

ABSTRACT

In the spring of 1996, Bulgaria was hit by an extremely severe financial crisis, with repeated bank runs, large fiscal slippages and a rapid depreciation of the domestic currency (the Lev). The crisis reached a peak in February 1997, with a short period of hyperinflation occurring in the midst of social and political upheavals. The purpose of this paper is to explain the Bulgarian crisis and explore, in particular, the relationships between the banking crisis and the currency crash. Four approaches are used to that end: i) an overview of the literature on financial crises, with an emphasis on the so-called “twin-crises;” ii) a comparison of the Bulgarian experience with that of other transition economies; iii) a detailed chronology of the banking and currency crises in Bulgaria; and iv) empirical investigations on the magnitude and causes of portfolio shifts during the crisis. All four approaches point towards the same set of conclusions and highlight two *principal* channels between the banking and currency crises. First, the banking crisis led to large fiscal and quasi-fiscal costs, a swelling of domestic debt, and the realization, by Bulgarian households, that the government would not be able to absorb those costs without resorting to the printing press (as in standard models of financial crises). It is worth mentioning in that regard that the core of the currency crash occurred *after* the banking system had been stabilized, and losses had been transferred to the government budget through (unsustainable) levels of public debt. Second, the level of international reserves held by the central bank appears to have had an impact on both the timing and magnitude of the bank and currency runs. The most compelling argument in that regard was found in the literature, and suggests

that foreign exchange reserves acted as a signal of the government's ability to act as a lender of last resort in both the banking and currency crises. The empirical analysis presented in the paper attempts to quantify the effect of changes in foreign exchange reserves on households' expectations and portfolio decisions, and provides an estimate for the impact of future expected depreciation on currency holdings.