

- Chew, Lillian. "A Bit of a Jam." *Risk* 5 (September 1992): 82ff.
- Cornell, Bradford, and Alan C. Shapiro. "The Reaction of Bank Stock Prices to the International Debt Crisis." *Journal of Banking and Finance* 10 (March 1986): 55-73.
- Cummins, Claudia. "Fed to Charge Banks for Intraday Overdrafts." *American Banker*, October 1, 1992, 1, 12.
- Diamond, Douglas W., and Philip H. Dybvig. "Bank Runs, Liquidity, and Deposit Insurance." *Journal of Political Economy* (June 1983): 401-19.
- Dickinson, Amy, David R. Peterson, and William A. Christiansen. "An Empirical Investigation into the Failure of the First Republic Bank: Is There a Contagion Effect?" *Financial Review* 26 (August 1991): 303-18.
- Garcia, Gillian, and Elizabeth Plautz. *The Federal Reserve: Lender of Last Resort*. Cambridge, Mass.: Ballinger Publishing Company, 1988.
- Gay, Gerald D., Stephen G. Timme, and Kenneth Yung. "Bank Failure and Contagion Effects: Evidence from Hong Kong." *Journal of Financial Research* 14 (Summer 1991): 153-65.
- Gilbert, R. Alton, and Levis A. Kochin. "Local Economic Effects on Bank Failures." *Journal of Financial Services Research* 3 (December 1989): 333-45.
- Gorton, Gary. "Bank Panics and Business Cycles." *Oxford Economic Papers* 40 (December 1988): 751-81.
- Group of Experts on Payments Systems. *Large-Value Funds Transfer Systems in the Group of Ten Countries*. Basle: Bank for International Settlements, May 1990.
- Hansell, Saul, and Kevin Muehring. "Why Derivatives Rattle the Regulators." *Institutional Investor* 26 (September 1992): 27-33.
- Haraf, William S. "The Collapse of Drexel, Burnham, Lambert: Lessons for the Bank Regulators." *Regulation* 14 (Winter 1991): 22-25.
- Holland, Kelley. "Swaps: The Next Debacle for Banking?" *American Banker*, August 4, 1992, 1, 10.
- Kaufman, George G. "Are Some Banks Too Large to Fail? Myth and Reality." *Contemporary Policy Issues* 8 (October 1990): 1-14.
- Lamy, Robert E., and G. Rodney Thompson. "Penn Square, Problem Loans, and Insolvency Risk." *Journal of Financial Research* 9 (Summer 1986): 103-12.
- Leander, Tom. "Old Stone's Theodore Barnes Stopped a Run in Its Tracks." *American Banker*, February 1, 1991, 2.
- Moen, Jon, and Ellis Tallman. "The Bank Panic of 1907: The Role of the Trusts." *Journal of Economic History* 52 (September 1992): 611-30.
- Peavy, John W., III, and George H. Hempel. "The Penn Square Bank Failure." *Journal of Banking and Finance* 12 (March 1988): 141-50.
- Pozdena, Randall J. "Is Banking Really Prone to Panics?" Federal Reserve Bank of San Francisco *Weekly Letter* (October 11, 1991).
- Roberts, William. "The Rise of Electronic Payment Networks and the Future Role of the Fed with Regard to Payment Finality." *Federal Reserve Bank of Atlanta Economic Review* 78 (March/April 1993, forthcoming).
- Saunders, Anthony. "The Inter-Bank Market, Contagion Effects, and International Financial Crises." In *Threats to International Financial Stability*, edited by Richard Portes and Alexander K. Swoboda, 196-232. New York: Cambridge University Press, 1987.
- Shirreff, David. "Dealing with Default." *Risk* 4 (March 1991): 19ff.
- _____. "Swap and Think." *Risk* 5 (March 1992): 29ff.
- Smirlock, Michael, and Howard Kaufold. "Bank Foreign Lending, Mandatory Disclosure Rules, and the Reaction of Bank Stock Prices to the Mexican Debt Crisis." *Journal of Business* 60 (July 1987): 347-64.
- Smith, Stephen D., and Larry D. Wall. "Financial Panics, Bank Failures, and the Role of Regulatory Policy." *Federal Reserve Bank of Atlanta Economic Review* 77 (January/February 1992): 1-11.
- Sprague, Irvine H. *Bailout: An Insiders Account of Bank Failures and Rescues*. New York: Basic Books, 1986.
- Swary, Itzhak. "Stock Market Reaction to Regulatory Action in the Continental Illinois Crisis." *Journal of Business* (July 1986): 451-73.
- Tallman, Ellis. "Some Unanswered Questions about Bank Panics." *Federal Reserve Bank of Atlanta Economic Review* 73 (November/December 1988): 2-21.
- Torres, Craig. "Dangerous Deals: How Financial Squeeze Was Narrowly Avoided in 'Derivatives' Trade; Bank of New England's Woes Battle Currency Markets as its Credit Evaporated a Hazard that Could Return." *Wall Street Journal*, June 18, 1991, A1.
- U.S. Congress. House. Committee on Banking, Finance, and Urban Affairs. Subcommittee on Financial Institutions, Supervision, Regulation, and Insurance. *Continental Illinois National Bank Failure and Its Potential Impact on Correspondent Banks*. Staff Report. 98th Cong., 2d sess., October 6, 1984.
- Wall, Larry D., and David R. Peterson. "The Effect of Continental Illinois' Failure on the Financial Performance of Other Banks." *Journal of Monetary Economics* 26 (August 1990): 77-99.
- Wall, Larry D., John J. Pringle, and James E. McNulty. "Capital Requirements for Interest Rate and Foreign-Exchange Hedges." *Federal Reserve Bank of Atlanta Economic Review* 75 (May/June 1990): 14-28.

