

Key Trends in the Development of the Bulgarian Banking System between the Two World Wars

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Summary:

The development of the Bulgarian banking system is a specific process which reflects both the state of the economy as a whole and the financial sector in particular. The system was shaped in the years after the First World War. After the war, the entire development of the country's economy, including that of the banking system, was largely affected by the fact that Bulgaria had lost the war. BNB was in charge of the payment of the post-war reparations. The bank introduced the so called gold-currency standard – the lev was backed by both gold and foreign currency. Prof. Alexander Tsankov's government introduced a state monopoly on currency trade (1923). By the beginning of the 1929/1933 crisis the lending system in the country was built and complete. The broad picture showed that there was long-term capital insufficiency in Bulgaria. There were a few big loans – the Bulgarian national loan (1921), the Stabilisation loan (1928) and Redemption Bank bonds. The lending activity in the country and that of the BNB were closely related to foreign loans such as the Refugee loan (1926) and the Stabilisation loan (1928). A law on BNB was passed in 1928, which stipulated that it became a full-bodied issuance

institution. The law was also an attempt to establish the bank's independence from the government.

The commercial banks responded to the 1929/33 crisis through consolidation. In 1929 there were 137 banks, in 1934 – 118 and in 1935 their number fell to 99. BNB's intervention, which involved refinancing the ailing banks, turned out to be of crucial importance to the stability of the banking system. The economic crisis resulted in very high indebtedness of agricultural businesses. The state attempted to curb that negative trend and adopted a Law on the protection of agricultural producers (1932). Redemption bank at the Government debts Directorate was founded. One of the strongest banks in the 1930s was Bulgarian Credit bank. The cooperative companies became more active in banking during that period. Typical characteristic features of the Bulgarian banking system during the 1930s until the start of the Second World War are: stronger centralization, industry concentration, the growing importance of both the public lending institutions and of the big Bulgarian commercial banks, the increased circulation of banknotes and of the financial aid provided to the government by BNB.

Key words: banks, central bank, history of banking, monetary policy.

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The development of the Bulgarian banking system is a specific process which reflects both the state of the economy as a whole and the financial sector in particular. It is closely related to the changes in and the establishment of the functions of the national currency, floated upon The Liberation (1878). It reflects the degree of the country's openness, and its economic and political orientation. This process has been unfolding over a period of 150 years. The aim of this paper is to outline certain interdependencies between the development of the banking sector and the political and economic process that took place in the country. The reason why the period between the two world wars has been selected is the fact that economically it accurately represents the maturity of the market relationships, the lending and saving processes, and the brisk investment activity.

During the greater part of this period Germany had a very strong impact on the political and economic life in the country. But the development of the banking sector as a whole followed the process of establishment of certain market relationships and was dependent to some degree on the existing political environment. Another typical characteristic feature of the period was the expanded role the government had in the economy. This had its impact on the development of the banking system, which was dependent on the pursued macroeconomic policy. Unlike this sub period, the years between 1947 and 1989 witnessed the marked influence of the political factor, when the country's economic development was influenced by and modelled in line with the communist paradigm and concept of the role of the banks in the USSR and throughout the socialist bloc. All that resulted in underestimating the banks' position.

Three distinct stages in the development of the Bulgarian banking system can be

defined on the basis of the established complex structures and prevailing relationships:

The first stage includes the period before and after the Liberation (1878) and ends with the banks' nationalisation in 1947.

The second stage spans the period between 1947 and November 1989.

The third stage started in 1990 and continues to the present moment.

The criteria applied to define those three stages are the following:

1. The degree of development of the market economy. Under this criterion we could divide all the three stages into sub-stages which correspond to the production level, the demand for bank loans and other bank services. There was not very strong demand for loans before the Liberation (1878), but it gained momentum in the post-1878 years. Such peaks in the number of the granted loans can be observed in the periods after economic crisis.
2. The prevailing form of ownership and degree of government intervention in the economy. State ownership was the predominant form in the economy between 1946/47 – 1989. All issues concerning lending and banking were dealt with by the central government. BNB¹ was forced to perform as a commercial bank and extend loans to socialist enterprises in line with the recommendations and tasks set in the five-year plans.
3. The development of the regulatory framework related to the performance of the central bank and the other monetary units. The adoption of certain laws, their amendment and the accompanying regulatory documents had significant impact on the monetary policy conducted by the central bank and the performance of the commercial banks.
4. The state of the banking system. It is related to the development of the credit

¹ Bulgarian National Bank was and still is central bank.

intermediation and the process of deposit accumulation, as well as the provision of other banking services. This criterion is closely related to processes intrinsic to the processes in the banking system which shapes to a very great extent the functioning of the institutions and the future of this important economic branch.

