

THE ROLE OF SOCIAL NORMS FOR THE RELATIONSHIP BETWEEN PRIVATE OWNERSHIP AND THE PERFORMANCE OF BANKING SECTORS IN TRANSITION COUNTRIES: THE CASES OF BULGARIA AND HUNGARY AS EXAMPLES

Ingrid Gröbl*, Nadine Levratto**

Abstract

We start with a theoretical reflection on the merits of private ownership in banking sectors concluding that the merits of private ownership in a market economy crucially depend on the overall compliance with principles of good governance. We show that it is pivotal in this respect that the underlying legal order is in action and not just on the books. Whether this is the case depends on accepted social norms which in their turn derive from cultural value orientations. We use these insights to compare the development and performance of banking sectors in Bulgaria and Hungary with the attempt to establish relationships of found differences between the countries to different basic value orientations.

Keywords: private ownership, banking sector, transition countries, Bulgaria, Hungary

* University of Hamburg

** École Supérieure de Cachan

1. Introduction

Private ownership is widely accepted as the heart of market economies. Private owners possess the right to alienation setting them incentives to choose actions which promise to enhance the value of their assets thus contributing to aggregate welfare, too. It is also widely accepted that banks pose no exception to this rule, and indeed even in Germany, where public ownership in the banking sector used to have a long-standing tradition, restructurings towards minimizing the ratio of public banks are under way. It is therefore not astonishing that the privatization of socialist financial and non-financial firms together with the creation of new private firms has been considered as pivotal to successful transition. Advocates of the Washington Consensus even held the view that privatization combined with stabilization policies implementing hard budget constraints would be sufficient to pave the way towards flourishing market economies. From the very beginning it appeared obvious that banks would have to play a crucial role in financing necessary restructurings and investments in the business sector. Contrary to banks, organized financial markets were absent, and it was clear that it would take years for them to develop. A major problem of the socialist banking sector was its lending practice which followed political criteria and in this respect regularly violated principles of prudence and efficiency. It appeared quite logical to identify this malfunctioning of socialist banks with state ownership which lead to recommend swift privatization. Looking back at the more than 15 years which have passed

since the demise of Communism, we observe that privatization was neither a fast happening event, nor did it prove to be a panacea. We moreover observe remarkable differences between transition countries as regards the speed at which private ownership took over, the modes of privatization as well as economic consequences. The large number of empirical works focusing on the role of privatization confirms that in particular the type of owner with its significant impact on governance, has played an important role for the success of privatization activities (Frydman et al., 1999; Crotty et al., 2004). However, the investigations also emphasize a role of the legal order and its enforcement in general and with respect to banks, the regulatory framework in particular. In our paper we take up this issue. Based on theoretical reflections we show that the merits of private ownership are crucially dependent on the overall compliance with *principle of good governance* like the rule of law, transparency together with accountability and the absence of graft (corruption and fraudulent practices) which – provided that they are honoured in corporations as well as in the political and judicial sphere – constitute the pillar of a well-functioning market economy in general and a stable and efficient banking system in particular. The rule of law can be considered to be pivotal in the sense that whenever this rule is absent, it can hardly be expected that judges will pose an exception implying that accountability will hardly be observed and corruption will flourish. Transition countries have revealed a considerable reluctance of governments to implement laws prescribing good governance. But even if the required legal institutions

were brought on the way, they often remained on the books (Gray, 1997; Pistor, 1999). The missing link between law on the books and law in action has been found to be *informal institutions*, i.e. rules which cannot be legally enforced but rely on informal sanctioning mechanisms like loss of reputation, ostracism or feelings of guilt. In our paper we elaborate the hypothesis that in this respect, *injunctive* informal institutions which in a society prescribe what ought to be considered as good and bad, play a crucial role – to be called “social norms” henceforth¹¹ – play a crucial role. More precisely we follow Licht (2004) stating that social norms do not appear in isolation but rather are interrelated to form a system. Such a system of social norms constitutes a pyramid standing on top with fundamental norms on a very general level giving rise to more and more concrete social norms governing everyday social interaction (Licht, 2004). These fundamental social norms which can be interpreted as basic cultural value orientations will be shown to play an important role for the relationship between private ownership and the performance of banking sectors in transition countries. In this respect we have found that Hungary and Bulgaria constitute contrasting examples.

For the remainder of the paper we proceed as follows. After having specified the requirements for the superiority of private ownership in banking sectors thus clarifying the role of overall governance structures, we make the relationship between governance structures and basic cultural value orientations more concrete. In particular we make evident which value orientations foster the evolution of governance principles like the rule of law, accountability and the absence of graft. We then turn to Bulgaria and Hungary studying the performance of their banking systems in relation to private ownership. Since we devote much space to more interdisciplinary issues we do not intend to provide a careful econometric analysis as regards the relationship between private ownership and popular indicators of banking systems’ performance like the degree of concentration, rate of return on equity, capital adequacy ratio and the like. Rather, in this respect we resort to the manifold studies which already exist.

2. The Merits and Limits of Private Ownership for the Performance of Banking Sectors

2.1 Some Reflections on the Role of Private Ownership in Market Economies

When students of economics learn about the advantages of a market economy, they are very

quickly confronted with the General Equilibrium Model (GEM). Its basic message is that in a world of perfect information aggregate welfare can be maximized provided that property rights which entitle individuals to decide on scarce resources are completely specified and tradable through a price mechanism in perfectly competitive markets. A maximum of aggregate welfare is characterized by Pareto efficiency which implies that individuals achieve a maximum of utility by the choice of waste-avoiding production strategies and by the exclusion of personal enrichment at the cost of others. The upshot is that in such a world the type of property right, i.e. whether individuals have the right to just use resources or in addition to modify and sell it, is irrelevant. Differently put, it does not play a role whether ownership of scarce resources is individually or collectively held; private ownership hence has no special merit in a GEM world. The GEM describes the ideal of a market economy which provides every economic actor with the capacity to exercise choice, and ensures that social interaction is marked by exchange which implies that trading parties meet each other at eye level. This is equivalent to saying that *power relations* i.e. relations that provide one trading party with the capacity to exercise choice at the expense of the other party are absent. It should not be overlooked that this view tacitly assumes away, that even in the GEM world there exist power relations which basically follow from the physical superiority of some individuals over others. Hence, perfectly competitive markets and perfect information will not rule out theft through the use of physical violence. Connected to this, nothing- at least not explicitly - is said about a widely observed inclination of market participants to form coalitions thus obtaining the power to turn competitive into concentrated markets. How power relations are structured, is now debated under the term “governance” (Kaufmann et al., 1999, Hellmann et al., 2000). The GEM *tacitly* contains governance principles which make sure that individuals do not abuse power or even refrain from acquiring power as such. These governance principles forbid agents to violate agreements, to steal others’ property rights, and they tell them to acknowledge the price mechanism as the exclusive coordination mechanism thus abstaining from graft and other strategies that allow to achieving market power and thus the power to dictate prices.

If we leave the GEM world, power relations increase in importance. Their major origin can be found in information deficits. In this respect information asymmetries and transaction-specific investments which are not contractible due to unforeseen or indescribable future contingencies play an important role. Now agents with superior information as well as a trading party who has not invested into a contractual relationship whereas the other party has done this, are endowed with (bargaining) power which they can use in an opportunistic manner thus redistributing wealth.

¹¹ As is elaborated in Licht (2004), there exist manifold definitions of social norms. The definition we have chosen serves to distinguish injunctive informal institutions from mere habits but also as will be explained below from rules which are followed out of mere self-interest (Elster, 1989).

Information asymmetries as well as non-contractible transaction-specific investments are at the core of property rights theory which emphasizes that it is in particular in these cases where private ownership becomes crucial (Hart et al., 1990). As an example consider an agent who has been given the right to use a factory but not to sell it, i.e. on the one hand he does not profit from selling the factory after it has gained value but on the other hand he also does not bear losses due to value destroying actions. In a world of perfect information a principal who possesses the right to alienation will be able to prevent his agent to whom he has delegated the right to use the asset, from taking choosing-destroying actions. However, in a world of information asymmetry this is not that easy. Monitoring is costly and costs may even be prohibitive. Hence the user of the factory might have an incentive to use up the factory, and he might be indifferent with respect to value destructions. In contrast an owner-manager will have a clear-cut incentive to choose strategies which promise to be value-enhancing and he will be accountable for losses due to expectation errors. In the same way property rights theory has shown that whenever social interaction requires one party to engage more heavily in transaction-specific investments which cannot be contracted upon initially, this agent should own the underlying asset to which the investment adds value (Williamson, 1975). It is important to recognize that the described merits of private ownership depend on existing well-functioning markets for ownership rights. Only then will market participants price firm assets according to their "true" value setting owner-managers incentives to choose investments with positive present value. Given a system of perfectly specified property rights which allows to avoiding externalities, investments which are value-enhancing at a firm level increase aggregate welfare, too and thus contribute to Pareto-efficiency. This model indeed constitutes the backbone of the Washington Consensus which has put privatization into the centre of transition strategies.

Given information asymmetry and transaction-specific investments which cannot be contracted upon, private ownership *prevents* the creation of a power relation held by the mere user of an asset which could be exploited in a Pareto-inferior manner. However, a word of caution is in order here because private ownership gives rise to new power relations which can be abused in a welfare deteriorating manner. In these power relations, the owner himself may possess power for basically three reasons: First, malfunctioning markets for ownership, second the existence of debt as a financing device, third transaction-specific investments by other stakeholders. Turning to the first argument, it has to be taken into account that information asymmetry as a widespread phenomenon will guide the behaviours of market participants, too. In particular those possessing superior information will have the power to exploit others for example by revealing false information.