Banking Reform and the Transition to a Market Economy in Bulgaria: Problems and Prospects

William C. Hunter

The Bulgarian banking and financial system changed dramatically in 1989 when the Communist Party lost its ruling monopoly and Bulgaria, like most of its East European neighbors, started down the road to political and economic democratization. The enthusiasm accompanying the breakdown of Communist control made the obstacles to a smooth transition to a market economy seem relatively minor. However, the pervasiveness of these stumbling blocks (internal budget deficits, massive external debt, inefficient state-owned enterprises, and a banking system mired in nonperforming assets, to name a few) has now become painfully apparent. These problems, intensified by the recent collapse of the ruling political coalition on October 28, 1992, make the task of restructuring the financial system monumental indeed.

Despite the magnitude of the difficulties confronting Bulgaria, it is important that the country persist in efforts already under way to revitalize and privatize its banking and financial system, which will play a vital role in the transition to a market economy. This article presents an overview of the banking reform taking place in Bulgaria, discussing the lack of information on creditworthiness, the lack of effective accounting and legal systems, and the problems associated with bad loans within the banking system and among state-owned enterprises.¹ In Bulgaria, as in other transition economies of Eastern Europe, the banking system's ability to fulfill its role in stimulating economic growth depends directly on how it handles the deadweight

The author is vice president and senior economist in charge of basic research in the Atlanta Fed's research department. The views expressed in this article are the author's and not necessarily those of the Federal Reserve Bank of Atlanta, the Federal Reserve System, the U.S. Treasury, the Bulgarian National Bank and its Bank Consolidation Company, or other international agencies.

losses associated with failed state-owned firms, which have been transformed into bad loans on commercial banks' balance sheets.

The nature of the reforms being undertaken in Bulgaria parallel those occurring in other East European countries such as Hungary, Romania, the independent states of the former Soviet Union, and the Czech and Slovak Republics. Thus, while this article focuses on the Bulgarian case, the problems, prospects, and proposed solutions are also relevant to these other economies in transition. To begin, a brief overview of the economic history of Bulgaria provides the necessary background for describing the particulars of the Bulgarian banking system.

