

## The interplay of legal and social norms and the failure of the bank credit market in Bulgaria

Größl, Ingrid

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**INGRID GRÖSSL**

**THE INTERPLAY OF LEGAL AND SOCIAL NORMS  
AND THE FAILURE OF THE BANK CREDIT  
MARKET IN BULGARIA**

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**Redaktion:**

Dipl.-Sozialökonomin Marcelle Weber  
ZÖSS – Department Wirtschaft und Politik  
Universität Hamburg  
Von-Melle-Park 9  
D – 20146 Hamburg

Im Internet: [www.zoess.de](http://www.zoess.de)  
E-Mail: [zoess@wiso.uni-hamburg.de](mailto:zoess@wiso.uni-hamburg.de)

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### Abstract

We take up the widely held view that the observed discrepancy between law on the books and law in action has prevented economic transition and investigate its role for the failure of the Bulgarian credit market. In doing so, we focus on the role of injunctive informal institutions which have become internalized in the course of social development. Based on cross-cultural psychology, we show that a particular bundle of fundamental social norms which constitute basic value orientations have both prevented the development of stabilizing regulations and an overall compliance with prevailing laws.

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## 1. Introduction

The break-up of communism and the decision of involved countries to establish market economies hit the world unexpectedly. By then economic scholars had not devoted many resources to problems of economic transition. Hence they borrowed concepts that the major Washington institutes<sup>1</sup> had developed for emerging countries, in particular with the purpose to overcome the Latin American structural crisis (Kolodko, 2002). Following the original version of the Washington Consensus necessary as well as sufficient conditions for the successful implementation of functioning market economies are stabilization policies that impose hard budget constraints on all actors, free trade with goods and capital, privatization and deregulation. Countries like the Czech Republic that took much effort to follow the Washington Consensus experienced a harsh economic downturn and in this respect they did not differ significantly from countries which opted for other ways (McDermott, 2003). Increasingly it became evident that the most crucial hurdles on their ways to market economies were missing or false and ineffective enforcement mechanisms (Kolodko, 2002). The role of social norms and related to this of social capital became the topic of quite a few articles (Raiser, 1997; 1999). In this context it also became evident that law transplants may lead to situations where law is on the books only but not in action, and it is in this respect too, that social norms assume a crucial role (Gray, 1997; Pistor, 1999). The relationship between legal and social norms can be *complementary* in the sense that social norms support the enforcement of the law or indicate the necessity of a new law. However, the relationship between legal and social norms can also be *substitutive* in the sense that social norms undermine the law thus leading to institutional inconsistency. It has been found that law transplants in particular bear the risk of institutional inconsistency thus imposing a major hurdle to successful transition.

In the following paper we take up the idea that the interplay between legal and social norms affects economic transition and in doing so we focus on Bulgaria's bank credit markets. In particular we are interested in the question to what extent institutional inconsistency might have contributed to the failure of the Bulgarian banking system in channelling households' savings into profitable and growth enhancing investment projects. We focus on the bank credit market because bank loans provide the most important financial source to firms in transition countries, and this is in particular the case in Bulgaria. Our article differs from the numerous publications

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<sup>1</sup> John Williamson coined the term "Washington Consensus" and summarized the main proposals, cf. Williamson (1990)

which focus on the Bulgarian banking system insofar as we analyse the interaction between legal and social norms as crucial determinants of the functioning of Bulgaria's bank credit market. In taking up the idea of institutional inconsistency we borrow from those publications that have a focus on law transplants and economic transition. However, we go further by giving the institutional inconsistency hypothesis a theoretical underpinning. In this regard we resort to the law and economics literature as well as to research results on cultural value dimensions which have been achieved in cultural psychology.

Our analysis will reveal that the causes for the Bulgarian banking crisis are deeply rooted in a value system that has produced social norms which countervail legal principles of sound banking. In this respect the absence of the rule of law in the business sector and civil society but also – and crucially so – among members of the government, members of the parliament as well as members of the judiciary is shown to have played a pivotal role. The absence of the rule of law also explains why at the end of the banking crisis Bulgaria opted for the introduction of a currency board which constitutes an external legal enforcement mechanism with respect to the banking sector.

In the remainder of the paper we proceed as follows: The next section provides some theory on the interaction between law and social norms. The merits and gaps of game-theoretic approaches will be clarified. These gaps are shown to be filled by the theory of value dimensions as proposed by cultural psychologists like Hofstede and Schwartz. We then proceed illuminating the role of banks and bank credit in the financial systems and make evident how their behaviour and in due consequence the soundness and efficiency of the banking system is affected by legal and social norms. In section 4 we turn to Bulgaria and the functioning of its bank credit market. In doing so we use the theory of value dimension which delivers an explanation for Bulgaria's institutional legacy. We show how the ensued institutional inconsistency drove Bulgaria into a banking crisis and evaluate implications of the currency board for the soundness and efficiency of the bank credit market.

## **2. Approaches to Explaining the Interaction of Law and Social Norms**

### ***2.1 Definitions and Preliminary Remarks***

Following the New Institutional Economics we define institutions as rules plus their enforcement mechanisms. Formal institutions rely on legal enforcement, informal institutions on private enforcement. Norms in our definition constitute a subset of the set of institutions by having an

obligatory i.e. injunctive content, with legal norms constituting a subset of formal institutions and social norms being a subset of informal institutions.

Compatible market economies based on democratic principles are norms promoting processes of social interaction in which individual and social preferences are reconciled thus enhancing aggregate welfare. Market economies allow for a high degree of individual freedom to choose actions that best serve individual ends. Since individuals are in need of others to reach their personal goals, social interaction is necessary but not sufficient in order to achieve a Pareto-efficient situation. The reason is that some individuals might have the capacity and willingness to increase their personal welfare at the cost of others. In order to avoid these kinds of involuntary redistributions, cooperation is needed. Institutions assume a crucial role in setting individuals appropriate incentives.

Law consists of rules which impose restrictions upon human behaviour in the sense that they constrain the set of feasible actions individuals may choose upon in order to achieve their goals. The extent to which these restrictions are binding, however, depends on the existence of effective enforcement or equivalently, sanctioning mechanisms. In western economies which are based on the factual independence of the courts, this effectiveness has usually been taken for granted. By consequence, legal norms typically are defined as rules which are effectively enforced by state coercion.

Social norms, too, affect human behaviour. Like in the case of legal norms, this may happen by imposing restrictions. However, social norms may also be internalized thus shaping actors' preferences. The effectiveness of social norms depends on private enforcement mechanisms. In terms of internalized social norms external sanctioning mechanisms are replaced by feeling of guilt or satisfaction. By contrast, social norms depending on external mechanisms rely on the loss of reputation, despise by others or on ostracism all of which give rise to costs implying disutility. Of particular interest for the topic of this paper are norms that involve a sense of obligation (Eisenberg, 1999). By this is meant that the violation of an obligational or synonymously – injunctive – norm leads to self-criticism or criticism by others.<sup>2</sup> Social norms which improve the

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<sup>2</sup> Eisenberg draws a clear demarcation line between pure regularities and obligational norms. Some scholars denote these mere regularities as conventions. It can be doubted, however, whether such a clear-cut distinction actually exists, because even those norms that appear to be pure regularities at first sight often contain “ought” messages. Think of the convention not to work on Sundays. When this rule was disputed by politicians in Germany who

performance of liberal market economies are frequently called pro-social norms examples of this being truth-telling, meeting one's commitments, solidarity, the a priori inclination to cooperate in Prisoner Dilemma's situations. Norms like this allow trust to emerge which as soon as it extends the boundaries of small communities and characterizes social interaction in a society as such and in this way turns into (positive) social capital.

