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EUROSYSTEM

Working Paper

The banking sector and the great
depression in Bulgaria, 1924 - 1938:
interlocking and financial
sector profitability

Kiril Danailov Kossev

SEEMHN

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ISSN 1109-6691

Editorial

The South-Eastern European Monetary History Network (SEEMHN) is a community of financial historians, economists and statisticians, established in April 2006 at the initiation of the Bulgarian National Bank and the Bank of Greece. Its objective is to spread knowledge on the economic history of the region in the context of European experience with a specific focus on financial, monetary and banking history. The First and the Second Annual Conferences were held in Sofia (BNB) in 2006 and in Vienna (OeNB) in 2007. Additionally, the SEEMHN Data Collection Task Force aims at establishing a historical data base with 19th and 20th century financial and monetary data for countries in the region. A set of data has already been published as an annex to the 2007 conference proceedings, released by the OeNB (2008, Workshops, no 13).

On 13-14 March 2008, the Third Annual Conference was held in Athens, hosted by the Bank of Greece. The conference was dedicated to *Banking and Finance in South-Eastern Europe: Lessons of Historical Experience*. It was attended by representatives of the Albanian, Austrian, Belgian, Bulgarian, German, Greek, Romanian, Russian, Serbian and Turkish central banks, as well as participants from a number of universities and research institutions. Professor Michael Bordo delivered the key note speech on *Growing up to Financial Stability*. The participants presented, reviewed and assessed the experience of SE Europe with financial development, banking and central banking from a comparative and historical perspective.

The 4th Annual SEEMHN Conference will be hosted by the National Serbian Bank on 27th March 2009 in Belgrade. The topic of the Conference will be *Economic and Financial Stability in SE Europe in a Historical and Comparative Perspective*.

The papers presented at the 2008 SEEMHN Conference are being made available to a wider audience in the Working Paper Series of the Bank of Greece. Here we present the third of these papers, by Kiril Koshev.

June, 2008

Sophia Lazaretou
SEEMHN Coordinator
Member of the Scientific and Organizing Committee

THE BANKING SECTOR AND THE GREAT DEPRESSION IN BULGARIA, 1924-1938: INTERLOCKING AND FINANCIAL SECTOR PROFITABILITY

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ABSTRACT

The economic narratives of Southeast Europe during the first part of the 20th century are currently being re-written. A story of failed industrialisation and delayed modernisation during the Interwar period has dominated since the pioneering work of Gerschenkron, but not enough aggregate data are available to see this as the only interpretation. In particular, virtually nothing is known about the financial system. This paper has two aims. First, it looks at the banking sector in Bulgaria in 1924-1938. We provide new data for the 1920s rise and the 1930s decline of the Bulgarian banking sector and we evaluate its potential contribution to Bulgarian economic growth. In the second part, we discuss different explanations for the widespread collapse of commercial banks after the onset of the Great Depression. Relying on a new data set for over 100 Bulgarian commercial banks, we show that traditional explanations for the collapse of European commercial banks in the 1930s (based on the default of risky loans and falling asset prices due to deflation) need to be complemented by the pernicious effects of widespread insider lending in the Bulgarian case. We conclude that insider lending was the single most important factor behind the demise of the private banking system after the onset of the Depression.

Keywords: Bulgarian economic development; Banking and finance; Great Depression; Insider lending.

JEL classification: E44; G21; G14; N24.

Acknowledgements: the author is grateful to Matthias Morys (Economic Department, University of Oxford) for his exceptional support. Martin Ivanov (BAS), Nikolay Nenovsky (BNB), Roumen Avramov (CLS), Avner Offer, Knick Harley, Jane Humphries and David Chambers (all from the University of Oxford) provided me with invaluable comments. An internship at the Bulgarian National Bank and work with Nikolay Nenovsky and Kalina Dimitrova (BNB) has given me the time and resources to work at the archives for much longer than I could have hoped for otherwise. I am grateful to the Economic and Social Research Council in the UK and the George Webb Medley Fund at the Economics Department of Oxford University for funding my studies and research.

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1. Introduction

In a recent paper, Ivanov and Tooze (2007) have pointed out the lack of consistent narratives about the economic development of South-East Europe pre-1945¹. While they have put forward this agenda to the attention of economists and economic historians, and have laid some of the groundwork, work on the aggregate is still incomplete. Quantitative analysis of the factors contributing to growth in the regions is yet to come. The stylised facts of stagnating agriculture, failed industrialisation and buoyant, yet inefficient financial sector, have to be placed in appropriate quantitative framework.

The divergent views on the economic development of the Southeast European region range from the overly optimistic paper of Good and Ma (1999), through to the extreme pessimism of Palairret (2001)². The former view, backed by Maddison in his cross-country GDP estimates, suggests slow convergence of the European periphery to the core. Palairret's work stops in 1914 and presents a bleak picture of stagnation and decline, especially in the predominant agricultural sector. The rather outdated *Bulgarian Economy* by John Lampe and the economic survey of the Balkan countries during the last century by Lampe and Jackson are rather more moderate³.

Two modern works by Avramov and Daskalov follow the conclusions of Alexander Gerschenkron about a failed attempt at modernisation and industrialisation during the Interwar period⁴. Without doubt, the work of Gerschenkron stands out as a pioneering attempt at using aggregate data, yet it is, as Gerschenkron himself suggested, 'unsystematic and of narrow scope'⁵. Bulgarian scholars writing in the communist period have adhered to a descriptive tradition presenting a steady decline until 1945, which ignores the obvious dynamics of a developing economy. The works of Berov have become classics now⁶. They are, however, heavily laden with extreme ideological material and provide little in the way of analysis.

Contemporaries of the interwar period, on the other hand, have written numerous and provoking accounts of the country's financial system. Iconic figures

¹ Ivanov and Tooze (2007).

² Good and Ma (1999) and Palairret (2001).

³ Lampe (1986) and Lampe and Jackson (1988).

⁴ Avramov (2007), Daskalov (2005) and Gerschenkron (1962).

⁵ Gerschenkron (1962, p. 198).

⁶ Berov (1989).

like Stoyan Bochev, a long-term banker and influential figure in the economic circles of interwar Bulgaria was a prolific writer. Christoforov – a popular economic scholar, and Tchakalov – director of research at the Bulgarian National Bank, both made valuable contributions⁷. These, together with an aggregate quantitative analysis can help further our insights into the dynamics of finance in the Interwar Period.

As far as the role of finance and the banking sector in the development of the Bulgarian economy is concerned – there is very little in the way of modern scholarly research. Avramov (2007) has provided some invaluable insights through case studies. The first aim of this paper is to provide an overview of Bulgarian Interwar finance and make suggestions about its possible influences on economic growth. We provide new data for the 1920s rise and the 1930s decline of the Bulgarian banking sector and we evaluate its potential contribution to Bulgarian economic growth. The data is constructed from a previously unused archive of an institution created in 1931, the Bank Board, complementary to the Bulgarian National Bank and the Ministry of Finance, to oversee the commercial banking sector and account for the widespread insolvencies⁸. This new source is a unique opportunity to gain a fresh glimpse at the workings of the financial system during Interwar Bulgaria. A central problem that emerges from the data is the high levels of insider lending. Our hypothesis is therefore that this factor may explain the widespread bank failures of the 1930s.

Insider lending was by no means unique for Interwar Bulgaria. A great deal of economic literature deals with the positive effects of finance on economic development. Levine (1993) provides an excellent survey of the theoretical underpinnings and the empirical tests that have been conducted. More recently, Trew (2006) has summarised the findings of the literature on the finance-growth nexus. One branch of that literature deals with the suggestion that the structural specifics of national financial system can have profound effects on the development of these nations⁹. In particular – universal banking and relationship banking – have been at the core of a debate regarding the benefits of long-term links between banks and industry¹⁰. Lamoreux (1994) has discussed the practice of insider lending, associated with universal banking and has concluded positively regarding this phenomenon using

⁷Bochev (1926), Christoforov (1946) and Tchakalov (1946).

⁸ Bankersky Suvet (translated to Bank Board by League of Nations 1934 publication on Commercial Banks).

⁹ Cameron (1967) and more recently see, Forsyth and Verdier (2003).

¹⁰ Cameron (1967) and Fohlin (2007).

19th century east-coast US banks. More recent analysis of insider lending has moved away from praise to the other extreme. La Porta *et al* has blamed this practice for the severity of the mid-1990s banking crisis in Mexico¹¹. Chapter 4 will discuss the views of the economic literature on the subject. It will also suggest the theoretical underpinnings of the paper suggested by this literature.

This paper argues that persistent credit constraints led to banks-industry interlocking and prevalence of insider loans and these set up a trap for underdeveloped industry during the deflation. Using unique archive material, we are able to test the suggestion that insider lending was one of the main causes for the sweeping bank failures during the depression. The conclusion is that interlocking – presented as a solution to a moral hazard problem – exemplified the negative consequences of underdeveloped financial markets in a time of economic crisis. The power of personal relations is linked to central problems in economics – agency theory and models of principal-agent incentives. Empirical evidence of the impact of such activities can further the finance-growth nexus and help bring these problems to the forefront of policy-making.

The remainder of this paper is organized as follows. In the second section, we will discuss the literature on Bulgarian interwar economic history. Recent research might have improved our knowledge of the real economy, but very little is known about the financial sector. We will fill this gap, partly at least, in the third chapter by providing the reader with new data showing the rise of the Bulgarian banking system in the 1920s and its dramatic decline after the onset of the Great Depression. We then turn to the second aim of this paper, i.e. explaining the dramatic decline of the banking system in the 1930s. In section four, we will set the stage by discussing what we know about bank failures in other European countries in the 1930s. We will also provide some theoretical guidance to the problem of interlocking. The fifth section is the centrepiece of this paper in which we show econometrically that widespread insider lending was the single most important factor behind the demise of the private banking system after the onset of the Depression. The final part concludes.

¹¹ La Porta *et al* (2002).