Potential buyers of a firm facing high screening costs may be unable to verify a firm's true quality. Hence market prices may be distorted leading to Akerlof's lemon problem (Akerlof, 1970). The second reason accounts for the fact that under information asymmetry it also plays a role how private ownership over physical assets has been financed (Jensen et al., 1986). Private ownership of firms for example does not require that firm-owners have used their own financial funds to finance machinery and other assets. Money can be borrowed, and owners might abuse information advantages compared to their lenders in order to select excessively risky projects. The third reason deals with implications of specialization. In a world of specialization, in particular owners of firms will have to employ workers whose income depends exclusively on their human capital and who have to undertake firm-specific investments which cannot be verified by third parties thus being locked into the firm. The same is true for locked-in suppliers or customers.

The above stated arguments support the view that under information asymmetries and transaction-specific investments, private ownership conveys power to the owner himself. However, it is also true that owners may be the addressees of expropriation. For example the enforcement of private ownership rights might be ineffective. This is the case if contracts concluded with suppliers, customers, employees, financiers are not honoured and if the courts lack material independence. A further point which gave rise to a large body of literature is related to the fact that in modern economies it is common for owners to delegate property rights to managers who – as insiders- gain superior information. In this case a low degree of concentration of ownership i.e. widely dispersed ownership may expose every individual owner to excessive monitoring costs leading to a free-rider problem and thus sub-optimal monitoring. But even with concentrated ownership problems arise since even a large owner will be an outsider being exposed to residual information disadvantages (Shleifer et al., 1997). In this respect it has also been found that a market for corporate control may fail for the same reasons that set managers incentives to choose value-destroying actions. Indeed, managers with superior information can use this advantage to offset the disciplinary effects of the price mechanism in markets for corporate control. Hence the malfunctioning of private ownership and the malfunctioning of markets are closely interrelated in the sense that better market mechanisms will hardly be achieved without solving information asymmetry problems.

We may therefore conclude that private ownership as such does not guarantee Pareto-efficiency in a world of information problems, and indeed private banks were upon the prominent actors triggering off banking crises and credit crunches as well.

In the following we show that the relative success or failure of transition countries is closely related to their successful overall establishment of principles of good governance thus ensuring the necessary conditions for welfare-enhancing contributions of privately owned firms. In order to guarantee overall good governance, a system of checks and balances is needed which rests on the following pillars: first, division and separation of powers which implies that legislation and the execution as well as the enforcement of laws are separated, second, a legal system that specifies personal freedoms, imposes constraints in a unanimous manner and provides legal enforcement mechanisms. Third, a political system allowing that politicians can be voted out of office if they do not perform their tasks. Fourth, a private sector which accepts the democratic order and its major institutions as guides of behaviour. It is important to recognize that a formal apparatus based on legal norms, i.e. law on the books, will not suffice. Law has to be in action, and in order to achieve this, democracy has to be accepted as a societal consensus which as we shall see below is deeply rooted in inherited cultural values giving rise to a particular set of social preferences and social norms. The disciplinary role of the market, too, is limited if this societal understanding does not exist because economic agents possessing power will offset these mechanisms in their favour.

Private Ownership in the Banking Sector

The existence and special merits of private banking institutions and bank credit in particular, too, has been associated with information asymmetries and non-contractible transaction-specific investments. Following the academic literature, banks as an element of financial systems owe their existence basically two reasons: first a missing ability of savers to verify the true performance of their debtors (Diamond, 1984) and second, contractual incompleteness due to failures of the legal system or unforeseen and indescribable future contingencies which exclude legal enforcement (Rajan 1998). Following Diamond, Rajan (1997), the details of the relationship between the bank and its clients – debtors and depositors as well – are important in this respect. These details are marked by noncontractual mechanisms like a bank's investment into reputation (Book, Greenbaum, and Thakor 1993) due to the insight that a bank engages in the same business many times, or its investment into keeping a borrower as a client (Petersen et al., 1995, Diamond and Rajan, 1999). Borrowers, too, might have an incentive to building a reputation for honouring their obligations. Private enforcement of loans is then promoted by enduring relationships between banks and their borrowers marked by mutual endeavours to keep their reputation. Both strands of research reveal that banks serve to enhance economic growth by overcoming information problems which might imply misallocations of financial funds.

Implicitly the study of banks as financial intermediaries assumes that banks are privately owned with owners having an interest in enhancing the value of their banks. And indeed at least on the microeconomic level empirical investigations assign to privately owned banks a higher performance than state state-owned banks. (Barth et al., 1999; Sapienza, 2002). However, banking sectors have been regularly plagued by banking crises and at least for industrial countries there is no evidence that state-owned banks have played a superior role in triggering off these crises. Levine (2004) emphasizes that banks give rise to corporate governance problems which are more pronounced than in non-financial firms. In this respect he emphasizes the role of opaqueness which aggravates problems associated with information asymmetry and which Levine has found to be higher in banks than in non-financial firms. Into the bargain comes the fact that a bank's major creditors, i.e. the depositors are widely dispersed lacking both the capacity and willingness to engage in intensive monitoring processes. Whenever the bank and depositors follow different objectives, the bank can use its information advantage to ignore depositors' interests. This is in particular the case if either the bank-owner-manager is not fully liable or if bank-managers do not fully participate in losses. Then moral hazard might follow leading to the accumulation of bad credit risks which may lead the economy into banking crises. On the other hand information asymmetries might render the rationing of credit to high-quality borrowers to be a value-maximizing strategy thus contributing to declining GDP growth. Also as Prowse (1997) has found hostile takeovers tend to be rare in banking sectors which, too, is closely related to opacity implying that the information advantage of bank insiders is more pronounced than in non-financial firms.

Reputation which has been emphasized as a major reason for the rise of banks in an environment marked by weak legal enforcement, is not a natural outcome of private ownership (Rajan, 1998). As is shown in formal models assuming rational egoists (Shapiro 1993; Kreps, 1990), a value maximizing agent has an incentive to build reputation if this promises a positive net value which exceeds the immediate benefits of cheating. This in turn requires that the number of repetitions is unknown, that the bank's subjective time preference is sufficiently low and that the prices for financial services are sufficiently high which conflicts with a high degree of competition. As a further implicit assumption the formal models take for granted that buyers, for example bank clients do not face high exit costs thus being able to quit a bank after having made bad experiences. Bank credit, however, typically involves a bank-borrower relationship with significant exit costs above all for the borrower. The bank has the capacity to exploit its advantage and increase the interest rate or claim further collateral driving borrowers into insolvency.

Indeed, banking crises in which bad bank governance plays an important role have been a widespread phenomenon not only in developing, emerging or transition countries. Since the banking crises of the 1930s a dense network of regulations and more recently increasing supervision has spanned financial systems in general and banks of Western industrialized countries in particular with the major purpose to improve bank governance on behalf of financial institutions' soundness and financial system stability. However, regulation and supervision constitute further governance problems. As Llewellyn (1999) emphasizes, the relationship between regulators and regulated financial institutions constitutes a principal agency relationship marked by information asymmetries which can give rise to opportunistic behaviour on the part of the better informed banks thus undermining the intention of prudential regulation if monitoring procedures are without success. Regulators or supervisors on the other hand might give priority to their personal objectives thus being concerned about their personal career and in this respect future job prospects in the private sector in general or banking sector in particular. "Regulators may be "captured" by the industry they are supposed to oversee" (Chami et al, 2003: 15). It is now increasingly accepted that the soundness and stability of the banking sector is a problem of *overall* governance (see Llewellyn, 2000 for a conception of regulatory regime and Das et al, 2004 for the role of Basel II in this respect). Overall governance is meant to describe practices which are accepted 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. Again independence which is closely associated with the rule of law, accountability and connected to this, transparency and integrity as well as the absence of corruption are appealed as principles of good governance which contribute to well functioning banking sectors in private ownership (Das et al., 2004).

Principles of Good Governance and Social Norms

It is a main hypothesis of this paper that the merits of private ownership depend on its integration into a democratic order which is "in action" and not only "on the books" thus giving rise to a general acceptance of principles of good governance. In this respect, the interplay between legal and social norms gains importance. In accordance with Licht (2003 and 2004), Elster (1989), Fehr and Gächter (2000) and similarly Ostrom (2000) we define social norms as rules which are based on a shared belief on how one ought to behave in particular situations and which - contrary to legal norms - depend on effective *private*

enforcement mechanisms like the loss of reputation despise by others, ostracism or feelings of guilt or shame. The major point is that social and legal norms are not independent, and that in particular widely accepted social norms have a crucial impact on the formation of legal and political institutions itself as well as on the degree to which a given legal and political order is accepted. If legal and social norms are complementary, then the legal order will be widely accepted with the consequence that law is in action. This does not only imply that the courts are factually independent but also that private enforcement mechanisms may even replace legal enforcement (law then becomes expressive, cf. Cooter, 1998). We may go a step further in this respect stating that social norms have a major impact on whether *principles of good governance* are on the books only or in action. Take the rule of law as an example. Of course a system of legal enforcement mechanisms can be established in favour of a society's compliance with this rule. However, this will be of little use as long as the courts lack factual independence. One could attempt to establish judicial independence by help of legal sanctioning mechanisms, too. However, in a society marked by a consensus that it is neither necessary nor desirable to abide by the law, this will not be very fruitful. This implies that the rule of law is sustainable only if this rule constitutes a social norm itself (Licht et al., 2003) or is the outcome of the more general social norm to honour agreements. In the same vein accountancy/voice and the absence of corruption as a government principles will survive only if social norms exist that prescribe individuals to comply with principles of truth-telling, fairness and reciprocity

There is a growing literature focusing on the issue how social norms evolve and which factors induce compliance with them. Experimental studies are concerned with the role of deviations from rational egoistic behaviour in promoting collective action.¹² Following Kreps (1997), theoretical approaches can be classified into external and internal views. According to an external view social norms impose constraints on individual behaviour which are binding due to effective sanctioning mechanisms like the loss of reputation. This approach has been developed within the framework of game theory¹³. For example in Bowles et al. (1998) it is derived that social norms like truth-telling, fairness, reciprocity, honouring one's commitment have a high probability to develop in small communities where social interaction is marked by high exit and entry costs rendering a high frequency of interaction and a correspondingly high probability of meeting the same trading partner again. Given such a setting, costs of information will be low and the probability that uncooperative behaviour is

¹² For an overview cf Ostrom (2000).