A Brief Economic History of Bulgaria²

Situated on the northeastern section of the Balkan Peninsula, the Republic of Bulgaria has a population of about 9 million people. The Bulgarian standard of living, while low, is above that of Romania and Albania, two of its neighbors. The average Bulgarian worker earns about \$90.00 (U.S.) per month. Blessed with a warm climate and fertile soil, the country has a natural comparative advantage in the production of agricultural commodities.

The contemporary Bulgarian state dates back to 681, when the Bulgarian Kingdom was founded after the Byzantine Empire formally recognized Bulgar control of the region between the Balkan Mountains and the Danube River. For the next seven centuries the Bulgarian state was controlled by a succession of various ruling factions, and the Bulgars were gradually assimilated into the region's more numerous Slavic population. In the latter half of the fourteenth century Bulgaria was invaded by the Ottoman Turks and in 1396 lost its independence for the next five centuries. After the Russian-Turkish War in 1878 Bulgaria was liberated from Turkish domination and became an independent state.

Until well into the twentieth century Bulgaria's economy was dominated by agricultural production. Between 1920 and 1944 the Bulgarian economy showed signs of resilience despite the worldwide depression during the early 1930s. For example, from 1929 to 1939 the average annual growth rate in industrial output in Bulgaria was 4.8 percent, compared with only 1.1 percent for Europe as a whole. This economic resilience came at a price, however. The constraints imposed by the depressed world economy and a

shrinking export market in Europe led Bulgaria to seek alternative trade arrangements, including bilateral trade agreements with Germany. While these agreements, which covered an estimated 88 percent of the country's agricultural output, guaranteed the sale of Bulgarian agricultural products to Germany, they also tied the Bulgarian economy closely to Germany's. As a result, much of Bulgarian industry was excluded from the European free trade zone, isolating the country from market forces governing the European and world economies and leading to its alignment with Germany during World War II.

Following the war, Bulgaria came under the Soviet Union's influence, and economic development was subjected to the Communist Party's doctrine. The government gradually assumed direct control of the entire economy, nationalizing agriculture, financial industries, and virtually all private industry and determining the allocation of resources and output at all levels of production.

During the period of Communist domination the Bulgarian government's main economic objective was to create new industries—engineering, metallurgy, chemicals, electricity generation, and appliances, among others. This emphasis virtually reversed the comparative contributions of industry and agriculture to aggregate production or output, resulting in a massive shift in occupations and in migration of the population from rural to urban areas.

Bulgaria's East European neighbors, including Czechoslovakia, East Germany, Hungary, Poland, and Romania, were also brought into the Soviet sphere after World War II. Given the similarity of their economic institutions and policy objectives and their common concern for fostering industrialization, income redistribution, and social equality, these countries, along with the Soviet Union and others with centrally planned economies, formed an economic union—the Council for Mutual Economic Assistance (CMEA)—in January 1949. An essential component of the Soviet growth strategy, the council provided a framework within which its members could promote their own (and the Soviet Union's) national objectives.³

The Bulgarian economy showed significant signs of weakness as early as the late 1950s, and the government's five-year economic plans issued following the nationalization of industry were rarely achieved. In recognition of this failure, the government introduced several economic reform programs during the 1960s and 1970s. At the end of the 1970s, the so-called New Economic Mechanism was introduced with the aim of creating self-financing firms at all

levels of industry and thereby enhancing productivity and efficiency. These reforms were deemed ineffective. Indeed, the rate of economic development actually slowed in the years following adoption of the program.

Attempts at economic reform continued through the 1980s. However, as late as 1988 state-owned enterprises and cooperatives still dominated the Bulgarian economy, producing virtually all of the country's output and employing almost all of the work force. With the downfall of the Communist Party in 1989, Bulgaria took its most important steps toward economic reform by discontinuing the central planning of firm management and developing the mechanisms to establish private ownership and property rights.