2. Bulgarian Economic History Literature on the Interwar Period

Ivanov and Tooze (2007) suggest that there are three strands to the debate about East and Southeast European growth experience since the late 19th century. Those who write in the spirit of the late 19th century globalisation, like to see convergence to the European core, albeit in very moderate terms. Revisionists like Michael Palairat, on the contrary, detect divergence, falls in productivity and digression from a market to a subsistence agricultural economy. The reason for such divergent views is the lack of consistent quantitative evidence, which can establish the growth rates of the economy on the aggregate but also the different strands of industry, agriculture and services. Ivanov and Tooze who start off on that path, using data for Bulgaria, have pointed to some important conclusions already, which suggest a middle ground for thinking about the economic development of that country. We have no intention of suggesting a consensus amongst the growth narratives and it is not our aim to present a new take on the data available regarding industrial or agricultural performance either. Rather we aim to persuade in this first section that more work is needed to find a consistent and convincing narrative about economic development and especially accentuate on the lack of work and data on the aggregate for one very important sector – banking and finance.

John Lampe's book on the Bulgarian economy is still the only book-length account in English that attempts to present an aggregate view of the 20th century development of that country¹². Thus it is necessarily the benchmark against, which all other analyses are presented. Partially using data from the earlier work by Bairoch, it provides a sterling case for the optimistic view of convergence¹³. Including the years of the two world wars, Lampe's figure of 2.7% growth, nearly double the European average of 1.7%¹⁴. Thus the optimistic case has been more or less influenced by the stylised fact of economic catch-up on part of the less developed periphery suggested by neo-classical growth theory. Good and Ma (1999) have framed their quantitative analysis in such lines. They conclude that the potential growth, consistent with catch-up on the developed core was only achieved in the late 19th century up until 1914. During the Interwar period and subsequent communist regime there was very little

¹² Lampe (1986).

¹³ Bairoch (1976), pp.273-340.

¹⁴ Lampe (1986) p.14.

economic advancement. They, therefore present a middle ground amongst growth historians of the Balkan region.

Ivanov and Tooze have re-estimated the national income of Bulgaria for 1892 and 1911, whilst adding new data points 1899, 1905 and 1921. The difficulties of gathering new data have meant that they can not present an unbroken sequence of figures, but from the estimates they provide, a number of conclusions can be drawn. Prior to 1914 no significant progress was achieved, yet they claim that the Interwar period was notable for the changes that took place within the agrarian sector in the economy – like switching to production of industrial crops. Still figures for industrial share of output were around 15%, which is little changed from earlier parts of the 20th century. The literature on Bulgaria presents a predominantly agricultural economy, where the share of the agrarian sector amounted to 70%-80% throughout the late 19th and early 20th centuries. This evidence seems to confirm Palairret's phrase – evolution without development.

The latter has provided a rather bleak picture of the Balkan economies pre-1914¹⁵. His arguments suggest that the break with the Ottoman Empire resulted in restricted domestic markets, redistribution of land into small landholding and gradual retreat from the market and a return to subsistence farming on the part of the peasant populations. This resulted in the divergence from the European core rather than growth in development.

Bulgarian historians have taken a similar stance. Two recent works by Daskalov and Avramov have largely agreed with the pessimistic narrative¹⁶. They very much agree to a story presented by Gerschenkron in 1950s- amounting to failed modernisation and industrialisation. Daskalov claims that the only sectors outside agriculture, which exhibited some growth, were the state protected industries – mining, metal works, electricity production, chemical products, etc. Figures he borrows from contemporary writers show fourfold increase in the number of enterprises, which received state support, and around threefold increase in the number of workers employed there between the years of 1909-1939¹⁷. He gives us a feel for

¹⁵ Palairret, (2001).

¹⁶ Avramov (2007) and Daskalov (2005).

¹⁷ Daskalov (2003), p. 323.

the stagnation in other sectors by putting forward a number of examples to act as case studies. Avramov (2007) uses a similar approach to present not dissimilar results.

The work of Ivanov and Tooze has boosted the case of the pessimists. Given the painstaking efforts to gather data for the period pre-1924 and match that across other available estimates, it seems that the case of divergence, suggested by Palairé, is more believable than the overly optimistic picture, painted by Lampe and Lampe & Jackson. Further inconsistency is the evolution of the agrarian sector between the world wars. Ivanov and Tooze's data suggests a move towards industrial crops, decline in grain production and shifting the balance of exports to tobacco¹⁸. Lampe's figures, taken from the Statistical Yearbook of Bulgaria, suggest growth in grain and tobacco production, but a decline in industrial crops¹⁹. A conclusion that follows is that agriculture did not stay stagnant – there were clear efforts to overcome the world-wide decline in the prices of primary products and the increasing trade isolation, faced by the agricultural producers in the periphery during and after the Depression.

If aggregate data about the real economy is sparse and difficult to put together, then data on the financial sector is even more so. All of Lampe, Avramov and Daskalov talk about expansion in the banking sector during the 1920s and then a severe contraction during the 1930s. The second part of the Interwar period was also allegedly characterised by an increased role of state capital, a centralisation of private bank capital into fewer, but larger institutions and a near complete flight of foreign capitals from the country. This very much represented a return to the pre-1919 state of the economy, as Avramov (2007) has suggested. Lampe has provided some data on loan value of banks during the 1920s to illustrate the much-increased share of private commercial banks. He suggests a near doubling in the value of loans given out by private commercial institutions from 1911 to 1928²⁰. Avramov has used case studies to illustrate the dynamics of the microcosm of the financial world. His conclusions of the overbearing role of the state and foreign capital in the Bulgarian financial system and the chronic shortage of capital will form the starting premise of the next chapter. He has also provided some very good examples of insider lending with fatal

¹⁸ Ivanov and Tooze, p. 25

¹⁹ Lampe (1986), p. 85. Lampe suggests largest growth in vegetable output between 1931-1935, by around 29%. For the same period yield per hectare in industrial crop fell by 29%, but due to increased land in cultivation, actual output per capital increased by 12%. Grain output per capital increased by 9%, but yield/h went up by some 14%.

²⁰ Ibid., p. 67

consequences for the banks²¹. We very much agree with his conclusion of widespread practice of insider lending, which rotted the banking system from inside – we provide quantitative evidence on the aggregate for this and a formal test in chapter 6. We also feel there is a need for a narrative on the aggregate level, about the experience of the banking sector. The following section takes steps towards that aim.

3. Banking Structure and Finance in the Bulgarian Economy, 1924-1936

Given the uncertainties in quantitative terms about the economic experience of the Southeast European region and Bulgaria in particular during the Interwar Period – the majority of scholars have followed the general trend of explaining the 1920s as years of dynamic growth, which descended into slowdown and a lengthy depression. The 1930s were then the time of slow recovery, but also increasing international isolation²².

Fall in prices of primary products undermined significant parts of the peripheral countries' income. As export income dried up, reparation and foreign debt payments became extremely difficult. By 1931 countries like Poland, Romania, Yugoslavia and Bulgaria were in an untenable indebtedness²³. Policies used to alleviate the crisis involved rigorous exchange controls and increased state intervention into the industrial and financial sector. These had significant deflationary effects on enterprises and a knock on effect on the financial and credit facilities. Figure 1, below, shows the movement of GDP for a selection of Balkan countries and Austria, as a central European benchmark. Figure 2 shows the movements of Bulgarian NI throughout the interwar period.

²¹ Avramov (2007), vol. 2, pp. 405-455.

²² Lampe, (1986), p. 78

²³ Feinstein, Temin, and Toniolo, in Feinstein, C. (ed.), (1995), p. 35

Figure 1:

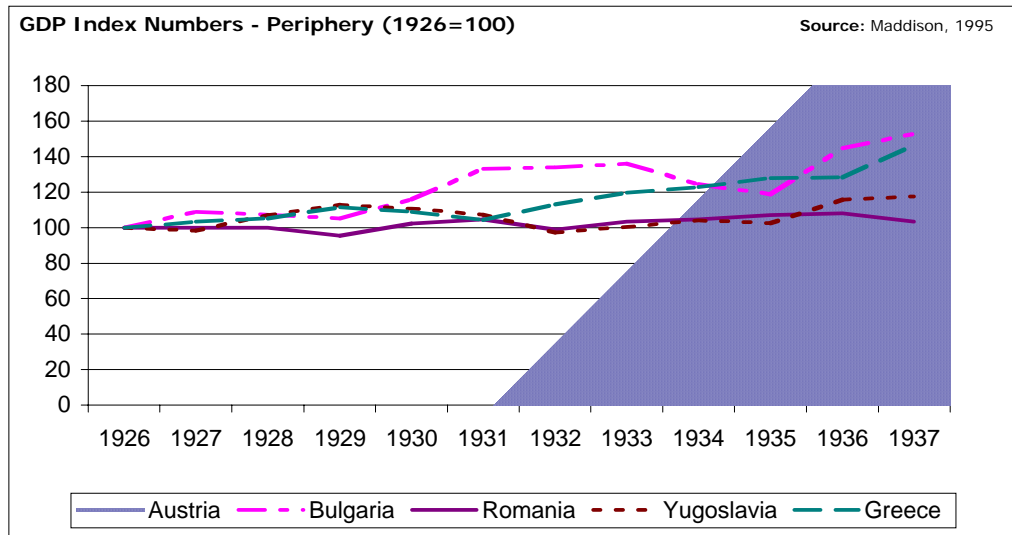
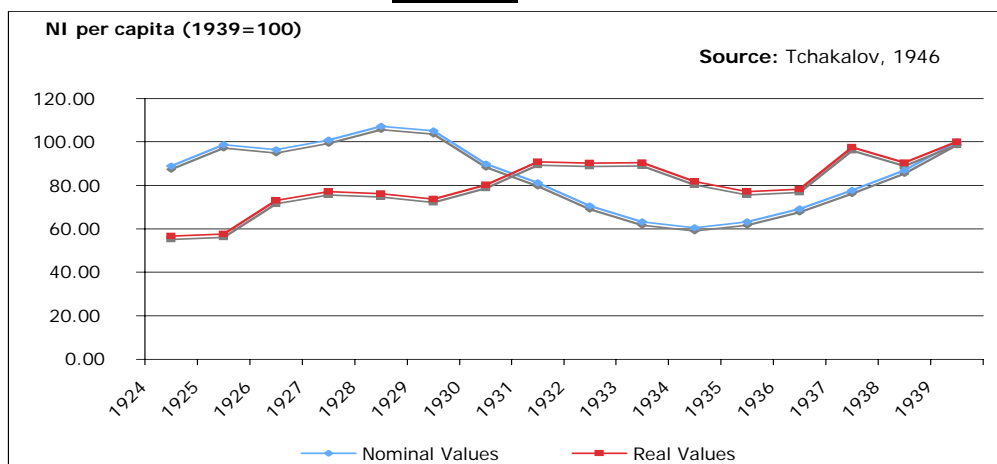