¹³ Increasingly norms are investigated within the framework of evolutionary games, cf. Binmore (1998), Skyrms (1996), Bicchieri (1997).

retaliated, will be high. 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 behave well (Shapiro, 1983; Axelrod, 1984; Gintis, 1989; Kreps, 1990; Bowles et al, 1997) Unfortunately the external view leaves unexplained how social norms in *large* communities evolve and are enforced where the degree of anonymity is high and where subgroups are common implying that one group may develop norms which subordinate other groups. (Cooter, 2001) Beyond that reputational equilibria are far from being robust with respect to changes of exogenous conditions thus implying that social norms are highly fragile. This contradicts the empirical finding that social norms are rather sluggish as regards their adjustment to a changing environment. Indeed as Jon Elster (1989) describes it, approaches based on rational choice view economic agents as guided by the prospect of future rewards always willing to modify behaviours in light of new information about cost and benefits. In this respect norms derived in a game-theoretic framework share a great resemblance to what Robert Sugden (1989) denotes as conventions whose survival depends on whether they promise a substantively better outcome for the players.

Alternatively, internal views locate the components driving compliance with social norms within the individual person thus shaping individual preferences (Licht, 2004). Whereas the external view explains the evolution of new social norms and compliance with prevailing norms with cost-benefit considerations¹⁴, the internal view rests on endogenous individual preferences with the social environment being a major determinant. Social norms regulate human activities with the purpose to establish a social order by specifying behaviours which are accepted as desirable and by providing private enforcement mechanisms which include emotions like feelings of guilt (Licht, 2004; Rutherford, 1991). Endogenous preferences play a role in the Old Institutional Economics as well as in evolutionary economics¹⁵. These literatures doubtlessly offer interesting insights into the evolution and enforcement of *particular* social norms derived in isolation. However, social norms rarely appear in isolation but rather constitute a system in which norms are related to each other. This directs the question of what determines a particular norm to the question of raises of what determines a particular *structure* of prevailing

norms. With respect to transition countries this implies that the development of social norms fostering good governance might be hindered because these norms do not fit into the inherited structure of social norms. We think that in this respect cross-cultural psychology offers some interesting insights which can be applied to explaining both institutional impediments to economic transition as well as country-specific differences in this respect.

According to cross-cultural psychology every society is encountered with basically three issues: The first question concerns the relationship between the individual and the group or society as a whole. The second question is about how responsible behaviour can be ensured thus that the social fabric can be sustained. The third question concerns the relationship of humankind to the natural and social world. (Schwartz et al. 1995: 97). Following Licht (2004) the answers given in a society give rise to a pyramid of social norms meaning that social norms are interrelated and that norms can be distinguished according to their importance. This pyramid of social norms stands on its head since only a few fundamental social norms constitute its basis in the sense that any other social norm which is accepted in a society is derived from these fundamental rules. In cultural psychology these fundamental social norms are referred to as *cultural value dimensions* which describe societal preferences as regards the way how the relationship between the individual and the society should look like, how social interaction and the relationship between humankind and the natural and social world should be regulated (Shalom Schwartz (1992, 1995) and Geert Hofstede (1980, 1997, 2001).

The first issue concerning the individual and the society leads to two contrasting value pairs denoted as "autonomy" versus "embeddedness" by Schwartz and "individualism" versus "collectivism" by Hofstede. "Autonomy" or "individualism" denotes a cultural value that attaches to individuals a high degree of autonomy with respect to the choice of their personal goals and the ways to achieve them. Individuals are valued as human beings that are conscious of their uniqueness. According to "embeddedness" or "collectivism" individuals are valued and value themselves as members of a social group which means that they identify themselves with the social network they belong to. Notably this social network goes beyond the boundaries of the nuclear family or kinship. Group solidarity and unquestioning group loyalty are undisputed. The second question concerns ways how individuals can be induced to consider the welfare of others, thus retaining the social fabric. Again the answer is seen to depend on entrenched cultural values where now "hierarchy" versus "egalitarianism" in the terminology of Schwartz or the degree of power distance in the terminology of Hofstede constitute contrasting cultural values. Hierarchy as a cultural value implies a societal order which relies on large power differences, i.e. hierarchical systems of ascribed roles. As Schwartz

¹⁴ Therefore Rutherford (1991) denotes norms which are based on rational choice as conventions.

¹⁵ An excellent introduction is provided in Bowles (2004).

(1995:96) describes it “People are socialized and sanctioned to fulfil their roles, the roles define social obligations, and acceptance of the hierarchical order assures compliance with the rules that preserve the social fabric.” Alternatively, a cultural value might be to consider other people as equals thus inducing individuals to recognize common interests as a basis of cooperation on a voluntary level. Social interaction then will be marked by low power distance. Schwartz calls this cultural value egalitarianism to express a generally accepted “...emphasis on transcendence of selfish interests in favour of voluntary commitment to promoting the welfare of others.” (Schwartz, 1995:97) The third question concerns the relation of humankind to the natural and social world. The contrasting pair of cultural values in this respect is “harmony-mastery” in the terminology of Schwartz whereas Hofstede quotes contrasting pairs of feminine versus masculine values complemented by high or low degrees of uncertainty avoidance which describes how societies value uncertainty. Harmony as well as feminist values coupled with a high degree of uncertainty avoidance describe an emphasis on fitting into the social and natural environment without any pronounced tendency to change it. Harmony hence expresses a conservative value dimension. By contrast mastery or masculine values emphasize the “...getting ahead through active self-assertion, through changing and mastering the natural and social environment.” (Schwartz, 1995:97/8)

The contrasting pairs of value dimensions do not exist in isolation but rather correlate with each other. For example, hierarchy and harmony (conservatism) relate positively to each other, since the acceptance of inherited roles mirrors a high value to keep the status quo. In the same vein we find a positive correlation between autonomy and egalitarianism because both build on the view that the individual should be valued as an autonomous being. (Schwartz, 1995: 98) Mastery which does not reject efforts to get ahead at the expense of others by contrast is positively related to both autonomy and hierarchy but negatively to egalitarianism.

Cultural values which characterize societies and thus their social preferences give rise to a particular system of social norms and thus also to a particular widely accepted governance structure. Licht et al. (2003), Licht (2004) show that for example the rule of law as a social norm which prescribes people to take the *law* as a guidance of behaviour instead of tradition, elderlies’ or superiors’ command, is consistent with societal emphasis on autonomy and egalitarianism, whereas this rule is less likely to be accepted in societies where embeddedness is valued high. They also found that in particular mastery does not show a close connection to the rule of law. Mastery legitimizes using other people if necessary in order to satisfy one’s own needs or those of the group. Corruption, defined as a common emphasis on use of power positions for private gains is found to be more likely to be accepted as a social norm in societies

marked by embeddedness, hierarchy and mastery than in societies where the autonomy of the individual together with egalitarianism are preferred. Finally, accountability will be accepted as principle of good governance in particular in societies with autonomy and egalitarianism as cultural orientations. The reason is that accountability claims from holders of power to give account of their decisions, i.e. make them transparent and legitimize them requiring that the powerful feel obliged to respect people subordinate in power. The authors emphasize that accountability which contains aspects of a representative democracy as well as civil liberties and voice will also have a high probability to rise as a social norm in societies high on egalitarianism but not in hierarchical societies. They also find mastery as incompatible with accountability since mastery legitimizes the pursuit of self-interest at the expense of others.

To summarize, principles of governance like the rule of law, accountability and absence of corruption which are accepted by governance researchers as pivotal for good governance are rooted in particular cultures, namely those emphasizing autonomy together with egalitarianism as prominent societal orientations. Investigations undertaken by Hofstede and Schwartz indeed make evident that in Western Europe and the US these values are more emphasized and accepted than in Asia and Eastern Europe, and indeed these cultures have developed a well-established democratic order and well-performing market economies resting on private ownership.

Research on the origins of cultural values as well as on factors determining their change is still in its infancy. Schwartz (1995) emphasizes historical events and religious orientations as well as accepted philosophical orientations and states that the greater emphasis of Western continental Europe on egalitarianism compared to the US roots in the motto of the French Revolution which combines “liberté” with “égalité” and “fraternité”. He furthermore holds that intellectual developments of the 17th and 18th century like the works of Hobbes and Locke provided the philosophical underpinnings for autonomy values. Furthermore he states that in “...the realm of religion, the Protestant Reformation and, subsequently, the secularization that affected Roman Catholic as well as Protestant nations, may also have contributed to the development of the view that the autonomous individual is the meaningful social entity...This was likely to promote Autonomy values at the expense of Hierarchy values.” (Schwartz, 1995: 112). He sees the rise of egalitarianism as a cultural value as closely related to the impact of Kant’s philosophy who stated that through reasoning the autonomous individual may commit itself to moral action, and Rousseau who stated that the autonomous individual is capable of compassion.