(Injunctive) social norms and the law are not independent. First, the relationship between legal and social norms can be supportive. This is the case if social norms and the law complement each other. Then private enforcement mechanisms will reduce the importance of legal enforcement mechanisms or even replace them. In the law and economics literature we find the term "*expressive law*" to characterize such a situation. An example is given by Robert Cooter (1998) who refers to the introduction of a law in California that prescribed dog owners to remove dog mess in the streets (scooper-pooper law) which has been enforced effectively so far, but hardly ever by using the courts. Rather, people claimed from dog owners to remove the mess made by their dogs by stating that "it's the law" which obviously was sufficient to induce dog owners to uphold this law. On the other hand, social norms and legal norms may compete with each other thus leading to institutional inconsistency. If this is the case, the relative strength of private enforcement mechanism as compared to legal enforcement mechanisms decides on which type of the norm will finally be complied with. Law then has to become *imperative* in the sense that legal enforcement mechanisms have to become sufficiently coercive. However, the situation is not that simple. The reason is that those who are responsible for law enforcement themselves might be guided by the same social norms that undermine the functioning of the law. Stated differently, law will neither be imperative nor expressive as long as the judiciary lacks factual independence. In contrast, societies which are marked by the factual independence of the judiciary, the expressive part of the law as compared to imperativeness, looms large. In these societies, law is not only on the books, but in action. To conclude, whenever the system of prevailing social norms does not support informal law enforcement, it can also not be expected that legal enforcement procedures will work effectively as long as the independence of the courts cannot be ensured. This makes evident that a factual independence of the court relies on the acceptance of the rule of law as a social norm, i.e. a binding rule which is privately enforced.

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favoured open shops even on Sundays, a vivid debate started which turned around normative issues that even touched a moral content of the norm to rest on Sundays.

Basically the rule of law states that members of a society are allowed to exercise power, i.e. to have the capacity to exercise choice only if they are entitled to do so by the law. Thus understood, the rule of law implies that those with legitimate power are expected to use it, i.e. the courts are expected to enforce the law, and it also implies a general compliance with the law. In societies where this rule of law is missing, law enforcement has a high probability to be rather poor thus leading to the predomination of countervailing social norms in all areas of life. As a result the society may continue to live with a high gap between law on the books and law in action.<sup>3</sup> Negative social effects have to be expected in particular if prevailing law is based on democratic principles, and if disobedience with the law undermines a democratic order. However, there are exceptions characterizing situations where the law is used to formalize power relations which entail terror and violence. Hence if we henceforth use the term “rule of law” Hence if we henceforth refer to the rule of law we tacitly assume that law is based on democratic principles.

The posted relationship between legal and social norms raises several questions which all turn around the issue of causality: Do social norms decide on which laws are sustainable in a society? Are there ways how new laws themselves might affect social norms? Under which conditions will these social norms support law enforcement? In the following we will show how these issues are tackled by two approaches representing an external view on the one hand and internal view on the other.

## **2.2 The External View**

For many years social norms were largely ignored both in the so-called mainstream economics as well as in the law literature of the Anglo-Saxon type. Increasingly, however, they are attracting the attention of in particular law and economics scholars.<sup>4</sup> Economic scholars’ interest in social norms and their interaction with legal norms is related to empirical findings that social norms affect the efficiency of resource allocation as well as economic growth. In the literature the impact of social norms on the economy has predominantly been discussed under the heading “social capital”.<sup>5</sup> By this is meant that the way how people interact with each other affects aggregate welfare, i.e. social interaction produces externalities. For example if cheating, lying,

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<sup>3</sup> Pistor (1999) found evidence for such a discrepancy in South East Asia.

<sup>4</sup> Prominent initiators have been Robert C. Ellickson and Richard A. Posner. Cf for example Ellickson (1998), (2001); Posner (1998).

<sup>5</sup> Cf Bourdieu (1983), Coleman (1988), Putnam (1995), Fukuyama (1999).



bribing and stealing are commonly accepted behaviours i.e. social norms, then the process of social interaction will be marked by negative externalities – negative social capital – which is welfare deteriorating at an aggregate level. By contrast, if the process of social interaction is marked by truth-telling, honouring commitments, reciprocity, solidarity and some apriori inclination to cooperate, i.e. to take mutual benefits into account, which all denote social norms, then general trust will follow exceeding the personal level thus rendering an externality.

The external approach views social norms from a pure instrumentalist perspective. In this respect social norms – like the law – restrict the options among which individuals may choose in order to achieve their objectives. This **external view** uses evolutionary game-theory where the evolution of social rules traditionally has a tradition. Within this framework individuals copy behaviours that have proven successful to others. In this way these behaviours are diffused and hence replicated. Successful behaviours thus become privileged cultural models (Bowles et al., 1997). Against this background, pro-social norms like truth-telling, honouring one's commitment reciprocity, and the a priori inclination to cooperate, develop if social interaction is marked by structural traits which characterize small communities: High exit and entry costs increase the frequency of interaction between the same members which in its turn lowers the cost of accessing information about other actors. This will increase members' initiative to act in ways beneficial to others (e.g. telling the truth). A high frequency of interaction between the same people together with high exit and entry costs increases the probability of retaliation for uncooperative behaviour. Both, low cost of information and a high probability of retaliation imply that the immediate benefits of defecting are significantly outweighed by high future benefits of building up a reputation for cooperative behaviour. Given this, high exit and entry costs tend to reinforce the information and retaliation effect rendering truth-telling and an inclination to cooperate as social norms providing a set of stable and widely shared expectations about other actors' willingness to well-behave.<sup>6</sup>

Robert Cooter (2001) rightly criticizes that this widely used model may explain norms arising in small groups but not in a large society being marked by a high level of anonymity and low exit and entry costs. In larger communities access to information is costly and retaliation effects may be low. This implies in particular that the enforcement of cooperation which requires the

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<sup>6</sup> Cf Shapiro (1983); Axelrod (1984); Gintis (1989); Kreps (1990); Bowles et al. (1997).

punishment of defectors may turn into a costly undertaking. Cooter makes evident, that in models drawing on the external view, the cost of punishing defectors, i.e. the cost of enforcing cooperative behaviour cannot be assumed to be sufficiently small a priori if we leave the small group and turn to the large society, rather it may be positively correlated with the size of population and thus turn out to be too high to foster pro-social norms. In a small model he makes evident how in large societies the existence of a legal norm can give rise to complementary social norms which help to make the law expressive. The upshot is that the mere existence of a law reduces costs of private enforcement thus increasing the portion of those actors which are willing to sanction defectors. However, in deriving this result, he tacitly assumes effective legal enforcement which in the end is based on people's belief in the metanorm that law has to be abided to, i.e., in the rule of law. It is indeed in this case that it is easier and more effective to say "it's the law" than "tell the truth".

### **2.3 The Internal View**

Game-theoretic approaches fail with respect to two problems which characterize in particular transition countries. First social norms may arise or they exist which do not increase but decrease aggregate welfare. These are norms that render behaviours socially acceptable which lead to redistributions of aggregate wealth rather than increasing it. Second, legal enforcement may be poor which, too, may be an outcome of prevailing "bad" social norms. By drawing on underlying value dimensions, the so-called internal view offers explanations how all types of social norms those enhancing social welfare and those reducing it, may evolve and it appears better suited to explaining conflicts between the law and social norms (Licht, 2002; Licht et al., 2003). Contrary to external approaches the internal view states that individuals internalize social norms which then become part of their objectives. As a rule economists obviously have problems with this notion as becomes evident for example in Basu (1998) who denotes internalized social norms as "rationality-limiting". Eisenberg (1999) criticizes this view by emphasizing that individual preferences do not necessarily relate exclusively to material goods and wealth. Rather he considers it "... perfectly rational to forgo an increase in wealth by adhering to an internalized social norm or, for that matter, by engaging in conduct that is intellectually, creatively, or socially gratifying" (Eisenberg, 1999:9). He then quotes Cass Sunstein who even considers individual rationality as a function of social norms (Sunstein, 1996). Internalized social norms imply that an agent "... may maximize his utility by keeping his promises or telling the truth, even in cases

where breaking a promise or lying would maximize the actor' wealth" (Eisenberg 1999:9, 10). Eisenberg also emphasizes that a cost-benefit perspective, even if it includes psychological cost like the feeling of guilt or psychological benefits like the feeling of satisfaction might not suffice to explain the role of internalized norms. Rather, sympathy and commitment would have to be recognized as independent motivations. They form an actor's moral or social character and offer an explanation for situations in which people abide by norms for the sake of the norms.