The first stage can be divided into two sub-stages – the period from the Liberation (1878) until the First World War (1919) and the period between the two wars until 1947 when the bank capital was nationalised – after the political coup in 1944. The first sub-period saw the formation of the country's banking system, the foundation of the commercial banks and other financial institutions, which had a specific influence on the state of the economy as a whole. During the First World War there was a certain slowdown in the development of the banking system that came as a logical consequence of the country's involvement in the war and the contraction in production and trade. As a whole, the sub-period until the end of the war can be regarded as successful since a big number of banks were set up, the lending activity intensified and the money in circulation increased, a variety of bank services emerged, the BNB asserted itself as the leading institution in the country.

The second sub-period, which includes the time between end of the First World War and 1947, witnessed serious changes in the methods and principles applied in the management and functioning of the economy. The Bulgarian banking system was shaped in the years after the First World War. Significant structural changes occurred. The state capital was prevalent in the banking sector until the war. The private banks were relatively weak. Considerable changes took place in the banking sector in the period of post-war recovery and economic development.

A problem that the Bulgarian economy faced after the war was the wartime and post-war inflation. As early as October 1915 the public debt monetisation got out of hand. One of the reasons for that process were the German military advance payments, negotiated by the government headed by Vasil Radoslavov and considered to be an adequate bank guarantee. They became a legal ground for issuing banknotes and via the latter BNB² financed the government's military expenses. The German advance payments were not the bank's liquid assets and could not function as a guarantee for the issue of banknotes. The Bulgarian lev was pegged to the German mark.

A parliamentary commission of enquiry was appointed after the war and its task was to determine whether the actions of BNB were in conformity with the laws. According to the conclusions made, the key reasons for the failures in the area of money circulation and lending were the conflicts between the Ministry of Finance and the bank and the complete disregard for BNB's independence.

After the war, the entire development of the country's economy, including that of the banking system, was largely affected by the fact that Bulgaria had lost the war. By virtue of the Treaty of Neuilly-sur-Seine (1919) Bulgaria was forced to pay reparations. It required Bulgaria to cede some of its territories. The flows of refugees from Macedonia and Thrace heading toward the country also caused problems. A committee comprising representatives of the allies (Allies committee) with exclusive rights to control the budget was set up to supervise the payment of the reparations. BNB was in charge of the payment of the post-war reparations. The bank introduced the so called gold-currency standard – the lev was backed by both gold and foreign currency. In 1918 the bank set up a Currency Office, thus gaining control over foreign currency

² Berov et al., *Stopanska istoria*, S. Nauka i izkustvo, 1982, pp. 536-537.

trade. The commercial banks were obligated to buy and sell currency only via the Currency office. Prof. Alexander Tsankov's government introduced a state monopoly on currency trade (1923). The currency monopoly facilitated the process of resolving issues related to reparations. The exchange rate of the Bulgarian lev stabilised and the country's gold-currency reserve movement was put under control.

The Allies committee played a significant role to curb post-war inflation. It functioned as a kind of external regulator of the economic policy pursued by the government and to some extent it played the role of a currency board³. The Committee restricted the state's access to the resources of the BNB as the key issuing institution which contributed to the efforts to eliminate the post-war budget deficit. The committee forced the government led by Alexander Stamboliiski to pass a law (1922) restricting the issuance of banknotes and the acceptable amount of government debt to BNB.

The direct financing of the budget by BNB was also limited. However, this principle was often breached. In 1922-1923 the Allies committee agreed that BNB could discount short-term Treasury bills amounting to 550 million leva. In 1924 their maturity was extended to six years. That meant that BNB became the government's creditor for long-term loans. In 1925 200 million worth of bills were discounted and their maturity was also extended. In 1931 the public debt amounted to 4.5 billion leva. In 1924 and 1926 the Law on BNB was amended. These amendments put a ban on direct lending to the government. One exception remained – discounting six-month Treasury bills up to 300 million leva.