The Role of Private Ownership for the Performance of Banking Systems in Transition Economies

Implications of How Private Ownership Has Been Achieved

Starting from a socialist economy, manifold ways are possible to achieve a privately owned banking sector. This concerns the speed at which state-owned firms are privatized as well as the implementation of laws ensuring the enforcement of ownership rights. This also concerns the relative importance of newly created banks compared to privatized state banks. Further criteria are related to the difference between domestic and foreign ownership, the difference between dispersed and concentrated ownership, and also the issue of how state banks should be priced. Indeed, empirical investigations reveal that the choice of a particular privatization process had marked effects upon the results. Studies focusing on Central European countries have found a better performance of newly created banks compared to state banks both with respect to their profit as well as their risk situations. Notably this result is not only a consequence of inherited bad debts which exposed privatized firms with significantly worse initial conditions but also to their reluctance to change governance structures (Crotty et al., 2004). Also foreign-owned banks have been found to outperform domestic banks at least with respect to revenues. On the other hand it could not be confirmed that foreign-owned banks have enhanced the stability of the banking sector (Frydman et al., 1999; Mérö et al., 2003). A further issue concerns the structure of ownership. Transition countries share with Continental Europe a corporate governance structure marked by concentrated ownership (Berglöf and Thadden, 1999). Even in the Czech Republic which opted for voucher privatization initially dispersed ownership quickly turned into concentrated ownership through the creation of investment funds Crotty et al., 2004). Berglöf and Thadden (1999), emphasize that in evaluating the performance of closely held firms emphasis has to shift from boards of directors and shareholder meetings to cross-ownership and management networks.

In comparing the relative success of privatization in China and Eastern Europe, Miller et al. (2005) have found that a crucial explaining factor relates to the role of the state. They emphasize that privatization does not only involve a change in ownership but also a transformation in the role of the state. On the one hand the state had to give up power with respect to decisions on the allocation of scarce economic resources. On the other hand, however, strong state intervention was necessary to manage the process of transferring ownership and to implement the necessary legal order. In order to achieve these aims, the government must be willing and able to make credible commitments encompassing effective law

enforcement. In this respect the state does not act in a vacuum but has to be viewed as a part of the society which as has been emphasized for example by Raiser (1997) and Pistor (1999) has been guided by institutional legacy.

Institutional Legacy as A Major Impediment

The demise of communism did not leave the concerned societies with an institutional and cultural value vacuum. Formal as well as informal institutions including social norms were in place but the vast majority of them did not come up with the requirements of a market economy. The overall governance of the socialist society in general and economy in particular was marked by high centralization building on hierarchical principles. The result, however, was notorious scarcity of economic goods which gave rise to a system of informal institutions. Depending on the severity with which socialist principles were introduced, these institutions ranged from private firms which allowed to increasing overall production, and informal governance procedures in the state-owned firms attempting to circumvent regulation and thereby overcoming plan inefficiency and inconsistency (Crotty, et al., 2004) 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 governing principles. Governance structures in the political as well as business sector were marked by a reliance on personal networks to achieve objectives, and low trust between rather closed network groups. These findings are closely related to the observation that the rule of law was never really accepted by the public. Following Tanchev (1998), the major reasons for the absence of the 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: 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.

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 hyper inflation. However, the same economic restructurings that are needed in favour of economic development pose challenges to providers and users of financial funds that previously have never been experienced by any country in this

world. Comparable historical examples have 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. That (private bank) debt can act as a disciplinary device has been one of the messages of agency theory. However, in order to achieve this, bank managers have to follow principles of good governance themselves and beyond that the collection of debt has to be supported by appropriate laws and their effective enforcement which requires that sound banking governance principles are embedded in a system of overall governance promoting the honouring of contracts and providing external sanctioning mechanism to banks' mismanagement.

Increasingly scholars refer to institutional legacy as an impediment to economic transition (Raiser, 1997; Pistor, 1999). By this they mean in particular informal institutions, i.e. (injunctive) social norms and conventions. Our hypothesis is that in particular social norms stand out as informal institutions of significant endurance. The reason is that contrary to conventions which draw their wide acceptance from primarily cost-benefit advantages, social norms have been internalized shaping preferences. We show that in Hungary which already very early in history opted for Western cultural values, the institutional legacy was primarily marked by assumed conventions resulting from some pragmatic arrangement with the unavoidable Communist regime whereas in Bulgaria institutional legacy refers to a system of social norms grounding in cultural values which are hostile to a stable and efficient banking sector.

The Case of Bulgaria

Basic Cultural Value Dimensions

Bulgaria's history provided a rather unfavourable environment for the development of a civil society which shows a keen interest in socially benevolent patterns of interactions based on democratic rules. During five centuries, Bulgaria was under Turkish rule, and Orthodox Bulgarians saw no reason to comply with Islamic law (Tanchev, 1998) 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 highly liberal standards. 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 beginning of communism by two 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." However, there appears to be a third attitude that 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) During the Communist era Bulgaria developed into a totalitarian system marked by successful attempts of the Bulgarian Communist Party (BCP) to use the judiciary in order to strengthen its political power.

Between 2000 and 2002 a sociological survey with the title "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, masculinity – femininity (harmony versus mastery in the terminology of Schwartz). (Davidkov, 2004). The study confirms that still in 2002 Bulgaria fell among countries with pronounced power distance. The study also discovers indicators of strong uncertainty avoidance. In accordance with uncertainty aversion it was found that Bulgarians are rather reluctant to accept novel ideas and innovations. Furthermore heterogeneity is perceived as a major threat and not as a resource that can be taken advantage of. On the other hand Davidkov (2004) remarks that Bulgaria does not show traits which are also typical of countries with high uncertainty avoidance, namely a high respect of the law. In contrast he finds that the law in Bulgaria is not highly respected. This indicates that values do not appear in isolation. A low or missing respect of the law might be connected to high power distance (hierarchy) coupled with collectiveness. Indeed, the study confirms that Bulgaria is better described by a low level of individualism (autonomy) and correspondingly high level of collectivism (embeddedness) 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 investigated cases personal opinion is not encouraged. Finally the study finds Bulgaria to value traits high that correspond to feminine values (harmony in the terminology of Schwartz). 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. "The evaluation comment "he is a good person" prevails over the evaluation comment "he is a true professional". (Davidkov, 2004: 27) 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).

Implications for the Development of Bulgaria's Banking Sector until 1997

This found cultural profile can be said to have had an impact on the process of political and economic

transition to be observed in Bulgaria in general and the development of the banking sector in particular leading the country into a disastrous crisis by the middle of the 1990s (National Development Report, 1998). It is true that Bulgaria faced even harder initial conditions than countries like Hungary or Poland a major reason being its higher dependence on USSR markets and a more pronounced interference of the socialist government into practically all spheres of life which did not allow to developing even fragments of a private sector (Berlemann et al., 2002). Bulgaria's role as a showpiece of Soviet communism might have contributed to the observation that "...the disenchantment with the communist regime in Bulgaria had not reached its peak." Mihov (1999: 4)) This finding might offer a plausible explanation for the fact that the former socialist elite who had profited most from the system basically remained in political and economic power thus determining not only the development of a new institutional order but also the rules of governance in the political and judicial sphere as well as in the business sector. These rules were marked by corporatist patterns between all parties fostering personal enrichment. It is true, that the first private banks were already licensed in 1991 and grew in numbers during the following years. It is also true, however, that with the exception of the First Private Banks they all remained small and did little to promote real development (Enoch et al., 200). In particular a private banking sector which acted a promoter of economic transition was largely absent. A crucial role in this process was played by financial elites which entertained close relationships with the Bulgarian Socialist Party 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 (Daskalov, 1998). The newly created private banking sector 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, 2002:8). 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). In due consequence, 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 with 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" which means 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 sybiosis 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. In sum we may state that 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 thus being marked by poor governance (Daskalov, 1998; Berlemann et al., 2002).

The then prevailing governance structure in the business sector which was running counter to principles like the rule of law, accountability/transparency and absence of graft was complemented by governance failures in the political and judicial sectors which basically were under heavy influence of the same groups that dominated the banking industry. In this respect the Law of the Budget which subordinated the independence of the central bank to fiscal needs features high (Berlemann, 2002; Mihov, 1999). Schönfelder (2005) emphasizes that Soviet-type procedural law remained in action until 1997 which restricted the seizure of essential assets of socialized companies and provided for liberal exemptions for all sorts of debtors. A final example for 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. In 1992 the Law on Banks and Credit Activity was adopted which established the regulatory framework for the activities of banking institutions. It regulated licensing and enacted a minimum capital requirement of 4%. Furthermore banks were required to collateralize debt. It left open, however, the issue how failing banks should be handled and in particular it did not contain the legal option to close insolvent banks. Moreover 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 that had been imposed to the central bank's supervisory powers. In fact the Bulgarian central bank (BNB) was not allowed to place conservators in failing banks (Enoch et al, 2002: 12). Another example concerns the courts which proved rather unwilling to punish fraudulent behaviour as a cause of loan default (Enoch et al, 2002: 22). Schönfelder (2005) adds that the judges were highly dependent on the government. He describes that "...at least under the socialist Videnov government ruling in 1995-1997 a judge who ignored the exemptions went against the explicit will of government...Videnov's minister of economics... expressly proposed that state-owned companies should not service their debt to state-owned banks, arguing that state companies should engage in mutual support." (179)

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 pushing the banking sector into a crisis. 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 (Enoch et al, 2002). The real economy plunged into a deep depression.

Lessons from the Crisis: Bulgaria relies on Outside Control Mechanisms

Bulgaria's way into the banking crisis was marked by a governance structure with insider control mechanisms dominating. Insider-controlled systems are not a priori detrimental to aggregate welfare as the German example shows, a necessary condition being that the actors in power take aggregate consequences of their actions into account thus giving priority to efficiency and not redistribution (Cable, 1985)

However, this necessary condition obviously was not met in Bulgaria where networking served to maximize personal interests at the cost of others. State ownership proves particularly detrimental in such environment since political and economic powers coalesce and leave no chance to taking minority interests into account. However, private ownership, too, is unable to promote transition. In particular the former socialist elite formed a powerful group controlling the political, judicial and business sector,

and in doing so, they controlled themselves. With respect to the bank credit market for example, this implied that the knowledge of individual personalities served as a substitute for objective data, and that for example lending to friends and members of the own network who never repaid, was popular (Koford et al., 1997). On the other hand, borrowers who did not participate in the same networks like their bank were rather reluctant to repay their debt which also meant that collateralized assets would disappear all of a sudden (Koford et al., 1997). If a bank sought litigation it soon found itself treated unfair by the courts which had frequently been influenced by their borrowers (Koford et al., 1997). Indeed, following Schönfelder (2005) litigation was not common among banks and he adds that banks rather preferred illicit Mafia methods to get their money back.