The internal view draws heavily on findings achieved by cross-cultural psychology on the relation between individual and social preferences. Following this approach, social preferences are given content and structure by using the concept of value dimensions. Values denote trans-situational criteria and as such constitute internalized guiding principles of life. Upholding values conveys the feeling of pleasure or satisfaction, whereas violating values conveys feelings of guilt. Every social order is based on commonly accepted values which express socially approved objectives (Licht, 2002; Licht et al., 2003; Kaplow, Shavell, 2001). In this way shared values are the essence of culture and convey members a notion of what is to be viewed as good and desirable in the society. Schwartz et al. (1995) have found that every society recognizes a set of values which is basically the same. However, different cultures can be made out depending on the weights they attach to each value. In this respect unique cultural profiles can be achieved, that may be distinguished by their value dimensions and the system of social norms that follow from these values. (Licht, 2002:16)

Theories of values with respect to their relationship to social norms have been developed by Geert Hofstede (1980; 1991; 2001) and Shalom Schwartz (1992). As a point of departure Hofstede and Schwartz consider basic issues that confront every society. A first issue concerns the relationship between individuals and social groups or the society. *Individualism* in the terminology of Hofstede and *autonomy* in the terminology of Schwartz denote a cultural value that attaches to individuals a high degree of personal autonomy. Individuals should be given all opportunities to develop their own identities with tight social links being restricted to the immediate and nuclear family consisting of brothers, sisters and parents only. Individualism (autonomy) also attaches much value to self-responsibility. In contrast, *collectivism* or *embeddedness* in the terminology of Schwartz denotes a cultural value according to which individuals (ought to) be embedded into social groups implying that they identify themselves by

the social network they belong to. This social network goes beyond the realms of the nuclear family or kinship. Group solidarity and unquestioning group loyalty are important. A second issue concerns the question how responsible behaviour which preserves the social fabric (Schwartz et al., 1995) can be guaranteed. In this respect the wielding of power gains importance. Following Hofstede, high *power distance* denotes a cultural trait that attaches high value to unequal distributions of power, whereas low power distance attaches high value to treating people as equals. Schwartz distinguishes between *egalitarianism* and *hierarchy* in this respect. If power distance is high then steep hierarchies denote a highly appreciated relationship between higher-ups and lower-downs. If power distance is low, however, hierarchies will be accepted only for the sake of convenience. A third issue concerns the relation of humankind to the natural and social world. In this regard Schwartz distinguishes between mastery and harmony with mastery placing emphasis on getting ahead through mastering the natural and social environment in order to further individual or group interest, and harmony denoting the acceptance of a given environment. Hofstede considers the role of women compared to men in a society as well as the role of uncertainty avoidance. Following Hofstede the first aspect is in particular important because the relative dominance of either sex decides on the prevalence of specific values like solidarity, sympathy for the weak, harmony, preservation of nature and traditions which are ascribed to feminine societies as opposed to material success and progress, exploitation of any available opportunity, sympathy for the strong which characterize masculine societies. Finally, depending on whether cultures value uncertainty as something threatening or fascinating, Hofstede distinguishes between high or low uncertainty avoidance.

These basic value dimensions prevail in every society, however, the weight which is attached to each may differ substantially moulding specific cultures. For example Schwartz et al. (1995) found that Western Europe as well as in the USA values like autonomy and egalitarianism play a more important role than in anywhere else in the world. However, he also found that Western Europe is not as homogeneous in this regard. In particular he found that in the US hierarchy and mastery are considered as more important than in (continental) Western Europe where egalitarianism and harmony are valued higher.

Values become internalized through socialization and in this way they mould individual preferences, and in this way societal members replicate what previous generations have done thus

contributing to the permanence of a particular culture (Licht, 2002). The thus achieved cultural profile allows individuals to calculate how their actions will be assessed by others, i.e. whether they will be considered as good or bad, right or wrong. It is in this way that cultural values shape more concrete social norms, i.e. regularities that are embraced by a critical mass of societal members thus giving rise to a pyramid of social norms with cultural values for example autonomy (individualism) over embeddedness (collectivism) as its basis (Licht, 2002). These fundamental norms set the stage for more concrete norms on higher strata. For example embeddedness (collectivism) together with high power distance promote the evolution of the social norm that people may accept bribery and corruption as something benevolent.<sup>7</sup> In contrast, autonomy (individualism) together with egalitarianism (low power distance) might foster social norms that prescribe fairness in the process of voluntary exchange of goods, factors of production and ideas between equals.

What role do legal norms play in this context? First, the “density” of legislation embraced by a society may depend on its cultural profile. For example uncertainty avoiding countries will have a greater desire for a dense network of (written) laws than less uncertainty-avoiding countries with Germany being a prominent example for the first group. Of particular interest for the topic of this paper is the relationship between the rule-of-law-norm and the value dimensions. In societies that subscribe to this norm, law on the books and law in action are basically the same. Following Licht et al. (2003), a widespread acceptance of the rule of law will be more likely in societies marked by autonomy and egalitarianism. Legal norms that are upheld offer a fair chance to each individual to follow his or her individual goals. In collectivist societies by contrast the taking care of individuals is assumed by the group. This may lead to a low compliance with the law because group norms may be valued higher. The rule of law, too, expresses that individuals respect others as equals which promotes their willingness to comply with constraints on personal freedoms favouring others. However, the rule of law will be rather incompatible with hierarchy (high power distance). The reason is that with high power distance people feel entitled to take advantage of subordinated people, and this irrespective of what the law prescribes whereas lower-downs accept this as a fact of life (Licht, 2002).

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<sup>7</sup> This view is also held in the Human Development Report on Bulgaria, 1998.

### 3. Legal and Social Norms in the Bank Credit Market

#### 3.1 *Legal and Social Norms and the Role of Banks*

Banks are an element of the financial system which serves primarily two functions, namely to provide the economy with money and to facilitate the intertemporal exchange of purchasing power. Intertemporal exchange implies that savers (so-called surplus units) provide financial funds in the present whereas investors (so-called deficit units) promise to repay in a yet unknown future gives rise to conflicting interests which the parties seek to solve in a financial contract. Temporal divergence requires the solution of problems the scope of which extends the situation to be usually encountered in commodity markets. Of particular importance in this respect are information deficiencies regarding the willingness of the deficit unit to honour his or her promises (information asymmetry) and his ability to do so which is closely related of yet unknown future contingencies. Information deficiencies give rise to special coordination problems which require special solutions. These special solutions are characterized by a great variety of contractual alternatives thus taking into account that risks may be different and that the actors' behaviours towards risk may be different, too.

The financial economics literature shows that *debt* results as an optimal financial contract if the saver is unable to verify the investor's true profit or wealth situation at the repayment date (Townsend 1979) or, alternatively, if the saver is risk-averse in the sense that he dislikes fluctuations of income.<sup>8</sup> *Equity* then is optimal if for example both parties are risk-averse and thus want to share the risk of fluctuating revenues.

Financial contracts also differ with respect to their material duration. As McNeil (1974) has shown, short or long durations provide different reactions of the trading parties to uncertainty with respect to future developments. A short duration implies that the parties do not want to cope with unforeseen contingencies and thus restrict their relation to a foreseeable future, i.e. exit is used to minimize risk (transactional contracts). Alternatively, a long duration implies that the parties are ready to deal with unforeseen contingencies by resorting to renegotiation when the true state of the world materializes, i.e. voice is used (relational contracts). One explanation for a long contractual duration has been offered by New Institutionalists who point to contract-specific

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<sup>8</sup> This is a major result of principal agency theory.

investments (Williamson, 1975). By this is meant that potential contract parties may have to invest into the creation and sustenance of a contractual relationship, and the fruits of these investments can only be harvested within the ongoing relationship.

Typically in a market economy demand and supply of commodities are coordinated in markets as the predominating coordination organization. This, however, is not the case with respect to financial funds. Here the variety of contracts has given rise to a variety of coordination organizations. The market solution has proven successful in the case of highly standardized debt and equity contracts which allow to exit at factually any time are traded in organized financial markets, where the term “organized” indicates that the functioning of these markets rely crucially on formal rules that all intend to insure high quality on the part of the users of financial funds. These formal rules which are largely backed by the law impose barriers to access by requiring minimum quality standards and aim at market transparency through the imposition of disclosure obligations. In this way organized financial markets rest crucially on public access to relevant information about the quality of investors.

Banks in contrast step between saving units and investors by offering them separate contracts. The first theoretical approaches to explaining the rise of banks argued in an institutional vacuum.<sup>9</sup> Savers are provided with a deposit contract that provides them with liquidity insurance. Investors are offered debt contracts which regularly have a longer maturity than deposits. As Diamond (1984) has shown, the safety of deposits crucially depends on the validity of the law of great numbers with respect to borrowers. By this is meant that banks attract a sufficiently large number of borrowers whose risks are identically and independently distributed. In this case the repayment of loans to be expected as an average over many borrowers equals the size of factual repayments to be distributed to depositors. Another advantage of intermediated lending as opposed to direct lending concerns control costs which are significantly lower in the first case. Finally, due to repeated lending it pays for banks to undertake and develop more sophisticated and efficient screening and monitoring technologies. Lower control costs and incentives to undertake efficient screening and monitoring devices avoid a free-rider problem that exists with respect to controlling in financial markets where the supply side of financial funds is marked by a multitude of small savers relying on others to do the job.