By the beginning of the 1929/1933 crisis the lending system in the country was built and complete. Big banks were founded with foreign capital – Italian-Bulgarian bank, Franco-Belgian bank, Anglo-Parisian bank

etc. A considerable number of small and medium-sized banks of the popular-type were set up. They provided services to small craftsmen and traders and functioned on the principle of mutual lending.

The process of consolidation of commercial banks continued. Financial and industrial groups were created, which included the hundred leading industrial companies in Bulgaria. In 1928 there were eight big commercial banks which had borrowed twice as big loans and accumulated deposits in comparison to 1911. In 1927 the Bulgarian Mortgage Bank was created, mostly with foreign capital. Its business activity was modest, guided by the principle of conservative lending. But the establishment of the bank was the first important attempt of the private sector to overcome the shortage of capital for long-term leveraged investments. In the first ten years the bank granted some 5,000 mortgage loans amounting to 800 million leva. They were aimed at purchasing property in Sofia (700 million leva) and only 8 million leva were directed at agriculture.

The state's presence in the lending market became more prominent. In 1904 the Bulgarian Agricultural Bank was set up as the third state-owned bank after BNB and the Post Savings Bank. It had an important role in the economic life of the country – it granted 40% of all loans. In 1934 it merged with the Bulgarian Central Cooperative Bank and was called Bulgarian Agricultural and Cooperative Bank. The Bulgarian Central Cooperative Bank was created in 1910 as the fourth state-owned bank in the country. The idea about its establishment belonged to the then Minister of Finance Andrey Lyapchev, who tried to introduce certain elements from the Prussian banking model, namely, to use a state-owned bank to support the cooperative movement. Its activity was not very efficient, which required its merger with the Bulgarian Agricultural Bank.

³ R. Avramov, *Komunalniat kapitalizm*, Tom 2., 2007, pp. 586-603.

The broad picture showed that there was long-term capital insufficiency in Bulgaria. One of the reasons for this situation was the government policy of issuing securities and thus taking all the free money resource. There were a few big loans – the Bulgarian national loan (1921), the Stabilisation loan (1928) and Redemption Bank bonds. Only 20% of the securities total turnover was carried through Sofia stock exchange. The rest was over-the-counter trade carried out by money-changers, insurance companies, mutual funds. The banks were also part of that trade. The lending activity in the country and that of the BNB were closely related to the foreign loans such as the Refugee loan (1926) and the Stabilisation loan (1928). They strengthened the BNB reserves and effectively transformed the accumulated national debts into foreign.

A law on BNB was passed in 1928 in relation to the Stabilisation loan, which stipulated that it became a full-bodied issuance institution. The law was also an attempt to establish the bank's independence from the government. The adoption of the law caused a political crisis and the minister for railways, postal service and telegraphs K. Georgiev resigned. Bulgaria abandoned the gold standard and adopted the gold-currency one. A number of countries along with Great Britain formed "the sterling block", while others, including Bulgaria showed their pro-French stance and created "the gold block".

Significant changes took place in the activity of BNB in the period between 1926 and 1928:

- The bank withdrew from providing direct services to the public and the business and became a typical central bank with regulatory and issuing functions. The bank guaranteed the stability of the gold value of the lev by covering each issue of banknotes with 33% gold. Regulations were introduced and the exchange of banknotes for gold was strictly controlled.

- The bank was responsible, in the first place, to the tsar and consequently reported its activity to the Minister of Finance. It became more independent as an institution. Fewer loans were extended to the state. The securitization of the government loans decreased. BNB became a modern, European central bank.

During the economic crisis in 1929/33 a number of bank bankruptcies were averted, but certain pressure on the deposits in some institutions was observed – massive deposit withdrawals. These were local bank runs but they did not lead to a systemic risk and systemic crisis. The economic crisis affected the stability of the Bulgarian lev. It devalued by 20%. Financial pyramid-like companies emerged right before the crisis – savings and building funds (1927). They pooled capital from gullible depositors, promising them interest-free loans (only the fees had to be paid) to purchase homes. The first depositors actually provided the resource for the initial payments – about 200 mln leva for the first two years. By 1935 30 thousand people had registered in those companies. They started encountering difficulties when the number of new depositors decreased – mostly in the autumn of 1935. Most of them went bankrupt since loans worth of 5 billion leva were applied for and the granted ones amounted to nearly 300 mln leva.