In such a setting, a basic message of agency theory gains importance namely that *outside* control has disciplinary effects on opportunistic agents. Of course, outside control in this country promised to be successful only if outside meant "foreign" and if in this respect not only the private sector was concerned but the public sector, too. Indeed Bulgaria has chosen this way – at the time supported by a large majority of voters who had triggered off a political change in favour of a government which appeared more determined and capable to establish necessary reforms. The introduction of the *currency board* was not only a first but also a major step taking into account that its functioning does not only imply a factual independence of the central banks. 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 which 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%. 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 rating procedures according to the Basel Accord, are now regularly controlled by experts of the Banking Department the result of which is reported in a Quarterly Bulletin issued by the BNB.

As a further measure of capital controls were lifted thus facilitating FDIs as a potential further external control mechanism. These measures were coupled with a massive privatization programme, and by 2000 more than 73% of banking system assets were in foreign ownership (Miller et al., 2002). The share of foreign banks increased even further and in 2003

reached 86 per cent of assets in the banking system (Tschöegl, 2003).

However, the implementation of external control mechanisms appears to be a necessary condition only for the avoidance of credit crunches or hazardous over-lending, respectively. Though the currency board together with a deposit insurance system increased households' trust in the banking sector and also made foreign denominated deposits available to banks, the years until 2001 were marked by a 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, 2002; Nenovsky et al, 2003). Credit shrank dramatically shortly after the crisis had reached its peak, 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 empiricaleconometric analysis 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, implying that 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 to be 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 (2002) 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 have been marked by the 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. With respect to the development of further credit-market friendly institutions, the bankruptcy code has been the primary subject of Schönfelder (2005). He observes that despite several amendments in the years 2000 and 2003, legal means to collect bank loans are still exposed to constraints. Upon these constraints he mentions that for example after "the trial court has decided...the creditor still needs to institute proceedings at the enforcement court. Only the fisc, some public utilities and holders of special liens are exempted from this requirement." (185) He continues to note that even if the execution court has started to work, the debtor may delay the further proceedings by various objections. In 1997 it became punishable under criminal law if an insolvent firm did not file for bankruptcy. However, according to Schönfelder (2005) among borrowers this law has not yet been perceived as a serious threat.

As regards bank governance some results of BNB supervision between January and March 2004 may be conclusive (BNB Quarterly Bulletin, March 2004). Here the BNB deplors as a new development the lack of 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 bank 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 any more 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 a significant role for the Bulgarian cultural legacy might still exist.

The Case of Hungary

Basic Cultural Value Dimensions

Contrary to Bulgaria and other countries of South-East-Europe, Hungary opted very early in her history

for the value system shaped by Roman catholic Christendom.¹⁶ From the 11th century Hungary's eastern and southern borders marked the borders of the Western world. Notably the influence of Italian Renaissance had reached Hungary earlier than any other country in central Europe.¹⁷ Like Bulgaria, Hungary was threatened by the approaching Ottoman Turks. Contrary to Bulgaria it called for the help of the then rising Habsburg Empire. Even though Habsburg did not really provide sufficient support to prevent the Turks from occupying at least one third of Hungary, this decision marked another milestone with respect to Hungary's value orientation. Indeed, Hungarian guardsmen at the Viennese Court became familiar with the French and German Enlightenment and influenced greatly the Hungarian literature. It appears that in particular a literary elite survived the political upheavals in the aftermath of the French Revolution. This cultural value orientation that put democratic principles, freedom but also social responsibility and political independence into the centre provided the background of a resistance against the Habsburg Empire which culminated in the March revolution of 1848, but also in the October Revolution of 1956 and it paved the way of Hungary into democracy in the 1980s. Hungary's history fosters Hofstede's finding that this country does not deviate much from the average of West European countries as regards power distance and individualism.¹⁸

In particular the upheaval of 1956 had a sustainable impact on the Communist government led by Kádár who remained in power until the demise of Communism. In order to keep the population "quiet", Kádár's attempts were directed at providing households with a high standard of consumption. In order to achieve this, increasingly market mechanisms were tolerated, starting with the New Economic Mechanism in 1968 and culminating in the 1980s with a significant opening of the Hungarian economy and the introduction of a two-tier banking system (Habuda, 1995). Foreign trade was characterized by close economic ties with Western Europe and the implementation of joint ventures with foreign companies like General Electric, Siemens, and Shell. Increasingly Hungarian employees were involved in a growing market economy which became an important driving force of Hungarian well-being. Judging from this evidence, Hungary started transition with significantly better initial conditions than Bulgaria since Hungarians could resort to a long standing democratic tradition as well as to some experience with market mechanisms, and economic relations to OECD countries.

¹⁶ Already in the 10th century Hungary converted to Roman Catholic Christendom.

¹⁷ Fact Sheets on Hungary. Ministry of Foreign Affairs, Budapest 2000

¹⁸ Hofstede replicated his 1980 studies several times. This result dates from 2002 published as electronic source www.geert-hofstede.com/hofstede-hungary.shtml.

However, the Kádár regime gave rise to its own system of informal institutions that hampered the process of economic transition in general and a well-functioning banking sector in particular until the middle of the 1990s. The attempt to provide the Hungarian population with a high standard of consumption produced a paternalistic system with the incumbent management of the large state-owned firms gaining more and more economic as well as political powers. In this paternalistic system workers were granted regular wage increases and improvements in social securities whereas trade unions were weakened and did not play a significant role. On the one hand managers assumed the task to deliver consumption goods which at the time were termed "political goods" (Bruszt, 1995) since they were considered as important in favour of political stability. On the other hand, incumbent managers were treated as responsible for economic rationality (Bruszt, 1995) which provided them with a high degree of economic independence. In order to provide these political goods, managers bargained successfully for more resources and they too gained control over strategic political decisions by being co-opted into the higher decision-making bodies of the state (Bruszt, 1995). Rising power of the incumbent management was paralleled by dwindling powers of in particular the branch ministries.

Hence the political and economic governance of the country was crucially influenced by the managers of state-owned enterprises whereas the workforce either saw its major playing field in the private sector if this proved successful or coalesced with managers if they found that entrepreneurship would bring them no extra income (Bruszt, 1995) Indeed the Kádár era is also marked by an ongoing struggle of state offices and managers against each other. This struggle was continuing after the beginning of the transition process and affected in particular privatization which turned out to be a highly opaque process lacking a solid legal foundation approved of by the Parliament.

The Kádár Legacy Determines the First Attempts of Privatization

In the literature we find Hungary's privatization process classified into three stages: spontaneous, centralized and decentralized privatization (Bruszt, 1995). The management retained its power at the beginning of the transition process. Active managers of large firms became members of political bodies and they started a process of so-called "spontaneous privatization" which in fact meant that managers became the legal owners of public enterprises (Bruszt, 1995) However, this process did not go uncriticized. In particular the state bureaucracy saw its chance to regain control. In the spring of 1990, the Hungarian Democratic Forum came into power and sought to strengthen the role of state bureaucracy insulated from outside political pressure at the same time intending to weaken the role of managers. A process of

“centralized privatization” was initiated which meant that a newly created agency (State Privatization Agency, SPA) received the right to re-nationalize any public enterprise if this served to protect state assets and its sale. Later on the State Property Company (SPC) was founded with the task to control enterprises which were not intended to become private (Bruszt, 1995). A major consequence of centralized privatization was the re-nationalization of large firms thus turning the firms again towards the state. This was also mirrored by a strengthened control of the governing party over the SPA. Its privatization strategy aimed at avoiding splitting up or restructuring firms. In due consequence mainly foreign investors could finance the purchase. It is true that the sales price was fixed in a competitive bidding. However, it is also true that increasingly investors had to commit themselves to fulfil other criteria like maintaining employment. Indeed the success of this privatization programme turned out to be rather modest (Voszka, 1995). The Financial Ministry, deploring insufficient revenues from privatization together with branch ministries concluded an alliance against the SPA and initiated a third round which later on was termed “decentralized privatization.” (Voszka, 1995) because now the ownership was transferred without direct interference of the SPA, but with the support of consulting firms. In fact the decentralization strategy was accompanied by re-nationalization which meant that a growing part of SOEs were transformed into companies without majority private ownership (Voszka, 1995).

This development was accompanied by a significant decrease of production and increase in employment promoting a political change in 1994 when the Hungarian Socialist Party gained an absolute majority in Parliament. This government attempted to speed up the process of transition by selecting increasingly strategic foreign investors allowing them to gain majority shareholdings. In this way Hungary, too, resorted to external control mechanisms. This course was continued beyond the 1998 elections when again the first post-Communist government regained political power transferring the bulk of the country’s industrial and trading enterprises, as well as financial institutions, from state to private ownership.

Implications for the Hungarian Banking Sector

The Hungarian banking sector can be said to mirror the described developments in the Hungarian society and business sector in general. Already in the 1970s the first foreign participations in the Hungarian banking sector took place, a development which is closely associated with Hungary’s opening to foreign trade at that time (Majnoni et al., 2003). Already prior to the establishment of a two-tier banking system, foreign ownership was present with three joint venture commercial banks having reaching a market

share of 5% (Szapáry, 2001) Furthermore due to Hungary’s opening to trade some international orientation of the National Bank of Hungary and the Hungarian Foreign Trade Bank could be observed already in the 1970s. When IMF membership was acquired, these relations were further enhanced (Várhegyi, 1996). Irrespective of political criteria which predominated in particular the selection of top managers, in the banking sector it even proved to be harder than in the real sector to ignore professional aptitudes. This was a due consequence of international credit transactions which produced some control mechanisms exercised by foreign creditors (Várhegyi, 1996). Throughout the 1970s and 1980s the credit personnel of the Hungarian National Bank increasingly acquired skills which are characteristic of lending practices in market economies. Hence it was not a lack of skills that prevented the incumbent management from prudent lending but both the consequence of political pressure and missing sanctions in case of defaulting loans. As Várhegyi (1996) puts it: “If it became obvious that an earlier allocation of credit was a mistake, the creditors of the bank and the financial managers of the company lacking the credit supported each other, proving that poor performance was attributable to the deterioration of external conditions” (2). Practically this meant that the problem of bad debts could not be avoided.