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<sup>9</sup> Diamond et al. (1983); Diamond (1984); Williamson (1987).

A current generation of models explaining the rise of banks acknowledges the role of the legal environment and social norms. In doing so, Diamond and Rajan (1999) and Rajan (1998) put contractual incompleteness into the centre of their arguments. If contracts are incomplete, then they suffer in particular from the risk that they cannot be enforced. Legal enforcement may be impossible if judicial authorities are corruptible or a transparent bankruptcy procedure is missing. Legal enforcement might also be impossible, if the contract contains gaps and ambiguities due to the parties' inability to foresee all future contingencies that affect the creditworthiness of the borrower. If the legal enforcement of a contract is not possible, effective private enforcement mechanism might still be available. It is in this respect that banks might do a better job than markets. Following Diamond, Rajan (1999) the reason concerns the details of the relationships between a bank, its borrowers and depositors as well. These details are marked by noncontractual mechanisms like a bank's investment into reputation (Boot, Greenbaum, and Thakor, 1993), or its investment in relationships with clients (Diamond and Rajan, 1999). Furthermore, borrowers, too, might have an incentive to building a reputation for honouring their obligations. What the authors refer to is that mutual trust may act as a powerful private enforcement mechanism. As we have seen in section 2, a trusting atmosphere may in particular emerge if a borrower or lender, respectively, expects to interact with the same party repeatedly and when exit and entry costs are high. Private enforcement of loans is then promoted by enduring relationships between banks and their borrowers marked by mutual endeavours to keep their reputation and hence a system of pro-social norms.

Following Rajan (1998), banks play a crucial role in underdeveloped countries where the missing rule of law together with the absence of widely available information technologies and widely used sophisticated accounting principles make debt contracts highly incomplete. Banks also play a role in mature economies marked by effective legal enforcement mechanisms. Their role in these countries is closely associated with intrinsic and deliberate contractual incompleteness. For quite a time we could also observe differences between mature economies with respect to the role banks actually played leading to a distinction between bank-based and market-based financial systems. In bank-based financial systems not only do bank loans play a prominent role for the financing of corporate investment. Furthermore the bank-borrower relationship is marked by an enduring relationship constituting relationship banking. In market-based financial systems by



contrast banks offer rather short-run debt contracts thus mimicking financial markets (arm's chair banking).

### **3.2 The Role of Legal and Social Norms for the Functioning of the Bank Credit Market**<sup>10</sup>

By providing the economy with money and “managing” the intertemporal exchange of purchasing power, a financial system contributes significantly to real development and the degree of price stability (Levine, 1997). Banks play a special role in this regard since their decisions on lending affect directly the supply of money and hence a major determinant of inflation (La Porta et al., 1998; Garretsen et al., 2003; Carlin et al., 1999). Moreover by selecting their borrowers they affect the choice of investment projects which in its turn has an impact on economic growth.

The performance of the bank credit market measured by its contribution to economic growth and stability, is highly dependent on how banks and their clients handle information problems which both relate to information asymmetry as well as to uncertainty with respect to future developments of the economic and political environment. Arm chair's lending provides some protection against external unforeseen contingencies but it does not protect a bank from borrowers' attempts to exploit informational advantages about their own qualities. Relationship banking by contrast allows banks to mitigate the information asymmetry problem but leaves them with considerable risk following unforeseen contingencies. Relationship banking mirrors a high degree of cooperation between the borrower and the lender the mutual advantage of which rests on the degree of mutual trust which in its turn is highly correlated with pro-social norms like reciprocity, telling the truth and fulfilling one's commitments. As game-theoretic approaches have revealed, these pro-social norms are likely to develop in small communities marked by high exit and entry costs and a high frequency to interact with one and the same party. In Japan the evolution of these communities was promoted by the “artificial” creation of Keiretsus, i.e. networks of firms and banks that were supposed to provide the firms with credit. In Germany these communities were promoted by extensive networks of bank branches together with regional constraints encountered by public savings banks but also by cooperative banks. Personal acquaintance between bank managers and firm owners of managers, banks' interest in the well-being of “their region” increased the attractiveness of these banking institutions in the eyes of

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<sup>10</sup> Cf La Porta et al. (1998), Garretsen et al. (2003).

local inhabitants. Exit and entry costs may in such an environment increase even further as the relationship develops and the parties undertake increasingly contract-specific relationships.

However, it is also true that the German housebank system has outperformed the Japanese mainbank system. For both countries harmony was found as a cultural value (Schwartz et al. 1995) which promotes solidarity rendering the sustainability of a relation more valuable than exit thus avoiding holdup in cases requiring renegotiation. In Germany a high emphasis on both autonomy (individualism) and egalitarianism might explain the existence of an appropriate balance between strong and weak ties in the sense of Granovetter (1985) which helps to avoid that exit is rejected as a possible sanctioning mechanism independent on its economic consequences. By contrast, the “mixture” of embeddedness, hierarchy and harmony might promote a corporatism leading to the accumulation of bad debts.

So far we have largely ignored the role of law to which we turn now. Indeed the law has always played an important role in the banking sectors of market economies. Legal norms regulate the rights of creditors and lenders, respectively and above all are directed to ensuring the stability of the banking sector thus preventing banking crises. It is with respect to this last mentioned purpose that we talk about (state) regulation. Indeed, empirical evidence has shown that banking crises have been a widespread phenomenon not only in developing, emerging or transition countries (Basel Committee, 2004). There is now a vast literature dealing with the major reasons for banking crises.<sup>11</sup> This literature puts the interaction between poor governance practices in banking institutions and non-financial firms on the one hand and adverse macroeconomic conditions on the other into the centre. It is emphasized that even if poor governance concerning credit, market or interest rate risk hits one or just a few banks, contagion effects due to depositors' inability to distinguish between good and bad banks as well as a high degree of concentration leading to pronounced inter-bank relationships may foster a global banking crises.

The history of regulation in the banking sector began in the 1930s when a severe panic threw the industrial world into a deep depression and left millions of household highly impoverished due to the loss of their deposits. The network of regulations intensified in the course of time. A major reason for this development is to be found in the various loopholes which the law provided for

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<sup>11</sup> A survey is presented by Demirgüç-Kunt et al. (2000) and the Basel Committee (2004).

bank managers and which regularly resulted in even higher risks. A prominent example of this is posed by the deposit insurance system which has become a core of regulation to protect in particular small savers' wealth. If deposits are insured by some external mechanism, this may set bank managers incentives to engage in excessive risk taking, i.e., deposit insurance may lead to moral hazard. Also capital requirement schemes which were proposed by the Basle Committee in the 1980s and were translated into national laws by OECD have frequently not fulfilled expectations setting banks incentives to take even higher risks (Chami et al., 2003). Basel II contains a novel conception of regulation insofar as banks take a more active role in accomplishing the goals of regulation. This is achieved firstly by their obligation to make their risk measures transparent, either by following external ratings or by developing their own models which of course have to find regulators' approval. Of equal importance is their role in the process of supervision which rests on a communication process between banks and regulators.

Basel II reveals that regulators and supervisors having experienced their limits as regards the effectiveness of prudential regulation and its enforcement, now increasingly view the objective of sound banking systems to be a problem of overall governance instead of top-down state regulations (Borio, 1993; Das et al., 2004). Overall governance is meant to describe practices that are performed by all participants of the banking systems, i.e., regulators as well as banking institutions but also firms and beyond that the broader public sector. Das et al. (2004) use the term "government nexus" in this respect to describe the impact of government practices at each layer – government, supervisors, banking institutions and the corporate sector. In this respect the regulators and supervisors take into account that *law is not enough*. The emphasis on practices of good governance acknowledges the support by pro-social norms that broaden the minds of the participants of financial systems to take mutual advantage into account.