The commercial banks responded to the 1929/33 crisis through consolidation. In 1929 there were 137 banks, in 1934 – 118 and in 1935 their number fell to 99. BNB introduced regulation on the activity of the commercial banks at the start of 1931 under the Law on guaranteeing savings in private banks. A special body at the Council of Ministers, called Bankers' council, exercised the control. It was a bank supervisory body. Representatives of the Ministry of Finance, the BNB and the commercial banks were members of that body. First and foremost they aimed to guarantee the bank deposits, another goal was aiding the banks which experienced difficulties. For example, in

1934 BNB consolidated 19 ailing banks into Bulgarian Credit Bank, which later turned into one of the key financial bodies in the state.

The activities of the private banks where foreign capital was deposited were limited during the crisis. The reasons for introducing that measure were the following:

- The stiff currency control exercised by BNB hindered the free and limitless export of profit from the country;
- The economic destabilisation affected adversely the banking business no matter where the capital originated. This led to a decrease in bank profits;
- Bulgaria's pro-German political and economic orientation. That was the reason why there was a decline in French, Belgian and other capital in the Bulgarian banking system. The close relations with Germany had their positive impact, especially in terms of conducting monetary policy and imposing discipline in the banking sector.

Under the Law on guaranteeing the savings deposits the banks were obligated to keep a reserve at the BNB of 5% of the attracted capital plus another 5% in a reliable liquid portfolio with three months maturity. Certain restrictions existed on the way the attracted capital in the form of savings was invested as well as on the activities the banks were allowed to perform. The listed components of the monetary policy considerably improved the functioning of the country's banking system. In 1931 the bank crisis in Central Europe affected Bulgaria through Credit bank, owned by Deutsche Bank. BNB's intervention, which involved refinancing the ailing banks, turned out to be of crucial importance to the stability of the banking system. This intervention put an end to the pressure exercised on deposits and the risk of systemic crisis. On BNB's suggestion the Bankers' council declared 34 banks in bankrupt or in safeguard concordat and other 18 smaller banks in silent liquidation.

The economic crisis resulted in very high indebtedness of agricultural businesses. The state attempted to rein that negative trend and adopted a Law on protection of agricultural producers (1932) which stipulated that those who had received loans from the Bulgarian Agricultural Bank could take advantage of certain reliefs. Redemption bank⁴ at the Government debts Directorate was founded. It was a state-owned lending institution whose main task was to function as a mediator between private lenders and debtors. For the loans they had extended the creditors were given interest-bearing bonds issued by the Redemption bank. To meet the bond issuance costs the state gave some tax revenue to the bank and granted it an annual subsidy of 200 mln. leva from the state budget. Thus the Law on debtors and lending strengthening adopted in 1933 helped to resolve issues related to the borrowings before and during the crisis. The Bank issued debt even against borrowings from bad debtors. Those borrowers who met the law requirements were given a deferral of up to 15 years at a reduced annual interest of 6% and became indebted to the bank for the restructured debt.

The lax legislation of the 1930s resulted in the accumulation of large amounts of low yield bonds issued by Redemption bank in banks and lending cooperation's. In 1941 they presented a serious problem for their holders and the Bulgarian Agricultural and Cooperative Bank bought the unwanted bonds with government capital. These actions of the government aimed to heal the ailing lending institutions. They reminded of BNB's failed attempt in 1995 to rescue two big banks - Mineralbank and Economic Bank by buying the so called ZUNK bonds.

One of the strongest banks in the 30s of the past century was "Bulgarian Credit" bank. In practice it was run by the state. Its main task was to support the big industrial

⁴ See L. Berov et al., *Stopanska istoria*, S. "Nauka i izkustvo", 1982, p. 549.

and commercial capital. There were two subsidiaries related to transport and trade – the Bulgarian public stores and Bulgarian public transport.

In 1935 27% of all loans extended to all commercial banks (99) were received by Bulgarian Credit Bank. In 1939 there were 89 private banks and the Bulgarian Credit Bank owned 43.5% of their assets. The bank was in close cooperation with other commercial banks. It eased its competition with them and strengthened its cooperation – it supported them by discounting securities and lent them money. A Fund for interbank support was set up, which was the start of deposit insurance in the country and it existed until 1947.

During the 30s, before the start of the Second World War, the influence of commercial banks with French and Belgian capital –Balkan Bank and General Bank – considerably decreased. The role of German capital and Credit Bank increased. Another institution that gained significant importance in the banking system was Bulgarian Commercial Bank. Its main shareholders were Atanas Burov and Georgi Gubidelnikov.