Figure 2:



For the majority of the countries in South-East Europe the Depression meant a long and difficult period of economic stagnation, which lasted until the end of World War II. Figure 1 suggests that exceptions were Greece and Bulgaria. Given the acute awareness of contemporaries of the economic depression the figures presented above are puzzling. An interpretation regarding Bulgaria, involve the invigorating injection of foreign capital through two major loans – the Refugee Settlement Loan in 1926 and the Stabilisation Loan of 1928²⁴. There is a danger of overstatement, as experience

²⁴ Pasvolsky (1930), pp. 109-110

from the developing countries tends to show that such loans are usually recycled through the state bureaucracies and hardly ever reach the credit system or the industrial base of the country in question²⁵. More work is needed to disentangle the picture resented to us by GDP estimates. The nominal values of figure 2 are more representative of the depression period – as the real values, corrected for inflation, necessarily present the deflation years 1929-1933 as a period of stability.

Figure 3 presents a price index of Bulgaria that we have constructed using similar data to Lampe and Jackson, with 1927 as a base year. There, the sharp fall during the turn of the decade is evident. Figure 4 presents a breakdown of the price fall into the prices of manufactured and agricultural goods.

Figure 3:

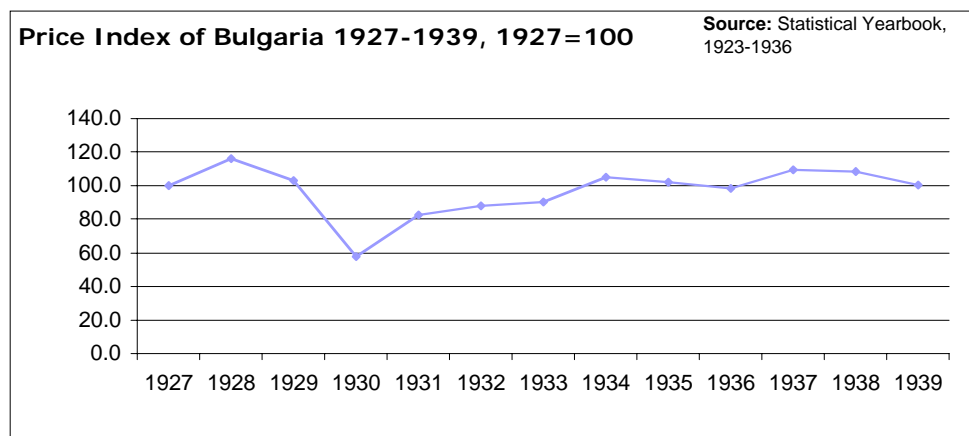
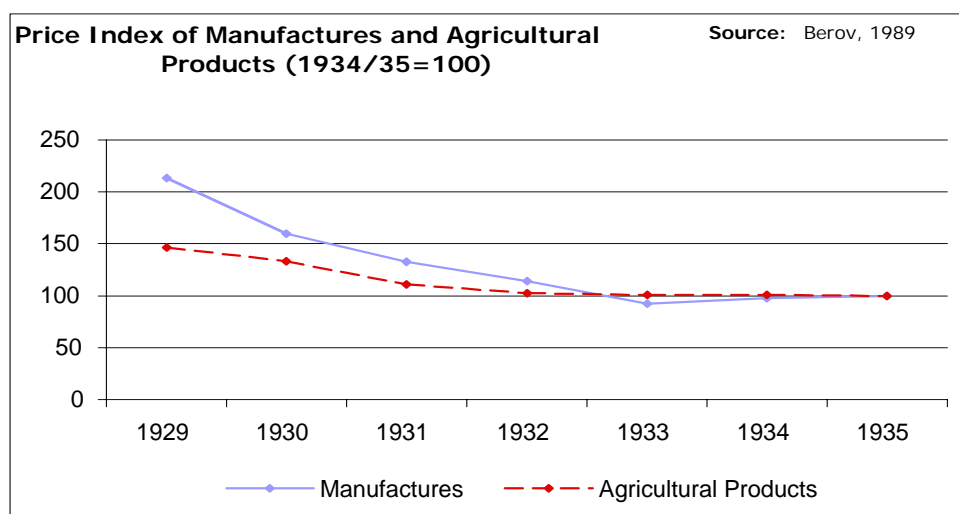


Figure 4:



²⁵ Dadush and Nielson, (2007), for a most recent view on the inefficiency of international loans and aid, see, Easterling, *The White Man's Burden* (2007).

Unambiguous and sharp fall in prices began in the late 1920s. Somewhat surprisingly our index shows a steady recovery from 1933 onwards, while Berov's data reaches a bottom around the same time and remains there.

Agricultural production, in terms of total crops output, shrunk by 18%²⁶. The industrial sector shrank by about 34%, but its recovery was much more rapid in comparison to the agricultural sector²⁷. Overall the Bulgarian economy seems to have reached a nadir in terms of output around 1934. The data presented above, however, fully reflects the controversies of the scholarly literature. It opens more questions than the answers it can provide.

Most of our original data comes from previously unused archive materials, to be found in the Central Archive in Bulgaria. Very useful additions were publications by contemporaries as well as League of Nations reports on the commercial banking systems²⁸. The latter provide a useful crosscheck since the financial data is presented in the format of an orderly balance sheet.

The database used in the quantitative analysis of this paper has been collected from the archive of an institution called *Bankerski Suvet* (Banking Committee, BC thereafter), created within the Ministry of Finance, now preserved within the Central State Archive of Bulgaria, in Sofia²⁹. This institution was set up on 4th January 1931, with the Act for the Protection of Private Deposits³⁰. Its functions were to act as a regulator to the banking sector, demand standardized balance sheets and reports from each bank and review any misconduct of banking institutions. Its members were central bankers from the Bulgarian National Bank (BNB) and experienced auditors working for the BNB as well as the Ministry of Finance, in addition to representatives from commercial banks.

²⁶ Pasvolski, p. 438.

²⁷ Tchakalov (1946), p. 114; see also Avramov (2007), p.64.

²⁸ *League of Nations Memorandum on Commercial Banks*, Geneva (1934).

²⁹ Central State Archive, file 602k, 1.

³⁰ *Durjaven Vestnik* [State Newspaper], v. 227 from 12/1/1931.

Picture 1:
A sample of BNB auditor report

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	Спестовни влогове	Търговски влогове	Други кредитори
Къмъ 30. 6. 934	1.279	1.364	654
30. 9. 934	1.241	1.394	581
31. 12. 934	1.239	1.290	637
31. 3. 935	1.251	1.368	588
30. 6. 935	1.252	1.389	567
30. 9. 935	1.255	1.371	608

Както спестовните така и търговските влогове показват постоянно намаление съ- слабо и несигурно задържано презъ 1935 г. Отъ горните спестовни влогове съ срока надъ 3 месеца къмъ 30.9.931 г.сх лв.263 милиона, а къмъ 30.9.935 г.104 милиона.

Само чуждите банки показватъ креди- тори:

	Спестовни влогове	Търговски влогове	Други кредитори
Къмъ 30. 9. 931	809	1.107	464
31. 12. 931	634	1.085	160
30. 9. 933	556	1.088	90
30. 9. 934	489	831	318
30. 9. 935	474	747	283

Кредиторитъ въ чужда валута спадатъ

The early 1930s saw a series of legislative acts, caused by the anxiety of consecutive bank failures and serious increase in the indebtedness of the population. By 1932, three laws were passed to protect banks having problems of liquidity, debtors as well as debtors involved in small-scale agriculture³¹. These pieces of legislation were instrumental in establishing set rules for financial accountability.

Importantly, once a bank was in difficulties with the payment of its reserve deposit with the BNB or following complaints by customers for delayed payment of their deposits, the BC was obliged to send an external auditor whose job was to examine thoroughly the accounts and report on the bank situation. It is these reports that turned out to be most useful for the current research, because they contain end-of-year balance sheets and, more often than not, a list of main debtors as well as main depositors, list of the members of the governing council of each bank, and analysis of the external auditor as to the nature of the bank difficulties and the possible reasons. Within the archived documents of the BC there were 101 folders for each bank registered with the BC and allowed legally to practice banking. These contained reasonably detailed quantitative information, as well as qualitative reports and opinions by the external auditor³².

Most of the quantitative data was extracted from the balance sheets of banks, but gathering the data on interlocking presented some problems of methodological

³¹ *ibid.*, pp.216-217; the laws are *Zakon za Predpaznia Konkordat*, *Zakon za Oblekchenie na Dlujnicite* and *Zakon za Zakrila na Zemedeleca Stopanin*.

³² For a list of all archival folders, see section on primary sources in the Bibliography.

nature. I have followed standard legal practice, outlined in La Porta *et al*, and have defined related debtors as those who are: (1) shareholder, director or officers of the banks; (2) family members of shareholders, directors or officers of the bank; (3) firms where the previous two categories of individuals are officers or directors; or (4) firms where the bank itself owns shares³³. This information was extracted from the auditors control report, where the auditors themselves have on a number of occasions branded debtors as insiders. This procedure is imperfect and it is possible that a certain volume of insider loans were not recorded. The bias however is more likely to act in support of our conclusions, because it likely that, if anything, we have underestimated the total volume of insider loans.

