholders and investors, in combination with a high participation of government bodies in the management structures, suggests that privatized companies in Bulgaria had not overcome their reliance on the state. Put differently, former owners (the state) and

²⁶ See Proharska and Tchipev (2000) for a detailed analysis and explanation of the sociological survey they present.

insiders (incumbent managers) retained the ownership and control rights in the firms even after their privatization.

Hence, weak corporate governance structures allowed the group of incumbents to remain in control of the enterprise assets in Bulgaria. Unclearly defined property rights over company assets coupled with ineffective corporate governance encouraged the use of soft resources and allowed for the personal enrichment of insiders and politicians in the state administration. As a whole, MEBOs and mass privatization produced enterprises with inadequate incentive structures that restored the relationships and interactions between the state and firms of the pre-privatization period.

* * *

To sum up, for as long as the tight links between the state apparatus and the firms prevailed, the enterprises' management had no incentives to rely on market mechanisms to obtain financial resources. State officials used the state-owned banks not only for political reasons (such as keeping employment high) but often also for their own betterment. As the examples in section 2.3 show, the banks were overburdened with loans to connected or political parties throughout the 1990s. The delayed industry privatization and the lack of financial discipline facilitated the ability of industrial enterprises to transfer their accumulated losses to the banking system using soft lending techniques. Still, in 1997 about 30 percent of the SOEs were loss-makers (Peev 2001).

The strategy of unconditional and repeated bailouts of successive governments in Bulgaria became extremely burdensome for the commercial banks in 1996, when a third of the total number of banks found themselves insolvent and struggling for liquidity (Zoli 2001, 32). To reiterate, the relationship between the banks, the

incumbent firms and the state was problematic, given the fact that loans were extended to projects with few prospects for repayment.

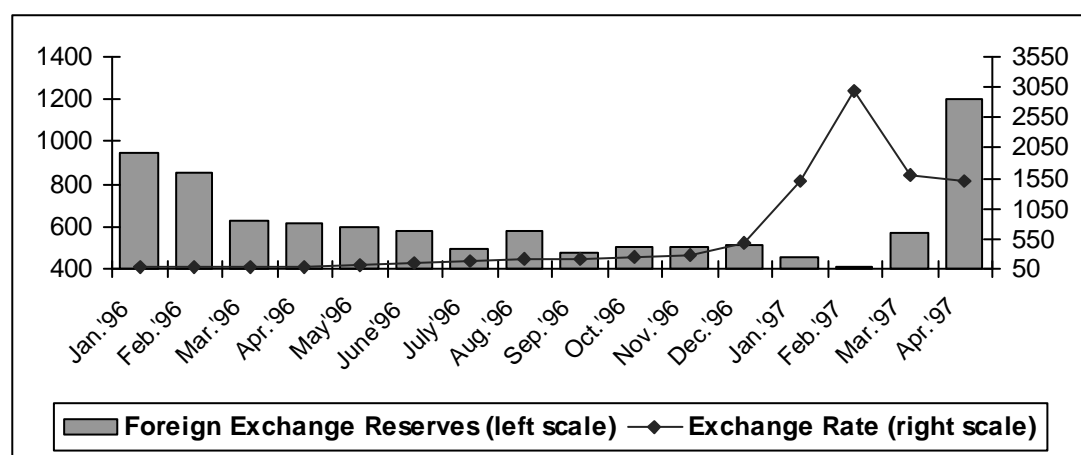
5. Things Turn Around:

They Need to Get Worse before Getting Better

5.1. The Crisis

In 1996, Bulgaria entered into a financial crisis that seemed impossible to resolve for many years to come. As deficits were multiplying and being transferred from firms to banks through bad debts and eventually to the government budget through bailouts or monetization, the lev went into continuous free fall in April 1996 and collapsed in February 1997. The year 1996 showed an almost six-fold depreciation, as the currency dropped from some BGL 70 to the US dollar in January to almost BGL 500 at the year-end. Moreover, at the beginning of 1997 this depreciation accelerated and reached unprecedented levels of about BGL 3000 to the dollar in February 1997, while foreign exchange reserves dried out (see Figure 6).

Figure 6 Monthly Exchange Rate and Foreign Exchange Reserves in Bulgaria



Source: National Statistics Institute and BNB.

Note: Exchange rate of the lev to 1 USD; Reserves in billion USD.

The loss of confidence in both the Bulgarian lev and the commercial banks inflamed the banking crisis of 1996. Several reasons that led to the final financial shakeup of the banking system ought to be pointed out. To start with, no prudential regulation on foreign exchange positions existed, while numerous commercial banks switched to higher-yield lev-denominated assets in early 1995 and continued to hold significant hard currency deposits (Mietkowski 1997).

In 1995, the authorities decreased the basic interest rate from 98 percent in March to 39 percent in August (see Figure 4). This led to a tremendous fall in the return on lev-denominated assets, which consequently reduced the ability of commercial banks to serve their deposits. In addition, the system became totally unable to manage its non-performing credits. The confidence in the banking system was shattered due to the collapse of several financial pyramids in 1995, too.

These facts sent fearsome signals to the public and depositors ran to withdraw and convert their savings into hard currency in order to keep their value. The first two banking establishments to experience a massive withdrawal of deposits were the Crystal Bank and the Private Agricultural and Investment Bank (in April 1996). When the public found its deposits frozen, they began to fear for the safety of their money in other banks and started a run on the system. The withdrawn funds moved to the foreign exchange market, making foreign currencies a scarce commodity.

The withdrawals distressed the commercial banks, depriving them of much-needed liquidity. The central bank responded with an acceleration of the refinancing of commercial banks in an attempt to prevent an overall collapse of the banking system (see Table 7). The central bank made provisions for losses on credit to banks to the amount of 2.8 percent of GDP in 1995 and 6.6 percent in 1996 (see Table 8).

This monetary expansion also exacerbated the situation in the forex market, by essentially making the authorities absorb the additional lev liquidity that they themselves were creating through the even more rapid depletion of reserves (Figure 6). Public expectations destabilized. Furthermore, the decline in foreign currency reserves compromised the credibility of any possible attempts by the state to guarantee hard currency deposits (OECD 1997, 33). As a result, the banking system collapsed in the fall of 1996. Apparently, the financial sector in Bulgaria had to “hit the bottom” before the government attempted to initiate a sound financial reform.²⁷

5.2. Restoring Fiscal Responsibility

The response of the Bulgarian political system to the economic instability in the country in January 1997 led to an unprecedented overthrow of the ruling socialist government. The caretaker government of Stefan Sofyanski, supported by the International Financial Institutions (IFIs), introduced a currency board as a way of achieving financial stabilization. Although it had to give up its discretion over some monetary policy instruments, the new government initiated the board in order to produce rapid and credible anti-inflationary effects and at the same time create legitimacy for the new policy course.²⁸ The key mechanism of operation of the currency board came from the rule that any fluctuation in the chosen monetary aggregate must originate from changes in the reserves, but not from the discretion of

²⁷ Interviews with Bulgarian bank officials conducted in May 2000.

²⁸ The underlying proposition of the board was “the rule for money creation,” i.e. the authority defined a narrow monetary aggregate and backed it fully with the foreign exchange reserves at a chosen fixed exchange rate. In many cases, foreign reserves of 105 to 110 percent are maintained in order to provide a margin of protection for the local currency.

the monetary authority.²⁹ The exchange rate became a nominal anchor of the stabilization policy.

What were the implications of the currency board to the troubled banking system in Bulgaria? First, the currency board came with a couple of important messages. Specifically, it attained the functions typical for a central bank in imposing minimum reserve requirements on commercial banks. Second, within the BNB the Issue Department was formed to manage the excess coverage of the currency board arrangement, and only in limited occasions (for example, severe liquidity problems) extended it to commercial banks (Miller 1999, 19).³⁰ The law stipulated a maximum constraint on the possibility for refinancing of the banking system with the funds at the Issue Department. The third implication of the currency board for the financial sector was the strengthening of discipline on the financial market. The government established its own deposit at the Issue Department. This account was intended for use only on a conditional basis, namely financing budget deficits or negative differences in net financing by the BNB.³¹ Recklessly using the Issue Department's deposits for covering budget deficits, however, might have called into question the government's

²⁹ For more on currency boards, see Hanke et al. 1993, Schuler 1996, Ghosh et al. 1998.

³⁰ In 1997, the currency board arrangement was established with foreign exchange reserves exceeding the monetary liabilities of the BNB, referred to as excess coverage. For example, Jeffrey Miller reports that the deposits at the Banking Department at the Issue Department within the BNB amounted to 140 percent of reserves in June 1999 (Miller 1999, 19).

³¹ Funds are generated through channels from the IFIs to Bulgaria and privatization revenues. As of July 2000, for example, the value of government deposits at the Issue Department of the BNB reached BGL 2.9 billion, about 45 percent of the assets of the Issue Department (Reported in *Capital* 2000, no. 32).

commitment to cease soft financing and once again create conditions for moral hazard.

With these “dangers” in mind, the success of stabilizing the economy depended on the commitment of Bulgarian politicians to respect the currency board arrangement and enforce financial discipline for all participants on the market, be they private entrepreneurs or state firms. Terminating soft lending was key to achieving the stabilization goals.

The early results of the stabilization program were positive. Both inflation and interest rate levels fell to single-digit figures (see Table 10). Output recovered and the exchange rate arrangement was respected, too. In addition, the interest rate spread drastically decreased.³² Banks improved their capital-adequacy ratio, which went up from about 11 percent in 1996 to 26.86 percent at the end of 1997, going on to reach levels of 41.8 percent two years later.

Table 10 Selected Economic and Banking Indicators in Bulgaria, 1995-1999

Economic Indicators	1995	1996	1997	1998	1999
GDP Growth	2.9	-10.1	-7.0	3.5	2.4
CPI, cumulative *	33.8	310.4	578.6	1.0	6.2
Nominal exchange rate BGL/USD*	67.0	178.0	1674.0	1760.0	1836.0
Basic interest rate, percent *	38.59	435.03	6.95	5.17	4.54
Short-term credits	51.43	481.11	13.85	13.51	12.41
Time deposits	25.29	211.87	3.04	3.30	3.25
Marginal spread	23.03	48.8	37.13	10.31	9.57
Total assets, percent of GDP	113.6	207.6	43.3	34.8	36.4
Total loans, percent of GDP	47.8	115.3	22.2	20.7	22.5
Private sector loans, percent of GDP	21.6	37.0	13.1	12.8	7.2

Source: BNB Statistics, Business Central Europe, WDI, and WB (1999).

Note: * end of year

³² The decrease was significant – from 86.33 percent in December 1996 to 6.07 percent in March 2000 (World Bank 1999, 30).

The side-effect of strengthening the regulatory environment after the crisis was the lower level of deposits and loans in the banks. For example, it took almost two years after the crisis to restore the level of deposits in the system to their pre-crisis levels. Moreover, the behavior of Bulgarian commercial banks remained quite passive in the tight financial conditions after the crash of the system.³³ Although liquidity in the banking sector has been quite high, the ratio of total loans to GDP in 1998 was at its lowest levels at 20.7 percent, and, in addition, loans to the private sector had severely declined (Table 10). Clearly, the loan-making rules have been changed and tightened.

5.3. Establishing Formal Rules

The faulty restructuring and recapitalization of commercial banks proved to be a method that only increased the instability of the economy. It also provided the wrong incentives for banks in lending and risk-management, which translated in unproductive investments toward non-reforming borrowers. In addition, the BNB had a significant credibility problem at the time, in the sense that its regulations could not be effectively enforced. For example, the capital requirements were often set too high and thereby impossible for banks to comply with. On the whole, lax regulation and supervision enabled banks to operate without taking too much compliance with the written rules in the system. Changes in the regulatory basis were needed urgently.

After the crisis, a new law on governing the BNB was adopted in June 1997. The law significantly strengthened supervision and regulation in the financial sector.

³³ See Avramov (1999), Dobrev (1999), Nenovsky and Hristov (1997), Yotzov et al. (1998) for extensive discussions on the development of the financial and monetary system after the introduction of the currency board in Bulgaria.

Open foreign currency position rules became one such area.³⁴ The Banking Law of 1997 also introduced various regulatory requirements, such as capital adequacy requirements, loan concentration to individual borrowers, valuation of collateral rules, different accounting standards, and asset classification and provisioning guidance, among others. Table 11 summarizes the main prudential standards that came into force after the crisis.

Table 11 Main Prudential Standards for Bulgaria

Minimum capital	DEM 10 million
Capital adequacy (risk-weighted)	12 percent
Tier I capital or risk-adjusted assets	6 percent
Single party, large exposure (more than 10 percent of bank capital)	25 percent of own funds
Large exposure aggregate	8 times bank's own capital
Aggregate exposure to a single party	10 percent of capital
Aggregate equity in non-financial companies	75 percent of capital
Open forex position	30 percent of capital per currency; 60 percent of capital for aggregate
Minimum required reserves	8 percent

Source: Ulgenerk and Zlaoui (2000, 16).

The enforcement of the new banking regulations and the significantly strengthened supervision improved the health of the banking system in Bulgaria. The new approach that the government took, established the rules of the game in the financial sector and institutions to enforce financial contracts, safeguard property rights, and allow the policymakers to minimize their ability for resource manipulation. In addition, it restrained Bulgarian banks and politicians from connected lending.

³⁴ There was a gap in the regulatory framework that allowed banks to hold significant hard currency deposits prior to the crisis. This became a problem for the Bulgarian banking system, as the relative return on lev-denominated assets decreased sharply, due to indexation of the basic rate. As a result, many banks could not service these deposits anymore and collapsed in 1997.

The resolution of the financial crisis in Bulgaria extended a powerful message to the market participants. The government committed itself to fiscal discipline and ceasing to pour funds into politically driven lending. Sheltering problem borrowers and insider financing became difficult. The restoration of public confidence as well as the new institutional environment provided for the start of the reforms in the financial sector in the country, at last.

6. The Longed-For Changes

6.1. The Real Sector

The medium-term strategy for the economic development undertaken in 1997 by Ivan Kostov's government relied on large-scale structural changes in the real sector. The goal was to maintain macroeconomic stability and create sustainable non-inflationary growth. How did these policy goals influence the development of the financial industry in Bulgaria, however? Two main and related implications triggered the weakening of the anti-reform groups and spurred the financial sector reforms in the country. First, this was the commitment of the government to pursue the politics of active restructuring in the real economy. And second, the regulatory changes that started with the resolution of the crisis allowed for the breakdown of informal exchanges between state bureaucrats and anti-reform groups.

Active Industrial Restructuring. On the regulatory front, more than 19 amendments to the Privatization Law of 1992 were made before coming up with the current organizational structure of the process. The Law delegated responsibility in

the hands of a number of privatization bodies.³⁵ But the privatization and restructuring of the state-owned loss-makers were in the center of the reforms undertaken only after the financial crises. The active restructuring policies, and specifically the new Privatization Law, included not only strengthening the transparency of the privatization process by eliminating direct negotiations with potential buyers³⁶ but also the breakdown of natural monopolies such as energy, the railways, telecommunication, and others as well as the isolation of the worst loss-makers among the state firms. The loss-makers were prohibited from obtaining additional financing, but at the same time were sheltered from their creditors' demands for a limited period.

Two lists (A and B) that presented the enterprises in isolation were created at the end of 1996. The isolation program aimed to include large state-owned loss-makers with the objective of forcing managers of these firms to cut operational deficits to the point where the firms in question would generate positive cash flows. Also, losses of the firms under the isolation program were not to be covered by

³⁵ For example, Article 3 of the Privatization Law defined the following agents as responsible for the sale of state-owned and municipal enterprises: The Privatization Agency, for enterprises with a value of long-term assets as of 31 December 1997 of more than BGN 1 million (amended in *State Gazette* 1994, no.51; 1998, no. 39; and 1999, no. 12). The Branch Ministries, for enterprises with a value of long-term assets of less than BGN 1 million (amended *State Gazette* 1994, no. 51; 1997, no. 89; 1998, no. 39; 1999, no. 12). The Municipal Councils, for municipally owned enterprises or shares owned by municipalities in state companies (amended *State Gazette* 1996, no. 85). The Center for Mass Privatization, for enterprises included in the mass privatization scheme (*State Gazette* 1994, no. 51). Other, these could be agents such as consulting firms, delegated to sell enterprises on a success fee basis.

³⁶ The current *Privatization Law* allows privatization through public tenders, public auctions, and public offerings of shares.

building arrears to creditors or support from the national budget. Transparency and financial discipline were expected to improve, too.

List A included 35 state companies that were found to be unsuitable for liquidation, but their restructuring was urgent in order to restore their viability. Amongst the companies were some of the big monopolies like the National Energy Company (NEC), Bulgarian railways, and the heating and coal mining companies.

The fate of the 41 companies on list B was either liquidation or privatization. By the end of June 1999, the government had sold or liquidated all but one of the firms on list B.³⁷ Among the privatized state enterprises were Kremikovtsi steelworks, the castings firm Radomir Lekoko (part of the Plant for Heavy Metal Building), the Cherven-Bryag armored personnel carrier maker Beta, the defense works Optoelectron, DZU, Agropolichim Devnya, Vidachim, the Chavdar bus-manufacturer, and the ore-mining companies in the Gorubso complex in Madan, Rudozem and Zlatograd.³⁸ The impact of the isolation program was positive as it hardened the budget constraints of the firms and signaled to them that failures to pursue active restructuring would be penalized by exiting the market.

The institutional aspect of the reforms of 1997 had an important role in weakening the demands of anti-reform industrial interests. After the amendments in the Privatization Law of 1997, the Privatization Agency emerged as the main privatization authority in the country. The power of the branch ministries and

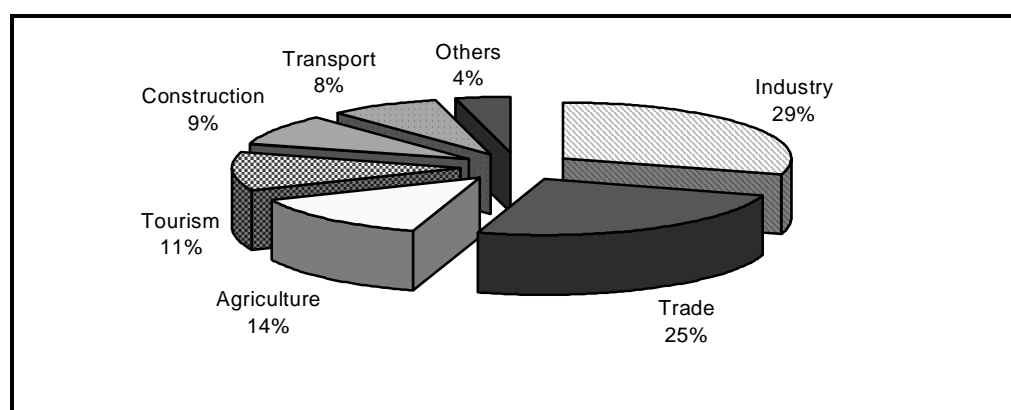
³⁷ The military plan Arsenal in Kazanlak was transferred to list A. Later on, Arsenal was privatized via the management buy-out method for some USD 2.1 million.

³⁸ The government has often been criticized for rushing some of the privatization deals in order to meet the 30 June 1999 deadline by the IFIs and complete the deals for the firms on list B. The privatization of the national carrier Balkan proved a complete failure; the state had to renationalized the airline shortly after its bankruptcy.

municipalities had considerably decreased. At the same time, the subsequent restructuring of troubled SOEs has been more transparent than prior to 1997 and is under the close monitoring of the government, which managed to break the bond between sectoral ministries and enterprise managers.

Although many companies were privatized through MEBOs and through mass privatization, the government recognized the importance of outside investors (both foreign and domestic) and moved toward selling state assets to core investors. In addition, the regulatory framework to strengthen corporate governance structures in Bulgaria has been improving. For example, transparency, outside financial audits, disclosure of company information, and protection of minority shareholders' rights have gradually become concepts with practical meaning in Bulgaria.

Figure 7 Distribution of Concluded Transactions by Sectors in Bulgaria, March 2000



Source: Privatization Agency.

As a result, 78 percent of state-owned assets selected for privatization were sold out by the end of 2000. A total of 1,224 deals were completed in 1999, of which 641 were for entire enterprises (not parts thereof). The revenues from privatization were USD 366.8 million, as the new owners also repaid old debts of USD 509

million.³⁹ An additional 473 deals were made in 2000. Figure 7 summarizes the distribution of privatization transactions by industrial sector up to March 2000.

The ongoing privatization and restructuring triggered a boost in the development of the private sector, including the creation of new firms. For example the share of private companies in the total number of firms reached 72 percent in 1999, having grown by 7.8 percent over the previous year (Eteba 2001). The private sector produced 70 percent of output in 1999 and continued to grow in the subsequent years (EBRD 2001). A similar trend of growth in the private sector employment relative to total employment has been observed since 1998.⁴⁰

Also, the development of SMEs and especially the lowering of the barriers to entry for new businesses have become areas of active changes. For example, the number of licensing requirements as well as the number of steps in registering a business have both decreased significantly. As the World Bank reports, it currently takes 30 days and 10 procedures to open a firm in Bulgaria.⁴¹

6.2. Banking Sector Privatization

As a whole, pursuing active restructuring and privatization, lowering barriers to entry and exit as well as abolishing the informal structures that supported the incumbent firms have made it difficult for anti-reform firms to resurrect their reliance

³⁹ About 40 percent of the privatization deals in 1999 were signed with MEBO companies, which enjoy a 10 percent down payment and ten years delayed payment for the negotiated price. This preferential treatment was partly lifted in 2000, when changes in the privatization legislation introduced the method of discounted cash flows for delayed payments.

⁴⁰ The share of those employed in the private sector in 2000 was 71 percent; the share of industry fell to 24 percent (World Development Indicators 2001).

⁴¹ Doing Business Database at <http://rru.worldbank.org/DoingBusiness>

on soft financing since the crisis in 1997. These changes broke down the dominance of anti-reform industrial lobbies and created conditions conducive to the hardening of budget constraints and the long-awaited development of the financial sector in Bulgaria. Banking privatization started in 1997. The process removed the state from its dominant ownership position of a “supplier” of credit.

The targeted investors for the banking assets had to commit to improve the performance of the banks they bought through technological modernization and flow of capital. The BCC provided assistance and evaluation of the bidders, so as to choose the best buyers for the six state-owned banks offered for privatization in 1997. The record shows that by the end of 2000, five Bulgarian banks were privatized: United Bulgarian Bank, Bulgarian Post Bank, Express Bank, Bulbank and Hebros Bank. Biochim was privatized in the summer of 2002, and the SSB was sold in the spring of 2003.

The privatized banks became the leading financial institutions in the country with a clientele mainly of corporate private businesses, but also state enterprises and individual clients. The privatized banks have been increasingly engaged in improving the quality of their loan-portfolios by investing in screening and monitoring of borrowers. As a result, the irregular credits constituted a little less than 8 percent of total loans in 2001 (EBRD 2002).

* * *

After the resolution of the financial crisis in 1997, the changes in the market structure brought about through privatization, the restructuring and new entries, as well as the strengthening of the formal channels and rules for loan-making, the government was able to distance itself from the demands of anti-reform industrial managers for soft credits and enforce previously unpopular financial sector reforms.