The cooperative companies became more active in banking during that period. By 1939 the Union of Popular banks had opened 212 branches and had attracted 143 thousand members. The Union of People's Banks had 75 subsidiaries and 90 thousand members. The Cooperative credit companies held 23% of the loans granted in the country – as much as the small joint stock banks. In 1936 the government bought out the shares of the Bulgarian Mortgage Bank and started extending long-term loans to municipalities and to the construction business.

Typical characteristic features of the Bulgarian banking system during the 30s until the start of the Second World War are:

- Stronger centralization. It was influenced by the politics of the Bulgarian government and the model of the German banking system.

- Industry concentration. In 1938 there were 41 commercial banks functioning effectively. The remaining units were either experiencing serious difficulties and were facing bankruptcy.
- The importance of the public lending institutions increased. To this group we could add the cooperative units or the state-cooperative funds.
- The importance of the big Bulgarian commercial banks grew at the expense of foreign ones.
- The circulation of banknotes increased. The money supply in 1938 amounted to 5.4 billion levs. This growth was the result of stronger production and trade.
- The financial aid provided by BNB for the government increased. In 1937 a law was adopted which regulated that the bank should cover a government debt of 1 billion levs in bonds.

The activities of BNB during the 1929/33 crisis and after that lead to the 'nationalisation' of huge bad debts and to extended government role in the sector – a number of banks were nationalised. By the end of WWII private capital in the banking sector was limited at the expense of government and cooperative one.

A common characteristic feature of the entire period before the Second World War was the deficit of national capital for a large-scale investment activity. A reason for that was the low rate of saving. Between 1924 and 1939 the Bulgarian people had little capacity for saving – 15% of their personal income. Around 70% of their income was spent on consumption, 7-9% - on rent and travel, 6-7% - on taxes.

The economy at that time can be defined as slightly monetized and agrarian. Mostly the urban population could afford to save money. These savings were not long-term ones since there were a small number of individuals who were likely to accumulate huge sums and make a living just from the interest. The capital market was underdeveloped. Most depositors had

specific, short-term goals related to the purchase and furnishing of homes and meeting other everyday needs.

The inflation in the country edged up during World War Two as a result of the increased issuance of banknotes and Treasury bonds. The price index in 1944 was 413.8 relative to 1939 and that of money in circulation – 1025. The accumulated debts of the state to BNB for the period 1912-1937 amounted to 5.7 billion leva. Some 4.7 billion of that debt ensued from the financing of the country's participation in the military operations. BNB was the main source of capital for the government. This caused certain tension and stimulated the issuance of money which stoked pro-inflationary price growth.

Another source of finance that could be used to cover the budget deficit came from the state-owned commercial banks⁵. Examples can be given with Post Savings Bank and the Bulgaria Agricultural Bank which had a varied portfolio of securities. This was a way to redirect resources from small depositors to the state. The funds accumulated in the budget were not always used to the interest of the entire society. That money was sapped through various corruption schemes or funnelled to projects with insignificant economic efficiency.

In 1941 a new law on BNB was passed and the German currency was adopted as full value coverage of the Bulgarian lev. This had an adverse effect on the existing gold-currency standard. Being the currency of a country at war, the German mark was unstable and turned into a fictitious asset for Bulgaria. That was how the situation from the First World War when the issue was backed with depreciating German marks repeated. The outcome in both cases was paper money inflation.

The development of the country's banking system between the two world wars, albeit somewhat controversial, can be defined as positive. It reflects the stabilization and growth in industrial and agricultural production and

the growing export – primarily to Germany. The improvement in the key macroeconomic parameters during the period affected lending positively. People's savings increased gradually, though slowly. The government's policy to support the banks and to facilitate the resolution of issues related to the security of deposits, the generation of long-term capital resource, on the one hand and the pressure to solve the budget deficits through the banking system, on the other, has ambivalent effect. This, eventually, leads to neutral government policy and the institution which safeguards the interests of the sector and controls the maintenance of acceptable balance in it was BNB. One of the most typical features of banking in that sub-period in Bulgaria was the transformation of BNB into a modern European bank with clear regulatory and supervisory functions.

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⁵ O. Nedyalkov, L. Dimova, Bulgarskata narodna banka i neinata rolia v stopanskoto razvitie na Bulgaria, Sofia, izdanie na BNB, 2009, p. 56.