What follows is a schematic outline of the findings in aggregate terms of the structure of the banking sector in interwar Bulgaria as well as its experience during the Great Depression.

The financial system of Bulgaria began its development immediately after the country gained independence – in 1880 the *lev* was adopted as a national currency, while the pillar of the banking system, the Bulgarian National Bank, was set up in 1879. By 1885 the BNB had full issuing rights and was involved in the provision of credit to customers. BNB's role of a creditor should have legally ended in 1928, but it retained a sizeable 10% of the direct credit for some time after that³⁴. The state gave the initial impetus of the credit sector – within a period of 30 years, 1879-1910, the BNB, the *Bulgarska Zemedelska Banka* (BZB) and *Bulgarska Centralna Kooperativna Banka* (BCKB) were created³⁵.

A complex substructure formed below these large institutions – agricultural credit cooperatives operated in the countryside, being fed on the funds of the BZB, and a town and city equivalent, called popular banks, formed to provide loans to crafts and industrial cooperatives. The relationship was not entirely unidirectional – sometimes the BZB and BCKB sidestepped the smaller intermediaries and lent directly to the final consumer.

The private banking sector presents a simpler picture. Private finance was organized around the representatives of a few foreign banks, which entered the credit

³³ La Porta *et al* (2002), p. 8.

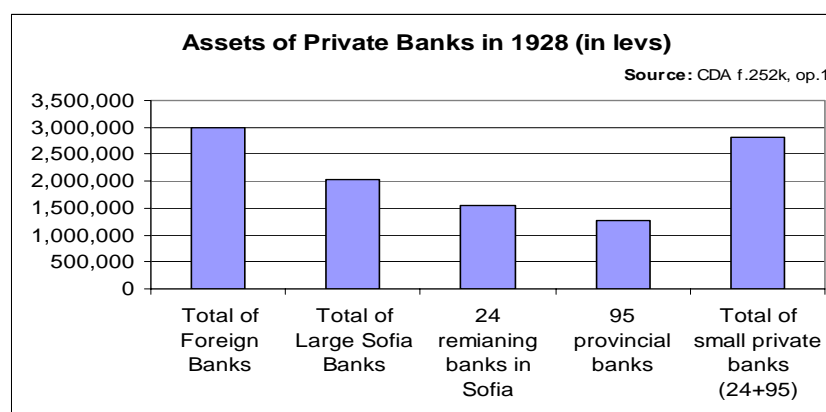
³⁴ *Annual Reports of the BNB*, 1880-1929.

³⁵ Avramov, (2007), vol. 2, p. 72.

market in Bulgaria in the 1900s³⁶. In 1903 there was a reform in the commercial legislation, which allowed foreign residents to sit in the controlling committees of joint stock companies³⁷. This significantly boosted the chances of foreign presence and there was real influx of foreign banks and capital after 1919. A total of 13 large foreign banks accounted for some 40% of the private bank capital of Bulgaria by 1929³⁸.

A number of large independent financial institutions was formed, mainly in the capital city of Sofia, however after 1919, the difference between these and the foreign banks became very slight – foreign capital leaked through to the significant banks based in Sofia. At the bottom, in terms of size according to assets and credits were the small shareholding banks, which operated mainly outside Sofia. These were the institutions, which had to break through the credit constraints faced by industrialists, agricultural workers and craftsmen, who were not large or well-organized enough to obtain access to the big foreign banks. These were also the institutions hit worst by the deflation and the prolonged depression – so many of them collapsed that by 1935, a *Banka Bulgarski Kredit* (BBC) was formed to gather the remnants into one large institution. Although legally private, it was de facto controlled by the state and its capital was mainly supplied by funds from the BNB reserves. Figure 5, below, shows the assets of private banks in *levs*, classified according to the above discussion, in 1928, just before the onset of the depression.

Figure 5:



³⁶ The first foreign bank to enter the Bulgarian credit market was Deutschebank, through the establishment of Credit Bank in 1906 in Sofia.

³⁷ Crampton (2007), p. 304.

³⁸ Lampe (1986), p. 66.

Private banks, located in Sofia, were by far the largest in terms of asset volume. Banks with foreign capital were larger as a group than the total of all small private banks in Bulgaria³⁹. It is important to point out that although the figure above suggests provincial private banks possessed smallest volume of assets, they were very important for local agricultural producers, merchants and craftsmen.

Figure 6 compares the asset shares of the three state owned banks versus the private banks (the latter include all private institutions – from large foreign banks to small provincial banks). It is evident that state capital was a pillar in the financial system. BZB, the Agricultural Bank, in particular, possessed as much as half of the assets of all private banks in total.

Figure 6:

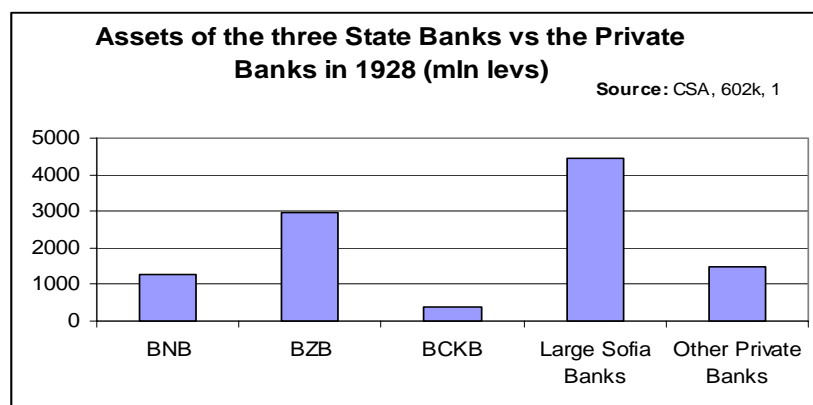
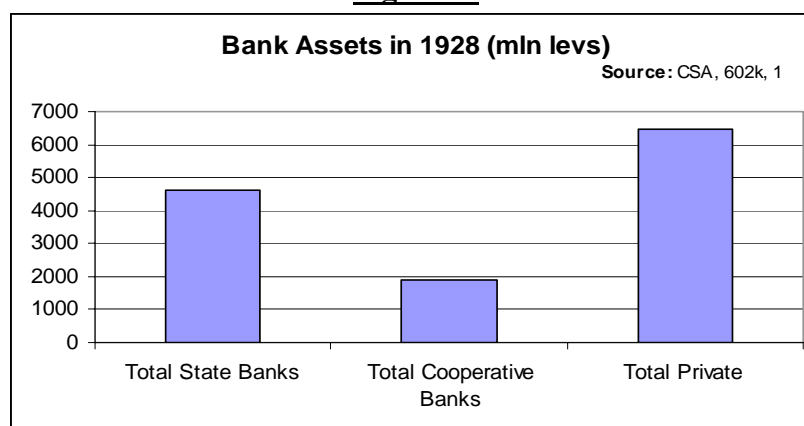


Figure 7:



³⁹ 'Small' is classified as a bank with less than 30,000 leva as total assets.

Figure 7 provides further evidence for the structure of the banking sector in the 1920s. It presents the aggregate assets shares of state banks, cooperative banks (intermediaries between the BCKB and BZB and the final consumer), and private banks. The total share of assets of the private banks is larger than each of the shares of state or cooperative banks and just over half of the total assets. Given the small number of state institutions – three- each of them is more significant than any of the private banks on its own. More data, providing a further breakdown of the banking sector in 1928 and 1932, is shown in the appendix, at the end of the paper.

Figure 8:

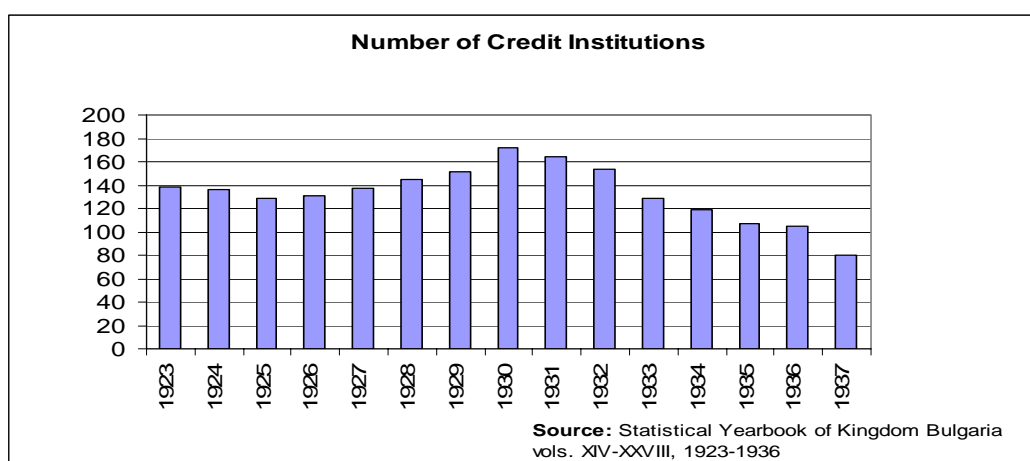
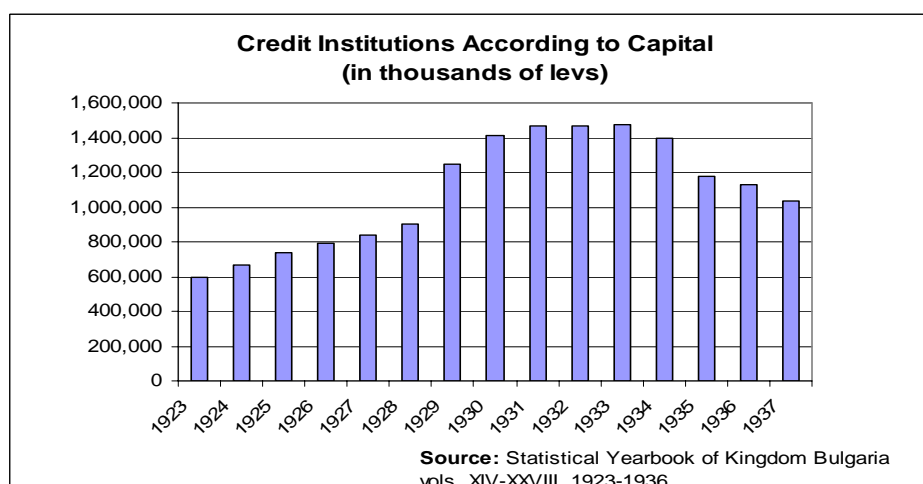


Figure 9:



Figures 8 and 9 show an overall picture of the credit system in Interwar Bulgaria. The early 1920s, years of hyperinflation and currency instability brought very slow development. Sharp increase in the number of institutions and amount of credit can be seen in 1928-1929 and then a steady contraction throughout the 1930s. The private commercial banks saw the most dramatic changes in their portfolios. During the second half of the 1920s deposits held in them increased by about 100%, while only for the period 1929-1932 they declined by about 50%⁴⁰. In this respect, the Bulgaria banking sector did not have a unique experience – the irrational exuberance of the 1920s was severely checked by the depression period.