The banking sector in Bulgaria emerged as well-supervised, with significantly reduced risk-aversion and increased profitability after the crisis. As a result, the intermediation of financial resources improved, as resources reached competitive projects that were not politically sheltered.

7. Lessons from the Bulgarian Experience

To understand the delayed financial development in Bulgaria, this chapter looked at the characteristics of the political-economic environment, which made anti-reform industrial groups' quest for preferential funds successful for the better part of the 1990s. Four characteristics helped us understand the mechanism through which the anti-reform interest secured its position: first, the process of inactive restructuring; second, the insiders' access to the institutions of privatization; third, the restricted entry of new players; and fourth, the informal relationship between firms, banks, and the state.

Several lessons might be highlighted from the Bulgarian story. The banking experience attests that, first, in a world of informal arrangements and distorted markets economically important players find it advantageous to maximize rents, extracted through political patronage. Second, the financial crash of 1996 brought about a positive effect for the development of the Bulgarian banking sector, as it created conditions for the mobilization of potential beneficiaries of financial reforms and the ousting anti-reform insiders. Third, the absence of a functioning financial sector jeopardizes the success of reform policies as well as the entry of new foreign and domestic firms, which need access to capital (both debt and equity) from banks and/or non-bank financial institutions. A well-functioning financial sector is critical

for the establishment of a vibrant private sector and a keystone of broad-based economic growth and job creation.

Bulgaria made a first difficult step toward modernizing its financial industry at the end of the 1990s. Yet, a myriad of challenges are still to come. Nonetheless, well-defined property rights, prudent regulation and supervision, and depolitization of resource allocation lay the foundations of a well-functioning financial sector.

CHAPTER V

POLAND: BANK-LED ENTERPRISE RESTRUCTURING

1. Introduction

This chapter focuses on the Polish experience with banking restructuring in the 1990s. It expands on the discussion in the previous country case, where state capture and massive reform delays hindered the intermediation of financial resources. It aims to understand the interaction between the domestic forces of change that influenced the shapeup of the institutional environment of the financial sector for hardening budget constraints in Poland. The banking sector restructuring is explained as a function of the strengths of anti-reform and pro-change groups. The chapter looks at how active restructuring of the real economy, market entry, insiders' assets to privatization, and the presence of institutions that undermined informal exchanges through the banking system affected the nurturing of groups with preferences for financial development.

The next part reviews the changes in the banking organization and structure, as it evolved from the communist monobank. It singles out the problem of bad debts and the policy alternatives to solving it. Section 3 discusses the implementation and the challenges of the government approach to banking restructuring. It emphasizes the ineffectiveness of the government's approach in bringing about the active transformation of indebted enterprises and in creating high-quality borrowers. The next section reveals the importance of the growing private sector for counterbalancing anti-reform groups. Section 4 is about the dynamics of new entry. Section 5 reviews the privatization process in Poland and also presents a link between the termination of soft credits and the emerging type of ownership structures on the enterprise level.

Section 6 discusses the institutionalization of formal exchanges between banks and borrowers through changes in regulation, consolidation, and bank ownership. The chapter concludes in section 7.

2. The Banking Reform Context

2.1. The Emerging Banking Sector

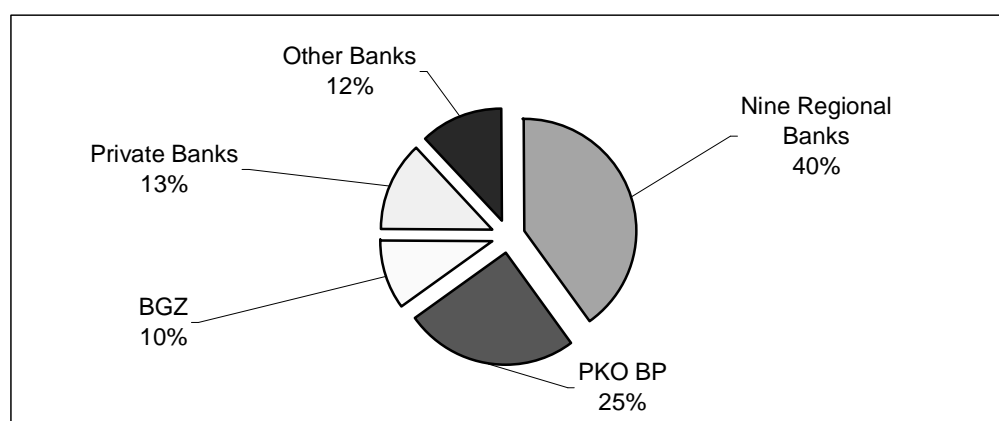
Undertaking neoliberal postulates to establish stable financial and economic fundamentals, Lezsek Balcerowicz and his team pursued general economic policies that aimed to remove the burden of structural distortions inherited from the socialist era. Their policies were designed to restore the fiscal balance, tame inflation, liberalize prices and trade, and start privatization, while “encouraging a huge surge in private enterprise” (EIU 2001; Bonin 1995). These initiatives, however, were not enough to trigger early market reforms in the banking sector. At the beginning of the decade, the Polish financial system still had a limited and mostly passive function, resembling the allocative arrangement of centrally planned economies. The transfer of financial resources among sectors was performed directly by the state through the price system, taxes, and subsidies.⁴²

Poland undertook a regional approach to the separation of commercial bank functions from those of the central bank, creating a two-tier system modeled on the banking system of Germany. The government approached the transformation of the financial sector by spreading the commercial functions among 14 state-owned banks and delegating control over regional finance to nine of these intermediaries (Meyendorff and Snyder 1997, 9). In 1991, the nine banks were transformed into joint-stock companies under the ownership of the treasury and given exclusively

⁴² For a thorough discussion on banking and finance in the socialist system, Kornai (1992, Chap. 8).

regional functions. The remaining five state banks had specialized functions: two in trade credit (PKO SA and Bank Handlowy), one in export (Razwoju Eksportni), one in housing (the savings bank PKO BP), and the agricultural bank (BGZ). The fourteen banks (the five specialized and the nine regional) were the main financial intermediaries in Poland at the time (see Figure 8). The Act on the National Bank of Poland (NBP) and the Act of Banking institutionalized these changes. Although liberalization of entry led to the emergence of some 80 banks in the country in the early 1990s, competition was negligible. Banking operations were concentrated primarily in several specialized or regional state-owned banks (see Figure 8).

Figure 8 Breakdown of Banking Sector Deposits in Poland, 1991



Source: Selected data from Eastwood (1992).

In addition to the spinoffs from the monobank, small cooperative banks were scattered throughout the country at the beginning of the 1990s. The scope of their operations was small, providing about 7 percent of the loans in the banking system, accounting for some 6.6 percent of the total banking assets, and attracting 7.6 percent of the non-financial sector deposits in 1993 (NBP 2000). Unable to resist the increasing competition on the financial markets, most of these banks were brought under the reign of the state's agricultural bank (BGZ) as the bank responded to its

government-directed role to coordinate the reform of the sprawling cooperative banks in Poland.

In addition to the regional banks and the cooperative banks, private commercial banks started to emerge in Poland. Initially, their role and operations were quite limited, but there were a comparatively large number of them (see Table 12). They attracted less than 15 percent of the deposits in the banking system in Poland in 1991 and constituted only about 13 percent of the total assets in the industry two years later (1993).⁴³

Table 12 Banks in Poland, 1993-1999

Banks	1993	1994	1995	1996	1997	1998	1999	2000
Commercial banks, of which:	87	82	81	81	83	83	77	75
Banks with majority public-sector interest *	29	29	27	24	15	13	7	7
Banks with majority private-sector interest :	58	53	54	57	68	70	70	68
- with majority Polish equity	48	42	36	32	39	39	31	20
- with majority foreign equity **	10	11	18	25	29	31	39	48
Cooperative banks	1 653	1 612	1 510	1 394	1 295	1 189	781	-
Total banks	1 740	1 694	1 591	1 475	1 378	1 272	858	-

Source: Adapted from NBP (2000) and EBRD (2001).

Notes: * Banks owned directly or indirectly by the treasury, other state institutions, or the NBP and that exercise at least [50%+1] votes at shareholders' general meetings.

** Branches of foreign banks and joint-stock banks where foreign parties hold equity, entitling them to exercise at least [50%+1] votes at shareholders' general meetings.

Given the low level of private stock capital after the fall of the regime, private banks found it difficult to emerge. Nonetheless, the economic actors have found ways to attract capital and launch new banks. Establishing private banks was particularly attractive for industrial lobbies, as it provided an opportunity to access financial resources by controlling financial and investment decisions at these banks. Since the majority of the enterprises were state-owned, the state had to facilitate the setup of

⁴³ Data from the NBP.

such commercial banks. In an environment of limited private capital and lax rules, the shortest road to establishing a commercial bank at the time was through engaging with the political leadership. For example, at the time of its registration in 1989, 98 percent of the capital of Bank Inicjatyw Gospodarczych (BIG) was provided by several heavily indebted state-owned enterprises such as the Polish Post Office and the state insurer PZU with the endorsement of the state. The remaining share of 2 percent was held by private persons, among which were some of the management of the same enterprises that provided capital to the bank but also people from the National Bank of Poland (NBP) and even politicians such as the former financial minister Wilczek.⁴⁴

Apparently, the Polish banking sector was evolving around the introduced changes of demonopolization and liberalization but also the exploitation of informal links with the government.

2.2. Banking Restructuring

Alternatives. The big challenge in the restructuring of Polish banks was the bad loans problem in the banking sector. Similarly to the experience in the other East European countries, the bad loans problem in Poland consisted of a stock component – old non-performing debt inherited from the socialist monobank, and a flow component – new lending to low-quality borrowers with poor prospects for timely repayment. The non-performing-loans problem became acute at the end of 1992, when the value of bad debts in the banking system reached PLZ 40 trillion (USD 2.5

⁴⁴ Although it had this obvious political connection, the BIG later on tried to free itself from the alleged political favoritism. The bank significantly decreased the share of some of its financially troubled founders (SOEs such as Universal, the Polish Post Office, and the insurance company PZU). At the same time, the bank issued several emissions of both new and privileged shares to increase its capital and private participation but minimize the share of the troubled state-owned shareholders.

billion) (Pawlowicz 1995). In 1993 and 1994, the share of the non-performing loans was over a third of the total loans in the system (EBRD 2002). Certainly, undercapitalized banks could not provide sufficient intermediation of financial resources. At the same time, their recapitalization was costly, and the government was reluctant to absorb the costs.

To solve the problem, the Polish policymakers considered several options: the closure or liquidation of unsound banks, regulatory forbearance, and/or bank restructuring. Montes-Negret and Papi (1997) point to the unattractiveness of bank closures and the risk that they bring to the financial system, as well as the short-term fixes of the regulatory forbearance. The only option to solving the non-performing loans problem was through bank restructuring. The success of any bank-restructuring program, however, depends on improving the quality of bank borrowers, i.e. on the restructuring of the enterprise sector. The main constraint to the program was that the beneficiaries of the bad debt that was subject to restructuring constituted a considerable proportion of the Polish SOEs hit by the sharp recession. Radical approaches to solving the problem on a bank level implied massive exit and closure of illiquid enterprises. This alternative was not attractive for the government, however, as it would have entailed massive layoffs. As observers commented in this early transition period, many large enterprises resorted to their political weight and “resisted change, attempting to win government assistance by calling upon political contacts” (Pawlowicz 1995).

In such an environment of pressure from the incumbent firms, the government considered two approaches to solving the bad debt problem. First, if the banks were recapitalized and excluded from the restructuring of SOEs, the burden of the firms’ bad debt would be placed solely on the state budget. The state, struggling with budget

deficits at the time, did not want to acquire this additional burden. The second option was to engage the creditors, i.e. the commercial banks, in the restructuring of SOEs through ownership stakes in exchange for state-owned defaulted loans. This way, it would be in the banks' interest to help the enterprises revitalize and restore their production levels through using debt as a control device. The industrial management in Poland favored such an arrangement, as it provided a guarantee for financial resources through the direct involvement of commercial banks in the restructuring of struggling industrial enterprises.

However, the costs of implementing the latter option were high. Had the banks engaged in cross-ownership with the troubled SOEs, their financial sustainability would have been endangered immediately, which might consequently have brought large-scale financial distress to the system. The reasons were simple: the incentive structure for efficient credit allocation and clearly defined property rights would be missing in the cross-ownership scenario, as both banks and firms were owned by the state. In addition, such arrangements would *per se* delay the restructuring process of both banks and firms.

Another alternative to the restructuring of the Polish financial system was the immediate sale of the state-owned banks ("as is," i.e. with the overhanging bad debt on their balance sheets). However, this approach was not acceptable to the industrial elite in Poland, as the new bank owners would probably seek their creditors' rights with regard to the indebted SOEs. At the same time, this approach did not have political clout either, as it would have been contrary to a central plank of the government's restructuring program, which was to attain control over financial intermediaries in order to facilitate reorganization and recovery in the industry.

The Government's Approach. A middle road was hard to find. However, in March 1993, a Law on the Financial Restructuring of Enterprises and Banks was passed with the ambitious goal of quickly combating the economic recession in Poland. The restructuring of firms and banks was meant to be complementary. The law pertained to the restructuring of the nine commercial banks that emerged from the Polish monobank and the revitalizing of a group of financially troubled SOEs through workout procedures. To launch the program, the government of Waldemar Pawlak allocated some USD 650 million to the undercapitalized banks as early as September 1993.⁴⁵

Another feature of the program was that the government opted for marginalization of the debt of state-owned borrowers by fully engaging the commercial banks in their restructuring process (Bear and Gray 1996, 67-108). Each bank had to find a workable solution for every troubled borrower. By law, the banks had three options in dealing with their non-performing credits: (i) using the court system and filing procedure for liquidation; (ii) initiating bankruptcy; or (iii) coming to an informal workout agreement with the management of the SOEs. Each of the regional banks in Poland opened a special department to deal with the problematic loans and tried to recover as much as possible from its borrowers.

However, the lack of working exit-rules made it difficult to initiate liquidation or bankruptcy of debtors (options i. and ii. above), as Poland relied on cumbersome court conciliation procedures regulated by the 1934 Bankruptcy and Arrangements Act (Johnson 1999). This fact created a potential danger of aggravating a moral hazard situation by raising expectations for possible future financial assistance on the

⁴⁵ The Pawlak government was a coalition government between the Democratic Left Alliance and the Polish Peasant Party, which lasted from September 1993 to January 1995.

side of both commercial banks and SOEs and ultimately undermining the restructuring program.

Regardless of the risks of the government losing credibility in the restructuring process, the program was launched. Workout schemes were encouraged, aiming to restore the creditworthiness of borrowers and to extend a positive impact over the real sector of the economy.

The policymakers favored the workout schemes for several reasons, as outlined by Montes-Negret and Papi (1997). First, the bank-led restructuring was the better alternative to closure of illiquid SOEs, as the politicians feared large declines in employment rates. Second, trading of the assets of a bankrupt SOE might have ended up generating only negligible revenues to the creditors/banks in the process of liquidation and only partially repaying past obligations. Third and related, the court and legal system in Poland were inefficient at the time. The unclear procedures for undertaking liquidation actions against SOEs made it an unpopular and time-consuming tool for restructuring (Bear and Gray 1996). At the end, the government had shifted the responsibility of resolving non-performing loans to the banks without ensuring that the institutional framework in the country supported the mechanisms given in the Law.

3. Bank-Led Enterprise Restructuring

3.1. The Program's Implementation and Inactive Restructuring of SOEs

The Polish government launched the bank-led enterprise-restructuring program in 1993. The program gave the Polish banks the liberty to come up with a plan of how to deal with their non-performing loans, extended prior to 1991. The Law on Financial Restructuring of Enterprises and Banks of 1993 intended that

enterprises' arrears would be resolved through arrangements such as debt-for-equity or debt-for-debt swaps, sale of bank debt on the secondary market, or debt transfers to the government, other enterprises, or banks. As noted above, the state encouraged Polish banks to use debt-for-equity swaps, turning them from creditors into owners of their borrowers, but allowed them to decide on the viability of each case. In fact, the program envisioned debt-for-equity swaps as the main technique through which privatization of SOEs would be promoted.

As a result, the debt-for-equity swaps were favored in over 21 percent of the bank assets included in the restructuring program in 1994. However, the commercial banks became increasingly reluctant to engage in a cross-ownership relationship with their borrowers in the two subsequent years and resorted to this method of debt restructuring in only 4 percent of the cases (see Table 13). The reasons for the reluctance of the banks to take equity stakes in the SOEs ranged from their inability to manage large equity portfolios, to the poor investment conditions of their borrowers (Dittus and Prowse 1995). In addition, the time horizon for these swaps to translate into effective private ownership was not foreseeable then (Gray and Holle 1996).

Instead, informal bank-borrower workouts became the most popular technique for resolving the bad debt problem in Poland (see Table 13). These agreements were used to reschedule debt to commercial banks for up to three years (for example, through deferring payment dates, cushioning the debt repayment, or writing off part of the debt) and to work out repayment schemes.⁴⁶ For example, in the nine regional banks, which were holders of about 24 percent of the restructured credits, the bank-led conciliation agreements were implemented in more than half of the problematic cases, mainly because of the efforts of their specialized workout departments

⁴⁶ For an extensive discussion of bank-led conciliation agreements see Gray and Holle (1996).

(Montes-Negret and Papi 1997, 15).⁴⁷ The share of consolidation agreements and other informal bank-borrower workouts for the overall banking sector was between 43 and 52 percent of total assets for restructuring in the period 1994-1996 (see Table 13).

Table 13 Bank Assets Restructuring in Poland, 1994-1996

Bank Assets to be Restructured	1994	1995	1996
Arrangement proceedings, % of total	7.61	29.76	22.20
Court composition, % of total	1.28	4.18	4.08
Debt-for-equity swaps, % of total	21.65	3.92	4.39
Public sale of assets, % of total	32.80	12.10	7.82
Insolvency or liquidation, % of total	1.03	27.64	40.39
Other forms of restructuring, % of total	35.63	22.41	21.13
Total, in mln PLZ	3576.4	4027.5	4083.3

Source: NBP (2001, 59).

3.2. Restructuring Program Caveats

Inevitably, the restructuring program had caveats. First, it was directed only toward the stock component of non-performing loans generated prior to the end of 1991. At the same time, the enterprise sector continued to experience problems due to price liberalization, the sharp decrease in subsidies, output contraction, and other factors. Through the conciliation agreements, state-owned banks had an incentive to renegotiate non-performing loans and provide new funds to the very same SOEs. As a result, the Polish banks were left to accumulate new flows of loans of a questionable quality to their old enterprise borrowers. At the same time, the SOEs had no real incentives to restructure. Instead, the enterprises anticipated a new wave of restructuring arrangements for their problematic loans.

⁴⁷ Specialized banks held 75 percent of the restructured credits, but a breakdown of the form of restructuring undertaken by them is not available (Montes-Negret and Papi 1997, 15).

Moreover, the government singled out enterprise borrowers to whom additional restructuring funds were made available. Smaller restructuring initiatives were launched to foster the reform efforts in Poland, too. For example, financial support to various groups of state enterprises was extended through the Stabilization-Restructuring-Privatization program, which was designed for 30 big state firms; the Regional Asset Funds program for small SOEs in financial difficulties; the privatization initiatives support program for small and medium-sized companies at the regional level (Wspierania Inicjatyw Prywatyzacyjnych); the initiative for municipal enterprise privatization (Wspierania Prywatyzacji Przedsiębiorstw Komunalnych), among others.

The conciliation agreements as well as the non-bank-led restructuring programs, provided opportunities for restoring “old” networks between political leaders and SOEs’ incumbents through the banks. Such practices hindered the financing of better projects and the overall economic growth of the country. Regardless of the principles of the restructuring programs, the web of forced credit relations continued to corrupt the balance sheets of the banks, as incumbent state borrowers engaged in new borrowing without pursuing active restructuring.

In addition, even though a large proportion of strategic enterprises were not included in the bank-led restructuring program, only loans classified as lost and doubtful on the banks’ balance sheets were subject to resolution. Moreover, the program was extended only to enterprises with at least 50 percent state ownership prior to 1991. The limited scope of the program did not allow the approach to tackle the bad debt problem in the entire banking system or to create incentives for terminating politically motivated soft credits.

Apart from the questionable credibility of the government approach to bank restructuring, the banks in Poland lacked the experience and skills in evaluating projects and managing loans, which resulted in an additional future deterioration of their portfolio situation. Realizing the inability of the banks to effectively screen projects and enforce financial discipline, borrowers relied on informal ties in competing for funds.

Deficient crediting needed to be neutralized through the techniques of prudential, Western-style regulation, so that intermediaries could take politically independent decisions. Baer and Gray (1996) point to the lost opportunity of strengthening the regulatory framework of the financial sector through improving the bankruptcy law in the early 1990s. The laws on collateral and secured lending and liquidation procedures of non-viable enterprises, as well as other related legislation, should have been initiated with the launch of the program. These changes, however, did not materialize at the time of the restructuring program but only came about in 1998.⁴⁸

4. The Power of Informal Ties

4.1. The Fate of the Nine Regional Banks

Inactive enterprise restructuring in the first half of the 1990s prevented the commercial banks from cleaning their loan portfolios and restructuring their operations. It also placed the beneficiaries of soft credits in an important political position of protectionism with regard to the commercial banks by resisting their restructuring and privatization. Although the Polish government had envisioned the divestiture of commercial banks in principle and already in 1992 had formed a list of

⁴⁸ See footnote 60 below.

banks for sale, restructuring through privatization was set back. The foreign strategic participation in the banks was desirable for capital and investment contributions, but potentially big stakes of foreign ownership in Polish banks were yet to be politically justified.⁴⁹

Examples illustrate well this point. The first two banks to go through the privatization program were Wielkopolski Bank Kredytowy (WBK) and Bank Slaski in Katowice (BSK) in 1993. The government engaged in the cleanup of their loan portfolio from the non-performing loans. The WBK approached its undercapitalization problem by increasing its capital. In March 1993, a new issue of shares, entirely backed by government securities, attempted to make up for the insufficient funds. However, this influx of capital did not solve the loan problem. Although a share of the WBK was bought by the EBRD shortly after the former's recapitalization, observers commented that the institutional investor took part in the bank in order to send a signal to the international financial community that the Polish market was opening (Anderson and Kegels, 1998).

The privatization experience of BSK was similarly insightful. A proportion of the problematic loans were settled through agreements between the government and BSK's state borrowers. Later this debt was completely written off (Abarbanell and

⁴⁹ The goals of the bank privatization program were to obtain a good price for the nine regional banks, while at the same time controlling the level of foreign strategic participation in them. The initial scheme under which the government had envisioned the privatization of commercial banks was according to the model that the state would hold 30 percent, domestic investors would have around 40 to 50 percent, bank employees would have around 10 percent, and the remaining shares of 10 to 20 percent were to be sold to foreign strategic investors (Anderson and Kegels 1998).