The country began the process of economic reform with a parliament controlled by a fragile democratic coalition. This coalition collapsed in late October 1992, and it is not yet clear how this development will affect the speed with which reforms are implemented. In addition, the country has an external debt of approximately \$12 billion (U.S.) owed primarily to the Federal Republic of Germany, Japan, and the United Kingdom. The government also faces the difficulties of managing an internal budget deficit estimated to be approximately 9 billion Bulgarian leva (approximately \$500 million [U.S.] at the current official exchange rate of about 23 leva to \$1 [U.S.]) for fiscal 1992.

their savings deposits and financing housing credits much as savings and loan associations do in the United States.

Bulgaria's three-bank system ended in 1981 when the government created a special bank to finance business activities that were not included in its official economic plan or that exceeded the plan's target budget. Further change occurred in 1987, when the government set up seven specialized commercial banks, each restricted to lending in a particular economic sector, such as transportation, electronics, construction, or chemicals. The seven banks operated as full-service universal banks, able to provide loans in the domestic or foreign currency and to take equity positions in other firms, companies, and joint ventures in their respective sectors. In 1989 the government created fifty-nine new commercial banks out of the former branches of the Bulgarian National Bank and simultaneously eliminated the requirement that certain banks engage in specialized lending.⁴ This action allowed all banks to function as universal banks. Since 1989 several new banks have been granted charters by the Bulgarian National Bank, including at least four private banks (as of late 1992). As of July 1991 there were a total of seventy-four banks (excluding the Bulgarian National Bank and the Bulgarian Foreign Trade Bank) with a total of 4,033 offices operating in the country.

Most Bulgarian banks are organized as joint stock companies. Until late 1991 the shares of all banks except the four recently created private banks were owned principally by the Bulgarian National Bank, the Bulgarian Foreign Trade Bank, and a few large state enterprises in the nonfinancial sector. As of July 1991 the Bulgarian National Bank owned approximately 32 percent of the shares of the older commercial banks (the seven created in 1987 and the Bulgarian Foreign Trade Bank) and about 65 percent of the shares of the fifty-nine banks created in 1989 out of its former branches. The Bulgarian Foreign Trade Bank and the seven specialized banks created in 1987 also own a significant percentage of the shares of these fifty-nine banks.

In conjunction with the World Bank, the Bulgarian National Bank has designed a merger and privatization program to consolidate Bulgaria's commercial banks into eight to ten institutions with shares held by private domestic and international investors. The shares of the commercial banks owned by the Bulgarian National Bank and the state-owned enterprises were recently transferred to the Bank Consolidation Company, a wholly owned subsidiary of the Bulgarian National

The Structure of the Bulgarian Banking System

The modern era in Bulgarian banking and finance began with the passage of the Banking Law of December 27, 1947, which effectively nationalized the system. From 1948 until 1981, this system, similar to those of other East European countries, comprised three distinct banks. The Bulgarian National Bank, much like the Gosbank in the classic Soviet economic model of centralized planning, monitored the financial aspects and financed the investments of the central government's annual economic plan. It also monitored the payments of enterprises, received their deposits, and extended credit in the domestic currency. The Bulgarian Foreign Trade Bank had sole responsibility for foreign exchange operations (payments associated with imports and exports, foreign credits, and management of foreign currency reserves). The State Savings Bank was limited to serving the household sector, receiving

Bank established to manage and oversee the consolidation effort.

Banking and Financial System Obstacles to the Bulgarian Transition

Of the many problems confronting the Bulgarian and other East European economies, the lack of well-functioning money and capital markets is especially critical. The existing markets in these countries are less diverse and stable than those of Western economies primarily because they lack the complex information required to assess risks and the creditworthiness of borrowers. This dearth of information is understandable given that central planning regimes offered few incentives to accumulate such data.