Figure 10:

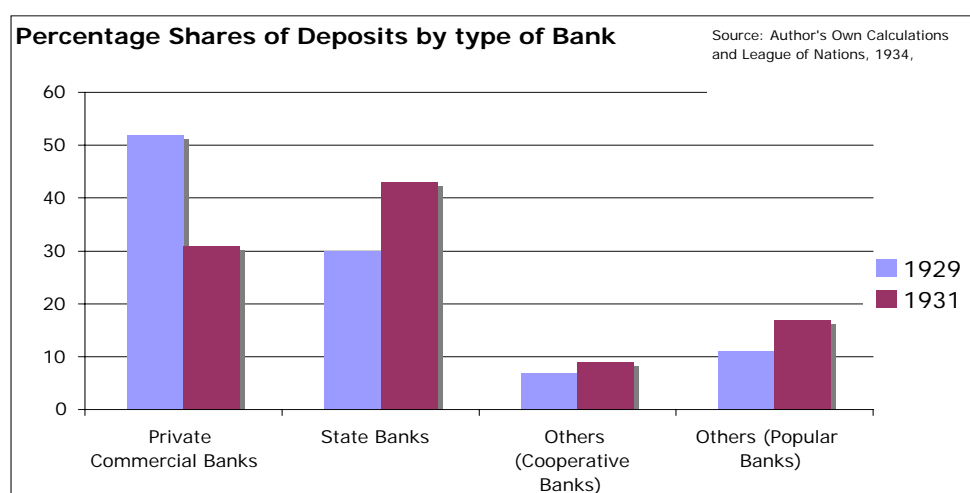
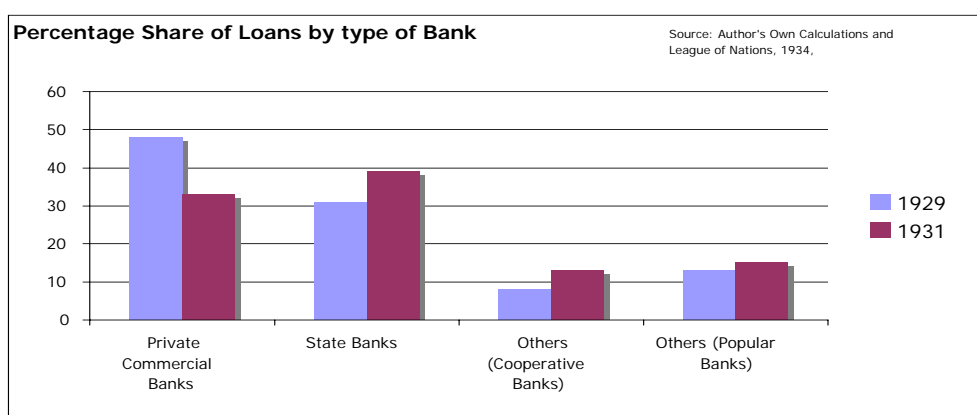


Figure 11:



⁴⁰ Author's own data. See, tables 2,3 and 4 in the Appendix.

During the Depression years, significantly, the role of foreign capital diminished radically – from 20% of total active capital in 1931, to below 7% in 1934. In absolute terms the short-term foreign credits fell from 2,500 mln. *levs* in 1929 to 812 mln. in 1931 and 210 mln. in 1934⁴¹. This had a severe deflationary effect and led to a radical restructuring of the banking system. The private sector was supposed to fill the gap, and indeed, by 1936 the two largest private institutions had more deposits than the four foreign banks still present in the Bulgarian credit market after the depression, but also twice as much as all the small private banks together⁴². This suggests an interesting dynamic – expectedly, the largest institutions were best placed to survive the depression and retained their assets and increased their market share, in light of the distress of small private institutions of local importance. So many of the latter experiences severe difficulties of liquidity, that by 1934, a state intervention was necessary to restructure the feeble private sector. The choice of banks facing ruin was either to merge into the de facto state bank BBC or to be liquidating, if they had lost more than 50% of their operational capital. Figures 8 and 9 illustrate the results of the liquidity shock that the depression caused. The former presents the rise in the number of credit institutions during the euphoria of the late 1920s, after the Stabilization and Refugee loans injected liquidity into the credit system, but also the subsequent fall, caused by bankruptcy and merger, in the early 1930s. The latter graph illustrates the same situation, but in terms of capital. There, the drop seems less significant, but has to be kept in mind, that bank liquidation was a very slow process, sometimes taking the whole of the 1930s decade, due to prolonged law suits to recover bad loans. Furthermore, many of the banks, which merged into BBC still counted a substantial part of their capital as recoverable, while in fact it was either acutely diminished or totally lost, due to the deflation and bankruptcy of their debtors. Figures 10 and 11 illustrate a further interesting dynamic, where the state sector took over a large part of the decline of the private sector. This is illustrated in terms of share of deposits and share of loans respectively.

Tables 1 and 2 below, present the changes in commercial bank deposits just before and during the depression in an international context. We can see that Bulgaria experiences a healthy increase in deposits of commercial banks during the 1920s, but

⁴¹ Christoforov (1946), p. 179.

⁴² Avramov (2007), vol. 2, p. 411.

by 1932 a sharp decline can be detected – Bulgaria was amongst the countries, the banking sectors of which suffered most heavily.

Table 1: Movements of Commercial Bank Deposits, 1925-1929				
<i>Source: League of Nations, Geneva 1934</i>				
Increase of 100% or more	Increase 50-100%	Increase 25-50%	Increase 25-1%	No increase or Decline
Poland	Germany	Mexico	Yugoslavia	Sweden
Hungary	Belgium	Switzerland	Czechoslovakia	India
Latvia	Romania	Venezuela	Canada	Denmark
Estonia	Lithuania	Finland	Argentina	Bolivia
Colombia	<u>Bulgaria</u>	Austria	USA	Norway
	France		Japan	
	Brazil		Italy	
			England and Wales	
	Uruguay		Netherlands	
	Spain			

Table 2: Percentage Decline in Total Commercial Bank Deposits in Various Countries, 1929-1932				
<i>Source: League of Nations, Geneva 1934</i>				
Decline of 60-40%	30-20%	20-10%	10-0%	Increase
Latvia	Venezuela	Estonia	Argentina	Lithuania
Poland	SA	Netherlands	Italy	Sweden
Austria	Mexico	Chile	Czechoslovakia	Switzerland
<u>Bulgaria</u>	Colombia	Canada	Australia	UK
Germany	Portugal	Norway	Hungary	Brazil
Romania	Belgium	Ecuador	Denmark	Bolivia
		Yugoslavia	France	Peru

The experience of the banking sector is consistent with the leak performance of the overall economy during the Interwar period. In fact the state of the banking sector and the serious inefficiencies in capital allocation that we point out resulted from insider lending may have had a further negative effect on growth.

Figure 12:

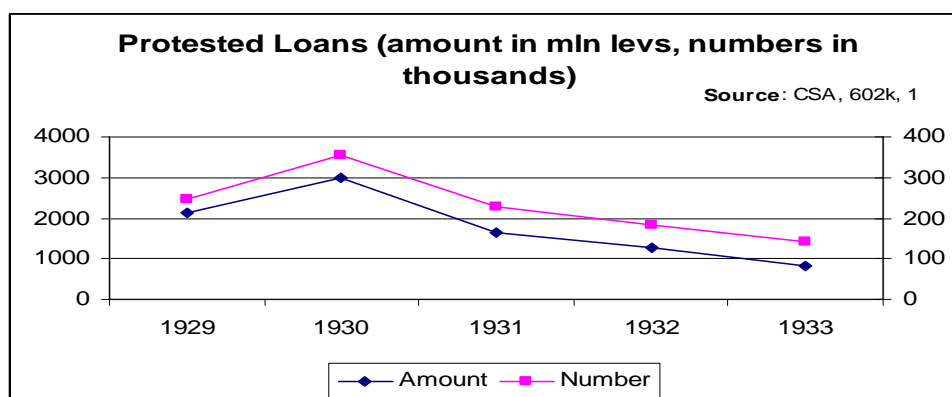


Figure 13:

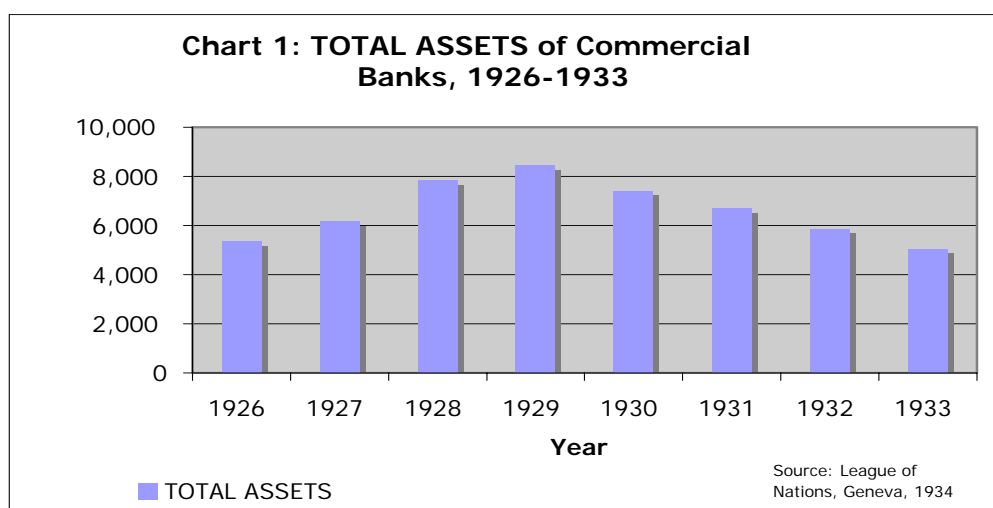


Figure 14:

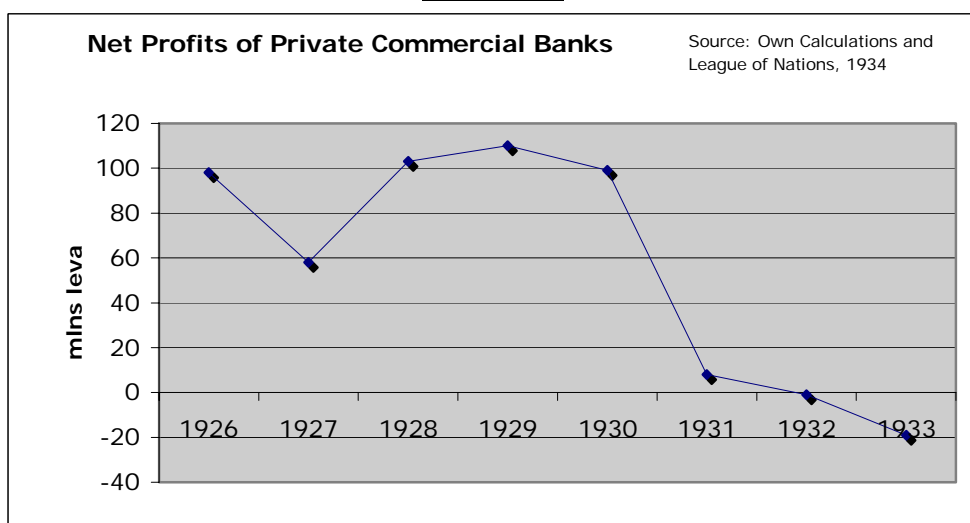


Table 3: Summary Position at the end of the following years (in leva 000,000): <i>Source: League of Nations, Geneva 1934</i>								
Summary Accounts for Commercial Banks	1926	1927	1928	1929	1930	1931	1932	1933
Number of Banks (branches and sub-branches)	110	116	128	135	138	131	129	118
ASSETS								
<i>cash</i>	597	602	782	714	870	968	884	662
<i>bills+investmens and securites+participations</i>	1,514	2,110	2,965	3,056	2,293	1,865	1,575	1,262
<i>loans and dues</i>	2,793	2,880	3,483	3,938	3,489	2,621	2,101	1,992
<i>sundry assets</i>	287	382	405	511	545	1,133	1,173	1,029
TOTAL ASSETS	5,349	6,154	7,838	8,442	7,412	6,684	5,861	5,046
LIABILITIES								
Net Profit	99	87	105	118	114	62	30	16
Deposits, due to banks, other borrowings	4,198	4,983	6,563	6,959	5,887	4,545	3,996	3,347
TOTAL LIABILITIES	5,349	6,154	7,838	8,442	7,412	6,684	5,861	5,064

Figures 12, 13, 14, and table 3 summarise the experience of Depression. The year 1930 was the turning point for the banking system. It marks that peak in protested, irrecoverable, loans. It was also the beginning of the gradual erosion of bank assets, which by 1933 had dropped to the pre currency stabilisation year of 1926. In 1930 began the sharp downward slide of bank profits and rise of net losses. By 1932 net losses had outstripped profits in the commercial banks balance sheets. The rest of the paper explains this drop in profitability and the increase in protested loans and eventual losses.

4. European Experience during the Depression: A Theoretical Model

Economic theory suggests that a sophisticated and efficient financial system is highly beneficial to the rest of the economy. A basic function of finance is to mobilise aggregate savings and channel them towards investment in productive enterprise⁴³. Schumpeter's seminal work (1939) has identified the role of financial institution in seeking out profitable investment and thus acting as an essential agent in the process of creative destruction, which drives economic development in a capitalist economy. Asymmetric information problems may arise because investors and entrepreneurs

⁴³ Levine (1997), p.691.

have different information about a project. Entrepreneurs have inside information and can estimate the worthiness of a project much better than outside investors, who will find it costly to acquire information about the profitability of a project. More recent literature has put forward the function of financial institutions in monitoring firms, in terms of their efficient use of the funds provided⁴⁴. In this case moral hazard may arise as a post-contractual information problem, where entrepreneurs have lower incentive of pursuing their project to a profitable end, once they have secured funds for their expenses and salaries. Essentially - financial intermediaries are there to solve information problems in imperfect investment markets.

A second set of theoretical problems is centred on the idea that well-developed and open financial markets spread opportunity to a wide section of economic agents, while underdeveloped credit markets under strong government influence, are prone to restrict access and benefit a select group⁴⁵. Firstly, this is detrimental to economic growth, as it means that the function of seeking out potentially profitable, but possibly risky, projects is severely constrained, and secondly, it is socially harmful as it deepens inequality. This literature provides theoretical underpinning of our argument that insider lending undermines economic efficiency.

Insider lending can thus be damaging to the financial system, as it prevents prudent regulations of lending to take place – like research of the prospective debtor, their financial prospects or real asset ownership, which can compensate the bank in case of the latter's bankruptcy⁴⁶. It has been argued that motivation for interlocking exists to increase the potential to facilitate relationships between corporations and their directors, and has been interpreted in terms of either organizational or class dynamics⁴⁷. In this paper, it is the inter-organizational perspective that is of interest – where corporations create interlocks in response to their needs for resources controlled by other organizations in their environment. Particularly attractive partners for interlocks are banks, because they control one of the most essential of resources - credit.

⁴⁴ Paulet (1999), p.3, Levine (1993) provides an excellent survey of the theoretical underpinnings and the empirical tests that have been conducted on the effects of finance on economic development. More recently, Trew (2006) has summarised the findings of the literature on the finance-growth nexus.

⁴⁵ Rajan and Zingales, (1998, 2003).

⁴⁶ Soref and Zeitlin (1987), p. 60.

⁴⁷ Palmer, Friedland and Singh (1986), p. 783.

Avramov (2007) argued that insider lending due to constrained credit was widespread in the Interwar Bulgarian banking sector⁴⁸. Following in his steps and those of La Porta *et al.* this paper's second aim is one of testing a hypothesis that the practice of insider lending prevented the financial system of playing an active role in the process of economic development and proved its demise during the experience of the Great Depression.

Specific models have been developed to estimate banking efficiency/profitability and their responses to crises and the Great Depression in particular. Calomiris (1993) reports on the changing perceptions of credit allocation under asymmetric information in recent times⁴⁹. Information costs means that 'insiders' – firm managers and financial intermediaries with a long-term relationship with the bank/firm – can supply funds at a lower cost than 'outsiders' – relatively uninformed stockholders and bondholders⁵⁰. Thus changes in the wealth distribution between insiders and outsiders can alter the performance of banks. Mishkin (1976) followed up by Bernanke (1983) have looked deeper into the problem of debt deflation, excessive leverage and allocative consequences of wealth redistribution in the presence of capital market imperfections. They have applied this approach to analyse the role of financial factors in the story of the Great Depression in the US.

In European perspective, Jonker and Van Zanden (1995) have found the common explanation of bank failure during the Depression to be falling asset prices and default of risky loans⁵¹. Their model is centred on the pattern of deflation to try and bring currencies back on par with the levels of 1914. This eroded the incomes of banks by squeezing debtors and reducing asset prices. The argument runs as follows - effectively, the changes that took part in the banking practice during the high inflations in the post-1919 world exposed banks to the latter deflations.

Inflation had positive effects on exporting industries and industries where assets increase in value. The banking sector, however, where most assets were nominal, experienced adverse effects. Banks had to increase their real activities to keep up with the rising prices – as their loans to industry decreased in value. Two

⁴⁸ Avramov (2007), pp. 454-464.

⁴⁹ Calomiris (1993).

⁵⁰ Akerloff's 1970 seminal work began research in this area. Followers were Stiglitz and Weiss (1981) and Myers and Majluf (1984).

⁵¹ Jonker and Van Zanden (1995).

strategies emerged to cope with the inflation periods – to convert nominal assets into real ones, in other words the rise in investment banking and the purchase of physical assets, or to expand lending rapidly, certainly faster than inflation. Both strategies resulted in exposure to the deflation during the Depression years.

The first strategy directly affected banks liquidity position and the value of their balance sheet, once prices of real assets started falling after 1929. Expanding lending rapidly meant increased competition between banks for profitable loans and as a result the quality of debtors decreased. In this case the exposure to the deflation was indirect, but just as harmful, since bankrupt debtor meant a loss to the bank. Thus a rational response to the inflations in the beginning of the 1920s resulted in bank vulnerability by the end of the same decade when deflation kicked in.

Jonker and Van Zanden's explanation is an appealing one, and it is also backed up by compelling empirical evidence. It is aimed at the core of industrialised European countries and although putting the blame on ill-conceived loans made during an inflationary period, it does not do enough to explain the origins of these loans. Particularly for countries where the credit institutions were closely linked to industry, it is essential to probe deeper into the origins of these ties and the likelihood of them being reasons for widespread bad loans.