Broadly speaking, problems of governance typically encountered in financial systems relate to situations where two parties are supposed to cooperate but one party – the agent – has superior information or cannot be monitored perfectly by the other party – the principal – thus that problems of moral hazard arise. This indeed does not only characterize the relationship between banks and clients but also the relationship between banks and regulators with regulators being principals and banks being agents. Regulators or supervisors on the other hand are not only principals, however. Rather, they are part of a broader political system and thus depend on

politicians as their principals who by themselves might depend on the interests of a mighty banking industry. This might lead to forbearance in the sense that regulators who are concerned about their personal career and maybe future job prospects in the private sector impede effective enforcement of regulations or even postpone necessary legal norms. “Regulators may be “captured” by the industry they are supposed to oversee.” (Chami et al., 2003:15; Kane, 1989, 1990).

Traditionally, governance problems have been debated in the context with the relationship between stakeholders and managers in large corporations leading to the development of principles of practices of good governance like those recommended by the OECD or at national levels. The basic ideas are now increasingly recommended for the participants of the banking system in general and the bank credit market in particular. For example Das and Quintyn (2002) identified independence, accountability, transparency and integrity as important components of governance principles of the regulating and supervising sector. According to the principle of independence, the regulatory and supervisory agency should be “...insulated from improper influence from the political sphere and from the supervised entities.” (Das et al., 2004:15). Regulators and supervisors – given their independence – should be accountable to the legislature and to the public at large. Transparency relates to regulators’ objectives, procedures and decisions. It serves to reveal poor enforcement practices and to make regulation understandable to the public. Integrity requires from regulators to follow the “public” objective to ensure sound banking systems instead of their narrow self-interest.

Licht et al. (2003) establish relationships between principles of good governance and cultural value dimensions. In particular, they have found that the rule of law as an overarching norm is endorsed by societal emphases on autonomy (individualism) and egalitarianism (low power distance). In contrast the rule of law is less likely to be found in countries whose culture emphasizes embeddedness and hierarchy. Relationships with more concrete social norms are easily detected. As soon as the rule of law is widely accepted in the society, independence of regulators and supervisors will mirror independence of the legal sector as such. Independence – if it does not stand on the books only – requires a high level of integrity on the part of regulators and supervisors, which, too is associated with the rule of law. However, as has been observed above, the rule of law can still be compatible with behaviours that do not violate a legal norm

which may be rather general but use the scope offered by the law in a socially harmful manner. Beyond that regulators ought to have a primary interest in a priori cooperation that takes the mutual advantage of all stakeholders' interests into account. This is what integrity seeks to achieve.

## **4. Implications for the Bulgarian Transition Process in General and the Bank Credit Market in Particular**

### ***4.1 Some General Remarks on Economic Transition and the Conflict between Legal and Social Norms***

Socialist economic systems were characterized by highly centralized solutions to economic problems which, broadly speaking turn around the productive use of scarce resources and their distribution among the members of a society. By implication these systems rested on institutions constituting a top-down hierarchical societal order. Since obviously socialist countries have failed in covering the manifold needs of their populations, a system of rather informal institutions in these countries developed which was directed at attenuating the scarcity of goods. Depending on the severity with which socialist principles were introduced, these institutions ranged from private firms which allowed to increasing overall production to those that merely redistributed produced goods. To these institutions belonged rules governing voluntary exchange in underground markets as well as corruption and bribery which at the time characterized widely accepted behaviours even from a moral point of view, i.e. they posed social norms. The acceptance of bribery, corruption and other fraudulent behaviours as social norms is closely related to the finding that in Communist countries the rule of law apparently was lacking widespread acceptance. Following Tanchev (1998) the major reasons for a missing rule of law which she denotes as "legal nihilism" are to be found in the fact that communist constitutions never served to divide and thus limit power: "They were never intended to define the regime's authority, for in reality the regime defined everything, including the constitution." (Tanchev, 1998). The endeavours of the regime which was completely represented by the communist party, were directed to sustaining its power and an important tool in this respect was to decide legal questions politically. It is in this way that the legal order was subordinated to "...the whims of a tyrant or a despotic majority." (Tanchev, 1998:68).

In market economies by contrast the issue how to use scarce resources is shifted to individuals who seek to solve the problem in a utility maximizing manner. Market economies hence constitute bottom-up societies where individuals decide on the size of their income, on the ways how they earn it and on how they spend it. In this process individuals are dependent on each other, i.e. they have to interact and the basic idea is that this process of social interaction ought to be governed by a voluntary exchange of resources and goods the sustainability of which depends crucially on the existence of rules that guarantee fairness and mutual respect, i.e. norms like reciprocity, truth-telling, honouring one's commitment etc play a crucial role. Law and social norms have to complement each other in this respect with the rule of law norm playing a crucial role. This is a main reason for the finding that market economies and democratic structures are coupled. The constitution of market economies ensures that powers are divided and limited and hence that the judiciary receives formal and material independence.

Obviously, the communist legal order and the system of social norms whose development was promoted by communist law, stand in sharp contrast to the requirement of successful market economies. To the extent that the "typical" communist social order is rooted in internalized social norms which in the end rest on a cultural profile being marked by a combination of collectivism (embeddedness) and great power distance (hierarchy), ingrained cultural values strongly affect political decisions on the introduction of pro-market legal norms as well as the enforcement of newly established norms leading to institutional consistency in the sense that transplanted law is undermined by still prevailing social norms. Pistor (1999) shows that the pre-existence of countervailing social norms makes an immediate implementation of transplanted law ineffective and recommends a gradualist approach.

#### ***4.2 Bulgaria's Cultural Profile and Major Characteristics of the First Seven Years of Transition***

As John Bell remarks in his introductory article to "Bulgaria in Transition", Bulgaria shares with other Balkan states many commonalities which have posed severe barriers to political and economic success in the course of transition. However, referring to the first seven years after the demise of communism, he adds that "...the Bulgarian model" has found its own path to unhappiness" (Bell, 1998:1). The roots for these peculiarities are connected to Bulgaria's history which provides a rather unfavourable environment for the development of a democratic society.

During five centuries, Bulgaria was under Turkish rule, and Orthodox Bulgarians saw no reason to comply with Islamic law (Tanchev, 1998:68). Rather, disobedience to the law encompassing not only the civic society but also members of state and political institutions was considered as a national virtue. With Russian help the Ottoman era found an end by 1879 when a new constitution was put in place which by the standards of the time was characterized by a highly liberal orientation. Obviously, however, the liberal spirit of the constitution has never governed policymaking. Rather, as Tanchev (1998:67) puts it "...actual power steadily gravitated to the royal head-of-state." Mitev (1998:39) characterizes the era until the rise of communism by three attitudes toward politics: "One looks on politics as a means of personal advancement and enrichment. The second takes the form of an aloof, sceptical, alienated attitude toward politics." A third attitude finally characterizes a paternalistic tradition which led to the idealization of rescuers from all kinds of evils and leading to a cult of personality (Mitev, 1998:40).

The communist era which started in 1944 led to a totalitarian regime with an undisputed role of the Communist Party (BCP) that used the judiciary for the strengthening and sustenance of its political power. Civil resistance upon its introduction was largely missing (Mitev, 1998).

"The tradition of paternalism was revived in a communist form. The General Secretary of the Bulgarian Communist Party (BCP) was nicknamed "Daddy." ... power in Bulgaria assumed a familial character and was becoming hereditary." The best life insurance proved to be loyalty to the regime which guaranteed a job "... and with it the possibility, unknown in the West, of turning the workplace into a refuge from work" (Mitev, 1998:40).

What kind of cultural profile is compatible with these behaviours? Quite a few empirical studies have been carried out throughout the 1990s to explore this issue (Davidkov, 2004). It is interesting to note that the latest sociological survey which was carried through between 2000 and 2002 largely confirms the existence of engrained cultural values. The survey entitled "Organizational Culture in Bulgaria – 2000-2002", followed the methodology of Geert Hofstede with the aim to calculate indices of power distance, uncertainty avoidance, individualism – collectivism and masculinity – femininity (Davidkov, 2004). The study finds that still in 2002 Bulgaria falls among countries with strong power distance and strong uncertainty avoidance. But whereas in other countries strong uncertainty avoidance leads to high respect of the law, this is not the case in Bulgaria which reveals that values do not appear in isolation. A low or missing respect of the law might be connected to high power distance coupled with collectiveness. Indeed, the study confirms that Bulgaria is better described by a low level of individualism and

correspondingly high level of collectivism implying that typically Bulgarians define their identity by the social network to which they belong and that trespassing this network leads to shame and loss. In accordance with this it was found that in most of the cases investigated personal opinion is not encouraged. "In most of the organizations the best employees have to "dissolve" into the great mass of people". (Davidkov, 2004:22) Finally the study finds Bulgaria to value traits high that correspond to feminine values in the terminology of Hofstede. For example, in general both men and women are expected to be timid and not assertive. The prevailing norm for schools has been found to be the average student. Managers are more often concerned with solidarity among workers and not with competition between them. However, the study also makes evident that these values are more pronounced among the elderly, among less educated groups and among inhabitants of smaller towns and villages (Davidkov, 2004:28).

