

**CERGE-EI Foundation Project_08_2002'Currency Board, Corruption and
Corporate Governance Effects on Banks-Firms Relations in Bulgaria'**

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NON-TECHNICAL SUMMARY

Five years after the introduction of the Currency Board (CB) in Bulgaria the relation 'banks - firms' is still in the centre of economic discussions. In the period 1990-1996 banks accumulated many bad loans, supporting 'crony' firms, which led to the bank crisis in 1996/1997. At the end of 2001, banks were accused of the opposite - their unwillingness to give credits and their tendency to invest abroad. Some time ago, the unprecedented increase in credit was blamed for being a cause of the loss of financial stability (OECD, 1999). At the end of 2001, the low credit activity of banks was conceived as one of the essential obstacles to economic growth (Feyzioglu and Gelos, 2001).

The main objectives of this project are as follows: to examine the role of traditional factors on bank and firm activity, to analyse the effect of the CB, other institutional and political factors on the bank-firm relations, to examine the common impact of the corporate governance structures and the corruption environment on the bank-firm relations, to identify different dimensions of ownership structures of the largest Bulgarian firms, to provide a theoretical description of how different ownership structures and financial constraints influence firm performance.

This study has applied an original methodology. It comprises: (i) a survey of all Bulgarian banks; (ii) a survey of the largest non-financial firms in Bulgaria. This allows to 'intersect' the factors determining the supply and demand of credit both by the banks and the firms. The credit market model allows incorporating a new vector of variables apart from the ones used traditionally. The novelty of this approach is the construction of a cross sectional model, based on both bank and firm empirical data base, and including a set of variables reflecting not only traditional factors, but also a large range of new ones –

institutional and political factors, factors linked to CB regime, corruption, ownership and control etc. This allows to investigate and to check theoretical hypothesis about the link between different factors in the large context of Bulgarian transition. The study also applies institutional analysis of both conventional and specific ‘transitional’ dimensions of ownership structures in largest firms in Bulgaria, and tests hypotheses about the effects of different aspects of ownership and control (state ownership, stable private majority owners, ownership concentration, transitional ownership structures, etc.) and other institutional constraints (capital structure, product market competition, size structure, etc.) on firm performance.

The data collected was of three main kinds. First, survey of all the banks in Bulgaria containing accounting information (balance sheet and income statement), ownership data, information about the perceptions of bank managers, some additional data. The basic sources used for the preparation of this database were: balance sheets and the income statements of commercial banks, the database of the Bulgarian National Bank (BNB) and questionnaire survey. Second, survey of the largest Bulgarian firms (both listed on the Bulgarian Stock Exchange (BSE) and not listed on the BSE) containing information about performance indicators (revenues, profitability, etc.), ownership data, firms-government relations (tax payments, security payments), affiliation to interest groups, other data (board of directors, etc.). The sources for this unique database of largest firms in Bulgaria were: the Bulgarian Chamber of Commerce and Industry, Bulgarian Stock Exchange, Privatization Agency, Ministry of Finance, Bulgarian Foreign Investment Agency. Third, narratives of company managers, bank managers, state officials and politicians about banks-firms credit relations, state capture, ownership change.

The key results of this research are contained in the following two papers.

(i) Dennis C. Mueller Helmut Dietl and Evgeni Peev, *Ownership, Control and Performance in Large Bulgarian Firms*.

(ii) Nikolay Nenovsky , Evgeni Peev and Todor Yalamov, *Banks-Firms Nexus under the Currency Board: Empirical Evidence from Bulgaria..*

The first paper of the project analyses the key dimensions of ownership structures and their effects on performance in the largest non-financial firms in Bulgaria. We find that direct ownership is highly concentrated and domestic holding companies and non-financial firms are the key largest shareholders. The ultimate ownership observed, however, is dispersed due to the dispersed ownership structures of holding companies. This creates specific separation of ownership and control and twofold agency issues. Specific ownership structures like firms affiliated to business groups and firms with offshore owners were also described. We find a positive relationship between ownership and profitability of companies with stable majority private shareholders and negative relationship between state ownership and profitability. The study cannot find support for the proposition about the active controlling role of the second largest shareholders under the Bulgarian conditions. The results show that debt pressure is not an efficient mechanism for constraining managerial discretion in public companies over the period 1998-2001 in Bulgaria.

In the second paper of the project we analyse bank lending in the larger context of bank-firm relations within the Bulgarian specificity of currency board. The paper focuses on the 'intersection' of credit supply and demand on the side of banks and firms simultaneously. We suggest both traditional and new hypotheses corresponding to the specific conditions of the Bulgarian ownership change, transitional corruption and other institutional and political factors. The model is based on a survey on Bulgarian banks and a unique database on firms. The study found that the dynamics and structure of credit is affected mainly by the features of the institutional environment, whereas the 'resource' and traditional factors became secondary. During the period 1998 – 2001, there is separation of the banking sector activity from the activity of the real sector in Bulgaria. In the new conditions of currency board, the dual sector of enterprises and the specific institutional environment continue their existence. Despite its disciplining effect the currency board by itself is not sufficiently effective to overcome the remaining 'institutional obstacles, associated mainly with the inefficiency of the judicial system, corruption, state capture, uncertain property rights, etc.

