INTRODUCTION

In the spring of 1996, Bulgaria was hit by an extremely severe economic crisis. The crisis culminated in February 1997 with a short period of hyperinflation and shortages of basic items such as bread and gasoline. It also led to the tumble of the government, a coalition of former communists that proved unable to run the country. Overall, the collapse of the Bulgarian economy can best be described as a general loss of confidence: loss of confidence in the banking system, in the domestic currency, and ultimately, in the government.

Rumors about the poor conditions of commercial banks started circulating in the second half of 1995. In early 1996, these allegations motivated extensive bank runs. In May, two large banks, Mineral Bank and the First Private Bank, were closed. In September, the Bulgarian National Bank (BNB) placed nine banks (representing a fourth of the Bulgarian banking system) under conservatorship. In November, the State Savings Bank itself (Bulgaria's largest bank with almost a third of household deposits) was subject to a run. Overall, out of the country's thirty-five banks, fourteen would be closed before the end of the crisis, including five state-owned institutions.

In late 1995, after an extended period of relative calm, the foreign exchange market started experiencing some turbulence. The Central Bank had to intervene to defend the Lev in November. Speculation against the domestic currency was fed by rumors about Bulgaria's limited ability to defend the Lev given the relatively low level of foreign exchange reserves and substantial foreign debt payments due in early 1996. It was allegedly precipitated by repeated reductions in the nominal interest rate paid on Lev deposits, in early 1995. The banking crisis further undermined the confidence in the domestic currency, as Bulgarians exchanged the proceeds of their Lev deposits directly for foreign cash. Significant amounts of U.S. Dollars and Deutsche Marks were reportedly kept "under the mattress." On March 7th 1996, the Press announced: *"Today, the foreign exchange market got completely out of control"*. On May 8th, the Lev depreciated by 30 percent within twenty-four hours.[1] Overall, from early March to late December, the Lev depreciated by more than 500 percent. To hedge against accelerating inflation and looming shortages, people started piling up canned food and other commodities. Shopkeepers were gradually refusing Lev as payment for goods and services.

As the economy broke down, popular discontent against Prime Minister and head of the Bulgarian Socialist Party (BSP), Zhan Videnov, grew. In November 1996, Videnov lost the presidential elections to Petur Stoyanov, the opposition candidate, and was forced to resign the following month. The designation of Videnov's police minister, Nikolay Dobrev, as next premier motivated a massive demonstration in front of the Parliament on January 10th. The Banker Weekly, a Bulgarian newspaper, reported that day: *"People gathered (...) to express their protest against hunger, against haughty rulers, against the absurd pricing mechanisms introduced by the Videnov cabinet."* Strikes, blockages of major roads and demonstrations followed throughout the month. In early February, economic activity nearly stopped: retail shops were closed; most workers were staying at home.

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[1] Throughout the paper, the rate of depreciation of the Lev is expressed as the percentage change in the Lev value of one U.S. dollar, and is not a depreciation rate *stricto sensu*. This formulation was chosen, in particular, to help compare the rate of depreciation with domestic inflation.

On February 4th, President Stoyanov summoned the Consultative National Security Council to a meeting. The Council denied Dobrev the right to form a new cabinet and decided the appointment of a caretaker government. Parliamentary elections were to be held in April. On February 7th, the Videnov cabinet held its last meeting while Stefan Sofianski, Mayor of Sofia and chair of the transitional cabinet, revealed the priorities of his government. Uncertainties about who were running the country, together with rumors that the IMF had recommended the blocking of households and enterprises' deposits, inflamed the foreign exchange market. From February 1st to February 7th, the Lev depreciated by more than 150 percent. It further depreciated in the second week of the month to reach 3,000 Lev for a dollar on February 12th (compared to 74 Lev for a dollar, just a year before). Meanwhile, consumer price inflation was reaching near-hyperinflation levels: consumer prices increased by 44 percent in January, and by more than 240 percent in February alone.

The crisis somewhat subsided in mid-February, with the appointment of the caretaker cabinet. The Lev slowly recovered in the foreign exchange market (the exchange rate was down to 2,000 Lev for one dollar at the end of the month). Hyperinflation was eliminated in March. The relative success of the new government helped Sofianski's allies grouped within a pro-reform anticommunist coalition (the United Democratic Forces) win a clear majority of seats in the parliamentary elections of April 1997. In July of that year, the country implemented a currency board, backed by the IMF and the World Bank. The currency board arrangement put an end to the crisis.

The purpose of this paper is to provide a comprehensive framework for understanding Bulgaria's 1996-1997 financial crisis and exploring, in particular, the links between the banking and currency crises. A brief review of the literature is provided in Chapter 1; selected case studies and empirical analyses are presented as well. The chapter concludes with a discussion on the relevance of prevailing theoretical frameworks for assessing the Bulgarian crisis. Existing analyses of the crisis and evidence from similar economies can be found in Chapter 2. A detailed chronology of the crisis is provided in Chapter 3. The chapter explains, in particular, how the combination of severe banking weaknesses and large fiscal deficits led to deteriorating expectations and to a rapid depreciation of the Lev in late 1996 - early 1997. Finally, a simple model of asset substitution is introduced in Chapter 4, to help understand the formation of exchange rate expectations at the time of the crisis, and illustrate the rapid portfolio shifts characteristic of "financial panics."