Before 1987 the governments of centrally planned economies like Bulgaria served as the lender of last resort, automatically financing the losses of state-owned enterprises. These governments essentially provided a form of comprehensive insurance to firms without charging the appropriate premiums, and this practice led, in most cases, to the overextension of credit between state-owned enterprises and by commercial banks to these firms. In Bulgaria, where most commercial banks' balance sheets are dominated by such loans, an estimated 54 percent of all bank credits, equaling 34.4 percent of the country's gross domestic product, were nonperforming. For the specialized commercial banks created in 1987, nonperforming loans accounted for 65 percent of the loans held on their balance sheets.⁵

Currently, Bulgarian state-owned enterprises have an estimated total outstanding debt of about 100 billion leva. Of this total, more than a quarter is owed to other state-owned enterprises and about half is owed to Bulgarian commercial banks. This interdependence of the balance sheets of state-owned enterprises and commercial banks impedes the operation of the Bulgarian money and capital markets because it makes it difficult to distinguish efficient and economically or financially viable firms from those that are inefficient and nonviable. This situation, in turn, makes it almost impossible for banks or other investors to make rational credit decisions, creating negative spillover effects for consumers.

The overall uncertainty in the Bulgarian economy adversely affects the profitability of business enterprises in general and reduces the market value of their installed capital, thereby limiting their capacity to borrow against this capital. This atmosphere of uncer-

tainty, overlying a complex system of interfirm credits that links the fortunes of well-run firms to the poorly run ones, is slowing the transition to a market economy.

The narrowness of the capital markets in the evolving economies of Bulgaria and other East European countries exposes investors and creditors to excessive degrees of systemic risk because they cannot diversify. This inability to diversify leads to large risk premiums and overly expensive credit, and, coupled with the interdependence of state-owned enterprises' and commercial banks' balance sheets, allows small shocks incurred by a particular firm or sector to be transmitted to other firms and sectors and eventually to the commercial banks and the entire economy. To limit their exposure to such risks, lenders and investors will tend to shorten their investment and lending horizons. From a social viewpoint the domination of short-term quick-payback investments may not be optimal because they may squeeze out more desirable (and more profitable) longer-term investments.

Removing the Obstacles

The factors identified above represent major impediments to Bulgaria's successful shift to a market economy. It is clear that the Bulgarian banking and financial system would be made more efficient by the implementation of policies that would (1) improve the financial information system and the legal instruments available to lenders, investors, and borrowers; (2) cleanse commercial banks' and state-owned enterprises' balance sheets of their bad loans; and (3) enhance Bulgarian policymakers' credibility.

Financial Information. An improved financial information system in Bulgaria and similar transition economies would provide for a better assessment of individual firms' creditworthiness, thereby encouraging more lending and investment. Developing a framework of legal instruments to enforce contracts and protect both lenders' and borrowers' property rights would also improve the lending environment.

A uniform set of transparent accounting standards, including rules for public disclosure of nonproprietary financial information, is critical to the further liberalization of Bulgaria's banking and financial sectors. Accounting standards form part of the resource allocation process, allowing banks to compare the merits of one borrower over another. Similarly, bank supervisors, investors, depositors, and managers need dependable

bank financial statements to make informed judgments about bank financial health and performance.

For banks, a vital component of the accounting system is a set of rules relating to valuation of assets and capital. Without such rules, accounting systems become relatively worthless and the value of banks' equity capital may be called into question. Assets need to be valued on a bank's books at their true worth, particularly when this value is less than the price paid for them. Considering the scope of the nonperforming loan problem among Bulgarian commercial banks, the application of accounting standards would require that such assets be written down or written off, depending on their status, before the banks will be free to function as true financial intermediaries.

Cleansing Balance Sheets. Finding appropriate ways to clean up commercial banks' and state-owned firms' balance sheets from bad loans would uncouple the fortunes of firms that should continue operating from those that ought to be shut down, restructured, or reorganized. A major challenge in Bulgaria and other former Soviet Bloc countries is to achieve this objective without imposing excessive costs on the national budget or further hampering the incentive structure faced by market participants.