Taking Hungary’s international orientation into account, it is not surprising that Hungary was the first CEEC country to start a fundamental reform of its banking system. The process started with turning the mono-bank system into a two-tier-system which left the newly founded three commercial banks in state ownership. Furthermore a liberal entry policy was decided with licenses being granted rather automatically. This led to a growing number of Greenfield banks until 1994.

The process of establishing a banking sector marked by private ownership in Hungary is closely related to foreign ownership. Empirical findings reveal that basically three motives drive foreign investors (Mérö et al., 2003): to serve their domestic clients abroad (defensive expansion hypothesis), to exploit host country opportunities, and to avoid regulations at home. The liberal licensing policy in Hungary together with its tradition to allow foreign trade thus establishing firm relations to foreign firms, have attracted foreign investors in the banking sector already in the 1980s. Foreign owners came primarily from EU member states with banks of neighbouring countries (in particular Austria) having a prominent share (Mérö et al., 2003). For the first years of the 1990s Greenfield investment in the banking sector was characteristic, and there are some signs that foreign investment in the banking industry was led by the defensive expansion hypothesis (Mérö et al., 2003; Majnoni et al., 2003). On the other hand, Austrian banks have been attracted by growth opportunities from the very beginning which can be explained by their past historical and cultural relations

thus providing them with a well-founded knowledge of the Hungarian economy and society (Majnoni et al., 10). The main motive of the Hungarian government to attract foreign banks was to stabilize the banking sector by increasing banks' capital. By the end of 1994 eight wholly foreign owned Greenfield banks accounted for 10 percent of the capital in the Hungarian banking sector (Majnoni et al., 2003). Privatization of state banks did not play an important role until 1994. It is true that already in 1989 some West European banks sought to acquire participations in the two largest commercial banks which was welcomed as a chance to increase banks' capital.¹⁹ It is also true that partial privatization of banks of lower importance took place in the early 1990s. Taking into account the newly created banks, by the end of 1990 the share of the state in the banking sector had fallen to 39%. However, private participation in state banks was not allowed to exceed 10%, and beyond that, in the course of the consolidation programmes, the state regained direct influence ending up with 86 percent as a proportion of equity capital (Majnoni et al., 2004).

Hungary, too, had to suffer a banking crisis, though with significantly less harmful effects than in Bulgaria. Apart from the sharp drop in aggregate output in the initial years of reform, two further reasons stand out in this respect: First, the state banks which were created in 1987 encountered rather unfavourable initial conditions not only due to inherited bad debts as such but also because the portfolios taken over from the NBH were marked by sectoral segmentation enhancing the accumulation of bad risks even further (Szapáry, 2001). A second reason is rooted in the regulatory framework which until the end of 1991 did not oblige banks to practice prudent lending, and which at the end of 1991 resorted to a legislative shock therapy. For example the Financial Institutions Act imposed stricter rules for loan classification based at least partly on BIS standards, making loan-loss provisioning compulsory. The Accounting Act forbade to treat interest rate receipts as income in the books. A Bankruptcy Law required firms to initiate self-bankruptcy procedures in case of default for more than 90 days. In 1992 Bank supervision was transferred to an autonomous agency (Szapáry, 2001). Whereas the shortcomings of the regulatory frameworks encouraged banks to mask their true problems and encouraged them to continue "evergreening", the obligation to make loan-loss provisions and implied by this the obligation to increase transparency regarding credit risks together with a strict enforcement of the Bankruptcy Codes (Szapáry, 2001), contributed significantly to the fact that by 1992 some of the state-owned banks had lost their entire capital.

¹⁹ The state sold 20% of the Inter-Európa Bank to San Paolo di Torino, 50% of AEB to US financial investors, and 20% of the Postabank to three Austrian financial institutions (Majnoni, et al., 2004)

In this situation the government decided to launch a consolidation programme in late 1992. The programme proceeded in three stages thus responding to the fact that the true magnitude of the problems was recognized only gradually. The first stage was marked by portfolio cleaning. Basically this meant that banks and savings cooperatives having a capital asset ratio below 7% were allowed to transfer part of their bad debts in exchange for government bonds. Banks tried to sell remaining bad loans to special work-out companies. This first stage of consolidation was not successful because the really doubtful loans were never exchanged against government bonds but remained on the books and furthermore the measures taken were not tied to changes in the management of banks (Szapáry, 2001). This gave rise to the second stage at the end of 1993, focusing primarily on enterprise-oriented portfolio cleaning. Following Szapáry (2001) these measures saved some of the large debtor firms which were reorganized and successfully privatized later on. However, stage two consolidation also did not stop the increase of non-performing loans which reached close 30% of total bank portfolio in 1993 (Szapáry, 2001). In this respect the tighter regulatory framework plays an important role (Szapáry, 2001), but also inherited corporate governance practices. Corporate governance in the banks with significant state ownership was characterized by the fact that top managers continued to be nominated by the government which according to Várhegyi (1996) "...renewed the formerly well known bargaining processes between the bank managers and the government" (9). She remarks that during the consolidation of credit, managers tried to mask the existence of bad credit whereas later on when privatization was on the political agenda, they overestimated losses. An example of close relations to the Ministry of Finance is provided by the way how the incumbent management reacted to the Act on Financial Institutions which obliged banks to build provisions for bad loans. In fact the Ministry of Finance encouraged state banks not to do so but rather pay taxes, and state banks indeed welcomed this idea. Recapitalization characterizes the third stage of bank consolidation. Banks were allowed to issue shares which were purchased by the government (Szapáry, 2001). Recapitalized banks were required to set up a consolidation programme including measures to improve internal controls. Total cost of consolidation in Hungary were only slightly less (13%) than in Bulgaria (14%) the reason for this being that the level of bank intermediation in both countries have been rather low measured by international standards. Still in 1999, the percentage of loans to the private sector of GDP was only 25% compared to more than 100% in Germany and Japan (Szapáry, 2001).

Like in Bulgaria, the banking crisis or better to say its negative consequences for the economy might have contributed significantly to the change in government in 1994. But whereas in Bulgaria a Communist government was dismissed, and a

democratic party came into power which initiated necessary reforms, in Hungary the Socialist party won the elections over the democratic party, and it was the Socialist party which now followed a decisive market-friendly course. This course was characterized by the privatization of yet state-owned firms with state banks posing no exception. In this respect foreign strategic investors were supposed to play a crucial role. Strategic investors regularly have a keen interest in a company's business which requires them to achieve a majority shareholding, and indeed by the end of 1995 six state banks which together represented a market share of 31%, were sold to foreign banks (Szapáry, 2001). The contribution of foreign capital to the Hungarian banking sector increased continuously in the years to follow and reached 78% of the banking sector's registered capital in 2002, whereas state ownership has dropped to 19% and is restricted to banks with specific public functions (Mérő et al., 2003). A further trait of the "new conception" was the attempt to comply with the requirements for EU accession. To achieve this, in 1997 the Credit Institutions Act was enacted which harmonized prudential supervision with EU and BIS standards. In 1998 and 1999 further regulations to harmonize other banking practices with EU requirements were introduced. The evaluation of the effects of private ownership on the performance of the Hungarian banking system is closely related to the assessment of how foreign ownership in the form of strategic investments affected stability and the banking sector's contribution to growth. Evidence so far suggests that foreign investors have contributed to creating a stable and well functioning banking sector (Ábel et al., 2001). In this respect Ábel et al. (2001) found a continuous increase in the portfolio quality of Hungarian Banks as a whole between 1987 and 1997 as well as a continuous increase in the capital adequacy ratio. Whether banks contribute to economic growth is also dependent on the degree of concentration. A high concentration in the banking sector indicates market power which can be abused to claim excessive interest rates and collateral. Foreign banks contributed significantly to enhancing competition which is mirrored in a continuous decline of concentration in the banking sector between 1989 and 1999. (Ábel et al., 2001). Szapáry (2001) found that the degree of concentration is lower in the market for corporate loans than in the market for consumer loans due to a higher number of banks operating in the former. Profitability is also used to indicate a banking sector's stability. Measuring profitability by cost efficiency (measured by operating and labour costs) and profit efficiency (measured by the return on assets), Majnoni et al. (2003) have found Greenfield banks with performing better both with respect to cost and return irrespective of whether they are domestically or foreign owned. In particular only Greenfield banks were able to reduce interest rate margins. The authors also observe that management styles have been more important with respect to cost

efficiency. In particular local management has supported the reduction of operating costs. In fact the Hungarian company law prescribes that at least two directors of a bank shall be Hungarian citizens. In particular Austrian, German and Italian banks entrusted local managers with the management of their banks more than others. Total assets of credit institutions as a percentage of GDP have increased since 1997. The share of loans to the corporate and household sectors in the total assets of banks which remained between 33% and 34% between 1995 and 1998, rose to almost 42% in 2000, whereas the share of non-performing loans in the total loan portfolio of banks continued to decline (Szapáry, 2001)

Judging from Hungary's cultural legacy it appears astonishing that Hungary, too, resorted to external mechanisms in order to improve the performance of its banking sector. On the other hand it should not be overlooked that the Communist regime, too has left its traces. A combination of practical and political reasons might explain why foreign strategic investors were highly welcome. Practical reasons are closely related to the fact that the Hungarian banking sector by the middle of the 1990s suffered from a massive lack of capital. Foreign ownership in this situation offered a solution which, different from money creation, was neutral with respect to inflation. The decision in favour of foreign ownership was certainly facilitated by Hungary's long-standing relationships to the Western business world. However, political reasons might also have played a role. Political dependency greatly contributed to mismanagement in state banks irrespective of managers' skills, and contributed to violating the regulatory framework. And indeed, the Open Society Institute 2002 does not mention the banking sector as a prominent place of corruption in its report on corruption and anti-corruption policy in Hungary. Taking into account that countries like Austria, Germany and Italy who pertain to the group of the largest strategic investors rely heavily on local managers, this indicates that foreign ownership has fostered the separation between banks management and politics. On the other hand, it should be recognized that the relative success of the Hungarian banking sector will be sustainable only if principles of good governance also characterize banks' corporate borrowers as well as the public sector. In this respect Hungary has revealed significantly less reluctance than Bulgaria with respect to the implementation of appropriate laws. Also law enforcement has proven to be superior to what has been found in Bulgaria. For example Hungary has been perceived as one of the least corrupt post-communist state (Open Society Institute 2002). This confirms a higher validity of the rule of law as a social norm.