A cultural portrait marked by collectivism (embeddedness), high power distance (hierarchy), high uncertainty aversion and aversion against competition and maximizing behaviour has indeed marked the process of political and economic transition to be observed in Bulgaria in general and the development of the banking sector in particular (National Human Development Report, 1998). Successful economic transition is promoted by the interplay of the rule of law as a guiding principle both in the public as well as private sector with a civil society that actively controls the prevailing political institutions thus materializing the formally guaranteed democratic fundamentals, and individual actors who are willing to assume responsibilities for their personal welfare and accept principles of fairness in the process of social interaction. During the first seven years of transition in Bulgaria, neither condition was met. A fatal interaction between civil indifference towards ongoing political changes and the attempt of the former political elites to preserve their powers and privileges proved crucial in this respect. Indeed the demise of communism in Bulgaria was the result of activities by then ruling communist ministers who removed Todor Zhivkov from power thus retaining as much power as possible (Daskalov, 1998). It is true that Bulgaria had a new democratic constitution earlier than other transition countries. However, again, its ideas did not launch the necessary process of reforms. One major reason for this failure was the emergence of cooperative patterns between opposing parties in the Parliament which was fostered by a keen interest of its members in salaries, perquisites and work as lobbyists for shadowy economic groups (Daskalov, 1998). Hence structural reforms were considered by the parties in power as important only if they served the interests of their



supporters. This is in particular valid for the BSP – the former Communist party who came into power in 1994 but also for the short-lived government of the largest democratic party UDF in 1991 which primarily focused on land restitution and in doing so met the interests of their most ardent supporters. By contrast, privatization of industrial plants was largely ignored (Daskalov, 1998).

In particular the rule of law never functioned properly. “Despite their formal independence from the government and the incumbent party, the judiciary and the police have been largely ineffective throughout the transition process” (Daskalov, 1998:25). Partly this can be explained by the still ruling tradition that politics rules the law and not the other way round. Of major importance, however, is *corruption*. Following the Human Development Report 1998, in Bulgaria corruption is still widely accepted as a social norm. It continued to flourish after the demise of communism due to the fact that political leaders did not take a moral leadership and in fact became part of corruptive and fraudulent practices. This led to a delay in privatization with continuing ambiguous property rights which reinforced corruption even more. Economic elites with close connections to the BSP guided the economic fate during the first seven years of transition, as Daskalov (1998) puts it:

“It was from the BSP that most of them received the money and the official permission to start banks and other “businesses” ... Once rich, they were able to gain their way in political administrative matters: refinancing unsound banks, appointing their protégés to key economic positions, dealing with disobedient politicians through threats or violence” (Daskalov, 1998:27).

#### ***4.3 Implications for the Bank Credit Market during the First Seven Years of Transition***

Given the gigantic economic restructurings which are necessary in order to successfully turn a socialist country into a competitive market economy and given the low availability of internal financial funds during this process, it is without doubt true that the financial system plays an important role in channelling savings to promising investments without giving rise to rationing phenomena or conversely the accumulation of excessive risks thus plunging the economy into a financial crisis and hyperinflation. However, the same economic restructurings that are needed in favour of economic development pose tremendous challenges to providers and users of financial funds. Comparable historical examples had been missing, and hence providers of funds were exposed to radical uncertainty both with respect to the development of macroeconomic variables

and markets as well as with respect to the capability and willingness of the users of funds to honour their contractual obligations. Of course financial markets like the stock exchange or a market for corporate bonds will hardly develop in an environment lacking reliable accountancy principles, transparency and a kind of uncertainty that can be calculated in one way or another. However, this is not to say that banks are in a situation to handle the manifold information problems in the desired manner. Banks take deposits and originate loans, and in doing so they offer depositors liquidity insurance which in turn requires that banks handle risks appropriately. At the time when socialist countries opted for market economies no blueprint for a banking system was available that could be considered as sufficiently appropriate to handle the challenges of transition thus avoiding excessive risk-taking without resorting to massive credit rationing.

Bulgaria started its transition process with three major drawbacks: On the one hand there existed a huge volume of external debt. On the other hand, Bulgaria had developed a considerable dependence on markets in USSR. Following Dobrinsky et al. (2000), in the late 1980s, Bulgarian trade with USSR represented 50 percent of all its trade flows. Moreover, the government interfered into all spheres of the Bulgarian economy, where any private initiative was largely missing (Berlemann et al., 2002:18). Hence from the very beginning the transition process promised to become harder for Bulgaria than for the rest of former socialist countries. On the other hand as Mihov (1999:4) puts it "...the disenchantment with the communist regime in Bulgaria had not reached its peak." This might offer a plausible explanation for the fact that economic reforms during the whole period until 1997 had been taken rather half-heartedly and that reforms once implemented, used to be undermined.

Between 1987 and 1990 the socialist banking system which was made up of three banks: the Bank of Foreign Trade, the State Savings Bank, in charge of household deposit mobilization and housing loans, and the Bulgarian National Bank (BNB) in charge of currency issuance and lending to the corporate sector, was transferred into a two-tier system with the BNB as the central bank (Enoch, 2002). The bank branches of the BNB were converted into 59 new commercial banks. After in 1990 three more commercial banks had been licensed, the banking sector consisted of 71 relatively small banks. In response to this rather fragmented banking system, the Bulgarian government set up a Bank Consolidation Company (BCC) in 1992 with the purpose to serve as a temporary holding company for the shares of state-owned banks. It had furthermore a

mandate to merge existing banks and to strengthen them for privatization (Enoch et al., 2002). The first private banks were licensed in 1991 and grew heavily in numbers during the following years. With the exception of the First Private Banks they all remained small.

In 1991 the Law on the BNB was adopted which formally granted the BNB independence from the government. The Law furthermore formulated objectives and tools that bore great resemblance to those of Western central banks (Berlemann et al., 2002). In 1992 the Law on Banks and Credit Activity was adopted which established the regulatory framework for the activities of bank institutions. It regulated licensing and enacted a minimum capital requirement of 4%. Furthermore banks were required to collateralize debt. However, it left open the issue how failing banks should be handled and in particular it did not contain the legal option to close insolvent banks.

Notwithstanding these initial attempts, the already described “special political situation” which was marked by still powerful members of the socialist elite and peculiar cooperative patterns between all parties fostering personal enrichment spilled over to the economy in general and to the banking sector in particular. Hence the Bulgarian banking sector quickly developed into a rather fatal version of relationship banking embracing the corporate sector, the government sector and bank managers in a coalition that used the banking sector as a tool to rob households of their savings (Daskalov, 1998; Berlemann et al., 2002). A crucial role in this process was played by the financial elites which were connected to the BSP from which they received the money and the official permission to start banks. Once rich they were able to get access to political and administrative circles thus receiving the funds to refinance their unsound banks. Their behaviours explain why the newly created private banking sector did little to promote real development. Rather it was often used to finance dubious privatization deals executed by managers of state-owned firms (Berlemann et al., 2002).

By 1996 none of the banks had been privatized and it were the state banks that dominated the banking industry holding two thirds of bank assets (Enoch et al., 2002). Notably the shares of these banks were not only held by the government but also by state-owned firms who were borrowers themselves. (Enoch et al., 2002) The government used state-owned banks to extend loans to state enterprises thus subsidizing their losses (Berlemann, 2002; Mihov, 1999). Insider

lending was widespread and internal credit controls were largely missing. The low quality of loans extended to state-owned companies is closely related to a governance structure frequently referred to as “crony capitalism” that gave priority to asset stripping over restructurings in favour of long-run profitability (Peev, 2002). State enterprises were marked by “corporatization”, i.e. the state held 100% of the firm’s shares. These firms were largely controlled by their managers and other interest groups who both did not appear much interested in increasing the firm’s profitability but rather maximized their short-run utilities. As Peev (2002) describes it:

“During 1992-86, the system of “crony” capitalism emerged with its main network being among former communist nomenklatura circles, weak state institutions and the criminal world. The typical motivation of the agents in this symbiosis has been to ransack national wealth.” (84)

The principles of “crony capitalism” were also transplanted to private businesses which were created by managers of state enterprises in order to profit from transfer pricing. Notably these transactions were funded by the banking sector, too (Peev, 2002). A prominent feature of these “crony capitalism firms” was their reluctance to repay their debts. In state firms this attitude was supported by the ongoing readiness of the government to provide new debt, in the private sector an inclination of bank managers to flee the country might also have played a role.