Bonin 1997, 39).⁵⁰ At first, the government of Hanna Suchocka announced a tender for the bigger part of a two-tier IPO of BSK's shares, but shortly afterwards (October 1993) the new government of Pawlak cancelled it for political reasons. The situation was aggravated by populist sentiments against foreign and outsider participation in the privatization of Polish banks by the coalition partner in the 1993 government, the Peasant Party. Maneuvering the price to accommodate the desires of domestic investors while at the same time attracting a strategic foreign investor, the government agencies acted in a dubious manner. Transparency of the process was questionable, which signaled to the market that the political leadership was willing to accommodate the protectionist aspirations of domestic groups.

The SOEs' incumbent managers, primarily supported by leaders of the Peasant Party in the government, gained popularity and aggravated the desire to keep the banking sector in Polish hands. The governments of Waldemar Pawlak, Jozef Oleksy, and Wlodzimierz Cimoszewicz did not favor restructuring through privatization of the Polish banks and the issue became controversial in political circles (Blaszczyk 1998). The debate about the "proper" structure of the financial industry was on the leading agenda of the policymakers. Divisions over priorities and policies – such as the need for revenues to the state budget, the inability to manage the banking sector effectively, the need for fresh capital and know-how, and the attitude of some of the leading parties toward foreign participation – made the debates about privatization of the remaining banks last for over a year.

By the middle of 1995, shares in five of the regional banks were partly sold, too. The 1993-1995 left-wing government continued the privatization process but

⁵⁰ All of the information about the privatization of the BSK presented in this section is based on the case study of Bank Slaski in Abarbanell and Bonin (1997).

altered the banking restructuring approach, targeting domestic investors and alienating foreign partners (Blaszezyk 1999). The state kept its minority shareholder position in all five banks (Anderson and Kegels 1998, 228). For example, at the date of privatization the treasury owned 30 percent of WBK, 33 percent of BSK, 47 percent of Bank Przemyslowo-Handlowy (BPH), and 40 percent of Bank Gdanski (Abarbanell and Bonin 1997, 45).

The protectionist nature of the banking privatization was questioned in parliament, prompted by an acute parliamentary crisis and political scandals, revealing the informal nature of the relationships between commercial banks and government-protected borrowers.

In such an environment at the end of 1995, Bank Gdanski was lined up on the privatization market. At first, the sell-off was to be a split into two equal tranches aimed at local and foreign investors. Even though foreign investors were interested in acquiring the bank, the political mood swung entirely in favor of a local financial group. Given the financial difficulties of the BIG, the ultimate buyer of Bank Gdanski, legitimate concerns have been raised about the choice of the buyer and the origin of its funds. The BIG was in a favorable position, given that “preventing foreign domination in the banking sector had become a dominant government motivation” (Abarbanell and Bonin 1997, 55). The BIG itself magnified the concerns about the politicized nature of the restructuring process. The nomenclatura connection of the management of the bank as well as its own experience with “quiet” privatization provided grounds for questioning the motivation of the state to establish a competitive financial environment with dedication to the rules of the market.⁵¹

⁵¹ The reference is made in relation to the “quiet” privatization experience of the BIG through the emissions of new shares in the early years of transition. The government kept extending privileged

4.2. Banking Consolidation: Round One

The consolidation process became the answer to the fears of politicians and enterprise managers regarding a possible takeover by and domination of foreign investors in the financial sector. In 1996, the government initiated a strategy of consolidation as a “substitute for privatization” for the remaining state-owned banks (Abarbanell and Bonin 1997, 56; Bonin and Leven 1996). The idea was to unite healthy banks with the ones that were not performing well, and through various techniques, such as emissions of new shares for example, transform them into private institutions with improved performance. The privatization of both BPH and Powszechny Bank Kredytowy (PBK) evolved as a result of such consolidations.

Another similar technique was the takeover of failed private banks by larger Polish banks, including the Polish central bank (NBP). The policy was again politically favored and attempted to overcome potential social unrest from bank runs. The NBP, Kredyt Bank, Bank Zachodni, Prosper Bank and Pierwszy Komercyjny Bank, among others, took over small struggling banks. The takeovers were costly, however. The government had spent some USD 133 million on takeovers by the middle of 1994 (Abarbanell and Bonin 1997, 56). The takeovers did not solve the insolvency problem in the system. In practical terms, they only shifted it to the balance sheets of more healthy banks or the taxpayer.

In 1996, five years after the start of the privatization efforts in Poland, the banking sector was 67 percent state-owned – either directly or through SOEs, other

treatment to the BIG and engaged closely in its transformation. Political figures from the left and the right sat on the board of the bank and took part in managerial decisions, which confirmed the liaison between banking managers and politicians in the early 1990s. Later on, the NBP even agreed to exempt the BIG from reserve requirements until 2000, because of the purchase of the Bank Gdanski.

state institutions, or the NBP (*Gazeta Bankowa* 1997). As a result of retaining partial state ownership in the banks, the interests of private investors in these banks were at odds with those of the state when decisions for consolidation, takeovers, mergers, or debtors' bailouts were politically motivated. Inevitably, this hurt the performance of the sector, and steered interested outside parties away (Abarbanell and Bonin 1997). In 1995, for example, foreign banks represented only 7.7 percent of the banking sector in Poland (*Gazeta Bankowa* 1997). A major shift in the development of the banking sector in the country was needed in order to overcome insider favoring in the lending decisions of banks.

* * *

The restructuring experience of the Polish banks and firms discussed above did not seem to have enforced the benefits of competition and property rights, or the disengagement of the state from the management of the banking sector, as intended in the government's program for restructuring and privatization of banks and SOEs. Instead, it provided the conditions for shady deals and negotiations to capture the process. Stagnating over its responsibilities to manage the intermediation of funds even after the partial privatization of five of the regional banks, the Polish government found itself limited in its ability to attract foreign capital and investment in banking and alternative forms of assets or to spur competition in the financial industry. The program failed to dramatically improve the quality of the loan portfolios, as indebted SOEs had no incentives to restructure actively. The banking sector, even though partly privatized and recapitalized by the state on several occasions, was not able to effectively restructure its bad debts but kept accumulating new ones through informal workouts.

5. Pro-Reform Groups and Entry

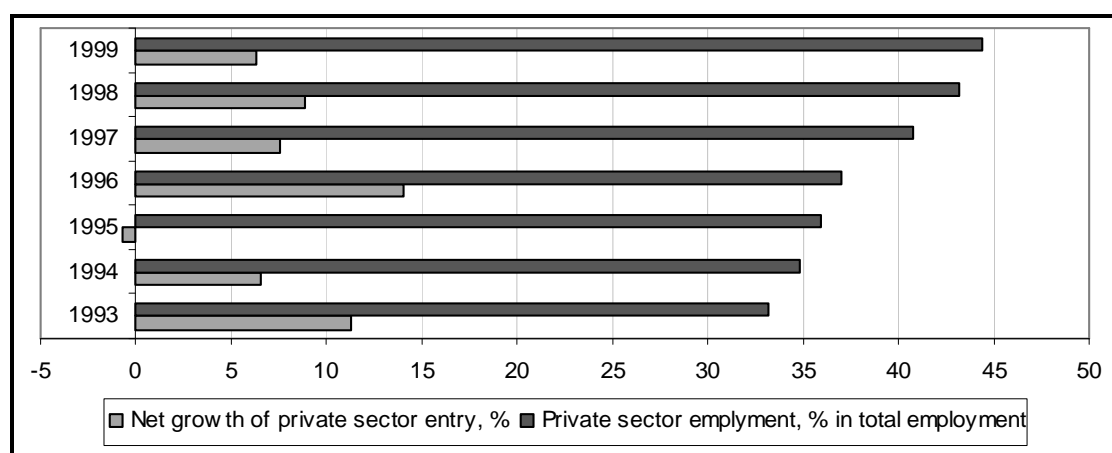
Why was the reform of the banking sector so ineffective in hardening budget constraints on enterprise borrowers in the first half of the 1990s? The sections above have partially answered this question, by attaching great importance to the inactive restructuring of bad debtors, and the informal ties that the program facilitated between the state (through its participation in the banks) and incumbent managers of indebted firms. There were strong political reasons behind the launch of the bank-led enterprise restructuring in Poland, too, as between 1993 and 1997 the ruling coalition included two post-communist parties (SLD and PSL) that were mainly identified with the incumbent enterprises' interests (Fedorowicz 2003, 12).

However, the position of the political groups was not static, as the transition process offered a great deal of changes, which reshaped the politics of power. Regardless of the power of the anti-reform groups in the early 1990s, pro-reform groups also had considerable political traditions in Poland. By the time the communist regime collapsed, Poland had a history of reforms and a more open economic system in comparison to the rest of the region (see for example, Balcerowicz 2003, 185-186; de Melo et al. 1997). These groups became even stronger in the 1990s, as they mobilized constituencies with potential benefits from financial reforms such as private sector participants, which were the losers of the status quo of soft credits.

New businesses emerged rapidly in the early 1990s. As Figure 9 demonstrates, the rate of entry was estimated at 11.3 percent and the share of private sector employment in total employment was already over 33 percent in 1993 and continued to grow over the next decade. *De novo* firms were usually created outside the web of political relationships between the state and SOEs incumbents and in the spheres of trade and service, construction, but also small-scale manufacturing. For example in

1993, private sector employment accounted for over 92 percent in the retail trade sector, 69 percent in construction, and 49 percent in manufacturing (Balcerowicz 2003, 191).

Figure 9 New Private Sector Entry and Private Sector Employment in Poland, 1993-2001



Source: Balcerowicz (2003, 197).

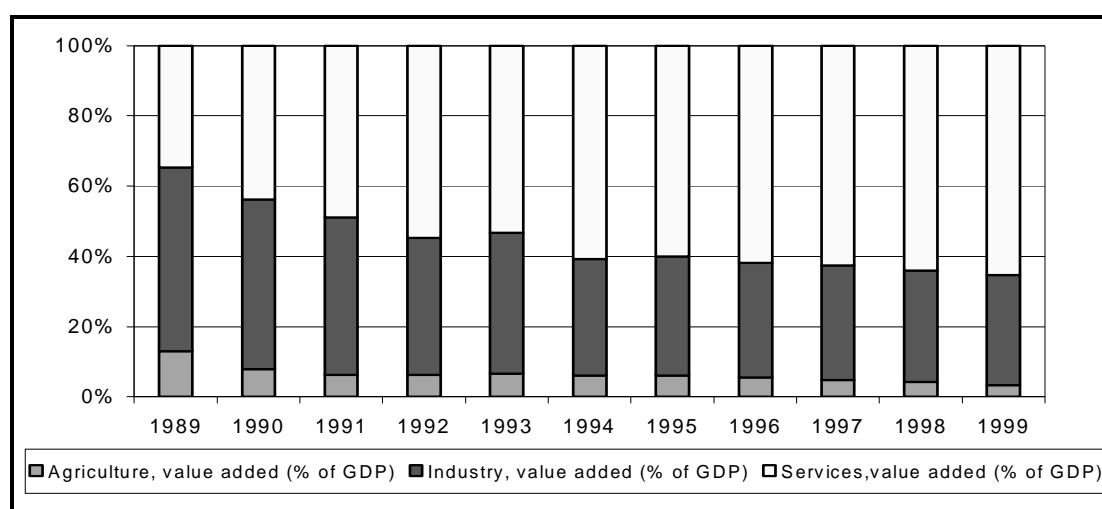
New firms were numerous, but too small and dispersed to exercise political influence prior to 1993. In addition, they did not rely on the banking sector for financial resources, as they used quick turnover strategies and reinvested profits (Fedorowicz 2003, 13). However, they mushroomed; the number of registered private firms increased from 1.2 million to over 3 million between 1990 and 1999.⁵² As the treasury's Report on Ownership Transformation concluded, "the establishment of new enterprises proved to be a much more important process for the development of the private sector than privatization of state enterprises, and the development of the private sector *de novo* was [...] the main factor behind the economic growth in Poland" after 1992.

The trend was visible in the aggregate economic indicators, too. The services and output generated by private means increased their share of the economy at the

⁵² Data quoted in this section are from the IMF Statistical Appendix for Poland (IMF 2000a).

expense of the declining industrial sector. For example, in the period of 1989 to 1994 the industrial sector's share of output fell from 52 percent to 33 percent, the share of agriculture contracted to half its starting figure, and the services sector became the dominant driving force in production (Figure 10). At the same time, the growth of the private sector in the Polish economy was continuous and strong in the 1990s. Private firms constituted 32 percent of industrial production in 1993, and their share continued to rise all through the 1990s. The private sector's share of GDP doubled – from 30.9 percent to 60.9 percent in 1998 – and constituted 71.2 percent of total industrial sales in 1999.

Figure 10 Composition of Output in Poland, 1989-1998



Source: World Development Indicators (2000).

However, the entry of new firms was closely related to the nature of the existing regulatory and fiscal framework, specifically the registration and licensing requirements, rules on sale or lease of real estate, export and import regulations, and taxes and contributions. Balcerowicz (2003) comments on the pre-transition efforts to make entry procedures less cumbersome with the passage of a liberal Law on Economic Activity (1988). However, she also points to the gradual but steady growth

of licensing and permit requirements prior to 1997. By 1997, permit and licensing procedures were the greatest obstacles to business operations for Polish entrepreneurs (Balcerowicz 2003, 206). The second Law of Economic Activity, which passed in 1999 and came into force in 2001, eased further entry of new firms by sharply reducing the number of activities subject to licensing. Observers have concluded that entry is currently cheap, quick, and easy for natural businesses and civil law partnerships but time-consuming and expensive for commercial law companies and cooperatives (Balcerowicz 2003, 210). The World Bank estimates that it takes on average 11 procedures, 58 days and USD 946 to open a firm in Poland.⁵³

Evidently, the emerging private sector in Poland, and especially its *de novo* component, was gaining economic importance in the 1990s. However, in order to boost new firms and private sector development, market participants also needed access to financial capital. For these constituencies, reforms in the financial sector would bring direct benefits.

6. Real Sector Privatization

The development of the private sector was affected by the outcomes of the privatization process for state firms, too. The political power of industrial SOE incumbents as well as the preservation of their informal ties to the commercial banks largely depended on the privatization methods of SOEs and the corporate governance in the new firms. The following sections explore precisely these links.

6.1. Institutional Structures and Organs

The foundations of the Polish privatization process were established in the Privatization Law of 13 July 1990. After numerous debates between the liberal wing

⁵³ Data accessed via <http://rru.worldbank.org/DoingBusiness>

of the government and Polish labor unions, a rather complicated framework of privatization was set forward.

Several features of the Polish privatization framework ought to be emphasized. First, the hard coal mines, the lignite mines and the energy and heat generators, as well as the enterprises producing goods of a military nature, were excluded from the privatization process from the start. Second, the rest of the SOEs were either to be transformed into treasury corporations and prepared for privatization or liquidated, depending on the method of privatization. Third, the Ministry of Ownership Transformation (MOT) emerged as the institution that would oversee all the matters of the ownership transformation (*Journal of Laws* 1990, no. 51, item 299).

However, the discretionary power of the MOT was limited. Considerable decision-making authority was given to other participants. For example, companies' employees obtained the power of veto in the decision for corporatization, a preferential price on up to 20 percent of companies share, and a large degree of choice regarding the actual type of privatization for state-owned firms. In the early 1990s, "the only organized group capable of articulating a position on privatization was the self-management movement and the political lobby that grew out of the Employee Council system of enterprise management. This group was over represented in parliament [...] Not surprisingly, it supported a decentralized model of privatization which de facto amounted to proposals for the creation of employee-owned enterprises" (Szomburg 1993, 76). Also, the founding organs of the state enterprises (i.e. the Industrial Ministry, the branch ministries and the local authorities) received an important role in different stages of the process. In effect, they could delay or expedite the process after its initial start through administrative procedures. Overall,

however, the privatization process of SOEs was in the hands of the founding organs and employees' council.

6.2. Methods

The power of the industrial incumbents was evident in the privatization methods developed in Poland.⁵⁴ First, capital privatization, also called *indirect privatization*, consisted of the sales of corporatized medium-scale and large-scale state firms through public offerings, public tenders, or public invitations to negotiations. In each of the cases, company's employees and management were favored and acquired shares on a preferential basis.

However, the absence of a developed financial market infrastructure in the early 1990s prevented this method of delivering encouraging results. In the first year (1990), only five companies were sold off.⁵⁵ Moreover, the dispersed nature of owners, the slow pace, and the high cost of the program presented considerable hurdles for the execution of this privatization method (Frydman and Rapaczynski 1994, 159). Thus, soon after the IPOs of these five companies, the government realized the importance of securing a core investor if future privatization deals were to succeed.⁵⁶

⁵⁴ For a detailed account of the privatization process in Poland see for example the *Report on Ownership Transformation in 1999*, published by the Ministry of Treasury 2000.

⁵⁵ Tonsil, Prochnik, Krosno, Exbud, and Slaska Fabryka Kabli were the five companies whose shares were sold through IPOs in Poland in 1990.

⁵⁶ One caveat was the amount spent on administrative costs. Observers have revealed that at least a quarter of the revenues raised from the privatization of the first five companies went toward such expenses (Frydman, Rapaczynski and Earle 1993, 185).

Second, the most widely implemented technique used in the privatization process in Poland was the liquidation method, also known as *direct privatization* of state-owned firms. This method was used for the privatization of small- and medium-size companies in comparatively good financial standing.⁵⁷ The various stakeholders at local and enterprise level conducted almost the entire privatization process by the direct method. In reality, the MOT only approved the decision reached by the founding organs and had no influence over the initiation, decision-making process, or valuation of the company in question. Moreover, the founding body (the voivodship or branch ministry) was the organ that would issue the order for the privatization and carry out the process.⁵⁸ As a result, the method was popular due to its flexibility and favoritism to insiders.

Third, *mass privatization* was applied to some several hundred large commercial enterprises through an indirect distribution of shares at a low nominal price. The program was started in 1993 and became the third avenue for privatizing state companies in Poland through the National Investment Funds (NIF) (*Journal of Laws* 1993, no.44, item 202). The NIF program encompassed some 512 big state

⁵⁷ The law stipulated that the process of direct privatization was to be executed through the following forms: i) Sale of enterprise, which offered the SOEs for sale on public tender first to domestic investors and only in the case of no interest to foreigners. ii) Contribution of enterprise to a company, which in practical terms implied the establishment of a new company in which the treasury and investors contributed capital. The procedure consisted of negotiations between the interested parties. iii) Giving of enterprise to be used for consideration, which allowed employee leasing, also known as leveraged lease buy-outs. The leases were not to exceed more than ten years. At the end of the lease, employees would usually be expected to buy the firm. See Ministry of Treasury (2000, chap. 1).

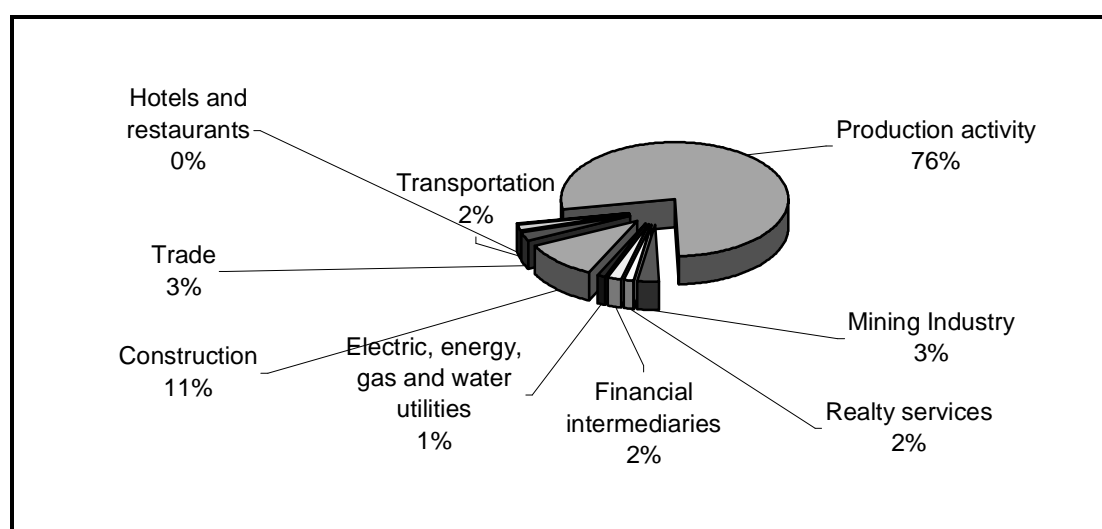
⁵⁸ Th voivodship (*Województwo* in Polish) is an administrative region broadly equivalent to a province. From 1975 to 1998 there were 49 voivodships in Poland, and as of 1 January 1999 there have been 16. Definition accessed at <http://www.wikipedia.org/wiki/Voivodship>.

companies. Fifteen funds bought shares in these companies with the sole purpose of restructuring and modernization. The NIFs, which became the legal owner of the shares in the state firms, distributed participation certificates to citizens, which were practically shares in the funds. The mass privatization program did not transform a considerable portion of SOEs and had a marginal effect on the process.

6.3. Privatization outcomes

Results. The number of state enterprises in the Polish economy as of 30 December 1991 was 8453, of which 17.2 percent were commercialized, over 20 percent privatized through the direct method of privatization, and about 19 percent liquidated by the end of 1999 (Ministry of Treasury data). The majority of the enterprises sold through capital privatization used the invitation-to-negotiations technique in their privatization (68.8 percent), and domestic investors acquired nearly half of them. Most of these companies came from the industrial sector (see Figure 11).

Figure 11 Capital Privatization by Sector, as of 31 December 1999



Source: Polish Ministry of Treasury.

For the period 1990 to 1999, 1062 companies were privatized through the direct privatization method, of which 65.5 percent went through the giving of an enterprise for consideration route, 21.5 percent through sale, 9 percent through bringing into a company, and the remaining 3.6 percent used mixed methods.

In addition, in the period 1990 to 1999 the total amount of privatization revenue was PLN 36,230 million (Ministry of Treasury data). More than 85 percent of the revenues came from capital privatization deals, which represented less than 8 percent of the total deals, however (Table 14). As emphasized above, the reason for this was the limited scope of the capital privatization relative to both the number and the sectors of the economy as well as the popularity of insider-type privatization deals, which usually did not bring financial resources to the firm and the state budget.

Table 14 Revenues from Privatization in Poland, 1991-1999

Revenues	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total privatization revenues (in million PLZ)	171	499	789	1614	2641	3564	6537	7068	13347
From capital privatization									
in million PLZ	157	323	502	1291	2235	2769	5164	6550	12949
in %	91.8	64.7	63.6	80.0	84.6	77.7	79.0	92.7	97.0

Source: Polish Ministry of Treasury.

A Corporate Governance Dimension. What do the privatization results mean for weakening of anti-reform groups in Poland? Obviously, the Polish privatization approach entrusted a great deal of power to industrial insiders. Observers have commented critically, “the decentralization, intended to confer on the insiders a degree of managerial autonomy, has been conflated with a devolution of pseudo-ownership rights [...] The managers and workers who took effective control of the enterprises quickly came to view their position as an entitlement, assuring them, in the wake of the communist demise, ordinary property rights in their enterprises”

(Frydman and Rapaczynski 1994, 157). The biggest danger that a predominant insider privatization of the industrial sector and the slow retreat of the state from the banking sector could have brought was the inability to break the ties between incumbent managers and the state in obtaining soft financing. But was this really the case in Poland?