Conclusions

Economic transition has proven to be above all a process of transforming socialist institutions into

institutions which are conformable to a successful market economy. In this process the establishment of private ownership played a crucial role. We have shown that the merits of private ownership depend on whether principles of good governance like the rule of law, accountability together with transparency as well as the absence of graft are widely accepted as guiding rules of behaviour not only within corporations but in the political and judicial sphere as well. We have also shown that the extent to which this occurs, is not primarily a matter of law but of the extent to which principles of good governance are widely accepted as social norms. According to cross-cultural psychology this depends on the acceptance of more fundamental social norms which constitute basic cultural value orientations. A society which values individual autonomy together with treating others as equals high, will be more prone to complying with the rule of law, with accountancy and transparency, and this society will be more reluctant to resort to fraudulent practices or corruption as means of coordination. Values like this are characteristic traits of mature market economies – or differently put – the well-functioning of a mature market economy can be explained as the final outcome of these value orientations. By contrast in societies where the individual draws its value from the value of the group he is embedded in, and where steep hierarchies are accepted as something natural, the rule of law will only play a minor role as compared to the role of tradition and the advice of superiors. Moreover the predominance of strong ties with group members facilitates closedness undermining transparency and accountability with respect to outsiders. The acceptance of hierarchies in its turn has been found to undermine the role of exchange at eye level in favour of graft. We have found some evidence that Bulgaria and Hungary expose differences regarding their basic value orientations which contributes to explaining differences as regards the performance of either banking system in relation to the role of private ownership. In Bulgaria where embeddedness and hierarchy has been found as basic value orientations, principles of bad governance like corruption, absence of the rule of law and missing accountability did not only hamper the privatization process. Of equal importance is the fact that private banks were frequently founded to maximize the personal interests of their owners depriving depositors from their savings. As a way out, Bulgaria opted for the introduction of a currency board thus resorting to external control mechanisms. This allowed the banking system to recover. However, there are still signs that crony capitalism undermining prudent and efficient lending plays a role. As compared to Bulgaria, throughout its history, Hungary has been more oriented towards Western value systems. This even affected the Kádár regime which did neither oppress entrepreneurship nor the evolution of markets and moreover fostered trade with OECD countries and even allowed joint ventures with Western banks.

Of course, market elements did not dominate politicization but it appears that the rules characterizing Hungarian paternalism of the Kádár regime had been accepted by people as conventions rather than as entrenched social norms. Hungary fostered the creation of private banks from the very beginning. However, like Bulgaria, Hungary proved rather reluctant to privatizing state owned banks. Like in Bulgaria this happened in Hungary only after alternative solutions to overcoming the banking crisis were not available. Both countries, however, differ with respect to how privatization was accomplished. In Hungary foreign strategic owners were successfully attracted who also invested in newly created banks. Notably, foreign ownership did not mean the exclusion of Hungarian managers from top levels. Rather, following empirical investigations, the best performing foreign banks rely heavily on local managers and directors. Our work has left open the question, how changes in value orientations can be achieved. In this respect further research exploring the role of education, but also the guiding role EU accession and membership appears promising.

References

1. Ábel, Istvan and Pierre L. Siklos. (2001): Privatizing a Banking System: A Case Study of Hungary, Working Paper <http://ssrn.com/abstract=286777>
2. Akerlof, George A. (1970): 'The Market for Lemons': Quality Uncertainty and the Market Mechanism, in: Quarterly Journal of Economics, 84: 488-500
3. Axelrod, Robert: (1984): The Evolution of Cooperation, New York, Basic Books
4. Baer, Herber.L, Gray, Cheryl W. (1995): Debt as a Control Device in Transitional Economies: The Experiences of Hungary and Poland, World Bank Research Paper
5. Barth, JamesR., Caprio, jr., Gerard, and Levine, Ross (1999): Banking Systems Around the Globe: Do Regulation and Ownership Affect Performance and Stability? NBER Conference on Prudential Supervision: What Works and What Doesn't, January
6. Berglof, Erik, von Thadden, Ernst-Ludwig (1999): The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries. Conference Paper, Annual World Bank Conference on Development Economics, Washington D.C
7. Berlemann, Michael, Hristov, Kalin, and Nenovsky, Nikolay N. (2002): Lending of Last Resort, Moral Hazard and Twin Crises. Lessons from the Bulgarian Banking Crises 1996/1997. William Davidson Institute Working Paper No. 464, University of Michigan
8. Bicchieri, Cristina, Skyms, Brian, and Jeffrey, Richard C. (ed.) (1998): The Dynamics of Norms, Cambridge University Press, Cambridge Mass
9. Binmore, Ken. (1998): Game theory and the Social Contract II – Just Playing, MIT Press, Cambridge Mass
10. Bitzenis, Aristidis. (2004): Why Foreign Banks Are Entering Transition Economies: The Case of Bulgaria, in: Global Business & Economics Review, Vol. 6#1
11. Boot, Arnoud, Greenbaum, Stuart, and Thakor, Anjan V. (1993): Reputation and Discretion in Financial Contracting, in: American Economic Review 83

12. Bowles, Samuel, Gintis, Herbert (1998): The Moral Economy of community: Structured Population and the Evolution of Prosocial Norms, in: *Evolution & Human Behavior* 19,1: 3-25
13. Bowles, Samuel (2004): *Microeconomics. Behavior, Institutions, and Evolution*: Princeton University Press, Princeton
14. Bruszt, Laszlo. (1995): Reforming Alliances: Labour, Management and State Bureaucracy in Hungary's Economic Transformation, in: Hausner, Jerzy, Jessop, Bob, and Nielsen, Klaus (eds.), *Strategic Choice and Path-Dependency in Post-Socialism Institutional Dynamics in the Transformation Process*, Edward Elgar: 262-286
15. Bulgarian National Bank (1994): *Quarterly Bulletin*, March
16. Cable, John R. (1985): Capital Market Information and Industrial Performance: the Role of West German Banks, in: *Economic Journal*, 95: 118-132
17. Chami, Ralph, Khan, Mohsin, and Sharma, Sunil (2003): *Emerging Issues in Banking Regulation*, IMF Working Paper May WP03/101
18. Cooter, Robert D.. (1998): Expressive Law and Economics, in: *Journal of Legal Studies* 27: 585-608
19. Cooter, Robert D. (2001): Law from Order: Economic Development and the Jurisprudence of Social Norms, John M. Olin Working Papers in Law, Economics, and Institutions 96/7-4, May
20. Crotty, Jo, Jobome, Gregory (2004): *Corporate Governance in Transition Economies: A Synthesis of the Evidence*, Aston Academy for Research in Management Centre Research Paper No. 0402
21. Daily, Catherine, Dalton, Dan R., and Cannella, Albert A. (2003): Corporate Governance: Decades of Dialogue & Data, in: *Academy of Management Review*, vol. 28, no. 3: 371-382
22. Dallago, Bruno (2002): *Corporate Governance, Governance Paradigms and Economic Transformation*, Manuscript, Department of Economics, University of Trento
23. Daskalov, Roumen. (1998): A Democracy Born in Pain, pp 39-64. In: John D. Bell (ed): *Bulgaria in Transition. Politics, Economics, Society, and Culture after Communism*: 9-38
24. Das, Udaibir S. and Quintyn, Marc G. (2002): *Crisis Prevention and Crisis Management: The Role of Regulatory Governance*, IMF Working Paper 02/163
25. Davidkov, Tsevetan (2004): Where Does Bulgaria Stand? In: *Papeles des Este, Transiciones poscomunistas*, No. 8
26. Diamond, Douglas W. (1984): Financial Intermediation and Delegated Monitoring, in: *Review of Economic Studies* 51 (3): 393-414
27. Diamond, Douglas.W. Rajan, Raghuram G (1999): *Liquidity Risk, Liquidity Creation and Financial Fragility: A Theory of Banking*, NBER Working Paper 7430, December
28. Elster, John. (1989): Social Norms and Economic Theory, in: *Journal of Economic Perspectives*, 3 (4)
29. Enoch, Charles., Gulde, Anne-Marie, Hardy, Daniel C. (2002): *Banking Crises and Bank Resolution: Experiences in Some Transition Economies*, IMF Working Paper 02/56
30. Fehr, Ernst, Gächter, Simon (2000): Fairness and Retaliation: The Economics of Reciprocity, in: *Journal of Economic Perspectives*, 14, 3, 159-181
31. Frydman, Roman, Gray, Cheryl, Hessel, Marek, Rapaczynski, Andrzej (1999): *When Does Privatization Work? The Impact of Private Ownership on Corporate Performance in the Transition Economies*, in: *Quarterly Journal of Economics*, November 1999
32. Garretsen, Harry, Lensink, Robert, Sterken, Elmer (2004): *Growth, Financial Development, Societal Norms and Legal Institutions*, in: *International Financial Markets, Institutions, and Money* 14:165-183
33. Gintis, Herbert (1989): *The Power to Switch: On the Political Economy of Consumer Sovereignty*, in: Bowles, S. et al. (eds.) *Unconventional Wisdom: Essays in Honour of John Kenneth Galbraith*, N.Y.: Houghton Mifflin: 65-80
34. Gray, Cheryl W. (1997): *Reforming Legal Systems in Developing and Transition Countries*, in: *Finance & Development*: 14-16
35. Habuda, Judit (1995): *Post-Socialist Transformation in Hungary: Entering a Second Stage?* in: Hausner, Jerzy, Jessop, Bob, and Nielsen, Klaus (eds.) *Strategic Choice and Path-Dependency in Post-Socialism Institutional Dynamics in the Transformation Process*, Edward Elgar: 309-324
36. Hart, Oliver, Moore, John (1990): *Property Rights and the Nature of the Firm*, in: *Journal of Political Economy*, 98: 1119-1158
37. Hellman, Joel, Jones, Geraint, Kaufmann, Daniel, Schankermann, Mark (2000): *Measuring Governance, Corruption, and State Capture. How Firms and Bureaucrats Shape the Business Environment in Transition Economies*, World Bank Policy Research Working Paper, No. 212, Washington DC, The World Bank
38. Hofstede, Geert H. (1980): *Culture's Consequences: International Differences in Work-Related Values*, Beverly Hills California: Sage Publications
39. Hofstede, Geert H. (2001): *Culture:s Consequences: Comparing Values, Behaviours, Institutions, and Organizations Across Nations*: Sage Publications
40. Hofstede, Geert H.(1997): *Cultures and Organizations: Software of the Mind*, New York: McGraw Hill
41. Hristov, Kalin, Mirkhalov, Mikhail, Petrov, Boris (2002): *Bulgaria's Currency Board and Commercial Bank Lending: Five Years on*, European Institute
42. Jensen, Michael.C, Meckling, William H. (1976): *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, in: *Journal of Financial Economics*, 3: 323-329
43. Kaufmann, Daniel., Lobatón, P. (1999): *Governance Matters*, World Bank Working Paper, Washington.
44. Kolodko, Grzegorz W. (2002): *Postcommunist Transition and Post-Washington Consensus: The Lessons for Policy Reforms*, in: Skreb, M.I. (ed.): *Transition in the First Decade*, MIT Cambridge
45. Koford, Kenneth and Tschoegl, Adrian, E. (1997): *Problems of Bank Lending in Bulgaria: Information Asymmetry and Institutional Learning*. The Wharton School, University of Pennsylvania, Financial Institutions Center, Working Paper No. 97-41
46. Kreps, David M. (1990): *Corporate Culture and Economic Theory*, in: Alt, J.E. and Shepsle, K.A. (eds.), *Perspectives on positive Political Economy*, Cambridge.
47. Kreps, David M. (1997): *Intrinsic Motivation and Extrinsic Incentives*, in: *American Economic Review* 359: 359-364
48. Levine, Ross (2004): *The Corporate Governance of Banks: A Concise Discussion of Concepts and*