The sustainability of ignoring borrower’s quality which finally drove the banking sector into a severe crisis by the middle of the 1990s was ensured by an interaction of poor and even counter-productive legislation and poor enforcement of those laws that on principle were appropriate to foster sound bank practices. One example for detrimental legal norms is provided by the Bad Loans Act which was passed at the end of 1993. The law allowed the government to issue securities (ZUNK bonds) which allowed to transforming bad bank loans into government obligations. Another example is provided by the Law of the Budget which subordinated the independence of the central bank which was formally confirmed by the Law of BNB to fiscal needs (Berlemann, 2002; Mihov, 1999) Both types of “false” regulation assigned a special role to the BNB which Berlemann (2002) describes as “lender of *first* resort”. In fact between 1991 and 1996 the sources of money supply exclusively rested on refinancing banks in order to back their bad loans and on granting loans to the government. Since banks used government bonds as collateral in order to obtain currency from BNB, its contribution to financing public debt was significantly higher. A final example of false regulation is given by the Bulgarian deposit

insurance scheme which was implemented by 1995 and factually was a state guarantee to 100% of deposits. This regulation enforced moral hazard in the banking industry further.

The legal order was not only characterized by “false regulations” but also by missing regulations. For example, the absence of a bankruptcy code until the middle of the 1990s prevented the central bank from closing failing banks. Besides false and missing regulations poor law enforcement of appropriate laws was significant. One example is provided by severe restrictions imposed to BNB’s supervisory powers rendering the bank unable to place conservators in failing (Enoch et al., 2002). Another example concerns the courts which proved rather unwilling to punish fraudulent behaviour as a cause of loan default (Enoch et al., 2002).

This development was tacitly tolerated by a rather mute community of depositors. In accordance with inherited paternalistic thinking they believed in the functioning of a public insurance system even before it was formally introduced. With inflation rising to exorbitant levels, with an increasing number of state banks being prone to fail, by 1995 the public finally became aware of the severity of the situation and reacted with bank runs which triggered contagion effects to yet profitable private banks. Initial policy response was marked by half-hearted measures. In particular the BNB failed to apply to the court system with the intention to close insolvent banks. The banking system relapsed into crisis which was now accompanied by severe depreciations of the Bulgarian currency as a due consequence of currency substitution. The banking crisis spilled over to public debt markets and the payments system finally plunging the economy into a deep recession (Enoch et al., 2002). Amidst the severe crisis a mass civic protest in the cities occurred marked by the conviction that radical change was imperative. And in fact, at the beginning of 1997, the socialist party BSP had to abdicate from power. The major political parties decided to introduce a Currency Board Arrangement which factually started to work as early as in March 1997 (Daskalov, 1998).

## **5. The New Legal Order and its Implications for the Bulgarian Bank Credit Market**

It is needless to say that the banking sector had failed in accomplishing its major tasks which following Stiglitz (1992) are in particular the channelling of sufficient savings into profitable investment projects and the ensurement of debt repayment. Between May and June 1997, Koford

and Tschoegl (1997) interviewed Bulgarian bankers with the aim to explore their capability (and willingness) to distinguish between good and bad borrowers as well as their capability to ensure debt repayment. Their analysis confirmed that bank lending in Bulgaria at the time was dominated by social norms that contributed significantly to the malfunctioning of the credit market. In this respect *secretiveness* as a social norm which can be considered to derive from basic values that are rooted in collectivism (embeddedness) and high power distance, stands out prominently. Credit risk can be reduced greatly if a bank has easy access to information about firms' quality which requires that firms are willing to reveal to banks or external rating agencies the necessary information. This, however, will not be observed in a society where people are convinced that the value of information decreases once it is passed around and where it is widely believed that "[h]olding information gives power" (Koford, Tschoegl, 1997:25). In due consequence firms were reluctant to present carefully worked out business plans, and external rating agencies did not develop. The impact of secretiveness as a social norm also affects borrowers' willingness to repay on the one hand and banks' willingness to cooperate thus making information about defaulting borrowers mutually available. A borrower's willingness to repay is significantly affected by the risk of losing reputation in case of default. However, the risk of losing one's reputation is high only if a bank's experience with a defaulting borrower becomes public knowledge which was not the case in Bulgaria. It is interesting to note at this place that there existed a secrecy law allowing banks to inform other banks about defaulting borrowers which in reality never worked (Koford, Tschoegl, 1997). Hostility between state banks and private banks played a role, but bankers also stated that they did not want to help competitors and that it would help them to get repaid if a borrower got a loan from a competitor. The authors also found evidence that personal acquaintance served as a substitute for objective data. Lending to friends and relations who never repaid their loans was popular (Koford, Tschoegl, 1997). A further tool to ensure loan repayment is collateral which according to bank regulations even before 1997 banks were required to take. Obviously collateral was common in Bulgaria, though inefficient. Apart from difficulties finding market prices for the collateralized assets, bankers complained that borrowers usually concentrate much efforts on preventing the collateral to be taken in case of default. Quite often, the collateralized assets would disappear all of a sudden. Banks also complained about being treated in an unfair manner by the courts which were frequently influenced by borrowers. Notwithstanding the fact that by 1997 banks no longer faced long delays in coming before the courts, they reported that borrowers could use procedural issues

to impose substantial delays (Koford, Tschoegl, 1997). The courts were reported not to show much interest in prosecuting fraudulent practices on the part of the borrower.

Against this background in July 1997 a currency board was introduced together with a comprehensive system of prudential regulation and bank supervision and the lifting of capital controls thus facilitating foreign investment. Furthermore the corporate sector (financial and non-financial firms) underwent a comprehensive privatization process. By 2000, only three state banks were left holding less than 20% of total banking system's assets and more than 73% of banking system assets were either in foreign owned banks or branches of foreign banks among these were also offshore banks (Miller et al., 2001). In the following we analyse how the new legal order affected the functioning of the bank credit market. In this respect we are in particular interested in the interaction between the novel legal norms and social norms that still in 1997 dominated the behaviour of lenders and borrowers alike.

As the law and economic literature reveals, whenever law is not expressive being the case if those social norms are absent which ensure private law enforcement, law has to become imperative marked by strong legal enforcement mechanisms. On the other hand strong legal enforcement mechanisms are possible only if the judiciary is factually independent requiring that at least the members of the legal sector acknowledge the rule of the law. If this is not the case then the only way to enforcing law is the imposition of some *external* mechanism. This exactly was the way which Bulgaria has chosen by introducing a currency board arrangement.

Under a pure currency board the volume of banknotes and coins to be issued by the central bank is fully determined by available foreign exchanges. Since the exchange rate is fixed this implies that the growth of banknotes and coins is completely determined by surpluses in the balance of payments (Ulgenerk et al., 2000; Miller et al., 2001). The central bank thus loses discretion over the money supply, its sole activities in this respect relate to converting foreign currency into domestic currency and vice versa at any time and without limit at the fixed exchange rate. This also means that lending to the government or to commercial banks is no longer possible. Hence, under a currency board, neither can the central bank finance public deficits, nor does the central bank have capabilities to sustain banks' excessive risk taking by cheap refinancing loans. In

particular if the banking sector should slide into a crisis, there is factually nothing which the central bank can do (Miller et al., 2001).

The Bulgarian currency board deviated from this ideal in some respects: Since the currency board was introduced at a time when the banking system was still highly fragile, it was decided to establish a Banking Department besides the Issue Department which is liable for the issue of banknotes and coins. A major task of the Banking Department was to act as a lender of *last* resort. To this purpose, the Banking Department received foreign exchanges which it is allowed to use under quite restrictive conditions: According to Regulation 6 a bank has to be illiquid and the stability of the banking system has to be at risk. Furthermore it has to be clear that liquidity from other sources is not available. Given these conditions, illiquid banks may obtain loans against liquid collateral for a period of 3 months (Miller et al., 2001). A second deviation of the Bulgarian currency board from its ideal version concerns the government's financial transactions which are executed by the central bank. Provided that the timing of revenues and expenditures does not match perfectly, this, too can affect the issue of banknotes and coins.