Although insider-controlled, the privatization process did not unconditionally empower incumbent managers, as the employees' councils often managed to counterbalance the anti-reform sentiments of the pre-privatization managers. The privatization methods also presented an opportunity for changes in demolishing the existing incumbent managerial–state network. Employees' councils were a powerful player, especially in the early 1990s (prior to enterprise privatization). In fact, employees' councils had a duty to appoint and dismiss the management of the company they represented, and more importantly, to approve or reject any change in the firms' organization or its privatization.⁵⁹ In this sense, employees' councils utilized their political weight not only in shaping privatization approaches, but also in exercising control on the management. Observers have described them as a “bottom-up” corporate governance mechanism for control over managerial performance that prevented the asset-stripping of SOEs prior to privatization (Fedorowicz 2003).

In many cases, councils did block the sale or restructuring of the firm they represented in a way, which directly affected its performance and even survival. In many other instances, however, employees' councils in fact worked with the management of the firms in the search for the best buyers. The complexity of the

⁵⁹ The Law on SOEs of 1981 institutionalized the position of employees' councils early in the transformation of the firms. Already in the 1980s, workers' councils had an agenda of diminishing the influence of the communist party (the state) on firms.

relationship between employees' councils and managers as well as their conduct is difficult to gauge as a whole due to the specificities at the firm level. As observers have commented, "how much market, and how much politics was there, is an individual question related to a concrete enterprise" (Fedorowicz 2003, 8). Nonetheless, employees' councils were important devices for management control prior to the privatization of firms, as they diminished the importance of informal ties between the incumbent managers and the state.

Employees' councils did not have the power to exercise control over the management everywhere, however. Some big firms, and especially the ones engaged with international transactions, resorted to their "old" informal ties to politicians for financial capital (for example, Universal and Polisa). These companies were privatized very quickly in 1990 in schemes typically involving incumbent managers but retaining a considerable degree of state ownership. In the subsequent years, such large firms partook in the privatization of smaller firms, owned by politically protected insiders, creating large holding groups. However, for the operation and purchases of new assets, these companies needed access to large financial resources. The presence of the established "old" state-management relations with respect to bank credits was important, as it provided the access to capital. Credits to these companies were easily obtainable from the state-owned banks (Fedrowicz 2003, 11). These firms were the most severe opponents of financial reforms.

* * *

To sum up, the process of private sector development through privatization and the entry of new firms diminished the importance and power of the industrial incumbents that managed the industrial sector in Poland. These counter-forces provided possibilities to override the interests of the SOEs' incumbents and ultimately

avored a financial system that would intermediate financial resources independently and would not crowd out good investment projects. The mobilization of potential beneficiaries of financial reforms created a momentum for changes in 1997.

7. Round Two of the Banking Sector Consolidation

The privatization and restructuring efforts in 1997 called for the strengthening of the regulatory environment in the financial sector in Poland and in particular financial discipline in the banking sector, if an efficient intermediation of financial resources was to be achieved. Something radical needed to be done, and policymakers were aware of the need to act quickly before the reform momentum backfired. This window of opportunity materialized after the September 1997 elections and demonstrated a growing awareness among the public of the benefits of private ownership and banking privatization. As a result, a new law on privatization was introduced, coming into effect on 1 January 1998. Its aim was to speed up the process of banking privatization and economic restructuring. The law called for improved transparency, more liberalization and competition, and less government involvement in the banking sector. For example, new registration procedures were enforced for commercial banks in Poland. A separate commission for banking supervision (Komisja Nadzoru Bankowego), independent from the NBP, was entrusted with the procedures for establishing domestic and foreign banks. In addition, the new legislature spelled out the rules and procedures for the structural and financial organization of banks in Poland, banking operations and security instruments, bank confidentiality, counteracting money laundering, banking supervision, electronic

banking, as well as mortgage operations. The institutional changes diminished the use of informal ties for soft financing and informal workouts.⁶⁰

In addition, attracting core foreign investors for the purchasing the banks was targeted in order to help upgrade banking sector operations and implement long-term development strategies. Also, the continuous banking sector support to non-performing borrowers had sent the wrong signals to the market and encouraged moral hazard but not financial discipline. Moreover, it crowded out productive investments. The privatization of the banks to outsiders was intended to further abolish any informal relations between commercial banks and their borrowers.

Table 15 Selected Banking Sector Indicators for Poland, 1998-1999

Banking Indicator	Type of Commercial Banks					
	Majority Public Sector Interest		Majority Private Polish Equity		Majority Foreign Equity	
	1998	1999	1998	1999	1998	1999
Share of total assets	45.9	23.9	33.2	24.6	16.6	47.2
Share of total net loans	38.8	21.4	34.3	22.6	21.9	50.9
Share of total deposits from non-financial sector	53.6	29.2	27.5	20.1	13.7	45.7
All Banks						
	1998	1999	Annual Change, %			
Net interest margin	4.5	4.05	-10.00			
Return on average assets	0.79	1.15	+45.57			
Return on average equity	7.04	9.48	+34.66			

Source: Calculated from NBP 2000 and Wagner and Iakova (2001, 8). Own calculations.

An ambitious privatization timetable was announced – one that envisioned the privatization of the remaining state-owned banks, among other privatization initiatives. Commercial banks were to be privatized without internal favoring. As a result, the presence of strategic foreign investors was in 1999, for the first time, very

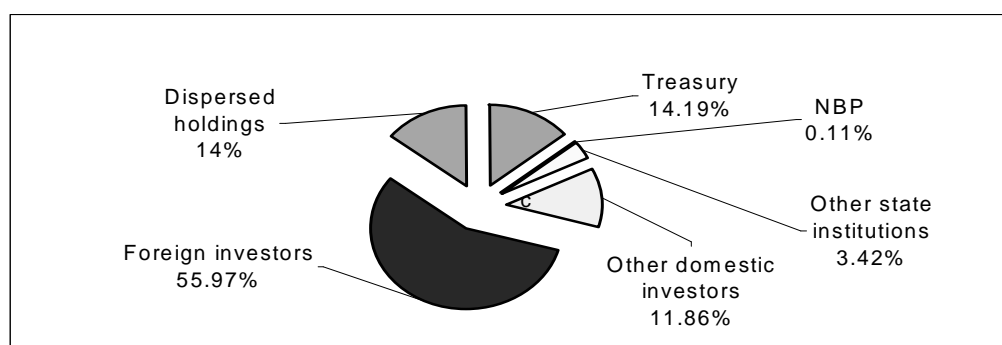
⁶⁰ Some of the legislation with direct relevance to the financial environment in Poland was the Act on the National Bank of Poland; the Banking Law; on Mortgage Banks and Mortgage Bonds; and on the Public Trading of Securities. An extensive commentary could be found in Postepska (1999).

sizable. The share of foreign assets rose from 16.6 percent in 1998 to 47.2 percent the following year, and a similar trend was observed in loans and deposits (see Table 15).

Reflecting the trend not only in the post-communist countries but also across the industrial world, the banking consolidation process in Poland continued. However, this time it was not used instead of privatization. Mergers became popular in Poland, as specialized banks were consolidated into banking groups and offered for sale. An illustration of this was the merger of four banks – Powszechny Bank Gospodarczy SA, Pomorski Bank Kredytowy SA, Bank Depozytowo-Kredytowy SA and Bank Polska Kasa Opieki SA – to form the PKO SA Group in 1999, undertaken just months before its privatization. In 1999, the privatization of four big Polish banks was completed; ownership of Bank Handlowy SA, PKO SA, Bank Zachodni SA, and Bank Własności Pracowniczej SA was transferred to private institutions and strategic foreign investors (NBP 2000).

The initiative by the government to use consolidation as a privatization technique and the parallel market penetration strategies of foreign banks to acquire Polish banks leads to several observations. First, demand for funds to market participants increased, because of the rise of the private sector share through privatization, new entry in the economy and competition in the enterprise sector. As the quality of projects from the private sector improved, the banks lost incentives to bail out old unsound borrowers. Politically backed soft financing was no longer possible, as the state diminished its involvement in the banks and strengthened the regulatory environment in the financial sector (Roland 2000, 292).

Figure 12 Equity Capital Distribution in the Polish Banking Sector, 1999



Source: NBP (2000).⁶¹

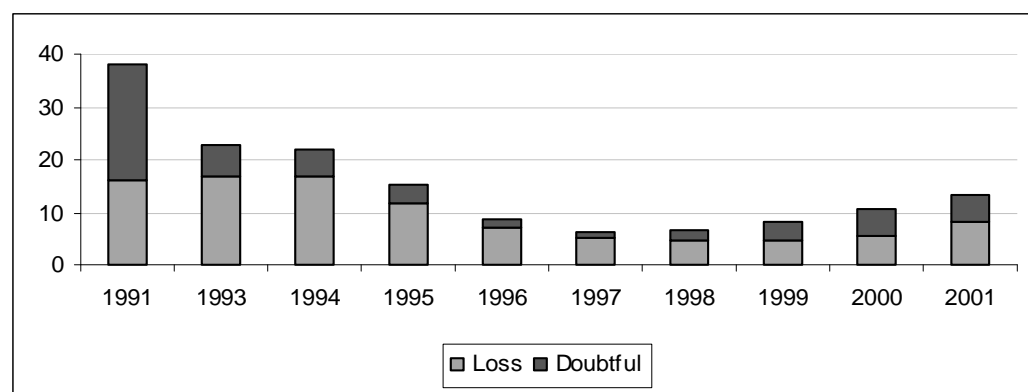
Second, foreign buyers and banks started to compete on the Polish banking market without being discriminated against, as a result of the cutting of informal ties between banks, politicians, and firms. It resulted in a breakdown of the protectionist policies in banking. Market participants, including foreign banking groups, bought consolidated banks and initiated mergers of sound operations under their control. Examples include the 1999 merger of three Polish banks with Bayerische Hypo- und Vereinsbank AG, the merger between BRE Bank SA and Polski Bank Rozwoju SA, the merger between Kredyt Bank SA with Polski Bank Inwestycyjny SA, among others (NBP 2000).

As a result, by the end of 1999 the Polish banking sector was for the first time predominantly foreign owned (see Figure 12). The share of state-related institutions rapidly dropped to below 20 percent, which demonstrated the government's commitment to increasing the efficiency of financial intermediation through foreign

⁶¹ "Other state institutions" are defined as state enterprises and banks, companies wholly owned or with a majority treasury interest, government agencies, etc. "Other domestic investors" include equity held by local government. "Dispersed holdings" refers to equity in banks held by shareholders with less than 5 percent of votes (NBP2000).

capital and know-how. It was also a sign of the government's resistance to the demands for soft financing.

Figure 13 Irregular Claims as a Percentage of Gross Claims in Poland, 1993-2000



Source: National Bank of Poland (2002).

Moreover, the portfolios of commercial banks were strengthened tremendously. As Figure 13 shows, although the share of non-performing loans remained visibly high, in fact the banks did not accumulate a considerable amount of new bad debts. The share of irregular claims classified as loss and doubtful was at its lowest level in 1997. The reason for the high share of non-performing loans after 1998 is that older loans, denoted as non-performing by many rating agencies, were kept on the books for fiscal reasons. Regulators heavily levy writeoffs of such debt. Instead, commercial banks keep the debts on their balance sheet but provisione *sufficiently* for their coverage. (Table 16 below summarizes the ratio of specific provisions to credit exposures classifies “irregular” and the share of unsecured “irregular” classifications to gross claims.) Thus, the level of irregular credits has been high on the banks’ books in Poland, but in fact financial fragility has not been an issue in recent years, according to the data and the assessments of the central bank and the IFIs (NBP 2002, IMF 2002).

Table 16 Irregular Credits in Poland: Share and Provisions, Dec. 2001 and June 2002

Irregular Loans	Provision to Irregular Credits		Share of Irregular Claims in Gross Claims	
	Required	Established, 31/12/2001	Banking Sector, 31/12/2001	Banking Sector, 06/30/2002
Substandard	20%	20.8%	4.6%	4.8%
Doubtful	50%	52.7%	5.1%	5.8%
Loss	100%	101.3%	8.2%	9.5%
Total	-	102.0%	17.9%	20.1%

Source: National Bank of Poland (2002).

Thus, an overall commitment on the side of the government to further diminish the informal relations between heavily indebted enterprises and commercial banks was seen in the way banking sector privatization, decentralization, and regulation in Poland were undertaken after 1997. Even though the privatization of the Polish banks occurred at a much slower rate in comparison to some other former socialist countries (Estonia, for example), and the target of completing the process was set for the end of 1996 and not met, banking privatization in Poland started to deliver the benefits of independent intermediation of financial resources at the end of the 1990s. Table 15 is an illustration of this observation as it presents the performance of some banking indicators in the years before and after the majority of the banking privatizations took place in Poland.

8. Conclusion

Three major elements characterized the early transition environment in Poland: “first, the extreme decentralization and dispersion of rights of ownership and control, second, the strong political and psychological attachment of employees to the idea of self-management, employees who shared a general feeling that the ‘firms are ours,’ and third, the extremely weak capacity of the state to supervise and monitor the behavior of the firms” (Szomburg 1993, 78). These elements shaped the

transformation policies, including the development of the banking system in the country, too.

Analyzing the relations between commercial banks and enterprises at the beginning of the 1990s, this chapter drew several important observations with respect to the restructuring of the financial industry in Poland. First, the inactive restructuring of the SOEs asserted the power of the industrial incumbents, blocking policies for the successful hardening of budget constraints. The aim of the beneficiaries of soft credits was to sustain their dominant position of control over the transformation of the industrial sector for as long as possible and utilize their informal links with the state for soft lending. Answering to pressure from the strong industrial lobby, the state prolonged its involvement in the ownership and decision-making of the commercial banks. Protectionist policies and the fear of opening to competition provided the conditions for delaying the banks' restructuring process itself.

Second, the system favored insiders in the process of SOE privatization but had created a mechanism for checks on management conduct that forced the incumbent managers to work with the employees' councils in the search for the best buyer. Without doubt, there were both big and small firms where insiders expropriated assets and relied on their old ties to the politicians in office in receiving financial resources. In the average privatized firm, however, incumbent managers were not able to preserve their strength in obtaining soft-credits. The outside presence of many new, foreign, and privatized firms made such relationships even more difficult to foster.

Third, and related, the rapid creation of new firms and the development of the private sector founded a growing group of potential beneficiaries of financial reforms. This group eventually weakened the dominant position of the anti-reform industrial

insiders, especially after the elections in 1997. The government used this possibility to offset the pressure from the anti-reform lobby for directed financing and pushed through some major privatization deals with the participation of strategic foreign investors. In addition, it strengthened the financial discipline on the market through fostering prudent financial regulation and bankruptcy procedures.

As demonstrated, the Polish experience asserted that well-defined property rights, competition, market-based relationships, and financial discipline between market participants helped eliminate government-directed preferential financing to anti-reform groups.

CHAPTER VI

ESTONIA: NO MONEY FOR BAILOUTS

1. Introduction

This chapter examines the development of the Estonian financial sector in relation to the abolition of the channels through which industry groups could extract rents and preferential treatment from the state. The approach of the Estonian governments of the 1990s to restructuring the banking sector was the most radical in comparison to the policies implemented in Bulgaria and Poland. In this chapter, I ask why this type of banking restructuring was followed and how come there was the ability to mobilize political support for it.

The country case presentation is structured as follows. The next part discusses the evolution of the Estonian banking sector and the separation of its ties with Moscow. It points to the danger of risky lending practices in an unstable economic environment. Section 3 reviews the options for the government in resolving the fragility of the financial system and looks at its commitment to a no-money-for-bailouts strategy for the restructuring of the commercial banks. Section 4 introduces the two main groups of constituencies and their motivation to either facilitate or oppose the implementation of the banking restructuring policy. Sections 5 through 7 discuss the characteristics of the economic environment, which strengthened the pro-reform constituencies' political power. These are: low barriers and strong entry of new firms (section 5), active restructuring of state firms and credible exit (section 6), and privatization methods that did not favor status quo beneficiaries but provided competitive access to assets (section 7). In section 8, the regulatory changes in the banking sector that institutionally weakened the informal ties of status quo

beneficiaries and the state machinery for soft credits are reviewed. The section touches upon the implications of the no-money-for-bailouts approach of the government for the development of the banking sector in Estonia. The chapter concludes in section 9.

2. The Estonian Banking Sector in the Early 1990s

2.1. Banking structure

For Estonia (as well as the other former Soviet republics) the collapse of the Soviet Union (SU) was the “defining political and economic event, as a result of which these countries gained their independence and began their transition to market economies” (de Melo et al. 1997). The separation of Estonia meant not only the establishment of a new sovereign state but also disintegration of the new country’s economy from the one managed from Moscow. The process of economic autonomy and political independence from the SU was characterized by the early introduction of market-oriented institutions, which carried a high social cost (Taaler 1995). So, from being one of the most prosperous regions of the SU, Estonia plunged into recession in the early 1990s. Real GDP fell 8 percent in 1991 and an additional 22.17 percent a year later (World Development Indicators 2000).

The political and economic separation from the SU affected the development of the institutions that governed the banking system and its relationship with local economic agents. With the state ownership of both banks and enterprises, for example, the credit decisions used to be mainly the result of the Soviet government’s decision about the way funds were to be distributed toward enterprises of its choosing. Banks in Estonia were part of the monobank system of the SU, with specialized banks to cater for specific branches of the economy. In the 1980s, the Soviet’s Gosbank (the

State Bank) was not only the sole note-issuing authority in the Union but also the main loan-making agency. In 1988, however, several state enterprises and individuals sought alternative sources to finance their economic activities and approached the authorities in Moscow to establish a commercial bank outside the all-Union banking system. As observers have commented on the process, “the initiators of the new banking system were managers of Estonian enterprises and private entrepreneurs, whose activities were most severely hindered by the existing arrangements” (Sorg 1995).

Within a year of the establishment of the first Estonian commercial bank (Tartu Bank), it had spun off five branches that by the end of 1989 had become independent commercial banks. The Estonian commercial banks had a small share of the loan market at just over 8 percent at the end of 1989, but their economic importance was growing rapidly. At the end of 1990, the six Estonian commercial banks already accounted for 26.5 percent of total loans.⁶²

The emergence of new banks was encouraged by lax regulatory and supervisory conditions in Estonia. For example, the minimum capital requirement to establish a bank was RUB 5 million, equivalent to less than USD 40,000 in 1992 (Fleming et al. 1997, 4). New banks mushroomed in the conditions of regulatory disarray, however. There were two functioning central banks in the country prior to 1992 – the Estonian and the Russian central banks, both with authority to license commercial banks. Eesti Pank had licensed 25 new banks by 1992 in order to counterbalance the existing system of state centralized banks managed from Moscow (Sorg 1999). At the same time, most of the existing commercial state banks became independent financial institutions as their branches were spun off from the former

⁶² Data in Sorg (1995). Own calculations.

Soviet state-owned banks in 1990 to 1991. For example, the Eesti Maapank (the Agri-Bank) split up into 14 independent units in 1991, among which were Revalia Pank and Narva Kommertspank (Fleming et al. 1996, 4). In November 1989, the authorities in Moscow passed a law that transferred the assets of the branches of the all-Union banks to the Baltic states. By the end of 1991, most of the hurdles in institutionalizing the independence of the former Soviet banks had been overcome.

Table 17 Estonian Banking Sector Capital and Assets, 1991-1995

Banks	1992	1993	1994	1995
Number of banks, of which:	43	22	24	23
State banks	18	2	3	1
New commercial banks	25	20	18	13
Foreign banks/branches	0	1	3	9
Total capital, million USD	16	62	89	282
Capital of state-owned banks, % of total	22	10	11	2
Total banking assets, million USD	427	543	880	1220
Asset share of state-owned banks	60	23	28	10

Source: Fleming et al. (1996, 7).

Note: Data for 1992 is for September, i.e. prior to the crisis.

2.2. The Stock and Flow of Risky Lending

Although separated, the commercial banks in Estonia did not lose their connection with Gosbank, as the local banks borrowed heavily from the SU's central bank. Generally, the arrangement was typical for the transition economies, as both the newly established and the pre-existing intermediaries depended mainly on credit from the central bank. Since the central bank of Estonia (Eesti Pank) was not able to sell loan certificates or lend to local commercial banks at the time, they continued to borrow from Moscow until May 1993. The cheap credits from Gosbank became one of the main reasons for the abundance of undercapitalized commercial banks in the early 1990s in Estonia.

These early years of transition were marked by instability and excessive risk-taking in the funding of investment projects, which generated a flow of loans of dubious quality. The local commercial banks supplied cheap financial resources to the local private economic actors at a much higher rate (Hansson 1994). At the same time, state firms often had their own credit guarantees from the Soviet government in the early 1990s, through which they had access to soft financing. Although the control over the state-owned industrial sector was technically shifted to the new state of Estonia, the shift of control rights did not change the incentive structure of operation in Estonian SOEs, as state firms still continued to receive support for their activities.

As a result, the structure of the loan composition on the balance sheets of all banks was poor. There was a problem of keeping the banks' books in order, too. Inexperienced managers could not hedge successfully against various risks, and had engaged in dangerous speculative lending in the early years of transformation.⁶³ The newly emerging Estonian banking sector ached for resources, because their access to funds from Gosbank was terminated shortly after Estonia's independence (Hansson 1994). In addition, in 1992 the Moscow offices of the Vnesheconombank (the Foreign Economic Bank) and the Savings Bank froze all assets of the non-Russian banks, which for Estonia meant around USD 100 million (Fleming et al. 1996, 8).⁶⁴

The faulty lending practices of commercial banks for soft loans in addition to the shortage of local capital to back up the operations of the new banks, the lack of banking experience, and the low levels of liquidity in the system created loan-

⁶³ Sorg (1999) reveals the case of the former Otepää Uhispank, where two of its managers (Arvo Kaseniit and Valmar Vasnapuu) ended up in prison because they had improperly extended huge credits and engaged the bank in shady financial deals.

⁶⁴ Assets were frozen primarily in three banks: the North-Estonian Share Bank (USD 40 million), Union Baltic Bank (USD 36 million), and the Savings Bank (USD 25 million)

portfolio problems in Estonia. By the end of 1992, there were 43 commercial banks in Estonia, of which only eight could meet the share capital requirement of EEK 6 million (Sorg 1999). The state banks held the majority of the assets in the system, but only a fifth of the capital in 1992 (Table 17).

The Estonian economy was no longer dependent on Moscow, but the danger of financial fragility was prevailing. The signs of the transformational recession were surfacing as the economy contracted sharply, and a crisis hit the financial sector (Table 18). The Estonian government faced the challenge of developing a financial sector that would operate without assistance and privileged resources from Moscow, but it needed to soothe the demands of its own beneficiaries of the partial reforms that had been introduced.

3. Resolution of Financial Distress

3.1. Exchange-Based Stabilization

The main reasons for the problems in the Estonian banking system in 1992 were the lack of transparency in the rules of the financial system, insufficiency of both experience and knowledge of the banking personnel, big risk exposure of the Estonian financial sector, and instability in the ruble-zone (Fleming et al. 1996). In such conditions, crisis was unavoidable. As Sorg points out, “the reorganization of the banking system coincided with the reorganization of the monetary and economic systems [...] Under similar circumstances [...] even the experienced bankers of the developed countries have not been able to avoid crises” (Sorg 1999). In any case, the new government needed suitable policy tools to quickly combat the crisis and stabilize the new currency. As a result, Estonia embarked on a strict exchange-based stabilization program. A currency board was implemented to control the rapidly rising

inflation,⁶⁵ to stop the currency depreciation, and to terminate the central bank's financing of the budget deficit.⁶⁶ Distancing politics from monetary and financial decisions was a way of pursuing these aims in a short time frame, while establishing the central bank's reputation for pursuing credible stabilization policy in Estonia.