A number of methods for cleansing the balance sheets of commercial banks and state-owned enterprises are being debated in the transition economies of Eastern Europe: the simple cancellation of state-owned enterprises' debts, socialization or nationalization of bad debts, privatization of bad debts through specialized asset liquidation or carve-out companies, or liquidation and restructuring of banks and state-owned enterprises through a specialized government restructuring agency or company.

The simple cancellation of all debts of state-owned enterprises is not advisable for several reasons. First, such a step would reduce the working capital of creditor firms and banks; it also carries the risk of driving good firms whose cash-flow requirements depend critically on debt service receipts into bankruptcy. Similarly, cancellation of only the acknowledged bad debts of state-owned enterprises is ill-advised because it could give rise to serious moral hazard or other incentive problems. Such a plan of debt forgiveness or cancellation might lead suppliers of inputs to the state-owned companies (both good and bad) to withhold financing in fear of further debt cancellation by the government or the outright repudiation of these obligations by state-owned enterprises in hopes of receiving further government protection. To the contrary, the East European governments should consider ex-

tending the credit of profitable state-owned enterprises to minimize disruptions to the financial sector as banks' and state-owned firms' balance sheets are cleansed.⁶

Separating the future prospects of the debtor and creditor enterprises and banks through the nationalization, socialization, or absorption of bad debts by the government is a feasible alternative to a simple debt cancellation policy. Such actions would transform the nature of these debts and alter their risk characteristics without changing their magnitude.

In nationalizing the debt, the government can engage in debt-for-debt swaps, exchanging its own debt (bonds or bills) for the bad loans that creditor firms and banks hold against other enterprises. In essence the transaction would recapitalize the firms and banks by replacing bad loans with government obligations and transforming debtor firms' liabilities to other enterprises and banks into government liabilities. By acting as a financial intermediary, the government essentially transfers the cost of the restructuring to Bulgarian taxpayers.⁷

By servicing its own debt the government would ensure that the creditor enterprises and banks are paid off. However, to secure its capacity to service its debt, the government must have at its disposal a functional tax system capable of collecting the needed revenues without resorting to inflationary finance. This need for revenue points out the urgency for quick development of an efficient tax and collection system.

The Bulgarian government has, in principle, adopted this bad-debt nationalization plan for a portion of commercial banks' bad loans granted before 1990. However, given Bulgaria's internal budget deficit, its tax system will have difficulty coping with the debt-service requirements on the government bonds used in this plan, as acknowledged by the existence of a five-year moratorium on the payment of interest on this debt.⁸

The presence of the internal budget deficit calls for other, innovative solutions to the country's bad debt problem. In addition to the debt swap program, the Bulgarian government has established the Bank Consolidation Company—similar in some respects to the Resolution Trust Corporation in the United States, which is charged with liquidating financially failed savings and loan associations—to oversee the restructuring, consolidation, and privatization of the banking system.⁹ A similar agency is being formed to handle this process for state-owned enterprises. The use of government entities to carry out the restructuring reflects the general lack of information on asset values, a shortage of private risk capital, and the absence of

established markets for asset liquidation. Thus, unlike the United States in recent cases, Bulgaria cannot rely on the formation of private companies to purchase and liquidate the failed companies.

In short, cleansing the balance sheets of the commercial banks and viable state-owned enterprises is critical to the success of the ongoing Bulgarian transition. Once these balance sheets are cleaned up and better valuation of assets is possible, the economy can be further opened up and the benefits associated with foreign capital investment can be realized. These benefits include financial and managerial assistance and better access to international capital markets. Foreign investors and managers can bring the know-how, contacts, information, and other skills needed to augment the country's existing expertise and improve the functioning of domestic money and capital markets.