The sustainability of the currency board depends on the credibility of the official exchange rate. In particular the accumulation of bad debts in the banking sector which gives rise to speculative attacks on the domestic currency can impair this credibility. In due consequence, the currency board was coupled with a new "Law on Banks". This new law introduced measures of prudential regulation that even exceed international and EU standards. This is in particular true with respect to the capital requirement ratio which amounts to 12% as compared to the EU provision of 8%. The required reserve ratios were initially fixed at 11% and later reduced to 8%. The new law also expands the supervisory authority of the BNB making it easier for the central bank to close failing banks. Moreover banks which now have to undertake internal risk control based on Basel II, are now regularly controlled by experts of the Banking Department the result of which is reported in a Quarterly Bulletin issued by the BNB.

The idea of the currency board is to impose hard budget constraints to economic actors, where the hope is that finally all economic actors will be affected. Concerning banks it was a due consequence of the currency board that they became highly dependent on funds attracted from nonfinancial institutions their share increasing to 65-67% by 2000 (Miller et al., 2001). Though



the currency board together with a deposit insurance system continually increased households' trust in the banking sector and also made foreign denominated deposits available to banks, the years until 2001 were marked by the pronounced reluctance of the commercial banking sector to extend loans to the Bulgarian private sector, in particular to firms. Rather, banks preferred investing abroad (Miller et al., 2001; Nenovsky et al., 2003). Credit shrank dramatically shortly after the crisis had reached its peak and declined even more after the introduction of the currency board and remained at below 20% of GDP until 2001 (Nenovsky et al., 2003). In an empirical analysis using econometric techniques Nenovsky et al. (2003) searched to explain this phenomenon. They did so testing hypotheses related to credit demand and supply based on data comprising the period between 1998 and 2001. Their major findings are the following: The currency board obviously did not curtail the lending capacity of the banking sector, i.e. foreign reserves did not impose an upper constraint to lending. Rather, banks' reluctance to lend to the corporate sector can be explained by conservatism supported by the new system of prudential regulation and supervision. However, the authors have also found evidence that in this period bank lending was not much related to the financial health of enterprises. For example, no negative correlation between borrowers' leverage and the size of loans was found. There is moreover evidence that larger firms and firms with the presence of majority owners had better access to bank loans. The same result was found for firms which are affiliated to business groups and have political connections, and firms with an offshore owner with rather dubious origin of capital. The authors conclude that the findings are related to prevailing governance structures which were still marked by crony capitalism. Indeed privatization in the corporate sector which took place above all between 1998 and 1999 (the so-called mass privatization), predominantly rested on voucher privatization and management and employee buyouts which according to Peev (2002) promoted the rise of new crony firms. Peev has found evidence for a dual enterprise sector with two types of governance structures, i.e. one resembling Western principles and crony capitalism. Notably crony firms were also found among enterprises under foreign ownership, and newly created firms, too. Obviously these crony firms enjoyed more favourable lending conditions between 1998 and 2001. Miller et al. (2001) have moreover found evidence that in the first years after the introduction of the currency board court procedures were still slow and inefficient throwing up many barriers to lenders.

The years following 2001 are marked by a gradual increase in bank lending to the private sector one reason for this being the gradual reduction of foreign rates of return due to the weak condition of the world economy as compared to the ongoing economic recovery in Bulgaria (BNB Economic Review, February 2005). To what extent governance practices in both banks and non-financial enterprises have changed and which role the legal order might have played in this process, remains unclear, however. Of interest in this respect are some results of BNB supervision between January and March 2004 that were published in BNB Quarterly Bulletin March 2004. Here the BNB deplores as new development lacking adequate and rational reactions by banks to potential hazards involved by credit expansion. Bank managers proved to be over-optimistic as regards their borrowers' investment strategies. The supervisors found increasing "risk appetites" of banks managers. Some banks made loans to firms with unclear liquidity conditions. The central bank found that credit risk increases due to serious weaknesses in lending process management and significant lending to related interest. Banks with already low ratings increased credit risk further. Banks were reducing their degree of gross asset provisioning. Finally the BNB supervisors detected banks that did not anymore meet capital requirements. Overall the capital adequacy indicator revealed a downward trend. Of course this evidence might also be explained with bank managers' lacking experience. However, taking the large degree of foreign ownership into account, one should not jump to conclusions. It may well be expected that foreign owners have an eye on their managers' skills and promote training programmes. Hence some role for the Bulgarian cultural legacy might still exist.

On the other hand we should not underestimate the overall favourable effects of the currency board on the bank credit market. Before 1997 developments in the banking sector that were marked by an increase in credit risk went largely unnoticed. Now, being legitimized to undertake active supervision, the BNB is capable to detect adverse developments at an early stage and react appropriately, and the BNB appears to be willing, too. Effective law enforcement thus may in the course of time have its pre-emptive effects setting bank managers the right incentives to avoid bad and excessive risks. The credit crunch that characterizes the first years after the introduction of the currency board, however, also reveals that it is not enough to regulate the banking sector efficiently. The well-functioning of the banking sector is highly dependent on good governance principles guiding the behaviour of all participants including the non-financial corporate sector, too. Given that the rule of law might still lack wide acceptance, enforcement has to be guaranteed

by external mechanisms. In this respect accession of Bulgaria to EU could be coupled with the requirement of adequate laws, and with respect to their enforcement, the EU could play an active role.

## 6. Conclusion

In fact there has by now been reached a consensus view that the Washington Consensus which in its original version recommended a shock therapy in order to achieve fast and successful transition, is at least not a sufficient condition for successful transition. Economic research has come to the conclusion that institutions – in particular legal and social norms – play a pivotal role in the process of economic transition. Since in particular social norms change only slowly, a gradualist approach has increasingly been recommended that allows law and social norms to complement each other in a welfare enhancing manner. Indeed the gradualist approaches that have been chosen by transition countries differ with respect to whether a relationship between law and social norms has been recognized and if so, how it was handled. A prominent example of a successful transition story is posed by Poland where politics assumed an active role in reconciling transplanted law and social norms and even successfully furthered the development of market-friendly norms (McDermott, 2003). The success of this “embedded politics approach”, however, has been crucially associated with politicians, legislators and judges who were convinced of the benefits accruing from transforming their socialist economies into democratic market economies. This made politicians rather innovative as regards the implementation of institutions that promised to foster transition without provoking poverty and mass unemployment and set members of the judiciary incentives to abide by the rule of law. In fact, in Poland collectivism and high power distance was never so much pronounced than in other transition countries like Bulgaria. In this country the public sector was far from being convinced about the necessity to increase *aggregate* welfare. Rather the institutional vacuum was used here for the benefit of some few well-organized groups. The rule of law was widely absent leading to rather poor law enforcement. Hence the embedded politics approach that proved successful in Poland would have been impossible in Bulgaria where gradualism “...actually amounted to the gradual exhaustion of resources...” (Daskalov, 1998:28). The banking sector and in particular the bank credit market played a prominent role in this unsuccessful transition process. Well organized groups used banks for personal enrichment, and in this process bribery and corruption lead to heavy involvement of the public sector, too. An already existing bank law thus was hardly ever

enforced. This development was more or less tacitly tolerated by the civil society that continued to be rooted in collective and paternalistic value dimensions.

Only after a banking crisis had plunged the real economy into depression and many households into poverty did the civil society finally wake up. However, the previous years and the crisis itself had eroded general trust in politics and judiciary as well. In order to increase credibility, the newly elected government opted for the introduction of a currency board as an external enforcement mechanism of legal norms in the financial system. Bulgaria has successfully avoided any banking crisis ever since. However, the bank credit market still reveals flaws with respect to soundness and efficiency which at least partly can be explained by the fact that still the norms of crony capitalism have a say. The introduction of further external enforcement mechanisms which ensure that managers' decisions are guided by good governance practice appears promising. This is not to say that external enforcement mechanisms provide a final and complete solution to Bulgaria's problems. But they may serve as some kind of educational mechanism and besides they give those people who are willing to comply with the law the informal power to bring others to comply with it, too. In this way law has a chance to become increasingly expressive.

## 7. References

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