We follow the key assumptions of La Porta *et al.*, to construct an incentive structure facing the agents involved⁵². The model presented below is an adaptation of their simple model of looting developed to explain a study of the Mexican banking system. We are focusing on the incentives for insiders to divert cash for their own benefit. A key assumption is that insiders structure self-dealing transaction to minimise recovery on related-party loans when these default⁵³. Related agents can avoid repaying their loans at the cost of foregoing their equity in the bank. Consequently, related parties repay their bank loans when the value of their equity in the bank is higher, but default otherwise⁵⁴.

⁵² La Porta *et al.* (2002), pp.3-6.

⁵³ Auditors of the Banking Committee, at the Ministry of Finance, post 1931, often talk about loans granted without the appropriate reference to the capacity of the debtor to repay; similarly, loans were provided against collateral that was either non-existent or did not cover the value of the *loan*. For instance, see the audit report for Bulgarska Chernomorksa Banka, CSA 602/1/36; Mackey (1999) provides similar evidence for 1990s Mexico.

⁵⁴ La Porta *et al.*, (2002), p. 4.

Further assumption is that each bank is controlled by a single shareholder who owns a fraction α of the cash flows of the bank and a larger fraction β ($>\alpha$) of the cash flows of an industrial firm (the related party), which he or she also controls. We also assume that the controlling shareholder has effective control over lending decisions – i.e. he can ensure the bank lends to related parties on non-market terms, but needs to engage in costly transactions to avoid repayment in the bad state (thus when the bank lends L to a related party, the controlling party only receives a fraction $\phi(L)$). The model's dynamics develops over two periods, where loans are be financed by deposits (D) and shareholder's equity (E); (r) is the promised interest on deposits. In period 1, the bank lends L to insiders and $E+D-L$ to unrelated parties (both promise to pay R per borrowed dollar). Loans are due in the second period when time ends. The world can be in good state (probability q) or bad state (probability $(1-q)$). In good state the bank recovers all loans, in the bad, only a fraction γ ($<R$) from unrelated loans. Expectedly, loans are unprofitable when made to related parties ($R_r=q*R<1$) and profitable when made to unrelated ($R_u=q*R+(1-q)*\gamma >1$). In equilibrium, insiders do not default in the good state. When $\alpha<\beta$, insiders always default. Below are shown the outcomes of lending policy during different states of the world.

(1) good state: $\alpha*(R*(E+D)-r*D) \geq \beta*R*L$

(2) bad state: $\alpha*(\gamma(E+D-L)+R*L-r*D) < \beta*R*L$

(3) value of deposits: $D=q*[r*D]+(1-q)*[\gamma*(E+D-L)]$

(4) in the good state the insider receives share of the profits of the bank: $\alpha*(R*(E+D)-r*D)$, but loses money on looting: $\beta*R*L$; in the bad state the insider forgoes equity in the bank, but captures $\beta*\phi(L)$ from looting.

(5) Expected profits of insider are:

$$E(\pi)=q*[\alpha*(R*(E+D)-r*D)+\beta*(\phi(L)-R*L)]+(1-q)*[\beta*\phi(L)]$$

(6) From (3) and (5), expected profit can be rewritten as:

$E(\pi) = \alpha * [R_u * (E + D - L) + R_r * L - D] + \beta * [\varphi(L) - R_r * L]$, where $R_u (= q * R + (1 - q) * \gamma)$ and $R_r (= q * r)$ denote the expected rates of return on loans to unrelated and related parties, respectively.

Thus from (6) the insider picks the level of related lending to maximize her expected profits.

(7) The first order condition for the incentive to lend to related parties is as follows:

$$\beta * \varphi = \alpha * (R_u - R_r) + \beta * R_r$$

Easily enough, at the margin the cost from engaging in related lending must exactly equal its benefit. Consider the following example: moving 1 unit of local currency from unrelated parties to related ones. The insider is a shareholder in the related party and receives $\beta * \varphi$, when the unit is diverted from the bank. As a shareholder in the bank, the insider bears a fraction α of the reduction in profits resulting from the change $(R_u - R_r)$. At the same time the insider pays R_r per borrowed unit, as a shareholder of the related firm. Thus, according to the above equation, related lending (or lending through interlocking) is restrained by a high equity stake of the insider in the bank and by attractive opportunities to lend to outsiders. Lending to interlocks increases with the insider's equity stake in the related firm (β) and when the opportunity for attractive borrowing terms on interlocked parties exists. Furthermore, insider lending becomes attractive when credit is rationed and firms meet with difficulties trying to attract outside funds. This is identical to a situation where $\beta > \alpha$ and the world is in a bad state. This model is very useful in describing the situation in Bulgaria during the interwar period, when industry leaders owned stakes in banks, but made most of their profits through non-financial enterprises. Their loyalty was thus to industry and not banks.

5. Econometrics and Robustness Checks

This part quantitatively examines the influence of interlocking on bank profitability during the depression period. Our data includes the detailed balances for 1930 for 101 banks. The table below summarises the data used in our econometric model.

Table 4: Summary of Data on Interlocked Banks				
Banks (N:101, 1930)	Total Assets (in leva)	Size of Interlocked Assets (in leva)	Interlocked Assets as Percentage of Total (%)	Bankrupt (N:)
<i>Total (101)</i>	12,365,118,842	317,709,783	2.6	72
Sofia banks (33)	10,613,754,531	215,404,426	2.1	-
Of which Bankrupt (13)	512,486,583	136,121,074	26.5	13
Countryside Banks (71)	1,751,364,311	102,305,357	5.8	-
Of which Bankrupt (61)	894,586,101	89,085,409	10.1	61
<i>Total (101)</i>	12,365,118,842	317,709,783	2.6	72
With Foreign Share (16)	5,449,915,004	44,354,494	0.8	-
Of which Bankrupt (5)	110,169,314	44,354,483	40.3	5
No Foreign Share (85)	6,915,203,838	273,355,289	4.1	-
Of which Bankrupt (66)	1,296,903,370	180,852,000	14.1	67
<i>Total (101)</i>	12,365,118,842	317,709,783	2.6	72
Bankrupt (72)	1,407,072,684	225,206,483	16.1	-
Survived (29)	10,958,046,158	92,503,300	0.8	-

In our model of bank profitability we use a number of well-known measures and one variable to represent our hypothesis that insider loans were the underlying reason for the failure of the private bank system.

Return to equity is a measure of profitability used by a number of studies⁵⁵. Due to lack of data on the dividends paid out by banks a proxy has been used - the ratio between profit/loss for 1930 and the capital. A simple model for bank profitability suggests that crucial factors are economies of scale, level of external competition and attitude to risk⁵⁶. We have included loan quality as a variable, which is represented by the ratio of bad loans, or interlocked loans, and total loans as well as a possibility for foreign capital share in an institution. The more insider loans were to be found, the weaker the bank is expected to have been. The opposite must have been true regarding foreign share – the more foreign capital was invested in a bank, the bigger and more stable a bank is likely to have been. A baseline model is presented below:

$$ROE = f \{LQ, COM, RISK, ES, EI\}$$

⁵⁵ See, Goddard, Molyneux and Wilson, (2004), p. 24; also Okazaki, Sawada and Yokoyama, (2005), p.13;

⁵⁶ Smirlock (1985, p3), Bourke (1989, p15), Berger (1995, p10) and Goddard *et al.* (2004, p26).

Profitability depends on economies of scale (ES), level of external competition (COM), attitude to risk (RISK), loan quality (LQ) and presence of external investor (EI).

Loan quality is controlled by the variable *Interlock2*, which is a ratio of interlocked loans over total loans. We expect the coefficient on *Interlock2* to be negative, since insider loans were modelled as having negative influence on bank performance and survival chances during an economic crisis. A measure of economies of scale is presented as a variable called *LnSize* – the total assets a bank had in 1930. *LnSize* is expected to have a positive effect on bank performance. External competition – *Com* – is best measured by the number of branches of competing banks in a city or town. In the regression a ranking represents this, where 3 is for largest cities with highest competition between largest number of banks and branches and 1 for least competition. Standard oligopoly theory suggests that the more concentrated a market is, the higher profits producer can command – in the case of banks, higher interest rates can be charged for loans and lower given on deposits. *Com* is expected to exhibit a negative coefficient.

Attitude to risk is difficult to measure. We have introduced a number of variables to control for it – *Levd* (leverage) performed best and were used in the final regression. It is expected that the coefficients will be positive, yet as with *Forgn* (see below) it is not a clear-cut case. Higher risk can amount to higher profits, especially, more loans provided should bring back higher revenue in terms of interest, but in time of economic slowdown, this tendency may be reversed. Presence of external investor, usually foreign is controlled by a binary variable, *Forgn*, which takes the value of 1 when there was foreign capital in the bank, and 0 otherwise. *Forgn* can take a positive value if we consider foreign capital to have been a factor boosting stability of profitability. This, however, is not entirely clear, because foreign capital pulled out during the depression leaving the institutions it used to support exposed to the crisis. It is possible too, that banks with foreign capital presence were very conservative in their investment decisions, and while a secure strategy - this may not have necessarily boosted profitability to any significant level. It is most likely to have only affected the Sofia region. A summary of the variables and their definitions is presented in table 5, below:

Table 5: Description of Variables		
Dependent Variable	ROE 2	ROE: as a measure of profitability; proxied by a ratio of profits over set up capital plus reserves (ROE 2); Ideally, ROE should be calculated using data from stock returns (dividend over the value of stock), however due to data limitations, the ratio of profit over capital is used.
LQ	Interlock2	Percentage of insider loans from total loans;
ES	LnSize	Size of total assets; used in logarithmic form in the regression
RISK	Levd	Ratio of deposits over total capital;
Dummies	COM (competition)	Dummy for competition, ranked from 1 (least) to 3 (most) depending on number of banks/branches in town;
	EI (Forgn)	1 if foreign capital present in the bank, 0 otherwise;

The final econometric model for the Ordinary Least Squares (OLS) regression is:

$$ROE_i = \beta_0 + \beta_1*(Interlock2) + \beta_2*(LnSize) + \beta_3*(Com) + \beta_4*(Forgn) + \beta_5*(Levd) + \varepsilon_i$$

Table 6 summarizes basic statistics about the data. Table 7 follows through with the results from the OLS regression on the whole sample, just banks in the Sofia region, just countryside banks, banks with only local capital, and banks with no foreign capital.