Enhancing Credibility. Among the countries of Eastern Europe, another obstacle to the successful transformation to a market economy is government policymakers' lack of credibility, which adds to the uncertainty faced by economic agents and results in inefficient decision making among market participants because they do not know the "rules of the game" in the newly liberalized markets. To enhance their credibility, policymakers must demonstrate that they are willing to introduce fundamental change in the manner in which policy is conducted and to be consistent in their policy choices. The adoption of a rule-based policy framework rather than one based on discretion represents one way of gaining credibility. A rule-based framework tends to reduce the perception of arbitrariness and thereby strengthens confidence in the policy-making process. However, a system devoid of some discretionary leeway is not advisable because it may not allow policymakers to respond to economic shocks or political crises in a timely and appropriate fashion.

Regardless of the degree of discretion allowed policymakers in these transition economies, at least two elements of policy credibility are crucial to the success of the changes. First, the economic reform program itself must be credible. It should be feasible, stand up to the test of professional scrutiny, and reflect the experiences and lessons from similar episodes in other countries. Second, policy commitments must be credible. They must not be changed in midcourse to take advantage of private sector agents' response to the initially announced policies. This practice can only result in policy ineffectiveness as economic decisionmakers learn not to trust their policymakers and react to policy pronouncements in perverse and undesirable ways that

neutralize the policies' intended effects. Clearly, policymakers must find ways to guarantee to market participants that policy will not be used to their disadvantage after they have altered their behavior in response to policy pronouncements.

There are many ways of achieving consistency and credibility in policy making in Bulgaria and the other former Soviet Bloc countries. Among these are political constraints like those imposed by constitutions (such as balanced budget provisions); legal constraints set forth by parliaments, congresses, and other official governing bodies; and external constraints of the type imposed by international organizations such as the Basle Committee on Banking Supervision, the General Agreement on Tariffs and Trade (GATT), the International Monetary Fund, and the World Bank.

The newly formed democratic governments of Eastern Europe face enormous political pressures as they attempt to implement reforms. In such an environment, the value of economic policy constraints imposed by international agencies should not be underestimated. In most cases these restrictions, in addition to fostering a smooth transition, also contribute much in the way of binding policymakers to credible and consistent economic policies.

The Bulgarian Banking Industry's Future

The short-run prospects of the Bulgarian banking industry hinge directly on the ability of the Bank Consolidation Company to carry out its task of restructuring, consolidation, and privatization. Given the banking sector's key role in the economic development process, the future of the Bulgarian economic transition is seen to depend critically on developments in this sector.

The Bank Consolidation Company's initial goal was to reduce the number of commercial banks from about seventy-four to around eight or ten through a judicious merger and consolidation program beginning in October 1991 and ending in February 1992. For numerous reasons, this ambitious goal was not achieved. As of September 1992 one merger involving twenty-two commercial banks was formalized with the voluntary signing of a merger agreement, spearheaded by the Bank Consolidation Company and approved by the Bulgarian National Bank, that resulted in the formation of the United Bulgarian Bank (formerly named the Bulgarian Credit Bank). This bank anticipates receiving equity investments and technical assistance

from the European Bank for Reconstruction and Development and other foreign organizations. Currently, it is anticipated that two or three mergers involving other commercial banks will be formalized during the winter of 1993.

Considering the magnitude of its task, it is not surprising that the Bank Consolidation Company failed to meet its initial consolidation goals. Clearly, the consolidation effort cannot be effectively carried out without proper attention to the problems discussed in this article. In trying to achieve consolidation, the Bank Consolidation Company faces a banking industry characterized by numerous banks of inefficient size (too small to exploit economies of scale) with undiversified loan portfolios, poor-quality assets and excessive bad debts, inadequate equity capital, and a labor force generally lacking in modern banking and financial skills.