However, the radical stabilization policy had some downsides, too. The Estonian government substantially reduced the ability of the monetary policy to act through the exchange rate regime. Generally, with a floating exchange rate both aggregate demand and aggregate supply would change in line with the fluctuation of the exchange rate, as decisions of consumers and producers would be affected by the relative price effect. In practical terms, by committing to hold the exchange rate fixed the Estonian government traded its free monetary policy, because every initial change in money supply needed to be offset later in order to keep the exchange rate steady (Schuler 1996; Hanke et al. 1993; Hagelberg 1996).

3.2. Consequences for the Banking System

The implications of the exchange-based stabilization for the development of the banking system in Estonia were along the lines discussed in the Bulgarian case (Chapter IV). The scope of activities that the central bank performed under the currency board regime was limited to the excess reserve assets. This fact implied constraints on bailing out banks in financial difficulties.⁶⁷ The Estonian currency

⁶⁵ Inflation reached levels of 202 percent in 1991, and in 1992 it was already above 1000 percent (see Table 18).

⁶⁶ See Arukaevu (1997), Pautola (1998), Hegelberg 1996, and Hoag and Kasoff (1999) for discussions on the issue.

⁶⁷ Similar to the design of the Bulgarian currency board, the one in Estonia allowed for a limited possibility for providing liquidity for sound but illiquid banks.

board ensured minimum control over interest rates for politicians. As Lepik (1995) pointed out, however, although intervention and smoothing interest rate fluctuations through open market operations or administrative control were possible, they could potentially compromise the credibility of the board, and the policymakers committed to stay away from such tactics.

Overall, the introduction of the board turned out to be a suitable policy instrument to signal the readiness of the policymakers in pursuing genuine reforms. The implications of adopting the currency board system were soon seen in stabilized price levels and decreased interest rates. Inflation was tamed and fell many times, from over 1000 percent in 1992 to 89.6 percent just a year later (see Table 18).

Table 18 Economic Indicators for Estonia, 1991-1995

Selected Economic Indicators	1991	1992	1993	1994	1995
GDP per capita, (USD)	..	707	1085	1530	2405
Inflation, consumer prices (annual %)	202.00	1078.2	89.60	47.90	28.90
GDP growth rate (%)	-8.00	-22.17	-7.98	-2.44	5.74
Interest rate spread	11.58	7.21
Total employment, 1989=100	96.4	91.4	84.3	82.7	78.3
General government budget balance (%GDP)	5.2	-0.3	-0.7	1.3	0.3

Source: EBRD (1999), UN (1998), Government of the Republic of Estonia and European Commission Directorate General for Economic and Financial Affairs (2000).

The success of the currency board in Estonia was not only a matter of stabilizing the kroon, as it also called for sustainable structural reforms in the financial and real sectors (Kuus 1997, 20). A major restructuring of borrowers was important for the success of the reforms in the banking sector. Considering the pressure from the restricted monetary policy in the country, developing a stable and healthy system of financial intermediation became a priority in the transformation process in Estonia. The government approached the problem by committing to no bailouts and preferential treatment of borrowers, no extensive intervention, and no direction for

allocation of financial resources. In effect, by announcing the no-money-for-bailouts approach the government tried to build a shield of protection against firms seeking preferential financial treatment.

3.3. The Government Approach to Banking Sector Restructuring

To strengthen the financial discipline in the sector and to terminate soft lending, the Estonian policymakers committed to no liquidity assistance and bailouts to insolvent commercial banks in October 1992. However, with the introduction of the Estonian currency board, the main sources of revenue for the existing commercial banks had dried up, as the profit margins from foreign exchange had shrunk and the cheap central bank credits flow from Gosbank had disappeared. At the same time, the commercial banks were not certain about the commitment of the government to the no bailouts policy, as no bank had ever been allowed to fail in Estonia. Hence, they continued their “old” lending practices. But in the autumn of 1992, the Estonian commercial banks faced serious liquidity problems (as their assets were tied up to credits of questionable quality that were irregularly serviced and impossible to recall) when they were unable to receive assistance from the central banks.

The problems had a systemic character. The insolvency of the commercial banks resulted from loans in arrears, losses on the exchange market, and unreasonably high interest rates to attract deposits (IMF 1993). Moreover, short-term resources were extensively used for long-term financing without exercising thorough screening and monitoring of borrowers. For example, by 1 November 1992, just before the crisis hit, the time deposits amounted to EEK 21 million in the banking system. At the same time, the long-term loans were almost EEK 300 million (Sorg 1999). This large mismatch between assets and liabilities brought difficulties in carrying out even simple banking operations at the time.

The political leadership in the country was committed “for real” to no rescue of problem banks, however. What happened in Estonia in November 1992 was unheard-of for Eastern Europe: the state did not rescue the three biggest banks in the country Balti Ühispank (Union Baltic Bank), Tartu Kommertspank and Pohja-Eesti Akstiapank (North Estonian Bank), which were predominantly state owned, when they became insolvent. Instead, on 17 November 1992, the central bank announced a moratorium on Tartu Bank, the Union Baltic Bank, and the North Estonian Joint-Stock Bank. A few weeks after the November crisis, the prime minister, Mart Laar, announced that in order to keep the sustainability of the currency board, the “excess cover”⁶⁸ might not be used for inflationary bailouts in the banking system. The policy announcement attempted to demonstrate the intent of the government to enforce a policy of financial discipline in the country.

Echoing Laar’s policy announcement, the central bank of Estonia withdrew the license of Tartu Bank and auctioned its assets. Only about 50 percent of the deposits were recovered. The largest bank, Tartu Bank, was liquidated, and the two other problematic big banks merged into one state-owned bank with the name Pohja-Eesti Pank (North Estonian Bank). Another eight small commercial banks experienced liquidity and solvency problems and failed; others were closed or consolidated into bigger units. As a result, by the beginning of 1993 half of operating banks had vanished (see Table 17).⁶⁹

⁶⁸ The “excess cover” is the remaining amount of foreign reserves above the base money liability. The Estonian currency board allowed for using the excess cover as a limited lender-of-last-resort source of financing. This was very similar to the later arrangement in Bulgaria. See the discussion in Chapter IV.

⁶⁹ The list of the banks with licenses after the crisis in 1992 can be seen in Sorg (1999).

4. The Agents of Change

How did the government come to introduce and carry out the no-money-for-bailouts approach to restructuring the banking system? I argue here that the early reform governments in Estonia were capable of politically mobilizing the potential beneficiaries of the financial reforms, through which the resistance of the partial reform winners of reforms was soothed. Applying the theoretical framework developed in Chapter III, I investigate the strength of the anti-reform lobbies, which aimed to capture the state and delay the market development of the financial industry. As argued, such strength is weakened by active enterprise restructuring, privatization to outsiders, low barriers to entry, and the lack of informal channels for influencing decisions on credit allocation. Before reviewing how these processes shaped the path of financial reforms, this section presents the composition of the main interest groups in the context of the political changes in the early 1990s.

I distinguish between two main groups of actors that had direct influence on the way financial reforms were pursued in Estonia: the pro-reformers and the partial reform/status quo beneficiaries. The pro-reform group generally comprised new entrepreneurs, former property owners and their decedents, and foreigners (Kein and Tali 1995). This group of constituencies was chiefly interested in the openness of privatization, removal of barriers to entry, fostering competition, and, ultimately, reforming the financial system. These constituencies were the main group of followers of the center-right parties that ran on radical market reform platforms.

The opposing camp consisted of a mixture of constituencies with different agendas. This group included management, employees, and leasees of SOEs, but also the former privileged authorities. Hence, in a way, it unified beneficiaries of the “old” system (such as party leaders and government officials, production managers) with

partial reform winners. These constituencies favored reforms that would keep them in control of the SOEs assets, as they believed that “the assets of their enterprise have been created by them and therefore they should have a priority right in the process of privatization” (Kein and Tali 1995). They tended to rely on informal connections for economic gains.

Although a clear-cut ideological divide did not exist between the two groups, as both supported the market direction of the reform process, they pursued very different agendas with respect to issues such as privatization methods, tariffs, and taxation. Thus, the divide was along economic issues and not so much about the general direction of the reform process. As a result, the early Estonian governments, even though coming from different parties and forming different coalitions, pursued policies with market-driven content.

The early Estonian governments comprised reformers whose market aspirations and ideas became the backbone of the transformational road at the time. The government of Edgar Savisaar (March 1990-January 1992) pursued a policy of rapid liberalization of prices and wages and greater enterprise independence from the state. Estonia was still part of the ruble zone, however, which affected its financial and economic transactions. Inflation skyrocketed, the standard of living soared, and the economy slipped into recession (see Table 18). As observers have noted, however, “Savisaar’s cabinet left a complicated legacy: a ‘deficit’ of state property due to uncontrolled privatization, accelerating economic decline, threatening hyperinflation, insolvency of many enterprises and several large banks, and shortages and rationing of essential commodities” (Taaler 1995). In January 1992, the Savisaar government was given a vote of no confidence, and the Coalition Party chief, Tiit Vahi, stepped in as prime minister. The supporters of Vahi came from urban areas and were mainly

people that did well during communism and the transition period (Kein and Tali 1995). The Coalition Party's constituencies were heterogeneous, and among them were radical reformers and nomenclatura. The party, though, generally favored market reforms, too.

In 1992, a new constitution was voted in, under which parliamentary elections were held in September. The Moderates, Pro Partia and the Liberal Democrats formed a right-wing government with Mart Laar as prime minister. Laar's government pursued radical market reforms with the conviction that privatization, competition, and protection of property rights and contracts would put Estonia on the track for building a functioning market economy. Unlike the previous governments, Laar's government had a prevailing majority in parliament until June 1994, which enabled it to carry out swift radical financial reform and ownership transformation.

5. Market Structure Changes

5.1. *De Novo* Creation

As noted above, the radical market reforms in Estonia received strong support from the rapidly emerging new entrepreneurial class. In 1989, pro-market economists and practitioners developed a Program of Estonian Economic Autonomy. The Program was delivered to and approved by the Estonian Supreme Council, and it laid down the principles of the changes in the economy,⁷⁰ including the establishment of new firms (Venesaar and Vitsur 1995).

⁷⁰ Venesaar and Vitsur (1995) describe the program as envisaging "radical changes in the hitherto existing economic relations, such as permitting plurality of ownership and entrepreneurship forms and their principal parity; decentralization of territorial management and the right to self-determination;

Although new firms had started to appear in Estonia as early as 1987 in the form of cooperatives, small state firms outside the planned-centralized network of Soviet firms, and joint ventures, subsequent changes in the regulatory regime in the next few years further encouraged the creation of new private firms. In addition, low capital requirements for market entry brought about many private firms into existence (see Table 19). For example, about 57,000 enterprises were registered in Estonia as of January 1995, and these constituted about 30 firms per 1000 people with a typical structure of nine employees (Venesaar 1995). The influx of new firms made the micro-firms the main economic unit in Estonia just a few years after its independence. Such firms constituted 80 percent of the registered companies in the country in 1995 (Venesaar 1995).

Table 19 Percentage Breakdown of Firms by Ownership in Estonia, 1993-1994

Ownership	Nov 1992	Nov 1993	Sept 1994
State-owned	18.7	3.3	2.3
Municipal-owned	1.3	1.0	1.0
Private	47.3	75.8	78.4
Cooperatives	18.	7.6	5.5
Firms of public organizations	6.0	0.1	0.1
Firms of leased firms	0.5	0.3	0.2
Firms of foundations	0.4	0.0	0.0
Firms with foreign capital participation	5.1	7.8	7.6
Foreign-owned	2.0	4.1	4.9

Source: Venesaar (1995).

The entry of new firms and the development of the private sector affected the structure and composition of output. The chief channel was the growth of the previously neglected services sector but expansion was also strong in retail trade, transport and communications, and real estate services. The growth in output of

more open economic relations and partnerships with other regions of the USSR as well as foreign countries on a mutually profitable basis, etc.”

services was on account of agriculture and industry. For example, at the end of 1999 services constituted slightly less than 70 percent of output, agriculture made up only 5.8 percent of GDP in 1999, down from 16.6 percent at the beginning of 1990, while industry's share declined from 49.7 percent to 25.7 percent over the same period (EBRD Transition Report 1999). The private sector generated over 75 percent of output in 1999, but even in 1995 it had constituted 65 percent of output.

The shift to new economic activities and private owners counterbalanced the economic dominance of incumbent enterprises. The strengths of the managers with vested interests in maintaining the status quo of central planning and government support to their industries was weakened, too. A new entrepreneurial class emerged rapidly and favored market-oriented reforms. These constituencies had expectations that further reforms would enable the development and growth of their business operations.

5.2. Restructuring and Exit

The process of active restructuring in the enterprise sector educed the rapid emergence of anti-reform opponents. The primary tool for restructuring of the Estonian economy was the privatization process in the country. In 1992, 90 percent of companies were state-owned and experienced in conducting economic activities according to the state's central Plan. By 1995, the process was nearly over: almost all the small former SOEs and 472 of the medium to large ones were sold to private owners (EBRD 2000, Estonian Privatization Agency). Quickly shifting the property rights from the state to private owners brought fundamental changes, not only in the composition of the economic activities but also in the incentives structure. Improvements in both governance and viability of the privatized companies have been observed. As Nelis (1996) points out, up to 1996, at least, no privatized firm had

failed, while the same former state companies continued to expand and hire more employees.

The aggregate numbers for the period after 1994 drew a similar picture: the average growth of exports was 8.7 percent (1994-99); industrial production grew on average by 5 percent a year (1994-2000); industrial labor productivity rose on average by almost 2 percent a year (1995-1999); unemployment only slightly increased (1.5 percent on average between 1994 and 2000); output recovered to 84.1 percent of its pre-transition levels (1994-2000); and the average investment rate was 28 percent a year (1995-1999).⁷¹

The institution of bankruptcy greatly facilitated the restructuring of Estonian industry and the termination of soft lending practices. The success of the restructuring program had greatly contributed to the tough and effectively implemented bankruptcy legislation as well as to the incentives the prospects of liquidation provided firms to find a strategic partner (OECD 2000, 119). The Bankruptcy Law was introduced in 1993 as one of the most active bankruptcy programs in the former socialist countries, according to experts in the field (Nelis 1994). For example, by May 1994 the registrar for the liquidation of enterprises had received notices of completed liquidation (due to bankruptcy) of 26 enterprises with another 200 bankruptcy cases in process (Nelis 1994). An important signal about the government's commitment to enforce property rights and financial discipline was sent out.

The active bankruptcy procedures, used in liquidating insolvent and unsound firms in Estonia, helped to strengthen financial discipline on the market. The government did not intervene but stepped back and allowed the new institution of exit to work its way in taking unsound firms off the market. Observers comment that “[t]o

⁷¹ Data from *Business Central Europe* statistics, EBRD (2000) and UN (2001).

their shock, many of the banks, who had assumed that credits to state-owned enterprises would be honored by the Government if the enterprises could not pay, discovered that they had to wait with other creditors for their share of recovered assets” (Fleming et al. 1996:20). As a result, the volume of potential bailouts of non-performing borrowers by the banks on behalf of the state was eradicated, ultimately resolving a moral hazard problem that was common for Eastern Europe.⁷²

* * *

To sum up, the Estonian economy emerged from its transformational recession and overcame the exigencies of the inherited command economy by imposing discipline on the market. The economic actors faced the incentive to restructure so that they would become more competitive and profitable in the new economic environment. Resistance to change on behalf of anti-reform industrial groups would lead to their firms’ closure. The Estonian government not only committed to no bailouts, but also managed to terminate the practice of preferential lending through the commercial banks and build support for enforcement of their policy approach. Encouraging new entry and restructuring created economic actors who stood against the old institutions of informal lending.

6. Privatization

The processes of private sector development shaped the structure of the economy and allowed for the emergence of a new entrepreneurial class from both new firms and ones that were old but restructured. What was the mechanism that prevented

⁷² For a thorough discussion on bankruptcy experiences and policy implications see Claessens, Djankov, and Mody (2001).

the industrial incumbents from gaining control of the privatized firms? This section looks at the process of privatization in answering this question.

6.1. Methods and Time Line

The process of privatization in Estonia started in 1990, when parliament adopted the Law on Ownership. Although privatization as a process had wide popularity, a consensus on the methods through which it was to be implemented did not form (see section 4 above). The governments of Savissar and Vahi were advocates of a quick privatization with economic benefits and capital for the privatized firms. Parliament, however, blocked or delayed the passage of such legislation to carry out the proposed policy for the privatization of the economy prior to 1992. In the meantime, the leasing of the state firms by their employees with preferential options for subsequent purchase, became a popular form of privatization between 1990 and 1991. More than 200 leases of SOEs were extended to company insiders, with the idea of converting them into joint-stock companies to improve their financial standing for later privatization and giving the leaseholders a stake in the company reflecting the improvements (Nelis 1994).

In 1992, several laws were adopted, which institutionalized the process of privatization and practically launched the start of the privatization of the enterprise sector. Strong pressure from industrial insiders influenced the rules of ownership transformation. As a result, the hallmark of this legislation was small-scale privatization that gave pre-emptive rights to SOE insiders.

The first companies offered for “real” privatization in 1991 were the ones operating in services, trade and catering with a book value of less than RUB 0.5 million. Although each company could have been privatized through auctions, tenders, or sales of shares, employees and managers purchased 80 percent of the

SOEs at an initial discounted price (Kein and Tali 1995). By June 1992, some 449 firms had been sold through this method.

However, both the leases and the insider method lost popularity due to the inability to adjust the value of the firms for privatization to the high inflation at the time. Most of the companies sold in this period were purchased below the market price. The expected revenues from privatization were much higher than the ones actually generated. In addition, strong pro-reform supporters felt left out from the process and rejected the exclusive insider method of privatization. As a result, amendments to extend the scope of small-scale privatization to bigger firms and limit the advantages of insiders in the bidding process were passed in May 1992. Insiders were still favored, however, as they were given the opportunity to match the highest bid prior to its acceptance. This arrangement lasted until June 1993, when the control of all privatization deals, including small-scale sales, was shifted to the Estonian Privatization Agency, and the privileges of insiders were removed (OECD 2000, 125). Auctions became the most widely used method in the privatization of the SMEs. As Kein and Tali (1995) report, by the end of 1993, 825 such firms had been sold, generating over 50 percent more than their initial valuation.

Early in the transition period, vouchers that could be used to buy shares in privatized firms, housing, and land were also distributed to the population. However, the Estonian voucher program had a very limited scope in the enterprise privatization process. Nelis (1996) reports that in only two large and fifteen small “combination” sales in Estonia (which included a strategic core investor in the privatization) a small part of shares were offered to the public in exchange for vouchers.

The experience with small-scale privatization influenced the decision to implement a Treuhand-type of sale for the divestiture of the large-scale firms. The

Estonian model of privatization envisioned that the Estonian Privatization Agency would take charge of the sale of all state assets.⁷³ The role of the agency was “to find real owners capable of running a durable, productive firm” (Nelis 1996). The autonomous nature of such an institutional arrangement ensured minimum pressure from industrial interests in the privatization process. According to the Privatization Law, the employees of an enterprise could not receive any special privileges or rights in the privatization process (Estonian Privatization Law, chap. 4). However, workers and managers could take part in the privatization by submitting their bids and business plans, i.e. following the very same procedure as any other outside bidder. The quality of privatization bids was judged on the basis of expected investments and the creation of new jobs (Estonian Privatization Law, Art.21). Thus, the law ensured that all potential buyers compete on an equal basis.

By the end of 1995, over 90 percent of the industrial and manufacturing enterprises in Estonia were no longer state-owned (Nelis 1996). The privatization of large-scale firms was completed by 1997, while the small enterprises were mostly privatized by 1994, and the new owners were mainly outsiders with access to capital, including foreign investors (see Table 20). Strategic foreign participation was one of the most popular ways to sell and was favored not only for the required capital for restructuring and modernization but also for the technological know-how and exposure to new markets it brought to these companies. Big infrastructure and strategic companies such as Estonian Air, Estonian Shipping, parts of the electricity

⁷³ Until August 1993, two separate agencies responsible for the privatization process existed in Estonia: the State Property Department arranged auctions for smaller SOEs, while the Estonian Privatization Enterprise initiated the large-scale privatization of state firms. The two agencies merged into one in 1993 under the Estonian Law on Privatization to form the EPA as the only agency responsible for the organization of the privatization of state property (Estonian Privatization Law, Art.6(2) and 7).

grid, Eesti Telekom, and Estonian Railways were privatized, too. Their privatization was conducted mostly between 1996 and 1999. Again, no insider favoring took place.

Table 20 Summary of the Estonian Privatization Experience

Year	Privatization Initiatives
1989-1991	About 200 companies were leased by employees.
1991	A transfer of the "people's enterprises" was made to their employees for fees.
1991-May 1992	Early small-scale privatization in services, trade, and catering, favoring employees.
Since 1992	Most of the small-scale as well as large-scale privatization favors economic groups with access to capital, including foreigners.

Source: Based on Jones and Mygind (1999, 426), (Kein and Tili 1995).

Observers have assessed the privatization in Estonia as being the "most successful part in the spheres of structural reforms" (Lohmus 1999). Insider participation and treatment were greatly diminished after 1992. Selling firms to outsiders managed to break the informal ties between the incumbent managers and the state, and, more importantly, allowed the government to effectively disengage itself from the firms.

6.2. Owners and Corporate Governance in the New Firms

The main motive to use sales to outsiders in the privatization of SOEs was the conviction that in order to undertake effective strategic restructuring in the industry, both capital and expertise were much needed. In the early stages of privatization, capital was not an obstacle, as insiders bought small-scale firms for very low values. Investments, however, were essential in the restructuring and development of the privatized firms as well as for the successful implementation of the direct-sales method.

With the strengthening of the rules under which banks lend to firms in Estonia and the presence of bankruptcy as a real threat, the enforceability of property rights improved dramatically. For example, firms became able to use their assets as

collateral in exchange for financial resources. Also, the tradability of assets allowed banks to effectively exercise its creditors' rights. The scarcity of financial resources in the still small banking sector as well as the government's approach to no bailouts made the banks scrutinize their borrowers thoroughly before extending a loan (see next section). In addition, the increased number of new and privatized companies made the competition for funds stronger. Thus, financial resources became available to firms where incentives to restructuring were present.

The predominant outsider ownership of the firms in Estonia, and especially in the large firms with alleged ties to the state in receiving soft financing, stimulated the emergence of companies with clearly defined property rights and a profit-oriented incentive structure. This therefore established strong corporate governance structures in Estonia, where ownership rights were well defined, enforceable, and tradable, improving the competitiveness of firms in obtaining financial resources (OECD 2000).