Table 6: Descriptive Statistics					
Variables:	Observations	Mean	Std. Dev.	Min	Max
ROE 2	101	2.31	21.04	-107.98	22.75
Interlock2	101	0.21	0.26	0	0.93
Levd	101	3.43	4.75	0.06	37.01
Forgn	101	0.16	0.36	0	1
COM	101	1.90	0.96	1	3
Ln Size	101	16.75	1.65	13.53	22.18

Columns two and three in table 7 show the results of the OLS regression for the whole sample. The coefficient of Interlock2 is negative across all regression and significant for regression of the whole sample, the countryside and non-foreign banks. The results show that insider lending was not statistically significant for the large banks in Sofia region and the one with foreign capital. This is consistent with our hypothesis. First – insider lending was pointed to as the underlying reason for severely diminished profitability during the depression. Second – our expectation was that it was most widespread across small, private, and commercial banks. Third – we

pointed out that their auditors better controlled foreign banks and the reason for the decline in foreign share in the banking sector was the outward flight of foreign capital. All three arguments find support in the econometric analysis.

The positive and significant coefficients on *lnSize* across all regressions suggest that economies of scale matter. Too much competition was bad news for bank profits during the depression, suggested by the highly significant and negative coefficient. The risk attitude variable, *Levd*, is statistically significant. Leveraged position caused distress to banks as the economic slowdown began. Foreign capital is only significant at the 10% confidence level and only in the regression of the whole sample. Size rather than presence of external investor was what mattered for profits of large Bulgarian banks.

Table 7: OLS Regression										
Dependent Variable is ROE2 (Profits/Total House Capital)										
Variable	All Banks		Large Banks		Small Banks		Foreign only		Non - foreign	
	Coeff.	t-stat.	Coeff.	t-stat.	Coeff.	t-stat.	Coeff.	t-stat.	Coeff.	t-stat.
LQ (Interlock2)	-25.7	-3.48***	-3.3	-0.28	-30.7	-3.41***	-23.6	-1.02	-19.0	-2.39**
ES (lnSIZE)	5.0	3.48***	8.6	2.32**	3.7	2.55**	9.73	2.83***	3.0	1.82**
COM (Com)	-11.1	-4.96***	---	---	---	---	-8.8	-0.90	-10.3	-4.48***
EI (Forgn)	-6.9	-1.24*	5.9	0.80	7.1	0.69	---	---	---	---
RISK (Levd)	-9.6	-2.07**	1.8	1.45*	-1.8	-1.82**	-0.4	-0.02	-6.7	-1.43**
Intercept	-52.2	-2.18**	-140.3	-2.38**	-30.7	-1.21	-155.9	-2.43**	-19.1	-0.71
R-squared	0.31		0.20		0.24		0.54		0.27	
Adj. R-squared	0.28		0.08		0.21		0.38		0.23	
F-test	(5,95) 8.6		(4,28) 1.77		(3,64) 6.92		(4,11) 3.29		(4,80) 7.32	
N: obs	101		33		68		16		85	
(robust st errors used, *** - significant to 1%, ** - significant to 5%, * - significant to 10%)										

Some robustness checks on the results above follow:

The econometric results presented above show strong relationship between interlocking and bank profitability, especially in light of possible drawbacks/deficiencies in the data. There are a number of ways to improve the exercise. The results can be checked using alternative measures for interlocking. Okazaki *et al.* measure the number of directors, who had posts in banks and industry

and use this to represent interlocking⁵⁷. Their idea can be furthered by gathering data on the number of enterprises interlocked to a bank, or the number of interlocks per director. In my case, however, such data will be very difficult and much too long to gather, to be of practical use. The most effective manner of improving the data set is to polish the *Interlock2* variable by cross referencing data on internal loans. A more extensive look at the available evidence for individual banks can also allow a more in depth survey of bank case studies, which would throw significant light on the personal relationships. This in turn will help us better distinguish between the theories of information asymmetries and pure looting as answers to credit rationing.

Alternative measures of interlocking were used in successive regressions to confirm the robustness of the results. Using *Interlock1* (defined as percentage of insider loans from total assets) provided quantitatively very similar results as in table 7, above. Most problematic were the measurements, constructed to control for attitude to risk. Given the data available from bank balances, we constructed a number of variables. *Levd* was the best performing one in the series of regressions, this why we have chosen it for our model. Tables 8 and 9 below show a list of the variables used in the robustness checks, their definitions and a summary statistics.

Table 8: Description of all Variables (including ones used in the robustness checks)		
Dependent Variables	ROE 1	ROE: as a measure of profitability; proxied by a ratio of profits over set up capital plus reserves plus deposits (ROE 1) and profits over set up capital plus reserves (ROE 2); Ideally, ROE should be calculated using data from stock returns (dividend over the value of stock), however due to data limitations, the ratio of profit over capital is used.
	ROE 2	
LQ (Loan Quality)	Interlock1	Percentage of insider loans from total assets;
	Interlock2	Percentage of insider loans from total loans;
ES (Economies of Scale)	LnSize	Size of total assets; used in logarithmic form in the regression
RISK (Attitude to Risk)	LoanDepo	Ratio of total credits to total deposits;
	CapDep	Ratio of total capital (set up capital plus reserves plus profits for 1930) over deposits;
	Levd	Ratio of deposits over total capital;
	ResDepo	Ratio of reserves over total deposits;
	Sec	Ratio of Total Security Holdings (government bonds and debentures to the Total Value of Capital + Total Deposits
Dummies	COM (competition)	Dummy for competition, ranked from 1 (least) to 3 (most) depending on number of banks/branches in town;
	EI (Forgn)	1 if foreign capital present in the bank, 0 otherwise;

⁵⁷ Okazaki *et al.* (2005, p20).

Table 9: Descriptive Statistics of All Variables (including used in Robustness Checks)					
Variables:	Observations	Mean	Std. Dev.	Min	Max
Ln Size	101	16.75	1.65	13.53	22.18
ROE 1	101	0.50	8.31	-56.10	14.00
ROE 2	101	2.31	21.04	-107.98	22.75
Interlock1	101	0.14	0.21	0	0.88
Interlock2	101	0.21	0.26	0	0.93
CapDepo	101	1.25	2.35	0.03	15.66
Sec	101	0.06	0.12	0	0.75
LoanDep	101	1.67	1.81	0	11.85
ResDepo	101	0.09	0.19	0	1.07
Forgn	101	0.16	0.36	0	1
COM	101	1.90	0.96	1	3
Levd	101	0.64	0.42	0	1.4
Lev	101	3.43	4.75	0.06	37.01

6. Conclusion

More than 40 years ago Gerschenkron proposed his thesis of economic development in relative backwardness, where the state acted as a substitute to supposed prerequisites of economic growth⁵⁸. Concentrated and mixed banking sector, where banks were involved in investment, credit provision and commercial practices, is central to such mode of development. Gerschenkron's ideas about the positive effects of such institutions have been strongly contested, especially on the grounds of evidence from the Interwar period. Late developing economies and their universal banking systems, like Germany, Italy and Austria, for different reasons, had very difficult time during the depression. Similarly, developing countries in the periphery of industrialised Europe experienced widespread bank failures.

In theory, lending to friendly groups can ensure higher information inflow and better opportunities for monitoring ones investment – in other words reducing the risk of investment; however, it also means that innovative and possible more profitable projects may be left out. A further danger is the consistent and rational channelling of funds to insiders' projects, because they appear to provide most lucrative returns and an interlocked agent expects to receive a higher payoff from the enterprise rather than his equity in the bank. A formal model of this type of lending, consistent with La Porta et al, was used to present it as institutional looting. This hypothesis was

⁵⁸ Gerschenkron (1962).

suggested in addition to Jonkers and Van Zanden's model of rational madness in accumulating bad loans in a hyperinflation-deflation dynamics.

To test the theoretical propositions, this paper studies the experience of Bulgarian banks during the years of the Great Depression – a peripheral country with a developing economy and financial sector. A quantitative exercise, to account for the aggregate effects of interlocking on bank performance, was applied on a dataset, gathered from previously unused archival material.

The econometric results confirm the conclusion the theoretical setting – interlocking and insider lending was prevalent in the interwar Bulgarian financial system, not only in the small credit institutions of importance to the local economy, but also amongst large and well-established banks. More often than not, interlocking acted in the direction industry-banks, with a clear aim of leaders of business to use their positions in banks to attract as much funding as possible to their own enterprises. This had catastrophic effects during the long deflationary period during the depression, since both sectors suffered grievous losses.

Our model confirms some established views from the literature on bank profitability. Size of banks mattered for their financial success, competition reduced profits, while foreign or government backing had positive effects on financial stability. Bad loans given to related parties, however, turned out to be one of the major factors in bank ruins during the outset of the depression in the Bulgarian economy. This conclusion runs contrary to Lamoreaux' major work on insider lending during 19th century east coast US financial structures.⁵⁹ Economists and economic historians need to consider a two-way effect of strong links between banks and industry.

Given the prevalence of insider lending as 'looting' in the present day developing countries, this paper points at two solutions. Low profitability will be widespread amongst banks ridden with insider loans, and these will fail during economic crises - a case of natural selection⁶⁰. Encouraging government regulation to deal with the problem can be a second solution. The first suggestion burdens a financial system with long-term inefficiency and then a sharp correction during a downturn. The second – runs against the policy recommendation of the neoclassical

⁵⁹ Lamoreaux (1991).

⁶⁰ Okazaki *et al.* (2005).

paradigm, yet may prove necessary given the number and scale of financial crises over the past decade.

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