Despite its lack of resources, the Bank Consolidation Company has made important strides in establishing a framework for merging Bulgaria's banks. A uniform accounting system and an analysis system for appraising banks' financial health have been established. The analysis system resembles the CAMEL rating system used by commercial bank regulators in the United States, which appraises bank capital, asset quality, management, earnings potential, and liquidity for all commercial banks as well as for merger candidates. Under the Bank Consolidation Company's guidelines, the bank resulting from a merger must have sufficient equity capital in accordance with the existing international capital regulations (8 percent of total assets), must not contain excessive bad debts in its loan portfolio (nonperforming assets must be written down, written off, or reserved), and must be well

diversified. In addition, the bank management must be of high quality, and the bank must have positive earnings potential and excellent liquidity on its balance sheet. As for most Western banks, the merged institution must also have formal written policies covering all aspects of its operations.

Conclusion

A natural function for banks in the transition from a command to a market economy is to replace central plans for financial intermediation and economic development in such a way as to bring market forces to bear on the process of transferring savings into investment. This process is the key to both the failure of the system of central planning in pre-1989 Bulgaria and to the country's prospects for future economic reform.

Unfortunately, as this article suggests, the Bulgarian banking and financial system is currently incapable of carrying out this function effectively. The problems in the Bulgarian banking and financial system are both broad-based and deep-rooted and will probably be eliminated only through a slow and difficult process of economic transition. Despite this pessimistic outlook, however, there are several positive developments taking place in the banking system. Bulgarian policymakers seem to understand the need for further banking system reform and are taking steps to restructure the industry to put it on a sound economic footing. As these system reforms are carried out, they should generate positive external effects for price reform, monetary policy, trade liberalization, and other key elements in the economic transition process.

Notes

1. During the spring of 1992 the author was on special assignment in Bulgaria working with the University of Delaware-Bulgarian Coalition and with the Bulgarian National Bank and its Bank Consolidation Company. More recently, he visited Bulgaria as part of a Federal Reserve Bank of Atlanta-U.S. Treasury short-term technical assistance mission at the Bank Consolidation Company. Much of this article is based on information obtained during these visits, such as unpublished memoranda and conversations with officials of the Bulgarian National Bank, the Bulgarian Bank Consolidation Company, the International Monetary Fund, the World Bank, the University of Delaware-

Bulgarian Coalition, and the managements of several Bulgarian commercial banks.

2. This description draws heavily on documents of the Bulgarian National Bank, including its 1990 *Annual Report*.
3. Approximately 90 percent of Bulgaria's foreign trade was conducted with CMEA countries until 1989, when the CMEA relationships began to disintegrate.
4. Although sector-specific lending by commercial banks is no longer mandatory, many still lend to only a few firms in designated sectors. This behavior, combined with the fact that many of the newly created commercial banks were allocated

the loans accumulated by state-owned enterprises under the old Gosbank-type financial system, has resulted in a banking system characterized by inadequate loan portfolio diversification. Inadequate diversification exacerbates other problems in Bulgaria's banks, including small capital bases and inexperienced managements, that are discussed elsewhere in the article.

5. Given the accounting principles employed in Bulgarian banks, these estimates are extremely conservative by Western standards.
6. Identifying which state-owned enterprises are profitable requires the adoption of meaningful accounting conventions, as discussed earlier.
7. It should be kept in mind that, unlike bad loans that resulted from the savings and loan debacle in the United States, the bad loans of the Bulgarian commercial banks have always been government obligations. These loans were made by the government's monobank and assigned to the newly created commercial banks once the two-tiered banking system was

adopted. However, as in the U.S. savings and loan crisis, the Bulgarian government should commit not to engage in future bailouts of banks if it is to avoid the problems of excessive risk taking associated with the moral hazard dilemma.

8. However it is financed, any plan to nationalize debt hinges on the question of government credibility; government bonds swapped for bad loans must be marketable if the plan is to be effective. By substituting public debt for private or quasi-private debt, the government is merely making explicit an existing obligation. The point is that it must commit itself to raise taxes or earmark revenues (for example, cut future spending) to service this newly issued debt. If the government cannot credibly commit, its debt will not be marketable. An alternative to the issue of government debt would be obligations of the central bank serviced by earmarked taxes (fees) collected from the banking system.
9. The activities of the Bank Consolidation Company are discussed in more detail in the section that follows.