7. Implications for the Banking System

7.1. Abolishing Informal Ties

Low barriers to entry, active restructuring, and privatization created conditions for the emergence of strong political supporters in favor of decisive reforms in the financial sector early in the transition period. Abolition of the informal ties between the state and firms was relevant, however, if the government commitment to no bailouts was to succeed. The state managed to harden budget constraints on banks by institutional strengthening of the banking system and the process of loan-making.

To this end, Eesti Pank adopted a series of regulatory changes. For example, in 1993, a new licensing procedure and a new requirement regarding the minimum share

capital for the commercial banks were enforced through the new Law on Credit Institutions. Also, Eesti Pank increased the level of required reserves and the capital adequacy ratio (from 8 to 10 percent), and introduced a reserve requirement of 5 percent of risk-weighted assets (see Table 21; also Government of the Republic of Estonia and European Commission Directorate General for Economic and Financial Affairs 2000). In addition, internal audit departments and the requirement for an annual external audit for all banks were institutionalized through the Law on Credit Institutions of 1993 (Fleming et al. 1996, 15). Such institutional measures ultimately increased the transparency in loan-making.

Table 21 Banking Regulatory Requirements in Estonia, 1992-1999

Year	Capital Adequacy Ratio Requirement (%)	Minimum Capital Requirement (unless stated, mln EEK)
1992	8	0.5
1993	8	6
1994	8	15
1995	8	25
1996	8	50
1997	10	60
1998	10	75
1999	10	EUR 5 million

Source: Estonian Central Bank.

The regulatory changes aimed at ceasing the operation of small undercapitalized banks and encouraging the creation of larger consolidated commercial banks with levels of capital adequacy meeting international banking standards (Table 21). The aim of the regulator was to consolidate the system and in the long run create a smoother financial intermediation with a higher degree of capitalization.

The government policy of no money for bailouts was not painless, however. A second crisis hit the Estonian banking sector in 1994 resulting from another chain of

unprofessional lending decisions to “old” but understructured borrowers in some of the banks, the withdrawal of budgetary funds in others, and inability of banks to adapt to the new dynamics of the macroeconomic environment. The liquidation of the Eesti Sotsiaalpank (Estonian Social Bank) and Arengupank (Development Bank) were such examples. Both banks plunged into difficulties for their inability to embark on a market-type credit assessment and lending and engage in prudent managerial practice.

Although, the problems in these banks did not have systemic consequences for the rest of the sector, a new wave of strengthening of the regulatory framework subsequently took place that affected the structure of the banking sector in Estonia (see Table 21). The increased requirements for the minimum funds owned by the banks, for example, provoked the merger of some banks. Banks with a small capital base were unable to survive; they either had to be consolidated or closed, but they were not allowed to operate undercapitalized. The mergers’ effect was more stabilizing for the industry than harming competition. The market was small enough to be catered by several healthy banks with a higher degree of capitalization rather than an array of small unstable banks.

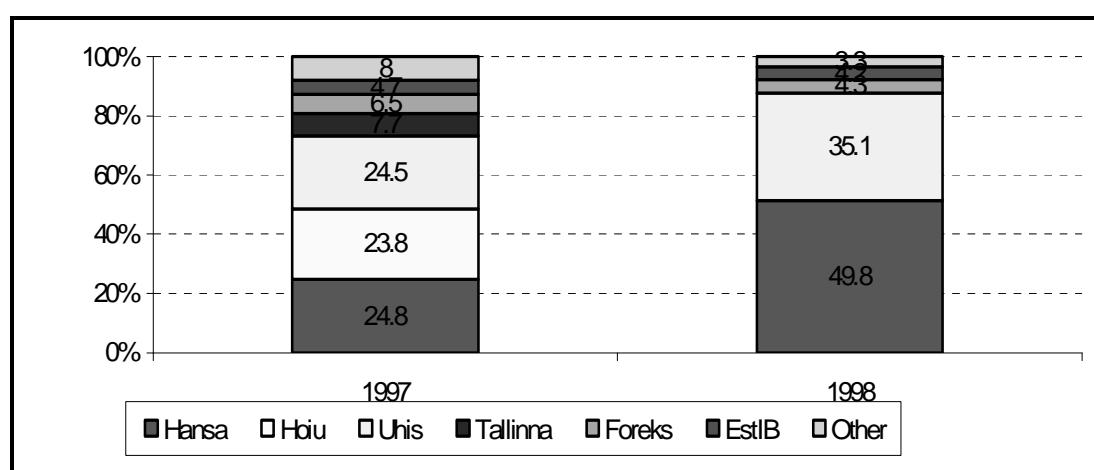
7.2. Banking Consolidation and Privatization

Enforcing stringent rules on the way banks were to operate and make loans affected not only the quality of the loan portfolios in the banks but also the structure of the banking system. The first sizeable wave of consolidation took place in 1995 and 1996, when four banks jointly formed Eesti Maapank (Rahvapank, Keila Pank, Eesti Maapank, and Varummapank). At the same time two other banks, Eesti Foreksipank and Raepank, incorporated into Eesti Foreksipank. In the same period, Eesti Toostusipank, the industrial bank of Estonia, merged into the structures of Eesti Hoiupank.

The Estonian banking sector, similarly to the other East European banking industries, went through a second banking consolidation of the financial system later on. The shakeup of the financial markets in the country in 1997 after the Russian crisis was one of the reasons to undertake some additional closures of several inefficient financial institutions. The closures of such banks were a result of the mismanagement of the risks and the involvement of individual banks in the Russian market (Lohmus 1999, Sorg 1999). The bankruptcy of ERA Bank and EVEA Bank in late 1998 was an illustration of this phenomenon.

Three big consortiums emerged as a result of the continued process of bank consolidation in 1998 in Estonia (see Figure 14): the merger between Hansa Bank and the state savings bank Hoiupank formed the biggest financial intermediation institution in Estonia under the name Hansapank. The bank became the market leader in customers' deposits on the Estonian market and as of September 1998 the bank owned about 47.8 percent of the total assets in the banking sector (Sorg 1999).

Figure 14 Estonian Banking Consolidations: Breakdown by Assets



Source: Own calculations from Danil (1998).

The second largest of the six commercial banks operating in 2000 in the country, Uhispank, emerged from another merger between two financial institutions

in 1998: Ühispank and the Tallinna Pank, the latter supplying experience in corporate banking and electronic know-how. The two new banks, Hansapank and Ühispank account for about 80 percent of the Estonian market (of the consolidated balance). The third merger was between the Forexpank and Estonian Investment Bank. The new commercial bank, Optiva Bank, entered the market with a share of about 9 percent.

In addition to the consolidation process, the privatization of the commercial banks in Estonia helped abolish the informal nature of lending practices, which were associated with high risks. The banking privatization was characterized by two distinctive characteristics: a pronounced presence of strategic foreign investors and no delays. Scandinavian investors gained a leading participation in the Estonian banking sector, not only through opening branches of their banks but also (and mainly) through buying shares in local commercial banks. As early as 1993, several Finnish banks opened their offices in the country, and later on Eesti Pank granted the first foreign banking licenses to KOP and SYP from Finland. Scandinavian banks such as OKO Bank, Baltiiski Bank, Svenska Handelsbanken, Siberian Trade Bank and Basis Bank are still among the leading foreign financial institutions in Estonia.

In 1998, the Swedbank purchased 60 percent of Hansapank, after a fierce competition with the Skandinaviska Enskilda Banken. The foreign group strengthened the position of the Estonian bank on the market by bringing capital (by purchasing almost all of one of the emissions of Hansapank shares and increasing the capital by EEK 1.4 billion), expertise, and corporate governance (Danil 1998).⁷⁴ Skandinaviska

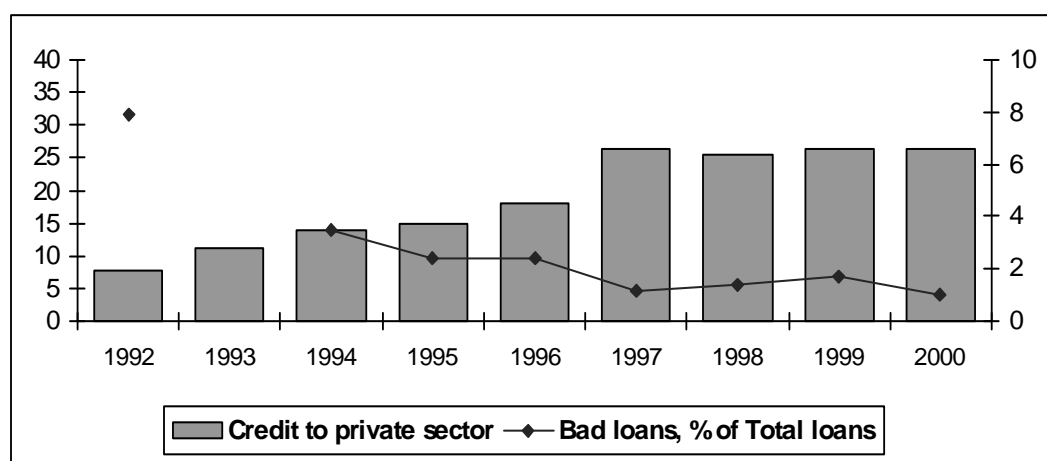
⁷⁴ The remaining shareholders in Hansapank at the end of 1998 were the Merita clients (12 percent), the EBRD (9.7 percent), HTAS (2 percent), and others.

Enskilda made a strong entry in the Baltics through the purchase of a large packet of shares in Uhispank, too.⁷⁵

7.3. Overall Outlook on the Banking System

The no-money-for-bailouts approach had positive overall implications for the development of the financial sector in Estonia. The commercial banks established a more cautious behavior in their lending policies and stronger credit portfolios. For example, the credit provided to the private sector went up and interest rates on loans decreased (see Figure 15 and Table 22). At the same time, the share of overdue loans decreased to 3.5 percent of total assets in 1994. Banks stopped lending to defaulting incumbent customers, as no state guarantees for rescue existed any longer.

Figure 15 Private Sector Credit (*left scale*) and Bad Loans (*right scale*) in Estonia, 1992-1998



Source: EBRD (1999).

⁷⁵ Uhispank's shareholder structure is an example of a dominant foreign participation corporate structure. As of 1998 Scandinaviska Enskilda Banken owned 32 percent of Uhispank, the IFC held about 10 percent, Swedfund had about 4.4 percent and the rest was spread among different private clients and individuals (Danil 1998).

By hardening the budget constraints of the firms, credit became available to both old and new borrowers, without the threat of crowding out viable projects. At the same time, the measures strengthened the financial discipline for both borrowers and creditors and enforced rules for exit of unsound firms and banks. As a result, the strength of the anti-reform groups was disrupted, as preferential treatment for financial resources dried up.

The Estonian banking sector responded to the development of the private sector by supplying funds for investments, directed toward restructuring or creation of new ventures in the economy. The long-term loans, for example, accounted for over 85 percent of the lending in the banking system. Broken down by individual banks, such loans represented over 90 percent of the loan portfolio of Eesti Krediidipank in 1999, 87.57 percent of Uhispak, 66.58 percent of Hansapank, and 87.20 percent of Optivapank (Eesti Pank Statistics).⁷⁶

Looking at the loan portfolio composition of the overall Estonian banking sector broken down by the type of customer shows that on average 77 percent of borrowers were private sector undertakings or individuals, while credits to the general government or funding of commercial undertakings of local or state governments amounted to approximately 1.5 percent on average for the five-year-period (Eesti

⁷⁶ **Table Deposits and Loans in the Estonian Banking Sector, 1994-1998**

Deposits (mln EEK)		Date	Loans (mln EEK)	
Total, mln EEK	Demand deposits, %		Total, mln EEK	Long-term loans, %
6933	81.7	31 December 1994	4276	50.9
9635	81.1	31 December 1995	6733	67.4
13860	75.0	31 December 1996	12070	74.2
21401	67.8	31 December 1997	21295	76.3
21470	59.4	31 December 1998	23898	86.6
26412	63.0	31 December 1999	26660	85.6
34773	61.0	31 December 2000	34237	86.0

Source: IMF survey.

Pank statistics; also see Table 22). Obviously, commercial banks in Estonia had geared their lending in accordance to the changing structure of the economy.

* * *

To summarize, the problems in the Estonian banking sector were tackled with untraditional methods for the East European countries. The major difference lay in the fact that the Estonian government did not use informal arrangements in the allocation of financial resources or repeated recapitalization. Instead, the government consolidated and privatized the commercial banks, and strengthened discipline on the market. By 1999 there were seven commercial banks in Estonia, in which the share of state-owned banking assets was only 7.9 percent. Such developments found appearance in the financial indicators of the system. The strengthened health of the banking sector was visible in the small interest rate spread, the increase in credit to the private sector, the decrease in the support to SOEs, and the improved perception of Estonia by foreign investors (see Table 22). The average return on assets was 1.3 percent, return on capital 10.24 percent, and the average share of non-performing loans in the system 1.05 percent for the period between 1996-2000 (IMF 2001).

Table 22 Financial Indicators for Estonia, 1990-1999

Selected Financial Indicators	1991	1992	1993	1994	1995	1996	1997	1998	1999
Interest rate spread	-	-	-	11.58	7.21	3.4	0.4	7.4	0.3
Private sector share in GDP	10.00	25.00	40	55	65	70	70	70	70
Credit to private sector (% of GDP)	20.20	7.53	11.17	14.12	14.88	18.08	26.33	25.33	26.35
FDI, net inflows (% of GDP)	-	1.94	4.14	5.44	4.21	3.44	5.61	11.17	5.83
Domestic savings (% of GDP)	11	29.2	-	-	18.66	16.28	19.31	18.96	18.83

Source: EBRD (1999) and UN (2001).

8. Conclusion

In the early 1990s, the Estonian reformers faced the dilemma of reforming quickly and expanding the banking sector or using it as a vehicle to stabilize the rest of the economy, which had been hit by the transformational recession. The latter option, almost inevitably, would entail accumulation of new problem loans and costly bailouts. Moreover, ambiguity about how much involvement through direct and indirect ties the government should bear in both reforming and rescuing the industrial complex while not risking the entire stability of the financial sector in Estonia, existed.

In effect, the government opted for a no-money-for-bailouts approach in restructuring the financial sector. For the success of this policy approach, the government needed to improve the quality of the bank borrowers. Supporters of such reforms became the beneficiaries of low barriers to entry, active restructuring, and privatization of the state firms as well as institutional guarantees for no privileged access to soft money. This policy approach encouraged the development of financial intermediation by securing financial discipline and thorough evaluation of financial projects, with no expectations for state bailouts.

Estonia pursued a policy that encouraged the existence of only a few banks, but stable and healthy ones where political patronage and bailouts were unpopular. The wave of bank closures and stringent regulation made the rest of the sector cautious in its lending decisions. It became apparent for borrowers and lenders and for private and state-owned firms that the regulator punished those who did not respect the rules. The times of cheap credits from above were over, and developing good skills for risk analysis and diversification proved to be existential for the banks. As a result, the commercial banks stopped being reckless in their lending policies.

CHAPTER VII

COMPARATIVE OVERVIEW

1. Introduction

Important progress on several chief dimensions was made in the 1990s in the development of the financial system in Eastern Europe. First, the introduction of a two-tier banking system facilitated the separation of the activities of commercial banks from those of the central bank and influenced the modernization of the financial industry in the region. Second, the liberalization of entry of banks into the market provided an opportunity not only for newly established banks to emerge but also for foreign banks to start operations in a market chiefly dominated by state-owned specialized banks from the era of socialist planning. Third, various institutional reforms to strengthen and improve the process of intermediation of financial resources were initiated. Although this progress has been significant, the changes came with challenges at every step in the development of the banking sector in the region. Cleaning the inherited bad loans from the monobank, and terminating the subsequent practice of soft lending was one such challenge and the most persistent problem in the banking sector in the 1990s. This study focused specifically on the problem of the restructuring of bad debt and analyzed the experiences of Bulgaria, Poland, and Estonia in order to understand the motivation of these three governments in tackling the same problem differently.

As Chapter II emphasized, soft lending is chiefly an incentive problem that needs to be tackled with the appropriate institutional considerations. I proposed the hypothesis that the intermediation of financial resources from banks to borrowers becomes impeded when the strong beneficiaries of soft credits suppress demand from other market participants for financial institutions with market features. This

proposition prompted more precise research about the structural impediments to the development of the financial system in Eastern Europe at the end of the 1990s. However, structural variables alone did not provide a sound enough understanding of the forces that shaped the development of the sector. Therefore, I also recognized the importance of placing the actors and their motivations in the center of the analysis, in order to understand the incentives behind their decisions to block or support a market-ruled intermediation of resources. As a result, market structure as well as incentives for interest groups became major factors that helped me unveil why some East European states made solid progress in launching a successful restructuring of bad debt while others failed to do so.

The three countries offered diverse experiences, as presented in Chapters IV to VI, which will be briefly summarized on a comparative basis in the sections below (sections 3 and 4). This chapter, however, will also focus on an important question that was not explicitly emphasized in the analysis in the preceding chapters but which I believe is key to understanding the success of combating the soft loans problem and of launching financial reforms in Eastern Europe – namely, the link between soft loans and anti-reform groups and the direction of the causality in the argument (see section 2). Section 5 draws together the chapter with some conclusions.

2. Direction of Causality or Feedback?

The leading argument of this study was based on the premise that where strong anti-reform industrial groups existed, soft credits prevailed. The anti-reform groups preferred to preserve the status quo in finance and continue to rely on soft funds. Strong anti-reform groups blocked both the termination of soft loans and consequently the effective restructuring of bad debt in commercial banks' portfolios.

However, the relationship between the soft credits and the strength of the anti-reform groups is not necessarily an obvious one. As argued in the theoretical chapters, restricted entry of market participants, inactive restructuring of the enterprise sector, insider privatization of firms, and the presence of informal ties between the supplier of soft credits and the firms to which they are given all foster strong anti-reform groups. The flip side of this argument, however, may be equally valid, too. When budget constraints are hardened and soft lending is terminated, market participants have incentives to restructure their companies effectively or exit the market if their business operations are unsound. In addition, new firms have an incentive to enter the market, as preferential treatment to old players ceases and access to bank financing is not restricted only to incumbent firms. Conversely, when soft budgets prevail, there is no mechanism for effective exit of firms (and banks), and hence little restructuring occurs. By the same line of reasoning, soft lending guarantees banks that they will be rescued, regardless of the risk they take in lending to politically protected borrowers. Banks have no interest in seeking their creditors' rights in a bankruptcy procedure of their borrowers, as they have *ex ante* the knowledge that losses on doubtful loans to shielded firms will be covered *ex post* by the state. When soft credits of banks are no threat to the commercial banks' own existence, exit is not an issue for the financial intermediaries, either. With these competing explanations, one inevitably questions the direction of causality of the argument in this study.

This study argues that the motivation behind the interest of the domestic industrial incumbents to block financial reforms resulted from their ability to extract privileged financial support and non-market based intermediation of financial resources. For as long as such groups were in dominant market positions, they could compel the state to secure their demands and consequently resisted the hardening of

budget constraints. Even though circularity between non-market intermediation of loans and strong anti-reform industrial groups might be initially apparent, the causality of the argument is valid. Anti-reform interests reigned not because of the existence of underdeveloped banking in Eastern Europe but because their market and political position enabled them to secure channels for obtaining privileged access to financial resources from commercial banks by capturing the early transition states. By keeping the channels of soft financing open, the governments “fed” the strengths of anti-reform groups, creating a mechanism for re-enforcing the power of the anti-reform incumbents.

This is to emphasize once again that soft budgets are subject to the design of the institutions that govern the relationship between firms, banks, and the state. Where the beneficiaries of soft budgets were strong, they were able to affect the institutions that direct financial exchanges in a way that secured their own preferences for soft lending.

3. Comparative Experiences with Anti-Reformers

After emphasizing the role of the feedback interaction between the weakening of the anti-reform groups and the process of hardening budget constraints, I can now draw some comparisons from the experience of the three countries discussed in Chapters IV to VI.

3.1. Structural Comparisons

Structural variables can be employed to explain the practice of soft lending by the commercial banks, which leads to a dangerous accumulation of non-performing loans (see for example, Berglof and Roland 1997). This approach attributes the phenomena of soft credits to the low-level quality of available investment projects.

Without competitive borrowers, banks end up lending to firms with poor overall prospects for growth, which inevitably increases the likelihood of the firms facing difficulties in debt servicing of such loans and ultimately leads to the transformation of these loans into non-performing debt.

Following the logic of these structural arguments, the quality of loans should broadly reflect the changes in the economy, which in turn will affect the relationships between firms and commercial banks. For example, in countries where output recovered quickly after the transformational recession, the quality of investment projects should be higher than those in the countries that were unable to rebound. Similarly, countries with deep structural distortions left from the period of socialism would be expected to have difficulties in supplying high quality investment opportunities in the real sector for commercial banks. Although both of these propositions might be valid in general, testing such hypotheses on the three country cases does not prove fruitful. To illustrate this difficulty, let us see how the three countries fare on both of these structural variables in relation to soft loans.

Estonia, compared to Bulgaria and Poland, started the transition period with more pronounced overall distortions in the economy. Even though the country was among the most developed republics of the SU, the mere fact that it was a part of the USSR for 51 years brought higher levels of repressed inflation, black-market premium, and larger CMEA trade dependence than in the other two countries (see de Melo et. al 1997; Popov 1998; de Melo et al. 1996). The combination of these factors suggests that structural distortions were deeper in Estonia at the beginning of the 1990s than in the other two countries. However, in spite of the high level of

distortions, Estonia demonstrated less vulnerability to dominant anti-reform incumbents in the 1990s, as well as a higher quality of bank loans.⁷⁷

Another example is the recovery of output. The initial causes for the massive fall in output, and especially in industrial production, had a systemic character, as the economic conditions inherited from communism exerted an adverse influence on the economic prosperity of these nations (see for example, Blanchard 1993, de Melo et al. 1996, World Bank 2002). However, Poland, for example, managed to recover more quickly than the other two comparators, although the quality of its investment projects, as indicated by bad debt in the banks' portfolios, was poor for several years after the recovery of output. In contrast, Estonia suffered a sharp output decline but nonetheless managed to abolish soft financing fastest.

These examples do not imply that structural variables are not well suited to explain variations in the quality of borrowers. Rather, the explanatory power of output recovery and inherited structural distortions is not sufficient *per se* to account for variations in soft loans, and one needs to probe deeper. For example, among the many hypotheses regarding the fall in output in Eastern Europe, the importance of disruption to production chains in an environment lacking coordination from central planners seems of utmost importance (Blanchard and Kremer 1997).⁷⁸ It draws the attention to the agents (firms) and their options in solving business and production problems. It also takes into account the market structure, as the “disorganization” effect on the existing production links caused by the early liberalization was huge, but

⁷⁷ For an interesting discussion on the evolution of output in transition economies, see Berg et al. (1999) and Blanchard (1993).

⁷⁸ See Raland (2000, Ch. 7 and 8) for a comprehensive review of the literature on output fall in the 1990s in Eastern Europe.

the influx of new firms was unable to offset the effects quickly (see for example, Roland 2000).

Thus, the emerging market structure has an important role in breeding contention among market participants about the way resources are allocated. The basic premise, emphasized in Chapters II and III, was that where *distorted markets* prevailed, “new” agents such as *de novo*, restructured, or foreign firm would not emerge to contest the soft allocation of funds toward borrowers with political protections.