- Evidence, World Bank Policy Research Working Paper 3404
49. Llewellyn, David T. (1999): The Economic Rationale of Financial Regulation, in: Occasional Paper, No.2, Financial Services Authority, London
 50. Llewellyn, David T. (2000): Regulatory Lessons from Recent Banking Crises, De Nederlandsche Bank Discussion Paper, Amsterdam May
 51. Llewellyn, David T. (2001): A Regulatory Regime for Financial Stability, Oesterreichische Nationalbank Working Paper No. 48
 52. Licht, Amir N. (2002): The Pyramid of Social Norms, Interdisciplinary Center Herzliya Israel.
 53. Licht, Amir N. (2004): "It's the Law": Social Norms and the Rule of Law, ExpressO Reprint Series, paper 149
 54. Licht, Amir N., Goldschmidt, Chanan, and Schwartz, Shalom, H. (2003): Culture Rules: The Foundations of the Rule of Law and Other Norms of Governance, Williamson Davidson Institute Working Paper No. 605, August.
 55. Majnoni, Giovanni, Shankar, Rashmi, and Várhegyi, Eva (2003): The Dynamics of Foreign Bank Ownership. Evidence from Hungary. Policy Research Working Paper 3114, World Bank.
 56. Mérö, Katalin, Valentinyi, Mariana E. (2003): The Role of Foreign Banks in Five Central and Eastern European Countries, MNB Working Paper, November.
 57. Miller, Jeffrey. and Tenev, Stefan (2005): China vs. the Orthodoxy: State and Ownership Reforms in Transition Economies, Working Paper Series, Department of Economics, University of Delaware, WP No. 10
 58. Miller, Jeffrey. and Stefan. Petranov (2002): The Financial System in the Bulgarian Economy, Bulgarian National Bank Discussion Paper DP/19/2002
 59. Ministry of Foreign Affairs (2000): Fact Sheets on Hungary, Budapest, www.mfa.gov.hu/kum/en/bal/hungary/about_hungary
 60. Mitev, Petúr-Emil (1998): Popular Attitudes toward Politics, in: John D. Bell (ed): Bulgaria in Transition. Politics, Economics, Society, and Culture after Communism: 9-38
 61. Mihov, Illian. (1999): The Economic Transition in Bulgaria 1989-1999, ISEAD Working Paper September
 62. National Human Development Report Bulgaria 1998: The State of Transition and Transition of the State, Published by United Nations Development Programme Sofia.
 63. Nenovsky, Nicolay., Peev, Evgeni, and Ylamov, Todor (2003): Banks-Firms Nexus under the Currency board: Empirical Evidence from Bulgaria, William Davidson Working paper No. 555, April
 64. Ostrom, Elinor. (2000): Collective Action and the Evolution of Social Norms, in: Journal of Economic Perspectives, Vol. 14, No. 3: 137-158.
 65. Peev, Evgeni. (2002): Ownership and Control Structures in Transition to "Crony" Capitalism. In: Eastern European Economics, vol. 40, no. r: 73-91
 66. Petersen, Mitchell, A., Rajan, Raghuram G. (1995): The Effect of Credit Market Competition on Lending Relationships, in: Quarterly Journal of Economics 110: 407-443
 67. Pistor, Katharina (1999): The Evolution of Legal Institutions and Economic Regime Change. Paper prepared for the annual Bank Conference on Development Economics in Europe on Governance, Equity and Global Markets, 12-23 June in Paris
 68. Prowse, Stephen (1997): Corporate Control in Commercial Banks, in: Journal of Financial Research, 20 (4), 509-527, Federal Reserve Bank of Dallas
 69. Raiser Martin (1997): Informal Institutions, Social Capital and Economic Transition: Reflections on a Neglected Dimension, EBRD Working paper No. 25
 70. Rajan, Raghuram G. (1998): The Past and Future of commercial Banking Viewed through an Incomplete Contract Lens, in: Journal of Money, Credit, and Banking. Vol. 30, No. 3
 71. Sapienza, Paola (2002): The Effects of Government Ownership on Bank Lending, in: Journal of Financial Economics, vol. 72, 2004:357-384
 72. Schönfelder, Bruno (2005): Bulgaria's Long March Towards Meaningful Credit Contracts, in: Post-Communist Economies, Vol. 17, No. 2: 173-204
 73. Schwartz, Shalom H (1992): Universals in the Content and Structure of Values: Theoretical Advances and Empirical Tests in 20 Countries, in Zanna, M. (ed.), Advances in Experimental Social Psychology 1
 74. Schwartz, Shalom H., Ros, Maria (1995): Values in the West: A Theoretical and Empirical Challenge to the Individualism-Collectivism Cultural Dimension, in: World Psychology, 1 (2): 91-122.
 75. Shapiro, Carl (1983): Premiums for High Quality Products as Returns to Reputations, in: Quarterly Journal of Economics, 97: 659-679
 76. Shleifer, Andrei (1998): State Versus Private Ownership, in: Journal of Economic Perspectives, Vol. 12, No. 4: 133-150
 77. Shleifer, Andrei, Vishny, Robert, W. (1997): A Survey of Corporate Governance, in: Journal of Finance, vol. 52: 737-783
 78. Skym, Brian (1996): Evolution of social Contract, Cambridge University Press, Cambridge, Mass.
 79. Sudgen, Robert (1989): Spontaneous Order, in: Journal of Economic Perspectives, 3(4): 85-97
 80. Szapáry, Gyorgy. (2001): Banking Sector Reform in Hungary: Lessons Learned, Current Trends and Prospects; NBH Working Paper 2001/5, December
 81. Tanchev, Evgeni (1998): The Constitution and The Rule of Law, in: John D. Bell (ed.), Bulgaria in transition. Politics, Economic, Society, and culture after Communism: 65-92)
 82. Tschoegl, Adrian E. (2003): Financial Crises & the Presence of Foreign Banks, paper prepared for and presented at the World Bank conference: Systemic Financial Distress: Containment and Resolution, 7-8 October 2003
 83. Ulgenerk, Esen, Zlaoui, Leila (2000): From Transition to Accession. Developing Stable and Competitive Financial Markets in Bulgaria, World Bank
 84. Várhegyi, Éva (1996): The Selection of Bank Managers in Hungary in the 80s and the 90s, Hungarian Sociological Association, Special Issue
 85. Voszka, Éva (1995): Centralization, Re-Nationalization, and Redistribution: Governments's Role in Changing Hungary's Ownership Structure, in: Hausner, J. Jessop, Bob, and Nielsen, Klaus (eds.) Strategic Choice and Path-Dependency in Post-Socialism Institutional Dynamics in the Transformation Process, Edward Elgar: 287-307
 86. Williamson, Oliver (1975): Markets and Hierarchies. Analysis and Antitrust Implications, New York