Two channels underpinned the weakening of the status quo beneficiaries of soft financing in Eastern Europe on market structure. These were the emergence of new types of firms through restructuring of SOEs and new entry. Spurring competition and private sector development through lowering barriers to entry and exit undermined unproductive incumbents and weakened their market position. For example, massive new entry in Estonia secured support for radical market reforms and offset the strengths of the beneficiaries of risky bank lending. In addition, the swiftly implemented bankruptcy law facilitated the exit of SOEs and improved the incentive for them to restructure actively.

In Poland, the barriers to entry of domestic firms were also low at the beginning of the 1990s, which gave a strong push for the development of the private sector in the country. However, market competition suffered, as the appropriate exit procedures for unsound firms were not politically favored. As a result, loss-makers were kept afloat for political reasons through soft financing. This certainly hurt the restructuring process and prevented the enforcement of financial discipline on the market.

Bulgaria fared worst among the three countries. Although new entry of firms seemed strong in the early 1990s, many of the new registered entities were only companies on paper. At the same time, there was a complete lack of restructuring and the state relied exclusively on state firms to run their operations. Neither of the two channels was successful in generating market participants with strong pro-reform preferences in Bulgaria.

The message from the three case studies is that where the state stamps out competition and *de novo* business creation in order to support anti-reform incumbents, the termination of soft loans and ultimately the development of the financial sector slows down. At the same time, ineffective restructuring efforts create firms with operations unsuitable for the requirements of a competitive market structure. As the experience in the three countries reveals, the success in meeting the efficiency goals of the market through active restructuring and competition was not common and swift where industrial incumbents remained in an uncontested market position.

3.2. Incentives

Insiders and Corporate Governance in Privatized Firms. Privatization of the economy in Eastern Europe was one of the most significant processes for the changes in the economic environment of the region. It entailed shifts not only in the ownership structure of the real sector but also in the incentives and motivation of how the economic agents conducted their activities. The ownership transformation process was seen as a great opportunity to facilitate the shift from socialist to market-based rules in the economy through the institution of private property rights. However, it was also confronted by obstacles of various natures, among which were the unfamiliarity with the market and the lack of capital for privatization transactions, allowing only the well-positioned incumbent groups to influence the methods of state

divestiture and consequently take control over the state economy. In this study, I argued that where the industrial incumbents had access to the ownership transformation process, corporate governance of privatized firms suffered, as managers had incentives to seek rents but not profits for the firms through soft credits.

The three East European countries under study here offered a rich variety of methods and motivation in the privatization of their industrial sectors, as reviewed in Chapters IV, V, and VI. The Estonian experience revealed that shortly after the country's independence, an agency to handle the ownership transformation process was created and entrusted to fulfill its mandate in an independent manner. The initiated privatization process provided for a minimum of favoring and equal treatment for all potential buyers in the period prior to the sell-off of state firms. The most widely spread privatization technique was the direct sale of the SOEs. As pointed out in Chapter VI, within only a few years of the start of the privatization process, over 90 percent of the industrial and manufacturing sectors were privatized, including the privatization of large-scale firms (Nelis 1996). Most of the privatization deals were achieved with economic groups with access to capital, including foreigners (Jones and Mygind 1999, 426). The new owners brought much needed investment as well as modern know-how, technology, contemporary managerial practice, and new markets to these firms. The outsiders' technique in the ownership transformation process also enabled the conditions for good corporate governance by creating firms with clearly defined ownership structures and market incentives.

In contrast, delayed privatization and insider favoritism, allowed the incumbents' interest groups to remain in control of the industrial firms in Bulgaria, as demonstrated in Chapter IV. For a long period, most of the industrial restructuring in Bulgaria consisted of politically driven changes in the management, rather than in

restructuring, privatization, or investment in capital improvements. As a result, the corporate governance structure of these firms was weak and the incentives to seek soft loans were strong. The heavy pressure from non-restructured SOEs for funds and support from the state remained present for most of the 1990s.

Poland responded to privatization in a different way from Estonia and Bulgaria. The privatization of the industrial sector started with an emphasis on methods that would favor domestic groups, and the power of dominant insiders – company managers and employees, sectoral ministries and voivodships – was strong, especially in the direct privatization of state-owned firms. The decentralized nature of the privatization process ensured that the founding organs controlled the process from the initiation of the privatization of each enterprise to the actual decision of the methods through which its ownership structure was to be transformed. Surprisingly, however, the insider method of privatization did not necessarily bring weak owners. The role of employees' councils in the privatization of firms was crucial, because in many firms they served as a control mechanism on managerial conduct prior to the privatization. Not only did they prevent the managers from asset stripping the firms but they also often worked with them in searching for the best buyer for the firm.

Although commentators point to the advantages that insiders had in the privatization of state firms in Poland, it was demonstrated in Chapter V that the Polish insiders had less opportunities for extracting rents in comparison to the incumbent managers of the SOEs in Bulgaria, for example. This can be attributed to the stronger corporate governance structure in Polish firms, especially prior to their privatization.

Informal Ties. In the sections above, I emphasized the importance of the process of restructuring and of new business creation for the emergence of a

competitive market structure in Eastern Europe. I also stressed the differences in the incentive structures of outsider versus insider privatized firms. However, the economic reforms, including the changes in the banking sector, could not have become sustainable without the institutional grounds to ensure a profit-motivated relationship between borrowers and lenders. The environment of relationship-based financing encouraged the functioning of institutions where economic actors were treated selectively and rules were not respected uniformly. As a result, there always emerged groups favored by the incumbent system with a powerful say in policy-making. In turn, economic transactions became skewed toward the preferences of privileged incumbent firms, as these transactions enabled the incumbents' access to valuable financial resources from the state.

The presence of informal ties between the “supplier” of soft credits and the firms became a powerful disincentive for the market participants to adapt their operations to the requirements of a competitive market. As illustrated in the case of Bulgaria, by maintaining its rigid structure of decision-making, the state (through sectoral and local administration) continued to provide preferential credits to industrial insiders for years. Keeping the financial sector under the state's control accommodated the politically driven allocation of credits. Loss-making firms were given soft loans by commercial banks, which themselves received soft-credit terms from the central bank and the government. The arrangement only reaffirmed the position of the incumbent industrial groups.

In contrast, Estonia tried to establish formal links and institutions between borrowers and lenders by strengthening the regulatory side of the banking sector and credibly keeping its commitment for no bailouts of firms or banks. For example, as early as 1992, the capital adequacy requirements were at 8 percent. At the same time,

the minimum capital requirement for banks increased in steps from EEK 0.5 million in 1992 to EEK 75 million in 1998 and to EUR 5 million a year later.

However, such regulatory changes were not introduced and enforced as early in the transition period in Bulgaria or Poland (or in most other East European countries). As a result, the vulnerability of the banking system to informal arrangements in loan making was prolonged. In Bulgaria, for example, only after the crisis of 1997 was the regulatory environment strengthened to prevent such practices as concentration of loans to individual borrowers, faulty valuation of assets, inadequate capital reserves, or high-risk exposure of the commercial banks. The outcome of these rules had a disciplining effect as expected, but at the same time bankers became very conservative in project financing, as government backup was no longer available. In all three countries, bankers had to learn effective screening and monitoring techniques for their lending operations in order to adjust to new conditions on the financial market. As a result, banks terminated loans to risky projects and treated borrowers with cautiousness.

Policymakers in Poland tried to avoid the fiscal burden of the non-performing loans in the banking sector and shifted the responsibility of cleaning the banks' portfolios to the financial intermediaries. However, instead of formalizing the institutional relationship between banks and firms through the implementation of clear rules for loan-making, the state policy practically encouraged the continuation of informal relations between borrowers and lenders. Non-performing loans were restructured via new loans. This refinancing, however, was a dangerous policy exercise, as it created a disincentive for the borrowers to repay their new loans and kept the channels for loan-workouts open. Accordingly, forced credit relations threatened to corrupt the balance sheet of banks.

4. Approaches to Bad Debt Restructuring

At the onset of transition, the East European governments had several options in cleaning non-performing debt from the banking system and at the same time minimizing moral hazard and strengthening financial discipline. This study argues that the strategy of restructuring non-performing debt in the banking sector in the three Eastern European countries reflects circumstances of political economy, reviewed in the previous section, which may empower or weaken the strength of the beneficiaries of soft financing in their quest for soft loans.

The bad debt restructuring experience in the three Eastern European countries was be classified in three distinct types: first, a government that assumes all losses from recapitalization of the banking sector through its guarantees, as in the case of Bulgaria; second, a government that closes unsound banks and imposes some losses on depositors, as in the case of Estonia; and third, a government that makes commercial banks deal with their losses and work out restructuring of bad debt with their borrowers, as in the case of Poland. What are the distinct characteristics and benefits (if any) of each of these approaches?

The chapter on Estonia emphasized the importance of the credible commitment of the government to terminate support of and bailouts for unsound firms and banks. The *no-money-for-bailouts* approach was the more radical in comparison to the other two strategies and delivered the fastest results in enforcing financial discipline. Its commitment was credible, as the government revoked the licenses of several illiquid banks as early as 1993 and continued to exit unsound banks in the following years. At the same time, it strengthened the regulatory environment and privatized the financial sector, enabling the emergence of healthy banks in the country.

In Poland, the process started with recapitalization of the commercial banks in 1993 and the consequent launch of the *bank-led-enterprise-restructuring* strategy for bad debt resolution, which aimed at commercial banks' full engagement in the restructuring of heavily indebted enterprises. Although commercial banks were left to deal with their problem borrowers on a case-by-case basis, the government tried to push for their involvement with the indebted enterprises through debt-for-equity swaps and conciliation agreements. The commercial banks, however, did not embark on the debt-for-equity exchanges on a significant scale but used other lending techniques and liquidation to restructure the bad debt of their borrowers. The approach was not particularly successful, as it encouraged new lending to "old" borrowers with questionable quality. It also created conditions for aggravating the moral-hazard problem.

The Bulgarian experience with the restructuring of the commercial banks' portfolios was one of repeated and *unconditional bailouts*. The ZUNK bonds became an expensive and inefficient instrument to cover non-performing credits accumulated prior to 1990. The mismatch between the return and the maturity of the bonds led to an alarming liquidity drain in the banks holding them. At the same time, financial discipline was never enforced on the market, as commercial banks kept amassing new bad loans through political crediting and bailouts. The consequences were alarming, and the banking sector collapsed in late 1996.

From the case studies of banking restructuring experience in the three East European countries, several points deserve emphasis. First, as highlighted in the case of Estonia, for any government to successfully resolve a system-wide bad debt problem, credibility is an important requirement. Policymakers need to ensure that the

recapitalization of banks is a once-and-for-all action, but not “an open-ended intention to bail out shareholders, managers or large creditors in the future” (Honohan 2001, 6).

Second, the approach to bad debt restructuring that the government chooses may have significant fiscal consequences. How much it has cost to the East European governments to re-capitalize their troubled banking sectors has varied from country to country (Caprio and Klingebiel 2003). I have compared the fiscal estimate of combating bad debt in the system for the three countries subject to study here, and Bulgaria has accumulated by far the highest costs in comparison with Poland and Estonia (see Table 1).

Third, apart from the fiscal considerations, which the government needs to account for, there is an important monetary policy dimension, which also requires some emphasis. In choosing an approach to bank restructuring, policymakers need to ensure that the resolve does not destabilize monetary conditions in an unintended way, as “the central bank is often the first official agency in line to provide financial support to a failing bank” (Honohan 2001, 18). The Bulgarian experience is a “text book” example of the danger of repeated recapitalization of commercial banks to monetary policy stability, due to the central bank lending to insolvent financial institutions.⁷⁹ In contrast, the resolution of the bad debt problems in Estonia and Poland did not have adverse effects on monetary stability due to the stringent monetary policy of the respective central banks in the two countries.

* * *

⁷⁹ Bagehot (1873) in *Lombard Street* elaborates on the idea of the central bank as the lender of last resort and emphasizes that the central bank should lend only to solvent, but illiquid financial institutions, i.e., “the central bank should not create a soft budget constraint” (Maskin and Xu 2001, 22).

As demonstrated in the country studies and already noted above, the success of banking restructuring in the three East European countries depended on the market structure and incentive framework under which both banks and firms operated. Improving the incentive framework included the abolition of informal channels for soft credits and strengthening the regulatory environment in which loans were made. A “proper” incentive structure also implied corporate governance and ownership structure of banks and borrowers, well-defined property rights, and respect for contracts, as well as transparency, the speedy restructuring of viable firms and the exit of unsound ones (Claessens et al. 2001,6).

5. Conclusion

The shift from a socialist to a market-based economic system in Eastern Europe presented the challenge of how quickly to change structures and rules in the economy. The foundations of the economy at the beginning of the 1990s were based on socialist planning, where prices, allocation of resources, level of production, capacity and employment were all results of the government Plan. The ‘invisible hand’ of the market was not there to bring supply and demand together at a market-clearing price. The fall of the socialist regime in Eastern Europe, however, did not deposit a functioning capitalist system in its place. Instead, the economy was pierced by market distortions and informal exchanges, which left their mark on the relationship and interactions between the economic agents in each of these countries.

In the sections above, the main argument and findings of the study were sketched out. From the many questions that were raised throughout this study, it has become apparent that the forces that determined the approach of the three Eastern European governments to abolishing soft lending reflected the strengths of the

beneficiaries of soft credits. The economic structure and institutions of the transition period shaped the power of anti-reform incumbents.

The general aim of the financial reform process was to eventually bring about a system of financial intermediation that resembled the capitalist one – with maximized efficiency and minimized transaction costs. The concept could have easily tempted us to vouch for a uniform targeting of a policy mix that would eventually facilitate the transition to a market-based loan making. This study, however, tried to avoid building *ex post* a "best practice" model for bad debt resolution. Instead, it focused on studying the domestic forces that shaped the evolution of the government approach to the problem of soft lending in three East European countries.

This study analyzed the relationships between several key factors that influenced the governments' approaches to the restructuring of bad debt in the three countries. These four elements – namely, market entry, active restructuring, outsiders' privatization and formal rules – conspired dynamically to varying degrees to produce a rich legacy of experience and lessons learned from the banking systems in Bulgaria, Poland, and Estonia.

REFERENCES

- Abarbanell, Jeffery S. and John P. Bonin. 1997. Bank Privatization in Poland: The Case of Bank Slaski. *Journal of Comparative Economics* 25 (1):31-61.
- Acemoglu, Daron and James Robinson. 2003. "Chapter1: Introduction." In Acemoglu and Robinson. *Political Origins of Dictatorship and Democracy*. (forthcoming). At <http://web.mit.edu/14.773/www/Chapter%2011.pdf> [accessed May 2003].
- Acemoglu, Daron. 2002. Why Not A Political Coase Theorem? Social Conflict, Commitment and Politics. *National Bureau of Economic Research working paper* 9377:1-48. (December). At <http://www.nber.org/papers/w9377> [accessed May 2003].
- Agency of Small and Medium Enterprises. 1999. *Report on the Small and Medium-Sized Enterprises in Bulgaria, 1996-1999*. Sofia: ASMEs. At <http://www.asme.bg/en/comments/rep1999/summary.doc> [accessed May 2003].
- Alesina, Alberto and Allan Drazen. 1991. Why Are Stabilizations Delayed? *National Bureau of Economic Research working paper* 3053. Cambridge, MA: NBER.
- Anderson, Ronald W. and Chantal Kegels. 1998. *Transition Banking: Financial Development of Central and Eastern Europe*. Oxford: Clarendon Press.
- APIS. 1995. Law on the Settlement of Non-performing Credits. *Collection of Bulgarian Laws* Vols. 6 and 7. Sofia: Sofia Press.
- Arukaevu, Riita. 1997. Estonian Money Market. *Review of Economies in Transition* 7. Helsinki: Bank of Finland.

- Aslund, Andres, Peter Boone, and Simon Johnson. 1996 How to Stabilize: Lessons from Post-communist Countries. *Brookings Papers on Economic Activity* 1:217-313. Washington, D.C.
- Avramov, Roumen. 1999. The Role of a Currency Board in Financial Crises: The Case of Bulgaria. *Bulgarian National Bank Discussion Paper* 6. Sofia: BNB.
- Baer, Herbert L. and Cheryl W. Gray. 1996. "Debt as a Control Device in Transitional Economies: The Experience of Hungary and Poland." In *Corporate Governance in Central Europe and Russia*, eds. Roman Frydman, Cheryl Gray and Andrzej Rapaczynski. Budapest: CEU Press.
- Bagehot, W. 1873. *Lombard Street: A Description of the Money Market*. London: H.S. King.
- Balcerowicz, Ewa. 2003. "Barriers to Entry and their Impact on Private Sector Growth in Poland." In *Barriers to Entry and Growth of new Firms in Early Transition: A Comparative Study of Poland, Hungary, Czech Republic, Albania and Lithuania*, eds. Iraj Hoshi, Ewa Balcerowicz, and Leszek Balcerowicz. Boston, MA, Dordrecht, and London: Kluwer Academic Publishers.
- Balcerowicz, Leszek. 1995. *Socialism, Capitalism, Transformation*. CEU Press: Budapest.
- Balyozov, Zdravko. 1995. Bolnite Banki i merkite za tiahnoto ozdraviavane. [Unhealthy banks and measures for their recovery] *Bankov Pregled* 3. Sofia.
- Banker* [weekly newspaper]. 1995. April 3 Issue.
- Berg, Andrew, Eduardo Borensztein, Ratna Sahay, and Jeromin Zettelmeyer. 1999. The Evolution of Output in Transition Economies: Explaining the Differences. *International Monetary Fund Working Papers* 73. Washington, D.C.: IMF.

- Berglof, Erik and Patrick Bolton. 2002. The Great Divide and beyond: Financial Architecture in Transition. *Center for Economic Policy Research Discussion Paper* No 3476. London: CEPR.
- Berglof, Erik and Gerard Roland. 1997a. Soft Budget Constraints and Banking in Transition Economies. *Stockholm Institute of Transition Economics and East European Economies Working Paper* 131:1-46. Stockholm: SITE.
- Berglof, Erik and Gerard Roland. 1997b. Soft Budget Constraints and Credit Crunches in Financial Transition. *European Economic Review* 41 (3-5):807-818.
- Blanchard, Olivier and Michael Kremer. 1997. Disorganization. *Quarterly Journal of Economics* 112 (4):1091-1126.
- Blanchard, Olivier and Philippe Aghion. 1996. On Insider Privatization. *European Economic Review* 40: 759-766.
- Blanchard, Olivier. 1993. *Post-Communist Reform: Pain and Progress*. Cambridge, Mass.: MIT Press.
- Blaszczyk, Barbara. 1998. Moving Ahead: Privatization in Poland. *Economic Reform Today*, Center for International Private Enterprise Publication. At http://www.cipe.org/publications/fs/ert/e32/e32_04.htm [accessed May 2003].
- Bonin, John P. 1995. Banking in the Transition: Privatizing Banks in Hungary, Poland, and the Czech Republic. *Institute for East West Studies* (October).
- Bonin, John P. and Bozena Leven. 1996. Polish Bank Consolidation and Foreign Competition: Creating a Market-Oriented Banking Sector. *Journal of Comparative Economics* 21 (1): 52-72.
- Bristow, John A. 1996. *The Bulgarian Economy in Transition*. Cheltenham, UK; Brookfield, Vt.: Edward Elgar.

- Buchanan, James M., and Gordon Tullock (1962). *The Calculus of Consent*. Ann Arbor MI: University of Michigan Press.
- Buchanan, James M., Robert D. Tollison, and Gordon Tullock. 1980. *Toward a Theory of the Rent-Seeking Society*. College Station: Texas A & M University.
- Bulgarian National Bank. 1995. *Bulletin*. 1. Sofia: BNB.
- Bulgarian National Bank. *Statistics*. Sofia: BNB. Via <http://www.bnb.bg> [accessed May 2003].
- Business Central Europe*. 2000. At <http://www.bcemag.com/statsdb/index.php3> [accessed March 2000].
- Capital* [weekly newspaper]. 1998. Spisakat potvardi i podredi izvestni kreditni pirati. [The list confirmed and ranked famous credit-pirates]. Issue no.3
- Capital* [weekly newspaper]. 2000. Otdushnitzite na valutnia board. [The vents of the currency board]. Issue no.32.
- Caprio, Gerard and Daniela Klingebiel. 2003. Episodes of Systemic and Borderline Financial Crises. Mimeo (January). Washington, D.C.: The World Bank. Via <http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf> [accessed May 2003].
- Caprio, Gerard Jr. and Patrick Honohan. 1999. Beyond Capital Ideals: Restoring Banking Stability. *World Bank Policy Research Working Paper* 2235. Washington, DC: World Bank.
- Claessens, Sijn. 1997. State enterprise performance and soft budget constraints: the case of Bulgaria. *EBRD Economics of Transition* 5: 305-22 (November).
- Claessens, Stijn, Daniela Klingebiel and Luc Laeven. 2001. Financial Restructuring in Banking and Corporate Sector Crises: What Policies to Pursue? paper

- presented at the NBER conference on Management of Currency Crises, held in Monterey, 28-31 March 2001.
- Claessens, Stijn, Simeon Djankov, and Ashoka Mody, eds. 2001. *Resolution of Financial Distress: An International Perspective on the Design of Bankruptcy Laws*. WBI Development Studies. Washington, DC: World Bank.
- Coase, Ronald H. 1937. The Nature of the Firm. *Economica* 4:386-405.
- Coase, Ronald H. 1960. The Problem of Social Cost. *Journal of Law and Economics* 3 (1):1-44.
- Coase, Ronald. 1960. The Problem of Social Cost. *Journal of Law and Economics* 3: 1-31.
- Danil, Sander. 1998. Estonian Banking Sector. *Millennia*. Tallinn: Eesti Uhispank, via <http://www.eyp.ee> [accessed November 1999].
- de Melo, Martha, Cevdet Denizer, Alan Gelb, and Stoyan Tenev. 1997. Circumstance and Choice: The Role of initial Conditions and Policies in Transition Economies. *Policy Research Working Paper* 1866. Washington, D.C.: World Bank.
- de Melo, Martha, Cevdet Denizer, and Alan Gelb. 1996. From Plan to market: Patterns of Transition. *Policy Research Working Paper* 1564. Washington, D.C.: World Bank.
- Debande, Olivier and Guido Friebel. 1999. A Positive Theory of Insider-Privatization. *Stockholm Institute of Transition Economics and East European Economies Working Paper*. SITE: Stockholm.
- Demsetz, Harold. 1967. Toward a Theory of Property Rights. *American Economic Review* 57: 347-359.

- Dewatripont, Mathias and Eric Maskin. 1995. Credit and Efficiency in Centralized and Decentralized Economies. *Reviews of Economic Studies* 62: 541-555.
- Dewatripont, Mathias and Gerard Roland. 2000. Soft Budget Constraints, Transition, and Financial Systems. *Journal of Institutional and Theoretical Economics* 156(1): 245-269.
- Dittus, Peter and Stephen Prowse. 1995. Corporate control in Central Europe and Russia: Should Banks Own Shares? *World Bank Policy Research Working Papers* 1481. Washington, D.C.: World Bank.
- Djankov, Simeon and Peter Murrell. 2000. The determinants of enterprise restructuring in transition: an assessment of the evidence. World Bank (mimeo). Via <http://rru.worldbank.org/DoingBusiness> [accessed May 2003].
- Djankov, Simeon and Peter Murrell. 2002. Enterprise restructuring in transition: a quantitative survey. *Journal of Economic Literature* 40 (3):739-92 (September).
- Dobrev, Dobrislav. 1999. The Currency Board in Bulgaria: Design, Peculiarities and Management of Foreign Exchange Cover. *Bulgarian National Bank Discussion Paper* 9. Sofia: BNB.
- Dobrinsky, Rumen. 1994. "Reform of the Financial System in Bulgaria." In *The Development and Reform of Financial Systems in Central and Eastern Europe*, eds. John P. Bonin and Istvan P. Szekely. Aldershot, Hants, England; Brookfield, VT: Edward Elgar.
- DoingBusiness Database. At <http://rru.worldbank.org/DoingBusiness> [accessed May 2003].
- Eastwood, Robert and Adam Durski. 1992. Financial Reform in Poland; Some Parallels with Chilean Experience 1973-83. *University of Maryland Center for*

International Business Education and Research. Occasional Paper 24
(October):1-18.

EBRD. 1995. *Transition Report*. London: EBRD.

EBRD. 1997. *Transition Report*. London: EBRD.

EBRD. 1999. *Transition Report*. London: EBRD.

EBRD. 2000. *Transition Report*. London: EBRD.

EBRD. 2002. *Transition Report*. London: EBRD.

Estonian Privatization Agency. *Estonian Law on Privatization*. Via <http://www.eea.ee>
[accessed October 2000].

Eteba. 2001. Weekly Bulletin, 9-15 June. Via <http://www.eteba.bg> [accessed
September 2001].

European Commission (DG ECFIN). 2002. Report on Macroeconomic and financial
sector stability developments in candidate countries. *Enlargement Papers* 8.

Fernandez, Raquel and Dani Rodrik. 1991. Resistance to Reform: Status Quo in the
Presence of Individual-Specific Uncertainty. *American Economic Review*
81:1146-55.

Fleming, Alex, Lily Chu and Marie-Renee Bakker. 1996. The Baltics – Banking
Crises Observed. *Policy Research Working Papers* 1647. Washington, D.C.:
World Bank.

Frydman, Roman and Andrzej Rapaczynski. 1994. *Privatization in Eastern Europe: is
the state withering away?* Budapest: Central European University Press.

Frydman, Roman, Andrzej Rapaczynski, John S. Earle eds. 1993. *The Privatization
Process in Central Europe: Economic Environment, Legal and Ownership
Structure, Institutions for State Regulation, Overview of Privatization
Programs, Initial Transformation of Enterprises*. Budapest: CEU Press.

- Frydman, Roman, Cheryl W. Gray, and Andrzej Rapaczynski, eds. 1996. *Insiders and the State*. Budapest: CEU Press.
- Frydman, Roman, Kenneth Murphy, Andrzej Rapaczynski. 1998. *Capitalism with a comrade's face: studies in the post-communist transition*. Budapest, Hungary: Central European University Press.
- Gazeta Bankowa*. 1997. Vol. 9, no. 436. (Translated from Polish).
- Gerschenkron, Alexander. 1962. *Economic Backwardness in Historical Perspective*. Cambridge, MA: Belknap Press of Harvard University Press.
- Gertler, Mark and Andrew Rose. 1991. *Finance, growth, and public policy*. Washington, D.C.: Country Economics Dept., World Bank.
- Ghosh, Atish R., Anne-Marie Gulde, and Holger C. Wolf. 1998. Currency boards : the ultimate fix? *International Monetary Fund Working Paper* 8. Washington, D.C.: IMF.
- Government of the Republic of Estonia and European Commission Directorate General for Economic and Financial Affairs. 2000. Joint Assessment of the Economic Policy Priorities of the Republic of Estonia. Brussels March 28, 2000. At http://www.fin.ee/english/development_plan/ja_final_2303.htm [accessed May 2003].
- Gray, Cheryl W. and Arnold Holle. 1996. Bank-led Restructuring in Poland: An Empirical Look at the Bank Consolidation Process. *World Bank Policy Research Working Papers* 1650. Washington, D.C.: World Bank.
- Hagelberg, Raimund. 1996. Observations on Banking in the Context of Macroeconomic Relations. *Eesti Pank Bulletin* 3 (22). At <http://www.ee/epbe/bulletin96/3/> [accessed November 1999]

- Hanke, Steve H. 1987. "The necessity of property rights." In *Privatization and Development*, ed. Steve H. Hanke. Institute for Contemporary Studies: San Francisco, CA.
- Hanke, Steve, Lars Joung and Kurt Schuler. 1993. *Russian Currency and Finance*. London: Routledge.
- Hansson, Ardo. 1994. Reforming the Banking System in Estonia. Presented for the LSE/IEWS conference Banking Reform in fSU and Eastern Europe: Lessons from Central Europe, Budapest, 14-15 January 1994.
- Hashi, Iraj. 1997. The Economics of Bankruptcy, Reorganization, and Liquidation: Lessons for East European Transition Economies. *Russian and East European Finance and Trade* 33 (4):6-34. (July-August).
- Hellman, Joel and Daniel Kaufmann. 2001. Confronting the Challenge of State Capture in Transition Economies. *Finance and Development* 38 (3):31-35.
- Hellman, Joel, Geraint Jones and Daniel Kaufmann. 2000. Seize the State, Seize the Day' State Capture, Corruption, and Influence in Transition. *World Bank Policy Research Working Paper 2444*. Washington, D.C.: World Bank.
- Hellman, Joel. 1998. Winners Take All: The Politics of Partial Reform in Postcommunist Transitions. *World Politics* 50: 203-34.
- Heritage Foundation. *Index of Economic Freedom*. At <http://www.heritage.org/research/features/index> [accessed May 2003].
- Hoag, John and Mark Kasoff. 1999. Estonia in transition. *Journal of Economic Issues* 33 (4):919-31.
- Honohan, Patrick. 2001. Recapitalizing Banking Systems: Implication for Incentives and fiscal and Monetary Policy. DECRG (mimeo). Washington, D.C.: The World Bank. Via

- <http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf> [accessed May 2003].
- Housner, Jassob and Nielsen eds. 1995. *Strategic Choice and Path-dependency*. Aldershot, Hants UK; Brookfield, Vt.: Edward Elger.
- IMF. 1993. *Economic Review: Estonia*. Washington, D.C.: IMF.
- IMF. 2000a. Statistical Appendix: Poland. Washington, D.C.: IMF.
- IMF. 2000b. *World Economic Outlook: Focus on Transition Economies*. Washington, D.C.: IMF.
- Johnson, Gordon W. 1999. "State-Owned Enterprise Insolvency: Treatment of Financial Distress." In *Building Effective Insolvency System*. World Bank, D.C. At http://www4.worldbank.org/legal/insolvency_ini/WG8-paper.htm [accessed May 2003].
- Jones, Derek C. and Niels Mygind. 1999. The Nature of Ownership changes after Privatizaion: Evidence from Estonia. *Journal of Comparative Economics* 27 (3):422-441.
- Journal of Laws*. 1990, no. 51; 1993, no. 44.
- Kaufmann, Daniel, Aart Kraay, Pablo Zoido-Lobaton. 1999. Governance Matter. *World Bank Policy Research Working Paper* 2196. Washington, D.C.: The World Bank.
- Kein, Alar and Veiko Tali. 1995. "The Process of Ownership reform and Privatization" In *Transforming the Estonian Economy*. Institute of Economics, Estonian Academy of Sciences: Tallinn.
- Keremdechiev, Spartak and Todor Gradev. 1999. "Company restructuring in the Bulgarian Transition." In *Privatization and Economic Performance in CEE:*

- Lessons to be Learnt from Western Europe*, ed. Ivan Major. Cheltenham, UK. Northampton, MA, USA: Edwards Elgar.
- Kitschelt, Herbert, Zdenka Mansfeldova, Radoslaw Markowski, Gabor Toka. 1999. *Post-Communist Party System: Competition, Representation, and Inter-Party Cooperation*. Cambridge: Cambridge University Press.
- Korhonen, Liika. 1996. Banking Sectors in Baltic Countries. *Review of Economies in Transition*. Helsinki: Bank of Finland.
- Korhonen, Liika. 2000. Baltic Privatization Bogs Down *Transition Newsletter of the World Bank Development Economic Research Group* 11 (5). Washington, D.C.: World Bank. At <http://www.worldbank.org/html/prddr/trans/augsep00/page41.htm> [accessed May 2003].
- Kornai, Janos 1986. *Contradictions and Dilemma: Studies on the Socialist Economy and Society*. Cambridge, MA: MIT Press.
- Kornai, Janos. 1980. *The Economies of Shortage*. New York: North-Holland.
- Kornai, János. 1992. *The Socialist System: The Political Economy of Communism*. Princeton, N.J.: Princeton University Press.
- Kornai, Janos. 1998. The Place of Soft Budget Constraint Syndrome in Economic Theory. *Journal of Comparative Economics* 26 (1):11-18.
- Kuus, Toivo. 1997. Estonia and EMU Perspective. *Review of Economies in Transition* 7. Helsinki: Bank of Finland.
- La Porta, Rafael, Florencio Lopez-De-Silanes, and Andrei Shleifer. 2002. Government Ownership of Bank. *The Journal of Finance* 57 (1):265-301.
- Landesmann, Michael. 2000. "Structural Change in the Transition Economies, 1989-1999." In *United Nations Economic Survey of Europe 2000* 2 (3). Paris: UN.

- Lepik, Ilmar. 1995. Development of Financial Intermediation in Estonia in 1992-1995 Presented for Financial Markets in the Transformation Process – Prerequisite or Result of Successful Reforms Workshop in Kiel Institute fur Weltwirtschaft.
- Lewis, W. Arthur. 1950. *The Principles of Economic Planning*. London: G. Allen and Unwin.
- Lichback, M. I. 1997. "Social Theory and Comparative Politics." In *Comparative Politics: Rationality, Culture, and Structure*, M. I. Lichback and A.S. Zucherman. Cambridge: Cambridge University Press.
- Litwack, John. 1993. Coordination, Incentives and the Ratchet Effect. *Rand Journal of Economics* 24 (2):271-285.
- Lohmus, Peter. 1999. Recent Economic Trends in Estonia. Speaking notes presented at The Central and East European Issuers and Investors Forum. Vienna, 19-20 January 1999. Via <http://www.ee/epbe/en/release/ar990119.html> [accessed November 2000].
- Maskin, Eric and Chenggang Xu. 2001. Soft Budget Constraint theories. *Economics of Transition*. 9 (1):1-27.
- Meyendorff, Anna and Snyder. 1997. Transactional structures of bank privatizations in Central Europe and Russia. *Journal of Comparative Economics* 25 (1):5-30.
- Mietkowski, P. 1997. Bulgaria: the Chronicle of a Predicted Collapse *Conjuncture* 7-11 (June).
- Miller, Jeffrey B. 1999. The Currency Board in Bulgaria: The First Two Years. *Bulgarian National Bank Discussion Paper* 11. Sofia: BNB.
- Minkov, Plamen. 1993. Banks and Banking Reform in Bulgaria. *Russian and East European Finance and Trade* 29 (2):22-37.

- Mitchell, Janet. 2000. Theories of Soft budget Constraints and the Analysis of Banking Crises. *Economics of Transition* 8 (1):59-100.
- Mitchell, Janet. 2001. Bad Debts and the Cleaning of Banks' Balance Sheets: an Application to Transition Economies. *Journal of Financial Intermediation* 10 (1):1-27 (January).
- Montes-Negret, Fernando and Luca Papi. 1997. The Polish Experience with Bank and Enterprise Restructuring. *World Bank Policy Research Working Papers* 1705. Washington, D.C.: World Bank.
- Nagaoka, Sadao and Izak Atiyas. 1990. Tightening the Soft budget Constraint in Reforming Socialist Economies. *The World Bank Industry and Energy Department Working Paper, Industry Series Paper* 35. Washington, D.C.: World Bank.
- National Bank of Poland. 2000. *Summary Evaluation of the Financial Situation of Polish Banks 1999*. Banking System Analysis Section and Banking System Off-Site Analysis Division. Warsaw: NBP.
- National Bank of Poland. 2001. *The Polish Banking System in the Nineties*. Warsaw: NBP. At <http://www.nbp.pl/en/publikacje/index.html> [accessed May 2003].
- National Bank of Poland. 2002. *Summary evaluation of the financial Situation of Polish Banks: First Half of 2002*. General Inspectorate of banking Supervision. Warsaw: NBP.
- National Bank of Poland. 2002. *Summary evaluation of the financial Situation of Polish Banks: First Half of 2002*. General Inspectorate of banking Supervision. Warsaw: NBP.
- Nelis, John. 1994. Privatization in Estonia: Major Accomplishments and Remaining Problems. *Viewpoint*. FPD Note no. 19. Washington, DC: World Bank.

- Nelis, John. 1996. Finding Real Owners – Lessons from Estonia’s Privatization Program. *Viewpoint*, FPD Note no. 66. Washington, DC: World Bank.
- Nenova, Mariela, Nikolina Miltcheva, Tzvetan Manchev, Aleksandar Mihailov. 1997. *Finansovata politika v Bulgaria v usloviata na prehod kam pazarna iкономика*. (In Bulgarian). Sofia: Bulgarian National Bank. [Financial policy in Bulgaria in the conditions of transition to market economy].
- Nenovsky, Nikolay and Kalin Hristov. 1997. “Criteria for Evaluation of the Systemic Risk Under Currency Board.” In *The Banking Sector in the Conditions of the Currency Board*. Sofia: Institute for Market Economy and Open Society Press.
- North, Douglas. 1990. *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press.
- North, Douglass C. 1990. *Institutions, Institutional change, and Economic Performance*, Cambridge University Press, New York.
- OECD. 1997. *Economic Surveys: Bulgaria 1997-1997*. Center for Co-operation with the Economies in Transition. Paris: OECD.
- OECD. 2000. *Baltic States: A Regional Economic Assessment*. OECD: Paris.
- Olson, Mancur. 1982. *The Rise and Decline of Nations: Economic Growth, Stagflation, and Economic Rigidities*. Yale University Press, New Haven and London.
- Palda, Filip. 2002. Interest Groups: A Survey of Public Choice Thinking. At <http://econwpa.wustl.edu/eps/pe/papers/0209/0209006.pdf> [accessed May 2003].
- Parisi, Francesco. 2003. Political Coase Theorem. *Public Choice Journal* 115 (1-2): 1-36 (April).

- Pautola, Niina. 1998. Optimal Currency Areas, EMU and the Outlook for Eastern Europe. *Review of Economies in Transition* 1. Helsinki: Bank of Finland.
- Pawlowicz, Leszek. 1995. A Polish Primer on Reforms: Privatize, Commercialize, Temporize. *Economic Reform Today banking and Financial Reform* 1. At <http://www.cipe.org/publications/fs/ert/e15/poland.htm> [accessed May 2003]
- Peev, Evgeni. 2001. Corporate Governance Transformation in Transition Economies: Evidence from Bulgaria. Proceedings of the 3rd Workshop on Corporate Governance in Europe. DIW: Berlin.
http://www.diw.de/deutsch/publikationen/vierteljahrshefte/docs/papers/v_01_2_10.pdf [accessed May 2003].
- Perotti, Enrico C. 1993. Bank Lending in Transition Economies. *Journal of Banking and Finance* 17 (5):1021-32.
- Person, Torsten, Gerard Roland and Guido Tabellini. 1997. Separation of Powers and Political Accountability. *Quarterly Journal of Economics* 112:1163-1202.
- Pissarides, Francesca, Miroslav Singer, and Jan Svejnar. 2001. Objectives and Constraints of Entrepreneurs Evidence from Small and Medium Size Enterprises in Russia and Bulgaria. *William Davidson Institute Working Papers*. Michigan: William Davidson Institute.
- Polish Ministry of Treasury. 2000. Report on Ownership Transformation in 1999. Via <http://www.mst.gov.pl> [accessed February 2001].
- Popov, Vladimir. 1998. Will Russia Achieve Economic Growth? *Communist Economies an Economic Transformation* 10 (4): 421-449.
- Postepska, Grazyna. 1999 The newest changes in the Polish legislation referring the banking area and related areas. *The Poland Outlook*. At <http://www.cmck.com.pl> [accessed February 2001]

- Proharska, Maria and Plamen Tchipev. 2000. *Establishing Corporate Governance in an Emerging Market: Bulgaria*. Sofia: Center for Study of Democracy. At: <http://www.csd.bg/pdf/eng/corgov/full.pdf> [accessed May 2003].
- Ravitz, M. 1992. The Bulgarian Banking System, *Bank Review* 2. Sofia: BNB
- Roland, Gerard. 2000. *Transition and Economics: Politics, Markets and Firms*. Cambridge, MA London, England: The MIT Press.
- Schaffer, Mark E. 1998. Do Firms in Transition Economies Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence, *Journal of Comparative Economics* 26 (1):80-104.
- Schuler, Kurt. 1996. *Should Developing Countries Have Central Banks? Currency Quality and Monetary Systems in 155 Countries*. London: Institute of Economic Affairs.
- Schumpeter, Joseph A. [1934] 1983. *The Theory of Economic Development*. New Brunswick and London: Transaction Books.
- Schumpeter, Joseph A. 1939. *Business Cycles: a Theoretical, Historical, and Statistical Analysis of the Capitalist Process*. New York, London, McGraw-Hill Book Company, Inc.
- Schumpeter, Joseph A. 1950. *Capitalism, Socialism, and Democracy*. New York, Harper.
- Sega (Daily Newspaper)*. 2000. August 8 Issue.
- Shleifer, Andrei and Robert Vishny. 1992. Corruption. *Quarterly Journal of Economics*. 108:599-618.
- Shleifer, Andrei and Robert Vishny. 1994. Politicians and Firms. *Quarterly Journal of Economics*. 109:995-1025.

- Shleifer, Andrei and Robert W. Vishny. 1998. *The Grabbing Hand: Government Pathologies and their Cures*. Cambridge, MA: Harvard University Press,.
- Shleifer, Andrei. 1994. Establishing property rights. *Discussion paper series Harvard Institute of Economic Research* 1683: Cambridge, MA: Harvard University.
- Sõrg, Mart. 1995. "Banking Reform." In *Transforming the Estonian Economy*. Tallinn: Institute of Economics, Estonian Academy of Sciences.
- Sorg, Mart. 1999. Risk During the Restructuring of Banking: The Estonian Experience. *Eesti Pank Bulletin* 3 (45). At http://www.eestipank.info/pub/en/dokumendid/publikatsioonid/seeriad/bulletaan/bylletaan99/_3/article/index.html [accessed May 2003].
- Stark, David. 1992. Path Dependence and Privatization Strategies in East Central Europe. *East European Politics and Society* 6 (1):17-54.
- State Gazette*. 1992, no. 38; 1994, no. 51; 1996, no. 85; 1997, no. 89; 1998, no. 39; 1999, no. 12.
- Stiglitz, Joseph. 2001. "Bankruptcy Laws: basic Economic Principles." In *Resolution of Financial distress: An International Perspective on the Design of Bankruptcy Laws*, ed. Stijn Claessens, Simeon Djankov, and Ashoka Mody. WBI Development Studies: Washington, DC.
- Szomburg, Jan 1993. "The decision-making structure of Polish privatization." In *Privatization in the Transition to a Market Economy*, eds. John S. Earle, Roman Frydman and Andrzej Rapaczynski. London: Pinter Publishers.
- Taaler, Jaan. 1995. "Economic Reforms: The Main Stages, Programmes and Evaluations." In *Transforming the Estonian Economy*. Tallinn: Institute of Economics, Estonian Academy of Sciences.

- Tang, Helena, Edda Zoli and Irina Klytchnikova. 2000. Banking crises in transition economies: fiscal costs and related issues. *World Bank Policy Research Working Paper* 2484. Washington, D.C.: World Bank.
- The Economist*. 2001. A Survey of Poland. 27 October - 2 November Issue.
- Ulgenerk, Esen and Leila Zlaoui. 2000. From Transition to Accession: Developing Stable and Competitive Financial Markets in Bulgaria. *World Bank Technical Paper* 473. Washington, D.C.: World Bank.
- United Nations. 1998. *Economic Survey of Europe*. Geneva, New York: UN.
- United Nations. 2001. *Economic Survey of Europe*. Geneva, New York: UN.
- Venesaar, Urve 1995. Chapter II: "Private Sector Development." In *Economic and Social Changes in the Baltic States in 1992-1994*, eds. Urve Venesaar and George A. Hachey, Jr. Tallinn: Institute of Economics, Estonian Academy of Sciences.
- Venesaar, Urve and Endel Vitsur. 1995. "Development of Entrepreneurship." In *Economic and Social Changes in the Baltic States in 1992-1994*, eds. Urve Venesaar and George A. Hachey, Jr. Tallinn: Institute of Economics, Estonian Academy of Sciences.
- Wagner, Nancy and Dora Iakova. 2001. Financial sector evolution in the Central European economies: challenges in supporting macroeconomic stability and sustainable growth. *International Monetary Fund Working Paper* 141. Washington, D.C.: IMF.
- WIIW. 2003. Statistics. Via <http://www.wiwi.at> [accessed January 2003].
- Wikipedia: The Free Encyclopedia*. At <http://www.wikipedia.org> [accessed May 2003].

- World Bank. 1996. *Bulgaria Private Sector Assessment*. Report no. 14546-BUL of the Country Operations, Country Department I, Europe and Central Asia Region. Washington, D.C.: World Bank.
- World Bank. 1996. *World Development Report: From Plan to Market*. New York: Oxford University Press.
- World Bank. 1999. *Economic Report: Bulgaria*. Washington, DC: World Bank.
- World Bank. 2000a. *Anticorruption in Transition. A Contribution to the Policy Debate*. Washington, D.C.
- World Bank. 2000b. *World Development Indicators*. CD ROM. Washington, DC: World Bank.
- World Bank. 2001. *World Development Report: Building Institutions for Markets*. New York: Published for the World Bank, Oxford University Press.
- World Bank. 2002. *Transition: The First Ten Years*. Washington, D.C.: World Bank: Washington, DC.
- Wunner, Norbert. 2000. Bad Loans, Soft Budget Constraints and the Political Economy of Financial Market Reform in Transition Economies. *Journal of Policy Reform* 4 (1):51-74.
- Yonkova, A., S. Alexandrova and L. Bogdanov. 1999. "Development of the Banking Sector in Bulgaria." In *The Banking Sector in the Conditions of the Currency Board*. Sofia: Institute for Market Economy and Open Society Press.
- Yotzov, V., N. Nenovsky, K. Hristov, I. Petrova, and B. Petrov 1998. The First Year of the Currency Board in Bulgaria. *Bulgarian National Bank Discussion Paper 1*. Sofia: BNB.

Zoli, Edda. 2001. Cost and effectiveness of banking sector restructuring in transition economies. *International Monetary Fund Working Paper* 157. Washington, D.C.: IMF.

Zuckerman, A. S. 1991. *Doing Political Science: An Introduction to Political Analysis*. Boulder, CO: Westview Press.